Jobs Act Attorney Fee Provision: Is It Enough?

By Robert W. Wood

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In a word: No. But lest I look a gift horse in the mouth, read on. It has taken many years to get *any* relief on the tax treatment of attorney fees. Indeed, the provision that was finally passed as part of the American Jobs Creation Act of 2004 (P.L. 108-357) has been kicking around since 1999 when it was introduced as the Civil Rights Tax Relief Bill. The issue had cried out for attention long before that.

Most lawsuit proceeds received by way of settlement or judgment represent taxable income. Logic suggests that all expenses to achieve this income (such as lawyers' fees and costs) would be deductible against that income. Yet a majority of circuit courts have held that a plaintiff cannot simply net legal fees against a recovery. The plaintiff must generally include the gross recovery in income, even if the fees are paid directly to the contingent-fee lawyer.

The plaintiff can deduct the attorney fees, but usually only as a miscellaneous itemized deduction, and then only to the extent they exceed 2 percent of the plaintiff's adjusted gross income. Overall limits also apply to itemized deductions.[1] Most draconian of all, the alternative minimum tax allows no deduction at all for miscellaneous itemized deductions.

An often cited *New York Times* article highlights a Chicago police officer who won a sex discrimination suit only to find that her recovery resulted in her *paying* \$99,000 in *extra* taxes (so she actually *lost* money on the suit).[2] Although a taxpayer going out-of-pocket to pay taxes on a settlement or judgment may be unusual, successful plaintiffs often face a disproportionate tax burden on their recoveries as compared to the tax burden borne by other income. When you consider that contingent attorney fees may be 40 percent or 50 percent of a recovery, and sometimes are much higher (I have seen contingent attorney fees as high as 73 percent), the problem is manifest.

The fact that the circuits are split with no uniform rule throughout the country has encouraged at least some forum shopping, although arguably that makes the situation even worse, underscoring the lack of equity. Of course, the problem is not limited to employment cases. It arises with many nonemployment claims, although employment cases have served as the poster child of inequity.

Jobs Act Prospective Fix

The American Jobs Creation Act of 2004, signed by President Bush on October 22, 2004, provides much needed relief. It allows an above-the-line deduction for amounts attributable to attorney fees and costs received by individuals on account of claims of unlawful discrimination or specified claims against the government. The identified claims against the government are those brought under the False Claims Act. Regarding employment discrimination, the new law identifies the types of qualifying ''unlawful discrimination'' by reference to a long laundry list of laws that provide for employment claims. Specifically enumerated are:

(1) the Civil Rights Act of 1991;

(2) the Congressional Accountability Act of 1995;

(3) the National Labor Relations Act;

(4) the Fair Labor Standards Act of 1938;

(5) the Age Discrimination in Employment Act of 1967;

(6) the Rehabilitation Act of 1973;

(7) the Employee Retirement Income Security Act of 1974;

(8) the Education Amendments of 1972;

(9) the Employee Polygraph Protection Act of 1988;

(10) the Worker Adjustment and Retraining Notification Act;

(11) the Family and Medical Leave Act of 1993;

(12) Chapter 43 of Title 38 (relating to employment rights of uniformed service personnel);

(13) Sections 1981, 1983, and 1985 cases;

(14) the Civil Rights Act of 1964;

(15) the Fair Housing Act;

(16) the Americans With Disabilities Act of 1990;

(17) any provision of federal law (known as whistle-blower protection provisions) that prohibits the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law; or

(18) any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law, that provides for the enforcement of civil rights or regulates any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

The list is noteworthy in that it covers two basic groups: employment claims and federal False Claims Act claims.

[1] *See* section 68. This limitation is generally referred to as ''phaseout.''

[2] *See* Liptak, ''Tax Bill Exceeds Award to Officer in Sex Bias Suit,'' *The New York Times*, Aug. 11, 2002.

False Claims Act

False Claims Act cases are generally brought to expose fraud and to recover monies for the federal government. Many states have their own versions of the False Claims Act to recover monies for their state (more about state claims below).

A whistle-blower who uncovers fraud serves in the capacity of a private attorney general, and on the successful prosecution of the case is entitled to a relator's share. The government may or may not choose to intervene in the case. Litigation is often protracted, and attorney fees and costs tend to be very high. The latter fact exacerbates the already difficult attorney fee deductibility problem.

Congress has now granted relief for the attorney fee problem in the employment litigation context and for False Claims Act cases, but relators in cases brought under state counterparts to the False Claims Act get no relief. That omission, like some others noted below, does not alter the fact that it is vitally important that the legislation passed. However, it does make me wonder.

Employment Nexus

Of course, the Jobs Act includes a whistle-blower provision. It covers provisions of federal law (thus omitting state whistle-blower protections) that prohibit the discharge of (or discrimination or reprisal against) an employee for blowing a whistle. There is also the last catchall category, but that applies only to employment cases, too. Most whistle-blowers are employees or former employees who have access to information. A federal whistle-blower case (or a state one) in which the relator is seeking a recovery for the government (with a share to the relator) might *also* need to rely on some whistle-blower protection statute, but that would generally be a separate action.

With increasing legal specialization, a whistle-blower may use one set of lawyers to bring a False Claims Act action and another set to bring an employment action if the employee/whistle-blower is fired or discriminated against on the job. Suppose a whistle-blower receives a $300,000 recovery in the employment action that, after the date of enactment, would be protected from double taxation of attorney fees, and a $3 million relator's share under a state counterpart to the False Claims Act. The latter would not be brought within the ambit of the attorney fee provision, thus being subject to the current inequitable treatment of attorney fees.

How Much Is Within the 'Catchall'?

At the bottom of the list of provisions under which attorney fee relief is provided is a catchall. An above-the-line deduction for attorney fees is provided for actions relying on any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law that provides either (a) for the enforcement of civil rights; or (b) for regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Federal False Claims Act cases are now entitled to attorney fee relief. However, is the catchall broad enough to bring within it claims under state counterparts to the False Claims Act? I don't see how. Indeed, after the litany of specific statutes that are employment claims, this is merely a catchall *employment* provision and would seem not to bring other things within it. While it does scoop up state and local laws (and even common law claims made under federal, state, or local law), it is hard (at least for me as a nonemployment lawyer) to imagine exactly what goes into the catchall.

Let me list some other claims that I do not think are within the catchall. What about defamation claims? If I am defamed and successfully bring an action through a contingent fee lawyer, I will suffer the same kind of attorney fee problems that taxpayers have been dealing with for years. If my recovery is small in relationship to the attorney fees, I may face the wrath of the various limitations, particularly the AMT. Is a vicious defamation not deserving of the type of tax relief that an act of employment discrimination deserves?

Defamation, a tort under the common law, would not be entitled to attorney fee tax relief unless it occurs in the context of employment. That suggests one set of rules if I am defamed outside of the employment context and quite another if I am defamed by my employer. To me, that makes no sense.

More Discrimination

False imprisonment is another tort that deserves mention. I see more of these types of actions today than I used to. I suppose that if a false imprisonment case occurs in the context of employment, then there might be attorney fee tax relief. Conversely, if the false imprisonment occurs outside of that context, then I'm on my own (along with my nemesis, the AMT). If my employer locks me up in my office and won't let me leave, I don't incur extra tax; if the police lock me up, having arrested me in error, I'd pay more tax.

Perhaps if I am creative, and if I actually suffer physical injuries in the false imprisonment, I can obviate some or the entire attorney fee problem in this latter case by claiming a section 104 exclusion. Yet that, as we know, is also a hot button issue with the IRS. The IRS has given very little guidance on the scope of section 104 as it was amended in 1996. We still do not know precisely how serious something must be before it is considered a physical injury. The IRS evidently wants to see bruises before it places a halo of excludability on the injured plaintiff.

Other causes of action excluded from this list are negligent and intentional infliction of emotional distress cases. While emotional distress claims are often brought in the employment context, they are also often brought *outside* of this context. As with the defamation example noted above (where a defamation claim inside the employment arena may be treated differently for tax purposes from a defamation claim occurring outside that context), emotional distress claims seem favored for attorney fee tax relief only if they occur in the employment context.

Perhaps I am wrong that ancillary emotional distress claims made in the context of an employment action (let's say a sexual harassment suit, for example) would be entitled to relief. With this example and the others I have noted above, I suppose the IRS could seek to allocate attorney fees between various claims. If the IRS does choose to allocate attorney fees between the claims, that will be a mess.

What about invasion of privacy claims? That tort action has become popular in recent years. Does it matter if the tort occurs in the employment context? What about interference with contractual relations (such as contacting prospective employers)? What about claims for investment losses? On the latter, I suppose if your broker has made bad investment decisions on your behalf and you recover from him, you have an attorney fee problem. Conversely, if your employer makes the bad investment decisions for you, and the investment claim is made in the context of your employment litigation, presumably you do not.

Employment Cases That Miss Out?

There is a long list of types of claims included within the bill. And there is the catchall category at the end. Nevertheless, some employment lawyers bring employment cases that are not true discrimination cases at all. In fact, some lawyers may be concerned that at least some of their cases will not fall within the group of claims enumerated, even given the long list and its catchall. Might some of the claims an employment lawyer brings not be within this list?

Consider ERISA claims. ERISA, which applies to pension and welfare benefit cases, preempts state law. Of course, the new law enumerates ERISA cases as one of the categories to which the attorney fee fix applies. Yet the bill refers only to ERISA cases under section 510 of ERISA. That section deals with discrimination claims.

Furthermore, that section, employment lawyers tell me, is nearly impossible to use under current case law and, in any case, accounts for only a small fraction of successful ERISA claims. The more typical ERISA claim is one for benefits (pension or long-term disability, for example). I suppose (and I hope) that these other ERISA claims are entitled to attorney fee tax relief under the catchall.

Overtime pay is another example of the problem. Overtime pay claims are generally not regarded as discrimination claims. At the same time, the Jobs Act seems to suggest that any unlawful act that is pursued under the Fair Labor Standards Act (FLSA) should give rise to relief (the above-the-line deduction for attorney fees in such a case). The term ''discrimination'' will probably be interpreted narrowly by the IRS. That suggests that only true discrimination claims under the FLSA (such as retaliation claims and Equal Pay Act claims) would qualify. Again, I think that the catchall provision would bring many cases under its protection, including overtime, minimum wage, and benefit cases.

Punitive Damages

The term ''punitive damages'' may seem out of place in this article. Since the 1996 Act (and the almost contemporaneous *O'Gilvie* decision handed down by the Supreme Court), punitive damages are clearly taxable. Perverting that intended clarity, with cases that settle, it is extremely common for it to be unclear what is punitive and what is not. The IRS has done nothing to address that ambiguity. Increasingly, though, the states are getting in on the action and are taking a chunk of punitive awards themselves. Many states require that in a civil action in which punitive damages are paid to a private party, the state automatically gets a share.

Suppose that I receive a punitive damage award for a willful defamation in California. Let's say I recover $1 in actual damages and $1 million in punitive damages. Under current California law, 75 percent of that punitive damage award goes to the state of California (believe me, California needs the money). I would get the other 25 percent. How is this distribution to be taxed, particularly when I throw my contingent attorney fees into the mix? (By the way, do you think contingent attorneys are happy about the attorney fees being awarded to the state?)

Back in 2003, when the Senate bill was being considered, Sen. Orrin Hatch, R-Utah, tried to address the increasing popularity of state punitive damage-splitting laws. Hatch had introduced a last-minute amendment to the Senate bill to deal with punitive damage awards. The Hatch amendment indicated that even though punitive damages are now always taxable to the recipient (and that was made clear back in 1996), a plaintiff will not be taxed on any punitive damages that must be paid to a state under a split-award statute. In that case, that clarification would have made clear that even though the punitive damages received by the plaintiff would be taxable to the plaintiff, those going to the state would not. It should not be otherwise.

Perhaps more pertinent to this topic of attorney fees is the second portion of the Hatch amendment, which said that in that kind of case, any attorney fees or other costs that are incurred by the taxpayer in connection with obtaining an award of punitive damages would also not be taxable. The Hatch amendment was not included in the Jobs Act. I do not know whether the amendment, having been proposed and not adopted, suggests anything about how this provision of the tax law will be interpreted when the IRS or the courts are faced with punitive damage awards.

Prospective Relief

Finally, and most obviously, there is the issue of the effective date. Quite apart from the issues I've tried to raise here, the Jobs Act provides attorney fee tax relief only on a prospective basis. The amendments apply only to fees and costs paid after the date of enactment (October 22, 2004), for any judgment or settlement occurring after that date. So the fees and costs must be paid after October 22, 2004, and they must be paid thereafter on a settlement or judgment that occurs after that date. That makes *Banks* and *Banaitis*, the attorney fee cases currently pending in the U.S. Supreme Court, of continuing interest.

The briefs in the Supreme Court in *Banks* and *Banaitis* are voluminous. Thirty-seven *amici* have filed a total of 11 briefs in the two consolidated cases. Some of the briefs, perhaps predictably, hedge their bets. For example, one employment law group argues that if the Supreme Court reverses *Banks* and *Banaitis* (thus siding with the IRS), the High Court should distinguish between cases involving statutory attorney fees and those arising under more ordinary contingent attorney fee agreements.

Of great interest to me is the *amicus* brief filed by the Taxpayers Against Fraud Education Fund. That public interest group, which promotes *qui tam* actions under the False Claims Act, supports the *Banks* and *Banaitis* decisions. Their brief says that a relator under the False Claims Act is not advancing his own cause of action, but rather the cause of action of the government.

Thus, it is hard to fathom how the False Claims Act relator could be described as someone who ''earns'' the income. The relator, this brief argues, is an assignee himself of a specified portion of the recovery. Consequently, taxing an individual relator on the full amount of the award (under the assignment of income doctrine, the doctrine that surfaces in virtually all of the contingent attorney fee cases) seems unthinkable.

Although the Supreme Court has not yet rendered its decision, it did hear arguments on November 1, 2004. Justice Antonin Scalia was unimpressed by the partnership theory. My favorite comments were by Justice Sandra Day O'Connor, who suggested that such extreme taxation might amount to unconstitutional taxing, and on a more collegial level simply said, ''It's an appalling situation.''

Last Word

Congress was clearly right to pass this provision, even if it does not solve everything. Still, I believe an approach that differentiates some claims from others may prompt taxpayers to attempt to pigeonhole their claims within the list of ''good'' attorney fees — those paid or incurred to pursue federal False Claims Act cases and claims of employment discrimination. That, of course, is a hugely positive change.

Even so, in the real world, the vast majority of lawsuits have multiple causes of action and a mixture of messy factual details. What will happen if someone sues for six different causes of action based on a set of facts? Assume that only one of these causes of action is for employment discrimination, and that the other claims include defamation arising out of employment. Will the IRS try to allocate the attorney fees? Will it be like the situation so often occurring in the context of divorce, in which attorneys commonly allocate their fees between regular divorce legal fees and tax legal fees, the latter being deductible?