

## Effective Date of Attorney Fee Deduction Misses Many Judgments

By Robert W. Wood

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Many attorneys and tax advisers are anxious for the Supreme Court decisions to be rendered in *Banks* and *Banaitis*. The Court heard oral argument on November 1, and a transcript of the argument (particularly the justices' questions) proves interesting reading. I hope the Court will resolve the taxation of attorney fees in favor of taxpayers. Congress addressed the problem, prospectively at least, in the American Jobs Creation Act of 2004 (P.L. 108-357).

Unfortunately, the Jobs Act provision applies only to employment claims and to Federal False Claims Act claims. It does not resolve the attorney fee problem (even prospectively) in many cases. See Wood, "Jobs Act Attorney Fee Provision: Is It Enough?" *Tax Notes*, Nov. 15, 2004, p. 961. And even in the cases to which the new above-the-line deduction applies, the provision is prospective only in effect — at least by its terms. I qualify that statement because considerable attention has been paid to the effective date of the new above-the-line deduction of the Jobs Act.

Although stated to apply only prospectively, a now well-known Senate colloquy suggests that the Senate (or at least Sens. Max Baucus, D-Mont., and Charles E. Grassley, R-Iowa) believe the Jobs Act provision merely reaffirms existing (good circuit) law on the tax treatment of attorney fees. The floor debate leading up to passage of the Jobs Act included the following:

Mr. Baucus:

As I understand it, the case law with respect to the tax treatment of attorney's fees paid by those that receive settlements or judgments in connection with a claim of unlawful discrimination, a False Claims Act, 'Qui Tam' proceeding or similar actions is unclear and that its application was questionable as interpreted by the IRS. Further, it was never the intent of Congress that the attorneys' fees portions of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes.

It is the understanding of the chairman that it was the conferees' intention for Section 703 [which provides an above-the-line deduction for attorneys' fees] to clarify the proper interpretation of the prior law, and any settlements prior to the date of enactment should be treated in a manner consistent with such intent.

Mr. Grassley:

The Senator is correct. The conferees are acting to make it clear that attorneys' fees and costs in these

cases are not taxable income, especially where the plaintiff, or in the case of a Qui Tam proceeding, the relator, never actually receives the portion of the award paid to the attorneys. Despite differing opinions by certain jurisdictions and the IRS, it is my opinion that this is the correct interpretation of the law prior to enactment of Section 703 as it will be going forward. In adopting this provision, Congress is codifying the fair and equitable policy that the tax treatment of settlements or awards made after or prior to the effective date of this provision should be the same. The courts and IRS should not treat attorneys' fees and other costs as taxable income.

As I stated in my May 12, 2004, press release summarizing this and other provisions passed by the Senate as part of S. 1637:

Tax relief gets the headlines, but part of tax relief is tax fairness. It's clearly a fairness issue to make sure people don't have to pay income taxes on income that was never theirs in the first place. That's common sense.

Section 703 will help in well-known cases, such as that of Cynthia Spina, an Illinois police officer that secured a settlement in a sexual discrimination case that left her owing \$10,000 or more. There are literally dozens of others like her in similar situations, and it is my strong belief that the courts and the IRS should apply the guidelines of Section 703 not only after the date of enactment, but also to settlements put in place prior to that time. *Congressional Record* S11036, October 10, 2004.

### Prospective Effective Date

One can question the slightly different technical approach to the issue provided by the good circuits (the attorney fees do not represent income to the plaintiff at all) compared with the Jobs Act (the attorney fees represent gross income, but qualify for an above-the-line deduction). In any case, despite the appeal of a retrospective effective date based on Senate floor discussion, the language of the statute itself calls for a prospective effective date. It will be interesting to see if, when, and how this effective date debate will arise in the future. Of course, some of that may depend on what the Supreme Court does with *Banks* and *Banaitis*.

However, on a more pedestrian level, mere examination of the Jobs Act provision itself raises legitimate questions as to how one determines what settlements or judgments are covered by the new law. Looking at this issue recently, I was surprised that the answer does not seem to be more clear cut. I was also surprised that the result (at least based on my reading of the issue) does not seem to be terribly fair.

Settlements seem to be straightforward. Both the execution of the settlement agreement and the payment of the money must occur after October 22, 2004, to qualify for the protection of the new above-the-line deduction. Judgments, however, are not so simple. Relying on common sense (dangerous with tax law, I recognize), I would have thought that for a judgment, the new law would apply to any judgment that becomes final after the

date of enactment (October 22, 2004). After all, a verdict may be appealed, and that may prevent a judgment from becoming final and enforceable for years.

Some judgments predating the enactment of the Jobs Act may be on appeal and may not get resolved until 2005 or 2006. Consider the following example:

*Example:* Taxpayer A brings suit for employment discrimination and recovers a verdict of \$800,000 in 2003. Judgment is entered, but the defendant appeals. The appeals court affirms in November 2004. On December 15, 2004, the date for petition for rehearing to the state supreme court expires, and the defendant prepares to pay the judgment. When the defendant pays the judgment, is the plaintiff governed by the old attorney fee law (split in the circuits, and so forth), or is the plaintiff entitled to the above-the-line deduction available under the Jobs Act?

The Jobs Act's amendment to section 62 (allowing an above-the-line deduction for attorney fees) specifically states that the new law applies to "fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date." The triggering event here is when the judgment can be said to "occur."

### When Does a Judgment Occur?

I find no ready answer in the statute or its legislative history to when a judgment is considered to occur. Presumably this generic layman-like language refers to something different from the time when a judgment is entered, or the time when a judgment becomes final. The entry of judgment has a legal meaning and can be ascertained accurately. The same can be said for the time when a judgment becomes final.

Granted, there have been similar effective date provisions in related areas in the past. However, many of those have been more clear-cut. For example, when the 1996 tax act added the physical modifier to section 104, it did so for all amounts received after the date of enactment (August 20, 1996), except for amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

The time at which a judgment occurs, on the other hand, is not too precise. That language of the statute prompted me to look to other areas of the tax law. In the context of the priority of a federal tax lien, a judgment occurs when the judgment is first rendered by the court. See *In Re Crocker National Bank v. Trical Manufacturing Co.*, 37 AFTR2d 76-592 (9th Cir. 1975); *United States v. Morrison*, 247 F.2d 285 (5th Cir. 1957). In *United States v. Dishman Independent Oil Co. Inc.*, 46 F.3d 523 (6th Cir. 1995), the court reviewed the procedural history of the litigation, finding that the judgment occurred when the bankruptcy court first entered its final decision, despite an appeal to the federal district court and, ultimately, to the appeals court. The court stated:

Dishman was granted judgment by the bankruptcy court on April 27, 1992. The IRS tax lien seeks to collect \$2,851,910.09 which is owed to the United

States by the debtors for unpaid taxes from the third quarter of 1987 through the third quarter of 1988.

On May 29, 1992, the IRS was permitted to intervene in the proceeding to seek a determination by the court that its federal tax lien was valid and prior to any interest held by Dishman in the debtors' property. The IRS eventually filed a motion for summary judgment which the bankruptcy court denied.

Dishman then filed its own motion for summary judgment against the IRS. The bankruptcy court granted Dishman's motion for summary judgment, after finding that Dishman's attachment lien was perfected by the judgment entered in its favor on April 27, 1992, and was therefore prior to the federal tax lien against the debtors. *In re Dishman Indep. Oil Corp.*, Nos. 91-00057, Adv. No. 91-0078, 1993 WL 110032 (Bankr. E.D. Ky. Jan. 8, 1993). The district court affirmed the bankruptcy court's order granting Dishman's motion for summary judgment.

The taxpayer appealed the case to the Sixth Circuit, which recognized that the taxpayer's judgment occurred on April 27, 1992, despite the appeals. The court stated:

We believe this issue is controlled by the holding of *United States v. Acri*, 348 U.S. 211 (1955), which supports the IRS's position. In *Acri*, the Supreme Court unequivocally held that a federal tax lien filed after an attachment lien was executed had priority over the attachment lien because judgment on the attachment lien *did not occur* until after the filing of the tax lien. *Id.* at 214. In *Acri*, the Court was not persuaded by the recognition of the attachment lien as perfected under Ohio law. *Id.* at 213. Rather, for "federal tax purposes" the lien was "inchoate . . . because, at the time the attachment issued, the fact and the amount of the lien were contingent upon the outcome of the suit for damages." *Id.* at 214. [Emphasis added.]

I recognize that these lien authorities are not necessarily controlling for fixing when a judgment occurs under section 62. Nevertheless, they appear to give the IRS authority to conclude that a judgment occurs when it is first rendered. They also suggest that the IRS would interpret this "occurring" term generally, rather than by reference to some technical lapsing of appeal periods or to a judgment somehow otherwise becoming final. There may well be other areas of the body of federal tax law in which this kind of spadework should also be done.

The rudimentary formulation of the statute's effective date, with its almost simplistic concept of the occurrence of a judgment as a trigger for the effective date of this important provision, would seem to preclude the new law's application to many cases.

### Settlements Are Better

I have not yet faced a case in which a thorough and painstaking answer to this judgment "occurring" question must be given. Fortunately, often it should be possible to enter into a settlement agreement to make the timing of the judgment irrelevant. Thus, if a judgment

would otherwise not be covered by the new above-the-line deduction because the judgment occurred before October 23, 2004, a settlement of the dispute between plaintiff and defendant after October 22, 2004, would seem to work. A binding settlement agreement dated after October 22, 2004, would serve as the vehicle for the payment, not the judgment. As long as there is some procedural possibility for keeping the case alive — a writ, an appeal, or a proceeding to attempt to set aside the judgment — a settlement should be effective.

Even if there is no appeal or other action still possible, a settlement may still be effective in invoking the new law. The plaintiff who needs the settlement for tax purposes may be willing to give up some of the consideration that would be paid via the judgment. Or the plaintiff may be willing to make other concessions,

perhaps agreeing to confidentiality obligations or other nonmonetary items. Given the procedural wranglings (and just plain delays) that are often encountered in enforcing a judgment, a consensual resolution would seem appropriate. A settlement should not be regarded as a sham if any material term in the settlement differs from those in the judgment.

There may be cases in which the defendant insists on paying the judgment and not settling a case. There may also be defendants who are willing to settle but who insist on extracting a hefty price for their cooperation, perhaps seeking to split what they perceive as tax benefits. However, in nearly all cases, a settlement should be possible that hopefully will secure the plaintiff's above-the-line deduction. Pending favorable Supreme Court decisions, that would appear to be as good as it gets.

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