Tax Aspects of Litigation Awards and Settlements

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I. GENERAL INCOME TAX RULES

A. **Settlement or Judgment**. The tax consequences of a payment made in connection with a lawsuit are the same whether the lawsuit is settled or proceeds to judgment. Either type of payment is referred to herein as an "Award".

B. **Origin of Claim**. In general, the origin of the claim presented in the lawsuit determines the tax consequences of the Award. A plaintiff's tax treatment is determined by reference to the genesis and gravamen of the underlying claims. U.S. v. Gilmore, 372 U.S. 39 (1963); U.S. v Woodward, 397 U.S. 572 (1970); Keller St. Dev. Co. v. Comm'r, 688 F.2d 675 (9th Cir. 1982). Often, however, lawsuits involve multiple claims and complex facts.

1. **Lost Profits Versus Goodwill**. Claims which arise in a business context often involve elements relating to both lost profits and damage to identifiable assets, such as goodwill. The burden is on the taxpayer to demonstrate the existence of an asset, as well as damage thereto, in order to avoid treatment of an Award as ordinary income. Rev. Rul. 75-527, 1975-2 C.B. 30. Raytheon Corp. v. Comm'r, 144 F.2d 110 (1st Cir. 1944). See also Messer v. Comm'r, 438 F.2d 774 (3d Cir. 1971); Milenbach v. Comm'r, 318 F.3d 924 (9th Cir. 2003) *rev'g in part* 106 T.C. 184 (1996) ($4 million received by Oakland Raiders from City of Oakland in settlement for damage claim stemming from the two years the team was prevented from moving to Los Angeles treated as substitute for lost income).

2. **Return of Capital**. To the extent that the amount received for damage to an identifiable asset does not exceed the taxpayer's basis in the asset, the Award is treated as a nontaxable return of capital, which decreases the remaining basis in the asset. Rev. Rul. 81-277, 1981-2 C.B. 14; Daugherty v. Comm'r, 78 T.C. 623 (1982).

3. **Awards in Excess of Basis**. Existing case law is not clear on the issue of whether an Award in excess of basis with respect to a capital asset is taxable as ordinary income or as capital gain. Compare Fahey v. Comm'r, 16 T.C. 105 (1951) (no capital gain because no "sale or exchange") with Durkee v. Comm'r, 181 F.2d 189 (6th Cir. 1950) (award for destruction of zero-basis goodwill taxable as capital gain even in the absence of a demonstrable sale or exchange). See also, Turzillo v. Comm., 346 F.2d 884 (6th Cir. 1965) (inquiry into "sale or "exchange" found "formalistic," Award for breach of agreement to acquire shares held taxable as capital gains); Inco Electroenergy v. Comm'r, T.C.M. 1987-437 (1987) (capital gain where

Award in trademark litigation found to be compensation for damage to trademark and goodwill).

4. **Recent Developments.** Most recently in Steel, T.C.M. 2002-113, the Tax Court emphasized the "sale or exchange" requirement in treating as ordinary income the settlement of an insurance claim assigned to the taxpayers by a corporation. The court also rejected the taxpayer's argument that the distribution of the claim should be integrated with a sale of the distributing corporation's stock occurring shortly thereafter. The distinction between capital gain and ordinary income has grown more significant after the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") which reduced the maximum tax rate on capital gains for individuals to 15%.

5. **Acquired Legal Claims**. Recent opinions of the Seventh Circuit and the Tax Court suggest that a different rule may apply to settlement of an acquired legal claim. Nahey v. Comm'r, 196 F.3d 866 (7th Cir. 1999) aff'g 111 T.C. 256 (1998). The taxpayer in Nahey acquired all the assets of a corporation, including a breach of contract claim against Xerox related to installation of a new computer system. Without addressing the "origin" of the claim against Xerox, both courts concluded that taxpayer necessarily realized ordinary income because the extinguishment of the claim did not amount to a sale or exchange. One commentator has suggested that the Seventh Circuit and Tax Court's holding is "incompatible with" the origin of the claim doctrine. See David B. Flassing, From Fahey to Nahey: Wandering Off the Origin of Claim Path in Settlement of Acquired Legal Claims, TAXES – THE TAX MAGAZINE, Aug. 2002, at 35. The Nahey rule also suggests that a plaintiff may recognize capital gain on any sale of a claim to a third party.

6. **Involuntary Conversion.** In FSA 200217001, the IRS held that an Award for breach of contract and tortious interference was not an involuntary conversion for purposes of I.R.C. § 1033, finding that no theft occurred due to the lack of criminal activity.

7. **Claims for Lost Tax Benefits.** In Clark v. Comm'r, 40 B.T.A. 333 (1939), acq. 1957-2 C.B. 4, and Rev. Rul. 57-47, 1957-1 C.B. 3 the Tax Court held (and the IRS ultimately agreed) that a payment made by a tax practitioner to reimburse a client who had overpaid taxes due to faulty advice was not includible in the taxpayer's income. The holdings were premised on a variant of the tax benefit rule – i.e., recovery on a non-deductible

expenditure (federal income taxes paid) should not produce income. See also, Concord Instruments Corp. T.C.M. 1994-248 (malpractice award received by taxpayer due to attorney's failure to timely appeal adverse Tax Court decision allocated between non-taxable portion for additional tax owned and taxable portion for interest owed.) In a series of private rulings, however, the IRS has tried to narrow the scope of Clark. In the IRS' view, where a third party reimburses a taxpayer for income taxes paid, the reimbursement will constitute income – unless the difference is the result of payment of more tax than the minimum that would have been due absent return preparation errors. See PLR 9226033 (where taxpayer paid no more than minimum amount of tax properly due, taxpayer is taxable on breach of contract damages due to misrepresentation of tax consequences on securities found ineligible for Section 936 credit and a lease found ineligible for safe harbor lease status). For a discussion of the distinction between Clark and the 1992 private rulings in the context of damage determination (i.e., the need for a "gross up") see Centex Corp. v. U.S., 55 Fed. Cl. 381 (Fed. Cl. Ct. 2003).

C. **Limitation on Origin of the Claims Doctrine**. Even if a claim arises out of an item, the receipt of which would have been tax-free to the plaintiff, the receipt of an Award may not be tax-free unless all requirements of the applicable Code Section are met. For example, in PLR 200528023 (released 7/15/05), the IRS analyzed settlement payments made by a corporation to the estates of various former employees of the corporation. Unbeknownst to the employees, the corporation had purchased insurance on their lives with the corporation named as the beneficiary. Although life insurance proceeds are generally excluded form income under Code §101(a), the IRS held that the settlements received were taxable as a recovery of "converted funds" because they were received from the corporation, not the insurance company, and were less than the amount of the death benefit.

II. INCOME TAX CONSEQUENCES ARISING FROM PERSONAL INJURY CLAIMS

A. **Workmen's Compensation**. Amounts received under workmen's compensation acts as compensation for personal injuries or sickness are not taxable. I.R.C. §104(a)(1).

B. **Personal Physical Injuries or Physical Sickness**. Under current law, amounts received for personal *physical* injuries or *physical* sickness are not taxable, whether the Award is paid in a lump sum or in installments. I.R.C. §104(a)(2). See, I.R.C. §130 regarding "qualified assignments" of defendant's liability to make periodic payments of personal injury Awards through the purchase of "qualified funding assets."

1. **Prior Law Background**. Historically, I.R.C. §104 excluded damages received for all (not just physical) personal injuries. Many traditional "dignatory" torts (e.g. defamation, intentional infliction of emotional distress) were held to result in excludable Awards. See e.g., Threlkeld v. Comm'r, 87 T.C. 1294 (1986), aff'd 848 F.2d 81 (6th Cir. 1988) (Awards for injury to reputation are excludable whether personal or professional reputation is involved).

2. **Employment Law Claims Under Prior Law**. At one time, wrongful termination and various employment discrimination claims were held to result in excludable Awards based upon the "tort-like" nature of the claim. See, e.g., Redfield v. Ins. Co. of North America, 940 F.2d 542 (9th Cir. 1991).

3. **Schleier Standard**. In Comm'r v. Schleier, 515 U.S. 323 (1995), the U.S. Supreme Court held that an Award under ADEA (federal age discrimination statute) was taxable. The Court applied a new two-part test which substantially narrowed the scope of then-applicable I.R.C. §104(a)(2). These tests require that for an Award to be excludable it must be (1) received through prosecution of tort or tort-type rights and (2) received "on account of" personal injuries or sickness. According to the Court, the ADEA Award failed the second test because the plaintiff did not need to prove that he suffered any physical or mental harm in order to recover damages. In a case which preceded Schleier, the Supreme Court held that the existence of a broad remedial scheme was necessary for an Award under an anti-discrimination to be considered to arise from tort or tort-type rights. U.S. v. Burke, 504 U.S. 229 (1992).

4. **Statutory Changes to I.R.C. §104**. Effective with respect to Awards received after August 20, 1996, the exclusion under I.R.C. §104(a)(2) is limited to Awards for *physical* as opposed to merely *personal* injuries. See, Small Business Job Protection Act of 1996 (H.R. 3448) (the "1996 Act") Section 1605. However, it remains the case that if an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages and interest, as discussed below) flowing from the injury qualify for exclusion. This is the case even if the damages are *measured by* lost wages or even if the recipient of the damages is not the injured party (e.g., loss of consortium). See PLR 200121031 (taxpayer may exclude from income entire amount received from asbestos claim where

taxpayer's husband died from exposure and taxpayer brought loss of consortium and wrongful death claims).

C. **Emotional Distress Under Current Law**. Emotional distress does not in itself constitute a physical injury or illness for purposes of income exclusion. However, if the emotional distress is the result of a personal physical injury, amounts received for emotional distress are not taxable. Also, even if emotional distress is not the result of a physical injury, amounts received for emotional distress are not taxable to the extent they do not exceed the amount paid by the plaintiff for medical care attributable to the emotional distress. I.R.C. §104(a) (flush language). It is not clear whether the 1996 Act would exempt an award allocable to future medical expenses. See Niles v. U.S., 520 F. Supp 808 (D. Cal. 1981) aff'd. 710 F.2d 1391 (9th Cir. 1983) for a discussion of this issue under prior law.

1. **Symptoms.** A footnote to the legislative history of the 1996 Act states that emotional distress includes physical symptoms (e.g. insomnia, headaches, stomach disorders) which may result from emotional distress.

2. **Observable Bodily Harm Required**. As a result, the 1996 Act would seem to elevate the underlying and initial harm to extreme importance. The IRS is likely to limit the scope of the "physical injury" exclusion to cases in which there is a physical touching, such as a battery, which results in observable bodily harm. See PLR 200041022 (unwanted touching by an employer which did not result in a physical injury under I.R.C. §104(a)(2), where touching caused no observable bodily harm (e.g., bruises, cuts, etc.); §104(a)(2) does apply after "first pain incident").

3. **Medical Monitoring Benefits.** The IRS has held that reimbursements of medical monitoring expenses and cash received in lieu of medical monitoring benefits are not taxable to the class members of a class actions suit. PLR 200222001 (qualified settlement fund to administer settlement to class action members diagnosed with a specific medical condition caused by a diet drug).

D. **Age, Sex and Race Discrimination Claims Under Current Law**. Amounts received representing Awards for claims of age, sex or race discrimination (as well as other claims not involving a personal physical injury) are taxable under the 1996 Act regardless whether they represent back pay, compensatory damages or other forms of damages.

E. **Punitive Damages**. Generally, punitive damages are taxable even if they are awarded in connection with a predicate claim under which damages are nontaxable (such as personal physical injury).

See O'Gilvie v. Comm., 519 U.S. 79 (1996). However, punitive damages are not taxable when they are received in a wrongful death action if the applicable state law (as in effect on September 13, 1995 without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in the wrongful death action. I.R.C. §§104(a)(2), 104(c) as amended by the 1996 Act. See also, N.O. Whitley, T.C.M. 1999-124 (suggesting, in dicta, that all punitive damages under Connecticut and Michigan law could be excludable); PLR 200107019 (transfer of a claim for punitive damages to a charitable remainder trust after jury award but prior to the time of the expiration of appeals in the case is not an assignment of income and thus not included in plaintiff's gross income), TAM 200243021 (exemplary damages awarded to surviving spouse and children of deceased employee held taxable because not "on account of" personal injury despite state law which limited damage recovery to exemplary damages only).

F. **Interest**. Interest on any Award is taxable regardless of whether the underlying Award is taxable or nontaxable. This is the case for both post-judgment interest and pre-judgment interest. See Aames v. Comm., 94 T.C. 189 (1990); Brabson v. Comm., 73 F.3d 1040 (10th Cir. 1996); Kovacs v. Comm., 100 T.C. 124 (1993) aff'd. 25 F.3d 1048 (6th Cir. 1994); Rozpad v. Comm., 154 F.3d 1 (1st Cir. 1998); Chamberlin v. U.S., 401 F. 3d 335 (5th Cir. 2005)

G. **Pennsylvania Delay Damages**. Pennsylvania Rule of Civil Procedure 238 authorizes a court to award damages for delay to prevailing plaintiffs in personal injury, wrongful death, and property damage actions. The Third Circuit has held that delay damages are taxable in the same way as post-judgment interest. Francisco v. U.S., 267 F.3d 303 (3d Cir. 2001).

H. Recent Cases

1. **Medina v. Comm'r T.C. Summary Opinion 2003-148**. In this case, Liberty Travel paid $58,000 to settle a lawsuit by a former employee. Liberty had terminated the employee after a problem pregnancy caused her to take a 4_ month leave from work. While the court acknowledged that complications of pregnancy qualified as a physical personal injury or illness, the court refused to apply a "but for" test under §104(a)(2). Since Liberty did not impregnate the plaintiff or contribute to her complications, the court concluded that Liberty was not settling a personal injury claim. Rather, Liberty settled a taxable claim for wrongful discharge.

2. **<u>Johnson v. U.S. 76 Fed App. 873 (10th Cir. 2003)</u>**. In a non-precedential order and judgment, the Tenth Circuit upheld a district court ruling that plaintiff received a fully taxable award from his former employer (a Colorado juvenile correctional institution) in an ADA case. Plaintiff, unlike the plaintiff in <u>Medina</u>, had suffered a job-related physical injury while restraining an inmate. Unable to perform his former duties, Johnson sued alleging that Colorado violated ADA by terminating him without offering him another job he could perform despite his injuries. Johnson received a jury Award consisting of front pay, back pay and emotional distress damages. Finding that the cause of the loss of income was the wrongful termination, not the prior injury, the court held that no portion of the Award was excludible under §104(a)(2).

3. **<u>Amos v. Comr, T.C. Memo 2003-329</u>**. Amos was injured when then Chicago Bulls' basketball player, Dennis Rodman, landed on a group of cameramen while chasing a loose ball out of bounds. Rodman took it upon himself to kick the nearest cameraman, who happened to be Amos, in the groin. Before a lawsuit was filed, Rodman entered into a settlement agreement with Amos. Under the terms of the agreement, Amos received $200,000 and agreed not to pursue criminal charges, not to defame Rodman and to keep the settlement confidential. Relying on §104(a)(2), Amos excluded the entire $200,000 from his gross income. The IRS disagreed on audit claiming that only $1.00 should be allocated to Amos' personal physical injury with the balance allocated to his agreement to keep silent. (The Settlement Agreement contained no express allocation.) Taking a Solomanic approach, the Tax Court came out somewhere in the middle, holding that $120,000 should be excluded and $80,000 was a taxable recovery.

4. **<u>Oyelola v. Commr.</u>**, T.C. Summ Op. 2004-28. Oyelola settled employment discrimination litigation against Mass Mutual, receiving $30,000 for "emotional distress" and $90,000 for lost wages. Despite Oyelola's claim that his emotional distress caused him to sleepwalk into a wall and sustain an injury to his lips, the Tax Court held that §104(a)(2) did not apply since the alleged discrimination, not the physical injury, was the source of Mr. Oyelola's emotional distress.

5. **<u>Tamberella v. Commr</u>**., T.C. Memo 2004-47. In another wrongful discharge case, the Tax Court analyzed a settlement agreement in which Mr. Tamberella received $25,000 for back wages and $89,000 for "all other claims." Although Mr. Tamberella alleged that his ex-employers action led to his high blood pressure and mental problems,

the Court held that no portion of the settlement qualified for exclusion under §104(a)(2).

III. WITHHOLDING AND REPORTING REQUIREMENTS

A. **Back Pay**. According to the IRS, an Award of back pay in connection with a claim not involving personal physical injury (such as a claim of age, sex or race discrimination in employment) is taxable as wages and therefore subject to income tax withholding, Social Security tax ("FICA") and federal unemployment tax ("FUTA") in the same manner as regular wages. The back pay is reported by the employer on Form W-2. See Rev. Rul. 96-65, 1996-2 C.B. 6; PLR 9635013 (lack of specific back pay formula in determining Award not dispositive).

1. **Importance to Parties**. In general, both the plaintiff and the defendant would prefer to treat taxable Awards as attributable to non-wage claims. Otherwise, the Award will give rise to at least a 1.45% FICA liability (the uncapped Medicare portion) to each of the employee and the employer and greater liability if the plaintiff is not otherwise over the FICA cap for the tax year in which the Award is received. See Prewitt v. Comm'r, T.C.M. 1995-24 (back pay Award taxable in year received not year in which damages were incurred).

2. **Recent Case Law**. Recent court decisions have cast some doubt on the IRS' position on the employment tax consequences of the back pay portion of employment discrimination Awards. In Churchill v. Star Enters., 98-1 U.S.T.C. ¶ 50, 390 (E.D. Pa 1998), the Court held that the defendant (the former employer) could not withhold from the back pay portion of a judgment awarded to the plaintiff. The Court rejected the IRS position as presented by the defendant (the IRS was not a party to the litigation) and held that the Award could not be considered "wages" for withholding purposes because the plaintiff (having been terminated) was not an employee of the defendant during the period for which back pay was awarded. See also Kim v. Monmouth College, 320 N.J. Super. 157 (1998) (same holding on facts similar to Churchill); Newhouse v. McCormick & Co., 157 F.3d 582 (8th Cir. 1998) (Award is not wages where employment applicant sued for wrongful non-hiring and was never an employee).

3. **Contract Rights**. In Rev. Rul. 2004-110, the IRS concluded that an amount paid to an employee as consideration for cancellation of an employment contract and relinquishment of contract rights is ordinary income and "wages." This revised a long-standing ruling, Rev. Rul. 55-520, 1955-2 CB 393, which held that such

payments were ordinary income but not "wages." The new ruling is effective for payments made on or after January 12, 2005.

4. **FMLA Exception**. Inclusion of the language "equal to the amount of" in the context of lost wages recognizes that Award, which is available under the Family and Medical Leave Act, does not *per se* constitute "wages" for the purpose of income tax withholding rules subjecting it to statutory deductions for wages. Longstreth v. Copple, 101 F. Supp. 2d. 776 (N.D. Iowa 2000).

5. **Defendant's Conundrum**. Well advised plaintiffs will argue on the basis of Churchill and other recent cases that no withholding is required on the back pay portion of employment discrimination Awards. Nevertheless, the IRS position remains to the contrary. If a defendant fails to withhold, the defendant may be liable for the tax which (in the IRS' opinion) should have been withheld, as well as interest and perhaps penalties. Defendants who agree not to withhold should seek protection from future IRS challenges through the use of indemnification agreements, escrow agreements, holdbacks or similar devices.

B. **Punitive, Liquidated and Compensatory Damage Awards**. Punitive damages, liquidated damages, compensatory damages for nonphysical injuries or sickness (e.g., emotional distress) and any taxable damages other than amounts constituting wages are reported by a business payor on Form 1099-MISC. These damages are not subject to income tax withholding, FICA or FUTA.

C. **Interest**. Interest on any Award paid by a business payor is reported on Form 1099-INT. Except in the unlikely event that the payee is subject to "backup withholding," no income tax withholding is required. In no event do FICA or FUTA apply to payments of interest.

D. **Pennsylvania Law**. Unlike Federal law, Pennsylvania taxes only specific categories of income. With respect to employment discrimination Awards, the only potentially applicable categories are wages (i.e., back pay) and interest. Therefore, Awards allocable to claims other than back pay or interest are not subject to Pennsylvania income tax or withholding.

IV. ALLOCATION OF AWARD TO MORE THAN ONE CLAIM

A. **Allocations Between Taxable and Nontaxable Claims**. Where an Award is based on more than one claim, allocation of the Award among the various claims has the most significant tax consequences if both taxable and nontaxable claims are involved.

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In such a case, successful allocation to the nontaxable claim saves the plaintiff income taxes and (depending on the claim) might also save both parties employment taxes. However, since Federal law was amended to limit nontaxable claims to those involving physical injury or physical sickness, opportunities to make allocations between taxable and nontaxable claims have become severely limited.

1. **No Allocation in Settlement Agreement**. Absent a specific allocation in a settlement agreement, courts will look to the plaintiff's complaint and the intention of the payor to allocate an Award among various asserted claims. See, e.g., Francisco v. U.S., 267 F.3d 303 (3d Cir. 2001); Rev. Rul. 85-98, 1985-2 C.B. 51 (lump sum settlement proceeds in defamation action allocated between compensatory (excludable under then-applicable law) and punitive (taxable under then-applicable and current law) damage claims based on respective numerical claims in complaint); Glynn v. Comm'r, 76 T.C. 116, aff'd. 676 F.2d 682 (1st Cir. 1982) (lump sum settlement payment treated 100% as back pay in employment contract dispute based on intent of payor); Amos v. Comm'r, supra. The payor's intent may be evidenced by the filing of information returns. Ray v. U.S., 92-1 U.S.T.C. ¶50, 187 (Ct. Cl. 1992).

2. **Specific Allocation in Settlement Agreement**. A bona fide arm's-length settlement agreement among adverse parties allocating specific amounts to specific claims generally will be respected. McKay v. Comm'r, 102 T.C. 465 (1994). The IRS, however, is not bound by the parties' allocation and may "go behind" the settlement agreement to challenge an artificial allocation. Robinson v. Comm'r, 70 F.3d 34 (5th Cir. 1994); FSA 200116005 (no damages allocated to personal injury claim where crux of litigation was contractual dispute and complaint did not mention personal injury claim).

3. **Allocation to Interest or Punitive Damages in a Personal Physical Injury Claim**. Upon the settlement of an otherwise excludable claim for personal physical injury, an issue may arise as to whether a portion of the settlement proceeds must be allocated to taxable interest or punitive damage claims. If settlement occurs before a judgment is rendered in the case, the parties generally need not allocate any portion of an Award to prejudgment interest or punitive damages. However, where a jury verdict and judgment contain separate itemizations of damages and interest, a court may conclude that a subsequent settlement is composed of both taxable interest and nontaxable damages in the same proportion. See Delaney v. Comm'r, 99 F.3d

20 (1st Cir. 1996); Rozpad v. Comm'r, 154 F.3d 1 (1st Cir. 1998). Taxpayers entering into post-judgment settlements may have greater success in avoiding pro rata allocations to punitive damages which are often reduced on appeal.

B. **Allocations Between Taxable Claims**. More customary under current law are allocations of a fully taxable Award (such as an Award for employment discrimination) between claims taxable as wages and claims taxable as something other than wages (for example, an employment discrimination Award consisting of back pay and compensatory damages). Pursuant to the rules described above, the amount allocated to back pay is (at least in the IRS' view) reported on Form W-2 and is subject to income tax withholding, FICA and FUTA. The amount allocated to compensatory damages or another non-wage category of damages is reported on Form 1099-MISC and is not subject to income tax withholding, FICA or FUTA. Again, the IRS will not be bound by the parties' allocation in a settlement agreement. In TAM 200244004 the National Office examined two settlement agreements in employment disputes. Each allocated a portion to emotional distress. The IRS respected the first agreement (in which 50% of the Award was allocated to emotional distress) but rejected the second agreement (in which 67% of the Award was allocated to emotional distress).

V. TAX CONSEQUENCES OF CONTINGENT FEE PAYMENTS

A. **Background**. Recent cases brought attention to problems that affect the tax treatment of contingency fee arrangements in the employment discrimination context. Prior to enactment of the 2004 Tax Act (discussed below), in a majority of Circuits, a plaintiff was entitled only to a miscellaneous itemized deduction for the contingent fee payment, the value of which was limited (often substantially) because of (i) the 2% threshold on miscellaneous itemized deductions under I.R.C. §67, (ii) the phase out of deductions for high-income taxpayers under I.R.C. §68, and (iii) (most significantly) the non-deductibility of such fees for purposes of the alternative minimum tax ("AMT") under Code §56(a); 56 (b)(1)(A)(i). See Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir, 2001), cert denied, 122 S.Ct 1915, (no AMT deduction for contingent fee paid to attorney's despite "unfair" result).

The "unfairness" of this situation received significant attention in the popular press. Several newspapers highlighted the tale of woe of a female Chicago police officer who received a $300,000 Award in a discrimination suit but actually faced a net after-tax cost after inclusion in her income of legal fees. See Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Suit," New York Times, Aug. 11, 2002, p.1.

Until the United States Supreme Court decided Comm'r v. Banks, Nos. 03-892 and 03-907 (U.S. Jan. 24, 2005), there had been a split among the Circuits on the issue. The Tax Court and a majority of the Courts of Appeal had held that a successful plaintiff in an employment litigation case must include in income the gross amount of an Award, including the portion paid to his or her attorney pursuant to a contingent fee agreement. In Banks, the Supreme Court sided with the Tax Court and the majority of the Courts of Appeal (see discussion below).

B. **Banks v. Comm'r.** The Supreme Court consolidated two cases from the Sixth and Ninth Circuits which dealt with the confusion over the tax treatment of attorney contingent fees and the importance of state attorney liens laws in determining the result. In Comm'r v. Banks, 345 F.3d 373 (6th Cir. 2003), the Sixth Circuit adhered to its position in Estate of Clarks (attorney fees not includible in client's income) and stated that its holding does not rest on the rationale that state lien laws governing attorney rights determine the correct tax result. Banks involved California lien law under which no ownership interest is conferred to the attorney. In Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), involving an Oregon plaintiff, the Ninth Circuit distinguished Oregon's strong attorney lien law from the weak attorney lien laws in California in holding that the plaintiff did not need to include on his income contingent fees paid directly to his attorney. The Supreme Court, in a unanimous decision, resolved the split by holding, "[A]s a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee." Banks, Nos. 03-892 and 03-907 at 2. For an in depth discussion of Banks, see Robert B. Wood, "Supreme Court Attorney Fees Decision Leaves Much Unresolved," Tax Notes, Feb. 14, 2005, at 792. Banks must be read in conjunction with the American Jobs Creation Act of 2004, P.L. 108-357, (see discussion below).

C. **Related Issues**

1. **Class Action Suits**. In PLR 200222001, the IRS held that payment of attorney fees to class counsel resulting from the settlement of an "opt-out" class action lawsuit should not be included in the calculation of a class member's gross income because the class members have not personally agreed to compensate class counsel. See also PLR 200518017 (attorney fees to class counsel not taxable to class members and class members need not report fees under 6041); PLR 200316040 and Rev. Rul. 80-364, 1980-2 CB 294 (labor union suit brought on behalf of union members). A different result may apply in "opt-in" class action lawsuits. See Kenseth, infra, involving an ADEA opt-in class action.

2. **Defendant Legally Liable for Plaintiff's Legal Fee**. Under some statutes, a defendant who is found liable to plaintiff is also liable for plaintiff's legal expenses. Many practitioners believed that under these circumstances the legal fee need not be reported to plaintiff because the defendant's payment of the legal fee discharges the defendant's own legal obligation rather than plaintiff's. However, the IRS does not take this position and, to date, the courts have agreed with the IRS. See Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001) (attorney's fees awarded under fee-shifting provision of ADEA included in plaintiff's gross income; injured party, not attorney, is eligible to receive court awarded fees). Note that Sinyard involved an "opt-in" class action claim. The Supreme Court reserved in this issue Banks. However, in Vincent v. Comm'r, T.C. Memo 2005-95, decided after Banks, the court concluded that the result is exactly the same as in Banks: income to the client.

D. "Cure" Under American Jobs Creation Act of 2004.

1. **Overview**. Section 703(a) of the American Jobs Creation Act of 2004 (P.L. 108-357) (the "Act") added new Section 62(a)(19) to the Code. The new Section creates an "above the line" deduction for attorneys' fees and court costs incurred in two types of claims: (1) employment claims and (2) federal False Claims Acts claims. The new provision is effective for fees and costs paid after October 23, 2004 with regard to any judgment or settlement occurring after that date.

2. **Import**. Because the new deduction is "above the line" qualifying attorneys' fees and court costs (1) are no longer subject to the reductions in itemized deductions for high income individuals and (2) can be claimed for AMT purposes.

3. **Scope**. The Act enumerates 17 specific laws that qualify as either employment or False Claims Act claims for Section 62(a)(19) purposes, including various Civil Rights Acts; ADA; ADEA; FLA; FMLA; Section 1981, 1983 and 1985 cases; certain ERISA claims and so-called "whistle blower" protection laws. The Act also contains a "catchall" provision for any federal, state or local laws (i) providing for the enforcement of civil rights or (ii) regulating any aspect of the employment relationship, including prohibiting retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

4. **Claims Outside the Scope of the Act**. The following claims appear to be outside the scope of Section 62(a)(1)

and therefore potentially subject to the same "double tax" as existed under prior law (if outside the employment context): (i) defamation claims, (ii) false imprisonment, (iii) invasion of privacy, and (iv) punitive damage claims.

VI. PROPOSED REGULATIONS ON REPORTING PAYMENTS TO ATTORNEYS

A. **Background.** On May 17, 2002, the Internal Revenue Service issued proposed regulations (the "2002 Proposed Regulations") concerning reporting requirements for certain payments to attorneys. Prop. Regs. §1.6045-5. The 2002 Proposed Regulations were in response to the comments generated by previously proposed regulations published in the Federal Register on May 21, 1999. The 2002 Proposed Regulations will apply only to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the Federal Register. In the meantime, payors of awards to attorneys may use the Proposed Regulations as a safe harbor. A payor of an Award to an attorney should not simply do nothing until the Proposed Regulations go into effect, because the requirement to report payments to attorneys is statutory. See I.R.C. §6045(f).

B. **Specifics of Payments to Attorneys**.

1. **General Rule of Reporting.** Generally, any person (including an individual or business entity) that makes a payment in the course of its business to an attorney for legal services must file an IRS Form 1099-MISC with the IRS for the calendar year of the payment.

   For example, reporting is required - -

   - Whether payment is made in cash or by check;
   - Even if the check is payable jointly to an attorney and his client;
   - Even if the check is payable to a law firm that is a corporation;
   - Even if another information return is required to be filed for some or all of the same payment.

2. **Special Reporting Rules**. The Proposed Regulations also deal with some special cases:

   - Amount Reportable for Attorney. If a check is made payable to an attorney and the payor does not know how much of the payment is the legal fee, the entire payment is reported for the attorney. If the payor knows how much of the payment is the legal fee, the payor reports only the legal fee for the attorney.

- Check Payable to More Than One Attorney. If the check names more than one attorney, the payor must file an information return only for the attorney who received the check.

- Payee Attorney Shares Payment With Other Attorneys. If the attorney shares the payment by making payments to other attorneys, the first attorney must file information returns for the other attorneys.

- Aggregate or Separate Reporting. Payors may file either one Form 1099-MISC that aggregates annual payments or separate Forms 1099-MISC for each payment.

- Definition of "Legal Services" "Legal services" has been defined as all services related to, or supportive of, the practice of law performed by, or under the supervision of, an attorney.

3. **Exceptions to Reporting**. The Proposed Regulations contain a few exceptions to reporting payments to attorneys. The exceptions are:

   - Payments of wages to an attorney by his employer;

   - Payments of partnership profits or dividends to an attorney who is a partner or shareholder in a law firm or accounting firm;

   - The balance of a payment of gross settlement or judgment proceeds to an attorney if the payor knows how much of the payment is the legal fee; and

   - Payments made to a foreign attorney who shows he is not subject to U.S. tax.

   - Payments made to an attorney that aggregate less than $600 during a year.

4. **Examples of Information Reporting**. In all three examples below, Attorney is plaintiff's attorney.

- ***<u>Example 1</u>*** – Plaintiff sues Defendant for lost wages. The suit is settled for $300,000 paid by check payable jointly to Plaintiff and Attorney. Defendant does not know the amount the Attorney will be paid. Attorney keeps $100,000 as his fee and pays the other $200,000 to Plaintiff.

  Defendant (Plaintiff's employer) must file Form W-2 for $300,000 for Plaintiff (with taxes withheld), and (because Defendant does not know the amount of the legal fee) also file Form 1099-MISC for Attorney for $300,000.

  Example 1 demonstrates that two information reports may be required for the same payment.

- ***<u>Example 2</u>*** – Same as Example 1, except Defendant knows that $100,000 is the legal fee. Defendant must file the same Form W-2 for Plaintiff for $300,000, and a Form 1099-MISC for Attorney for $100,000, the known amount of his legal fee.

  Example 2 demonstrates two principles. First, if the payor knows the amount of the legal fee, only the legal fee must be reported for the attorney. The balance paid to the attorney (the other $200,000) is not required to be reported for the attorney. Second, the amount reported for the plaintiff is not reduced by the legal fee. (This is the IRS' position. For a reference to case law both supporting and to the contrary, see Section V(B)(6) below.)

- ***<u>Example 3</u>*** – Plaintiff sues Defendant for personal physical injuries and any damages recovered by Plaintiff will not be taxable. Defendant's check in settlement is made out to Attorney. Defendant must file an information report for Attorney in the amount of the entire settlement check. No information reporting is required for Plaintiff.

  Example 3 demonstrates that information reporting of payments to attorneys does not depend on whether the settlement is taxable to the plaintiff. Presumably, Defendant in Example 3 did not know the amount of Attorney's legal fee.