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TAX LAW

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Litigants Face Tax on Legal Fees

Supreme Court, Congress shape tax treatment of settlements, judgments and fee awards

On Jan. 24, 2005, the United States Supreme Court ruled that attorneys' fees paid from a settlement or award pursuant to a contingent fee agreement are includible in a litigant's gross income for federal tax purposes. By a vote of 8-0 (Chief Justice William Rehnquist abstained), the Court followed the long-standing principle that a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. Though the recently enacted American Jobs Creation Act (AJCA) (discussed below) may limit the future effect of this decision, the present impact is an important one as employers and employees must now determine the tax implications of settlements and awards occurring throughout most of 2004.

These federal judicial and legislative actions should have a positive impact by simplifying taxation issues concerning settlements, judgments and fee awards in New Jersey. But significant questions still remain in this area, and practitioners and clients alike would do well to understand thoroughly

the impacts of these changes in the law.

The Cases

In reaching the decision in two consolidated cases, *Commissioner of Internal Revenue v. Banks*, No. 03-892, and *Commissioner of Internal Revenue v. Banaitis*, No. 03-907, cited together at 125 S. Ct. 826 (2005), the Court resolved a split between the lower courts. The Court of Appeals for the Fifth, Sixth and Eleventh Circuits adhered to the view that the contingent fee portion of a litigation recovery is not included in the plaintiff's gross income. The Ninth Circuit held that the portion paid to the attorney as a contingent fee is excluded from the plaintiff's gross income if state law gives the plaintiff's attorney a special property interest in the fee, but not otherwise. In contrast, the Second, Third, Fourth, Seventh, Tenth and Federal Circuits sided with the Internal Revenue Service in finding that the entire litigation recovery, including the portion paid to an attorney as a contingent fee, is income to plaintiff. While some of these Courts of Appeals discuss state law, other courts, including the Third Circuit, have been explicit that the fee portion of the recovery is always income to the plaintiff

regardless of nuances of state law. See, e.g., *O'Brien v. Commissioner*, 38 T. C. 707, 712 (1962), aff'd, 319 F. 2d 532 (3d Cir. 1963) (per curiam).

The Supreme Court based its decision on the "anticipatory assignment of income" doctrine, which states that one who earns or has control of income cannot avoid being taxed on that income even if he assigned it to another. In certain cases, plaintiffs would not be adversely affected by this decision because the legal expenses could be taken as a miscellaneous itemized deduction subject to the regular requirements of the tax code. In many cases, however, including the cases before the Court, this option would have been no help to plaintiffs due to the operation of the Alternative Minimum Tax. The AMT establishes a tax liability floor and, unlike ordinary gross income, does not allow any miscellaneous itemized deductions. Accordingly, the Court's ruling would have the effect in many cases of making it more costly for plaintiffs to settle disputes because attorneys' fees would be taxable income that is not deductible.

The American Jobs Creation Act

The practical impact of the Court's decision is somewhat muted, however, by congressional enactment of the civil rights tax relief provision (Section 703) of the AJCA, signed into law on October 22, 2004. Section 703 provides for an above-the-line deduction for attorneys' fees and costs paid by or on behalf of a plaintiff, specifically apply-

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ing to several employment and civil rights statutes, including Title VII, the Americans with Disabilities Act, the Family and Medical Leave Act, the Rehabilitation Act, the Employee Polygraph Protection Act, USERRA (relating to the employment and re-employment rights of members of the uniformed services), the Fair Labor Standards Act, the Age Discrimination in Employment Act, any federal whistleblower law (such as Sarbanes-Oxley and OSHA), the National Labor Relations Act, the WARN act, ERISA, and wage and hour claims. The statute also provides a catch all, applying the law to any provision of federal, state, local, or common law that provides for the enforcement of civil rights or regulates any aspect of employment relationships.

The plain effect of the law, therefore, will be to permit plaintiffs to avoid taxation of the entire amount of recovery that typically includes attorneys' fees by way of a contingent fee arrangement or fee-shifting statutes. The plaintiffs back pay or compensation component of any judgment of settlement will still be taxed. In addition, Section 703 does not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement. Thus, a taxpayer may not claim a deduction in advance of recovery.

Notably, Section 703 only applies to such fees and costs for any settlement or judgment occurring after October 22, 2004. Indeed, the Court noted that Section 703 likely would have pertained to the employment-related cases at issue, but because the law is not retroactive, it did not apply (plaintiffs settled their respective cases well before the enactment of the AJCA). The Court also articulated that it was not ruling on the tax implications of other federal laws that provide attorneys' fees, some of which exceed the award the plaintiff receives (e.g., where plaintiff seeks injunctive relief, cases involving statutory cap on recoveries).

Settlements and Awards

Prior to enactment of the AJCA, plaintiffs' counsel who represented a prevailing party under the New Jersey Law Against Discrimination often argued that plaintiff would be compelled to seek an additional monetary amount from defendant when faced with defendant's position to treat both plaintiff's award and the attorneys' fee portion as taxable income to plaintiff. A prevailing party is "one who succeeds on any significant issue in litigation [that] achieves some of the benefit the parties sought in bringing suit." *Tarr v. Ciasulli*, 181 N.J. 70, 85 (2004). In other words, plaintiffs' counsel reasoned that plaintiffs there should simply add an amount on top of the original total award due to the negative tax consequences to them caused by recognizing the full payment as taxable income. As a result, it often became challenging for the parties' counsel to resolve these payment issues in a case under the LAD, or similar fee-shifting law.

As can be surmised from the discussion above, Section 703 of the AJCA should now significantly eliminate the obstacles associated with the taxation of a plaintiff's award or settlement, including the attorneys' fee portion, by more easily facilitating a resolution of these issues between the parties. The new law should simplify settlement negotiations and make settlements less costly because the parties will no longer be forced to consider the plaintiff's tax consequences for fees and costs paid as part of the award or settlement.

Remaining Questions

Several issues relating to the tax treatment of certain settlements and awards for the year 2004 — as well as in the future — remain unresolved as a result of the Court's decision and passage of the AJCA. As a preliminary matter, the Court opted not to consider whether the assignment of income doctrine should apply where the antidiscrimination law at issue contains a fee-shifting provision

(i.e., where the court is allowed to require the employer to pay the plaintiff's attorney fees if the plaintiff prevails). The Court determined that it need not address such a scenario since the fees paid in *Banks* were made pursuant to a contingent fee arrangement and not awarded by a court. Therefore, an employee who before the effective date of AJCA won an award (or procured settlement), including provisions for the payment of attorney's fees under a fee-shifting statute, may still argue that attorneys' fees are not income to such an employee.

Additionally, employers must be mindful that, while Section 703 of the AJCA applies to a broad group of employment claims, certain claims brought by an employee may not be covered, such as defamation that is not in the context of employment, contract and invasion of privacy claims, ERISA cases (other than those under Section 510 of ERISA), products liability, personal injury and securities law. Further, there is some question whether Section 703 of the AJCA applies to settlements reached before a suit is filed or to payment or settlement of a claim before an administrative agency. Thus, whether a claim falls within the ambit of the AJCA is of critical import, as the old double taxation rule likely increased the settlement cost for employers because plaintiff employees focused on the net payment rather than the "settlement amount." Many employers there simply increased the settlement amount to provide the employee with a net that matched the proposed settlement.

Employers in all jurisdictions are therefore encouraged to seek legal advice when determining possible tax consequences arising from any employee settlement or award that occurred both before and after October 22, 2004 in light of the uncertainties resulting from the Supreme Court's decision and passage of the AJCA. ■