

THE PAST, PRESENT AND FUTURE
OF TAXABILITY
OF EMPLOYMENT AWARDS
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I. The Past

The taxability of awards in the arena of employment litigation has been a quagmire of uncertainty with practitioners in varying circuits having varying answers to questions surrounding whether awards are taxable and, if so, what part of the award is taxable. *See generally*, Commissioner v. Schleier, 515 *U.S.* 323, 115 *S. Ct.* 2159 (1995); United States v. Burke, 504 *U.S.* 229, 112 *S. Ct.* 1867 (1992); 26 *U.S.C.* § 104(a); and IRS Rev. Ruling 96-56. What has occurred in many jurisdictions, is that the contingency fee plaintiff pays federal and state income taxes on the attorneys' fees and costs part of the award that is paid by the defendant to the plaintiff's attorney. Then the plaintiff's attorney pays federal and state income taxes on that same payment of monies which results in double taxation.

Lawyers would face the difficult scenario found by the plaintiff in Illinois. There, Cynthia Spina prevailed in a hotly contested and litigated sexual harassment and discrimination lawsuit against the Illinois Police Department. Ms. Spina's recovery for compensatory damages was subject to the \$300,000 statutory damages cap found in Title VII of the Civil Rights Act of 1964, 42 *U.S.C.* § 2000e-2. Her attorneys were awarded fees and costs that approached \$1,000,000. At the end of the day, Ms. Spina's tax bill exceeded her damages award and left her with an additional tax liability of \$99,000. Spina v. Forest Preserve District of Cook County, 207 *F.Supp.2d* 764 (N.D. Ill. 2002).

II. *The Present*

a. *The US Supremes*

The issue of taxability of attorneys' fees to a contingency fee plaintiff was presented to the United States Supreme Court in Commissioner of Internal Revenue v. John W. Banks, II and Commissioner of Internal Revenue v. Sigitas J. Banaitis, Nos. 03-892 and 03-907, 2005 U.S. LEXIS 1370; 73 U.S.L.W. 4117; 94 Fair Empl. Prac. Cas. (BNA) 1793 (January 24, 2005).

In Commissioner of Internal Revenue v. John W. Banks, II, 345 F.3d 373 (2003), Banks was an educational consultant who was fired from the California Department of Education. He filed a cause of action alleging violations of, *inter alia*, 42 U.S.C. §§1981, 1983 and Title VII. Defendant settled with Banks and paid him \$464,000 of which Banks paid \$150,000 to his attorney in accordance with the contingent fee agreement. Banks did not include any of the monies as income and was issued a notice of deficiency for the \$464,000 by the Commissioner of the IRS. This was upheld by the Tax Court. The Sixth Circuit followed the Fifth and Eleventh Circuit and reversed in part as to the taxability of the \$150,000.

In Commissioner of Internal Revenue v. Sigitas J. Banaitis, 340 F.3d 1074 (2003), Banaitis was a vice president and loan officer at Bank of California that was acquired by Mitsubishi Bank. Banaitis filed a cause of action alleging, in essence, a breach of his employment contract. The matter proceeded to trial after which defendants filed post trial motions and appeals. After the resolution of these motions and appeals, the parties settled with Banaitis receiving \$4,864,547, and defendants paying an additional \$3,864,012 directly to his attorney. Banaitis did not include the additional \$3,864,012 as income and was issued a notice of deficiency for the \$3,864,012 by the Commissioner of the IRS. This was upheld by the Tax Court. The Ninth Circuit analyzed the law in Oregon. It found that only because Oregon law granted a special property right or superior lien on the attorneys' fee, then that fee should not be income to Banaitis.

The United States Supreme Court consolidated both cases in Commissioner of Internal Revenue v. John W. Banks, II and Commissioner of Internal Revenue v. Sigitas J. Banaitis, Nos. 03-892 and 03-907, 2005 U.S. LEXIS 1370; 73 U.S.L.W. 4117; 94 Fair Empl. Prac. Cas. (BNA) 1793 (January 24, 2005) ("Banks"). On January 24, 2005, the US Supreme Court reversed both the Sixth and Ninth Circuits and found in favor of the Commissioner of the IRS, in ruling that the payment of attorneys' fees was taxable to the plaintiff.

b. *The Analysis*

The analysis begins with the Internal Revenue Code that defines "gross income" for federal tax purposes as "all income from whatever source derived." 26 U.S.C. §61(a). This broad definition is all-encompassing and results in the IRS arguing that gross income includes all economic gains not otherwise exempted. Commissioner v. Glenshaw

Glass Co., 348 U.S. 426, 429-30, 99 L. Ed. 483, 75 S. Ct. 473 (1955); Commissioner v. Jacobson, 336 U.S. 28, 49, 93 L. Ed. 477, 69 S. Ct. 358 (1949).

Plaintiffs' attorneys have historically argued that the value of the legal claim found in the contingency fee agreement was speculative at the moment of assignment and may end up being worth nothing. Thus, the attorneys' fee and award should not be treated as an anticipatory assignment and thus should not be held as income to the plaintiff. They would argue that a contingent-fee arrangement is more like a partial assignment of income-producing property than an assignment of income. Estate of Clarks v. United States, 202 F.3d 854, 857-858 (2000).

The *Banks* Court definitively rejected this argument in stating that contingency fee agreements are still anticipatory assignments even though the value of the assignment may be unknown at the time of assignment Banks, *supra* at *17; Lucas v. Earl, 281 U.S. 111, 74 L. Ed. 731, 50 S. Ct. 241 (1930); United States v. Basye, 410 U.S. 441, 445, 450-452, 35 L. Ed. 2d 412, 93 S. Ct. 1080 (1973); Raymond v. United States, 355 F.3d 107, 115-116 (CA2 2004). Further, the Supreme Court has definitively held that such an anticipatory assignment of income is taxable to the plaintiff as he/she earned the income that gave rise to the attorneys' fee. Banks, *supra* 2005 US Lexis 1370 at *14; Lucas, *supra*; Comm'r v. Sunnen, 333 U.S. 591, 604, 92 L. Ed. 898, 68 S. Ct. 715 (1948); Helvering v. Horst, 311 U.S. 112, 116-117, 85 L. Ed. 75, 61 S. Ct. 144 (1940).

Plaintiff's attorneys have also historically argued that the plaintiff did not exercise dominion over the attorneys' fees and costs part of the award. They argued that payment of attorneys' fees and costs was compensation due to the attorneys' effort and skill, independent of the litigation. Thus, the relationship should be seen as a joint venture or partnership where each partner can be taxed for the separate rewards that they actually received. The *Banks* Court also rejected this argument and found the relationship was more akin to that of principal-agent. The Court found that the plaintiff controls the critical decisions and makes the final decision as to whether to settle or proceed to judgment. Thus, the client retains ultimate dominion and control over the underlying income generating asset which is the plaintiff's legal injury. Horst, *supra*, at 116-117, 85 L. Ed. 75, 61 S. Ct. 144. *See also* Lucas, *supra*, at 114-115, 85 L. Ed. 75, 61 S. Ct. 144; Helvering v. Eubank, 311 U.S. 122, 124-125, 85 L. Ed. 81, 61 S. Ct. 149 (1940); Sunnen, *supra*, at 604, 92 L. Ed. 898, 68 S. Ct. 715. The Court found that this is reflected by the attorney being ethically obligated to act for the exclusive benefit of the client-principal rather than for the benefit of the attorney. The Court favorably commented on Judge Posner's analogy of treating the contingent fee relationship as similar to that of a commission salesman. Kenseth v. Comm'r, 259 F.3d 881, 883 (CA7 2001). In that case, Judge Posner opined that the commission salesman has as much ownership of his employer's accounts receivable as the contingent fee lawyer has ownership over the plaintiff's claim. *Id.* In both situations, the principal relies on the agent to realize an economic gain, and, in both cases, the economic gain is income to the principal. *Id.*

b. *The American Jobs Creation Act*

On October 22, 2004, President George W. Bush signed the American Jobs Creation Act which included a key provision from the Civil Rights Tax Relief Act (H.R. 1155/S. 557) (“CRTRA”) into law.

This corporate tax bill which passed Congress on October 11, 2004 (H.R. 4520) has put to bed the issue of taxability of attorneys’ fees in contingency fee matters pertaining to employment discrimination and harassment lawsuits. The new law specifically eliminates the double tax on attorneys’ fees. The passage of the CRTRA is a massive victory to plaintiff and defense lawyers and to all parties to employment disputes. Due to the broad positive implications of the bill, it enjoyed wide support from the plaintiff and defense bar as well as broad bi-partisan support in the Congress. The CRTRA was an ABA legislative priority and was a focus during the ABA Day lobbying effort in Washington, DC.

Thus, H.R. 4520 §703, permits plaintiffs an above-the-line deduction for attorneys' fees and costs paid by or on behalf of the plaintiff in employment cases as noted below in the discussion on the amended Internal Revenue Code. This provision precludes such payments from being subject to the Alternative Minimum Tax or the 2% floor on itemized deductions.

Although lobbyists and members of both parties such as the Senate Finance Committee Chair, Charles Grassley (R-IA) and Ranking Member, Max Baucus (D-MT), attempted to make the provision retroactive to December 2002, the CRTRA will only apply to judgments or settlements occurring after the date the President signed the bill into law – October 22, 2004.

III. *The Future*

a. *Issues left for another day by the Banks Court*

The Court left open the following arguments due to the fact that they were not raised prior to the briefs submitted to the US Supreme Court.

(1) The contingent-fee agreement establishes a Subchapter K partnership under 26 U.S.C. § § 702, 704, and 761, Brief for Respondent Banaitis in No. 03-907, p. 5-21;

(2) litigation recoveries are proceeds from disposition of property, so the attorney's fee should be subtracted as a capital expense pursuant to § § 1001, 1012, and 1016, Brief for Association of Trial Lawyers of America as *Amicus Curiae* 23-28, Brief for Charles Davenport as *Amicus Curiae* 3-13; and

(3) the fees are deductible reimbursed employee business expenses under § 62(a)(2)(A) (2000 ed. and Supp. I), Brief for Stephen Cohen as *Amicus Curiae*.

Banks, *supra* at *21-22

b. Future issues not address by the Banks Court

The Court left open what it would do in the situation where there was a court-ordered fee award in so far as whether it would find the payment of court-ordered attorneys' fees and costs taxable to the plaintiff as this was not the situation in either matter. Banks, supra at *23

Further, the Court left open what it would do in the situation where there was an indication in the contingency fee contract that the contingent fee paid to the attorney was in lieu of statutory fees the plaintiff might otherwise have been entitled to recover. Banks, supra at *23-24

c. Questions surrounding the CRTRA

i. Type of cases subject to the CRTRA

The question arises as to the implications of the non-taxability of attorneys' fees for cases nor specifically surrounding the issue of discrimination or harassment. Are the payment of attorneys' fees in contingency fee matters for non-discrimination or harassment claims taxable to the plaintiff?

This issue has not yet been resolved by the Courts. The Internal Revenue Code, found at 26 USCS §62 (2005), states the general rule that, "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:" IRC §62(a). The new proposed amendment reflects the following deduction: "Costs involving discrimination suits, etc. Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code [31 USCS §§ 3721 et seq.] or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall 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 (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim." IRC §62(a)(20).

Although the provision commences with language about discrimination suits, many practitioners believe that any lawsuit pertaining to employment are included in the exception. It is important to take note of the US Supreme Court's *dicta* on this point. The *Banks* Court noted that, "[h]ad the Act been in force for the transactions now under review, these cases likely would not have arisen. The Act is not retroactive, however, so while it may cover future taxpayers in respondents' position, it does not pertain here. Banks, supra at *13-14. In this consolidated case, Banaitis was not a discrimination or

harassment lawsuit. It dealt with breach of employment contract wrongful discharge for attempting to coerce Banaitis to breach his fiduciary duties.

Further, a comprehensive review of IRC §62(e) is helpful to support this argument:

(e) Unlawful discrimination defined. For purposes of subsection (a)(19), the term "unlawful discrimination" means an act that is unlawful under any of the following:

- (1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).
- (2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).
- (3) The National Labor Relations Act (29 U.S.C. 151 et seq.).
- (4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).
- (5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).
- (6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).
- (7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).
- (8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).
- (9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).
- (10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
- (11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).
- (12) Chapter 43 of title 38, United States Code [38 USCS §§ 4301 et seq.] (relating to employment and reemployment rights of members of the uniformed services).
- (13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).
- (14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).
- (15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
- (16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
- (17) Any provision of Federal law (popularly known as whistleblower protection provisions) 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 under Federal law.
- (18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law--
 - (i) providing for the enforcement of civil rights, or
 - (ii) 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.

Thus, based upon IRC §62(e)(18)(ii), it appears that any dispute pertaining to any part of the employment relationship would be subject to the exception found in IRC §62(a)(20).

ii. CRTRA implicated pre-litigation or post-litigation only

Questions arise over whether cases have to go to trial or at least be put into litigation for you to treat the payment of attorneys' fees and costs as not taxable to the employee. The prevailing wisdom is that one does not have to put these disputes into litigation to get the benefit of the CRTRA. Notably, the CRTRA and the IRC language refers to, "any action involving a claim." It does not limit the coverage to lawsuits. However, it is certainly conceivable that an argument could be made that the definition of action is, in fact, a lawsuit. In fact, Black's Law Dictionary, Sixth Edition, states that the term "action" usually refers to a lawsuit. Such an argument would certainly have dubious prospects of success considering the obvious implications of same. Practitioners would be constrained to put matters into litigation rather than resolve them pre-litigation. This would of course affect the ability of parties to keep these disputes confidential which may very well be the motivating reason for the employer to resolve the dispute – not to mention the other numerous negative implications.

iii. Issuing a Form W-2 or a Form 1099 and deducting withholdings

It is unclear to many whether a former employer should issue a Form W-2 or 1099 and whether these tax documents should be issued for both plaintiff and plaintiff's lawyer and whether the company must deduct withholdings. Many New Jersey practitioners request that the monies are 1099'd to the lawfirm. Some employers insist that the monies need to be W-2'd. This issue requires a review of local decisional case law. In New Jersey and New York, there are cases such as Kim v. Monmouth County, 320 N. J. Super. 157 (Law Div. 1999) and Kelly v. Hunton & Williams, 1999 WL 759972 (USDC EDNY), which seem to hold that it is inappropriate to withhold taxes because the settlement (or judgment) proceeds cannot represent "wages for services performed" (even if for lost income damages). Thus, it supports the request that the monies should be subject to a Form 1099 without any withholdings

d. Issues beyond the CRTRA

i. Compensatory Damages

Compensatory wage damage awards to the plaintiff are construed as taxable income. In the world of personal injury, when a plaintiff receives monies to compensate them for a personal injury, the monies are generally not construed as taxable income to that plaintiff. If the facts suggest, one may want to have language in the settlement agreement stating that the monies are payment for the physical manifestation of emotional distress damages and/or physical injury as well as payment of attorneys' fees and costs in an action involving claims of discrimination or harassment.

Practitioners expect that there will be legislation introduced to the 109th Congress to restore the pre-1996 tax treatment of compensatory damages to make them not taxable to the plaintiff.

ii. Income Averaging

Plaintiffs will often get back and front pay awards that cover several years of employment in one payment. This payment will affect their income tax payment for the year that the payment is paid. Some practitioners will request additional awards to compensate plaintiffs for the negative consequence of receiving a backpay award in a single year under the doctrine that discrimination victims are entitled to "make whole" relief. *See, O'Neill v. Sears, Roebuck and Company*, 108 F.Supp.2d 443, 448 (E.D. Pa. 2000); *Sears v. Atchison, Topeka & Santa Fe Ry.*, 749F.2d 1451,1456 (10th Cir. 1984); *E.E.O.C. v. Joe's Stone Crab, Inc.*, 15 F.Supp.2d 1364 (S.D. Fla. 1998); *Arneson v. Sullivan*, 958 F.Supp. 443(E.D. Miss. 1996); *Gelof v. Papineau*, 648 F.Supp. 912 (D. Del. 1986), *aff'd in part and vacated in part*, 829 F.2d 452 (3d Cir. 1987). However, lobbyists are seeking to introduce legislation to the 109th Congress to mitigate the tax effect of receiving back pay and front pay in one year by providing income averaging for those recoveries.

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