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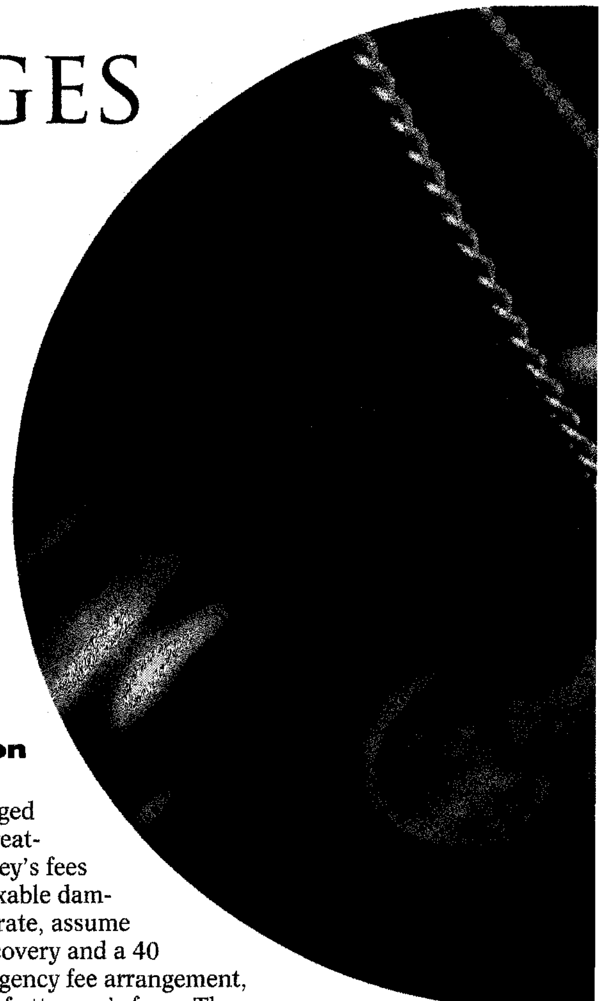
MAJOR CHANGES TO TAXATION OF TORT DAMAGES

BY STEVE JOHNSON*



Tax law touches virtually all economic and social transactions. Accordingly, no attorney — regardless of his or her specialty — can afford to be unaware of tax effects.[1] Moreover, tax law changes frequently, and obsolete knowledge is a synonym for malpractice.

This article discusses federal income taxation of damages recovered in tort actions. There were important changes in the area in 1996. More recently, a significant statutory change was made in October 2004, and the Supreme Court decided a key case in January 2005.

I. 1996 Changes

In defined circumstances, Section 104(a)(2) of the Internal Revenue Code excludes some damages from taxability. Before the mid-1990s, the exclusion was broader than it is now. It applied to essentially all damages recovered (whether via settlement or as a result of trial and whether received in a lump sum or in installments) in actions sounding in tort.[2]

However, as a result of Supreme Court decisions in the 1990s[3] and legislation in 1996,[4] the exclusion was significantly narrowed. It now applies only to compensatory damages received "on account of personal physical injuries or physical sickness." Thus, punitive damages are never excludable, and only natural persons, not entities, can qualify for the exclusion. Moreover, damages for emotional distress are not excludable except to the extent of "the amount paid for medical care . . . attributable to emotional distress."[5]

Several related considerations also are important. First, if an award consists in part of taxable damages and in part of excludable damages, a clear basis must exist by which to calculate the two components. Absent such an allocation, the IRS may be able to argue that the taxpayer has failed to meet her burden of proof, thus that all of the damages must be taxed.[6]

Second, the total amount received by the plaintiff-taxpayer may include interest as well as damages. Such interest is never excludable.[7] Again, this requires the attorney to achieve and clearly document an allocation.

Third, attorney's fees paid with respect to recovery of taxable damages will be deductible under rules discussed in parts II and III of this article. However, as a result of I.R.C. § 265(a)(1), the plaintiff-taxpayer will not be able to deduct attorney's fees and related costs allocable to recovery of excludable damages.

II. 2004 Legislation

For decades, controversy raged as to the tax treatment of attorney's fees allocable to taxable damages. To illustrate, assume a $100,000 recovery and a 40 percent contingency fee arrangement, thus $40,000 of attorney's fees. There are two ways to conceptualize the case: **(1)** the plaintiff-taxpayer has a $100,000 inclusion into gross income and a $40,000 deduction versus **(2)** the plaintiff-taxpayer has a $60,000 inclusion into gross income and no deduction. The second approach would be based on the idea that the attorney, not the plaintiff-taxpayer, had the right to the $40,000 all along, or a similar rationale.

One might ask: "What's the difference? The first approach nets out to be the same as the second approach." Not so. The tax consequences of Way 1 are dramatically different from, and far worse for, the plaintiff-taxpayer than are those of Way 2. This is because the $40,000 of deductions for the attorney's fees are treated disadvantageously for both regular tax and alternative minimum tax ("AMT") purposes.

For regular tax purposes, deductions for individual taxpayers are classified as either above-the-line or below-the-line. Typically, attorney's fees paid by tort plaintiffs were below-the-line deductions.[8] As such, they were subject to significant limitations inapplicable to above-the-line-deductions. In particular, **(1)** they were miscellaneous itemized deductions which, under I.R.C. § 67, are deductible only to the extent that their aggregate (along with all other such deductions for the year) exceeds two percent of the taxpayer's adjusted gross income for the year and **(2)** they were subject, under I.R.C. § 68, to being lost via phase-out as the taxpayer's adjusted gross income rises to substantial levels (which will be the case if the damages received are large).[9] The AMT situation was even worse. Under I.R.C. § 56(b)(1)(A)(i), the attorney's fees were wholly nondeductible for AMT purposes.

The combined effects were devastating. Some plaintiff-taxpayers have been taxed on their recoveries at an effective rate exceeding 100 percent. A well-publicized example was that of a Chicago police officer who had prevailed in a sex discrimination suit. Very large attorney's fees were the price of victory, and those fees were subject to the tax disadvantages described above. As a result, the officer paid $99,000 in additional taxes and actually lost money, on an after-tax basis, as a result of winning the suit.[10] That result was extreme but not unique. Moreover, numerous plaintiff-taxpayers who did not actually lose money nonetheless discovered that these tax traps severely diminished the value of their recoveries.[11]

Repeated attempts were made to redress this unfair situation through legislation. Partial success was achieved in the American Jobs Creation Act, signed into law in October 2004. Section 703 of the Act amends I.R.C. § 62(a)(19) to create an above-the-line deduction "for attorney's fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination" or a claim under either 31 U.S.C. ch. 37, subch. III (claims against the United States government) or 42 U.S.C. § 1395y(b)(3)(A) (private causes of action under the Medicare Secondary Payer provisions).

"Unlawful discrimination" is defined in Section 62(e). That section contains 18 paragraphs. The first 16 identify causes of action by specific statutory citation. The 17th relates to claims under federal whistleblower statutes. The 18th refers to common law or federal, state, or local statutory claims as to civil rights and employment.

The 2004 legislation does not make deductible any expense that previously was nondeductible. It simply elevates items that are deductible from below-the-line to above-the-line status. In doing so, however, it removes the regular tax and AMT disadvantages described above.

Under Section 703(c), the relief applies to fees and costs paid after the date of enactment (October 22, 2004) with respect to settlements and judgments after that date. There is arguable support for a contention that relief should apply earlier — on the theory that the Act did not change the law but merely clarified that the pro-taxpayer Way 2 always has been the law. However, as will be seen in part III below, such an argument would be inconsistent with the Supreme Court's teaching in 2005.

The amount of the above-the-line deduction for any year cannot exceed the amount of the taxpayer's income from the claim or suit for the year. This could happen, for example, if all the fees and costs were paid in Year 1 while the recovery going to the plaintiff-taxpayer were stretched out in installments over a number of years. Excess amounts over this limitation will be deductible below-the-line in the year paid.

The 2004 legislation provides important relief. However, there are significant questions as to the provision's reach. These are addressed in part IV below.

III. 2005 Supreme Court Decision

At the beginning of part II, we saw that there are two principal ways to conceptualize attorney's fees for income tax purposes. What we called Way 1 led to the tax traps; Way 2 avoided them. Over decades of litigation, the courts were split as to which Way was correct under the law. The majority of the courts held for Way 1. On a variety of theories, though, a significant minority of courts embraced Way 2. This led to forum shopping for taxpayers who were able and to inconsistent justice for those who were not.

For many years, the Supreme Court chose not to resolve the split, denying certiorari five times in cases presenting the issue. Finally, in March 2004, the Supreme Court accepted the issue, granting certiorari and consolidating cases from the Sixth and Ninth Circuits. In January 2005, the Court rendered its decision in Commissioner v. Banks.[12]

By 8 to 0, the Court held for Way 1. It stated: "as 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."[13] The same result (full inclusion) obtains irrespective of whether (i) the plaintiff-taxpayer received the full amount, then used part of it to pay her attorney or (ii) the attorney received his fee directly from the judgment or settlement, without it ever passing through the plaintiff-taxpayer's hands.

The Court based its decision on the "assignment of income" doctrine, under which gains are taxed to the person who earns them. The Court reasoned that the plaintiff is the earner since he retains dominion over the asset (the suit) throughout the litigation. The Court rejected arguments that the client-attorney relationship is like a business partnership or joint venture, instead seeing the client as the principal and the attorney as an agent.[14]

The Court noted the 2004 legislation, stating that the causes of action in the consolidated cases likely would have been among the categories covered. However, the Court held that the legislation is effective only prospectively, so it did not apply to the tax years at issue.[15]

IV. New Ambiguities

The relief provided by the 2004 legislation plainly is welcome. Unfortunately, both that legislation and Banks introduce new ambiguities that likely will bedevil taxpayers and the IRS for years.

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Pre-October 2004 fees and costs will be governed by Banks. Post-October 2004 fees and costs will be governed by the new legislation (if within one of the 18 categories) or by Banks (if outside all of the 18 categories). Although space does not permit their full exploration in this article, here are some of the unresolved questions as to Banks and the new statute:

(1) As quoted above, Banks' holding is prefaced by the tantalizing "as a general rule." What might be the exceptions to this "general rule?" A number of candidates can be imagined, but the Court offered no list.

(2) In addition to the taxpayer arguments the Court rejected, the taxpayers and commentators advanced several other theories, which the Court chose not to consider, because they had not been developed in the lower courts.[16] Presumably, taxpayers seeking to escape Banks will press those theories in future cases.

(3) Based on its language, there are a number of situations to which Banks either does not or may not apply. They include court-ordered or statutory fees, amounts paid by False Claims Act relators, and cases in which the successful plaintiff obtains injunctive relief rather than damages.

(4) Generally speaking, the eighteen categories of the 2004 legislation include employment-based claims and claims under the federal False Claims Act. However, close reading of the statutory language is required, and it will produce some surprises. For instance, it may be that some ERISA claims fall outside the Act's protection.[17]

(5) Section 62(e) ends with a residual category (category 18) for civil rights and employment claims. Just how elastic is that category? Inevitably, taxpayers will advance creative arguments as to why torts not within the Act's specific categories have some civil rights or employment flavor, to come within the residual category. Unless Congress revisits § 62(e) to broaden it to all or nearly all types of cases, we may expect a great deal of litigation testing the boundaries of its categories, especially the residual category.

In sum, the 1996, 2004, and 2005 developments should reaffirm to civil trial lawyers that ignorance of the tax consequences of settlements and awards is not a viable option.

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1. As the Supreme Court observed, "[n]o other branch of the law touches human activities at so many points." *Dobson v. Comm'r*, 320 U.S. 489, 494-95 (1943).
2. Treas. Reg. § 1.104-1(c)(damages from an action "based upon tort or tort type rights").
3. *See O'Gilvie v. United States*, 519 U.S. 79 (1996); *Comm'r v. Schleier*, 515 U.S. 323 (1995); *United States v. Burke*, 504 U.S. 229 (1992).
4. Pub. L. No. 104-188, § 1605(a)(amending I.R.C. § 104(a)(2) for amounts received after Aug. 20, 1996, for tax years ending after that date).
5. In addition to § 104(a)(2), other exclusions of limited application exist. E.g., I.R.C. § 104(a)(1)(excluding "amounts received under workmen's compensation acts as compensation for personal injuries or sickness").
6. Prominent allocation cases include *Rozpad v. Comm'r*, 154 F.3d 1 (1st Cir. 1998); *Delaney v. Comm'r*, 70 T.C.M. 353 (1995), aff'd, 99 F.3d 20 (1st Cir. 1996).
7. E.g., *Kovacs v. Comm'r*, 100 T.C. 124 (1993), aff'd without published opinion, 25 F.3d 1048 (6th Cir. 1994).
8. Such fees usually were deductible under I.R.C. § 212 or as employee-business-expenses under § 162. Both types are below-the-line under § 62(a). Above-the-line deductions are subtracted from "gross income" to produce "adjusted gross income," while below-the-line deductions are subtracted from "adjusted gross income" to produce "taxable income."
9. *See, e.g., Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995).
10. Adam Liptak, Tax Bill Exceeds Award to Officer in Sex Bias Suit, N.Y. Times, Aug. 11, 2002. § 1, p. 18.
11. *See Spina v. Forest Preserve District*, 207 F. Supp. 2d 764. 777 (N.D. Ill. 2002); 2004 National Taxpayer Advocate Report to Congress 166; Laura Sager & Stephen Cohen, How the Income Tax Undermines Civil Rights Law, 73 S. Cal. L. Rev. 1075 (2000).
12. 125 S. Ct. 826 (2005). Some of the prior, conflicting cases are cited at id. at 828-29. The pro-government outcome of the case was predicted by a prescient article in our Law School's journal. See Richard Mason, Will the Ninth Circuit Be Reversed in Banaitis v. Commissioner?, 5 Nev. L.J. 284 (2004).
13. Id. at 829.
14. Id. at 831-33. A consequence of Banks is that one of the taxpayers will have an inclusion into income of about $8 million, even though he received only about $5 million (the rest going directly to his lawyer). See Sheryl Stratton, Justices Side with Government in Contingent Attorney Fee Cases, Tax Notes, Jan. 31, 2005, at 511, 512 (citing attorney for taxpayer Banaitis).
15. Id. at 831. The Court declined the taxpayers' request to dismiss the cases as moot because of the 2004 legislation. Since the taxpayers had won below, dismissal would have preserved their victories.
16. See id. at 833.
17. Sec. 62(e)(7) identifies claims under § 510 of ERISA, but not claims under any other part of ERISA. Presumably, such other claims would not be protected unless they fit within the residual category in § 62(e)(18).