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Supreme Court Holds that Contingent Attorney Fees Are Income To Plaintiffs

By

Louis S. Nunes, III

Settling a long-standing split among the Courts of Appeals, the United States Supreme Court has held that a litigant must include in his gross income the portion of his recovery that is paid to his attorney as a contingent fee. *Commissioner of Internal Revenue v. Banks*, No. 03-892 (Jan. 24, 2005).

This issue has confounded tax advisors since 1959, when the Court of Appeals for the Fifth Circuit first examined the tax treatment of that portion of a recovery that is paid to a litigant's attorney under a contingency fee arrangement. The Fifth Circuit held that the attorney fees should not be included in the litigant's gross income. The Eleventh and Sixth Circuits have followed the Fifth circuit's position. The Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuit Courts have not followed the Fifth Circuit's position, but instead hold that contingent attorney fees must be included in the litigant's gross income. The Tax Court also has consistently held that contingent attorney fees must be included in the litigant's gross income.

Although not apparent to those not familiar with this issue, there has always been a lot at stake to successful litigants. If the attorney fees are not included in the litigant's gross income, the litigant is not required to pay income tax on that amount and is not allowed a deduction for the attorney fees. If the attorney fees are included in the litigant's gross income, the litigant is allowed a deduction for the attorney fees. At first glance, this seems to be an economic wash, but it isn't. The litigant who is required to include the attorney fees in his income is at an economic disadvantage, in many cases a severe disadvantage, for two reasons. First, the deduction for attorney fees is a miscellaneous itemized deduction that is subject to certain limitations based on adjusted gross income. Second, for purposes of computing the alternative minimum tax, the deduction for attorney fees is not allowed. Thus, litigants who are required to include the attorney fees in their gross income generally must pay income tax on an amount that exceeds the portion of the recovery that they keep after paying their attorney. An often-cited *New York Times* article highlights this dilemma, presenting the story of a police officer who won a sex discrimination suit and wound up paying \$99,000 of taxes in excess of the amount of her recovery after she paid her attorney fees. In other words, her victory cost her \$99,000 in taxes.¹

The *Banks* decision finally settles this issue. Contingent attorney fees must be included in a litigant's gross income.

¹ Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Suit," *The New York Times*, Aug. 11, 2002.

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The American Jobs Creation Act – Prospective Partial Relief

The American Jobs Creation Act of 2004, signed by President Bush on October 22, 2004, allows an above-the-line deduction for amounts attributable to attorney fees and costs received by individuals on account of claims of unlawful discrimination or specified claims against the government brought under the False Claims Act. By moving the deduction for attorney fees “above the line,” the deduction is no longer a miscellaneous itemized deduction, is not subject to limitations, and is allowed as a deduction for purposes of computing the alternative minimum tax. The new law identifies the types of qualifying “unlawful discrimination” by reference to a long list of other laws that provide for employment claims. Practitioners should carefully review this list prior to determining that the new law is applicable to any settlement or judgment. In addition, the new law is prospective only, applying to fees and costs paid after October 22, 2004 that relate to any judgment or settlement that occurs after that date.

There are many aspects of the new law that are not clear. If you have recently received a judgment or settlement, and are uncertain as to the treatment of contingent attorney fees, we can help you determine the application of the new tax law to your situation.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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