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Handling Taxation of Settlements and Court Judgments

-by Neil E. Harl

Although the issue has been controversial since the decision in Cotnam v. Commissioner in 1959, the handling of settlements and court judgment recoveries has been a matter of major concern only in the last decade. The issue is whether legal fees paid to the taxpayer’s attorney or attorneys are excludible from the recovery or whether the entire recovery must be included in the taxpayer’s income, with the attorney’s fee treated as a miscellaneous itemized deduction subject to the two percent floor which often triggers alternative minimum tax.

Courts requiring full inclusion in income

The First, Second, Seventh, Ninth, Tenth, and the Federal Circuits and the U.S. Tax Court have all held that legal fees paid to the taxpayer’s attorney and withheld from the settlement payment are fully includible in the taxpayer’s income. That has been the Internal Revenue Service position, also. IRS has ruled that the entire settlement must be included in income with the attorney fees then deductible as an itemized deduction or as a trade or business expense.

Courts allowing attorney’s fees to be excluded

However, the Fifth, Sixth and Eleventh Circuit Courts of Appeals have allowed the portion of an attorney’s contingency fee paid to the attorney to be excluded from income. The Tax Court, hearing cases in those circuits, takes the same position. The theories for excluding attorney’s fees are based on the argument that contingency fees are property of the attorney and are bolstered by state law providing a lien, including a common law lien, under state law.

Cases on appeal to the U.S. Supreme Court

On March 29, 2004, the U.S. Supreme Court granted review of two cases on appeal—Banks v. Commissioner, a Sixth Circuit Court of Appeals case and Banaitas v. Commissioner, a case decided by the Ninth Circuit Court of Appeals. A decision is expected in 2005.

Partial statutory solution

In the American Jobs Creation Act of 2004, Congress provided a partial solution to the dispute over how attorney’s fees should be handled. That legislation provides that an above-the-line deduction can be claimed for fees and costs paid after October 22, 2004, with respect to a judgment or settlement occurring after that date. The deduction is limited to amounts attributable to attorney’s fees and costs received by individuals...
on account of claims of unlawful discrimination or specified claims against the government.26 The identified claims against the government include those brought under the False Claims Act.27 Regarding employment discrimination, the legislation identifies the types of “unlawful discrimination” by reference to a lengthy list of statutes that provide for employment-related claims.28 Specifically enumerated are: (1) section 302 of the Civil Rights Act of 1991; (2) sections 201, 202, 203, 204, 205, 206 or 207 of the Congressional Accountability Act of 1995; (3) the National Labor Relations Act; (4) the Fair Labor Standards Act of 1938; (5) section 4 or 15 of the Age Discrimination in Employment Act of 1967; (6) section 501 or 504 of the Rehabilitation Act of 1973; (7) section 510 of the Employee Retirement Income Security Act of 1974; (8) Title IX of the Education Amendments of 1972; (9) the Employee Polygraph Protection Act of 1988; (10) the Worker Adjustment and Retraining Notification Act; (11) section 105 of the Family and Medical Leave Act of 1993; (12) chapter 43 of Title 38 of the United States Code; (13) sections 1977, 1979 or 1980 of the Revised Statutes; (14) sections 703, 704 or 717 of the Civil Rights Act of 1964; (15) sections 804, 805, 806, 808 or 818 of the Fair Housing Act; (16) sections 103, 202, 302 or 503 of the Americans with Disabilities Act of 1990; (17) any provision of federal law prohibiting any form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law (commonly referred to as “whistle-blower” protection provisions); or (18) any provision of federal, state or local law providing for the enforcement of civil rights or regulating any aspect of the employment relationship, or prohibiting any form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.29

Because it is an above-the-line deduction, the attorney’s fees and costs are no longer subject to the reduction in itemized deductions for high income individuals and can be claimed for alternative minimum tax purposes. The above-the-line deduction is limited to the amount includible in the individual’s gross income for the tax year on account of a judgment or settlement resulting from the claim. In addition to providing relief only prospectively, the 2004 legislation necessarily excludes some types of recoveries where the problem of deductibility as a miscellaneous itemized deduction exists.

FOOTNOTES

1 263 F.3d 119 (5th Cir. 1959).


4 See I.R.C. §§ 56(b)(1)(A)(i), 67(b).

5 Alexander v. Internal Revenue Service, 72 F.3d 938 (1st Cir. 1995).


7 Kenseth v. Comm’r, 114 T.C. 399 (2000), aff’d, 259 F.3d 881 (7th Cir. 2001) (contingency fee includible in taxpayer’s gross income with attorneys’ fees deductible as miscellaneous itemized deduction subject to two percent floor; Clarks and Cotnam case not followed). Compare Reynolds v. Comm’r, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,525 (7th Cir. 2002) (legal defense expenditures subject to two percent floor).

8 Coady v. Comm’r, T.C. Memo. 1998-291 aff’d, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001) (wrongful termination suit; fees under contingency fee agreement not excludible; court rejected argument that attorney had a property interest in the action); Bennick-Woodward v. Comm’r, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001) (portion of punitive damage award retained by attorneys includible in taxpayer’s income; under California law, attorney’s lien does not confer ownership interest); Sinyard v. Comm’r, T.C. Memo. 1998-364, aff’d, 268 F.3d 756 (9th Cir. 2001), cert. denied, 6/10/02 (age discrimination suit; full amount constructively received and taxable to client). See also Brewer v. Comm’r, 99-1 U.S. Tax Cas. (CCH) ¶ 50,378 (9th Cir. 1999) (amount paid directly to attorney as legal fees not excludible from income); Frank Biehl, 118 T.C. 467 (2002) aff’d, 351 F.3d 982 (9th Cir. 2003) (fee paid to attorney as part of settlement agreement of wrongful termination claim not excludible from income; treated as miscellaneous itemized deduction subject to two percent floor); Freeman v. Comm’r, T.C. Memo. 2001-254, aff’d, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,335 (9th Cir. 2003) (attorney’s fees included in income but eligible for miscellaneous itemized deduction); Banaitus v. Comm’r, 340 F.3d 1074 (9th Cir. 2003), cert. granted, 3/29/04.

9 Hukkanen-Campbell v. Comm’r, T.C. Memo. 2000-180, aff’d, 274 F.3d 1312 (10th Cir. 2001) (contingency fee portion of settlement taxed to individual).

10 Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

11 Brenner v. Comm’r, T.C. Memo. 2001-127 (legal fees for terminated employee in settlement of claims were miscellaneous itemized deductions and includible in calculating alternative minimum tax).

12 See 5 Harl, note 2 supra.


14 Id.
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CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

DISCHARGE. The debtor was the president of and owned 50 percent of a corporation which operated a grain warehouse. The debtor had issued eight warehouse receipts for corn and soybeans purchased from the warehouse when the warehouse did not have sufficient inventory to cover the receipts. The shortage was discovered on audit and the Nebraska Public Service Commission closed the warehouse, seized the inventory and took control of the corporation’s records. The holder of the warehouse receipts sued the debtor for fraudulent misrepresentation, negligent misrepresentation and deceptive trade practices. The debtor did not provide any testimony, invoking the debtor’s Fifth Amendment right against self-incrimination. A summary judgment was granted to the receipt holder, along with a monetary judgment. The debtor filed for Chapter 7 and the judgment creditor sought a ruling that its judgment was nondischargeable. The court held that the failure of the debtor to testify in the state court proceedings was insufficient to avoid application of res judicata or collateral estoppel. In addition, the court noted that the judgment creditor had presented sufficient independent evidence of fraud to support nondischargeability of the judgment award.


CHAPTER 13

LIEN AVOIDANCE. The debtor filed for Chapter 13 and sought avoidance of a tax lien. The IRS argued that the debtor did not have any power to avoid liens in Chapter 13. Although the court acknowledged a split of authority on the issue, the court upheld the Bankruptcy Court decision to allow the debtor to avoid the lien.


FEDERAL TAXATION

DISCHARGE. The debtor had timely filed income tax returns for 1981, 1982, 1983, and 1984. The returns were audited and assessments made for additional taxes due to the adjustment of the cost basis of the sale of stock. For several years, the debtor or the debtor’s attorney met with IRS agents, arguing that the adjustments were incorrectly made. The debtor made two offers in compromise, both of which were rejected. The debtor then filed for Chapter 7 and sought a ruling that the 1981 through 1984 taxes were dischargeable. The IRS argued that the taxes were nondischargeable under Section 523(a)(1)(C) for willfully attempting to evade payment of the taxes. The IRS pointed to the debtor’s closing of all bank accounts and stalling tactics in making very low offers in compromise. The court held that the debtor’s conduct was not sufficient to demonstrate a willful attempt to evade payment of the taxes. The court found that the debtor had worked with the IRS over the years to resolve the dispute and had made two offers in compromise. The court also noted that the debtor had not attempted to hide assets or made any false statements to mislead the IRS. The court held that the

15 Ltr. Rul. 200203010, Oct. 4, 2001 (attorney fees not itemized deduction but trade or business deduction so not subject to alternative minimum tax).
16 Cotnam v. Comm’r, 263 F.3d 119 (5th Cir. 1999); Srivastava v. Comm’r, T.C. Memo. 1998-362, rev’d, 220 F.3d 353 (5th Cir. 2000) (attorney had common law lien under Texas law).
17 Estate of Clarks, 202 F.3d 854 (6th Cir. 2000) (contingency fees are property of attorney; not taxable to client); Brisco v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,420 (6th Cir. 2001) (interest earned on attorney’s contingency fee could be excluded from income; involved personal injuries); Banks v. Comm’r, 345 F.3d 373 (6th Cir. 2003), cert. granted, 3/29/04.
18 Davis v. Comm’r, T.C. Memo. 1998-248, aff’d, 210 F.3d 1346 (11th Cir. 2000) (Cotnam v. Comm’r, supra, followed; involved same jurisdiction).
21 345 F.3d 373 (6th Cir. 2003), cert. granted, 3/29/04.
22 340 F.3d 1074 (9th Cir. 2003), cert. granted, 3/29/04.
24 It is not clear when a judgment or settlement “occurs.” See Wood, “Effective Date of Attorney Fee Deduction Misses Many Judgments,” 105 Tax Notes 1643, 1644 (Dec. 20, 2004).
26 Id.
27 Id.
28 I.R.C. § 62(e).
29 Id.