

New Rules, New Ruling

The tax treatment of litigation proceeds and legal fees.

BY RICHARD MASON

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EXECUTIVE SUMMARY

■ **The tax treatment of damages** and legal fees and costs varies according to the type of underlying claim. Congressional action providing an above-the-line deduction for legal fees for discrimination claims and a recent Supreme Court decision in *Commissioner v. Banks* have contributed to making the treatment of damage awards somewhat more manageable.

■ **Damages for personal injury** or sickness and the related legal fees and costs are excludable from gross income, but the punitive or interest components are not. Taxpayers must allocate legal fees according to the rules in IRC section 104(a)(2). Damages for discrimination and employment-related claims are included in gross income net of the legal fees and costs, but not less than zero under IRC section 62(a)(20).

■ **Only the net amount of damages** received from qualified settlement funds is included in gross income. Essentially, the legal fees and costs are afforded an above-the-line deduction.

■ **All other damages received** are included in gross income in full, including the amounts that may have been paid directly to the attorneys. Legal fees and costs are deductible only as miscellaneous deductions under IRC section 212 and are subject to both the 2% of AGI limit and the 3% overall limitation on itemized deductions and are disallowed under the AMT.

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Within the past two years two major developments—new legislation and a court decision—have changed the federal tax treatment of legal fees incurred in connection with personal damage awards. As a result, the taxability of litigation proceeds and the deductibility of related legal fees and court costs have become somewhat clearer. This article breaks litigation awards into four categories and summarizes the tax treatment afforded to each.

FINALLY, NEW GUIDANCE

In October 2004 Congress enacted the American Jobs Creation Act. Included in it was new IRC section 62(a)(20) which provides an above-the-line deduction for legal fees and court costs incurred in connection with discrimination awards. This provision allows individuals, who previously were entitled to only a miscellaneous

itemized deduction, to deduct their legal fees and court costs in arriving at adjusted gross income. The deduction cannot exceed the amount reported as gross income from the litigation. This provision was effective for all covered claims settled or awarded after October 22, 2004.

In January 2005 the U.S. Supreme Court rendered its decision in the consolidated cases of *Commissioner v. Banks* and *Commissioner v. Banaitis*, 543 US 426 (2005). The ruling eliminated an existing division in the circuit courts and required taxpayers to include in gross income all litigation proceeds, including any amount that went to the lawyers under a contingent fee arrangement.

THE FOUR CATEGORIES OF LITIGATION CLAIMS

Litigation proceeds and the related legal fees generally fall into four categories:

- Personal injury claims where the proceeds are excluded from gross income under IRC section 104(a)(2).
- Discrimination claims that qualify for the new deduction for AGI under section 62(a)(20).
- Claims where only the net proceeds of the litigation are reportable as gross income.
- Claims that remain fully includible in gross income, but where the related legal fees and court costs are not eligible for the above-the-line deduction outlined in section 62(a)(20).

Personal injury exclusion. Proceeds from personal injury or sickness-only claims are excluded from income under section 104(a)(2). The legal fees litigants pay for claims that fall fully under this exclusion are not at issue, since the exclusion of any income renders the legal fee deduction question irrelevant.

Personal injury awards can include both compensatory and punitive portions. An example would be when an individual sues a pharmaceutical company for drug-related injuries and is awarded both compensatory and punitive damages because the company failed to adequately warn doctors and consumers of the risks. Only the compensatory portion is excludable from income; punitive damages are included in gross income.

When a damage award or settlement has both components, the taxpayer must allocate the proceeds and legal fees paid. The punitive component is included in gross income and any allocated legal fees and court costs are deductible as miscellaneous itemized deductions under IRC section 212 as expenses incurred in the production of income. This classification puts punitive proceeds into the fourth category.

Taxpayers are unable to get advance rulings from the IRS on the excludability and allocations of damage awards (revenue procedure 2005-3). As a result many have attempted to exclude large portions or the entire damage award when they should have made a different allocation. CPAs should be aware the IRS does pursue the allocation issue and has been reasonably aggressive when the issue arises on audit, so clients should follow established law and case precedent or risk the consequences.

Discrimination claim. Section 62(a)(20) covers many claims. Section 62(e) defines “discrimination,” but goes beyond traditional discrimination. It applies to any civil rights claim as well as to a broad spectrum of employment-related claims, including any employment-related legal claim under federal, state, common or local law. This includes cases of age, gender or racial discrimination. Section 62(e)(18)(ii) says it includes any actions “regulating any aspect of the employment relationship, including claims for wages, compensation, or

benefits... any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.” On its face the statute seems to cover almost any employee vs. employer litigation. And in 2005 the Supreme Court interpreted it as covering the wrongful termination claim in *Banaitis*.

If a claim is covered under section 62(a)(20), the litigation proceeds, minus the legal fees and costs—but not less than zero—are includible in the taxpayer’s AGI. The statute does not distinguish between contingent or hourly legal fees, so all legal fees can be deducted if the claim is covered under this section.

Other claims where net proceeds are income. This category encompasses claims that fall outside sections 62(a)(20) and 104(a)(2) but under either fee-shifting statutes, where the court awards legal fees directly to counsel, or “qualified settlement funds” covered by Treasury regulations section 1.468B-1. The taxability of the distributions that are made from these funds is covered by regulations section 1.468B-4, which says

“Whether a distribution to a claimant is includible in the claimant’s gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor. For example, to the extent a distribution is in satisfaction of damages on account of personal injury or sickness, the distribution may be excludable from gross income under section 104(a)(2). Similarly, to the extent a distribution is in satisfaction of a claim for forgone taxable interest, the distribution is includible in the claimant’s gross income under section 61(a)(4).”

Examples of such claims include securities, non-personal-injury product liability and business practice class-actions with numerous plaintiffs. For instance, a telecommunications or cable company may systematically overcharge customers for certain fees, leading to a class action. The damages in such cases would not be excludable under section 104(a)(2) nor would they be considered discrimination or employment-related under section 62(a)(20). Accordingly, they are includible in income. The large majority of securities and other class-action cases result in the establishment of a qualified settlement fund from which legal fees are paid directly. Only the net amount distributed to claimants is includible in gross income under regulations section 1.468B-4. Thus, for claims in this category, the contingent legal fees are effectively deducted above the line by operation of the relevant Treasury regulation.

Claims that don’t fall into other categories. This category includes a variety of traditional non-personal-injury tort claims, such as slander or libel, as well as all other nonemployment and nondiscrimination cases such as contract claims. Disregarding any insurance implications, an example of such a claim would be a situation where a defective barbecue grill causes a home to catch fire. For claims in this category a litigant is subject to the ruling in *Banks*, which requires the total proceeds be included in income and the legal fees deducted as a miscellaneous itemized deduction under section 212 as an expense incurred to produce income.

These deductions are subject to the 2% of AGI floor and the 3% overall limitation on itemized deductions. They also are disallowed for alternative minimum tax (AMT) purposes, effectively negating the value of the deductions for many taxpayers. The problem is exacerbated for taxpayers living in states with a personal income tax, since itemized deductions for state and local taxes also are disallowed for AMT purposes. CPAs may wish to recommend these clients postpone—to the extent permitted by law—the payment of state and local taxes resulting from the suit to the year following a damage award.

» Practical Tips

- ▶ Be cautious about advising clients that damages are excluded from gross income under IRC section 104(a)(2). The IRS actively pursues this issue on audit and will not give taxpayers advance rulings.
- ▶ If damage awards will trigger the AMT, it may be possible to mitigate the impact by deferring the payment of any state and local taxes related to the damages into the next tax year.
- ▶ Keep an eye out for additional legislation, court decisions or changes in IRS policy that might resolve remaining inequities in the treatment of damage awards and related legal fees.

A PARTIAL SOLUTION

While Congress took a big step in resolving the taxability of contingent legal fees with the enactment of section 62(a)(20), it did not fully resolve the problem. Some uncertainty remains as to exactly what claims are covered and the same underlying economic problem exists for litigants whose claims are left out of the categories that either exclude the income or provide for either a stated or de facto above-the-line deduction for contingent legal fees. The allocation issue for personal injury claims also remains.

In addition the rules still fail to provide complete horizontal equity for taxpayers regarding litigation proceeds. This inequity likely will result in continued litigation between taxpayers and the IRS over legal fees and ongoing litigation over the personal injury allocation issue. *Banks* reached the Supreme Court because the circuit courts were divided. Once the remaining legal fee issues move through the courts, a similar division may again develop.

Congress may choose to resolve this issue for all claimants. Since it was willing to address the problem for discrimination and employment-related claims, it's not hard to envision additional legislation providing for a broader base of claims that receive the off-the-top deduction. This would be simpler than, and likely preferable to, continued litigation over these issues. It's also possible the IRS will change its current stance and begin to provide some useful advance guidance to aid taxpayers in allocating their personal injury claims.

Until one of these alternatives is realized, CPAs can help their clients—particularly in open fact situations—by advising them of the alternative tax treatments for particular types of litigation proceeds. This may be especially helpful to clients during settlement negotiations where there may be an opportunity to modify the settlement language to make the client eligible for more favorable tax treatment. ♦

RESOURCES

AICPA Tax Section

CPAs can keep up-to-date on tax regulatory and legislative developments by joining the AICPA Tax Section. Members of this section have access to technical resource panels and content, receive free publications including *Tax Practice Guides and Checklists*, and can subscribe to *The Tax Adviser* at a reduced price. For information on how to join, go to

<https://www.cpa2biz.com/ResourceCenters/Tax/AICPA+Tax+Section/MemTax.htm>

<https://www.cpa2biz.com/ResourceCenters/Tax/AICPA+Tax+Section/MemTax.htm>).

Publication

Taxation of Damage Awards and Settlement Payment (3rd edition), by Robert W. Wood (Tax Institute, Calif., 2006), covers key developments in this area and presents relevant cases.