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† *As the Article was going to press, a modified version of the Senate bill described in Part III cleared the Congressional conference committee and became effective when President Bush signed it into law on October 22, 2004 as part of the American Jobs Creation Act of 2004. This legislative development and its impact on the issues discussed in the Article are briefly addressed in an Addendum.*

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INTRODUCTION

One of the chief features of the alternative minimum tax (the "AMT") is a broadened tax base, accomplished in part through the disallowance of deductions that are not central to measuring an individual's net income. Yet in achieving its objective of limiting deductions, the AMT casts a wide net. Thus, in certain instances, an individual can be robbed of the tax benefit of expenses that were critical to the production of the income being taxed. An extreme example of this problem is the treatment of certain litigation expenses under the AMT. If an individual incurs attorney fees and other associated costs in connection with litigation that produces a taxable recovery and the litigation does not relate to the individuals's trade or business (excluding the trade or business of performing services as an employee), then deduction for litigation expenses is disallowed. This "AMT trap" results in the individual being taxed on the gross proceeds of the litigation for AMT purposes.

The most common lawsuits in which the AMT trap arises are employment-related lawsuits, such as those involving discrimination, harassment, whistleblower, and breach of employment contract claims. However, the AMT trap also affects other common claims, such as civil rights, intentional infliction of emotional distress, and defamation claims, provided that these claims do not involve personal physical injury.[1] The AMT trap is disconcerting for a number of reasons. First, it so obviously violates the fundamental income tax policy principle that expenses incurred to produce taxable income should not be included in the tax base. Second, the adverse consequences of the trap are typically quite severe. Third, though a legislative amendment would be relatively inexpensive, such an amendment has not yet been enacted because the victims of the trap lack sufficient political muscle and coordination. Fourth, the trap has consumed a tremendous amount of judicial resources. While most of these resources have been devoted to litigating the underlying tax issue, courts have been called upon to address a host of non-tax issues that arise on account of the AMT trap.

This Article discusses the AMT trap, beginning in Part I with a description of the mechanics of the trap. This Part also examines the current Circuit Court split regarding the tax issue that underlies the AMT trap and previews the upcoming United States Supreme Court decision that will resolve the Circuit Court split. Part II of the Article then considers the implications of the trap on plaintiffs, their lawyers, defendants, and the courts. Finally, Part III describes and critically analyzes two bills that have been proposed, but have not yet been enacted, that were designed to solve the AMT trap.

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1. The trap may also apply to claims for punitive damages even where the underlying claim relates to a personal physical injury. See IRC § 104(a)(2) (specifically excluding punitive damages from the scope of the gross income exclusion).

I. THE AMT TRAP

A. An Example

Assume that Paula settles an employment discrimination lawsuit for $1,000,000 and, pursuant to her fee agreement with her lawyer, $400,000 of the settlement is paid directly from the defendant to the lawyer.[2] For simplicity purposes, also assume that Paula has no other income or deductions.

The important tax issue facing Paula is whether she may exclude the attorney fee portion of the settlement from gross income and report only $600,000 of gross income on her return (the "exclusion method")[3] or whether Paula is required to report the entire $1,000,000 as gross income, leaving her with a $400,000 deduction for the attorney's fees paid (the "inclusion and deduction method").[4] If, under the latter method, Paula's fee deduction were unimpaired, the tax consequences under both methods would be identical, since she would ultimately be taxed only on her net $600,000 recovery. In fact, though, the fee deduction is impaired, most significantly by the AMT.

Under the exclusion method, Paula would report only $600,000 of gross income and take the standard deduction of $4,750,[5] which would result in $595,250 of taxable income. Applying the tax rates in section 1(c) to this amount yields a tax due of $189,670.[6] Paula's after-tax recovery from the lawsuit thus equals $410,331 and her effective tax rate on the recovery is 31.6%. Under the inclusion and deduction method, however, the AMT will be implicated. The fee deduction is characterized as an unreimbursed employee business expense and, as a result, is classified as a miscellaneous itemized deduction.[7] Because of this classification, the fee deduction is disallowed in its entirety for AMT purposes.[8] Accordingly, Paula's alternative minimum taxable

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2. In the typical case, the attorney would also be reimbursed out of the settlement proceeds for costs advanced in prosecuting the case. For tax purposes, whether amounts paid to the attorney represent attorney's fees or reimbursements of costs is immaterial. Accordingly, this Article refers only to attorney's fees; however, the analysis is equally applicable to costs.

3. See infra notes 20-21 and accompanying text.

4. See infra notes 22-24 and accompanying text.

5. See IRC § 63(c).

6. See IRC § 1(c) (providing tax rates for single taxpayers).

7. See Alexander v. Comm'r, 72 F.3d 938, 944-47 (1st Cir. 1995) (holding that employee's legal fees incurred in connection with litigation arising out of employee's employment constitute unreimbursed employee business expenses); Biehl v. Comm'r, 351 F.3d 982 (9th Cir. 2003) (same). But see Laura Sager & Stephen Cohen, How the Income Tax Undermines Civil Rights Law, 73 S. Cal. L. Rev. 1075, 1096-97 (2000) (arguing that legal fees such as Paula's should be treated as *reimbursed* employee business expenses).

8. IRC § 56(b)(1)(A) (miscellaneous itemized deductions disallowed under the AMT).

income equals $1,000,000, and her ultimate tax liability equals $276,500.[9] Paula's after-tax recovery on her lawsuit thus equals $323,500 and her effective tax rate on the recovery equals 46.1%.[10]

Therefore, under the exclusion method, Paula ends up with $86,831 more after tax than under the inclusion and deduction method. As a result, Paula would argue that the exclusion method is the one that should be applied.

B. Tax Policy Implications

Before explaining how the courts have gone about determining which of the two methods is appropriate, it is helpful first to analyze each method from a tax policy perspective. This analysis makes clear that the exclusion method, which results in the taxation of only the taxpayer's net recovery, is the correct one as a matter of policy.

It is axiomatic that, under an income tax, the expenses incurred to produce income must be excluded from the tax base.[11] Therefore, in Paula's case, she should not pay tax on the $400,000 of attorney's fees that she incurs because they are incurred to produce her $600,000 net recovery. This proper result can be achieved either by allowing Paula to exclude the $400,000 attorney fee portion of the recovery from gross income (as under the exclusion method) or, alternatively, by requiring her to include the entire $1,000,000 recovery in gross income but then allowing her a full and unimpaired deduction for the attorney's fees (as under the inclusion and deduction method but only if the deduction were unimpaired).

Therefore, the inclusion and deduction method achieves the wrong policy result primarily because Paula's deduction for attorney's fees constitutes a miscellaneous itemized deduction that is categorically disallowed for AMT purposes.[12] The AMT targets miscellaneous itemized deductions because they, in general, tend to constitute small expenses that have both tenuous relationships to the income that they help to create and "characteristics of voluntary personal

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9. IRC § 55(b)(i) (providing marginal rates for AMT). Paula would be taxed on the first $175,000 at a rate of 26% and on the additional $825,000 at a rate of 28%. Even though the AMT contains a significant exemption, Paula would be phased out of the exemption based on her income level. IRC § 55(d).

10. In a worst-case scenario, a plaintiff could actually be taxed on 100% or more of their actual recovery. See Kenseth v. Comm'r, 114 T.C. 399, 425-26 (2000); See also Adam Liptak, Tax Bill Exceeds Award to Officer in Sex Bias Suit, N.Y. Times, Aug. 11, 2002, § 1, at 18 (describing case of discrimination plaintiff, who despite obtaining $1,250,000 judgment, ends up with after-tax loss of $99,000).

11. Hantzis v. Comm'r, 638 F.2d 248, 249 (1st Cir. 1981).

12. We say "primarily" because even if the AMT were amended to allow the deduction in its entirety, the deduction would still be impaired under the regular tax system pursuant to §§ 67 and 68, though such impairment would tend to be relatively minor.

expenditures."[13] Of course, Paula's fee deduction lacks all three of these characteristics – it is extremely large, has a direct relationship to taxable income (i.e., her recovery), and has no personal consumption elements.[14] Therefore, Paula's deduction for her legal fees should be allowed in full.

C. Which Method Applies?

1. The Circuit Court Split

While it is abundantly clear that, from a tax policy perspective, only the exclusion method achieves the correct policy result,[15] it is not so clear that this result can be achieved under current law. In fact, there has been a great deal of litigation regarding the issue, causing a pronounced federal circuit split.[16] The First, Second, Third, Fourth, Seventh, Tenth, and Federal Circuits have determined that the inclusion and deduction method is required even though it yields the wrong policy result,[17] while the Fifth, Sixth, and Eleventh Circuits have concluded that the exclusion method is appropriate.[18] In addition, the juris

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13. Staff of the Joint Comm. on Tax'n, 100th Cong., General Explanation of the Tax Reform Act of 1986 78-79 (Comm. Print 1987). See also Deborah A. Geier, Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs, 88 Tax Notes 531, 533-34 (July 24, 2000).

14. See Geier, supra note 13, at 534.

15. See Robert J. Peroni, Reform in the Use of Phaseouts and Floors in the Individual Tax System, 91 Tax Notes 1415, 1423 (May 28, 2001) (stating that inclusion and deduction method provides "an inappropriate result from a tax policy point of view"); Sager & Cohen, supra note 7, at 1103 (stating that "tax policy considerations should favor permitting plaintiffs either to deduct fully or to exclude the recovery of attorney's fees"); James Serven, Oral Argument in Hukkanen-Campbell: Taxpayer's Last Stand?, 93 Tax Notes 854, 859 (Nov. 5, 2001) (stating that "[t]here is simply no public policy or conceptual theory by which the denial of a deduction under the AMT for...attorney's fees...can be plausibly defended"). Professors Sager and Cohen also argue that the effect of the inclusion and deduction method "undermines the national policy of encouraging the pursuit of meritorious civil rights claims." Sager & Cohen, supra note 7, at 1078.

16. See Nat'l Taxpayer Advocate, 2002 Ann. Rep. to Cong. at 161-166 (describing litigation and circuit split on the issue).

17. Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995); Raymond v. United States, 355 F.3d 107 (2d Cir. 2004); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

18. Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959); Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Estate of Clarks v. Comm'r, 202 F.3d 854 (6th Cir. 2000); Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), cert. granted 124 S.Ct. 1712 (2004). See also Gregg D. Polsky and Stephen F. Befort, Employment Discrimination Remedies

prudence from the Ninth Circuit on this issue is particularly bizarre. Different panels in this circuit have reached opposing conclusions based on the applicable attorney's lien statute, whereas yet another panel has suggested that the particulars of state attorney lien law are irrelevant.[19]

The issue in these cases has been the appropriate characterization of the contingent fee agreement. Courts using the exclusion method determine that the fee agreement operates to transfer a portion of the plaintiff's claim to the attorney at the time the fee agreement is executed.[20] According to this view, when the attorney is paid, the payment is attributable to the attorney's pre-existing interest in the claim. The payment therefore is not included in the plaintiff's gross income.[21]

On the other hand, courts using the inclusion and deduction method determine either that (i) the contingent fee agreement effects no such transfer of a portion of the claim,[22] or (ii) if such a transfer is deemed to occur, the transfer nevertheless is ineffective for tax purposes under the assignment of income doctrine.[23] As a result, these courts hold that the plaintiff must include the full amount of the recovery (including the attorney fee portion) in their gross income and then take a deduction for the attorney fee portion.[24]

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and Tax Gross Ups, 90 Iowa L. Rev. 67, 85 (2004) (providing chart demonstrating circuit split).

19. Compare Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000) (requiring full inclusion where fee agreement governed by California law) and Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001) (requiring full inclusion where fee agreement governed by Alaska law), with Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), cert. granted 124 S. Ct. 1713 (2004) (allowing exclusion where fee agreement governed by Oregon law). In the midst of these decisions that were decided on the basis of the applicable state attorney's lien law, the Ninth Circuit declared that the particulars of state law were not relevant in determining the federal tax consequences of the fee payment. See Sinyard v. Comm'r, 268 F.3d 756, 760 (9th Cir. 2001), cert. denied, 596 U.S. 94 (2002) (stating "we do not see how the existence of a lien in favor of the taxpayer's creditor makes the satisfaction of the debt any less income to the taxpayer whose obligation is satisfied"); see also Polsky and Befort, supra note 18, at 86 (describing split within the Ninth Circuit).

20. See, e.g., *Cotnam*, 263 F.2d at 125; Davis v. Comm'r, 210 F.3d 1346, 1347 (11th Cir. 2000); *Estate of Clarks*, 202 F.3d at 856; *Srivastava*, 220 F.3d at 364.

21. See, e.g., *Cotnam*, 263 F.2d at 125; *Srivastava*, 220 F.3d at 363.

22. See, e.g., *Young*, 240 F.3d at 376-77.

23. See, e.g., *Hukkanen-Campbell*, 274 F.3d at 1314; *Sinyard*, 268 F.3d at 758-59. For a full discussion of the assignment of income doctrine in the context of contingent fee arrangements, see Gregg D. Polsky, A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruit and the Trees, 37 Ga. L. Rev. 57, 78-92 (2002).

24. See *Kenseth*, 259 F.3d at 884; *Coady*, 213 F.3d at 1199; *Young*, 240 F.3d at 376-78.

In determining which method is appropriate, some courts have analyzed state attorney lien law to determine the strength of the attorney's rights and powers with respect to the attorney fee portion of the plaintiff's claim.[25] In general, these courts evaluate the attorney lien law to determine to what extent it grants the attorney a proprietary interest in the plaintiff's cause of action.[26]

For example, in *Raymond v. United States*,[27] the Second Circuit analyzed Vermont's attorney lien common law and concluded that, because Vermont law provided the attorney with only a mere security interest and precluded the attorney from taking a proprietary interest in his client's claim, no transfer of any portion of the claim occurred upon execution of the fee agreement.[28] As a result, the Second Circuit determined that the inclusion and deduction method was the proper one.[29] In contrast, in *Cotnam v. Comm'r*,[30] the Fifth Circuit analyzed Alabama's attorney lien statute and concluded that, because the statute gave attorneys "the same rights as their clients" with respect to the claim, a transfer of a portion of the claim did occur upon execution of the fee agreement.[31] Accordingly, the Fifth Circuit determined that the exclusion method was appropriate.[32]

Other Circuits have rejected completely the notion that the nuances of underlying attorney lien statutes have any relevance to the issue. While this group includes circuits that have adopted the inclusion-deduction method,[33] it also includes circuits that have adopted the exclusion method.[34] For instance, the Fifth Circuit in *Srivastava v. Comm'r* followed its holding in *Cotnam* that the contingent attorney's fee was not included in the plaintiff's gross income, refusing to distinguish the case based on the fact that the relevant attorney's lien statute in effect in Texas was not quite as strong as the Alabama statute at issue in *Cotnam*.[35] Instead, the Fifth Circuit agreed with the Tax Court that "the

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25. See, e.g., *Kenseth*, 259 F.3d at 883-84; *Baylin*, 43 F.3d at 1455; *Raymond*, 355 F.3d at 117; *Banaitis*, 340 F.3d at 1082-83.

26. For a full discussion of the attorney lien issue, see generally Thad Davis, Cotnam v. Comm'r and the Income Tax Treatment of Contingency-Based Attorneys' Fees: The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head-On, 51 Ala. L. Rev. 1683 (2000).

27. 355 F.3d 107 (2d Cir. 2004).

28. Id. at 117.

29. Id.

30. 263 F.2d 119 (5th Cir. 1959).

31. Id. at 125.

32. Id. at 126.

33. See *Alexander*, 72 F.3d at 942-43; O'Brien v. Comm'r, 38 T.C. 707, 712; *Young*, 240 F.3d at 372; *Hukkanen-Campbell*, 274 F.3d at 1314.

34. *Srivastava*, 220 F.3d at 355; *Banks*, 345 F.3d at 386.

35. *Srivastava*, 220 F.3d at 363-64.

answer does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state."[36]

2. *Critical Analysis of the Circuit Court Decisions*

a. *Critique of the Minority View*

The minority view, which follows the exclusion method based on the characterization of the contingent fee agreement as resulting in an immediate transfer of a portion of the plaintiff's claim, can be criticized on two grounds. First, it is questionable whether a contingent fee agreement should be considered to result in an immediate transfer of a portion of the plaintiff's claim for tax purposes. Second, even assuming such a transfer is deemed to occur, it would appear that a proper application of the tax law still requires the inclusion and deduction method.

The minority view holds that, when the fee agreement is executed, an immediate transfer occurs.[37] Under this characterization, the plaintiff and the attorney emerge from the execution of the fee agreement as co-owners of the claim, with the relative ownership of the claim determined by the percentage contingency fee charged by the attorney. However, it may be more accurate to characterize the contingent fee agreement as a mere promise on the part of the plaintiff to pay to the attorney a contingent amount of money upon final disposition of the claim. Under this "mere promise to pay" characterization, upon final disposition the plaintiff will be required to include the entire recovery in gross income (leaving her with a deduction for the fees paid), regardless of whether the parties arrange for the defendant to pay the contingent fee directly to the attorney.[38]

The issue of whether the fee agreement results in an immediate transfer or, alternatively, is a mere promise to pay, depends on which party is treated as the owner of the attorney fee portion of the claim for tax purposes.[39] In determining ownership of an asset, courts have analyzed the "incidents of ownership" to determine which party is, in substance, the owner.[40] With respect to the attorney fee portion of the claim, the incidents of ownership are divided. While the attorney would receive the benefit of future appreciation in the value

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36. Id. at 364.

37. See IRC § 83 (property transferred in exchange for services).

38. See Old Colony Trust Co. v. Comm'r, 279 U.S. 716, at 729-30 (holding that payment of another person's debt constitutes gross income to the debtor). See also Polsky, supra note 23, at 93-94.

39. See Treas. Reg. § 1.83-3(a) (providing that transfer of property occurs when taxpayer "acquires a beneficial ownership interest in such property").

40. See Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1237 (1981) (analyzing facts and circumstances to determine whether transfer of property occurred for tax purposes).

of his portion of the claim and would bear the risk of loss if such value diminished, the client retains the sole and unrestricted power to make the critical decisions with respect to the entire claim, such as the all-important decision of whether, when, and for how much to settle the claim.[41] Because of this division of the incidents of ownership, it is not entirely clear whether the fee agreement should be treated as resulting in an immediate transfer of the attorney fee portion of the claim.

Yet even if the fee agreement can be characterized as effecting an immediate transfer of the attorney fee portion of the claim to the attorney, such characterization would still produce the same results as the inclusion and deduction method. This is so because the transfer by the plaintiff to the attorney of the attorney fee portion of the claim (which has a zero basis in the hands of the plaintiff) in exchange for the attorney's provision of services is one that has tax consequences for the plaintiff. Courts in the minority have repeatedly ignored these consequences, concluding without any analysis that, once it is determined that the fee agreement results in an immediate transfer, the plaintiff is required to include only the net recovery in gross income.[42]

What these courts have failed to recognize, however, is that because the attorney fee portion of the claim is transferred in connection with the provision of services, section 83 governs the tax consequences of the transfer. Furthermore, because the attorney's interest in the cause of action is subject to a substantial risk of forfeiture in that the attorney is not entitled to his contingency fee unless he provides services until the claim is liquidated, the tax consequences of the transfer of the attorney portion of the cause of action are held in abeyance until the risk of forfeiture on the attorney's interest in the claim lapses (i.e., upon liquidation of the claim). At that point, the plaintiff realizes gain on the disposition of the attorney portion of the cause of action equal to the contingent fee.[43] Combining this gain with the recovery on the portion of the claim retained by the plaintiff after execution of the fee agreement leaves the plaintiff with gross income equal to the full recovery. To round matters out, the

41. See Polsky, supra note 23, at 104.

42. See Polsky, supra note 23 at 75-76; see also Brief for Amici Curiae Professor Gregg D. Polsky and Professor Brant J. Hellwig in Support of Petitioner, at 14-15, Comm'r v. Banks, U.S. Supreme Court Docket No. 03-892 (filed June 11, 2004) [hereinafter Polsky & Hellwig Brief].

43. See Treas. Reg. § 1.83-6(b) (providing that, when property is transferred in exchange for services, the property transferor realizes gain or loss as if the property was sold for its fair market value). For a detailed discussion of the tax consequences for the plaintiff resulting from a hypothetical transfer of the attorney-fee portion of the claim to the attorney, see Polsky, supra note 23, at 108-111; Polsky & Hellwig Brief, supra note 42, at 7-13.

plaintiff is entitled to deduct the value of the portion of the claim transferred to the attorney when the attorney's interest in the cause of action becomes vested.[44]

In summary, the cases adopting the minority view strain to characterize the fee agreement as more than a mere promise to pay without realizing that their attempt to achieve the right policy result on this basis should ultimately be futile. Once section 83 is appropriately applied to the purported transfer of the attorney fee portion of the claim that occurs upon execution of the fee agreement, the resulting tax consequences are the same as those obtained under the inclusion-deduction method.[45] The failure of the courts adopting the exclusion method to fully appreciate or so much as acknowledge the tax consequences of the transfer of the portion of the claim from plaintiff to attorney is a critical error, as it directly affects the outcome in those cases.

b. Critique of the Majority View

The cases that hold that the inclusion and deduction method is required achieve the correct doctrinal result, but, in many cases, their analysis is flawed because they inappropriately apply the assignment of income doctrine. The assignment of income argument usually goes as follows: to the extent that the contingent fee agreement operates to cause an immediate transfer of anything, it transfers only the right to the proceeds of the attorney fee portion of the claim and not the attorney fee portion of the claim itself.[46] Such a transfer is wholly ineffective for tax purposes because such a transfer is a transfer of "income" rather than a transfer of "property" for assignment of income purposes.[47] Using the familiar *Lucas v. Earl* metaphors,[48] because the agreement transfers fruit and not tree, the transfer is ignored. As a result, the plaintiff is treated as receiving

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44. IRC § 83(h). However, the deduction remains miscellaneous itemized deduction, subject to the various limitations that accompany this characterization. See IRC §§ 56(b)(1)(A); 67(a); 68(a).

45. See Polsky, supra note 23, at 108-111; see also Polsky & Hellwig Brief, supra note 42, at 12-13.

46. Hukkanen-Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001); Sinyard v. Comm'r, 268 F.3d 756, 758-59 (9th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881, 883-84 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 376-78 (4th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000); 121 F.3d 393, 395-96 (8th Cir. 1997); Alexander v. I.R.S., 72 F.3d 938, 942-43 (1st Cir. 1995); Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532, 532 (3d Cir. 1963).

47. *Kenseth*, 259 F.3d at 884.

48. 281 U.S. 111, 115 (1930) (using fruit and tree metaphor).

the entire settlement amount and then transferring the attorney fee portion to the attorney.[49]

The flaw in this analysis is that the court-developed assignment of income doctrine does not apply to arm's-length commercial transactions, such as contingent fee arrangements.[50] The purpose of the doctrine is to prevent manipulation of the progressive rate structure through the gratuitous deflection of pre-tax dollars to members of a taxpayer's bounty.[51] This, of course, is not what is taking place when clients hire attorneys on a contingent fee basis.

Because of the inapplicability of the assignment of income doctrine, it is completely irrelevant whether the "thing" that is purportedly transferred upon execution of the fee agreement is tree (a portion of the claim itself) or fruit (a right to the proceeds of a portion of the claim) for assignment of income purposes.[52] From a practical perspective, it does matter whether the fee agreement is treated as causing an immediate transfer of something (either a portion of the claim or a right to proceeds from such portion) or, alternatively, is treated as a mere promise to pay.[53] This determination is academic because, though it affects the mode of analysis, the outcome should be the same in that the plaintiff must include the entire settlement amount in gross income.[54]

c. The (Ir)Relevance of State Attorney Lien Law

Courts in both the minority and majority camps have sometimes scrutinized underlying state attorney lien law in determining whether the contingent fee agreement should be construed to result in an immediate transfer

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49. See *Kenseth*, 259 F.3d at 884; *Young*, 240 F.3d at 376-78; *Coady*, 213 F.3d at 1187.

50. See Michael Asimow, Applying the Assignment of Income Principle Correctly, 54 Tax Notes 607, 608 (1992) ("[The] [a]ssignment of income [doctrine] is an indispensable weapon to protect progressivity and to attack tax avoidance schemes. It should not be used to overturn economically rational, nontax avoidance contractual arrangements."); Ronald H. Jensen, Schneer v. Comm'r: Continuing Confusion over the Assignment of Income Doctrine and Personal Service Income, 1 Fla. Tax Rev. 623, 633 (1993) ("[a]ll the [seminal assignment of income] cases . . . involved *gratuitous* assignments of income."); Elliot Manning, The Service Corporation – Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351, 37 U. Miami L. Rev. 657, 668-69 (1983).

51. See Jensen, supra note 50, at 632 ("the essence of the assignment of income doctrine [is] . . . the concern that the progressive tax rate schedule not be subverted by permitting income to be artificially split among formally separate taxpayers who in fact constitute a single economic unit").

52. See Polsky, supra note 23, at 88-92 ("In an assignment for value case, it does not matter whether the taxpayer transfers fruit or tree").

53. See supra notes 37-45 and accompanying text.

54. See supra notes 42-45 and accompanying text.

of the attorney fee portion of the claim.[55] This reliance on state attorney lien law appears misplaced.

It is true that, in determining ownership of an asset (in these cases, the attorney fee portion of the claim), it is necessary to analyze the incidents of ownership.[56] It is also true that state law is critically important to this analysis, because state law governs the property rights of its residents. In this analysis, however, the incidents of ownership that are important are those that exist in substance and not merely in form.

The distinctions among various states' attorney lien statutes lack substantive impact. As the Fifth Circuit has noted, "the discrepanc[ies in state attorney lien law] do[] not meaningfully affect the economic reality facing the *taxpayer-plaintiff*."[57] In other words, although there are slightly different nuances in each state's exposition of its attorney lien law, these differences are not meaningful in that, as a practical matter, all attorney lien laws operate in the same way.[58] Resting a federal tax determination on the basis of these formalistic differences would appear to violate the fundamental notion that tax consequences depend on the substance rather than the form of the transaction.

D. The Upcoming Supreme Court Cases

On March 29, 2004, the United States Supreme Court granted certiorari on two contingent attorney fee cases, both of which involved circuit decisions that applied the exclusion method.[59] In one of the cases, *Banaitis v. Comm'r*, the Ninth Circuit relied on "the unique features of Oregon law" governing attorney liens in reaching its conclusion,[60] while in the other case, *Banks v. Comm'r*, the Sixth Circuit disclaimed the relevance of attorney lien law.[61]

In deciding these cases, the Court has three options. First, it could hold that, regardless of nuances in state attorney lien law, the inclusion and deduction method is required in all cases.[62] Second, it could hold that, regardless of these

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55. See supra notes 25-36 and accompanying text.

56. See supra notes 39-40 and accompanying text.

57. Srivastava v. Comm'r, 220 F.3d 353, 364 (5th Cir. 2000) (emphasis in original).

58. See Young v. Comm'r, 240 F.3d 369, 378 (4th Cir. 2001) (noting that courts relying on state attorney lien law have reached different conclusions even though there was no "relevant distinction" between the state law analyzed).

59. Comm'r v. Banks, 124 S. Ct. 1712 (2004); Comm'r v. Banaitis, 124 S.Ct. 1713 (2004).

60. 340 F.3d 1074, 1082-83 (9th Cir. 2003).

61. 345 F.3d 373, 386 (6th Cir. 2003).

62. See, e.g., Alexander v. I.R.S., 72 F.3d 938, 942-43 (1st Cir. 1995); Young v. Comm'r, 240 F.3d 369, 372 (4th Cir. 2001); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001).

nuances, the exclusion method is required in all cases.[63] Finally, it could hold that the appropriate method depends on the particulars of the relevant state attorney lien law.[64]

We believe that the state-by-state approach is the least likely outcome. As explained above, the approach is inconsistent with tax law's focus on the substance rather than form.[65] In addition, "[g]iven the various distinctions among attorney's lien laws among the fifty states, such a[n] . . . approach would not provide reliable precedent . . . or provide sufficient notice to taxpayers."[66] As a result, the state-by-state approach would lead only to more confusion and litigation regarding the question of whether a particular state's lien law contains the "magic language" to achieve the taxpayer's desired result. In addition, such an approach would likely stimulate the states to race to amend their attorney lien laws in an attempt to add the magic, though substantively meaningless, language.[67]

Thus, we believe that the Court will announce a "national" rule that is completely independent of the various nuances of state attorney lien law. As previously discussed, it would appear that, as a doctrinal matter, the inclusion and deduction method is required regardless of whether one concludes that the execution of the fee agreement results in an immediate transfer of the attorney fee portion of the claim.[68] If there is such an immediate transfer, however, the analysis is significantly more complicated, and it has not been addressed in the

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63. See, e.g., *Banks*, 345 F.3d at 386; Srivastava v. Comm'r, 220 F.3d 353, 355 (5th Cir. 2000).

64. See, e.g., Raymond v. Comm'r, 319 F.2d 532, 532 (2d Cir. 2004) (concluding that inclusion/deduction method applies after analyzing Vermont attorney lien law); *Banaitis*, 340 F.3d at 1082-83 (9th Cir. 2003) (concluding that exclusion method applies after analyzing Oregon attorney lien law).

65. See supra notes 55-58 and accompanying text.

66. *Banks*, 345 F.3d at 385. See also Hukkanen-Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001) (concluding that a "universal standard independent of" formalistic difference in state attorney lien law would be desirable).

67. See, e.g., Washington Senate Bill Report SB 6270 (as reported by Senate Committee on: Judiciary, January 22, 2004) at http://www.leg.wa.gov/pub/billinfo/2003-04/Senate/6250-6274/6270_sbr.pdf (explaining a proposal to amend Washington's attorney lien statute retroactively for the sole "purpose of making attorney's fees taxable solely to the attorney"). Cf. Patrick E. Hobbs, Entity Classification: The One Hundred-Year Debate, 44 Cath. U. L. Rev. 437, 515-17 (1995) (describing the proliferation of limited liability company (LLC) statutes after the IRS issued Rev. Rul. 88-76, 1988-2 C.B. 360, which announced that LLCs would be taxed as partnerships even if they operated in all important respects like closely held corporations).

68. See supra notes 42-45 and accompanying text.

lower courts.[69] For this reason, we think that the Court will most likely determine that a contingent fee arrangement is a mere promise to pay on the part of the plaintiff that does not result in the present transfer of anything.[70] As a result, the Court would conclude that the inclusion and deduction method is required.[71] This would yield the wrong policy result, which the Court would rationalize by pointing out that the remedy for this result rests singularly with Congress.[72]

E. Alternative Taxpayer Arguments

The briefs filed by the taxpayers in *Banks* and *Banaitis* with the Supreme Court, together with the various amici briefs filed on their behalf, have raised two interesting alternative arguments that, if accepted, would result in a decision in favor of the taxpayers. The first such argument contends that the contingent fee arrangement constitutes a joint venture for tax purposes, meaning that the tax consequences resulting from the division of the litigation proceeds would be governed by the partnership provisions contained in Subchapter K of the Code (the "partnership argument"). The second argument contends that the fee paid to the attorney is not properly analyzed as a deduction in the first place; rather, the argument goes, the fee constitutes a transaction cost that either (a) is capitalized into the basis of the claim that reduces the amount realized when the claim is liquidated, or (b) operates as a direct offset to the amount realized upon disposition of the claim (the "transaction cost argument").[73] These alternative arguments are discussed below.

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69. For a complete explanation of the tax consequences under the immediate transfer view, see Polsky, supra note 23, at 102-111; Polsky & Hellwig Brief, supra note 42, at 7-13.

70. See supra notes 37-38 and accompanying text.

71. See supra notes 31-32 and accompanying text.

72. For discussion on proposed Congressional remedies see Part III.A.

73. A third alternative argument was raised by Professor Stephen Cohen in his amicus brief. Cohen focuses on the tax treatment of the deduction for legal fees paid in the context of employment litigation, arguing that these fees may be deducted above-the-line as a reimbursed employee business expense under § 62(a)(2)(A). See Brief for Amicus Curiae Professor Stephen B. Cohen in support of Respondents, Comm'r v. Banks, U.S. Supreme Court Docket No. 03-892 (filed Aug. 14, 2004). As this argument was recently rejected by the Ninth Circuit in *Biehl v. Comm'r*, 351 F.3d 982, 983 (9th Cir. 2003), we will not address it in this article. For discussion of the *Biehl* case, see Stephen B. Cohen & Laura Sager, Final(?) Thoughts on the Biehl Decision, 99 Tax Notes 133 (Apr. 7, 2003); Stephen B. Cohen & Laura Sager, "Judicial Activism" Should Not Prolong the Attorney's Fee Problem, 98 Tax Notes 377 (Jan. 20, 2003); Brant J. Hellwig, Additional Thoughts on the Biehl Decision, 98 Tax Notes 1417 (Mar. 3, 2003); Brant J. Hellwig, Judicial Activism is Not the Solution to the Attorney's Fee Problem, 97 Tax Notes 693 (Nov. 4, 2002).

1. Partnership Argument

The brief filed with the Supreme Court by the taxpayer in *Banaitis* leads off with the argument that the contingent fee arrangement between a plaintiff and an attorney constitutes a joint venture that is governed by the partnership tax provisions contained in Subchapter K of the Code.[74] Seizing upon the broad definition of a joint venture that constitutes a partnership for tax purposes in section 761(a),[75] Banaitis argues that he and his attorney had combined their property and services in a joint effort to reduce the cause of action into a money judgment in the underlying employment litigation.[76] The goal of invoking the provisions of Subchapter K is to get to section 704(a), which would allocate the income generated by the joint venture (the $8.7 million settlement) among the partners in accordance with the terms of the partnership agreement (in this case, the contingent fee agreement). Pursuant to this argument, the gross income realized by Banaitis would not exceed his net recovery.

Even assuming that an individual's retention of an attorney on a contingent fee basis creates a partnership for tax purposes,[77] the partnership theory ultimately will not produce the intended result for taxpayers. The fundamental flaw in the argument lies not in the application of section 704(a) to the proceeds of the claim, but rather in the failure to appreciate the tax consequences of the partnership formation. If the execution of the fee agreement

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74. Brief for Respondent at 5-21, Comm'r v. Banaitis, U.S. Supreme Court Docket No. 03-907 (filed Aug. 12, 2004).

75. See id. at 7 (citing Podell v. Comm'r, 55 T.C. 429, 431 (1970), and S. & M. Plumbing Co. v. Comm'r, 55 T.C. 702, 707 (1971), for the proposition that a joint venture within the meaning of § 761(a) requires only the following three elements:

> (1) each of the participants agrees to contribute in a significant manner to the effort of the venture, such as by providing services, money or property; (2) the participants' entitlement to payments depends on the success of the venture; and (3) the amount of each participant's entitlement depends at least to some degree on the amount of income generated by the venture.)

76. Id. at 9.

77. The Sixth Circuit has described the contingent fee arrangement in terms of a partnership or joint venture. See Estate of Clarks v. United States, 202 F.3d 854, 857 (6th Cir. 2001) ("Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds). The Tax Court, on the other hand, has rejected the argument that the attorney-client relationship constitutes a partnership for tax purposes. See Bagley v. Comm'r, 105 T.C. 396, 419 (1995) (finding that, on the record, "there is nothing to indicate that the parties intended the contingency fee arrangement to be a joint venture or partnership"); see also Kenseth v. Comm'r, 144 T.C. 399, 413 (2000), aff'd, 259 F.3d 881 (7th Cir. 2001) ("Attorneys represent the interests of clients in a fiduciary capacity. It is difficult, in theory or fact, to convert that relationship into a joint venture or partnership.").

operates to form a partnership, then the plaintiff is deemed to have transferred a portion of the underlying partnership capital to the attorney,[78] followed by a contribution of such capital from the attorney to the partnership.[79] However, because the attorney's capital interest in the partnership is subject to a substantial risk of forfeiture, section 83(a) operates to defer the tax consequences of the capital shift until the claim is liquidated and the risk of forfeiture is extinguished. Under a proper application of section 83 to the formation of the partnership, the plaintiff includes the full amount of the litigation proceeds in

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78. While the Service has reasoned that, in certain situations, a service partner is not taxed upon receipt of a profits interest in a partnership, the attorney's interest in the partnership cannot be described as a profits interest. See Rev. Proc. 93-27, 1993-2 C.B. 343. Rather, because the attorney is entitled to a certain portion of the entire recovery on the claim (as opposed to a percentage of the increase in value of the claim after the partnership was formed), the attorney has received an interest in the partnership capital upon formation. See id. (defining a capital interest in a partnership as one "that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership" and a profits interest as any interest in a partnership other than a capital interest). The only way that an attorney's interest in the partnership could be characterized as a profits interest is if the claim itself were devoid of value when the fee agreement was executed. That, of course, defies common sense. If the attorney concludes that the claim has no value whatsoever – in other words, there is no chance of recovering on the claim – then the attorney would not lend her services and advance the litigation expenses on a contingency basis. See Kenseth v. Comm'r, 114 T.C. 399, 413 (2000), aff'd, 259 F.3d 881 (7th Cir. 2001) (noting that the taxpayer's cause of action "had value in the very beginning; otherwise, it is unlikely that [the attorney] would have agreed to represent petitioner on a contingent basis").

79. This two-step process was outlined by the Tax Court in *McDougal v. Comm'r*, 62 T.C. 720 (1974). In *McDougal*, the taxpayer purchased a horse and hired a trainer to nurse the horse back to racing condition, promising the trainer a 50% interest in the horse once the taxpayer recovered his acquisition costs. Id. at 721. After the trainer lived up to his end of the bargain, the taxpayer conveyed a 50% interest in the horse to the trainer. Id. at 722. The Tax Court held that this transfer created a partnership among the parties, and recast the transaction into the following two-step process: (1) A transfer of a 50% interest in the horse from the taxpayer to the trainer, followed by (2) the trainer's contribution of his 50% interest in the horse to the partnership. See id. at 725. The first step resulted in the trainer realizing compensation income equal to the value of his 50% interest in the horse. From the taxpayer's perspective, the taxpayer realized a gain on the transfer of the 50% interest in the horse to the trainer. Furthermore, the taxpayer was entitled to a deduction for the value of the interest in the horse transferred to the trainer, since the transfer was made in consideration of the trainer's past services. Id. at 728.

gross income, and is left with a deduction for the contingent fee paid to the attorney.[80]

In short, the theory that the contingent fee arrangement between the plaintiff and the attorney should be taxed under the partnership tax provisions of Subchapter K adds nothing to the present-transfer characterization adopted by the minority of the Circuit Courts of Appeal. Ultimately, it is the same argument in slightly more elaborate garb.

2. *The Transaction Cost Argument*

Through published articles[81] and an amicus brief submitted to the Supreme Court in the *Banks* and *Banaitis* cases,[82] Professor Charles Davenport has offered a solution to the attorney fee problem that approaches the issue from a completely different angle. Rather than claiming that the portion of the settlement or judgment paid to the attorney is excluded from the plaintiff's gross income based on the plaintiff's prior transfer of a fractional interest in the claim, Davenport focuses on the manner in which the plaintiff accounts for the amount paid to the attorney. Simply put, Davenport argues that the attorney's fee is not properly recovered by way of a deduction. Instead, he contends that the attorney's fee constitutes a transaction cost that reduces the plaintiff's amount realized upon liquidation of the claim. Under this view, the amount paid to the attorney operates as an offset to the amount recovered on the claim, leaving the

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80. For a thorough discussion of the tax consequences which result under the theory that the contingent fee arrangement constitutes a partnership for tax purposes, see Gregg D. Polsky, Contingent Fees: Why the Partnership Theory Doesn't Work, 104 Tax Notes 1089 (Sept. 6, 2004). This article stimulated a volley of letters to the editor debating the merits of the partnership theory. See John A. Bogdanski, Contingent Fees: The Partnership Theory is Sound, 105 Tax Notes 426 (Oct. 18, 2004); Gregg D. Polsky, Contingent Fees: The Partnership Theory Isn't Sound, 105 Tax Notes 612 (Oct. 25, 2004); Douglas Kahn, Partnership Theory Won't Help Taxpayers in Contingent Attorney Fee Cases, 105 Tax Notes 885 (Nov. 8, 2004); John A. Bogdanski, Beating a Dead Horse With a Surrebuttal, 105 Tax Notes 887 (Nov. 8, 2004); John A. Bogdanski, Tax Treatment of Contingent Attorney Fees: The Battle Rages On, 105 Tax Notes 1046 (Nov. 15, 2004); Douglass A. Kahn, Thoughts on the Partnership Theory in Contingent Fee Cases, 105 Tax Notes 1289 (Nov. 29, 2004).

81. Charles Davenport, Capitalization of Legal Fees: Professor Davenport Responds, 97 Tax Notes 1237 (Dec. 2, 2002); Charles Davenport, Why Tort Legal Fees Are Not Deductible, 97 Tax Notes 703 (Nov. 4, 2002); see also Deborah A. Geier, Attorney's Fees: Davenport Has the Right Idea, 97 Tax Notes 1627 (Dec. 23, 2002) (supporting Professor Davenport's argument).

82. Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents, Comm'r v. Banks, U.S. Supreme Court Docket No. 03-892 (filed Aug. 18, 2004) [hereinafter Davenport Brief]. See also Brief for Amicus Curiae Association of Trial Lawyers of America at 23-30, Comm'r v. Banks, U.S. Supreme Court Docket No. 03-892 (filed Aug. 18, 2004) (supporting Davenport's argument).

plaintiff with gross income of only the net proceeds. Because the attorney's fee would not be recovered through a deduction, it would not fall prey to the various limitations on miscellaneous itemized deductions.

To further elaborate on Davenport's argument, he argues that the amount paid to the attorney can be conceptualized in one of two alternative ways.[83] First, the attorney's fee can be viewed as a cost paid to acquire or to prove title to the cause of action. Under this approach, the fee is capitalized into the basis of the cause of action, in the same manner that an expenditure paid to acquire or to perfect title to a parcel of real property is added to the property's basis.[84] Alternatively, the attorney's fee can be viewed as a cost of disposing of the cause of action, similar to a fee paid to a broker to facilitate the sale of real property.[85] Davenport has no particular preference for either of the above-described characterizations,[86] nor does there exist any particular reason for him to take a stand. Under either theory, the plaintiff's amount realized upon liquidation of the claim is offset by the amount paid to the attorney in measuring gross income.[87]

At first glance, Davenport's transaction cost argument is quite appealing. It achieves a proper matching of income with its associated cost from a timing perspective. Furthermore, it achieves the desired equitable tax treatment of plaintiffs who pursue successful litigation through a contingency fee arrangement with the attorneys. While the transaction cost argument may well be the conceptually proper approach to determining the tax treatment of

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83. See Davenport Brief, supra note 82, at 8 ("The legal fees in the cases at bar are either acquisition costs, dispositions costs, or both.").

84. See Treas. Reg. § 1.263(a)-2(a), (c).

85. See Treas. Reg. § 1.263(a)-2(e) (treating the commissions paid in selling securities as a reduction of the taxpayer's amount realized on the transaction). On this front, Davenport places much emphasis on *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995). In *Baylin*, the state condemned the taxpayer's real property. The taxpayer sued to contest the condemnation award, and recovered additional sums. Id. at 1452-53. The legal fees were treated as a disposition cost added to the taxpayer's basis in the condemned property, reducing the taxpayer's gain on the involuntary sale. Id. at 1453. The result in *Baylin* is rather unremarkable, given that the litigation related to the disposition of the taxpayer's real property.

86. See Davenport Brief, supra note 82, at 8 ("The legal fees in the cases are bar are either acquisition costs, dispositions costs, or both.")

87. See Woodward v. Comm'r, 397 U.S. 572, 575 (1970) ("It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures."). As Davenport notes, the Service has proven inconsistent on the issue of whether a disposition cost is first added to basis that is subtracted from amount realized in determining gain, or whether the disposition cost constitutes a reduction to amount realized directly. See Davenport Brief, supra note 82, at 6 n.14. However, there exists no practical difference between the two approaches.

legal fees, it has one fundamental flaw. The argument requires that a legal claim entitling the holder to a payment of gross income be treated as a separate item of property for capitalization purposes.[88] As explained below, this approach runs counter to the long-standing tax treatment of legal fees.

Starting with the Code, two deduction-authorizing provisions are implicated in litigation aimed at recovering a payment of income: section 162 and section 212. If the suit relates to the plaintiff's trade or business of providing services as an employee (including, in particular, a wrongful termination suit), the relevant statute is section 162(a).[89] If the claim does not relate to a trade or business of the plaintiff, then the relevant statute is section 212(1). Given that section 162(a) authorizes a deduction for all "ordinary and necessary expenses paid or incurred in carrying on any trade or business" while section 212(1) authorizes a deduction for all "ordinary and necessary expenses paid or incurred . . . for the production or collection of income," a common question arises under both provisions: do legal fees constitute ordinary expenses that give rise to an immediate deduction,[90] or do they constitute capital expenditures subject to section 263(a)?[91] Nothing in the text of the statutes resolves this issue definitively.

While the statutes may be unclear as to whether legal fees paid in the prosecution of a cause of action to recover a payment of income give rise to a deduction, the regulations under section 212(1) provide direct guidance on the matter. Treasury Regulation section 1.212-1(k) does so by distinguishing

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88. See Davenport Brief, supra note 82, at 5 ("Once the taxpayers' tort claims are properly characterized as property, an entire new vista for tax treatment opens up."); see also id. at 5 n.12 ("Logically, there is little reason to limit the doctrine of capitalization of transaction costs to property. Rather, a properly defined transaction would be the limitation, but Amicus does not in this brief argue for application of the doctrine beyond an item properly characterized as property.").

89. See McKay v. Comm'r, 102 T.C. 465, 489 (1994) (fees in wrongful termination suit deductible under § 162(a)), vacated and remanded on another issue, 84 F.3d 433 (5th Cir. 1996); Alexander v. Comm'r, T.C. Memo. 1995-51, 69 T.C.M. (CCH) 1792, 1794.

90. In *Comm'r v. Tellier*, 383 U.S. 687 (1966), the Supreme Court explained that the purpose of the term "ordinary" in § 162(a) is "to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset." Id. at 689-90. Apart from the requirement of being incurred in a trade or business, the deductions authorized by § 212 are "subject . . . to all the restrictions and limitations that apply in the case of a deduction under [§ 162(a)] of an expense paid or incurred in carrying on any trade or business." H.R. Rept. No. 77-2333, at 57 (1942), reprinted in 1942-2 C.B. 372, 430.

91. Both § 162(a) and § 212(1) are subject to the capitalization rules of § 263. See IRC §§ 161, 261; see also INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) (noting that "[d]eductions are specifically enumerated and thus are subject to disallowance in favor of capitalization.").

between legal fees that must be capitalized into the basis of property and those that are currently deductible. The regulation provides as follows:

> Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents.[92]

This regulation makes clear that legal expenses incurred in recovering amounts that must be included in gross income are to be recovered, for tax purposes, by way of a deduction. Focusing on the example provided in the regulation, the legal expenses paid in establishing entitlement to and collecting the accrued rent would constitute transactions costs within Davenport's theory, as they are directly traceable to the payment of income. Thus, under Davenport's argument, none of the legal expenses in the example would be deductible; rather, all expenses would be capitalized. In short, Davenport's argument runs directly counter to the authority provided in Treasury Regulation section 1.212-1(k).

While Treasury Regulation section 1.212-1(k) does not have a counterpart under the regulations interpreting section 162(a), the regulation is consistent with the origin-of-the-claim doctrine articulated by the Supreme Court in determining whether business related legal expenses constitute deductible expenses under section 162 or capital expenditures under section 263. In the back-to-back cases of *Woodward v. Comm'r*[93] and *United States v. Hilton Hotels*,[94] the Supreme Court explained that the tax treatment of legal fees was determined by looking to the origin of the litigated claim. If the litigation concerns the acquisition of property or the defense of title to property, the legal fees must be capitalized; if the litigation concerns the establishment or the defense of entitlement to a payment of income, the legal fees are deductible.[95]

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92. Treas. Reg. § 1.212-1(k).
93. 397 U.S. 572 (1970).
94. 397 U.S. 580 (1970).
95. See, e.g., Leonard v. Comm'r, 94 F.3d 523, 526 (9th Cir. 1996) (litigation expenses attributable to obtaining pre-judgment interest deductible); McKeague v. U.S., 12 Cl. Ct. 671, 676-77 (1987) (legal fees incurred to recover lost dividends and lost wages deductible); Southland Royalty Co. v. U.S., 582 F.2d 604, 609-12 (Ct. Cl. 1978) (litigation costs to determine amount of royalty payments owed under existing lease deductible); Boagni v. Comm'r, 59 T.C. 708, 714-15 (1973) (litigation costs incurred to establish right to interpleaded royalty payment deductible).

Thus, the thrust of the origin-of-the-claim doctrine is that a claim or a cause of action is not itself a separate item of property having a basis into which associated legal costs must be capitalized.[96] Rather, as its name suggests, the doctrine requires that one look through the claim to the nature of the damages sought in order to determine the tax treatment of the litigation expenses. Accordingly, a cause of action entitling the plaintiff to a taxable damages recovery is not properly viewed as property for purposes of determining the tax treatment of legal fees.[97]

The issue of whether the resolution of a cause of action entitling the plaintiff to a payment of gross income should be treated as a disposition of property was addressed by the First Circuit in *Alexander v. I.R.S.*[98] In *Alexander*, the taxpayer-plaintiff argued that the legal fees paid in the course of

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96. The potential of the recently finalized "INDOPCO" regulations under § 263 to change this result is noteworthy. The regulations provide in relevant part that "[a]n amount paid to create or enhance a separate and distinct intangible asset" must be capitalized. Treas. Reg. § 1.263(a)-4(b)(1)(iii). For this purpose, a "separate and distinct intangible asset" is defined as

> a property interest of ascertainable and measurable value in money or money's worth that is subject to protection under applicable state, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.

Treas. Reg. § 1.263(a)-4(b)(3)(i). Whether a legal claim to a payment of income satisfies this definition is questionable. The regulation appears to refer to an item of property that is subject to protection under the law, while a cause of action itself embodies that legal protection. In any event, the INDOPCO regulations were widely viewed as increasing the range of expenditures that could be deducted as opposed to being capitalized. In that light, it is doubtful that the regulation would be read in this context as changing the status quo from deduction to capitalization. See Ethan Yale, The Final INDOPCO Regulations, 105 Tax Notes 435, 450-51 (Oct. 25, 2004).

97. This is not to say, however, that causes of action do not constitute property for other purposes; quite clearly, a cause of action constitutes property for state law purposes. In this regard, Davenport questions how we reconcile our conclusion that a cause of action constitutes property within the meaning of § 83 with our position that a cause of action should not be treated as a separate item of property for capitalization or disposition purposes. The explanation, however, is simple enough. The regulations under § 83 define property for purposes of that statute broadly to include all "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Treas. Reg. § 1.83-3(c). Because a cause of action clearly constitutes an item of personal property that is something other than a promise to pay in the future, then the transfer of a cause of action in consideration for services is governed by § 83. However, treating a cause of action for a payment of gross income as a separate item of property for capitalization and disposition purposes is inconsistent with the origin-of-the-claim doctrine.

98. 72 F.3d 938 (1st Cir. 1995).

employment litigation were a cost of disposing of the taxpayer's "valuable intangible assets" (the taxpayer's contract rights and the resulting legal claim) and, as a result, that the fees should offset the amount realized upon the disposition of such property.[99] Thus, the taxpayer's argument was similar, if not identical, to Davenport's transaction cost argument. The First Circuit rejected it as follows:

> [W]hether Taxpayer's employment contracts are "property" or "intangible assets" in the abstract is irrelevant to the proper analysis of the characterization of the settlement proceeds and, thus, the property tax treatment of the Legal Fee. . . . [H]ere, assuming the settlement was a "cancellation" of Taxpayer's contractual rights, what Taxpayer fought for, and received, is merely a substitute payment for the compensation and retirement benefits due him under his express and implied employment contracts. Because his salary and benefits would have been taxed as ordinary income without any offsetting basis if received in the ordinary course under Taxpayer's employment contract, the "substitute" payments can be treated no differently.[100]

The First Circuit, through the following footnote, elaborated on why the taxpayer's legal fees did not give rise to a basis that could offset the proceeds of the litigation:

> One might intuitively argue that some sort of "basis" should be recognized when one has to litigate to receive one's due compensation. The fact remains, however, that the Code simply does not provide for the offsetting of basis in such circumstances except in limited cases involving capital assets. Instead, the Code permits litigation expenses to be taken into account by way of deduction.[101]

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99. Id. at 941-42.

100. Id. at 942-43 (citations omitted). In this portion of the opinion, the First Circuit analogized the case to the facts before the Supreme Court in *Hort v. Comm'r*, 313 U.S. 28 (1941), finding the *Hort* decision to be "particularly instructive." Id. at 942.

101. Id. at 943 n.9. Of course, there exists a technical flaw in the First Circuit's explanation. A basis offset is appropriate when there is a disposition of property for tax purposes, whether that the character of the property is capital or ordinary. However, a basis offset is not appropriate when the asset being disposed of constitutes nothing more than a legal right to a payment of gross income.

In this manner, the First Circuit applied the origin-of-the claim doctrine to conclude that the taxpayer's legal fees were to be recovered only by way of a deduction.

For much of the same reason the First Circuit rejected the transaction cost argument in *Alexander*, we believe the United States Supreme Court should do the same in the *Banks* and *Banaitis* cases pending before it. Although Davenport's transaction cost argument is sound from a policy standpoint and, as applied in this context, would produce the equitable result, there simply exists too much established doctrine standing in its way. Of course, doctrine should not be exalted for its own sake. If the Court wanted to jettison the origin-of-the-claim doctrine in favor of a more thoughtful approach to the taxation of legal fees, then so be it.[102] But accepting the transaction cost argument would not only entail overturning court-made doctrine, it would also require either ignoring or marginalizing Treasury Regulation section 1.212-1(k). Furthermore, accepting the transaction cost argument would override settled expectations of those taxpayers who pay their business-related litigation costs by the hour.[103] In our view, taking such drastic measures in order to correct Congress' failure to afford above-the-line status to all deductible legal fees would be improper.

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102. If that were to occur, a loss for the government on the transaction cost argument in the contingent-fee cases would lead to much larger revenue gains in the context of everyday business litigation. Furthermore, such an approach would generate additional complexity to the tax treatment of legal fees. Suppose a business brought a lawsuit seeking business damages based on improper use of its intellectual property, and that the defendant in the lawsuit responded with a counterclaim seeking economic damages. Now, in addition to determining what portion of the legal fees must be capitalized as a cost of establishing title to the intellectual property and what portion of the legal fees must be capitalized as transaction costs in recovering the income payments, the analysis would necessitate an additional allocation to a third category: costs of defending the counterclaim (which presumably would be immediately deductible under § 162(a)).

103. See Joseph M. Dodge, J. Clifton Fleming, Jr., & Deborah A. Geier, Federal Income Tax: Doctrine, Structure, and Policy 576 (3d ed. 2004):

> The IRS has never taken this position [the transaction cost approach] with respect to attorney litigation fees, and you can bet that the business bar would vociferously oppose this treatment, since it would require attorneys fees incurred by plaintiffs in connection with multi-year business litigation to be capitalized and offset against the eventual recovery, or deducted as a "loss" at the time the litigation is unsuccessful, instead of being deducted when incurred by the taxpayer.

II. IMPACT OF THE AMT TRAP

The most obvious victims of the AMT trap are the plaintiffs, whose taxes go up, often very substantially. Importantly, the trap may affect not only "actual" plaintiffs, but also prospective plaintiffs who, because of the trap and its effect on their potential after-tax payoffs, decline to bring suits that they otherwise would prosecute.[104]

Negative fallout from the trap, however, is not limited to plaintiffs. This Part describes how the trap may also significantly affect plaintiffs' lawyers, defendants, and courts.

A. Plaintiffs' Lawyers

The AMT trap may drive a significant wedge between the interests of a plaintiff and her lawyer at various critical junctures during a lawsuit.[105] Ordinarily, it would be in the best interests of both the plaintiff and the lawyer to increase the pre-tax recovery because both the plaintiff and the attorney would end up with greater cash. Because of the AMT trap, however, this would not always be the case.

Perhaps the classic example involves a lawsuit filed under a statute that provides for fee-shifting, such as Title VII.[106] Such a statute allows a prevailing plaintiff to petition the court to award her reasonable attorney's fees. When a claim is filed under such a fee-shifting statute, the contingent fee agreement usually provides that the attorney will receive the greater of (a) some percentage of the overall recovery (possibly including court-awarded fees) or (b) the amount of court-awarded fees.

In some cases where the attorney's fee would otherwise be determined under (b), because of the AMT trap, it may actually be in the plaintiff's best interests to not petition for fees.[107] In contrast, it would obviously be in the attorney's best interests for the plaintiff to file the petition, as it would increase his fees.

Because of this conflict, the ABA Model Rules would require the attorney to advise the client of this conflict and to obtain informed consent prior

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104. See Sager & Cohen, supra note 7, at 1078 (arguing that excessively taxing discrimination plaintiffs "undermines the national policy of encouraging the pursuit of meritorious civil rights claims").

105. For a complete discussion of these conflicts of interests, as well as other ethical issues raised by the AMT trap, see generally Gregg D. Polsky, The Contingent Attorney's Fee Tax Trap: Ethical, Fiduciary Duty, and Malpractice Implications, 23 Va. Tax Rev. 615 (2004).

106. See 42 U.S.C. § 2000(e)-5(k) (providing that prevailing plaintiff in civil rights litigation under Title VII is eligible to receive reasonable attorney's fees).

107. See Polsky, supra note 105, at 625-26 (explaining why the petition for fees may actually leave plaintiff with less after-tax dollars than if no petition is made).

to the petitioning for fees.[108] Since a well-advised client might refuse to petition for fees without some assurances that she will not be in a worse economic position after the petition, the attorney might be forced to restructure the fee agreement so as to ensure that the plaintiff receives as many after-tax dollars as she would have received had she not petitioned for fees. Since such a restructuring takes money away from the lawyer and gives it to the government, the AMT trap would now adversely affect the attorney.[109]

B. The Defendant

1. Widening the Settlement Gap

By reducing the after-tax payoff to the plaintiff, while keeping the defendant's outlay constant, the AMT trap could become a substantial impediment to settlement in certain cases. As a result, the AMT trap would burden defendants as well as plaintiffs.

For example, leaving aside the AMT trap for now, assume that, a plaintiff would be willing to settle a case for $100,000 pre-tax dollars, which, assuming a 40% tax rate, would leave her with $60,000. The defendant on the other hand is willing to settle the case for $80,000 pre-tax dollars. In such a case, the settlement gap is $20,000 pre-tax dollars – the difference between what the plaintiff is willing to accept and what the defendant is willing to pay.

Now assume that, because of the AMT trap, the plaintiff's effective tax rate on her recovery is 60%. In order for the plaintiff to recover the same $60,000 after-tax, the settlement amount would have to equal $150,000. As a result, the settlement gap has widened from $20,000 to $70,000, significantly decreasing the likelihood of settlement.[110]

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108. Model Rules of Prof'l Conduct R. 1.7(b) (2003) (providing that certain conflicts of interest may be waived by the client through informed consent); Model Rules of Prof'l Conduct R. 1.0(e) (defining "informed consent" as consent "after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct").

109. See also Polsky, supra note 105, at 624 (describing other conflicts that may arise during litigation as a result of the AMT trap).

110. The increase in the settlement gap caused by the disallowance of a deduction for attorney's fees under the AMT was noted by the Association of Trial Lawyers of America (ATLA) in its amicus brief. ATLA described the effect of the tax treatment of legal fees under the AMT as follows:

> [A]s many trial lawyers can attest, the include-deduct tax treatment of attorney fees introduces additional complexity, uncertainty, and expense into settlement negotiations. Counsel must undertake a thorough review of the tax impact that fees may have on the client and adjust settlement demands upward to avoid an unanticipated and

2. Gross Ups

The discussion in this Part thus far has assumed that the increased tax liability resulting from the AMT trap could not be shifted from the plaintiff to the defendant through an augmented or "grossed up" award of damages. Several recent cases, however, have suggested that a gross up to the damages recovery may in fact be appropriate. If so, defendants will be the most direct victims of the AMT trap.

The leading gross up case is the recent Washington Supreme Court case of *Blaney v. Int'l Ass'n of Machinists & Aerospace Workers, Dist. No. 160*,[111] which dealt with Washington's Law Against Discrimination (WLAD). In *Blaney*, the plaintiff received an award of $638,764 for wages and benefits lost as a result of unlawful discrimination and an additional award of $237,625 for her attorney's fees and costs.[112] The plaintiff then sought a gross up of $244,753 to offset the additional federal income tax liability that she incurred as a result of the lawsuit.[113] Although the opinion is not entirely clear regarding how this gross up was computed or what exactly gave rise to the adverse tax consequences, it appears that the AMT trap caused the plaintiff to be taxed more heavily on her lost wages and benefits than if the unlawful discrimination had not occurred and the wages and benefits been earned in due course.[114] It was this excess tax burden for which the plaintiff requested relief.[115]

In analyzing the issue, the court first noted that WLAD was intended to incorporate the remedial provisions of federal Title VII.[116] The court then cited two federal cases supporting the view that gross ups were appropriate under Title VII to offset the adverse tax consequences caused by the bunching of multiple years' wages into a single taxable year.[117] As a result, the court concluded that gross ups under WLAD were permissible:

> unjust outcome. Defendants, as a result, may expect to face more difficult and expensive settlements.

Amicus Curiae Brief of the Ass'n of Trial Lawyers of America at 16, Comm'r v. Banks, U.S. Supreme Court Docket No. 03-892 (filed Aug. 18, 2004).

111. 87 P.3d 757 (Wash. 2004).

112. Id. at 759-60.

113. Id. at 760.

114. Id. at 760, n.2.

115. Id. at 761-62.

116. Id. at 763.

117. Id. The two cases cited in *Blaney* supporting the use of gross ups to offset adverse consequences are Sears v. Atchison, Topeka & Santa Fe Ry. Co., 749 F2.d 1451, 1456 (10th Cir. 1984) and EEOC v. Joe's Stone Crab, Inc., 15 F. Supp. 2d 1364, 1380 (S.D. Fla. 1998).

> Because WLAD incorporates remedies authorized by the federal civil rights act and that statute has been interpreted to provide the equitable remedy of offsetting additional federal income tax consequences of damage awards, we hold that WLAD allows offsets for additional federal income tax consequences.[118]

A New Jersey state trial court reached a similar conclusion under New Jersey's Laws Against Discrimination ("NJLAD") in *Ferrante v. Sciaretta*.[119] In that case, the plaintiff recovered $340,659 in back pay and front pay and $895,025 in attorney's fees and costs.[120] The plaintiff requested a gross up in the amount of $107,000 to neutralize the adverse tax consequences caused by the AMT trap.[121] In analyzing the propriety of a gross up, the court described the similarities in purpose and structure between the NJLAD and the federal anti-discrimination statutes and, as in *Blaney*, cited federal caselaw that supported gross ups to counteract the adverse tax consequences caused by bunched awards.[122] As a result, the court concluded, "defendants will be required to compensate [the] plaintiff for the negative tax consequences of receiving the lump sum award."[123]

Only one case involving federal law has addressed the propriety of gross ups to counteract adverse tax consequences resulting from the AMT trap. In that case, *Porter v. United States Agency for International Development*,[124] the district court concluded that, although it believed it had the power to order a gross up, such an order was inappropriate in that case because the adverse tax consequences were not "established [and] capable of precise calculation."[125] Presumably, the court felt that because the D.C. Circuit in which it sat had not yet weighed in on the underlying tax issue, it was uncertain whether the AMT trap would actually be implicated in the plaintiff-taxpayer's case.[126]

These three cases suggest that the gross up question may be the next, and perhaps final, stage in the evolution of the voluminous litigation surrounding the AMT trap. If successful, gross ups will effectively shift most of the burden of this unfair trap from isolated, uncoordinated, and politically powerless plaintiffs onto much more coordinated and politically powerful

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118. *Blaney*, 87 P.3d at 763.
119. 839 A.2d 993 (N.J. Super. Ct. Law Div. 2003).
120. *Ferrante*, 839 A.2d At 994.
121. Id. at 998.
122. Id. at 996. In addition to citing to *Blaney* and *Sears*, see supra notes 111 and 117, *Ferrante* also cited *O'Neill v. Sears, Roebuck & Co.*, 108 F. Supp. 2d 443 (E.D. Pa. 2000).
123. *Ferrante*, 839 A.2d at 996.
124. 293 F. Supp. 2d 152 (2003).
125. Id. at 156.
126. Id. at 153-56.

defendants.[127] As a result, it is likely that the long-awaited legislative fix would soon occur.

C. The Courts

In addition to its effect on litigants and plaintiffs' attorneys, the AMT trap has increased the workload of the courts. We have already described the pronounced circuit court split on the underlying tax issue, which will likely be settled by the Supreme Court in early 2005.[128] This tax litigation alone has taken up a good deal of the judiciary's time and resources.

The expended judicial resources, however, have not been limited to litigation concerning the proper tax treatment of contingent legal fees. The AMT trap has given rise to litigation over entirely non-tax issues as well. We have already described the two state cases and one federal case that considered the ability of courts to gross up damages recoveries to offset the adverse effects of the AMT trap.[129] The AMT trap has given rise to litigation over several other tangential issues, which are discussed below.

1. Plaintiff's Defense Against Motion for Remittitur

In *Spina v. Forest Preserve District of Cook County*,[130] the plaintiff was awarded $3,000,000 of damages by a jury for damage to her reputation and emotional distress in a Title VII case against her employer.[131] After the trial, the employer argued that the award was excessive and requested that the trial judge offer the plaintiff a remittitur, which would require the plaintiff either to accept a lower award or retry the case.[132]

The court agreed with the employer, finding the $3 million award to be "monstrously excessive" and concluding instead that $300,000 was appropriate.[133] In a last ditch effort to save the $3 million award, the plaintiff pointed to the implications of the AMT trap:

> In a final attempt to retain her clearly excessive $3 million award, Plaintiff asks the Court to exercise its equitable powers to uphold the jury's award. In this regard, Plaintiff notes that, under the Internal Revenue Service's regulations and Seventh

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127. Even though a formal gross up could be implemented only by way of an augmented judgment, defendants in all cases would potentially feel the consequences of the AMT trap as the prospect of a judicial gross up would affect settlement values.

128. See supra notes 16-19 and 59-72 and accompanying text.

129. See supra notes 111-127 and accompanying text.

130. 207 F. Supp. 2d 764 (N.D. Ill. 2002) (memorandum opinion and order).

131. *Spina*, 207 F. Supp at 767.

132. Id. at 771.

133. Id. at 778-79.

> Circuit caselaw, Plaintiff's judgment and any award for attorney's fees will be taxable as income to Plaintiff. Plaintiff contends that, because Plaintiff's attorney's fees and costs will exceed $1 million, a reduction of the jury's award to $200,000, for example, would actually result in Plaintiff paying her entire award, plus $154,322 of her own money (money which she does not have) to the IRS in income taxes.[134]

While the court was "not unsympathetic to [the p]laintiff's plight" and acknowledged that the AMT trap produced an "anomalous, unjust result," it was wary of "sneak[ing] through the back-door of equitable relief" a clearly excessive award.[135] Emphasizing that the plaintiff cited "absolutely no caselaw" to support its position, the court rejected the "invitation to venture down a slippery slope and wade into this legal morass under the guise of equitable relief."[136]

What is most interesting about *Spina* is that the plaintiff neglected to argue for a simple gross up based on the AMT trap, a position that had at least some authoritative support.[137] Instead, the plaintiff chose to use the AMT trap to defend an award that the court determined was clearly excessive. Presumably a gross up request, which unlike the defense to remittitur would be limited to the amount of adverse tax consequences, would have had a greater chance of success.

2. *Defendant's Defense Against Petition for Fees*

Like the plaintiff in *Spina*, there have been cases in which the defendant has attempted to use the AMT trap to its advantage in litigating non-tax issues. In *Shott v. Rush-Presbyterian-St. Luke's Medical Center*,[138] the Seventh Circuit considered the defendant's use of the AMT trap as a defense against the plaintiff's petition for $430,000 of attorney's fees.[139] The plaintiff had won $60,000 of compensatory damages pursuant to a claim under the Americans with Disabilities Act.[140]

The defendant used the AMT trap to argue that the plaintiff had rejected a "substantial settlement offer" early in the litigation.[141] Such an offer is relevant to the determination of a fee award because fees accumulated after the offer is

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134. Id. at 777.
135. Id.
136. Id.
137. See supra notes 111-127 and accompanying text (cases allowing gross-ups).
138. 338 F.3d 736 (7th Cir. 2003).
139. *Shott*, 338 F.3d at 744.
140. Id. at 739.
141. Id. at 744.

submitted may be disregarded in this determination.[142] An offer is considered substantial for this purpose if "the offered amount appears to be roughly equal to or more than the total damages recovered by the prevailing party."[143]

The early settlement offer made by the defendant would have allowed the plaintiff to retain her title and her salary, but would have required no payment whatsoever for damages, attorney's fees, or costs.[144] Because of the AMT trap, this offer of zero dollars would have provided a better after-tax result to plaintiff than that which she achieved by going to trial, according to the defendant.[145] If the plaintiff's petition for fees were successful, the defendant asserted that the plaintiff would actually owe $65,000 in federal income taxes in excess of her $60,000 net recovery. Accordingly, the defendant argued that the plaintiff's rejection of the early offer constituted a rejection of a substantial settlement offer and that, therefore, the fees accruing after the offer should be disregarded.[146]

The court was not persuaded by this argument, however. First, the court pointed out the "overriding problem with [defendant's] position argument is that none of the information upon which it relies in purporting to calculate [plaintiff's] tax liability is in the record."[147] As a result, the court could not "say with any assurance that [her] tax liability [would] exceed the damage award."[148]

The court went on to doubt that, even if there were no evidentiary problems with the defendant's position, the plaintiff's tax consequences would be relevant to the fee determination:

> [T]hough we need not decide this issue now, we doubt that it would be appropriate for this court to establish a precedent wherein attorneys would be required to know the tax status of their clients before accepting or rejecting a settlement offer or wherein courts would routinely have to delve into the tax records of the parties to determine an appropriate fee award... [F]ee litigation already places a heavy burden on the federal courts; adding a requirement to calculate the tax status of the parties would only increase that burden.[149]

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142. Moriarty v. Svec, 233 F.3d 955, 967 (7th Cir. 2000).
143. Id.
144. *Shott*, 338 F.3d at 743.
145. Id. at 744.
146. Id.
147. Id.
148. Id.
149. Id.

As a result, the court concluded that it was appropriate, in determining whether a settlement offer was substantial, to compare only the pre-tax results between the offer and the ultimate recovery.[150]

A similar argument was made in the recent Arizona federal case of *Fiolek v. Tucson Unified School District*.[151] In that case, the plaintiff was awarded $50,220 of damages under the ADA and sought attorney's fees and costs totaling $567,310. In arguing that the plaintiff's requested fee amount was unreasonable, the defendant pointed out that such a fee award would result in the plaintiff owing $121,938 more in federal income taxes than his $50,220 damages award. According to the defendant, "[i]ssuing a fee award that would cost the Plaintiff the entirety of his judgment, plus an additional substantial out-of-pocket expense, most certainly would undermine the reasonableness of the fee award."[152]

While the *Fiolek* court has not yet ruled on the fee issue, it would appear that the AMT trap should be of no help to the defendant. The impact of the trap depends primarily on the ratio of the attorney's fees to the overall recovery (including fees), which depends entirely on the underlying fee arrangement between the plaintiff and his attorney. To the extent the plaintiff would suffer a loss as a result of a petition for fees, his attorney has an ethical, and likely a legal, obligation to restructure the fee agreement so as to prevent this loss.[153] Simply put, the plaintiff's fee arrangement with his attorney is strictly a matter between those two parties and is none of the defendant's business.

3. *Plaintiff's Malpractice Claim Against Her Attorney*

In a case that is closely related to the ethical issues discussed above in Section A of this Part, the California state court of appeals in *Jalali v. Root*[154] considered the merits of a legal malpractice claim based on the AMT trap. In *Jalali*, the plaintiff accepted a $2.75 million settlement offer after being instructed by her attorney that her tax liability resulting from the settlement would equal "forty percent of [her] share" of the award.[155] Because of the AMT

150. Id.

151. Defendant's Responsive Memorandum in Opposition to Plaintiff's Motion For Award of Attorney's Fees and Related Non-Taxable Costs at 21-25, Fiolek v. Tucson Unified Sch. Dist., (D. Ariz. 2004) (No. CIV 01-036 TUC DCB).

152. Id. at 24-25.

153. For a discussion of the ethical implications raised by the existence of the AMT trap, see text accompanying supra notes 105-109. For a more thorough discussion of the topic, see Polsky, supra note 105.

154. 1 Cal. Rptr. 3d 689 (Cal. Ct. App. 4th 2003).

155. *Jalali*, 1 Cal. Rptr. 3d at 692.

trap, however, the plaintiff's tax liability was actually $310,000 greater than that amount.[156]

As a result of the attorney's erroneous tax conclusions, a jury awarded the plaintiff this $310,000 difference between what she expected to get and what she actually got.[157] The appellate court reversed on causation grounds, holding that in order to recover damages, the plaintiff was required to show that, but for the bad tax advice, she would have rejected the $2.75 million offer and ultimately recovered a greater amount.[158] Because the plaintiff failed to produce evidence as to what she would have done had proper advice been given, the court held that her legal malpractice claim must fail.[159]

The *Jalali* case as well as the other non-tax cases make clear that the burden of the AMT on the judiciary extends well beyond the time and resources spent in deciding the underlying tax issue. Absent a legislative fix (or a Supreme Court decision in favor of the taxpayer), one can expect that this burden will only increase.

III. The Legislative Abdication of Responsibility

The continued existence of the AMT trap is indefensible. The heightened and potentially confiscatory tax rate on the plaintiff's net recovery creates a myriad of policy problems that are not limited to the plaintiff's tax situation. Plaintiffs that are properly advised of the potential tax pitfall may forego pursuing meritorious claims, thereby gutting the private enforcement of civil rights cases (an area in which the AMT trap is prevalent) that was intended by Congress.[160] Attorneys representing clients in cases where the AMT trap lurks may face insurmountable conflicts of interest, as the payment of the fees may produce after-tax losses for the clients.[161] Even defendants in AMT-trap cases are affected. While the nominal incidence of the AMT trap may fall upon the plaintiff, the economic incidence of the tax anomaly may be shifted to the defense as tax-savvy plaintiffs hold out for higher settlements to compensate for the untoward tax treatment of their legal fees. Furthermore, even the nominal incidence of the tax-trap may be shifted to defendants, as courts might "gross up" the amount of the plaintiffs' damages to compensate for the effective non-deductibility of their legal fees.[162]

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156. Id. at 692. The plaintiff still ultimately ended up with an after-tax recovery of roughly $700,000, though she had expected to end up with about $1,000,000. Id. at 696.

157. Id. at 692.

158. Id. at 696.

159. Id. at 695.

160. See Sager & Cohen, supra note 7, at 1100.

161. See Polsky, supra note 105.

162. See generally Polsky & Befort, supra note 18 (analyzing plaintiff's gross-up argument).

Courts,[163] commentators,[164] and even the National Taxpayer Advocate[165] for years have urged Congress to address the unjust and unfair tax treatment of legal fees under the AMT. Yet, to date, Congress has failed to enact corrective legislation. Making congressional neglect of the topic all the more remarkable is that the legislation necessary to fix the improper treatment of legal fees under the AMT would be both simple and cheap.

Although Congress has failed to enact corrective legislation, proposals aimed at correcting the AMT trap for a discreet set of claims have been introduced, and portions of them have even garnered the approval of the Senate. This Part will describe and evaluate the various legislative proposals. After doing so, we will propose our own legislative solution, which would operate to eliminate the AMT trap in all cases.

A. Legislative Proposals

1. Exclusion of Certain Awards from Gross Income

The primary legislative proposal aimed at correcting the tax treatment of legal fees under the AMT is the Civil Rights Tax Relief Act of 2003.[166] This piece of proposed legislation was not limited to correcting the defective tax treatment of legal fees in discrimination cases; rather, it went further to provide that all amounts received on a claim of "unlawful discrimination" (other than backpay or frontpay, and punitive damages) would be excluded from gross income.[167] The legislation defined unlawful discrimination through an enumerated list of civil rights, pension security, and worker protection statutes

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163. See, e.g., Alexander v. I.R.S., 72 F.3d 938, 946 (1st Cir. 1995) ("[T]he outcome smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment"); Biehl v. Comm'r, 118 T.C. 467, 488 (2002), aff'd, 351 F.3d 982 (9th Cir. 2003) ("We conclude in this case, as we have in prior cases, that it is the job of Congress, if it should decide in its wisdom to do so, to cure the injustice.").

164. See, e.g., Deborah A. Geier, Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs, 88 Tax Notes 531, 549 (July 24, 2000) (concluding that "Congress should act now . . . to fix the problem – and do so retroactively for all open tax years"); Sager & Cohen, supra note 7, at 1103-04.

165. See Nat'l Taxpayer Advoc., FY 2002 Annual Report to Congress, at 167-69.

166. The legislation was introduced in the House as H.R. 1155, 108th Cong., and in the Senate as S. 557, 108th Cong.

167. S. 557, 108th Cong., § 2 (proposing IRC § 140). With regard to awards of frontpay and backpay, the legislation provided for income averaging. Id. § 3 (proposing IRC § 1302).

under federal law.[168] The last two enumerated examples of unlawful discrimination extended the scope of qualifying claims to include any act that was unlawful under:

> (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.

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168. The enumerated claims for "unlawful discrimination" include any act that was unlawful under the following statutes:

> (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 (29 U.S.C. 1681 et seq.).
> (9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 201 et seq.).
> (10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
> (11) Section 105 of the Family Medical Leave Act of 1993 (29 U.S.C. 2615).
> (12) Chapter 43 of title 38, United States Code (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, 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).

Civil Rights Tax Relief Act of 2003, S. 557, 108th Cong., § 2 (proposed IRC § 140(b)(1)-(16)).

> (18) Any provision of State or local law, or common law claims permitted under Federal, State, or local law providing for the enforcement of civil rights, 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.[169]

From the standpoint of addressing the improper tax treatment of legal fees under the AMT, the proposed Civil Rights Tax Relief Act of 2003 was underinclusive. While addressing discrimination cases in which the AMT trap can be the most egregious due to the operation of fee-shifting statutes, it is doubtful that the legislation would have addressed all types of employment claims. Take a garden variety wrongful termination claim, for example. If the damages resulted from a termination in breach of the employment contract and the employee's termination had no discriminatory or retaliatory motive, then it does not appear that the legislation would have excluded the damages (including the amount paid to the attorney) from gross income.[170] In addition, the proposed legislation failed to address a wide variety of other non-physical personal injury claims that give rise to the improper treatment of legal fees under the AMT. These include claims for punitive damages, defamation, intentional or negligent infliction of emotional distress, etc. Thus, while the terms of the proposed Civil Rights Tax Relief Act of 2003 would have eliminated the tax defect that serves to stifle the private enforcement of civil rights legislation, the proposal would not have gone far enough to correct the improper treatment of legal fees in all cases.

Of course, the Civil Rights Tax Relief Act of 2003 would have done much more than eliminate the AMT trap in discrimination cases; it would have excluded from gross income the entire amount of damages recovered on an enumerated claim. Excluding the damages received on a claim of unlawful discrimination may be legitimate in its own right, as a number of commentators have questioned the fairness[171] and even the constitutionality[172] of the 1996

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169. Id. § 2 (proposed IRC § 140(b)(17)-(18)).

170. On one hand, one could argue that the statute applies to damages received on account of a breach of employment contract on the theory that the common law of contracts is a provision of local law that prohibits discharge of an employee. However, nothing in the common law of contracts expressly prohibits an employer from discharging an employee in breach of the employment contract. Rather, contract law simply subjects the employer to damages on account of such breach.

171. See, e.g., Karen B. Brown, Not Color- or Gender-Neutral: New Tax Treatment of Employment Discrimination Damages, 7 S. Cal. Rev. & Women's Stud. 223 (1998); J. Martin Burke & Michael K. Friel, Getting Physical: Excluding Personal Injury Awards Under the New Section 104(A)(2), 58 Mont. L. Rev. 167 (1997); Mark J. Wolff, Sex, Race, and Age: Double Discrimination in Torts and Taxes, 78 Wash. U.L.Q. 1341 (2000); Laura Sager & Stephen Cohen, Discrimination Against Damages

legislation that restricted excluded damage recoveries under § 104(a)(2) to those received on account of a personal physical injury or physical sickness.[173] Yet by reaching beyond the improper tax treatment of legal fees in these cases and seeking an exclusion of the entire damages recovery, the legislation became more difficult to enact. There are undoubtedly members of Congress who support the 1996 limitation of section 104(a)(2) to personal physical injuries. Furthermore, there are undoubtedly members of Congress who are less than enthusiastic about federal civil rights protections. Thus, the broader reach of the legislation to exclude the entire damages recovery on the enumerated discrimination claims created ideological hurdles that likely made the legislation difficult, if not impossible, to enact it its entirety.

2. *Above-the-Line Treatment for Fees in Certain Cases*

Perhaps in recognition of the political difficulties in passing a full exclusion of damages received on claims of unlawful discrimination, the Senate later that year included a trimmed-down version of the Civil Rights Tax Relief Act of 2003 in its version of the Jobs and Growth Reconciliation Act of 2003. The proposal addressed only the tax treatment of legal expenses incurred in a claim of unlawful discrimination.[174] Citing the *Spina* decision, Republican Senator Charles Grassley, Chairman of the Senate Finance Committee, added the provision to the broader tax bill, stating: "If we don't fix this law, it could have a chilling effect on discrimination cases. Legitimately wronged people could have little recourse. A out-of-whack tax system is in danger of negating the value of discrimination lawsuits."[175] In a section captioned "Civil Rights Tax Relief," the legislation created an above-the-line deduction for attorney fees and courts costs paid by, or on behalf of, a taxpayer in connection with any claim of unlawful discrimination, to the extent that such expenses do not exceed the amount includible in the taxpayer's gross income for the taxable year attributable to a settlement or judgment resulting from the claim.[176]

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for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax, 35 Harv. J. on Legis. 447 (1998).

172. See F. Patrick Hubbard, Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress, 49 Fla. L. Rev. 725 (1997).

173. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755 (1996).

174. Amendment No. 680 to Jobs and Growth Tax Relief Reconciliation Act of 2003, S. 1054, 108th Cong.

175. Press Release, Sen. Charles E. Grassley (May 13, 2003), available at 2003 TNT 93-26.

176. S. 1054, 108th Cong., § 521(a) (proposed IRC § 62(a)(19) and § 223). It is interesting that the statute limits the above-the-line deduction to the amounts included in gross income on account of the claim. While this limitation would not come into

The proposal defined a claim of "unlawful discrimination" in virtually the identical manner as the Civil Rights Tax Relief Act of 2003, except the last catch-all category of claims was expanded as follows:

> (18) Any provision of Federal, State or local law, or common law claims permitted under Federal, State, or local law –
>
> (A) providing for the enforcement of civil rights, or
>
> (B) *regulating any aspect of the employment relationship*, including 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.[177]

The additional language added to the catch-all category is significant, as it arguably brought into the reach of the statute any employment related claim. Taking a garden variety breach of employment contract case as an example, the common law of contracts is state law that regulates the employment relationship. Thus, the legal fees paid in prosecution of such a claim could be afforded above-the-line treatment, to the extent they do not exceed the amount included in gross income attributable to the settlement or judgment.[178] On the other hand, given the context of the statute in which the seemingly broad "regulating any aspect of the employment relationship" falls,[179] it is not inconceivable that a court would interpret this phrase as being limited to situations involving the violation of laws specifically prohibiting the discharge,

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effect in the contingent fee context, it could prove problematic for a taxpayer who pays her attorney on an hourly basis. For instance, suppose that plaintiff sues her employer for wrongful termination and loses after paying her attorney $100,000 in hourly fees. These fees will not be entitled to above-the-line status under the legislative proposal. Perhaps the justification is that any legal fees paid in excess of the ultimate recovery would be properly viewed as conferring some elements of personal consumption (i.e., the pleasure of simply taking the defendant to court), justifying their treatment as miscellaneous itemized deductions. However, this explanation is suspect. The payment of the fees combined with the litigation loss likely produces the exact opposite of a consumption benefit to the plaintiff.

177. S. 1054, 108th Cong., § 521(a) (proposed IRC § 223(b)(18)) (emphasis supplied).

178. But see Robert W. Wood, "Civil Rights Tax Relief" Fails: How Do You Spell Relief?, 100 Tax Notes 401 (July 21, 2003) (questioning whether the legislation reached all types of employment related claims, particularly claims for overtime or benefits).

179. S. 1054, 108th Cong. § 54(a) (proposed IRC § 62(a)(19)(e)(18).

discrimination, or retaliatory conduct.[180] The statute is by no means a model of clarity, and it is not difficult to imagine that another round of litigation would be necessary to determine its exact confines.

The proposed legislation described above was passed by the Senate in its version of the Jobs and Growth Tax Relief Reconciliation Act of 2003, but it did not survive the conference committee.[181] Nonetheless, after years of no action being taken to address the improper tax treatment of legal fees under the AMT, getting corrective legislation moved through at least one body of Congress was significant. Perhaps more significant were the interest groups that backed the legislation. While the movement to correct the AMT trap had been viewed as the project of the trial lawyers' lobby, backers of the provision in the Senate bill included none other than the U.S. Chamber of Commerce. Michael Eastman, director of labor law policy at the Chamber, stated that "changing the law could make it less expensive for employers to settle claims while allowing plaintiffs to keep more of their awards."[182] Defendants in employment litigation, apparently recognizing that they bore at least a portion of the economic incidence of the improper tax treatment of the plaintiff's legal fees, thus lined up behind the corrective legislation. In a political environment where litigious individuals and the attorneys who represent them appear to be the bane of conservatives' existence, the support of interest groups associated with traditional defendants in employment cases may very well prove to be the turning point in the ultimate enactment of corrective legislation.

While the above-the-line deduction for legal fees in certain discrimination cases was not included in the broader 2003 tax legislation enacted by Congress, an almost identical proposal has once again passed in the Senate this year. Under the caption of "Civil Rights Tax Relief," the above-the-line deduction for legal expenses in certain discrimination cases now appears in section 643 of Senate version of the Jumpstart Our Business Strength (JOBS) Act.[183]

The only difference between the current legislative proposal and that passed by the Senate in 2003 is another expansion of the last catch-all category defining a claim of "unlawful discrimination" for purposes of the statute. The

180. In this regard, one would not ordinarily describe a claim for unpaid salary or benefits as a claim of "unlawful discrimination." As to the potential for a limited interpretation of the catch-all category of claims covered by the proposed § 62(a)(19), the government's reply brief in the *Banks* and *Banaitis* cases suggests it. In the brief, the government describes the corrective legislation as being "narrowly focused on certain civil rights cases." Petitioner Reply Brief at 19, Comm'r v. Banks, U.S. Supreme Court Docket No. 03-892 (filed Sept. 22, 2004).

181. See H.R. Rep. No. 108-126, at 192-94 (2003).

182. David S. Hilzenrath, Panel Backs End to "Double Taxation" on Jury Awards, Wash. Post, May 10, 2003, at A11.

183. H.R. 4520, 108th Cong. § 643(a) (as amended by the Senate).

catch-all now defines a claim of unlawful discrimination as any act that is unlawful under:

> (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.[184]

The expansion of the catch-all category was in apparent response to employment attorneys who were concerned that the legislation as previously drafted failed to address claims for overtime and other benefits.[185] Of course, with the catch-all category so broadly drafted, it makes little sense to define the causes of action covered by the statute in terms of claims for "unlawful discrimination." If the statute were truly intended to cover all employment-related claims, then a significant amount of complexity and confusion could have been eliminated if the legislation had been drafted to address legal expenses paid or incurred by the taxpayer *in connection with any action relating to the taxpayer's trade or business of performing services as an employee.*

From a revenue standpoint, section 643 of the Senate JOBS Act should not prove difficult to pass. The Joint Committee has scored the cost of the proposal at $342 million over the 10-year period from 2004 to 2013.[186]

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184. Id. § 643(b) (proposed IRC § 62(e)(18)) (emphasis supplied).

185. See, e.g., Wood, supra note 178, at 402.

186. Joint Comm. on Tax'n, Estimated Revenue Effects of S. 1637, the "Jumpstart Our Business Strength ('Jobs') Act," as Passed by the Senate, JCX-36-04, at 8 (2004). The year-by-year costs estimates are as follows:

Period	Decrease in Revenue
2004	$ 11 million
2005	$ 47 million
2006	$ 28 million
2007	$ 29 million
2008	$ 31 million
2009	$ 34 million
2010	$ 36 million
2011	$ 38 million
2012	$ 42 million
2013	$ 44 million
2004-2013	$ 342 million

Measured against the roughly $1.7 trillion in tax cuts enacted by the sitting administration,[187] this provision could hardly be described as material. Indeed, the $342 million figure over 10 years likely pales in comparison to the value of private and judicial resources that have been expended litigating the tax treatment of legal fees, not to mention the societal costs of litigation concerning legal malpractice claims and tax gross ups that is sure to follow if corrective legislation is not passed. Thus, even though mounting deficits have made any form of tax-cutting legislation more difficult to pass, the minimal cost of the limited fix to the AMT trap should not be raised as a legitimate obstacle to its passage.

Like its predecessors, the current legislative proposal contained in the JOBS bill is far from perfect. It is a complicated provision that does not address all claims in which the improper tax treatment of legal fees under the AMT arises. However, despite these shortcomings, the legislation if enacted would eliminate the AMT trap in a wide range of employment litigation where the AMT trap is most prevalent. Furthermore, by addressing civil rights cases, the legislation would correct the AMT trap in instances where, due to fee-shifting statutes, its impact on plaintiffs could be most severe. Since this is perhaps the best chance at eliminating a portion of the AMT trap, the legislation should be enacted. Something is better than nothing. The only downside of the proposed above-the-line deduction for legal expenses in certain cases of unlawful discrimination is that limited reform will likely doom the prospect of more comprehensive corrective legislation being enacted in the future.

B. A Comprehensive Solution

The need to correct the improper tax treatment of legal fees exists for all cases that are currently subject to the AMT trap – not just those relating to unlawful discrimination or broader claims arising in the employment context. There is no justifiable reason why legal fees paid or incurred to prosecute claims

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Id. The spike in lost revenue estimated for 2005 is on account of the legislation applying to all judgments or settlements executed after December 31, 2002.

By comparison, the Joint Committee scored almost identical legislation in the 2003 bill at only $205 million over the 2003-2013 time period. Joint Comm. on Tax'n, Estimated Budget Effects of the "Jobs and Growth Tax Relief Reconciliation Act of 2003," Scheduled for Consideration by the Committee on Finance on May 13, 2003, Fiscal Years 2001-2011, JCX-50-03, at 4 (2003).

187. See Joint Comm. on Tax'n, Estimated Budget Effects of the Conference Agreement for H.R. 1836, JCX-51-01, at 8 (2001) (estimating the total revenue cost of the Economic and Growth Tax Relief Reconciliation Act of 2001 at $1.35 trillion); Joint Comm. on Tax'n, Estimated Budget Effects of the Conference Agreement for H.R. 2, The "Jobs and Growth Tax Relief Reconciliation Act of 2003," Fiscal Years 2003-2013, JCX-55-03, at 2 (2001) (estimating the total revenue cost of the Jobs and Growth Tax Relief Reconciliation Act of 2003 at $350 billion).

for defamation, intentional infliction of emotional distress, or punitive damages should be relegated to the status of miscellaneous itemized deductions that are subject to complete disallowance under the AMT. Accordingly, the AMT trap should be corrected for all possible situations in which it would otherwise arise. This could be accomplished rather easily by amending section 62(a) to add to its list of above-the-line deductions the following: *deductions allowed under sections 162 or 212 which consist of expenses paid or incurred in connection with the prosecution of a cause of action.*

Taking the rules governing the taxation of damage awards under section 104(a) as a given, the amendment to section 62(a) proposed above would reach the legal fees incurred in order to obtain any taxable recovery. Yet because section 62(a) is a deduction-ordering statute as opposed to a deduction-granting provision, the proposed amendment would not affect the nondeductibility of legal fees incurred to procure damages that are excluded from gross income.[188] Thus, the proposed amendment to section 62(a) would address only the tax treatment of legal fees that give rise to the AMT trap, while being broad enough to reach any case in which above-the-line treatment is appropriate.

CONCLUSION

The unjust and unfair tax treatment of legal fees under the AMT has been known for years. While the issue of whether a portion of a taxable damages recovery that is paid to the plaintiff's attorney pursuant to a contingency fee arrangement is currently before the Supreme Court, a plausible interpretive solution to the problem does not appear to exist. Simply put, the responsibility for correcting the matter rests with Congress. Given the well-publicized tax burden placed on unsuspecting plaintiffs, the additional costs of settlement that properly advised plaintiffs may be able to shift to defendants, and the burdens placed on scarce judicial resources due to litigation concerning not only the plaintiff's underlying tax liability but also issues tangentially related to it (legal malpractice, tax gross-ups, etc.), the failure of Congress to act on the matter defies logic. This is particularly so when a comprehensive solution to the improper tax treatment of legal fees could be accomplished through a one-sentence provision that, if enacted, would have negligible impact on the federal fisc.

Looking on the bright side, the Senate has recently recognized that the tax treatment of plaintiff's legal fees in discrimination cases simply cannot stand. While this less comprehensive and more complicated legislative fix is not ideal, its enactment would be a welcome sign. By correcting the most visible and economically significant instances of the AMT trap, Congress will at least demonstrate that it will no longer turn a blind eye to the injustice caused by the tax treatment of litigation expenses under the AMT.

188. See IRC § 265(a)(1).

ADDENDUM

The portion of the Senate version of the American Jobs Creation Act of 2004 that conferred above-the-line status to certain legal fees[189] was adopted (with slight modification, as discussed below) by the House-Senate conference committee charged with reconciling the differences between the chambers' two bills.[190] Accordingly, section 703 of the American Jobs Creation Act of 2004 (hereinafter "Act section 703") created a new provision, enumerated as IRC section 62(a)(19),[191] conferring above-the-line status for attorney's fees and court costs paid in connection with the prosecution of a cause of action for certain claims against the federal government, a private cause of action under the Medicare Secondary Payer statute, and, most significantly, any claim of "unlawful discrimination" as defined in the statute.[192] The full text of the legislation is reproduced in the Appendix. The legislation adopted at the conference level was largely identical to that contained in the Senate bill; the only change made concerned the effective date of the legislation. Whereas the Senate bill would have been effective for all fees and costs paid after December 31, 2002, the conference agreement made Act section 703 effective only for "fees and costs paid after the date of enactment of [the] Act, with respect to any judgment or settlement occurring after such date."[193] That effective date is October 22, 2004, the day that President Bush signed the legislation into law.

As discussed in Part III of the Article, Act section 703 represents a significant improvement in the law (assuming that contingent attorney's fees and court costs otherwise would be recovered as miscellaneous itemized deductions.) By addressing legal fees incurred in virtually any employment-related claim, the legislation corrects the AMT trap for the vast majority of

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189. For a discussion of the Senate bill, see text accompanying supra notes 174-87.

190. See H.R. Rep. No. 108-755, at 252-54 (2004). The legislation as originally passed by the House of Representatives did not contain a corresponding provision addressing the taxation of attorney fees. See id. at 253.

191. While the legislation clearly intended to create a new provision following the last enumerated classification of an above-the-line deduction under § 62(a), § 62(a)(19) already existed to confer above-the-line status to the deduction under § 223 for contributions to health savings accounts. See IRC § 62(a)(19) (prior to amendment by American Jobs Creation Act of 2004, H.R. 4520, 108th Cong. Act § 703 (2004)). This mistake apparently stems from the fact that the attorney fee legislation had been proposed in bills that were proposed before the pre-existing § 62(a)(19) was inserted into the Code. Given that the legislation was clearly not intended to strike the pre-existing § 62(a)(19), presumably the new provision created by the legislation will be re-designated as § 62(a)(20) by way of a technical correction.

192. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703 (2004).

193. Id. § 703(c).

instances in which it will arise. Furthermore, by addressing legal claims arising under anti-discrimination and other statutes that provide for fee-shifting, the legislation fixes the AMT trap in the most egregious instances, where the plaintiff's tax liability could, in certain cases, exceed his or her net monetary recovery. However, while Act section 703 constitutes a substantial improvement in the law, the legislation by no means constitutes an ideal resolution to the improper and unjust treatment of legal fees under the AMT, as discussed below.

Senator Grassley, the apparent Senatorial champion of the legislation at the conference committee, issued a press release after the conferees voted on the final conference report stating that "Tax relief gets the headlines, but part of tax relief is tax fairness. . . . It's clearly a fairness issue to make sure people don't have to pay income taxes on income that was never theirs in the first place. That's common sense."[194] Measured against the goal of fairness in taxation, however, Act section 703 fails in two principal respects. First, the legislation is substantively underinclusive. Act section 703 does not fix the AMT trap for legal fees incurred in prosecuting punitive damage claims or common law tort claims not involving a personal physical injury (e.g., negligent or intentional infliction of emotional distress, defamation, slander). By creating this "favored" set of legal claims, Act section 703 violates the principle of horizontal equity.[195]

Second, the non-retroactive effective date of Act section 703 is disconcerting. If the legislation were intended to correct the acknowledged unfair tax treatment confronting certain litigants, then why was the legislation

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194. Press Release, Sen. Charles E. Grassley (Oct. 6, 2004), at http://finance.senate.gov/press/Gpress/2004/prg100604e.pdf (stating that Grassley secured inclusion of the legislation in the conference report). See also 150 Cong. Rec. S11036 (daily ed. Oct. 10, 2004) (statement of Sen. Baucus congratulating Sen. Grassley for assuring that the conference report included Act § 703).

195. The most economically significant category of claims still subject to the AMT would appear to be punitive damage claims. The legislation's denial of relief for punitive damage claimants could possibly be justified on grounds that punitive damages should normatively belong to the broader community, rather than to the plaintiff alone. See generally Catherine M. Sharkey, Punitive Damages as Societal Damages, 113 Yale L.J. 347 (2003). A growing number of states have passed legislation pursuant to which a portion of any punitive damage award escheats to the state. See id. at 373-74. By keeping punitive damage claims subject to the AMT trap (and therefore subject to excessive taxation), the legislation can be viewed as blessing a federal escheat regime. Even if a federal escheat regime is justified on policy grounds, the implementation of it through the AMT trap raises three concerns: (i) as noted above, the AMT trap remains for non-punitive damage claims, (ii) the decision to implement such a regime through the tax law in this fashion is entirely nontransparent, and (iii) depending on how the Supreme Court rules in *Banks* and *Banaitis*, such a federal escheat regime might apply to taxpayers residing in some circuits and not others. Even if such a federal escheat regime can be justified as a policy matter, it appears to be the product of legislative accident as opposed to thoughtful deliberation.

not made retroactively effective for all open tax years or at least for claims recently settled?[196] There would appear to be little substantive policy grounds to support non-retroactivity.[197] In all likelihood, the decision to reject retroactivity was likely a mere compromise between the House (which had no AMT trap provision at all) and the Senate (which provided relief on a retroactive basis). Furthermore, the revenue effect probably played some role. The estimated cost of making the legislation retroactive to 2003 was roughly $60 million.[198] Given that the final version of the American Jobs Creation Act of 2004 was scored to produce a net $1 million of additional revenue over the 10-year budget window, even the relatively minor revenue cost of retroactivity could have proven significant.[199]

The enactment of Act section 703 raises interesting questions as to what effect, if any, the legislation has on the determination of whether the portion of a plaintiff's recovery that is paid to an attorney pursuant to a contingent-fee arrangement is included in the plaintiff's gross income. On one hand, the corrective legislation is certainly consistent with the conclusion that contingent attorney's fees do not give rise to an exclusion from gross income, but rather a deduction that was (and in many instances, still is) subject to unwarranted

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196. Because of the nonretroactivity, the AMT trap will still apply for certain taxpayers who obtained judgments or settled causes of action during this taxable year (namely, before October 22, 2004) who have not yet paid the additional taxes attributable to the AMT trap. Indeed, one has to have some empathy for an individual who settled a cause of action giving rise to the AMT trap prior to the date of enactment, given that the legislation as proposed and passed by the Senate (but not by the conference committee) would have provided retroactive relief.

197. The only conceivable substantive policy justification for nonretroactivity is that perhaps one might view retroactivity as a windfall to a plaintiff who settled his or her claim with the knowledge that it would be subject to extra tax.

198. Cf. Joint Comm. on Tax'n, Estimated Budget Effects of the Conference Agreement for H.R. 4520, the "American Jobs Creation Act of 2004," JCX-69-04, at 6 (estimating the 10-year cost of the legislation having only prospective effect at $327 million); Joint Comm. on Tax'n, Comparison of the Estimated Budget Effects of H.R. 4520, the "American Jobs Creation Act of 2004" as Passed by the House of Representatives, and H.R. 4520, the "Jumpstart Our Business Strength ('JOBS') Act," as Amended by the Senate, JCX-53-04, at 8 (estimating the 10-year cost of the legislation having limited retroactive effect at $387 million).

199. See Joint Comm. on Tax'n, Estimated Budget Effects of the Conference Agreement for H.R. 4520, the "American Jobs Creation Act of 2004," JCX-69-04, at 10. It is possible that, because large amounts of tax could depend on the precise time when fees and costs are "paid" and when any settlement "occurs," litigants might attempt to amend earlier an earlier settlement (perhaps calling for a lower payment by the defendant) so that the taxpayer-plaintiff can take the position that the settlement occurred after the effective date. If so, because of the nonretroactive nature of the legislation, litigation might ensue between the IRS and the taxpayer regarding the timing of the settlement and payments in respect thereof.

limitation. Proponents of this interpretation, including the authors, have argued that the AMT trap for legal fees requires legislative correction, and now Congress has finally complied. On the other hand, one could argue that the corrective legislation has no bearing whatsoever on the inclusion/deduction versus exclusion debate. Rather, the legislation only operates to achieve a more equitable result for residents of those circuits in which the legal fees have been found to be deductible.[200]

A third interpretation of the enactment of Act section 703 is that the corrective legislation served to clarify that prior law produced a result favorable to the taxpayer. This argument was made by the taxpayers in the *Banks* and *Banaitis* cases, through supplemental briefing to the Supreme Court.[201] The taxpayers pointed to an exchange occurring on the Senate floor several days after adoption of the conference report between Senator Grassley and Senator Baucus, in which Senator Grassley suggested that Act section 703 was a mere clarification of pre-existing law that the attorney's fee portion of a recovery was not included in "taxable income whether for regular income or alternative minimum income purposes."[202] This interpretation is flawed in a number of

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200. This argument has one particular flaw. If the legislation was intended solely to maintain parity between taxpayers in the majority of circuits holding that contingent legal fees give rise to a deduction and those in the minority of circuits holding that contingent legal fees are excluded from gross income, then there is no reason for the corrective legislation to distinguish among those types of claims that give rise to a taxable damages recovery.

201. Joint Supplemental Brief for Respondents at 3-4, Comm'r v. Banks and Comm'r v. Banaitis, U.S. Supreme Court Docket Nos. 03-892 and 03-907 (filed Oct. 22, 2004).

202. The full exchange between the Senators appears in the Congressional Record as follows:

> *Mr. Baucus.* As I understand it, the case law with respect to the tax treatment of attorney's fees paid by those that receive settlements or judgments in connection with a claim of unfaithful discrimination, a False Claims Act, "Qui Tam," proceeding or similar actions is unclear and that its application was questionable as interpreted by the IRS. Further, it was never the intent of Congress that the attorneys' fees portion of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes.
>
> Is it the understanding of the chairman that it was the conferee's intention for Section 703 to clarify the proper interpretation of the prior law, and any settlements prior to the date of enactment should be treated in a manner consistent with such intent?
>
> *Mr. Grassley.* The Senator is correct. The conferees are

respects,[203] and it is belied by the conference report accompanying the legislation acknowledging that, under existing law, attorney's fees in this context were generally recovered as a miscellaneous itemized deduction.[204] Thus, interpreting Act section 703 as clarifying that prior law favored the taxpayer overstates the case. A better reading of Act section 703 is that it makes no particular statement regarding the interpretation of prior law, but applies only to the extent that legal fees in these instances are determined to be properly recovered by way of a deduction.

> acting to make it clear that attorneys' fees and costs in these cases are not taxable income, especially where the plaintiff, or in the case of a Qui Tam proceeding, the relator, never actually receives the portion of the award paid to the attorneys. Despite differing opinions by certain jurisdictions and the IRS, it is my opinion that this is the correct interpretation of the law prior to the enactment of Section 703 as it will be going forward. In adopting this provision, Congress is codifying the fair and equitable policy that the tax treatment of settlements or awards made after or prior to the effective date of this provision should be the same. The courts and IRS should not treat attorney's fees and other costs as taxable income.

150 Cong. Rec. S11036 (daily ed. Oct. 10, 2004).

203. To start, it is difficult to imagine how the creation of a new above-the-line deduction for attorney's fees paid in certain cases supports an interpretation that such fees give rise to an exclusion from gross income or constitute an above-the-line deduction under a different theory (either one of which is necessary for the taxpayer to prevail under prior law). If that were the case, then the new § 62(a)(19) created by the legislation would be a wholly superfluous provision. Second, if Act § 703 were intended to serve as a mere clarification of prior law, then there would be no reason for Act § 703 to distinguish between the claims to which it applies. Last, if Act § 703 were intended to serve as a mere clarification of prior law, then there would be no reason for the conferees to negotiate over the effective date of the legislation.

204. H.R. Rep. No. 108-755, at 252 (2004).

APPENDIX

The American Jobs Creation Act of 2004, Pub. L. No. 108-357

Sec. 703. Civil Rights Tax Relief.

(a) *Deduction Allowed Whether or Not Taxpayer Itemizes Other Deductions*.–Subsection (a) of Section 62 (defining adjusted gross income) is amended by inserting after paragraph (18) the following new item:

"(19) *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 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.".

(b) *Unlawful Discrimination Defined*.–Section 62 is amended by adding at the end the following new subsection:

"(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 Employment Retirement 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 (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 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 actions permitted by law."

(c) *Effective Date.*–The amendments made by this section shall apply to fees and costs paid after the date of enactment of this Act [October 22, 2004], with respect to any judgment or settlement occurring after such date.