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# TAX TIPS FOR ATTORNEYS: SUPREME COURT RULES ON TAXATION OF ATTORNEY FEES

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On January 24, 2005, in *Commissioner v. Banks*, \_\_\_ U.S. \_\_\_ [125 S.Ct. 826], the United States Supreme Court resolved a conflict among the federal appellate courts by holding that contingent fees paid to an attorney out of a taxable damage award or settlement are not excludible from the taxpayer's gross income, but rather are includible in the taxpayer's gross income and deductible only as miscellaneous itemized deductions. The decision reverses two pro-taxpayer decisions, *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003) and *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003). As a result, the portions of the taxpayers' wrongful discharge and employment termination settlements paid to their respective attorneys as contingent fees were includible in their gross income.

In *Banks*, the Sixth Circuit Court of Appeals, reversing the United States Tax Court, held that an individual who settled an employment termination lawsuit did not have to include in his income the contingent fees paid from the settlement directly to his attorneys. It reached this result even though the settlement was governed by California law, which did not give attorneys entitled to a contingent fee any special lien in the settlement or judgment, but rather treated them the same as other creditors.

In *Banaitis*, the Ninth Circuit, also reversing the United States Tax Court, held similarly that a taxpayer who reached a settlement with two banks after he successfully sued them for wrongful discharge did not have to include in his income the contingent fees paid directly from the settlement to his attorneys. It reached this result because Oregon law, which governed the case, gave the attorneys a property interest in the settlement.

Excluding the attorney fees from gross income involves no tax cost to the taxpayer on the portion of the award or settlement that is paid to the attorneys. Having to include the entire award or settlement in gross income and deduct the fees as miscellaneous itemized deductions can result in some or even a large amount of tax being

payable on the portion of the award or settlement that is paid to the attorneys. This is because of: (1) the 2% floor on miscellaneous itemized deductions under Internal Revenue Code § 67, (2) the overall limitation on itemized deductions under Internal Revenue Code § 68, and (3) Internal Revenue Code § 56(b)(1)(A)(i), which disallows miscellaneous itemized deductions for alternative minimum tax (AMT) purposes.

Supreme Court's Decision Not Applicable to Claims of Unlawful Discrimination Resolved After October 22, 2004. The American Jobs Creation Act of 2004 (Pub. L. No. 108-357, 118 Stat. 1418) added § 62(a)(19) to the Internal Revenue Code. This subsection provides that in computing adjusted gross income, a taxpayer may deduct attorney fees and court costs paid in connection with any actions involving a claim of "unlawful discrimination." Claims of unlawful discrimination would include violations of a number of specified federal statutes, as well as violations of any federal, state, or local law regulating any aspect of the employment relationship or prohibiting the discharge of an employee. (I.R.C. § 62(e).) This provision is effective for fees and costs paid after October 22, 2004 with respect to any judgment or settlement occurring after that date. Of particular importance is that this new provision allows an above-the-line deduction, as opposed to an itemized deduction, making it effective for AMT purposes as well.

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