



## **Dust Finally Settles On Contingency Fee Question**

A recent Supreme Court Decision and a new tax law have only added to the confusion surrounding the taxability of attorney contingency fees as of late. Fortunately, the dust appears to be finally settling. Here's what we know.

### **First, Some Background**

Public interest groups and civil rights plaintiffs have been crying foul for some time over the government's requirement that a victorious civil rights plaintiff pay taxes on the entire amount of a damage award even though a contingent fee went to the plaintiff's attorney (who would then, theoretically, pay taxes on the amount).

### **The Supreme Court Weighs In**

Stepping in to resolve conflicting rulings among different Federal Circuit Courts of Appeal, the Supreme Court unanimously ruled in January 2005 that contingent fees paid to an attorney out of a taxable damage award or settlement *are not* excludible from a client's gross income. The decision in *Commissioner v. Banks* and *Commissioner v. Banaitis* upholds the government's position that the fees are to be included in gross income and deductible as a miscellaneous itemized deduction.

### **Some (Limited) Relief**

However, last October's American Jobs Creation Act of 2004 contained a section addressing contingent fees in certain types of litigation. According to the law, taxpayers may rely on new Section 62(a)(19) for relief, which allows taxpayers with certain discrimination claims to deduct

attorney's fees and court costs from their adjusted gross income as an *above-the-line deduction* in very limited circumstances (certain civil rights actions, claims against the government and Medicare fraud claims incurred after October 22, 2004). Because this is an above-the-line deduction, the taxpayer does not have to itemize to claim the deduction.

In the end, it appears that any positive change for taxpayers applies in only very limited circumstances.