



New York State Bar Association

Tax Report #987

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February 13, 2001

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
United States House of Representatives
2208 Rayburn House Office Building
Washington, D.C. 20515

Re: Proposed Legislation on Taxation of Certain Litigation Awards and Settlements

Dear Chairman Thomas:

The enclosed Tax Section report¹ comments on proposed legislation that would amend the Internal Revenue Code to exclude from income compensatory damages and legal fees awarded in certain discrimination cases. The proposed legislation—introduced last year as the Civil Rights Tax Fairness Act—would partially reverse 1996 amendments that limited the exclusion of damage awards to physical injury cases. In addition to commenting on the proposed legislation, our report describes prior uncertainty as to the tax treatment of damage awards that lead to those amendments.

Our analysis of tax policy issues presented by the proposed legislation is in three parts. The first considers treatment of compensatory damages, which under current law are taxed unless they

¹ The enclosed report was drafted primarily by Lisa Levy (co-chair of the Section's Committee on Individuals) and Terence Dougherty.

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arise from a physical injury. The proposed legislation would exclude compensatory damages in discrimination cases from income, but would not exclude punitive damages or awards of backpay and frontpay.

Our report considers arguments that can be made for and against the proposed exclusion based on considerations of horizontal equity. Our report also expresses concerns about practical difficulties the Internal Revenue Service and courts may face in limiting the proposed exclusion to awards of the kinds contemplated. For example, it may not be feasible to distinguish settlements that are in substance severance pay from those that are properly characterized as settlements of claims covered by the proposed legislation. We also question whether the Service and courts will be able to police allocations of settlements between taxable backpay and frontpay, on the one hand, and nontaxable pain and suffering awards, on the other. Employers generally can deduct settlements and awards regardless of whether claimants are taxed; thus, competing tax interests may not serve to limit mischaracterizations and misallocations.

The second part of our analysis deals with treatment of legal fees. Under current law, a claimant may be required to include the full amount of recoveries that include legal fees in income but—because of the alternative minimum tax, the two-percent floor and other limits—be denied a full offsetting deduction for legal fees paid to secure that income. Thus, a claimant may be taxed on an amount that exceeds the net amount he or she can retain or even receive. As our report explains, the treatment of taxpayers may differ depending on state law governing the attorney's claim to a portion of the recovery. Based on applicable state property or contract law, some claimants may be able to exclude contingent fee awards from income. The proposed legislation would permit all claimants, regardless of applicable state law, to exclude recoveries of certain legal fees from income.

Our report supports consistent treatment of claimants regardless of state law. Our report also supports relief—either in the form of the proposed exclusion or in the form of full deductibility—from overtaxation that can result under current law. Any inclusion in income of recoveries of legal fees incurred to produce taxable income should be offset by full deduction. Our report also notes, however, that current limitations on deduction of legal fees is part of a larger problem; there may be many other cases in which substantial costs clearly incurred to produce taxable income are not fully deductible. Thus, we also express concern in our report about whether it is appropriate to single out legal fees for special relief from this problem.

The third part of our analysis deals with income averaging. The proposed legislation would permit income averaging of taxable backpay and frontpay awards. We consider arguments for and against this proposal.

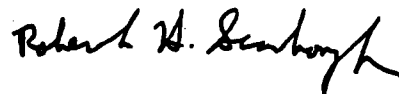
The enclosed report considers only issues of tax law, policy and administration presented by the proposed Civil Rights Tax Fairness Act. In addition to these issues, the proposed legislation also raises non-tax policy issues as to which we have no special expertise and which our report does not consider. Accordingly, our report does not make any recommendation as to whether the proposed legislation should or should not be enacted.

The enclosed report (as is the case with our reports generally) reflects only the views of the Tax Section and not necessarily those of the New York State Bar Association as a whole.

The Honorable William M. Thomas
February 13, 2001
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If we can be of further assistance in consideration of the issues addressed in the enclosed report, please contact the current Chair of the Tax Section, Bob Jacobs. Although my term as Chair ended last month, I am submitting this report because it was prepared during my term.

Sincerely,



Robert H. Scarborough

Enclosure

Identical letter to: The Honorable Charles E. Grassley
 Chairman, Senate Finance Committee

 Mark Weinberger, Esq.
 Office of Tax Policy
 United States Treasury Department

cc: The Honorable Charles B. Rangel

 James D. Clark, Esq.

 John Buckley, Esq.

 Lindy Paull, Esq.