

Article Published in *Northwest Suburban Bar Association Newsletter*- January 2005

Employment Law

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Civil Rights Tax Relief Act of 2004

On October 22, 2004, President George W. Bush signed the Civil Rights Tax Relief Act (CRTRA), a provision included in the American Jobs Creation Act of 2004 (H.R. 4520). The CRTRA ends the double taxation of attorneys' fees and costs applied to individuals who win or settle employment discrimination and related cases. Section 703 allows plaintiffs to exclude attorney's fees and costs from their adjusted gross income, ending double taxation of fees and costs and avoiding any problems with the Alternative Minimum Tax. The measure applies to civil rights cases, employment discrimination cases, FLSA and other wage and hour cases, ERISA benefits cases, and cases under any Federal, State or local statute, or common law, regulating the employment relationship.

The attorneys' fees provision is prospective only, and applies to fees and costs paid after that date, on judgments or settlements occurring after October 22, 2004. The original version of the CRTRA also included a provision that excluded non-economic awards or settlements such as emotional distress from taxation and a provision to allow income averaging so that plaintiffs receiving lump sum awards for their back pay didn't pay higher taxes. Along the way, those provisions were removed from the bill to allow passage of the end of double taxation since it was the most likely provision to pass before Congress.

Until the passage of the CRTRA, complications existed with nearly every settlement of an employment discrimination case since the IRS required a civil rights plaintiff who won or settled a case to pay taxes on the entire award or settlement including the payment that went to the plaintiff's attorney. For instance, if the plaintiff won an award of \$100,000, the plaintiff would be required to pay tax on the entire amount even though a contingent fee of \$30,000 went to the plaintiff's attorney and even though the plaintiff's attorney would have to pay taxes on the \$30,000.

The IRS position was that since the entire award went to the client it should be taxed to the client regardless of whether the client actually received the money since it was money received to extinguish a debt owed by the plaintiff to the attorney. The plaintiff argued that IRS position did not take into account that there would be no recovery without the assistance of the attorney creating a "joint venture" between the attorney and the plaintiff. This issue has been the subject of numerous court cases throughout the country with mixed results. Some circuits followed the "joint venture" approach siding with the plaintiff however, in the majority of the courts, including the Seventh Circuit, the IRS position has prevailed. See *Kenseth v. Commissioner of Internal Revenue*, 259 F.3d 881 (7th Cir. 2001).

A frequently cited case as to the injustice of the double taxation issue is *Spina v. Forest Preserve District of Cook County*, 207 F. Supp 2d 764 (2002). In *Spina*, the plaintiff successfully brought suit for discrimination, sexual harassment, and retaliation by her employer, the Cook County Forest Preserve. The plaintiff was awarded \$3 million by a federal jury that was later reduced by the court to \$300,000 (the statutory cap for compensatory damages). The Court awarded the plaintiff over \$850,000 in attorney's fees which resulted in the IRS requiring her to pay taxes on her entire award plus an additional \$100,000 for the taxes on the attorney's

fees award.

The *Spina* case was among those mentioned in early November when the United States Supreme Court heard oral argument in the combined cases of *Commissioner of Internal Revenue v. Banks and C.I.R. v. Banaitis*, where both plaintiffs won awards in employment disputes and challenged the IRS based on tax bills based on the full amount of the recovery including attorney's fees. The Supreme Court's decision remains important to the issue since the CRTRA applies to fee payments made after October 22, 2004, when the law became effective. As such, plaintiffs who have received awards or settlements before October 22, 2004 do not benefit from the new enactment.

However, there is now some confusion as to whether the enactment of the CRTRA has made the cases moot. That was the position taken by the plaintiffs before oral argument when they asked the Supreme Court to dismiss the case. The plaintiffs argued that the decision would have little or no impact on future tax disputes involving substantially the same facts and because some members of Congress believed that the impact of the law passing was to simply clarify existing law, rather than changing it. The Court declined to dismiss the case and heard oral arguments. A decision is not expected from the Court until the spring of 2005.

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