



National Association of Consumer Advocates

Memorandum

To: Tax Preparers

From: National Association of Consumer Advocates (NACA)

Re: Tax Treatment of Attorney Fees earned in Consumer Law Cases

During the last two decades, there has been some legal confusion about whether clients in consumer law cases should be taxed on the fees earned by their attorneys. The purpose of this memo is to explain this misunderstanding and provide attorneys, accountants, and other tax preparers a suggested guide on how best to treat attorney fees on a consumer client's tax return.

Before we discuss the proper tax treatment of attorney fees, it is important to take note of two essential points about consumer law cases. First, in most consumer law cases, attorneys are not directly paid by their clients, but instead are paid by the defendants, pursuant to "fee shifting" provisions that exist in almost every consumer statute. Second, many consumer cases involve the protection of fundamental "civil" rights. Understanding these facts are necessary in evaluating the proper tax treatment of attorney fees.

The general principle that attorney fees are taxable income to clients was stated in the 2005 U.S. Supreme Court case, "*Banks v. Commissioner*" which held that when a "litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the **attorney as a contingent fee** (NOTE: attorney fees in consumer cases are not typically paid as a contingent fee, but instead are paid pursuant to a fee shifting provision). As to attorney fees paid pursuant to a "fee shifting provision," the *Banks* court, after specifically recognizing the arguments that "... treating the fee award as income to the plaintiff in such cases ... **can lead to the perverse result that the plaintiff loses money by winning the suit,**" and that "treating statutory fee awards as income to plaintiffs **would undermine the effectiveness of fee-shifting statutes.** . ." did not address the issue. In fact, no appellate court since *Banks* has addressed this issue of the taxability of attorney fees awarded pursuant to a fee shifting statute.

While the *Banks* case was pending before the Supreme Court, Congress passed the "American Jobs Creation Act of 2004" which specifically eliminated awards of attorney's fees in **civil rights and employment law** cases from a prevailing plaintiff's adjusted gross income. In other words, attorney fees in civil rights and employment cases would be deducted "above the line" on a client's tax return.

Despite the broad exceptions to the general rule about the taxability of attorney fees, many defendants in consumer cases continue to issue 1099s to successful clients for the full settlement or judgement amount of the case (which includes both the attorney fees and client's actual award). In evaluating how much, if any, the defendant issued 1099's stated income should be counted as actual income on a consumer client's tax return, the tax preparer – with the help of the client and their attorney – should perform the following analysis and prepare the client's tax return accordingly.

1. *Was the 1099 issued for a case involving civil rights or employment?*

If the answer is yes, no further analysis needs to be done. Instead, the tax preparer should treat the attorney fee portion of the 1099 as an above the line deduction and enter that amount on the new IRS Schedule 1 to Form 1040, line 24 (h) – Other adjustments - Attorney fees and court costs for actions involving certain unlawful discrimination claims¹.

2. *If the case did not involve civil rights or employment, were the attorney fees in the case awarded or provided pursuant to a fee shifting provision in a consumer protection statute?*

If the answer is yes, NACA strongly believes that these attorney fees should not be considered income to the consumer client. While we seek to both litigate and/ or resolve this issue with the IRS, we believe tax preparers should treat the attorney fee portion of the 1099 stated income in the following manner (NOTE: the return cannot be filed electronically): The non-attorney fee amount included in the 1099² should be entered on Schedule 1 (Form 1040), Line 8z Other Income: as a litigation award and then add: *see Statement. The statement can be attached or added to the bottom of the form and should include the following:

- The 1099 issued to the taxpayer was incorrect as it included attorney fees awarded pursuant to a fee-shifting statute.
- The attorney in this matter received a 1099 for the same income and has or will be paying taxes on that income.

If you have any questions about this memo, please do not hesitate to contact the taxpayer's consumer attorney or the National Association of Consumer Advocates at 202-452-1989.

¹ The definition of unlawful discrimination claims is very broad and includes any provision of federal, state, local, or common law claims permitted under or providing for the enforcement of civil rights or regulating any aspect of the employment relationship

² For example, the issued 1099 states an income amount of \$10,000, \$9,000 of which was for attorney fees. \$1,000 should be included on line 8z.