
HOW THE INCOME TAX UNDERMINES CIVIL RIGHTS LAW

Laura Sager & Stephen Cohen*

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* Clinical Professor of Law, New York University Law School, and Professor of Law, Georgetown University Law Center. The authors thank, for their helpful comments, Noel Cunningham, Suzanne Garment, Martin Ginsburg, Stephen Glass, Daniel Halperin, Michael Knoll, Ronald Pearlman, Clarissa Potter, Jessica Sager, and Daniel Shaviro. Cheryl Mackay, Richard B. Spitzer, and Lesley Whitcomb provided valuable research assistance.

INTRODUCTION

Federal statutes entitle the prevailing plaintiff in civil rights litigation to recover attorney's fees from the defendant.¹ The recovery of attorney's fees under these so-called "fee-shifting provisions" constitutes a deliberate departure from the usual American rule that each litigant must bear her own legal costs.²

A civil rights plaintiff acts not just for herself alone, but also as a "private attorney general," vindicating national policy.³ The fee-shifting provisions enable the plaintiff who cannot pay a private attorney, and whose potential recovery is not sufficient for a contingency fee arrangement, to perform this private attorney general function.⁴

This objective has been undermined by recent decisions of the federal courts of appeals and the tax court, as well as by rulings of the Internal Revenue Service (IRS), concerning the taxation of plaintiffs in cases of employment discrimination.⁵ Under these decisions, an employment

1. See Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988 (1994) (providing for fee shifting in § 1988(b)); Civil Rights Act of 1964, § 102, 42 U.S.C. § 2000a (1994) (providing for fee shifting in § 2000a-3(b)); Civil Rights Act of 1964, §§ 701-16, 42 U.S.C. § 2000e (1994) (providing for fee shifting in § 2000e-5(k)) [hereinafter Title VII]; Fair Housing Act, 42 U.S.C. §§ 3601-19, 31 (1994) (providing for fee shifting in § 3612 (p)); Americans with Disabilities Act of 1990, Pub. L. No. 101-336, 104 Stat. 327 (codified as amended in scattered sections of 42 U.S.C.) (providing for fee shifting in § 12205). The Supreme Court has interpreted these statutes, which state that the court may award reasonable attorney's fees to the "prevailing party," as requiring an award of fees to a prevailing plaintiff, unless special circumstances would make an award unjust. See *Hensley v. Eckerhart*, 461 U.S. 424, 429 (1983); *New York Gaslight Club, Inc. v. Carey*, 447 U.S. 54, 68 (1980); *Newman v. Piggie Park Enters., Inc.*, 390 U.S. 400, 401-03 (1968).

2. See *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975) (holding that each party in a lawsuit ordinarily shall bear its own attorney's fees unless there is express statutory authorization to the contrary).

3. *Blum v. Stenson*, 465 U.S. 886, 894 n.10 (1984); *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412, 416 (1978); *Newman*, 390 U.S. at 402.

4. See *Newman*, 390 U.S. at 402.

5. See *Fredrickson v. Commissioner*, 99-1 U.S. Tax Cas. (CCH), ¶ 50,167, 83 A.F.T.R.2d 99-435 (9th Cir. 1998) (holding that entire amount received in settlement of claim under Title VII is taxable to plaintiff but attorney's fees are not fully deductible); *Brewer v. Commissioner*, 74 T.C.M. (CCH) 1337 (1997), *aff'd without published opinion*, 172 F.3d 875 (9th Cir. 1999) (same); *Hardin v. Commissioner*, 73 T.C.M. (CCH) 2693 (1997) (same); *Martinez v. Commissioner*, 73 T.C.M. (CCH) 2289 (1997) (same); *Kenseth v. Commissioner*, 114 T.C. No. 26, 2000 U.S. Tax Ct. LEXIS 32 (2000) (holding that entire amount received in settlement of claim under Age Discrimination in Employment Act of 1967 is taxable to plaintiff but attorney's fees are not fully deductible); *Sinyard v. Commissioner*, 76 T.C.M. (CCH) 654 (1998) (same); Rev. Rul. 80-364, 1980-2 C.B. 294, (ruling that entire award for individual claim for back pay is taxable to plaintiff); Priv. Ltr. Rul. 98-09-053 (Dec. 2, 1997) (ruling that entire amount of legal fees withheld from a damage award for gender and age discrimination is taxable to plaintiff but not fully deductible).

discrimination plaintiff must report her entire recovery as income.⁶ However, the attorney's fees—the cost of producing the income—are not fully deductible under the regular tax⁷ and are *not deductible at all* under the alternative minimum tax (AMT).⁸

The disallowance of AMT deductions is particularly significant.⁹ Suppose that a plaintiff settles an employment discrimination claim for a total of \$120,000, out of which she pays \$50,000 in attorney's fees. The plaintiff's economic income is only \$70,000, which equals the \$120,000 recovery, less the \$50,000 in attorney's fees that are the cost of producing the recovery.¹⁰ However, the plaintiff's taxable income under the AMT is calculated as \$120,000, which equals the entire recovery without any deduction for the attorney's fees and overstates the plaintiff's economic

6. Before 1992, the Internal Revenue Code was interpreted to exclude from taxation all damages received on account of personal injury, both physical and nonphysical, including damages for unlawful discrimination. See generally Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination*, 35 HARV. J. ON LEGIS. 447, 452–73 (1998). However, in 1992 and 1995, the Supreme Court ruled in two employment discrimination cases that damages for lost earnings were not excludable. See *United States v. Burke*, 504 U.S. 229 (1992); *Commissioner v. Schleier*, 515 U.S. 323 (1995). In 1996, Congress amended the Code to exclude from taxation only damages received on account of physical injuries. See I.R.C. § 104(a) (1997). Thus, damages for unlawful discrimination may no longer be excluded. See Julia K. Brazelton, *The Income Tax Treatment of Damage Awards*, 75 TAXES 562 (1997) (explaining that the 1996 amendment to I.R.C. § 104(a) affects damage awards in all nonphysical injury cases).

7. The attorney's fees of employment discrimination plaintiffs are classified by the courts as miscellaneous itemized deductions. See *Fredrickson*, 99-1 U.S. Tax Cas. (CCH), ¶ 50,167; *Brewer*, 74 T.C.M. (CCH) 1337; *Hardin*, 73 T.C.M. (CCH) 2693; *Martinez*, 73 T.C.M. (CCH) 2289; *Sinyard*, 76 T.C.M. (CCH) 654. Miscellaneous itemized deductions are deductible only to the extent that the aggregate amount of such deductions exceeds two percent of adjusted gross income. See I.R.C. § 67(a) (2000). In addition, otherwise allowable miscellaneous itemized deductions are phased out for high-income taxpayers. See I.R.C. § 68(a) (2000).

8. The attorney's fees are classified as miscellaneous itemized deductions. See *supra* note 7. Miscellaneous itemized deductions are not deductible under the AMT. See I.R.C. § 56(b)(1) (2000).

9. The AMT must be paid whenever liability under the AMT is greater than liability under the regular tax. See I.R.C. § 55(a) (2000). Whether AMT liability is greater than regular tax liability depends on the complex interaction of many variables. In general, AMT liability will be greater for any year in which the taxpayer has expenses that are deductible under the regular tax but not under the AMT and also has receipts that significantly exceed the AMT's exemption amount.

10. The plaintiff's economic income cannot simply equal the gross recovery. In order to arrive at a true income figure, there must be a full allowance for the attorney's fees that are the cost of generating the recovery. Although these costs should be fully deductible in principle, the timing of the deduction should depend on when the recovery itself is taxed. If the recovery is reported over a period of years—perhaps because it is structured to be paid over that period—then the attorney's fees should be deductible over that period, rather than immediately deductible in full. See I.R.C. § 453 (2000). In addition, if the recovery itself is tax exempt, as is the case with compensatory damages for a physical personal injury, then there is no reason or need for a deduction for the attorney's fees that are the cost of generating exempt income. See I.R.C. §§ 104(a), 265(a)(1) (2000).

income by \$50,000.¹¹ At the lower AMT tax rate of twenty-six percent, the overstatement of income by \$50,000 increases the plaintiff's AMT liability by \$13,000.¹²

If the ratio of attorney's fees to the entire recovery is high enough, a before-tax gain may metamorphose into an after-tax loss. In *Alexander v. Commissioner*, for example, the plaintiff settled a state law employment claim for \$250,000 but incurred \$245,000 in attorney's fees, for a pre-tax profit of \$5,000.¹³ Under the AMT, the entire \$250,000 recovery was taxable but none of the \$245,000 in attorney's fees was deductible.¹⁴ If we assume that the taxpayer files jointly and has no other income, his AMT liability would be \$53,900.¹⁵ Under these assumptions, the nondeductibility of the employee's attorney's fees under the AMT would convert a \$5,000 before-tax gain into a \$48,900 after-tax loss.¹⁶

We believe that the AMT's disallowance of deductions for attorney's fees in these instances is wrong as a matter of tax policy.¹⁷ The disallowance is even more troubling because it undermines the national policy of encouraging the pursuit of meritorious civil rights claims.¹⁸ We are aware of no instance in which the IRS has applied these rules to civil rights plaintiffs in areas other than employment discrimination. Nevertheless, given the precedents involving employment discrimination,

11. See I.R.C. § 56(b)(1) (2000).

12. See I.R.C. § 55(b)(1)(A)(i)(I) (2000).

13. 72 F.3d 938, 940 (1st Cir. 1995). This example refers only to the taxable portion of the recovery that was allocated to the plaintiff's breach of contract claims. See *infra* note 102.

14. See *Alexander*, 72 F.3d at 946–47.

15. In this example, AMT liability is calculated under the year 2000 tax law. For a married couple filing jointly, the first \$45,000 of AMT income is exempt from the AMT. See I.R.C. § 55(d)(1)(A)(i) (2000). The first \$175,000 of AMT income above the exemption amount is taxed at a rate of 26%. Any additional AMT income is taxed at a rate of 28%. See I.R.C. § 55(b)(1)(A)(i) (2000). In this example, AMT income is \$250,000. The tax due on the first \$175,000 of AMT income is \$45,500. The tax due on the \$30,000 of additional AMT income is \$8,400. Thus, the total tax due under the AMT in this example is \$53,900. In fact, because the actual taxpayer in *Alexander* had other income and because of different exemption amounts and rates in effect for the taxable year in question, namely 1989, the denial of any AMT deduction for attorney's fees actually caused the taxpayer to incur an AMT liability of \$57,441. See *Alexander*, 72 F.3d at 939.

16. In *Alexander* the settlement agreement also provided that the taxpayer would receive a retirement annuity of \$70,000 a year. Therefore, the \$250,000 in attorney's fees should be allocated between the immediate cash payment of \$250,000 and the retirement annuity. When such an allocation is made, the taxpayer's before-tax gain no longer becomes an after-tax loss. Nevertheless, in other cases, if the ratio of attorney's fees to the total recovery is high enough, the application of *Alexander* will transform a before-tax gain into an after-tax loss.

17. See *supra* text accompanying note 10; *infra* text accompanying notes 150–154.

18. See *New York Gaslight Club, Inc. v. Carey*, 447 U.S. 54, 63 (1980). See also *infra* text accompanying notes 116–124 and 137–139.

such a result is entirely possible and would frustrate the private enforcement of civil rights claims for discrimination in education, housing, and public accommodations and for the violation of constitutional rights.

The tax treatment of attorney's fees in civil rights cases was unimportant until recently for a simple reason. For many years, the Code excluded from taxation all damages received in personal injury cases, including civil rights claims.¹⁹ Since all personal injury damages were tax-exempt, no deduction was allowed for the cost of producing them.²⁰ In 1992 and 1995, however, the Supreme Court held in two employment discrimination cases that damages were taxable,²¹ a result codified and extended by Congress in 1996 to cover all nonphysical injuries, including all claims of unlawful discrimination.²² With damages for civil rights violations now taxable, the question of the tax treatment of attorney's fees in such cases has assumed new importance.

Part I of this article discusses two preliminary issues that help determine whether attorney's fees are in fact deductible under current law. The first is whether a plaintiff might be able to exclude from taxable income the portion of a recovery expended for attorney's fees, thereby obviating the need to claim a deduction. The second concerns how the Internal Revenue Code categorizes the expense for attorney's fees.

Part II examines the legislative history of Internal Revenue Code provisions that affect the tax treatment of attorney's fees in employment discrimination cases. These provisions distinguish between reimbursed employee business expenses, which are fully deductible, and *unreimbursed* expenses, which are not fully deductible under the regular tax and not deductible at all under the AMT. Part III criticizes the decisions of the federal courts that decline to classify the attorney's fees in employment cases as a reimbursed expense, with the consequence that the plaintiff's income is overstated and overtaxed. Part IV explains how the income tax may also frustrate the fee-shifting provisions of federal civil rights statutes that provide remedies for discrimination in education, housing, and public accommodations and for violations of constitutional rights. Part V

19. See *supra* note 6.

20. See I.R.C. § 265(a)(1) (2000).

21. In the first case, *United States v. Burke*, the Court held that the exclusion applied only if the victim was afforded a "broad range of damages." 504 U.S. 229, 233-37 (1992). In the second, *Commissioner v. Schleier*, the Court ruled that the exclusion applied only if available remedies included damages for pain and suffering and only if damages compensated for an injury to physical or mental health. 515 U.S. 323, 335-36 (1995).

22. See I.R.C. § 104(a) (1997).

evaluates two possible solutions: careful drafting of settlement agreements and amending the tax law.

We conclude that the tax law should permit civil rights plaintiffs either to deduct fully or to exclude from income the portion of a recovery expended for attorney's fees. Either a deduction in full or exclusion would provide a more accurate measure of the plaintiff's income and also preserve the purposes of the fee-shifting provisions of federal civil rights law.

I. PRELIMINARY ISSUES UNDER CURRENT LAW

A. MUST THE PLAINTIFF REPORT THE PORTION OF A RECOVERY EXPENDED FOR ATTORNEY'S FEES?

Taxpayers must ordinarily include all receipts in taxable income, unless excluded by a specific provision of the Internal Revenue Code.²³ However, if a plaintiff could report only her net recovery, *after* payment of attorney's fees, then the question of whether the plaintiff may deduct the fees would never arise. With the portion of the recovery expended for attorney's fees excluded from the plaintiff's taxable income to begin with, there would be no justification or need for the plaintiff to take an offsetting deduction.²⁴

In a number of cases, mostly involving contingent fee arrangements in ordinary civil litigation, the plaintiff has argued that she and her attorney should be viewed as joint owners of the claim. The portion of the recovery expended for attorney's fees would then constitute the return on the portion of the claim owned by the plaintiff's attorney. The plaintiff would not report the return on the portion of the claim owned, not by the plaintiff, but by the plaintiff's attorney. The plaintiff would report only the balance of the recovery, net of attorney's fees, which constitutes the return on the portion of the claim owned by the plaintiff.

This argument has met with some success. In *Cotnam v. Commissioner*, the Fifth Circuit held that the plaintiff could report only the net recovery, after attorney's fees, because Alabama law granted the plaintiff's attorney an equitable lien that amounted to joint ownership of the

23. See I.R.C. § 61(a) (2000). See also *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (ruling that Congress intended to tax all gains unless specifically exempted); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929) (holding that the discharge by a third person of an obligation of the taxpayer is equivalent to receipt by the taxpayer). See also *supra* text accompanying notes 19–22.

24. See I.R.C. § 265(a)(1) (2000).

plaintiff's claim.²⁵ However, in *Baylin v. Commissioner* the Court of Appeals for the Federal Circuit ruled that, although Maryland law gave the taxpayer's attorneys a lien on any recovery to the extent of attorney's fees, the lien did not make the attorney a joint owner of the claim.²⁶ Therefore, the *Baylin* court required the plaintiff to report the entire recovery, including the portion expended for attorney's fees.²⁷

The Tax Court reluctantly applied *Cotnam* in *Davis v. Commissioner*, a 1998 case in which the attorney had an ownership interest in the plaintiff's claim by virtue of Alabama's attorney's lien law.²⁸ The Tax Court indicated that it had no other choice, since *Cotnam* was the controlling precedent for the circuit in which the taxpayer resided.²⁹ Other

25. 263 F.2d 119 (5th Cir. 1959). The court stated:

The Alabama Code provides: "The attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them." In construing this statute the Alabama courts have given full effect to the statute. Attorneys have the same rights as their clients. Under Alabama law, therefore, Mrs. Cotnam could never have received the [amount in question], even if she had settled the case directly with the Bank.

Id. at 125 (quoting ALA. CODE § 64(2) (1940)) (citation omitted). Judges Rives and Brown added the following:

[Plaintiff's] claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder. Accordingly she, in effect, assigned to her attorneys forty per cent of the claim in order that she might collect the remaining sixty per cent.

Id. at 125 (Rives, J. and Brown, J., concurring).

This year, in *Estate of Clarks v. United States*, 202 F. 3d 854 (6th Cir. 2000), the Sixth Circuit followed *Cotnam*. The court found that the Michigan attorney's lien law also conveyed an ownership interest in the plaintiff's claim. *See id.* at 857. The plaintiff therefore could exclude from income the portion of the recovery expended for attorney's fees. *See id.* at 857-58.

26. 43 F.3d 1451 (Fed. Cir. 1995). The court noted:

[A] Maryland statute . . . gives an attorney a lien on "attorney's fees and compensation specially agreed on with the attorney's client." . . . The argument that this statute gives the attorney an ownership interest in those funds is unsound. Maryland courts have *not* interpreted the state's lien statutes as creating such an interest . . . The [taxpayer's] "contention that it had no right to or ownership in that portion of the condemnation proceeds it owed to its attorney under the contingency fee agreement is simply without legal basis," and the entire condemnation award was properly considered gross income to the partnership.

Id. at 1455 (emphasis added) (citations omitted).

27. *See id.* As this article went to press, the Ninth Circuit delivered a ringing endorsement of the *Baylin* opinion. *See Coady v. Commissioner*, No. 98-71358, 2000 U.S. App. LEXIS 13692 (9th Cir. June 14, 2000).

28. 76 T.C.M. (CCH) 46 (1998), *aff'd*, 210 F.3d 1346 (11th Cir. 2000).

29. *See id.* at 48. The Tax Court explained:

[The Commissioner] makes several arguments to the effect that contingent attorney's fees should not reduce the amount of a judgment but constitute a miscellaneous itemized deduction Under the *Golsen* rule, however, we follow the law of the circuit in which this case is appealable, here the Eleventh Circuit [D]ecisions of the former Court of Appeals for the Fifth Circuit are binding precedent for courts in the Eleventh Circuit. [The Commissioner] has not brought to our attention any legal authority that overrules the Court of Appeals for the Fifth Circuit's opinion in *Cotnam v. Commissioner* a case that is squarely on point. On brief, [the Commissioner] candidly admits that this Court may feel

Tax Court decisions have followed *Baylin*. The Tax Court has recently held that attorney's lien laws in Alaska, Arizona, Texas, and Wisconsin do not grant an ownership interest in the plaintiff's claim and therefore has treated the plaintiff as receiving the entire recovery, including the portion used to pay attorney's fees.³⁰

The IRS challenges the notion that the tax treatment of plaintiffs should depend on the vagaries of state attorney's lien laws. It has consistently taken the position that the plaintiff must report the portion of the recovery expended for attorney's fees.³¹ It continues to attack *Cotnam*'s holding that, by virtue of the Alabama attorney's lien law, the plaintiff need not report the attorney's fee portion of a recovery.³²

No court has yet applied *Cotnam* to a claim for lost earnings, even when state law provides the attorney with an ownership interest in the client's claim. Moreover, foundational principles of federal tax law should prevent its application to such cases.³³ Seventy years ago, in *Lucas v. Earl*, the taxpayer assigned to another individual the right to one half of all the taxpayer's earnings.³⁴ Despite the validity of the assignment under state law,³⁵ the Supreme Court held that the federal law "could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man

constrained to follow the rule in *Cotnam*. In fact, we do feel so constrained. Accordingly, we find that the portion of the award retained by petitioner's attorneys should be excluded from her income

Id. at 48 (citation omitted).

30. See *Coady v. Commissioner*, 76 T.C.M. (CCH) 257 (1998) (holding that an attorney's lien under Alaska law did not convey an ownership interest in the recovery); *Sinyard v. Commissioner*, 76 T.C.M. (CCH) 654 (holding that an attorney's lien under Arizona law did not convey an ownership interest in the recovery); *Srivastava v. Commissioner*, 76 T.C.M. (CCH) 638 (1998) (holding that an attorney's lien under Texas law did not convey an ownership interest in the recovery); *Kenseth v. Commissioner*, 114 T.C. No. 26, 2000 U.S. Tax Ct. LEXIS 32, at *37-38 (2000) (holding that an attorney's lien under Wisconsin law did not convey an ownership interest in the recovery). In *Kenseth*, the Tax Court issued a lengthy opinion reaffirming that a plaintiff must ordinarily report the entire amount received in settlement of a claim, including the amount expended for attorney's fees. See *id.*

31. See Priv. Ltr. Rul. 98-09-053 (Dec. 2, 1997); Rev. Rul. 80-364, 1980-2 C.B. 294.

32. See, e.g., *Sinyard*, 76 T.C.M. (CCH) 654. The Tax Court noted:

[The IRS] disagrees with the Court of Appeals for the Fifth Circuit, and respondent continues to assert that . . . notwithstanding the peculiarities of State law, under contingency fee agreements attorneys do not acquire ownership of those portions of funds recovered in lawsuits allocable to attorney's fees, and the attorney's clients are taxable on the full amount of the funds recovered in spite of any lien the attorneys may have thereon.

Id. at 657-58.

33. See generally BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 75.2.1 (2d ed. 1991).

34. 281 U.S. 111, 113-14 (1930).

35. See *id.* at 114.

who earned it.”³⁶ The Supreme Court has described *Lucas v. Earl* as a “cornerstone of our graduated income tax system,”³⁷ embodying “the first principle of income taxation: that income must be taxed to him who earns it.”³⁸ Under this principle, an employee cannot escape tax on her earnings by assigning the right to receive them, including assignment of part of an employment-related claim to her attorney.³⁹

To summarize, the plaintiff need not report the portion of the recovery expended for attorney’s fees if the attorney-client relationship is governed by a state attorney’s lien law that conveys a property interest in the plaintiff’s claim *and* if the claim is not for lost earnings. In other instances, plaintiffs will generally be required to report their entire recovery, including the portion expended for attorney’s fees. Plaintiffs will then be able to avoid being taxed on the portion of a recovery expended for attorney’s fees only by claiming an offsetting deduction.

B. CATEGORIZATION OF THE EXPENSE FOR ATTORNEY’S FEES

In principle, the plaintiff’s income cannot simply equal her gross recovery. The attorneys’ fees—the cost of producing the income—must be fully deductible in order to arrive at a true income figure.⁴⁰ The Internal Revenue Code, however, does not directly address the question of the deductibility of attorney’s fees. Instead, the Code places all expenses of individual taxpayers into one of five categories: nonemployee business;⁴¹ reimbursed employee business;⁴² *unreimbursed* employee business;⁴³

36. *Id.* at 114–15.

37. *United States v. Bayse*, 410 U.S. 441, 450 (1973).

38. *Commissioner v. Culbertson*, 337 U.S. 733, 739–40 (1949). BITTKER & LOKKEN, *supra* note 33, explains the foundational character of the case: “Rarely has a judicial decision shaped an entire area of tax practice as conclusively as *Lucas v. Earl*. It prevents ordinary wage earners and salaried employees from assigning portions of their earned income”

39. *See Culbertson*, 337 U.S. at 739. On the other hand, a 1930 Supreme Court decision permitted the earner to escape taxation when the assignment was mandated by a state community property statute. *See Poe v. Seaborn*, 282 U.S. 101 (1930). The court distinguished *Lucas v. Earl* as involving a private contractual arrangement. *See* 282 U.S. at 111, 116–17. It is therefore conceivable, although probably unlikely, that a court today might decide that the *Cotnam* rule applies even to claims for lost earnings if the assignment is mandated by state statute.

40. *See supra* text accompanying notes 9–10.

41. *See* I.R.C. § 62(a)(1) (2000).

42. *See* I.R.C. § 62(a)(2)(A) (2000).

43. *See* I.R.C. §§ 62(a)(2) (2000) (by its explicit reference to reimbursed employee expenses, the Code implicitly creates the category of unreimbursed employee expenses).

“production or collection of income”;⁴⁴ and activity not engaged in for profit.⁴⁵

The first two categories—nonemployee business and reimbursed employee business—are fully deductible under both the regular tax and the AMT.⁴⁶ The last three categories—unreimbursed employee business, production or collection of income, and activity not engaged in for profit—are not fully deductible under the regular income tax and not deductible at all under the AMT.⁴⁷ The Code therefore creates a sharp distinction between reimbursed and unreimbursed employee business expenses, a distinction on which the tax treatment of employment discrimination plaintiffs now turns. As explained below, this distinction reflects the concern of Congress that unreimbursed employee business expenses “have characteristics of [nondeductible] personal expenditures.”⁴⁸

II. REIMBURSED VERSUS UNREIMBURSED EXPENSES: THE LEGISLATIVE HISTORY

A. UNDER THE REGULAR TAX

Unreimbursed employee business expenses suffer two separate disadvantages under the regular tax. Both disadvantages result from the classification of such unreimbursed expenses as “miscellaneous itemized deductions.”⁴⁹ First, miscellaneous itemized deductions are deductible only to the extent that the aggregate amount of such deductions exceeds two percent of adjusted gross income.⁵⁰ Second, otherwise allowable miscellaneous itemized deductions are subject to a phaseout. Such deductions are reduced by three percent of the amount by which adjusted gross income exceeds \$100,000.⁵¹ When both of the restrictions apply,

44. I.R.C. § 212(1) (2000).

45. *See* I.R.C. § 183 (2000).

46. *See* I.R.C. §§ 56(b), 62(a)(1)–(2) (2000).

47. *See* I.R.C. §§ 56(b)(1), 62(a), 63(d), 67, 68 (2000).

48. STAFF OF JOINT COMM. ON TAX’N, 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78 (Comm. Print 1987).

49. I.R.C. § 67(b) (2000). Unreimbursed employee business expenses are not deductible from gross income for the purpose of computing adjusted gross income. *See* I.R.C. § 62(a)(1)–(2) (2000). As a consequence of not being deductible from gross income, such expenses are considered “miscellaneous itemized deductions.” *See* I.R.C. §§ 63(d), 67(b) (2000).

50. *See* I.R.C. § 67(a) (2000).

51. *See* I.R.C. § 68(a)(1), (b)(1) (2000). The reduction cannot exceed 80% of otherwise allowable itemized deductions. *See* I.R.C. § 68(a)(2) (2000). The \$100,000 threshold is subject to an annual inflation adjustment. *See* I.R.C. § 68(b)(2) (2000). For 1999, the inflation adjusted threshold was \$126,600. *See* Rev. Proc. 98-61, 1998-52 I.R.B. 22.

their effect is equivalent to increasing the nominal marginal tax rate by the nominal marginal rate times five percent.⁵²

The restrictions on deducting unreimbursed employee business expenses under the regular tax are largely the result of changes made in 1986 and 1988 to the Internal Revenue Code's distinction between nonitemized and itemized deductions.⁵³ Prior to 1986, the distinction between nonitemized and itemized expenses had only two consequences, both of which continue to this day. First, individual taxpayers must choose between itemized deductions and the standard deduction.⁵⁴ Second, nonitemized deductions create a lower floor for deducting medical expenses and casualty losses, while itemized deductions do not.⁵⁵

In addition, until 1986, the Code classified as nonitemized not only all reimbursed employee business expenses but also a broad range of unreimbursed expenses: for travel away from home, transportation while on business, and all expenses of outside salespersons.⁵⁶ Only those

52. For example, if the highest nominal marginal rate of 39.6% applies, the two provisions in effect raise the nominal rate by 39.6% times .05, or by nearly two percent to 41.58%. See I.R.C. § 1(a)–(e) (2000). The two-percent floor has the effect of increasing the tax rate by the nominal rate times two percent. The phase-out has the effect of increasing the tax rate by the nominal rate times three percent. Thus, the combined effect is equivalent to increasing the marginal tax rate by the nominal marginal rate times five percent. Moreover, the phaseout will generally apply to all adjusted gross income above the threshold amount.

Because most taxpayers with adjusted gross incomes exceeding \$100,000 have itemized deductions well in excess of 3% of adjusted gross income, the reduction usually has the same effect as an increase in the tax rate on income in excess of \$100,000 from the nominal top rate of 31% to 31.93% (31% plus 31% of 3%).

BITTKER & LOKKEN, *supra* note 33, ¶ 30.4.3 (2d ed. Supp. II 1999).

53. See I.R.C. § 62(a) (1987); I.R.C. § 62(c) (1989). The Code classifies all deductions for individual taxpayers as either nonitemized or itemized. Nonitemized deductions are commonly described as “above the line” deductions and itemized deductions as “below the line” deductions, referring to the place on tax forms where such items are entered.

54. See I.R.C. § 63(b), (d) (2000). The purpose is to simplify the administration and enforcement of the tax laws for individuals with itemized deductions equal to or below the standard deduction amount. See BITTKER & LOKKEN, *supra* note 33, ¶ 2.1.3 at 2-11 to 2-12 (3d ed. 1999).

55. The deduction for medical expenses is currently limited to the amount in excess of 7.5% of adjusted gross income and for casualty losses to the amount in excess of 10% of adjusted gross income. See I.R.C. §§ 213(a), 165(h)(2)(A) (2000). Nonitemized deductions are taken into account in calculating adjusted gross income. Such deductions make adjusted gross income smaller, the floor lower, and allowable deductions for medical expenses and casualty losses larger. On the other hand, itemized deductions do not affect adjusted gross income, the floor, or allowable deductions for medical expenses and casualty losses. See I.R.C. §§ 62(a)(2), 165(h)(2)(A), 213(a) (2000). This consequence of classifying an expense as either nonitemized or itemized affects only those relatively few taxpayers with medical expense or casualty loss deductions large enough to exceed the applicable percentage of adjusted gross income.

56. See I.R.C. § 62 (1986).

expenses in a residual category, consisting of other unreimbursed expenses, were treated as itemized deductions.

In 1986, Congress enacted significant new restrictions on unreimbursed employee business expenses⁵⁷ and, in so doing, for the first time referred to such expenses as representing voluntary personal consumption. As noted above, before 1986 the Code had treated unreimbursed employee business expenses for travel away from home and for transportation while on business, as well as unreimbursed expenses of outside salespersons, as nonitemized deductions. The 1986 tax act classified *all* unreimbursed employee business expenses as itemized deductions, with a minor exception for actors, musicians, and other performing artists.⁵⁸ Apart from this exception, only employee business expenses that are reimbursed continue to be treated as nonitemized.⁵⁹

The 1986 Code also placed substantive limits on deducting, under the regular tax, "miscellaneous itemized deductions,"⁶⁰ a new category defined to include most unreimbursed employee expenses.⁶¹ Such expenses are deductible only to the extent that the aggregate amount exceeds two percent of adjusted gross income.⁶²

As a result of these changes, Congress subjected unreimbursed expenses to a new and dramatic disadvantage under the regular tax, as compared with reimbursed expenses. The Joint Committee on Taxation justified this disadvantage on the ground that unreimbursed employee business expenses, along with other miscellaneous itemized deductions, are more likely to involve personal consumption:

57. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, § 142 (1986).

58. See I.R.C. §§ 62(a), 63(d) (1987). The Joint Committee on Taxation explained the decision to reclassify unreimbursed employee travel and transportation expenses, as well as expenses of outside salespersons, as itemized deductions: "[t]he Congress . . . concluded that the distinction under prior law between employee business expenses (other than reimbursements) that were allowable above-the-line, and such expenses that were allowable only [below-the-line], was not supportable in most instances." STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 79 (Comm. Print 1987).

59. See I.R.C. §§ 62(a), 63(d) (1987).

60. I.R.C. § 67(b) (2000).

61. All unreimbursed employee business expenses, except qualifying expenses of performing artists, are treated as itemized deductions. See I.R.C. §§ 62(a)(2), 63(d) (2000). All itemized deductions are treated as "miscellaneous itemized deductions," unless specifically excepted. *Id.* None of the exceptions applies to unreimbursed employee business expenses. See I.R.C. § 67(b) (2000). Consequently, all unreimbursed employee business expenses, except qualifying expenses of performing artists, are treated as miscellaneous itemized deductions.

62. See I.R.C. § 67(a) (2000).

[T]hese expenses have characteristics of voluntary personal expenditures . . . [S]ome miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business . . . activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits.⁶³

Employer reimbursement, on the other hand, indicates that such expenses are truly business-related: “generally it is appropriate to disallow deductions for employee business expenses because employers reimburse employees for those expenses that are most necessary for employment.”⁶⁴

Two years later, in 1988, Congress imposed further restrictions on miscellaneous itemized deductions, including unreimbursed employee business expenses.⁶⁵ It provided for the phaseout of miscellaneous itemized deductions of taxpayers with high adjusted gross incomes.⁶⁶ Such deductions are reduced by three percent of the amount by which adjusted gross income exceeds a \$100,000 threshold amount.⁶⁷

In addition, Congress enacted a new code provision for determining whether an employee business expense qualifies as reimbursed and is

63. STAFF OF JOINT COMM. ON TAX’N, 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78–79 (Comm. Print 1987).

64. S. REP. NO. 99-313, at 79 (1986). The Joint Committee Report also mentioned simplification as a reason for restricting the deduction of unreimbursed expenses, particularly when the amounts are small and recurring:

Congress concluded that the prior-law treatment of . . . miscellaneous itemized deductions fostered significant complexity . . . For taxpayers who anticipated claiming itemized deductions, prior law effectively required extensive record keeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service. These problems were exacerbated by the fact that taxpayers may frequently make errors of law regarding what types of expenditures were properly allowable under prior law as miscellaneous itemized deductions.

STAFF OF JOINT COMM. ON TAX’N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78 (Comm. Print 1987) (footnote omitted).

65. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

66. A taxpayer’s adjusted gross income may be high even though her economic income is actually low. Gross income minus specified deductions equals adjusted gross income. See I.R.C. §§ 61, 62 (2000). Miscellaneous itemized deductions are not deductible from gross income for the purpose of calculating adjusted gross income. See I.R.C. §§ 62(a), 63(a), (d) (2000). If miscellaneous itemized deductions should be deducted in order to measure income properly, adjusted gross income will overstate economic income.

67. See I.R.C. § 68(a)(1) (2000). The reduction cannot exceed 80% of otherwise allowable itemized deductions. See I.R.C. § 68(a)(2) (2000). The \$100,000 threshold is subject to an annual inflation adjustment. See I.R.C. § 68(b)(2) (2000).

therefore not classified as a miscellaneous itemized deduction, subject to special restrictions.⁶⁸ In order to qualify, the employee expense must be reimbursed under an “arrangement that *requires the employee to substantiate* to the employer the expenses covered by the arrangement.”⁶⁹ We cite the legislative history of the substantiation requirement in some detail, because it was this provision on which the leading case of *Alexander v. Commissioner* relied in order to classify attorney’s fees as an unreimbursed (rather than a reimbursed) employee expense.⁷⁰

The Conference Committee Report indicated that the substantiation requirement has a specific, limited purpose. The target is so-called “nonaccountable reimbursement plans” described as “arrangements that . . . do not require the employee to substantiate expenses covered by the arrangement to the person providing the reimbursement”⁷¹ The Report explained that a full deduction is allowed for reimbursed expenses because “Congress viewed an employer’s agreement to reimburse . . . as evidence that the item was a bona fide, ordinary, and necessary [business] expense [T]his rationale . . . does not apply in the case of nonaccountable plans”⁷² The Conference Committee Report also expressed concern about enforcement of the two-percent floor on the deduction of unreimbursed expenses if the nonaccountable plan were treated as reimbursing employee expenses:

[T]he two-percent floor enacted in the 1986 Act could be circumvented solely by restructuring the form of the employee’s compensation so that the salary amount is decreased, but the employee receives an equivalent nonaccountable expense allowance. Providing an exception from the two-percent floor for those employees whose employer is willing to utilize a nonaccountable plan is unfair to other employees incurring identical business expenses whose employer does not restructure their compensation through use of a nonaccountable plan.⁷³

A former Treasury official explained the reason for requiring substantiation: “From a policy standpoint, the bias in favor of reimbursement arrangements for which an adequate accounting is made to the employer may be justified by the fact that the employer’s willingness to

68. See I.R.C. § 62(c) (1989).

69. H.R. CONF. REP. NO. 100-998, at 204 (1988) (emphasis added).

70. 72 F.3d 938, 946 (1st Cir. 1995).

71. H.R. CONF. REP. NO. 100-998, at 203.

72. *Id.* at 202–03.

73. *Id.* at 203.

reimburse the expense provides an indication that the expense . . . had a legitimate business purpose.”⁷⁴

This history makes clear the purpose of the substantiation requirement. In the words of the same Treasury official, “an adequate accounting” indicates “a legitimate business purpose.”⁷⁵ Congress believed that expenses reimbursed under nonaccountable plans, for which there was no adequate accounting, were less likely to have substantial business purposes and more likely to reflect voluntary personal consumption.⁷⁶ Congress therefore imposed the substantiation requirement in order to restrict the deduction of personal consumption that was improperly labeled as business-related.

B. UNDER THE ALTERNATIVE MINIMUM TAX

The denial of a deduction for unreimbursed expenses under the current AMT also results from the Code’s distinction between nonitemized and itemized deductions.⁷⁷ Congress enacted the first minimum tax in 1969.⁷⁸ The earliest version was not an alternative to the regular tax, but rather an add-on tax, exacted in addition to the regular tax. This add-on minimum tax was imposed (initially at a ten-percent rate) on specified tax preference

74. Blake D. Rubin, *Tunneling Under the Two Percent Floor*, 38 TAX NOTES 177, 179 (1988). Prior to 1988 an earlier and weaker substantiation rule was contained in Treasury Regulations. See Treas. Reg. §§ 1.162-17 (1988) and Temp. Treas. Reg. § 1.274-5T(f) (1988). In 1988, Congress made a stronger substantiation requirement an explicit part of the Internal Revenue Code. Rubin’s comments quoted above were made in regard to the weaker substantiation rule contained in the regulations.

75. Rubin, *supra* note 74, at 179.

76. The presumption that reimbursed expenses subject to substantiation are less likely to be personal in nature than unreimbursed expenses is open to question. Employers frequently use expense account meals and travel to provide additional untaxed compensation to employees. Employees are happy to do the paperwork to substantiate expenses in order to achieve the desired tax result. The widespread availability and use of credit cards vastly simplify the task of substantiation. Employers and employees therefore have an incentive to agree to reduce the employee’s cash salary and increase the employee’s reimbursement allowance in order to convert unreimbursed expenses into reimbursed expenses.

On the other hand, transaction costs probably limit the ability of employers and employees to pursue such a tax minimization strategy. At some point it becomes too costly for the employer to finetune the allocation of each employee’s compensation between an expense account and freely spendable salary or to manufacture business justifications for employee expenses. Moreover, to withstand audit, the reimbursed expenditures must have at least some superficially plausible business connection.

77. See I.R.C. §§ 62(a), 63(d) (2000).

78. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 301(a), 83 Stat. 487, 580–85 (1969).

items, which originally did not include itemized deductions.⁷⁹ Therefore the earliest minimum tax had no impact at all on unreimbursed employee business expenses.

In 1976, Congress added "excess itemized deductions" to the list of tax preferences on which the add-on minimum tax was imposed.⁸⁰ Excess itemized deductions were defined as the amount by which itemized deductions, other than medical or casualty losses, exceeded sixty percent of the taxpayer's adjusted gross income. There was no explanation for the addition of excess itemized deductions to the list of add-on minimum tax preference items.⁸¹

In 1978, Congress enacted, as a supplement to the existing add-on minimum tax, a new Alternative Minimum Tax (AMT), payable as an alternative to the regular tax, when AMT liability exceeded regular tax liability.⁸² The preference for excess itemized deductions under the existing add-on minimum tax was repealed.⁸³ Under the new AMT, however, itemized deductions in excess of sixty percent of adjusted gross income were not deductible.⁸⁴ There was no explanation for the disallowance of excess itemized deductions under the new AMT.⁸⁵

In 1982, Congress repealed the add-on minimum tax for individuals and expanded the AMT.⁸⁶ Among other changes, Congress provided for the calculation of taxable income under the AMT without any allowance at all for specified itemized deductions (replacing earlier law that simply

79. See I.R.C. § 57 (1970). The add-on tax equaled 10% of tax preference income, a category that included a variety of investment incentives. The only itemized deduction specifically included in the list of tax preference items was the excess of investment interest over net investment income.

80. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1520, 1549-54 (1976). The Tax Reform Act of 1976 replaced the tax preference item for excess investment interest with a tax preference for excess itemized deductions.

81. See H.R. CONF. REP. NO. 94-1515 (1976), *reprinted in* 1976 U.S.C.C.A.N. 4118 (1976); S. REP. NO. 94-1236, at 425-26 (1976); H.R. CONF. REP. NO. 94-658, at 131 (1976), *reprinted in* U.S.C.C.A.N. 2897, 3026 (1976); S. REP. NO. 94-938, at 112 (1972), *reprinted in* U.S.C.C.A.N. 3439, 3548 (1972); STAFF OF JOINT COMM. ON TAX'N, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 105-07 (Comm. Print 1976).

82. See Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978). See also I.R.C. § 55 (1979).

83. See *id.*

84. See I.R.C. § 57(b) (1979).

85. See H.R. CONF. REP. NO. 95-1800, at 263-68 (1978), *reprinted in* U.S.C.C.A.N. 7198, 7259-65 (1978); H.R. REP. NO. 95-1445 (1978), *reprinted in* U.S.C.C.A.N. 7046 (1978); S. REP. NO. 95-1263, at 200-04 (1978), *reprinted in* U.S.C.C.A.N. 6761, 6963-67 (1978).

86. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 201, 96 Stat. 324, 411-21 (1982).

disallowed an excess amount).⁸⁷ There was no explanation for the change.⁸⁸

These 1976, 1978, and 1982 tax revisions that applied first the add-on minimum tax and later the AMT to itemized deductions had only a small impact on unreimbursed employee business expenses. As noted above, until 1986, unreimbursed employee expenses for travel away from home and for transportation while on business, as well as all unreimbursed expenses of outside salespersons, continued to be classified as nonitemized expenses and therefore were not affected at all by the minimum tax. Furthermore, even for those residual unreimbursed expenses that were classified as itemized, the minimum tax contained fairly generous exemption amounts and the tax rate was fairly low.⁸⁹

In 1986, Congress dramatically increased the AMT's impact on unreimbursed employee business expenses.⁹⁰ As noted above, Congress created the new category of miscellaneous itemized deductions, which includes virtually all unreimbursed employee business expenses, and made items in this category deductible under the regular tax only to the extent that the aggregate amount exceeds two percent of adjusted gross income.⁹¹ At the same time, Congress modified the AMT's language to state that "[n]o deduction shall be allowed for any miscellaneous itemized deduction."⁹²

As in 1976, 1978, and 1982, there was no explanation in the 1986 Act for the change in the AMT's treatment of itemized expenses, including unreimbursed employee business expenses.⁹³ However, the AMT's language specifically refers to "miscellaneous itemized deductions,"⁹⁴ which are allowed under the regular tax only to the extent that they exceed two percent of adjusted gross income. Moreover, Congress enacted the

87. See I.R.C. § 55 (1983).

88. See H.R. CONF. REP. NO. 97-760, at 473-76 (1982), *reprinted in* U.S.C.C.A.N. 1191, 1252-55 (1982); S. CONF. REP. NO. 97-5530, at 473-76 (1982); S. REP. NO. 97-494, at 107-09 (1982), *reprinted in* U.S.C.C.A.N. 781, 875-77 (1982); H.R. REP. NO. 97-404 (1981).

89. See DANIEL J. LATHROPE, *THE ALTERNATIVE MINIMUM TAX: COMPLIANCE AND PLANNING WITH ANALYSIS*, ¶ 1.02, at 1-1 to 1-11 (1994) (describing the exemptions and rates for individuals under the AMT prior to 1986). In addition, unlike exemptions under the regular tax, exemptions under the AMT do not have an annual inflation adjustment. Compare I.R.C. § 151(d)(4) (2000) with I.R.C. § 55 (2000). Therefore, each year the AMT exemption amount declines in real dollar terms.

90. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

91. See *supra* text accompanying notes 57-64.

92. I.R.C. § 56(b)(1)(A)(i) (1987).

93. See H.R. CONF. REP. NO. 99-841, pt. 2, at 259-60 (1986), *reprinted in* U.S.C.C.A.N. 4077, 4347-48 (1986); S. REP. NO. 99-313, at 535 (1986).

94. I.R.C. § 56(b)(1)(A)(i) (1987).

1986 changes to the AMT as part of the same legislation that created the new category of miscellaneous itemized deductions and made such deductions available under the regular tax only to the extent that the aggregated amount exceeds a two-percent floor.⁹⁵ These circumstances suggest that the AMT's objective in restricting such deductions is the same as the objective of the regular tax: to prevent the deduction of "expenses [that] have characteristics of voluntary personal consumption expenditures."⁹⁶

Moreover, only this objective is consistent with the overall purpose of the AMT.⁹⁷ Congress has stated again and again that the purpose is to produce an alternative measure of income (AMT income) that more accurately reflects economic income than taxable income as defined under the regular tax.⁹⁸ The author of the leading treatise on the AMT has observed:

95. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

96. STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78-79 (Comm. Print 1987).

97. A 1994 U.S. Department of Treasury report implied an entirely different justification for limits on deducting miscellaneous itemized deductions. See TREASURY DEP'T, REPORT TO THE CONGRESS ON SECTION 212 EXPENSES AND THE ALTERNATIVE MINIMUM TAX (1994), reprinted in *Treasury Sees No Need to Allow AMT Taxpayers to Deduct Investment Expenses*, TAX NOTES TODAY, Dec. 30, 1994, available in LEXIS, FEDTAX Library, File No. 94 TNT 255-5 [hereinafter TREASURY DEP'T]. The AMT denies any deduction for the expenses of the production or collection of income. See I.R.C. §§ 62(a), 63(d), 212(1). The Treasury Department examined whether the AMT's treatment of such expenses creates a disincentive for investments. See TREASURY DEP'T, *supra*. The report concluded that "AMT disallowance . . . affects only a small fraction of investment expenses . . . [T]he treatment . . . probably has little aggregate economic effect." *Id.*

The report also stated that in principle a deduction should be allowed for all expenses of the production or collection of income. Moreover, it conceded that the disallowance of an AMT deduction for such expenses could overstate income. However, the report expressed even greater concern about the understatement of income that occurs when taxpayers deduct currently in full costs that should be treated as capital expenditures, deductible only over a period of years. Moreover, the report cited this concern in recommending against an AMT deduction for the expenses of the production or collection of income. In effect, the Report implied that AMT disallowance was justified in order to counter taxpayer disregard of the capitalization requirement. See *id.*

The legislative history of the limits on miscellaneous itemized deductions, both under the regular tax and the AMT, makes no mention whatsoever of this alternative justification. See *supra* text accompanying notes 78-93. Moreover, the alternative justification has little relevance to the case of attorney's fees. It is true, as the Treasury Report claims, that "attributing a particular expense to either future or current income may be difficult in some cases." TREASURY DEP'T, *supra*. However, the timing and amount of the recovery will usually be specified with sufficient precision to determine whether to treat attorney's fees as a capital expenditure or not. For example, if the recovery is structured to be paid over a period of years, then the attorney's fees would be deductible over that period, rather than immediately deductible in full. See I.R.C. §§ 263, 263A (2000).

98. See LATHROPE, *supra* note 89, ¶ 1.02, at 1-2 to 1-3.

The Code's minimum tax provisions have undergone many legislative changes, but in each revision the congressional purpose underlying the minimum tax has remained constant When the minimum tax rules were revamped as part of the Tax Reform Act of 1986, the role of the minimum tax was restated, and the following justification was given:

"Congress concluded that the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability"⁹⁹

III. THE COURTS CLASSIFY ATTORNEY'S FEES

A. *ALEXANDER V. COMMISSIONER*

In the leading case, *Alexander v. Commissioner*, the First Circuit ruled that the portion of the plaintiff-employee's recovery expended for attorney's fees did not qualify as a reimbursed employee business expense.¹⁰⁰ Although *Alexander* did not itself involve a federal civil rights claim, the decision has been routinely followed, without exception or even discussion, in cases involving employment discrimination claims under federal law.¹⁰¹

In *Alexander*, the plaintiff filed a state law breach of contract claim against his former employer. The parties agreed to settle the claim for

99. *Id.* (quoting STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 432-433 (Comm. Print 1987) [hereinafter STAFF OF JOINT COMM. ON TAX'N]. Compare STAFF OF JOINT COMM. ON TAX'N, *supra*, with STAFF OF JOINT COMM. ON TAX'N, 91ST CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 105 (Comm. Print 1970) (explaining the purpose of the first add-on minimum tax as follows: "The Act provides a minimum tax on specified tax preference income received by individuals and corporations in order to make sure that all taxpayers are required to pay significant amounts of tax on their economic income.").

100. 72 F.3d 938, 944-47 (1995).

101. See *Fredrickson v. Commissioner*, 99-1 U.S. Tax Cas. (CCH), ¶ 50,167 83 A.F.T.R.2d 99-435 (9th Cir. 1998); *Brewer v. Commissioner*, 74 T.C.M. (CCH) 1337 (1997), *aff'd without published opinion*, 172 F.3d 875 (9th Cir. 1999); *Hardin v. Commissioner*, 73 T.C.M. (CCH) 2693 (1997); *Martinez v. Commissioner*, 73 T.C.M. (CCH) 2289 (1997); *Sinyard v. Commissioner*, 76 T.C.M. (CCH) 654 (1998). The three Tax Court opinions are memorandum decisions. The Tax Court provides memorandum decisions, rather than a fuller opinion, when it feels an issue is settled and not open to question. As this article was going to press, the Tax Court issued a lengthy opinion addressing the tax treatment of the amount received in settlement of a claim of age discrimination under federal law. See *Kenseth v. Commissioner*, 114 T.C. No. 26 (2000). The majority opinion and two dissents disagreed as to whether the plaintiff had to report the entire settlement, including the amount expended for attorney's fees. See *supra* text accompanying notes 23-39. However, all three opinions accepted, without question, *Alexander's* holding that such fees, if includable, were an unreimbursed expense. Moreover, none of the opinions recognized that the result in the case undermined the fee-shifting provisions of federal civil rights law.

\$250,000. As is customary, the defendant-employer wrote a check payable to both the plaintiff-employee and his attorneys. The plaintiff's attorney's fees of \$245,000 were paid directly from these settlement proceeds, and the plaintiff received the \$5,000 balance.¹⁰²

The plaintiff claimed that the attorney's fees were a nonitemized business expense, fully deductible under both the regular tax and the AMT.¹⁰³ After the IRS challenged the taxpayer's treatment, the Tax Court held that the attorney's fees were an employee business expense that was not paid under a "reimbursement or other expense allowance arrangement."¹⁰⁴ As an unreimbursed employee business expense, the attorney's fees were a miscellaneous itemized deduction, available under the regular tax only to the extent that miscellaneous itemized deductions in the aggregate exceeded two percent of adjusted gross income and subject to the phaseout.¹⁰⁵ Moreover, no deduction was available at all under the AMT.¹⁰⁶ On appeal, the First Circuit affirmed.¹⁰⁷

Neither the Tax Court nor the Court of Appeals explained why the attorney's fees constituted an unreimbursed as opposed to a reimbursed expense. However, the First Circuit cited a congressional report stating that the Code classifies an employee expense as reimbursed "only if incurred pursuant to a reimbursement or other expense allowance arrangement *requiring employees to substantiate the expenses covered thereunder to the person providing the reimbursement.*"¹⁰⁸

By quoting this language, the Court of Appeals implied that the attorney's fees did not qualify as reimbursed since the settlement

102. See *Alexander*, 72 F.3d at 940. The complaint actually listed three separate counts. Count I alleged a breach of the plaintiff's express employment contract. Count II alleged breach of an implied pension benefits contract. Count III alleged age discrimination under chapter 151B, section 1 of the General Laws of the Commonwealth of Massachusetts. See MASS. GEN. LAWS ANN. ch. 151B, § 1 (West 1976). The taxpayer and his former employer executed a written settlement agreement for an immediate payment of \$350,000, of which \$250,000 was allocated to the breach of contract counts and \$100,000 to the age discrimination count. See *Alexander*, 72 F.3d at 940. The taxpayer incurred legal fees of \$258,000, of which \$245,000 was allocated to the breach of contract counts and \$13,000 to the age discrimination count. See *id.* The \$100,000 payment allocated to the age discrimination count was excludible at the time. See *supra* note 6; I.R.C. § 104(a)(2) (1989). Therefore, the attorney's fees allocable to the age discrimination count were not deductible because they were an expense of producing exempt income. See I.R.C. § 265(a)(1) (1989).

103. See *Alexander*, 72 F.3d at 944.

104. *Id.* at 946.

105. See I.R.C. §§ 67(a), 68(a) (1989).

106. See I.R.C. § 56(b)(1) (1989).

107. See *Alexander*, 72 F.3d 938.

108. *Id.* at 945-46 n.17 (quoting H.R. CONF. REP. NO. 100-998, at 204 (1988), *reprinted in* 1998 U.S.C.C.A.N. 2776, 2992 (1988) (emphasis added).

agreement did not require the plaintiff to provide substantiation to the employer. However, the court failed to discuss or even to acknowledge the legislative history, which indicates that the substantiation rule was enacted in order to deal with a specific, narrowly defined problem, namely, nonaccountable reimbursement plans. This particular abuse bears repeating because it is critical to evaluating the *Alexander* court's ruling.¹⁰⁹

Before the enactment of the substantiation requirement, employers provided so-called nonaccountable reimbursement plans, expense account funds, which employees treated as fully deductible, without any requirement that the employees account for how they spent the money. Congress was concerned that, in the absence of an accounting, employees were obtaining tax-free funds to spend on personal consumption. The substantiation requirement, Congress believed, would provide some assurance that reimbursed expenditures in fact had a legitimate business purpose. As the legislative history indicates, the policy reason for requiring substantiation is that an accounting to the employer tends to demonstrate that the expense has a legitimate business connection and is not disguised personal consumption.

This problem of nonaccountable reimbursement plans is the only subject mentioned in the legislative history of the substantiation requirement. The congressional reports do not mention any other subject or problem or abuse. The sole purpose of the substantiation requirement was to provide the same treatment for employee expenses reimbursed under nonaccountable plans as for other unreimbursed employee expenses.

However, this reason for requiring substantiation is absent in the special case of attorney's fees for three reasons. First, while attorneys certainly profit from and may even enjoy litigation, individual litigants find the process traumatic and trying. Although there may be rare exceptions, employees generally do not sue their employers for the fun of it. Thus, unlike expenses for meals, travel, entertainment and the like, attorney's fees in employment cases will almost never reflect personal consumption.

Second, the substantiation requirement makes sense only if we presume a more or less cordial working relationship between employer and employee, in which there is a risk that the parties may collude to pretend that reimbursed expenses, which in fact represent personal consumption,

109. See *supra* text accompanying notes 63–75.

are related to business.¹¹⁰ The substantiation requirement is not necessary when the employer-employee relationship has ruptured, and the employee sues the employer. No rational employer will voluntarily reimburse an employee for the costs of such a lawsuit or establish a *plan* requiring substantiation. Thus, the fact that the employer has not established an accountable plan with respect to the attorney's fees does not indicate that the expenditure may represent personal consumption.

Third, the IRS should have no difficulty verifying the amount of the fees and establishing that they were actually incurred for the costs of litigation. The attorney representing the plaintiff will presumably have kept time sheets, reflecting the work performed. Most important, there will be evidence that the attorney, to whom the fees are due, actually received payment. Therefore, adequate substantiation of the amount expended for attorney's fees is almost certain to be available to the IRS.

The *Alexander* court, therefore, could have concluded that the substantiation requirement should not apply to the attorney's fees paid by a plaintiff-employee from an amount received from his defendant-employer in settlement of an employment-related claim.¹¹¹ Having declared the substantiation rule inapplicable, the court could then have held that in these circumstances the plaintiff's attorney's fees qualify as a reimbursed expense. This result would have recognized that the tax policy reason for limiting the deduction of unreimbursed expenses is inapplicable in the case of plaintiff's attorney's fees incurred in pursuit of an employment-related claim. It would also have avoided the absurd possibility of converting a pre-tax profit into an after-tax loss.

B. *FREDRICKSON V. COMMISSIONER*

The Ninth Circuit compounded the First Circuit's error in *Fredrickson v. Commissioner*.¹¹² In *Fredrickson*, the plaintiff settled a sex discrimination claim under Title VII of the 1964 Civil Rights Act.¹¹³ Title

110. The Conference Committee Report on the substantiation requirement stated, "the employer has an incentive to require sufficient substantiation to ensure that the allowance to the employee is limited to actual business expenditures." H.R. CONF. REP. NO. 100-998, at 203 (1988).

111. The court also noted that "both [employer and employee] were responsible for their respective legal costs." 72 F. 3d at 946. However, the fact that the employee was initially responsible for his own attorney's fees does not preclude the defendant from reimbursing the plaintiff.

112. 99-1 U.S. Tax Cas. (CCH), ¶ 50,167, 83 A.F.T.R.2d 99-435 (9th Cir. 1998).

113. *See id.*

VII contains a fee-shifting provision that requires the defendant to pay the attorney's fees of a prevailing plaintiff.¹¹⁴

The *Fredrickson* court mechanically followed *Alexander* and declined to treat the plaintiff's attorney's fees as a reimbursed employee business expense even though the fees were paid out of the settlement of a civil rights claim under a statute that *requires* the defendant to pay such fees.¹¹⁵ In reaching this result, the court not only ignored the policy reasons that Congress gave for limiting the deduction of miscellaneous itemized deductions, including unreimbursed employee business expenses. The court also failed to consider whether its treatment of attorney's fees contravenes the purpose of the fee-shifting provisions of federal civil rights laws.

To understand the implications of *Fredrickson*, it may be useful to consider its impact on a victim of unlawful discrimination who lacks the financial resources to pursue a meritorious claim and on an attorney who might represent the victim. Unlike other personal injury plaintiffs, civil rights plaintiffs generally cannot rely on contingency fee arrangements to attract attorneys to take their cases.¹¹⁶ The potential damages are usually too modest for such arrangements to attract legal representation.¹¹⁷

Attorneys who represent plaintiffs in civil rights cases generally rely instead on the fee-shifting provisions of federal civil rights laws.¹¹⁸ Under these provisions, the prevailing plaintiff is entitled to reasonable attorney's fees, and what constitutes a reasonable fee does not depend on the amount of damages.¹¹⁹ Instead, "a reasonable attorney's fee is properly calculated by multiplying the number of hours reasonably expended on the litigation times a reasonable hourly rate."¹²⁰ Thus, the attorney has a prospect of adequate compensation even if other damages for the discriminatory wrong are small.¹²¹

114. See Civil Rights Act of 1964, 42 U.S.C. § 2000e-5(k) (1994).

115. Both *Alexander* and *Fredrickson* declined to classify the attorney's fees as reimbursed employee business expenses. *Alexander* classified the fees as unreimbursed employee business expenses. See 72 F.3d at 946. *Fredrickson* classified the fees as expenses for the production or collection of income. See 99-1 U.S. Tax Cas. (CCH), ¶ 50,167. Despite this formal difference, the end result was the same. The fees were miscellaneous itemized deductions, not fully deductible under the regular tax and not deductible at all under the AMT.

116. See *City of Riverside v. Rivera*, 477 U.S. 561, 577 (1986) (plurality opinion).

117. See *Quarantino v. Tiffany & Co.*, 166 F.3d 422, 426 (2d Cir. 1999).

118. See *Rivera*, 477 U.S. at 576-79.

119. See *id.* at 575.

120. *Blum v. Stenson*, 465 U.S. 886, 888 (1984). See also *Hensley v. Eckerhart*, 461 U.S. 424, 433 (1983).

121. See *Quarantino*, 166 F.3d at 426-27.

However, the denial of an AMT deduction may cause the attorney's fees to be taxed to the prevailing plaintiff at the AMT tax rate of twenty-six or twenty-eight percent.¹²² After the plaintiff pays those taxes, there remains only seventy-four or seventy-two percent of reasonable fees to compensate the attorney. In these circumstances, either the attorney must be willing to accept reduced compensation or the plaintiff must make up the difference.

If the attorney is to bear this cost and thus not receive a reasonable fee, it will be more difficult for a plaintiff who cannot pay for an attorney, and whose potential recovery is not sufficient for a contingency fee arrangement, to obtain representation and perform her private attorney general function.¹²³ If the plaintiff is to bear the cost, she may be deterred from pursuing her claim, particularly since the tax liability may exceed her damages net of attorney's fees, transforming a before-tax gain into an after-tax loss.¹²⁴ Therefore, *Fredrickson's* decision to classify the attorney's fees as unreimbursed frustrates the objective of the fee-shifting provisions, which is to encourage the private enforcement of federal civil rights laws.

C. SETTLEMENTS VERSUS AWARDS

Both *Alexander* and *Fredrickson* involved settlement agreements rather than court awards. We are unaware of any case in which the IRS has attempted to limit the deduction of attorney's fees awarded by court order. We believe, moreover, that when a court orders a defendant-employer to pay the attorney's fees of a plaintiff-employee, the fees should be classified as reimbursed.¹²⁵

A court will award attorney's fees only upon application by the plaintiff, whose attorney submits extensive documentation to support the number of hours and hourly rate claimed, and only after the defendant has an opportunity to challenge the plaintiff's documentation.¹²⁶ The adversarial nature of this proceeding and the records on which the court will have based its order should more than satisfy the statutory requirement of substantiation of reimbursed employee expenses. Therefore, a court order that a defendant-employer pay the attorney's fees of the plaintiff-

122. See I.R.C. § 55(b)(1)(A)(i) (2000).

123. See *Blum*, 465 U.S. at 888.

124. See *supra* text accompanying notes 13–16.

125. See *Quarantino*, 166 F.3d at 424.

126. See *id.*

employee should *automatically* result in such fees being classified as a reimbursed employee business expense.

IV. ATTORNEY'S FEES FOR CIVIL RIGHTS CLAIMS OTHER THAN EMPLOYMENT DISCRIMINATION

Federal laws providing remedies for discrimination in education, housing, and public accommodations and for the violation of constitutional rights also contain fee-shifting provisions, which entitle the prevailing plaintiff to recover attorney's fees.¹²⁷ These fee-shifting provisions serve the same objective of enabling the plaintiff to function as a private attorney general.¹²⁸

Except for claims involving employment discrimination, we know of no instance to date in which the IRS has tried to tax the prevailing plaintiff on the recovery of attorney's fees under the fee-shifting provision of a federal civil rights statute. Nevertheless, if these amounts are taxable in employment discrimination cases such as *Fredrickson*, notwithstanding a fee-shifting provision, they might also be taxable to the prevailing plaintiff who sues for discrimination in education, housing, and public accommodations and for the violation of constitutional rights.¹²⁹ Moreover, the portion of a recovery expended for attorney's fees would not be fully deductible under the regular tax or deductible at all under the AMT, although the technical tax issue is different than in cases of employment discrimination.

There are two possible ways to categorize the attorney's fees in claims for discrimination in education, housing, public accommodations and for the violation of constitutional rights.¹³⁰ If the plaintiff seeks only injunctive relief, then the lawsuit will probably be characterized as "not for profit."¹³¹ Alternatively, if the plaintiff seeks money damages, the lawsuit will probably be characterized as an activity "for the production or collection of income."¹³²

127. See statutes cited, *supra* note 1.

128. See *Blum*, 465 U.S. at 894 n.10; *Newman v. Piggie Park Enters., Inc.*, 390 U.S. 400, 402.

129. However, there may be an exception for instances in which the *Cotnam* decision would permit the plaintiff to exclude the attorney's fee portion of the award because state attorneys' lien laws convey a partial ownership interest in the civil rights claim. See *supra* text accompanying notes 25–29.

130. See *supra* text accompanying notes 41–45.

131. Treas. Reg. § 1.183-2(9) (2000) (classifying an activity as engaged in for profit only if the taxpayer has the objective of making a profit).

132. I.R.C. § 212(1) (2000).

Regardless of which category applies, the result is basically the same. The costs of a not-for-profit activity are deductible up to the amount of revenue that the activity produces.¹³³ The costs of an activity “for the production or collection of income” are generally deductible.¹³⁴ However, both categories of costs are classified as miscellaneous itemized deductions.¹³⁵ As such, they are deductible under the regular tax only to the extent that miscellaneous itemized deductions in the aggregate exceed two percent of adjusted gross income and are phased out for taxpayers with high adjusted gross incomes.¹³⁶ Moreover, no deduction is available at all under the AMT.¹³⁷

Again, the disallowance of AMT deductions is especially significant. Suppose that a civil rights plaintiff settles a claim alleging racial discrimination in education in return for the defendant’s promise not to discriminate in the future plus the payment of the plaintiff’s \$50,000 in attorney’s fees. The plaintiff’s taxable income under the AMT is calculated as \$50,000, which equals the entire recovery without any deduction for the attorney’s fees.¹³⁸ Assuming that the lower AMT tax rate of twenty-six percent applies to this entire amount, the plaintiff’s AMT liability is \$13,000.¹³⁹

Once again, either the plaintiff’s attorney must accept reduced compensation, or the prevailing plaintiff must bear the tax cost. And once again, the AMT’s denial of a deduction for the attorney’s fees may discourage the private enforcement of civil rights claims and thereby undermine the purposes of the fee-shifting provisions.

133. See I.R.C. § 183(b) (2000). Thus, if the litigation is characterized as not for profit, the plaintiffs would be permitted a deduction up to the amount of the recovery (including the fees themselves).

134. I.R.C. § 212(1) (2000). See also I.R.C. § 167(a) (2000).

135. See I.R.C. §§ 62(a), 63(d), 67(b) (2000).

136. See I.R.C. §§ 67(a), 68(a) (2000).

137. See I.R.C. § 56(b)(1) (2000).

138. See *id.* Since the injunction provides benefits over an indefinite future period, it could be argued that the attorney’s fees in the example constitute a capital expenditure for a nonwasting asset. See I.R.C. §§ 263, 263A (2000). If this argument is accepted, the attorney’s fees would not be deductible under the regular tax. See Treas. Reg. § 1.167(a) (2000). The plaintiff’s taxable income would then be \$50,000 not only under the AMT but under the regular tax as well. This result would increase the plaintiff’s regular tax liability and thus frustrate even further the objectives of the fee-shifting provisions of federal civil rights law.

139. See I.R.C. § 55(b)(1)(A)(i)(I) (2000).

V. SOLUTIONS

A. DRAFTING AS A STOPGAP MEASURE

Despite the outcomes in *Alexander* and *Fredrickson*, the careful drafting of settlement agreements may cause the plaintiff's payment of attorney's fees in employment cases to be classified as a reimbursed expense that is fully deductible. In neither case did the settlement agreement state that it constituted a reimbursement arrangement.¹⁴⁰ In its opinion, the *Alexander* court specifically referred to this omission: "[T]he settlement agreement itself makes no mention of attorney's fees."¹⁴¹ Although not helpful to the plaintiff in *Alexander*, this statement offers hope for plaintiffs in future cases. If the agreement specifically refers to the settlement as employer reimbursement of employee expenses (and also requires substantiation), then perhaps the attorney's fees will be classified as reimbursed.

This drafting solution is, however, not completely satisfactory for three reasons. First, opposing counsel may refuse to agree to such language or may extract some premium from the plaintiff for agreeing to it. The extraction of a premium is an additional cost that either the plaintiff's attorney or the plaintiff must bear. Again, if the attorney bears this cost and thus receives less than a reasonable fee, it will be more difficult for a plaintiff to obtain representation and perform her private attorney general function.¹⁴² If the plaintiff bears the cost, she may be deterred from pursuing her civil rights claim.

Second, the Tax Court has not taken up the *Alexander* court's implication that a specific reference in the settlement agreement to attorney's fees should qualify the settlement agreement as a reimbursement arrangement. The Tax Court has to date heard several cases involving Title VII claims in which the settlement agreement recited that the settlement amount was in consideration for, among other things, a prevailing plaintiff's right to attorney's fees.¹⁴³ Nevertheless, despite specific

140. See *Alexander*, 72 F.3d at 946; *Fredrickson*, 99-1 U.S. Tax Cas. (CCH), ¶ 50,167, 83 A.F.T.R.2d 99-435 (9th Cir. 1998).

141. 72 F.3d at 946.

142. See *Blum v. Stenson*, 465 U.S. 886, 888 (1984).

143. In *Hardin v. Commissioner*, 73 T.C.M. (CCH) 2693 (1997), the taxpayer had unsuccessfully sought employment as a State Farm Insurance Company trainee. The taxpayer later became aware of a class action lawsuit against State Farm, alleging discrimination against women in violation of Title VII. The taxpayer and State Farm entered into a settlement agreement in which, in return for payments totaling nearly \$210,000, the taxpayer released her Title VII claims against State Farm. The settlement

references to attorney's fees in the settlement agreements, the Tax Court did not conclude that the fees in question were reimbursed.¹⁴⁴

Third, this drafting solution cannot help civil rights plaintiffs in areas other than employment discrimination. Only if the origin of the claim is an employment relationship with the defendant can the plaintiff attempt to characterize the portion of the recovery expended for attorney's fees as reimbursed employee business expenses.¹⁴⁵ When a plaintiff sues for discrimination in education, housing, public accommodations or for the violation of constitutional rights, the attorney's fees are categorized as the expense of either a not-for-profit activity or an activity for the production of income.¹⁴⁶ Regardless of which characterization applies, the attorney's fees are automatically classified as miscellaneous itemized deductions,¹⁴⁷ which are not deductible in full under the regular tax and not deductible at all under the AMT.¹⁴⁸ For these reasons, it is important to adopt a solution that does not depend on satisfying the Code's requirements for a reimbursed employee business expense.

agreement specifically recited that the payment was "inclusive of attorneys's [sic] fees and costs to which . . . Hardin . . . is entitled on a prevailing party basis . . ." *Id.* at 2694. Notwithstanding this language in the settlement agreement specifically providing that State Farm was reimbursing the attorney's fees to which the taxpayer was entitled, the Tax Court held that the fees were a miscellaneous itemized deduction, not fully deductible under the regular tax and not deductible at all under the AMT. *See id.* at 2697. In two other cases involving members of the class of plaintiffs suing State Farm, the Tax Court reached the same result. *See* *Martinez v. Commissioner*, 73 T.C.M. (CCH) 2289 (1997); *Brewer v. Commissioner*, 74 T.C.M. (CCH) 1337 (1997), *aff'd without published opinion*, 172 F.3d 875 (9th Cir. 1999).

144. The taxpayers in these cases appear not to have argued that the specific reference in the settlement agreement should mean that the attorney's fees should be treated as reimbursed employee business expenses. *See Hardin*, 73 T.C.M. (CCH) 2693; *Martinez*, 73 T.C.M. (CCH) 2289; *Brewer*, 74 T.C.M. (CCH) 1337.

145. *See Alexander*, 72 F.3d at 944 n.10. In *Alexander*, the categorization of the plaintiff's attorney's fees for an employment-related claim was made according to the "origin of the claim doctrine," announced by the Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963). Under *Gilmore*, the character of the legal expenses is determined by the nature of the activity from which the claim arises.

An alternative possibility would be to characterize the litigation as for the production or collection of income. *See* I.R.C. § 212(1) (2000); *Fredrickson*, 99-1 U.S. Tax Cas. (CCH), ¶ 50,167; *Srivastava v. Commissioner*, 76 T.C.M. (CCH) 638 (1998). However, with the exception of the production of rent or royalty income, the expenses of such activities are peremptorily classified as miscellaneous itemized deductions. *See* I.R.C. §§ 62(a)(4), 63(d), 67(b) (2000). Therefore, if adopted, this characterization will automatically result in the attorney's fees not being fully deductible under the regular tax and not deductible at all under the AMT. *See* I.R.C. §§ 56(b)(1), 67(a), 68(a) (2000).

146. *See supra* text accompanying notes 130–132.

147. *See supra* text accompanying notes 133–136.

148. *See* I.R.C. §§ 56(b)(1), 67(a), 68(a) (2000).

B. AMENDING THE TAX LAW

A more effective solution would amend the tax law. Both civil rights policy and tax policy considerations should favor permitting plaintiffs either to deduct fully or to exclude the recovery of attorney's fees. Taxing the civil rights plaintiff on the recovery of attorney's fees undeniably frustrates the purpose of the fee-shifting provisions, which is to encourage the private enforcement of civil rights law.¹⁴⁹ Either a deduction in full or exclusion would avoid undermining the fee-shifting provisions of federal civil rights statutes.

There are also compelling tax policy arguments for permitting employment discrimination plaintiffs to deduct their attorney's fees without special restrictions. There is little risk that the attorney's fees generated from an employment discrimination claim constitute personal consumption masquerading as a business expense.¹⁵⁰ Therefore, the cost of generating the recovery should be fully deductible in order to arrive at a true income figure.¹⁵¹ The income of such plaintiffs cannot simply equal the gross recovery. The same tax policy arguments also apply to other civil rights cases in which the plaintiff recovers money damages. Again, the cost of generating the damages must be fully deductible in order to arrive at an accurate measure of income.

In other civil rights cases, in which the plaintiff seeks only injunctive relief, there are different tax policy arguments for permitting the plaintiff either to deduct fully or to exclude the recovery of attorney's fees. First, by acting as a private attorney general, vindicating national policy, the civil rights plaintiff performs a public service similar to the public service performed by charities. The plaintiff's payment of attorney's fees therefore resembles the payment of a charitable contribution, which is not a miscellaneous itemized deduction and therefore not subject either to the two-percent floor or the phase-out under the regular tax or the denial of a deduction under the AMT.¹⁵²

Second, the recovery of fees merely helps to restore the civil rights plaintiff to the status quo that existed before the injury. The recovery of

149. See *supra* text accompanying notes 116–124 and 137–139.

150. See *supra* text accompanying notes 108–111.

151. See *supra* text accompanying notes 9–16.

152. See I.R.C. §§ 67(b), 170(a)(1) (2000). A similar point is that since the amount expended on attorney's fees does not represent private preclusive consumption by the plaintiff because of its public benefit, it therefore should not be counted as income. See William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 354–58 (1972) (arguing that expenditures for amounts that constitute public goods should not be counted as income).

attorney's fees is analogous, for example, to damages for the pain and suffering of a physical injury,¹⁵³ which are excludable because they make the plaintiff no better off than she was before the injury occurred.¹⁵⁴ Thus, even when the civil rights plaintiff seeks only injunctive relief, tax policy considerations favor permitting the plaintiff to deduct in full or to exclude the recovery of attorney's fees.

CONCLUSION

Although an employment discrimination plaintiff must report as income the entire amount of any recovery, her attorney's fees are not fully deductible under the regular income tax and not deductible at all under the alternative minimum tax. These tax results may also apply to plaintiffs who sue for discrimination in education, housing, and public accommodations and for the violation of constitutional rights. The consequent overstatement and overtaxation of the plaintiff's taxable income discourages the pursuit of civil rights claims and thereby undermines the purpose of the fee-shifting provisions of federal civil rights law.

A full deduction or exclusion would provide a more accurate measure of the plaintiff's income and also preserve the purpose of the fee-shifting provisions. In employment cases, the careful drafting of settlement agreements should cause the plaintiff's payment of attorney's fees to be fully deductible. However, opposing counsel may demand a premium for agreeing to the necessary language, and careful drafting cannot make the attorney's fees fully deductible in civil rights cases in other areas. Therefore, the tax law should be amended to permit civil rights plaintiffs either to deduct fully or exclude the portion of a civil rights recovery expended for attorney's fees. The tax law should not be construed or constructed to overstate and overtax the income of civil rights plaintiffs and thereby subvert the national policy of ending unlawful discrimination.

153. See I.R.C. § 104(a) (2000).

154. See Sager & Cohen, *supra* note 6, at 476–86. On the other hand, there are academic writers who argue that all pain and suffering damages should be taxable and presumably would reject the analogy as irrelevant. See Mark W. Cochran, *Should Personal Injury Damage Awards Be Taxed?*, 38 CASE W. RES. L. REV. 43, 45–46 (1987–88); Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 183–186 (1992); Thomas D. Griffith, *Should "Tax Norms" Be Abandoned? Rethinking Tax Policy Analysis and the Taxation of Personal Injury Recoveries*, 1993 WIS. L. REV. 1115, 1131–33.