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The Honorable William M. Thomas
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United States House of Representatives
Washington, D.C. 20515

The Honorable Charles Rangel
Ranking Member
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Subject: H.R. 1155, Civil Rights Tax Relief Act of 2003

Dear Mr. Chairman and Congressman Rangel:

The American Bar Association, with more than 400,000 members, strongly supports H.R. 1155, the Civil Rights Tax Relief Act of 2003. This legislation, sponsored by Deborah Pryce (R-OH) and cosponsored by at least 119 Member of the House of Representatives, would amend the Internal Revenue Code to provide fairness in the treatment of damages awards for unlawful employment discrimination. Many other organizations, including the U.S. Chamber of Commerce, support H.R. 1155 along with lawyers representing both employees and management.

The ABA Board of Governors in February made passage of H.R. 1155 a legislative priority for the Association. We urge you to work with your colleagues on the Ways and Means Committee to ensure that H.R. 1155 is included in whatever appropriate legislative vehicle is reported out of Committee during the 108th Congress.

This legislation is vitally needed to correct serious inequities in the tax treatment of employment discrimination awards, which resulted from provisions included in the Small Business Job Protection Act of 1996.

Before the passage of the Small Business Job Protection Act of 1996, recoveries through settlement or litigation that were back pay or front pay were taxable as wages, and employers withheld monies for taxes from that portion of a settlement attributable to back or front pay. Compensatory damages recovered for pain, suffering, or humiliation were not taxable. Punitive damages were taxable as gross income but not as wages with the attendant employment taxes and withholding.

In the Small Business Job Protection Act, Congress made compensatory damages in employment cases taxable. The change made employment cases harder to settle, because taxes consumed a large percentage of settlements and court awards, and more money had to be paid in order to give the plaintiff the same amount, at the end of the day, as he or she would have had prior to passage of that law.

Other related tax problems have compounded this problem. The Internal Revenue Service normally requires plaintiffs to pay taxes on the attorneys' fees recovered in litigation or settlements, although the attorney also pays taxes on those funds as income to him or her. That money is therefore being taxed twice, and it again either reduces the amount that a plaintiff will take home from any settlement or forces the employer to pay more to make up the difference. While a plaintiff who itemizes deductions may take a miscellaneous itemized deduction for the part of the fee and expense award that exceeds 2% of the plaintiff's adjusted gross income, the size of the deduction often triggers the Alternative Minimum Tax. Sometimes, this means that a plaintiff with a good claim winds up "in the hole," paying more in taxes than he or she receives in the settlement.

The tax effect of receiving the money in one year can also be onerous, particularly since, had it been earned in the normal course of employment, the tax burden would have been spread over a number of years.

At the same time that the 1996 Act imposed new taxes on damages paid in employment discrimination cases, it continued the exemption from those taxes of compensatory damages paid as a result of physical injuries. This created the anomalous result that plaintiffs in personal injury cases are treated very differently than plaintiffs in employment discrimination cases in terms of the percentage of their recoveries for pain and suffering that they retain. There is no reasoned basis for treating recovery for accidents caused by negligent behavior more favorably than recoveries for violation of antidiscrimination laws involving an important national policy. Compensatory damages in employment discrimination cases should receive the same tax-free status as compensatory damages in physical injury cases.

The combination of these factors has inflated the amounts necessary to settle employment discrimination claims, and, therefore, fewer cases are settled. This results in a growing percentage of the court caseload that is made up of employment and civil rights cases. The cost to workers, businesses, and the court system has been far greater than any benefit that might have been anticipated from the 1996 law.

H.R. 1155 is intended to solve all of the critical problems addressed above. It would restore the pre-1996 tax treatment of compensatory damages in employment discrimination cases by providing that gross income does not include amounts received by a claimant—whether by suit or agreement—on account of a claim of unlawful discrimination, other than back or front pay or punitive damages. It would also assure that attorneys' fees and expenses are not taxable to the plaintiff when paid in settlement or through a court judgment. This bill would also mitigate the tax effect of receiving back pay and front pay in one year by providing income averaging for those recoveries. Unlawful discrimination is defined to include violations of numerous specific federal discrimination and employment laws, federal whistle-blower provisions, and any provision of state or local law, including

common law claims, providing for the enforcement of civil rights, regulating any aspect of the employment relationship, or prohibiting discrimination, discharge, or retaliation.

This bill would also simplify the tax laws by removing an impediment to the taxation of back pay that exists under current law.

The law defines back pay as compensation that is attributable to services performed or that would have been performed but for a claimed violation of law, as an employee, former employee, or prospective employee for the taxpayer's employer, former employer, or prospective employer. The enactment of HR 1155 would bring needed clarity to this area of the law. In one recent case, contrary to the majority view, a federal appellate court held that money paid to a plaintiff who never worked for the defendant employer as a result of discrimination did not constitute wages because the parties had never been in an employment relationship. *Newhouse v. McCormick*, 157 F.3d 582 (8th Cir. 1998). This bill would clarify that if amounts are recovered by suit or settlement in such a situation, they would be taxable as wages, under the income averaging provisions of the Act. See also *Lubart v. CIR*, 154 F.3d 539 (5th Cir. 1998) (holding that all of the payments pursuant to an "open window" program were to be treated as wages for tax purposes, because they did not result from a dispute arising out of physical injury).

Enactment of H.R. 1155 would further serve the goal of simplicity in the tax laws by putting employment discrimination plaintiffs on a more equal footing with plaintiffs in personal injury cases and removing the current unwarranted differences in treatment between the two groups.

Enactment of the proposed legislation would also resolve a split among the U.S. Courts of Appeals for the various circuits. Some require percentage-of-recovery contingent attorneys' fees to be double-taxed to the plaintiff as well as to the attorney and some do not, based on the manner in which State law treats attorneys' contingent-fee retainers. For example, such contingent fees are not double-taxed to the plaintiff in Alabama, Michigan, and Texas, *Cotnam v. C.I.R.*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854 (6th Cir. 2000); *Srivastava v. C.I.R.*, 220 F.3d 353 (5th Cir. 2000), but are double-taxed to the plaintiff in Alaska, California, the Tax Court, and the federal First, and Third Circuits. *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995); *Alexander v. C.I.R.*, 72 F.3d 938 (1st Cir. 1995), *aff'g* 69 T.C.M. 1792 (T.C.Memo 1995-51); *O'Brien v. Commissioner*, 38 T.C. 707, 712, 1962 WL 1147 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963). (These cases are illustrative, and are not intended to be exhaustive.) In this respect, too, enactment of the legislation would help simplify the tax laws and end time-consuming litigation with the IRS that serves no one's interests.

The ABA urges Congress to enact H.R. 1155. Thank you very much for your consideration.

Sincerely,

Robert D. Evans

cc: Members of the Committee

