

CONSUMER PROTECTION AND TAX LAW: HOW THE TAX TREATMENT OF ATTORNEY’S FEES UNDERMINES THE FAIR DEBT COLLECTION PRACTICES ACT

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ABSTRACT

Almost forty years after the passage of the Fair Debt Collection Practices Act (FDCPA), abusive debt collection practices continue to wreak havoc on the lives of low- and moderate-income Americans. The FDCPA aims to prevent these abuses by relying in part on individual consumers to enforce the FDCPA’s fair debt collection rules. Consumer plaintiffs serve as “private attorneys general” by bringing lawsuits against abusive debt collectors, thereby deterring abusive debt collection activity. In order to encourage FDCPA actions in furtherance of the public interest, the FDCPA contains a statutory “fee-shifting” provision whereby a prevailing plaintiff can win attorney’s fees and costs paid by the defendant.

Unfortunately, current tax law creates an obstacle to the enforcement of the FDCPA by individual plaintiffs: attorney’s fee awards are considered part of the plaintiff’s “gross income” for federal income tax purposes. Attorney’s fees may be deducted from income “below-the-line,” but such deductions are subject to significant limitations. Therefore, prevailing FDCPA plaintiffs may end up paying substantial additional taxes as a result of the attorney’s fees included in their FDCPA awards. As illustrated in this article, it is possible for a plaintiff to even *lose* money by bringing an FDCPA action and subsequently being taxed on the award. Because the potential tax burden may deter consumers from bringing FDCPA actions, the taxation of FDCPA attorney’s fee awards undermines the FDCPA’s goal of using “private attorneys general” to hold debt collectors accountable for their illegal conduct.

This article argues that attorney’s fees awarded under the FDCPA—and under all other fee-shifting statutes—should not be included in the plaintiff’s

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income. This article first discusses the standard justifications for including attorney’s fees awards in the plaintiff’s income, and explains why these justifications have no merit in the FDCPA context. This article then outlines various strategies for changing the law, including litigation, Congressional action, and regulatory clarification of the Tax Code. Finally, this article discusses strategies that consumer lawyers can use to minimize or eliminate the tax burden that their clients suffer as a result of the inclusion of FDCPA attorney’s fee awards in their clients’ income.

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I.
INTRODUCTION

Almost forty years after the passage of the Fair Debt Collection Practices Act (FDCPA), which aimed to “eliminate abusive debt collection practices by debt collectors,”¹ abusive debt collection practices continue to wreak havoc on consumers’ lives.² Debt collection has become a multi-billion dollar industry³ that targets 14% of American adults each year.⁴ Each year, the Federal Trade Commission (FTC) receives more consumer complaints about debt collectors than about any other industry.⁵ Although not all complaints about debt collectors arise out of illegal activity, and not all debt collectors engage in abusive behavior, the debt collection industry as a whole is fraught with abusive practices.⁶ For example, debt collectors sue consumers without verifying that the alleged debts are owed, harass consumers over the phone, and make fraudulent representations in order to induce consumers to pay alleged debts.⁷

The FDCPA aims to prevent debt collection abuses by relying on both government agencies and individuals to enforce the Act. The FTC and the newly-formed Consumer Financial Protection Bureau (CFPB) have joint

1. Fair Debt Collection Practices Act § 802(e), 15 U.S.C. § 1692(e) (2012).

2. See generally CONSUMER FINANCIAL PROTECTION BUREAU, FAIR DEBT COLLECTION PRACTICES ACT: CFPB ANNUAL REPORT 2014 7 (2014), http://files.consumerfinance.gov/f/201403_cfpb_fair-debt-collection-practices-act.pdf [hereinafter CFPB 2014 FDCPA REPORT] (“In 2013, approximately 30 million individuals, or 14% of American adults, had debt in or subject to the collections process averaging approximately \$1,400.”); RICK JURGENS & ROBERT J. HOBBS, NATIONAL CONSUMER LAW CENTER, THE DEBT MACHINE: HOW THE COLLECTION INDUSTRY HOUNDS CONSUMERS AND OVERWHELMS THE COURTS 5 (July 2010), <http://www.nclc.org/images/pdf/pr-reports/debt-machine.pdf> (elaborates in detail the extent to which debt collectors harass consumers to the point where the victim’s bank accounts are drained simply to fight the charges).

3. CFPB 2014 FDCPA REPORT, *supra* note 2, at 7.

4. *Id.* (citing FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT (Nov. 2013), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2013Q3.pdf) (stating that, in 2013, approximately 14% of American adults had debt in or subject to the collections process, with alleged debts averaging approximately \$1,400).

5. CFPB 2014 FDCPA REPORT, *supra* note 2, at 7.

6. *Id.* at 10.

7. *Id.* at 11–14, 16–23.

enforcement authority over the debt collection industry, and they can issue fines and bring lawsuits against debt collectors that violate the law.⁸ However, the FTC and CFPB have limited capacity to regulate the debt collection industry along with all of the other industries under their watch.⁹ Therefore, government oversight is critically supplemented by private lawsuits brought by individual consumers.¹⁰

Under section 1692k of the FDCPA, individual consumers (and classes of consumers) may bring lawsuits against debt collection companies that have engaged in abusive practices.¹¹ This provision has a dual purpose: it allows consumers to obtain recovery for injuries they suffered at the hands of abusive debt collectors and it promotes the public interest goal of deterring abusive debt collection practices. For this reason, section 1692k of the FDCPA may be referred to as a “private attorney general” provision,¹² since “private” individual litigants supplement public enforcement agencies to punish abusive debt collectors and deter future debt collection abuses. To encourage these so-called “private attorneys general” to bring lawsuits, the FDCPA contains a fee-shifting provision whereby winning plaintiffs are entitled to attorney’s fees and costs paid by the defendant, in addition to whatever damages the plaintiffs receive.¹³ Thus, low-income consumers with potentially-victorious FDCPA claims can

8. 15 U.S.C. § 1692l.

9. See CONSUMER FINANCIAL PROTECTION BUREAU, STRATEGIC PLAN, BUDGET, AND PERFORMANCE PLAN AND REPORT 4–5, 11 (2014), <http://files.consumerfinance.gov/f/strategic-plan-budget-and-performance-plan-and-report-FY2013-15.pdf> (noting that the CFPB has a very specific budget that cannot be exceeded pursuant to the Dodd-Frank Act and engages in numerous efforts including supervision activities at various financial institutions; handling consumer complaints about mortgages, credit cards, and other financial products; and providing digital content and materials to consumers.); FEDERAL TRADE COMMISSION, FISCAL YEAR 2014 SUMMARY OF PERFORMANCE AND FINANCIAL INFORMATION 3–5, 17–21, <https://www.ftc.gov/system/files/documents/reports/ftc-fy-2014-summary-performance-financial-information/150218fy14spfi.pdf> (last visited Apr. 29, 2015) (noting that the FTC has a capped budget and describing the FTC’s numerous activities in the areas of consumer protection, promoting competition, outreach and partnerships, and financial management).

10. Approximately 10,000 FDCPA lawsuits are brought by consumers each year. See WebRecon, *What Goes Up... Debt Collection Litigation & CFPB Complaint Statistics, Nov 2015* (Dec. 16, 2015), <http://webrecon.com/what-goes-up-debt-collection-litigation-cfpb-complaint-statistics-nov-2015/> (reporting that 10,468 FDCPA lawsuits were filed between January 1, 2015 and November 30, 2015); see also WebRecon, *Debt Collection Litigation & CFPB Complaint Statistics, December 2014 and Year in Review* (Jan. 22, 2015), <http://webrecon.com/debt-collection-litigation-cfpb-complaint-statistics-december-2014-and-year-in-review/> (reporting that 9720 FDCPA lawsuits were filed in 2014).

11. 15 U.S.C. § 1692k.

12. See *Gonzales v. Arrow Fin. Servs., L.L.C.*, 660 F.3d 1055, 1061 (9th Cir. 2011) (“Though the Federal Trade Commission (“FTC”) is empowered to enforce the FDCPA, 15 U.S.C. § 1692l, Congress encouraged private enforcement by permitting aggrieved individuals to bring suit as private attorneys general.”); Catherine Palo, *Litigating Violations of Fair Debt Collection Practices Act*, 128 AM. JUR. TRIALS 243, § 3 (2013).

13. See 15 U.S.C. § 1692k(a)(3) (“in the case of any successful action to enforce the foregoing liability, [the plaintiff is awarded] the costs of the action, together with a reasonable attorney’s fee as determined by the court”).

bring lawsuits against debt collectors even if they lack the funds to hire an attorney. Further, all consumers with FDCPA claims may bring lawsuits even if the value of their damages award is likely to be less than the attorney's fees and costs associated with bringing the case.¹⁴

Unfortunately, current tax law creates a major obstacle to individual litigants' ability to enforce the FDCPA. Under the tax code, damages awarded in FDCPA actions, including attorney's fees, are considered part of the plaintiff's "gross income."¹⁵ Even though attorney's fees in FDCPA cases are collected by the attorney, they are deemed to be income to the plaintiff. This is part of a general rule delineated by the Supreme Court in the 2005 case *Commissioner v. Banks*: when a litigant's recovery constitutes taxable income, such income includes the portion of recovery paid to the litigant's attorney as a contingent fee.¹⁶ The same attorney's fees can be deducted from the taxpayer's income as an expense incurred "for the production or collection of income,"¹⁷ but because this is a "below-the-line" deduction (as opposed to an "above-the-line" deduction),¹⁸ the deduction does not fully eliminate the tax burden that may arise from the initial inclusion of the attorney's fees as income.¹⁹ As a result, winning plaintiffs may end up paying substantial additional taxes as a result of the attorney's fees awarded to them in FDCPA actions. Further, low-income consumers may lose valuable tax credits like the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC), which are important resources for working-poor individuals and families and are widely heralded as mechanisms for reducing poverty, promoting work, and increasing the well-being of low-

14. See *Tolentino v. Friedman*, 46 F.3d 645, 651 (7th Cir. 1995), *cert. denied*, 515 U.S. 1160 (1995) (justifying market-rate attorney's fee awards, even when they are many times as great as the plaintiff's recovery of a mere \$1000 in statutory damages, based on the principle that FDCPA plaintiffs function as private attorneys general).

15. Cf. I.R.C. § 61 (Except as exempted by the Tax Code, "[g]ross income means all income from whatever source derived.").

16. 543 U.S. 426, 431 (2005).

17. I.R.C. § 212(1).

18. An "above-the-line" deduction is a deduction taken directly from a taxpayer's gross income to arrive at a new amount called "adjusted gross income." I.R.C. § 62(a) ("For purposes of this subtitle, the term 'adjusted gross income' means, in the case of an individual, gross income minus the following deductions . . ."); WILLIAM A. KLEIN, JOSEPH BANKMAN, DANIEL N. SHAVIRO & KIRK J. STARK, *FEDERAL INCOME TAXATION* 353 (15th ed. 2009). An above-the-line deduction is effectively the same as excluding something from income altogether, because above-the-line deductions are not subject to any limitations; a taxpayer may reduce her adjusted gross income by the full amount of any above-the-line deduction. See *id.* ("Gross Income (§ 61) *minus* Above the Line Deductions (§ 62(a)) *equals* Adjusted Gross Income (§ 62)"). Below-the-line deductions, by contrast, are deducted after adjusted gross income is calculated and are subject to various limitations. See *id.* Therefore, below-the-line deductions are often less helpful to the individual taxpayer than above-the-line deductions. For a more detailed discussion of the difference between above-the-line and below-the-line deductions, see *infra* Part III(B)(1).

19. See *infra* Part III(B) for further discussion of the deductibility of attorney's fee awards. Other features of the tax code, like the Alternative Minimum Tax, prevent below-the-line deductions from fully mitigating the impact of including attorney's fees as part of adjusted gross income. *Id.*

income families.²⁰ The taxation of FDCPA attorney's fees disincentives consumers from bringing FDCPA actions and prevents plaintiffs from being made fully whole after being injured by a debt collector. In some cases, the plaintiff could even *lose* money by bringing an FDCPA action and subsequently being taxed on the award.²¹

The inclusion of attorney's fees in FDCPA plaintiffs' income undermines the policy goals of the FDCPA. Due to the inclusion of attorney's fees as part of their income, plaintiffs who were injured by debt collectors are taxed disproportionately high amounts relative to the amount of recovery they truly receive from their lawsuits.²² Moreover, the taxation of FDCPA attorney's fee awards is inconsistent with the notion that FDCPA plaintiffs serve as "private attorneys general" who are performing a public service in addition to seeking personal recovery. "The FDCPA enlists the efforts of sophisticated consumers . . . as 'private attorneys general' to aid their less sophisticated counterparts, who are unlikely themselves to bring suit under the Act, but who are assumed by the Act to benefit from the deterrent effect of civil actions brought by others."²³ The very purpose of the attorney's fee provision is to encourage plaintiffs to bring FDCPA actions, because the rest of society stands to benefit substantially from individual FDCPA actions. Because the attorney's fees provided in service of an FDCPA action are fees that benefit all of society, not just an individual plaintiff, it is misguided to hold individual plaintiffs liable for income taxes on attorney's fee awards.

This article argues that attorney's fees awarded in FDCPA actions—and in all other fee-shifting cases²⁴—should not be included in the plaintiff's income.²⁵

20. See CHUCK MARR, CHYE-CHING HUANG, ARLOC SHERMAN & BRANDON DEBOT, CENTER FOR BUDGET & POLICY PRIORITIES, EITC AND CHILD TAX CREDIT PROMOTE WORK, REDUCE POVERTY, AND SUPPORT CHILDREN'S DEVELOPMENT, RESEARCH FINDS (Apr. 3, 2015), <http://www.cbpp.org/research/eitc-and-child-tax-credit-promote-work-reduce-poverty-and-support-childrens-development?fa=view&id=3793> (describing the benefits of the Earned Income Tax Credit and Child Tax Credit).

21. See *infra* Part III(C)(2) (describing a hypothetical plaintiff who suffers a net loss after bringing an FDCPA case, winning only \$1000 in statutory damages, and subsequently being taxed on her attorney's fee award).

22. Although the right to seek attorney's fee awards belongs solely to the plaintiff, the right to *collect* attorney's fees belongs to the attorney. See *Pony v. Los Angeles*, 433 F.3d 1138, 1142 (9th Cir. 2006) (stating that attorney's fees are paid directly from the non-prevailing party to the plaintiff's attorney, and therefore never even pass through the hands of the plaintiff herself.)

23. *Jacobson v. Healthcare Fin. Servs., Inc.*, 516 F.3d 85, 91 (2d Cir. 2008)

24. I will discuss this issue almost exclusively in the context of the FDCPA. However, a variety of other consumer protection statutes—including the federal Truth in Lending Act, 15 U.S.C. § 1640(a)(3), and Electronic Fund Transfer Act, 15 U.S.C. § 1693m(a)(3), and state consumer protection laws—also have fee-shifting provisions akin to that of the FDCPA. The same policy arguments justifying the exclusion of FDCPA attorney's fees as income also apply to attorney's fees awarded in other statutes with fee-shifting provisions.

25. Or, in the alternative, they may be included as income but deducted from income above-the-line, such that the plaintiffs' tax burden would not be affected by the attorney's fee award. See *infra* Part III(B)(1) (describing the differing tax consequences of above-the-line and below-the-line

In recommending this change, this article discusses the standard justifications for including attorney's fee awards as part of the plaintiffs' income and argues that these justifications have no merit in the FDCPA context (Part III), and that the taxation of FDCPA attorney's fees undermines the goals of the FDCPA (Part IV). This article then outlines various routes for reform that advocates can pursue, either through litigation (Part V(A)) or through Congressional or regulatory clarification of the Tax Code (Part V(B)). Finally, this article will discuss strategies that consumer lawyers can use on behalf of individual clients to minimize or eliminate the additional tax burden that their clients suffer due to the inclusion of FDCPA attorney's fee awards in their clients' income (Part V(C)).

II.

BACKGROUND ON DEBT COLLECTION AND THE FDCPA

A. The Fair Debt Collection Practices Act

The Fair Debt Collection Practices Act (FDCPA), 15 U.S.C. § 1692 *et seq.*, is the leading federal law that regulates the debt collection industry.²⁶ The FDCPA aims to “eliminate abusive debt collection practices by debt collectors, to ensure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged, and to promote consistent State action to protect consumers against debt collection abuses.”²⁷ The FDCPA establishes a set of required and prohibited conduct for debt collectors.²⁸ For example, a debt collector may not falsely represent the “character, amount, or legal status” of a debt²⁹ or harass the consumer,³⁰ and a debt collector must mail verification of the debt to the consumer upon request.³¹

If a debt collector violates the FDCPA, it can be penalized in two ways. First, the Federal Trade Commission and/or Consumer Financial Protection Bureau can take enforcement action against a debt collector who violates the

deductions). Congress could enact an amendment to the tax code modeled after a provision in the American Jobs Creation Act of 2004, which amended § 62 of the tax code to allow attorney's fees awarded in discrimination lawsuits to be deducted above-the-line from adjusted gross income. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1548 (2004) (codified as amended at I.R.C. § 62 (West 2005)). See *infra* Part V(B)(1) (describing this statute in greater detail and proposing similar legislation to change the tax consequences of FDCPA attorney's fee awards).

26. The FDCPA was supplemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of 12 U.S.C. & 15 U.S.C.), which regulated a wide variety of financial institutions and included some provisions affecting creditors and debt collectors.

27. 15 U.S.C. § 1692(e).

28. *Id.* §§ 1692b-1692j.

29. *Id.* § 1692e(2)(A).

30. *Id.* § 1692d.

31. *Id.* § 1692g(a)(4).

FDCPA.³² Second, the debt collector can be subject to civil liability in individual or class action lawsuits.³³ This article focuses only on individual FDCPA actions, not class actions, since the income taxation of attorney's fees only poses a problem for individual plaintiffs.³⁴ The income taxation of attorney's fees also does not arise when actions are brought by government enforcement agencies, but this article focuses on private actions because they are an essential supplement to the agencies' limited capacity to supervise debt collectors.³⁵

In an individual FDCPA action, the plaintiff may be awarded a combination of actual damages, statutory damages of up to \$1000, and "the costs of the action, together with a reasonable attorney's fee as determined by the court."³⁶ A plaintiff need not allege or prove any actual harm resulting from a debt collector's violation of the statute in order to be awarded statutory damages.³⁷ In many cases, the plaintiff in an FDCPA action will receive only the \$1000 in statutory damages³⁸ along with the costs of the action and attorney's fees.³⁹

32. *Id.* § 1692l (conferring enforcement authority on the FTC); 12 U.S.C. § 5514 (providing that the CFPB may have enforcement authority over a "larger participant of a market for other consumer financial products or services," as the CFPB defines by rule); CFPB 2014 FDCPA REPORT, *supra* note 2, at 24 ("The Bureau began a critical new chapter in debt collection supervision on January 2, 2013, when the CFPB's larger participant rule for debt collection became effective. Under this larger participant rule, the Bureau has supervisory authority over any firm with more than \$10 million in annual receipts from consumer debt collection activities. This authority extends to about 175 debt collectors, which accounts for more than 60% of the industry's annual receipts in the consumer debt collection market. This new Federal authority enables the Bureau both to protect consumers and to promote a level playing field for law abiding debt collectors.").

33. 15 U.S.C. § 1692k.

34. The attorney's fees awarded in class action lawsuits are not generally included as income for any of the plaintiff class members (not even the named plaintiffs), so the income taxation of attorney's fees does not pose a problem for class plaintiffs. See Robert W. Wood, *Attorneys Fees in Class Actions*, BUSINESS LAW TODAY Vol. 18, No. 3 (Jan./Feb. 2009) [hereinafter Wood, *Attorneys Fees in Class Actions*], <http://apps.americanbar.org/buslaw/blt/2009-01-02/wood.shtml> (explaining that, in "opt-out" class actions, attorney's fees are not considered income to the class members). Although they won't be discussed extensively in this article, class action lawsuits are an important component of the FDCPA's enforcement structure and there have been a growing number of class actions under the FDCPA. NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 6.2.2.2. (8th ed. 2014) [hereinafter FAIR DEBT COLLECTION] If individual FDCPA actions are hampered by the tax system, consumer lawyers may find value in bringing more class action FDCPA lawsuits so as to avoid imposing negative tax consequences on their clients. See *infra* Part V(C)(4) (discussing the potential benefit of bringing class action lawsuits as an alternative to individual FDCPA actions with negative income tax consequences).

35. William B. Rubenstein, *On What a "Private Attorney General" Is—and Why It Matters*, 57 VAND. L. REV. 2129, 2150–51 (2004)

36. 15 U.S.C. § 1692k(a)(3).

37. *Jacobson v. Healthcare Fin. Servs., Inc.*, 516 F.3d 85, 91 (2d Cir. 2008) ("In order to prevail, it is not necessary for a plaintiff to show that she herself was confused by the communication she received; it is sufficient for a plaintiff to demonstrate that the least sophisticated consumer would be confused."); Rosemary E. Williams, *Proof Under the Fair Debt Collection Practices Act*, 104 AM. JUR. PROOF OF FACTS 3d 1 § 66 (2008).

38. 15 U.S.C. § 1692k(a)(2)(A).

However, actual damages⁴⁰ can be quite significant,⁴¹ and may include injuries caused by emotional distress like sleeplessness and stress-induced heart attacks,⁴² out-of-pocket losses like loss of job or payments on an invalid claim,⁴³ and injuries to personal relations.⁴⁴ For example, a federal jury in New Mexico awarded a woman \$161,000 in actual damages for emotional distress after a debt collector negligently pursued her for a debt she did not owe arising from an account that belonged to an entirely different person who shared a similar name.⁴⁵ In another case, a state jury in Jackson County, Kansas awarded \$250,000 in actual damages after a debt collector sued a woman for a debt she did not owe, failed to comply with discovery requests, and prolonged the case for fifteen months, even in the face of evidence that the actual holder of the debt was a man with a similar-sounding name.⁴⁶

39. See Matthew R. Bremner, *The Need for Reform in the Age of Financial Chaos*, 76 BROOK. L. REV. 1553, 1561–62, 1579–81 (2011) (explaining that many FDCPA actions are brought for technical violations that cause consumers no actual harm); Terry Carter, *Payback: Lawyers on Both Sides of Collection are Feeling Debt's Sting*, ABA JOURNAL (Dec. 1, 2010), http://www.abajournal.com/magazine/article/payback_lawyers_on_both_sides_of_collection_are_feeling_debts_sting (describing FDCPA attorney who, instead of pursuing actual damages, induces debt collectors to settle cases for statutory damages plus attorney's fees). "Statutory damages under the FDCPA are intended to 'deter violations by imposing a cost on the defendant even if his misconduct imposed no cost on the plaintiff.'" *Gonzales v. Arrow Fin. Servs.*, 660 F.3d 1055, 1067 (9th Cir. 2011) (quoting *Crabill v. Trans Union, L.L.C.*, 259 F.3d 662, 666 (7th Cir. 2001)). As a practical matter, many, if not most, FDCPA cases end in settlement. Bremner, *supra*, at 1580. See generally Victor Abel Pereyra & Benjamin Sunshine, *Access-to-Justice v. Efficiency: An Empirical Study of Settlement Rates after Twombly & Iqbal*, 2015 U. ILL. L. REV. 357, 372, 387 (2015) (noting that, among prior empirical studies that discuss rates at which federal civil cases are settling, "it seems that they all agree that the settlement rate of federal civil cases is somewhere between 60% and 70%" and reporting results of new study that found aggregate settlement rate of 46.1%). Debt collectors are especially likely to settle those cases which only seek statutory damages, because the value of the \$1000 statutory damages award plus attorney's fees and costs is often less than the cost to the debt collector of litigating an FDCPA action. *Id.*

40. 15 U.S.C. § 1692k(a)(1).

41. FAIR DEBT COLLECTION, *supra* note 34, § 2.5.2.1 (describing the array of high-value actual damages, and noting that "a common and most costly mistake made by an attorney in a debt collection abuse case is to pay scant attention to the nature and extent of the client's actual damages.").

42. *Id.* § 2.5.2.2.2 (prior FDCPA cases have included injuries such as heart attack, miscarriage, ulcers, diabetic flare-ups, loss of weight, loss of sleep, crying, becoming bedridden, embarrassment, indignation, and pain and suffering).

43. *Id.* § 2.5.2.2.3. Other out-of-pocket losses include medical or counseling expenses, telephone charges, attorney's fees incurred defending a debt collection lawsuit, and transportation expenses. *Id.*

44. *Id.* § 2.5.2.2.4. These so called "relational injuries" include injury to reputation, loss of privacy, loss of consortium, strain to marriage, strain with family, and humiliation. *Id.*

45. Patrick Lunsford, *Jury Awards Plaintiff \$1.26 million in FDCPA Violation Lawsuit*, INSIDEARM (July 31, 2011), <http://www.insidearm.com/opinion/jury-awards-plaintiff-1-26-million-in-fdcpa-violation-lawsuit/>.

46. Dan Margolies, *Jury Awards KC Woman \$83 Million in Debt Collection Case*, KCUR 89.3 (May 14, 2015), <http://kcur.org/post/jury-awards-kc-woman-83-million-debt-collection-case#stream/0>.

FDCPA actions are often combined with claims under common law rules or other statutes, like state consumer protection laws.⁴⁷ Many state laws allow types of damages that are not awarded under the FDCPA, such as punitive damages for abusive debt collection practices that amount to tortious conduct.⁴⁸ Punitive damage awards are often quite substantial; for example, in the above-mentioned New Mexico suit, the jury awarded \$1.1 million in punitive damages,⁴⁹ and in the above-mentioned Jackson County suit, the jury awarded nearly \$83 million in punitive damages.⁵⁰

Depending on the length and complexity of an FDCPA case, attorney's fees and costs may amount to thousands, tens of thousands, or even hundreds of thousands of dollars.⁵¹ Attorney's fees in FDCPA cases are generally awarded based on the "lodestar" method, whereby the starting point for calculating a prevailing party's attorney's fees is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate.⁵² The hourly rate must be the market rate, as recognized by the Seventh Circuit case *Tolentino v. Friedman*.⁵³ In *Tolentino*, a plaintiff brought an FDCPA action and won \$1000 in statutory damages, along with attorney's fees and costs. Based on the lodestar method and the area market rate for attorney's fees, the plaintiff sought attorney's fees of \$16,235. The district court declined to use the market rate of \$275 per hour in calculating attorney's fees, reasoning that paying clients would not pay an hourly rate that high to obtain a mere \$1000 in statutory damages. The Seventh Circuit reversed the district court decision, noting that the FDCPA "mandates an award of attorney's fees as a means of fulfilling Congress's intent that the Act should be enforced by debtors acting as private attorneys general."⁵⁴ *Tolentino* thus reinforced the importance of attorney's fee awards in advancing the public interest goals that Congress set out when it designed the private

47. See FAIR DEBT COLLECTION, *supra* note 34, § 2.6.

48. See *id.*

49. Lunsford, *supra* note 45.

50. Margolies, *supra* note 46.

51. See, e.g., *Cuevas v. Check Resolution Servs.*, No. 12-0981, 2013 U.S. Dist. LEXIS 189893, at *4 (E.D. Cal. Aug. 7, 2013) (awarding \$3515 in attorney's fees and \$749.70 in costs to plaintiff who won \$150 in statutory damages under the FDCPA and \$100 in statutory damages under a state statute); *McDermott v. Marcus, Errico, Emmer & Brooks, P.C.*, 53 F. Supp. 312, 325 (D. Mass. 2014) (awarding \$39,898.10 in attorney's fees and \$2157.60 in costs to plaintiff who won \$800 in statutory damages under the FDCPA); Order re: Judgment at 19, *McCullough v. Johnson, Rodenburg & Lauinger, L.L.C.*, 645 F. Supp. 2d 917 (D. Mont. 2009) (No. 1:07-cv-00166) (awarding \$107,770.17 in attorney's fees and costs to plaintiff who won \$301,000.00 in actual and statutory damages under the FDCPA), *aff'd*, 637 F.3d 939 (9th Cir. 2011); *Heritage Pacific Financial, L.L.C. v. Monroy*, 215 Cal. App. 4th 972, 980–81 (Cal. Ct. App. 2013) (affirming trial court's decision granting attorney's fees and costs of \$89,489.60 for plaintiff who won \$1 in nominal damages under the FDCPA).

52. Robert F. Koets, Annotation, *Award of Attorneys' Fees under § 813(A)(3) of Fair Debt Collection Practices Act*, 132 A.L.R. Fed. 477 (1996).

53. *Tolentino v. Friedman*, 46 F.3d 645, 652 (7th Cir. 1995), *cert. denied*, 515 U.S. 1160 (1995); FAIR DEBT COLLECTION, *supra* note 34, § 6.8.6.3.

54. *Tolentino*, 46 F.3d at 651–652.

attorney general function of the FDCPA: attorney's fee awards in FDCPA cases not only benefit the immediate plaintiff, but help protect the general public.⁵⁵ As this article will show, these goals are hampered when plaintiffs are required to pay substantial additional taxes as a result of attorney's fee awards.⁵⁶

B. Debt Collection Abuses: As Bad as Ever

When the Fair Debt Collection Practices Act was first proposed in 1975, its lead sponsor introduced it on the floor of the House of Representatives as follows:

There is an urgent need for this legislation because some debt collectors are abusing consumers with harassment, intimidation, threats, and deception. Often the debts are not even bona fide . . . Debt collectors will use any tactic imaginable to collect a debt that often is not even legitimate.⁵⁷

Forty years later, the debt collection industry can be described using precisely the same language. Consumers submit more complaints to the FTC and CFPB about debt collectors than about any other industry.⁵⁸ Among the complaints received by the CFPB in 2013, 34% reported debt collectors' continued attempts to collect debts not owed, 23% reported abusive communication tactics, 14% reported intimidation of consumers by taking or threatening illegal action against them, and 9% reported that debt collectors had made false statements or representations.⁵⁹ Similarly, top complaints received by the FTC include repeated calls (39.0%), misrepresentation of the character, amount, or status of the debt (38.1%), false threats of an illegal or unintended act (34.1%), and false threats of arrest or property seizure (27.9%).⁶⁰

Although debt collection abuses have remained a constant feature of the debt collection industry, the industry has changed over time, resulting in ever-shifting types of FDCPA violations. In recent years, consumer lending has multiplied⁶¹: as of November 2014, United States consumers hold nearly \$3.3 trillion in outstanding consumer credit.⁶² Credit card debt makes up

55. *Id.*

56. For example, the *Tolentino* plaintiff only won \$1000 in statutory damages but may have had to pay taxes not only on his damages but on \$16,235 in attorney's fees. See *infra* Part III(C)(2), for a discussion of the tax consequences for a hypothetical plaintiff based on the plaintiff in *Tolentino*. *Tolentino*'s additional tax burden arising from his attorney's fees would likely have exceeded the \$1000 he received in damages. *Id.*

57. 121 CONG. REC. E5404-5405 (daily ed. Oct. 9, 1975) (statement of Rep. Annunzio) (introducing the then-named Debt Collection Practices Act).

58. CFPB 2014 FDCPA REPORT, *supra* note 2, at 9.

59. *Id.* at 11-14. Some complaints reported more than one abusive tactic.

60. *Id.* at 16-23. Some complaints reported more than one abusive tactic.

61. RICK JURGENS & ROBERT J. HOBBS, *supra* note 2, at 4-6.

62. FEDERAL RESERVE, CONSUMER CREDIT NOVEMBER 2014 FEDERAL RESERVE STATISTICAL RELEASE (2014), <http://www.federalreserve.gov/RELEASES/g19/20150108/g19.pdf> ("Consumer

approximately 12% of outstanding consumer credit,⁶³ and substantial amounts of consumer debt are due to student loans and medical expenses.⁶⁴ Partially as a result of the expansion in consumer credit, the debt collection industry has experienced dramatic growth and an evolution of its business practices since the passage of the FDCPA in 1977.⁶⁵

One notable feature of the modern debt collection industry is the growth of a substantial debt-buying market, which puts consumers up against new creditors with whom they have never even done business.⁶⁶ Debt-buyers purchase defaulted debt from previous creditors for pennies on the dollar⁶⁷ and then pursue collection, often based on incomplete and even inaccurate records of the alleged debts.⁶⁸ As a result, consumers are frequently pursued for debts they do not owe, often in reference to accounts and purchases that the consumer does not even recognize.⁶⁹

Another feature of the modern debt collection industry is that technological changes have allowed debt collectors to target consumers more readily.⁷⁰ The debt collection industry has become more automated, and some of the same problems that famously contributed to the foreclosure crisis—like robo-signing and faulty documentation—have also caused problems in credit card debt collection.⁷¹ Additionally, debt collectors have increasingly begun contacting consumers on cell phones, which poses privacy concerns: consumers receive cell phone calls in public and debt collectors might call a single consumer hundreds or even thousands of times.⁷² Text messages from debt collectors are another

credit outstanding” includes most short- and intermediate-term credit extended to individuals, excluding loans secured by real estate).

63. *Id.*

64. CFPB 2014 FDCPA REPORT, *supra* note 2, at 7–8.

65. *Id.*

66. *See id.* (describing the growth of the debt buyer industry).

67. FEDERAL TRADE COMMISSION, THE STRUCTURE AND PRACTICES OF THE DEBT BUYING INDUSTRY ii, 23 (2013), <http://www.ftc.gov/sites/default/files/documents/reports/structure-and-practices-debt-buying-industry/debtbuyingreport.pdf> [hereinafter FTC DEBT BUYING REPORT] (reporting that, in a study of debt buyers conducted by the FTC, debt buyers paid an average of 4 cents per dollar of debt face value).

68. *Id.* at ii–iv.

69. *Id.*

70. FEDERAL TRADE COMMISSION, COLLECTING CONSUMER DEBTS: THE CHALLENGES OF CHANGE iv (2009), <https://www.ftc.gov/sites/default/files/documents/reports/collecting-consumer-debts-challenges-change-federal-trade-commission-workshop-report/dcwr.pdf> [hereinafter CHALLENGES OF CHANGE]. For example, debt collectors can “easily and relatively inexpensively mass-produce and send letters to debtors,” and “use sophisticated automated dialing and interactive voice recording technologies to efficiently place telephone calls to consumers.” *Id.*

71. Jessica Silver-Greenberg & Edward Wyatt, *U.S. Vows to Battle Abusive Debt Collectors*, N.Y. TIMES (July 10, 2013), <http://dealbook.nytimes.com/2013/07/10/usvowstobattleabusivedebtcollectors/>.

72. Ann Carrns, *Consumer Watchdog Takes Up Debt Collection*, N.Y. TIMES (Nov. 8, 2013), <http://www.nytimes.com/2013/11/09/your-money/consumer-watchdog-takes-up-debt-collection.html>. *See also* Robert J. Hobbs, National Consumer Law Center, Comment Letter on Proposed Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991

new concern. In 2013, the FTC brought its first action for unlawful text messaging practices by a debt collector.⁷³ The FTC has also raised concerns about the costs consumers incur for receiving text messages and calls, and has suggested that debt collectors should only be able to contact consumers on their cell phones if they first obtain consumer consent.⁷⁴

Abusive conduct by debt collectors has substantial negative consequences for consumers, the courts, and even creditors themselves. For example, a consumer named Tim McCollough, who lived on Social Security after a disabling head injury, was one of many consumers targeted with meritless lawsuits by a debt collector named CACV.⁷⁵ CACV had a practice of suing on debts after their statutes of limitations had expired.⁷⁶ The company filed and refiled meritless lawsuits, despite an awareness that the statutes of limitations had run out.⁷⁷ When McCollough was sued by CACV, he went to court and had the case dismissed on statute of limitations grounds, only to be sued by CACV again on the same claim—not once, but twice more.⁷⁸ As a result of CACV's unrelenting attacks, McCollough suffered great emotional distress, which impeded the healing of his head injury.⁷⁹ McCollough continued to resist CACV's attempts to illegally secure a judgment against him; he eventually obtained a lawyer and sued CACV under the FDCPA, winning \$301,000 in damages and \$107,770.17 in attorney's fees and costs.⁸⁰ McCollough, however,

(Apr. 13, 2006), <https://ecfsapi.fcc.gov/file/6518333643.pdf> (observing that “consumers generally carry their cell phones with them in places where they would not want to receive a debt collection call: their car, the bus, a restaurant” and that “[c]aller identity information may now be faked and some debt collectors are using these deceptive services to make debt collection calls to a consumer with a relative's, employers, or neighbor's phone number appearing as the caller's identity[,]” thereby depriving consumers of the freedom to decline to answer an unwanted debt collection call).

73. Press Release, Federal Trade Commission, FTC Brings First Case Alleging Text Messages Were Used in Illegal Debt Collection Scheme (Sep. 25, 2013), <https://www.ftc.gov/news-events/press-releases/2013/09/ftc-brings-first-case-alleging-text-messages-were-used-illegal>. In this action, a California-based debt collection company paid a \$1 million settlement after the FTC found it had sent consumers text messages in which the company failed to disclose it was a debt collector, falsely portrayed itself as a law firm, falsely threatened to sue consumers or garnish their wages if the consumers did not pay. *Id.*

74. CHALLENGES OF CHANGE, *supra* note 70, at 39–42 (noting that “debt collectors using newer technologies may inconvenience or embarrass consumers by contacting them while they are driving, at appointments, or at work,” but stating that debt collectors should be permitted to contact consumers on their mobile phones provided that they have previously obtained the consumers' express consent to do so).

75. JURGENS & HOBBS, *supra* note 2, at 3–4.

76. *Id.*

77. *Id.*

78. *Id.*

79. McCollough v. Johnson, Rodenburg & Lauinger, L.L.C., 637 F.3d 939, 945–947 (9th Cir. 2011).

80. Order re: Judgment at 19, *McCollough*, 645 F. Supp. 2d 917 (No. 1:07-cv-00166).

is the exception to the rule. Many consumers in similar situations end up being held liable for and paying debts they do not owe.⁸¹

Debt collection lawsuits also place a substantial burden on our legal system. Debt collectors flood the courts with lawsuits; in New York City, for example, thirty-six percent of civil court filings are debt collection lawsuits.⁸² Debt collectors prevail in the vast majority of suits, even when the suits are not meritorious, due to improper service of process and a lack of attorney representation for defendants sued in debt collection actions.⁸³ However, debt collectors—and especially debt buyers—virtually never prevail in contested debt collection cases, suggesting that the large number of victorious *uncontested* debt collection cases can be explained by due process violations (wherein debtors don't know about or can't effectively respond to lawsuits) rather than the merits of the claims.⁸⁴

Finally, even debt collectors may suffer as a result of abusive debt collection tactics. An under-recognized casualty of abusive debt collection practices is that well-intentioned creditors and debt collectors are put at a disadvantage when

81. CLAUDIA WILNER & NASOAN SHEFTEL-GOMES, DEBT DECEPTION: HOW DEBT BUYERS ABUSE THE LEGAL SYSTEM TO PREY ON LOWER-INCOME NEW YORKERS 8 (2010), http://www.neweconomynyc.org/wp-content/uploads/2014/08/DEBT_DECEPTION_FINAL_WEB-new-logo.pdf (stating that, in survey of debt collection cases brought by debt buyers between January 2006 and February 2008, 81.4% ended in default judgment for the debt buyer, and another 12.9% ended in settlement, even though more than half of consumers who settled cases expressed doubts about the validity or amount of the debt).

82. NEW ECONOMY PROJECT, THE DEBT COLLECTION RACKET IN NEW YORK: HOW THE INDUSTRY VIOLATES DUE PROCESS AND PERPETUATES ECONOMIC INEQUALITY 6 (2013), <http://www.neweconomynyc.org/wp-content/uploads/2014/08/DebtCollectionRacketUpdated.pdf>. In New Jersey, court judgments in debt collection cases have skyrocketed from 500 suits in 1996 to 140,000 suits in 2008, and debt buyers account for nearly half of these lawsuits. ProPublica, *So Sue Them: What We've Learned About the Debt Collection Lawsuit Machine* (May 5, 2016), <https://www.propublica.org/article/so-sue-them-what-weve-learned-about-the-debt-collection-lawsuit-machine>. In Texas in 2007, "suits on debt" accounted for 43.8% of civil cases filed in county-level courts statewide, and for more than 78% of civil cases filed in county-level courts in Dallas County. Mary Spector, *Debts, Defaults and Details: Exploring the Impact of Debt Collection Litigation on Consumers and Courts*, 6 VA. L. & BUS. REV. 257, 273 (Fall 2011). In Massachusetts in 2005, more than 60% of civil cases were brought by debt collectors. Beth Healy, *A Debtor's Hell: Part 2, A Court System Compromised*, BOSTON GLOBE (July 31, 2006), http://www.boston.com/news/special/spotlight_debt/part2/page1.html.

83. See FTC DEBT BUYING REPORT, *supra* note 67, at 12–16 (reporting that in New York City in 2008, 26 debt buyers filed a deluge of cases in New York City Civil Court and won 94% of the lawsuits. Only ten percent of the alleged debtors responded to a summons and complaint and only 1 percent had legal representation. A lawyer from a New York City legal services organization explained that, due to improper service, many consumers are simply unaware of debt collection lawsuits filed against them).

84. NEW ECONOMY PROJECT, *supra* note 82, at 3. For example, in a survey of debt collection cases brought by debt buyers between January 2006 and February 2008, the vast majority ended in default judgment (81.4%) or settlement (12.9%), but in the remaining 5.7% of cases, the suits were discontinued or dismissed. WILNER & SHEFTEL-GOMES, *supra* note 81, at 8–9. The debt buyers in the sample did not win a single case on the merits. *Id.*

their competitors use abusive tactics.⁸⁵ When consumers face undue financial burden at the hands of abusive debt collectors, they tend to pay off the debts associated with the abusive debt collection processes or incur other costs, like court fees, in contesting the debts. Hence, they end up with fewer financial resources to pay the debts they actually *do* owe, to creditors who are *not* engaging in abusive practices. If left unchecked, the debt collection industry could become a race to the bottom: debt collectors would be incentivized to use the most unconscionable, harassing and deceptive tactics in order to be the first to coerce consumers into paying.⁸⁶ Meaningful regulation of the debt collection industry is necessary to protect consumers, the civil legal system, and the debt collection industry itself.

III.

BACKGROUND ON THE INCOME TAXATION OF ATTORNEY'S FEES

A. Inclusion of Attorney's Fees in Gross Income

A starting point for any discussion of income tax is section 61 of the Internal Revenue Code, which states that gross income is defined as “all income from whatever source derived.”⁸⁷ Income may be “realized in any form, whether in money, property, or services.”⁸⁸ Court judgments and settlements typically constitute income, and are taxable unless specifically excluded or deducted by another section of the Code.⁸⁹ One such exclusion is section 104(a)(2) of the Code, which states that damages (other than punitive damages) received on account of personal physical injuries or physical sickness are excluded from the calculation of gross income.⁹⁰ For example, if a plaintiff received damages for injuries in a car accident, the entire damage award would likely be excluded from her gross income.⁹¹ In the FDCPA context, some plaintiffs may be able to exclude a portion of their damages under § 104(a)(2) if they received damages to

85. See 15 U.S.C. § 1692(e) (stating that one of the purposes of the FDCPA is “to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged. . .”).

86. Bremner, *supra* note 39, at 1564 (“[A]busive debt collectors gain a competitive advantage from their coercive tactics.”). See also Lauren Goldberg, *Dealing in Debt: the High Stakes World of Debt Collection After FDCPA*, 79 S. CAL. L. REV. 711, 716–17 (2006) (describing history of debt collection and noting that “[v]icious tactics were so effective that reputable companies found it hard to compete with ‘rogue agencies’”).

87. I.R.C. § 61(a). See also *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding that income includes all “undeniable accessions to wealth, clearly realized, and over which taxpayers have complete dominion.”).

88. Treas. Reg. § 1.611(a).

89. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. at 432; Michael B. Bogdanow, *Taxation of Judgments and Settlements*, MEEHAN, BOYLE, BLACK & BOGDANOW, P.C. (Apr. 2004), <http://www.meehanboyle.com/taxation-of-judgments-and-settlements/>.

90. I.R.C. § 104(a)(2).

91. See *Comm’r v. Schleier*, 515 U.S. 323, 329–331 (1995) (describing the tax consequences of a damage award arising from a hypothetical automobile accident).

compensate a personal injury or sickness that was caused by abusive debt collection practices. However, one important limitation is that emotional distress does not constitute a personal injury or sickness, even if emotional distress causes physical symptoms like insomnia, headaches, or stomach disorders.⁹² Most types of FDCPA damages, like statutory damages and actual damages not arising from personal injury or sickness (such as damages for emotional distress, for the loss of a job, or for payments made on an invalid claim), are not excludable under § 104(a)(2).⁹³

For many years, courts were divided on whether attorney's fee awards should be included in a winning plaintiff's income.⁹⁴ In 2005, the Supreme Court resolved this question in *Commissioner v. Banks*, which held that, "when a litigant's recovery constitutes income, such income includes the portion of the recovery paid to the attorney as a contingent fee."⁹⁵ The *Banks* plaintiff, John W. Banks, II, had retained an attorney on a contingency-fee basis and brought an employment discrimination action under Title VII of the Civil Rights Act of 1964⁹⁶—which contains a statutory fee-shifting provision⁹⁷—and other statutes. After trial began, Banks and his former employer settled the case for \$464,000, of which Banks paid \$150,000 to his attorney.⁹⁸ After Banks failed to report his settlement on his tax returns, the IRS issued Banks a notice of deficiency, and the matter was appealed to the United States Supreme Court.⁹⁹

The Supreme Court held that Banks' entire settlement award was taxable income, including both the amount he pocketed and the amount paid to his attorney.¹⁰⁰ The Court reached its holding based on the "anticipatory assignment of income" doctrine: "a taxpayer cannot exclude an economic gain from gross

92. Treas. Reg. § 1.104-1(c)(1) (as amended in 2012); H.R. REP. NO. 104-737, at 301 n.56 (1996) (Conf. Rep.), 1996-3 C.B. 741, 1041 ("[It] is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress"). See also *Blackwood v. Comm'r*, 104 T.C.M. (CCH) 27, *3 (2012) ("[T]he fact that a taxpayer suffers physical symptoms from emotional distress does not automatically qualify the taxpayer for an exclusion from gross income under section 104(a)(2)").

93. See *Banaitis v. Comm'r*, 340 F.3d 1074, 1080 (9th Cir. 2003).

94. See *Comm'r v. Banks*, 543 U.S. 426, 431 (2005) (resolving controversy among circuit courts and holding that, when a litigant's recovery constitutes taxable income, such income includes the portion of recovery paid to the litigant's attorney as a contingent fee); NATIONAL CONSUMER LAW CENTER, FAIR DEBT COLLECTION § 2.1.4 (5th ed. 2004) (consumer law manual, published in 2004, shortly before the *Banks* decision, discussing the uncertainty surrounding the circuit split over the income taxation of attorney's fees awarded on a contingency basis); FAIR DEBT COLLECTION SUPPLEMENT § 2.1.4 (2005 supplement to the 2004 manual explaining that *Banks* unfavorably resolved the confusion).

95. 543 U.S. at 430.

96. *Id.* (citing Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e to 2000e-17).

97. 42 U.S.C. § 2000e-5(k) ("In any action or proceeding under this subchapter the court, in its discretion, may allow the prevailing party, other than the Commission or the United States, a reasonable attorney's fee (including expert fees) as part of the costs[.]").

98. *Banks*, 543 U.S. at 431.

99. *Id.* at 431-32.

100. *Id.* at 438-39.

income by assigning the gain in advance to another party.”¹⁰¹ Because the plaintiff in a contingency-fee case “retains dominion over the income-generating asset”—namely, her claim—and because the attorney acts as the agent of the plaintiff, the Court held that the income generated in the case, including attorney’s fees, should be attached to the controlling plaintiff.¹⁰²

Banks was taxed for his attorney’s fees even though he brought his suit under statutes that, like the FDCPA, contain fee-shifting provisions.¹⁰³ The Court, however, declined to address arguments that applying the anticipatory assignment of income doctrine to fee-shifting cases would undermine the “private attorney general” function of statutory fee-shifting provisions, noting that the fee paid to Banks’ attorney was calculated solely on the basis of his private contingent-fee contract.¹⁰⁴ “There was no court-ordered fee award, nor was there any indication in Banks’ contract with his attorney, or in the settlement agreement with the defendant, that the contingent fee paid to Banks’ attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover.”¹⁰⁵ Therefore, the Court determined that it “need not address” arguments specific to the taxation of attorney’s fees awarded pursuant to a statutory fee-shifting provision.¹⁰⁶

The Court hinted, however, that there might be merit to the claim that the anticipatory assignment of income doctrine should not apply in cases arising under statutes with fee-shifting provisions.¹⁰⁷ It noted that, in such cases, “the plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs’ recoveries, or when for other reasons damages are substantially less than attorney’s fees, court-awarded attorney’s fees can exceed a plaintiff’s monetary recovery.”¹⁰⁸ Future plaintiffs and their attorneys may thus be successful in convincing the Court that *Banks* should not be extended to cases in which attorney’s fees are awarded exclusively under a fee-shifting provision.¹⁰⁹ Currently, however, the generally accepted rule has been that attorney’s fees constitute income to the plaintiff, regardless of whether they are awarded pursuant to a fee-shifting provision.¹¹⁰

101. *Id.* at 433 (citing *Lucas v. Earl*, 281 U.S. 111 (1930); *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Horst*, 311 U.S. 112 (1940)).

102. *Id.* at 434–438.

103. *Id.* at 438–439.

104. *Id.*

105. *Id.* at 439.

106. *Id.*

107. *Id.* at 438.

108. *Id.*

109. See Part V(A) for further discussion of the viability of this argument.

110. See *Sinyard v. Commissioner*, 268 F.3d 756, 759 (9th Cir. 2001), *aff’g.* 76 T.C.M. (CCH) 654 (1998); *Vincent v. Commissioner*, 89 T.C.M. (CCH) 1119 (2005) (attorney’s fees awarded pursuant to a fee shifting statute or regulation must be included in the gross income of the plaintiff where the awards are in lieu of contingency-fee); *Sanford v. Commissioner*, 95 T.C.M.

B. The Deductibility of Attorney's Fees and its Limitations

While attorney's fees awarded on a contingency basis are included in a consumer's adjusted gross income, they can be deducted below-the-line, as an itemized deduction, when calculating taxable income.¹¹¹ Taxpayers may take an itemized deduction for attorney's fees because they are an expense incurred "for the production or collection of income."¹¹² However, for several reasons, a below-the-line deduction does not fully eliminate the additional tax burden that arises from the initial inclusion of attorney's fees in the consumer's adjusted gross income.¹¹³ The deduction of attorney's fees, like all itemized deductions, is subject to the limitations of I.R.C. § 67 (2 percent floor) and § 68 (phaseout of itemized deductions), and may be entirely eliminated under the alternative minimum tax (AMT).¹¹⁴ Furthermore, because the taxpayer must itemize deductions in order to deduct attorney's fees, the taxpayer loses the benefit of the standard deduction.¹¹⁵ She may also lose important tax credits such as the Earned Income Tax Credit, the Child and Dependent Care Credit, the Credit for the Elderly or Disabled, and the Hope and Lifetime Learning Credit, which are calculated based on adjusted gross income, not taxable income.¹¹⁶ As a general matter, there are policy justifications for imposing limitations on below-the-line

(CCH) 16188 (2008); *Green v. Commissioner*, 93 T.C.M. (CCH) 917 (2007). However, the I.R.S. has indicated that there are at least some exceptions to the general rule that attorney's fees constitute income. In two Private Letter Rulings, the IRS has found that attorney's fees awarded to lawyers representing a client on a pro bono basis are not includable in the client's gross income. I.R.S. Priv. Ltr. Rul. 2015-52-001 (Dec. 24, 2015); I.R.S. Priv. Ltr. Rul. 2010-15-016 (Apr. 16, 2010); *Pro Bono Client Did Not Have Income from Attorney's Fees Awarded to Counsel*, 112 J. TAX'N 380 (2010) [hereinafter *Pro Bono Client*]. See Part V(B)(2) for further discussion of the Private Letter Rulings and their implications.

111. I.R.C. § 63(d); *Cf.* I.R.C. § 212 ("there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year— (1) for the production or collection of income"). Expenses incurred for the production of income are just one category of expense that can be deducted below-the-line. Other examples of below-the-line deductions include trade or business expenses, I.R.C. § 62(a)(1), and charitable contributions, I.R.C. § 170.

112. I.R.C. § 212(1).

113. See Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 57–67 (describing how IRC §§ 67, 68 and the Alternative Minimum Tax limit the benefits of deducting an attorney's fee award as a miscellaneous itemized deduction, such that the plaintiff's tax liability is greater under the "inclusion and deduction" method than it would have been if it was simply excluded from income altogether).

114. KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 18, at 603; Robert W. Wood, *Can Tax Rules Cut Legal Bills?*, 82 N.Y. ST. B. ASS'N J. 64, 64–65 (2010) [hereinafter Wood, *Can Tax Rules Cut Legal Bills?*]; Susan A. Bernson, *The Taxation of Tort Damage Awards and Settlements: When Recovering More for a Client May Result in Less*, 78 J. KAN. B. ASS'N 21, 22 (2009). Each of these limitations will be described in greater detail in *infra* Part III(B)(1).

115. See I.R.C. § 56(b)(1)(E) (stating that "[t]he standard deduction under section 63(c) . . . shall not be allowed" in computing alternative minimum taxable income).

116. See I.R.C. §§ 21(a), 22(d), 25A(d), 32(a) (describing that each of these credits is calculated based on adjusted gross income).

deductions, but those justifications do not apply in the context of FDCPA attorney's fee awards.¹¹⁷

1. Above-the-Line Versus Below-the-Line Deductions

The tax code allows a taxpayer's income to be reduced by various deductions, either for the purpose of measuring income more accurately or to incentivize certain activities or investments.¹¹⁸ In general, deductions fall into two categories: above-the-line and below-the-line deductions.¹¹⁹ An above-the-line deduction is taken directly from a taxpayer's gross income to arrive at a new amount called "adjusted gross income."¹²⁰ An above-the-line deduction is effectively the same as excluding something from income altogether. Since above-the-line deductions are not subject to any limitations, a taxpayer may reduce her adjusted gross income by the full amount of any above-the-line deduction.¹²¹

Below-the-line deductions, by contrast, are subject to various limitations and are potentially less helpful to the individual taxpayer. Below-the-line deductions are governed by I.R.C. § 63, which allows various additional amounts to be subtracted from adjusted gross income to calculate a new amount called "taxable income."¹²² Taxable income is defined as adjusted gross income minus a) either the standard deduction¹²³ or itemized deductions¹²⁴; and b) a deduction for personal exemptions for the taxpayer and each of her dependents.¹²⁵ Other than personal exemptions, most below-the-line deductions are only advantageous to the taxpayer if she chooses to itemize her deductions rather than taking the standard deduction. For taxpayers with relatively low-value itemized deductions, it is more advantageous to take the standard

117. See *infra* Part III(B)(3) (describing the general policy justifications for limiting below-the-line deductions and explaining why those justifications don't apply in the context of FDCPA attorney's fees).

118. MICHAEL J. GRAETZ & DEBORAH H. SCHENCK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 228 (6th ed. 2009).

119. KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 18, at 353.

120. I.R.C. § 62(a) ("For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions . . ."); KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 18, at 353.

121. See KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 18, at 353 ("Gross Income (§ 61) minus Above the Line Deductions (§ 62(a)) equals Adjusted Gross Income (§ 62)").

122. I.R.C. § 63; KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 18, at 353.

123. I.R.C. § 63(c).

124. § 63(d).

125. §§ 63, 151. All taxpayers are entitled to a personal exemption deduction for themselves and each of their dependents, regardless of whether they itemize deductions or take the standard deduction. KLEIN, BANKMAN, SHAVIRO & STARK, *supra* note 18, at 353. In 2015, the personal exemption amount was \$4,000. I.R.S. Rev. Proc. 2014-61.24, Personal Exemptions (Nov. 17, 2014). The personal exemption, like itemized deductions, is subject to the "phaseout" provision of section 68. I.R.C. §§ 68, 151(d)(3). See *infra* Part III(B)(2) for further discussion of the phaseout provision.

deduction, which allows taxpayers to take a uniform below-the-line deduction that varies only based on filing status.¹²⁶ Itemizing deductions requires taxpayers to keep track of and subtract various specific deductions that are provided for by the tax code, ranging from casualty losses¹²⁷ to charitable contributions¹²⁸ to expenses incurred in the production of income.¹²⁹ Attorney's fees awarded in FDCPA cases are deductible below-the-line as an expense incurred in the production of income, because they are incurred in the process of obtaining a taxable recovery.¹³⁰

2. Limitations on Below-the-Line Deductions

Below-the-line deductions are less helpful to the taxpayer than above-the-line deductions for a variety of reasons. First, below-the-line deductions require the taxpayer to face a trade-off between taking the standard deduction and itemizing deductions. Second, below-the-line deductions are subject to the limitations of I.R.C. § 67 (2 percent floor) and § 68 (phaseout of itemized deductions). Third, below-the-line deductions may be entirely eliminated under the alternative minimum tax (AMT). Finally, below-the-line deductions do not help the taxpayer qualify for various income-based tax credits such as the Earned Income Tax Credit (EITC) and the Child & Dependent Care Credit, which are calculated based on the taxpayer's adjusted gross income, not taxable income.

The first disadvantage of below-the-line deductions is that they force the taxpayer to face a trade-off between taking the standard deduction and itemizing deductions. Every taxpayer has a choice between itemizing her deductions (deducting the actual value of certain specified expenses, including expenses incurred for the production of income, state and local income taxes, and sales taxes) or taking a fixed standard deduction which is available to every taxpayer regardless of her actual expenses. The individual taxpayer's decision whether to itemize depends on the value of the itemized deductions to which she is entitled, and in many cases the taxpayer is better off taking the standard deduction. If a taxpayer does not itemize deductions, she automatically obtains a significant below-the-line standard deduction that amounts to thousands of dollars and varies only based on the year and the taxpayer's filing status.¹³¹ Taxpayers whose itemized deductions add up to less than the value of the standard

126. I.R.C. § 63(b).

127. I.R.C. § 165(c)(3).

128. § 170.

129. § 212.

130. *See id.* ("In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income. . . ."); BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 75.2, 1997 WL 439902, at *16 (2015).

131. I.R.C. § 63(b). For the 2015 tax year, the standard deduction was \$6,300 for individuals, \$12,600 for married couples filing jointly, and \$9,250 for heads of household. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .14 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

deduction are better off taking the standard deduction rather than itemizing their deductions. By doing so, however, they lose any benefit from individual itemized deductions such as a deduction for attorney's fees.¹³² Conversely, a taxpayer who chooses to itemize deductions loses the benefit of the standard deduction.¹³³ So, even though an FDCPA attorney's fee award may be deducted from income, the deduction comes at the substantial cost of losing the thousands of dollars that a taxpayer may have otherwise deducted using the standard deduction.¹³⁴

The second disadvantage of below-the-line deductions is that they are subject to the limitations of I.R.C. § 67, the two percent floor, and § 68, the phaseout of itemized deductions. Under § 67, the taxpayer can deduct "miscellaneous itemized deductions" only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income.¹³⁵ "Miscellaneous itemized deductions" include all itemized deductions other than certain specific exceptions that are listed in § 67.¹³⁶ So, for example, a taxpayer with an adjusted gross income of \$50,000 may only take itemized deductions to the extent that they exceed \$1000, which is two percent of her adjusted gross income. The first \$1000 of itemized deductions would not be deductible, but any amount beyond the first \$1000 is deductible.

Section 68 applies only to taxpayers whose adjusted gross income is above an applicable amount, which was \$250,000 for taxpayers filing as individuals when § 68 was passed and is adjusted each year for inflation.¹³⁷ Moderate-income taxpayers do not have to worry about § 68, but a taxpayer who has received a large award in an FDCPA lawsuit might become subject to § 68 even if her income would ordinarily fall well below its reach.¹³⁸ When a taxpayer's income is over the applicable amount, she must reduce the amount of her

132. For example, a taxpayer filing as an individual in 2015 is entitled to a standard deduction of \$6,300. If the total value of a tax payer's attorney's fee award plus any other itemized deductions is less than \$6,300, it is in her best interest to take the standard deduction of \$6,300 rather than itemizing her deductions. By doing so, however, she loses the opportunity to deduct the value of the attorney's fee award. Since she would have been able to take the \$6,300 regardless of whether she received an attorney's fee award, this puts her at a disadvantage, because she is not able to deduct the value of the attorney's fees from her income.

133. See I.R.C. § 56(b)(1)(E) (stating that "[t]he standard deduction under section 63 (c) . . . shall not be allowed" in computing alternative minimum taxable income).

134. See GRAETZ & SCHENK, *supra* note 118, at 422–23 (describing the justifications for the standard deduction).

135. I.R.C. § 67(a); GRAETZ & SCHENK, *supra* note 118, at 256.

136. § 67(b); GRAETZ & SCHENK, *supra* note 118, at 255–56. Some of the excluded deductions are the itemized deductions for interest, casualty losses, and charitable donations. *Id.*

137. For the 2015 tax year, the applicable amounts under § 68(b) are \$309,900 in the case of a joint return or a surviving spouse, \$284,050 in the case of a head of household, \$258,250 in the case of an individual who is not married and who is not a surviving spouse or head of household, \$154,950 in the case of a married individual filing a separate return. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .14 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

138. See *infra* Part III(C)(1), for an example of such a taxpayer.

itemized deductions by the lesser of: a) “3 percent of the excess of adjusted gross income over the applicable amount;”¹³⁹ or b) “80 percent of the amount of the itemized deductions otherwise allowable for such taxable year.”¹⁴⁰

An additional limitation on below-the-line deductions is that a taxpayer’s itemized deductions may be entirely eliminated if they are subject to the alternative minimum tax (AMT). Taxpayers are subject to the AMT if their alternative minimum tax amount—as specified in section 55 of the tax code—is greater than their tax liability under the regular tax system.¹⁴¹ The idea behind the AMT is that, if a taxpayer’s adjusted gross income is sufficiently high, the taxpayer should be required to pay some minimum amount of tax even if she would be able to reduce most or all of her tax burden by taking deductions.¹⁴² A taxpayer is subject to the AMT if the computation of her minimum tax produces an amount that is greater than the amount of tax that she would pay under the regular income tax computation.¹⁴³ Attorney’s fees are not deductible for purposes of the AMT, so if a taxpayer is subject to the AMT, her attorney’s fees are not deductible at all.¹⁴⁴

Finally—and probably most importantly for low-income consumers—the inclusion of attorney’s fees as income may impact a taxpayer’s eligibility for credits such as the Earned Income Tax Credit,¹⁴⁵ the Child and Dependent Care Credit,¹⁴⁶ the Credit for the Elderly or Disabled,¹⁴⁷ and the Hope and Lifetime Learning Credit.¹⁴⁸ Each of these credits is calculated in relation to adjusted gross income—not taxable income—and below-the-line deductions do not reduce adjusted gross income.¹⁴⁹ Therefore, the inclusion of attorney’s fees in a taxpayer’s income could cause a taxpayer who is otherwise eligible for these credits to receive lower credits or no credits at all.¹⁵⁰ For example, the Earned Income Tax Credit is subject to a “threshold phaseout amount” that is based on the taxpayer’s adjusted gross income, above which the maximum amount of the

139. I.R.C. § 68(a)(1).

140. § 68(a)(2). The “amount of the itemized deductions otherwise allowable” includes all of the taxpayer’s itemized deductions minus three exceptions: deductions for medical expenses, investment interest, and losses incurred due to casualty, theft, or business. § 68(c).

141. I.R.C. § 55(a).

142. GRAETZ & SCHENK, *supra* note 118, at 776.

143. *Id.* See *infra*, Part III(C)(1) for an example of an AMT computation.

144. I.R.C. §§ 55(b)(2)(A), 56(b)(1), 67(b). Attorney’s fees are deducted as an expense incurred “for the production or collection of income,” § 212(1), and are thus included as a “miscellaneous itemized deduction” under § 67(b). Miscellaneous itemized deductions are added back in during the calculation of alternative minimum taxable income. For a critique of the AMT’s treatment of attorney’s fees, see Brant J. Hellwig & Gregg D. Polsky, *Litigation Expenses and the Alternative Minimum Tax*, 6 FLA. TAX REV. 899 (2004).

145. I.R.C. § 32(a).

146. § 21(a).

147. § 22(d).

148. § 25A(d).

149. I.R.C. §§ 21(a), 22(d), 25A(d), 32(a).

150. *Id.*

credit is to be reduced incrementally.¹⁵¹ The “completed phaseout amount” for the EITC is the amount of adjusted gross income (or, if greater, earned income) at or above which no credit is allowed.¹⁵² In 2015, the completed phaseout amount was \$39,131 for a head of household with one qualifying child, and only \$14,820 for a taxpayer filing as an individual with no qualifying children.¹⁵³ For working-poor individuals and families, the impact of attorney’s fees on adjusted gross income could deprive them of valuable tax credits, delivering a devastating blow to those most in need of the extra income.¹⁵⁴

3. Justifications for Limitations on Deductions Do Not Apply to FDCPA Attorney’s Fees

There are important tax policy considerations supporting the distinction between above-the-line and below-the-line deductions and the various limitations on below-the-line deductions. However, these general considerations do not justify the inclusion of FDCPA attorney’s fees in a taxpayer’s income. There are several reasons why below-the-line deductions might be treated differently than above-the-line deductions, including skepticism about whether below-the-line deductions are real, an interest in ensuring that people with the ability to pay tax are not able to eliminate their tax liability through deductions, a desire to simplify the tax code for individual taxpayers, and the government’s basic need to raise money. These justifications, though perhaps sensible in other contexts, make far less sense in the context of FDCPA attorney’s fee awards, and are insufficient to justify undermining the goals of the FDCPA.

The first reason why the tax code limits below-the-line deductions is that there is skepticism about whether those deductions are real. It is often hard to distinguish between expenses that ought to be deducted and mere consumption.¹⁵⁵ A tax system that does not carefully regulate its deductions may thus open the door to abuse by allowing people to take deductions beyond those that Congress intended.¹⁵⁶ For example, there is a fine line between business

151. § 32(a)–(b); *See also* Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .06, <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

152. Rev. Rul. 2014-61, 2014-43 I.R.B. 746, <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

153. *Id.*

154. The Earned Income Tax Credit, Child Tax Credit, and other credits are important resources for working-poor individuals and families and are widely heralded as mechanisms for reducing poverty, promoting work, and generally increasing the well-being of low-income families. *See generally* CHUCK MARR, CHYE-CHING HUANG, ARLOC SHERMAN & BRANDON DEBOT, CTR. FOR BUDGET & POLICY PRIORITIES, EITC AND CHILD TAX CREDIT PROMOTE WORK, REDUCE POVERTY, AND SUPPORT CHILDREN’S DEVELOPMENT, RESEARCH FINDS (Updated Oct. 1, 2015), <http://www.cbpp.org/sites/default/files/atoms/files/6-26-12tax.pdf> (describing the benefits of the Earned Income Tax Credit and Child Tax Credit).

155. *See* GRAETZ & SCHENK, *supra* note 118, at 258 (citing Boris Bittker, *Income Tax Deductions, Credits and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 203–04 (1973)).

156. *See id.*

expenses that provide incidental personal benefits—such as a business trip in an exotic location—and personal expenditures that incidentally serve business purposes—such as a weekend golf outing with a friend who also happens to be a colleague.¹⁵⁷ Consequently, the tax system is wary of making it too easy for taxpayers to deduct business expenses.¹⁵⁸ For many types of business expenses, there is reason to wonder whether an expense was truly incurred “for the production or collection of income,”¹⁵⁹ or if it was merely a form of consumption that is tangentially related to some income-generating activity. That suspicion, however, is not merited in the context of FDCPA attorney’s fee awards, which are not awarded unless the plaintiff has successfully litigated an FDCPA action,¹⁶⁰ and thereby engaged in the “production or collection of income” in the form of statutory and/or actual damages under the FDCPA. Given that FDCPA lawsuits serve a private attorney general function¹⁶¹ and benefit not just the taxpayer but society as a whole, the taxpayer’s decision to deduct FDCPA attorney’s fees from her income should not be viewed with suspicion.

The second reason why the tax code limits below-the-line deductions is the desire to ensure that taxpayers with the ability to pay are not able to eliminate their tax liability through deductions.¹⁶² Congress is concerned that, if high-income individuals and large profitable corporations wind up paying no income tax due to their deductions, the public may regard the income tax as unfair.¹⁶³ For example, the legislative history of § 68 states that its purpose is to “personaliz[e] the Federal income tax based on each individual’s ability to pay taxes.”¹⁶⁴ Similarly, the Alternative Minimum Tax was enacted in part because

157. *Id.*

158. See GRAETZ & SCHENK, *supra* note 118, at 258–61. For this reason, employer-reimbursed business expenses (which are arguably more verifiably business-related) are deducted above-the-line, whereas unreimbursed business expenses are generally deducted below-the-line and are subject to a variety of limitations. See *id.* at 255.

159. I.R.C. § 212.

160. 15 U.S.C. § 1692k(a)(3) (“[I]n the case of any successful action to enforce the [FDCPA], [the plaintiff is awarded] the costs of the action, together with a reasonable attorney’s fee as determined by the court”).

161. See *infra* Part IV(B) (describing the “private attorney general” function of individual FDCPA lawsuits).

162. See James R. Hines Jr & Kyle D. Logue, *Understanding the AMT, and Its Unadopted Sibling, the AMxT*, 6 J. LEGAL ANALYSIS 367, 369 (2014) (noting that “[t]he AMT makes it possible for Congress to adopt a regular income tax that has two attributes that have long been fundamental aspects of the U.S. tax system: progressive tax burdens and preferential tax treatment of certain activities.”); STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2005 BUDGET PROPOSAL 8 (COMM. PRINT 2004) (“One of the basic tenets of tax policy is that an accurate measurement of ability to pay taxes is essential to tax fairness.”).

163. GRAETZ & SCHENK, *supra* note 118, at 776.

164. MARTIN J. MCMAHON & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 21.03 (2d ed. 2014) (citing Explanatory Material Concerning Committee on Finance 1990 Reconciliation Statement, 136 Cong. Rec. S15,632, S15,711 (Oct. 18, 1990)). Arguably, this goal could be better accomplished by simply adjusting marginal tax rates. *Id.*

of the popular belief that taxpayers who have relatively high economic income should pay taxes because they have a substantial ability to pay, regardless of which deductions they might be able to take.¹⁶⁵ While the desire to ensure that taxpayers with the ability to pay do not escape tax liability is a legitimate one, it does not apply in the context of FDCPA attorney's fees. When a plaintiff receives an FDCPA award, her income is artificially inflated by the attorney's fee award, which is remitted directly from the defendant to the plaintiff's attorney and does not in any way enhance her ability to afford taxes. FDCPA plaintiffs tend to be low- and moderate-income individuals (even though they might have unusually high income in the single year in which they win their FDCPA lawsuits), and are not the well-off taxpayers that Congress intended to target with restrictions such as § 68 and the AMT.¹⁶⁶ Moreover, the FDCPA provides for attorney's fees so that individual taxpayers are incentivized to bring these lawsuits as "private attorneys general," often resulting in only a small amount of damages (which are themselves taxed) for the litigant herself, while greatly benefiting society.¹⁶⁷ Therefore, limiting taxpayers' ability to deduct FDCPA attorney's fees does not meaningfully promote the goal of ensuring that taxes are paid by those with the ability to pay, and may actually impose severe tax burdens on low- and moderate-income consumers who *cannot* afford to pay a large amount of taxes.

The third justification for distinguishing between above-the-line and below-the-line deductions is simplification: a large number of taxpayers can greatly simplify the process of paying taxes by taking the standard deduction rather than keeping track of each of their individual itemized deductions.¹⁶⁸ However, this benefit likewise does not apply to FDCPA plaintiffs because FDCPA awards are one-time costs for taxpayers—not repeated year after year—and the need to calculate a precise deduction in the single year in which the taxpayer wins an FDCPA award would not impose an insensible burden on the taxpayer. Meanwhile, the tradeoff between the standard deduction and itemized deductions causes a taxpayer to lose all or part of a deduction regardless of whether they choose to itemize.¹⁶⁹

165. GRAETZ & SCHENK, *supra* note 118, at 776.; MCMAHON & ZELENAK ¶ 45.01 (3d. ed. 2016).

166. Abusive debt collection practices are highly concentrated in low- and moderate-income communities and communities of color, having deleterious effects on entire communities. WILNER & SHEFTEL-GOMES, *supra* note 81, at 10, http://www.neweconomynyc.org/wp-content/uploads/2014/08/DEBT_DECEPTION_FINAL_WEB-new-logo.pdf. According to a 2010 study, 91% of people sued by debt buyers and 95% of people with default judgments entered against them lived in low- or moderate-income communities. *Id.*

167. See *infra* Part IV(B) (describing the "private attorney general" function of the FDCPA).

168. See Allan J. Samansky, *Nonstandard Thoughts about the Standard Deduction*, 1991 UTAH L. REV. 531, 533 (1991) (noting that, when Congress enacted the standard deduction, "[p]robably its only purpose was simplification").

169. See *supra* Part III(B)(2) (describing the tax consequences of a taxpayer's choice between itemizing deductions and taking the standard deduction). Cf. Samansky, *supra* note 168, at 555 (noting that the standard deduction "increases the extent to which arbitrary factors

Finally, an obvious purpose for any kind of increase in taxation is the basic need to obtain money from the tax system to fund the workings of the government. Taxing FDCPA attorney's fees, like any other tax, certainly contributes to the revenue raised by the United States government. However, an FDCPA attorney's fee award is hardly an appropriate place to obtain revenue, and there are arguably far more valuable loopholes that Congress could close in order to raise additional taxes.¹⁷⁰ Additionally, FDCPA attorney's fees are already taxed when they are received by the attorney. By making the taxpayer liable for FDCPA attorney's fees, it may deter taxpayers from bringing FDCPA lawsuits (and thus incurring additional attorney's fees), and thereby might actually decrease the revenue that ultimately goes to Congress. Regardless, the mild revenue benefits that are gained by including FDCPA awards in the plaintiff's income are insufficient to outweigh the fact that doing so undermines the goals of the FDCPA.

C. Two Examples

To illustrate the practical consequences of including FDCPA attorney's fees in income, I will examine the tax burden of two hypothetical¹⁷¹ plaintiffs based on cases discussed earlier in this article. The first example is based on the plaintiff in *McCullough v. Johnson*, who had relatively high damages and attorney's fees.¹⁷² The second example is based on the plaintiff in *Tolentino v. Friedman*, who had more modest attorney's fees but received only \$1000 in statutory damages.¹⁷³ I chose these plaintiffs because their FDCPA awards were substantially different in size, which, in turn, causes them to be affected differently by the tax system. What they have in common, however, is that each of these plaintiffs is negatively impacted by the fact that her FDCPA attorney's

determine federal income tax liability and generally deprives low and middle income persons of any benefits from itemized deductions").

170. See, e.g., Victor Fleischer, *8 Tax Loopholes that the Obama Administration Could Close*, N.Y. TIMES, Feb. 18, 2015, <http://dealbook.nytimes.com/2015/02/18/8-tax-loopholes-the-obama-administration-could-close/> (describing loopholes such as the carried interest loophole, earnings stripping, and an unduly expansive definition of real estate); Ben Steverman, *The Six Weirdest Tax Loopholes*, BLOOMBERG BUSINESSWEEK (Feb. 12, 2015), <http://www.bloomberg.com/news/articles/2015-02-12/the-six-weirdest-tax-loopholes> (describing, for example, the grantor retained annuity trust, which allows individuals to place assets into a trust in exchange for an annuity payment, and any growth in the assets above the payment goes to their heirs tax-free).

171. I use hypothetical plaintiffs rather than actual individuals because individual tax liabilities vary widely based on factors such as wages, marital status, and number of dependents, which are not publicly reported in conjunction with FDCPA awards. In crafting the wages of my hypothetical plaintiffs, I chose the round, easily-calculable figure of \$50,000 that closely approximates the United States' median household income of \$53,657 in 2014. CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, U.S. CENSUS BUREAU, INCOME & POVERTY IN THE UNITED STATES: 2014 (Sept. 2015), <http://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-252.pdf>.

172. See *supra* notes 75–81 and accompanying text.

173. See *supra* notes 53–56 and accompanying text.

fees are included in her income. Moreover, for each of these plaintiffs, deducting the attorney's fees below-the-line has limited utility.

I. McCollough v. Johnson: High Damages, High Attorney's Fees

In *McCollough v. Johnson*, the plaintiff was awarded \$301,000 in damages and \$107,770.17 in attorney's fees and costs.¹⁷⁴ Based on this example, imagine a hypothetical plaintiff, *M*, who ordinarily earns \$50,000 per year in wages, and has no other income or deductions, so she typically takes the standard deduction on her income tax returns.¹⁷⁵ *M* is single and has no dependents, so her standard deduction would have been \$6,300 in 2015.¹⁷⁶ After suffering egregious harms due to harassment by a debt collector, *M* sues the debt collector under the FDCPA and wins \$300,000 in damages and \$100,000 in attorney's fees. Assume, for the purposes of this example, that all \$300,000 of *M*'s damages constitute income, and are not excluded under I.R.C. § 104(a)(2) (damages caused by personal physical injury or physical sickness) or any other provision of the Code. Under current interpretations of *Commissioner v. Banks*, *M*'s entire \$100,000 in attorney's fees would also be considered part of her adjusted gross income. *M*'s total adjusted gross income is \$450,000: \$50,000 in wages, plus \$300,000 in damages, plus \$100,000 in attorney's fees.

174. Order re: Judgment at 19, *McCollough*, 645 F. Supp. 2d 917 (No. 1:07-cv-00166).

175. See Polsky, *supra* note 113, at 63–64 (describing a similar hypothetical in the context of an employment discrimination lawsuit).

176. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .14 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

Taxpayer M Wage Income: \$50,000 FDCPA Damages Award: \$300,000 Attorney's Fee Award: \$100,000	
Attorney's Fees Included in Income	Attorney's Fees Not Included in Income
↓	↓
Adjusted Gross Income \$450,000	Adjusted Gross Income \$350,000
↓	↓
Below-the-Line Deduction \$85,247.50 (attorneys' fee award reduced by § 67 and § 68)	Below-the-Line Deduction \$6,300 (standard deduction in 2014)
↓	↓
Taxable Income \$364,752.50 (\$450,000 - \$85,247.50)	Taxable Income \$343,700
↓	↓
Non-AMT Tax Liability \$103,974.41	Non-AMT Tax Liability \$96,676.13
↓	↓
Subject to Alternative Minimum Tax? YES. Tax liability increases to \$122,936.	Subject to Alternative Minimum Tax? NO. Tax liability stays at \$96,676.13.
↓	↓
Total Tax Burden \$122,936	Total Tax Burden \$96,676.13

Under the regular tax system (as opposed to the Alternative Minimum Tax), *M* would be able to take the \$100,000 in attorney's fees as a miscellaneous itemized deduction, since it is an expense incurred "for the production or collection of income."¹⁷⁷ By itemizing deductions in order to deduct her \$100,000 attorney's fee award, *M* gives up her standard deduction of \$6300.¹⁷⁸

177. I.R.C. § 212(1).

178. See I.R.C. § 63(b) (providing that taxpayers may elect either to take the standard deduction or to take itemized deductions); *M* loses out on the \$6300 because she has no other deductions she would normally itemize, so the standard deduction is like a "bonus" that is now inapplicable. In actuality, any taxpayer who chose to itemize would be able to deduct at least a small amount in either sales taxes or state and local income taxes paid during the tax year. INTERNAL REVENUE SERVICE, TAX GUIDE 2015 FOR INDIVIDUALS 148 (2015), https://www.irs.gov/publications/p17/ch22.html#en_US_2015_publink1000173147. For *M* and *T* (the second hypothetical plaintiff example, discussed *infra* at Part III(C)(2)) however, the amount of sales taxes or state and local income taxes is still significantly lower than the standard deduction, because they would be calculated for a person who typically earns \$50,000 in wages. This caveat has been left out of the hypotheticals for the sake of simplicity.

Moreover, *M*'s initial below-the-line deduction of \$100,000 is reduced by § 67 and § 68 of the tax code.

M's deductions are reduced by § 67 of the tax code, the two percent floor on deductions. Because the \$100,000 fee is a miscellaneous itemized deduction,¹⁷⁹ it may be deducted only to the extent that it exceeds two percent of *M*'s adjusted gross income.¹⁸⁰ This reduces *M*'s deduction by \$9000 (two percent of \$450,000). *M* can deduct only \$91,000 after applying § 67.

M is also limited by § 68(a),¹⁸¹ which requires taxpayers to “phase out”¹⁸² their itemized deductions if their adjusted gross income reaches a statutorily-defined applicable amount.¹⁸³ In 2015, the applicable amount for single taxpayers was \$258,250.¹⁸⁴ Since *M*'s adjusted gross income is \$450,000, she is required to phase out her deductions in accordance with § 68. Pursuant to § 68, *M* must reduce her deductions by the lesser of: (a) three percent of the excess of *M*'s adjusted gross income over the applicable amount, which amounts to \$5752.50,¹⁸⁵ or (b) eighty percent of the amount of itemized deductions that she would otherwise be able to take, which amounts to \$72,800.¹⁸⁶ *M* must subtract the lesser of the two, \$5752.50, from her deduction, and may therefore deduct a total of \$85,247.50 below-the-line. After the deduction, *M*'s taxable income is \$364,752.50.¹⁸⁷

M's taxes are calculated based on her taxable income of \$364,752.50. Based on the Tax Code and 2015 regulations, *M*'s tax rate under the regular tax system is equal to \$46,075.25 plus 33% of her excess taxable income over \$189,300.¹⁸⁸

179. See I.R.C. § 67(b) (defining miscellaneous itemized deductions); § 212(1) (allowing a deduction for expenses incurred in the production of income).

180. I.R.C. § 67(a).

181. I.R.C. § 68(a).

182. Charles S. Hartman, *Missed it by that Much: Phase-Out Provisions in the Internal Revenue Code*, 22 DAYTON L. REV. 187, 188 (1996) (“Section 68 [of the I.R.C.] functions as a phase-out of itemized deductions, but does not contain the term ‘phaseout.’”; as a general matter, “a phase-out is a provision in the Internal Revenue Code requiring a particular attribute of the taxpayer’s return to be reduced because of the size of some other number.”)

183. See Polsky, *supra* note 113, at 64–65 (discussing an example of a taxpayer whose attorney’s fee deductions were restricted by § 68).

184. INTERNAL REVENUE SERVICE, REVENUE PROCEDURE 2014-61 13–14 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

185. I.R.C. § 68(a)(1). The “excess” of adjusted gross income over the applicable amount is equal to *M*'s adjusted gross income (\$450,000) minus the applicable amount (\$258,250), for an excess of \$191,750. Three percent of that excess is equal to \$5752.50.

186. § 68(a)(2). *M* would ordinarily be entitled to a deduction of \$91,000, eighty percent of which is \$72,800.

187. If her attorney’s fees were *not* included in *M*'s income, her taxable income would have been \$343,700 (\$350,000 minus the \$6300 standard deduction). Hence, under the regular tax system, she is being taxed on an additional \$15,300 of income despite the itemized deduction.

188. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .15 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>. See also I.R.C. § 1(c). In 2015, single taxpayers with a total taxable income over \$189,300 but not over \$411,500 were subject to a tax rate of \$46,075.25 plus 33% of the excess over \$189,300. *Id.*

This amounts to \$46,075.25 plus \$57,899.16. Thus, *M*'s total tax liability¹⁸⁹ under the regular tax system is \$103,974.41.

The analysis does not end there, however. We must consider whether *M* is subject to the alternative minimum tax (AMT).¹⁹⁰ Taxpayers are subject to the AMT if their alternative minimum tax amount—as specified in section 55 of the tax code—is greater than their tax liability under the regular tax system.¹⁹¹ In the computation of alternative minimum taxable income, *M* may not deduct attorney's fees, but she can instead take a standard exemption amount, which is up to \$53,600 for 2015 taxpayers but is reduced for taxpayers with high alternative minimum taxable income.¹⁹² *M*'s "alternative minimum taxable income" is equal to her taxable income with certain deductions—including the deduction for attorney's fees—added back in.¹⁹³ Thus, *M*'s "alternative minimum taxable income" is \$450,000. Unfortunately, *M*'s alternative minimum taxable income is high enough that she entirely loses her exemption amount.¹⁹⁴ *M*'s "taxable excess" (her alternative minimum taxable income minus the \$0 exemption amount) is \$450,000.¹⁹⁵ *M*'s tentative minimum tax, which is calculated based on the taxable excess, amounts to \$122,292.¹⁹⁶ Unfortunately for *M*, her tentative minimum tax (\$122,292) exceeds her regular tax liability (\$103,974.41), so she is required to pay the AMT of \$122,292 instead of her regular tax of \$103,974.41.¹⁹⁷ *M* therefore experiences a tax liability of \$122,936.

189. The term "tax liability" means the amount of tax that a taxpayer has to pay. BLACK'S LAW DICTIONARY 1690 (10th ed. 2014) (defining "tax liability" as "[t]he amount that a taxpayer legally owes after calculating the applicable tax; the amount of unpaid taxes.>").

190. See I.R.C. § 55 (imposing the alternative minimum tax).

191. I.R.C. § 55(a).

192. I.R.C. § 55(d); Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .11 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

193. I.R.C. §§ 55(b)(2)(A), 56(b)(1), 67(b). Attorney's fees are deducted as an expense incurred "for the production or collection of income," § 212(1), and are thus included as a "miscellaneous itemized deduction" under § 67(b). Miscellaneous itemized deductions are added back in during the calculation of alternative minimum taxable income. § 56(b)(1).

194. Under § 55(d)(3), "[t]he exemption amount of any taxpayer shall be reduced (but not below zero) by an amount equal to 25 percent of the amount by which the alternative minimum taxable income of the taxpayer exceeds" \$119,200 in 2015. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ 12 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>. Thus, *M*'s exemption amount is to be reduced by \$82,700, which is greater than the maximum exemption amount of \$53,600. Therefore, *M*'s exemption amount is \$0.

195. See I.R.C. § 55(b)(1)(A)(ii).

196. Under § 55(b), the tentative minimum tax is "26 percent of so much of the taxable excess as does not exceed \$175,000," plus "28 percent of so much of the taxable excess as exceeds \$175,000," adjusted for inflation. In 2015, the inflation-adjusted excess taxable income amount, above which the 28 percent tax rate applies, is \$185,400. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ 12 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>. Twenty-six percent of \$185,400 is \$48,204. *M*'s taxable excess exceeds \$185,400 by \$264,600, and twenty-eight percent of \$264,600 is \$74,088. *M*'s tentative minimum tax is equal to the sum of \$48,204 and \$74,088, which is \$122,292.

197. I.R.C. § 55(a).

If *M*'s attorney's fees had not been included in her adjusted gross income, she would have paid significantly less in taxes. Without attorney's fees, *M*'s adjusted gross income would have been \$350,000 and her tax liability under the regular tax system would have been \$96,676.13.¹⁹⁸ Under the alternative minimum tax, if *M*'s attorney's fees had not been included in her adjusted gross income, *M*'s tentative minimum tax would have been \$94,292.¹⁹⁹ So *M* would not have been subject to the alternative minimum tax if her attorney's fees had not been included in her income, and her tax liability would have been \$96,676.13. Thus, if *M*'s attorney's fee award had not been included in her adjusted gross income, her tax liability would have been much lower—\$96,676.13 as compared to \$122,292. *M* faces an extra \$25,615.87 in tax liability as a result of the inclusion of attorney's fees in her income.

2. Tolentino v. Friedman: Statutory Damages, Moderate Attorney's Fees

In *Tolentino v. Friedman*, the plaintiff in an FDCPA case won \$1000 in statutory damages and approximately \$16,789 in attorney's fees and costs.²⁰⁰ Based on this example, consider a hypothetical plaintiff, *T*, who brings an

198. If *M*'s attorney's fees had not been included in her adjusted gross income, she would not need to take any itemized deductions, so she would be able to take the standard deduction of \$6300. See I.R.C. § 63(b) (providing that taxpayers may elect either to take the standard deduction or to take itemized deductions). She also takes a partial personal exemption of \$1064, which, like the standard deduction, is subtracted from adjusted gross income. See I.R.C. § 151 (allowing for personal exemption of the exemption amount to be deducted for the taxpayer); INTERNAL REVENUE SERVICE, PERSONAL EXEMPTIONS AND DEPENDENTS (2015) [hereinafter "PERSONAL EXEMPTIONS"], https://www.irs.gov/publications/p17/ch03.html#en_US_2015_publink1000309843. Unlike the standard deduction, the personal exemption is deducted from income even if the taxpayer itemizes her deductions. *Id.* The personal exemption is \$4000 in 2015 but is phased out for single taxpayers whose adjusted gross incomes are above a certain amount, which is \$258,250 for single taxpayers in 2015. *Id.* Single taxpayers must reduce the amount of their personal exemption by 2% for every \$2500 of adjusted gross income above \$258,250. Thus, *M*'s personal exemption is \$1064 if attorney's fees are not included in her income (when attorney's fees are included in *M*'s income, her adjusted gross income is so high that she loses the personal exemption altogether). Taking both the standard deduction and the personal exemption into account, *M*'s taxable income would have been \$342,636. Under the regular tax system, her income tax would have been \$46,075.25 plus 33 percent of (\$342,636 – \$189,300). INTERNAL REVENUE SERVICE, REVENUE PROCEDURE 2014-61 ¶ .15 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>. See also I.R.C. § 1(c). Thus, her income tax is equal to the sum of \$46,075.25 and \$50,600.88, amounting to \$96,676.13.

199. *M*'s tentative minimum tax is equal to twenty-six percent of \$185,400 plus twenty-eight percent of so much of the taxable excess (\$350,000) as exceeds \$185,400. See INTERNAL REVENUE SERVICE, REVENUE PROCEDURE 2014-61, 11 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>. Thus, *M*'s tentative minimum tax is equal to \$48,204 plus \$46,088, which amounts to \$94,292.

200. See *Tolentino v. Friedman*, 46 F.3d 645, 652-53 (7th Cir. 1995) (holding that market rate should be used in the calculation of attorney's fees in an FDCPA case where the plaintiff only wins \$1000 in statutory damages); *Tolentino v. Friedman*, No. 93 C 878, 1994 WL 125005, at *1 (N.D. Ill. Apr. 11, 1994), *rev'd* 46 F.3d 645 (7th Cir. 1995) (plaintiff requests \$16,235 in attorney's fees and \$553.43 in costs). The Seventh Circuit remanded to the district court to determine the exact amount of attorney's fees, but the attorney's fee award probably amounted to something close to the attorney's market-rate based estimate of \$16,235 in attorney's fees and \$553.43 in costs.

FDCPA case and wins \$1000 in statutory damages and \$17,000 in attorney's fees. Like *M*, *T* is single, earns \$50,000 per year in wages, and has no other income or deductions, so she ordinarily takes the standard deduction (\$6300 in 2015).²⁰¹ With the statutory damages and attorney's fees included in her income, *T*'s total adjusted gross income is \$68,000.

Because *T*'s income is fairly low, she does not have to worry about being subject to the alternative minimum tax.²⁰² However, under the regular tax system, she suffers a significant additional tax burden as a result of her attorney's fee award. Like *M*, *T* can take her \$17,000 in attorney's fees as a miscellaneous itemized deduction, since it is an expense incurred for the production of income.²⁰³ By doing so, she gives up her standard deduction of \$6300.²⁰⁴ Because the \$17,000 attorney's fee is a miscellaneous itemized deduction,²⁰⁵ it may be deducted only to the extent that it exceeds two percent of *T*'s adjusted gross income.²⁰⁶ This reduces *T*'s deduction by \$1360 (two percent of \$68,000), so she can deduct \$15,640.²⁰⁷ After the deduction, *T* has a taxable income of \$52,360.²⁰⁸ *T* may also take a personal exemption of \$4000, for a taxable income of \$48,360.²⁰⁹ *T*'s tax rate is \$5156.25 plus 25% of her excess taxable income over \$37,450;²¹⁰ this amounts to \$5156.25 plus \$2727.50. Thus, *T*'s total tax liability under the regular tax system is \$7883.75.

201. See Polsky, *supra* note 113, at 63–64; Rev. Rul. 2014-61, 2014-43 I.R.B. 746, ¶ 13 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

202. *T*'s "taxable excess" would be just \$14,400, so her tentative minimum tax would be \$3744. I.R.C. § 55(a), (b)(1)(A)(ii), (d).

203. I.R.C. § 212(1).

204. See I.R.C. § 63(b) (providing that taxpayers may elect either to take the standard deduction or to take itemized deductions).

205. See I.R.C. § 67(b) (defining miscellaneous itemized deductions); § 212(1) (allowing a deduction for expenses incurred in the production of income).

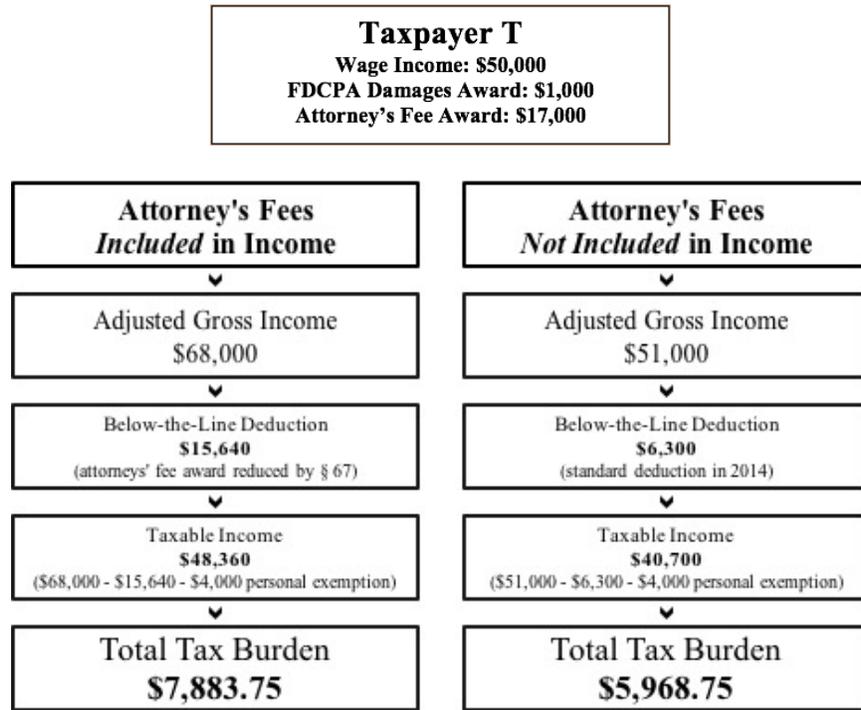
206. I.R.C. § 67(a).

207. *T* is not subject to § 68 because her adjusted gross income does not exceed the "applicable amount" of \$258,250. See Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ 13 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>.

208. If her attorney's fees were *not* included in *T*'s income, her taxable income would have been \$44,700 (\$51,000 minus the \$6300 standard deduction). Hence, under the regular tax system, she is being taxed on an additional \$7660 of income despite the itemized deduction.

209. I.R.C. § 151; PERSONAL EXEMPTIONS, *supra* note 198.

210. Rev. Rul. 2014-61, 2014-43 I.R.B. 746 ¶ .01 (2014), <http://www.irs.gov/pub/irs-drop/rp-14-61.pdf>. See also I.R.C. § 1(c). *T*'s tax rate is such because she is a single taxpayer with a total taxable income over \$37,450 but not over \$90,750. *Id.*



If *T*'s attorney's fees had not been included in her adjusted gross income, she would not have needed to take any itemized deductions, so she would have been able to take the standard deduction of \$6300. After the standard deduction and a personal exemption, *T*'s taxable income would have been \$40,700.²¹¹ Ultimately, *T*'s tax liability would have been \$5968.75.²¹² Therefore, *T* faces an additional \$1915 in taxes as a result of the inclusion of attorney's fees in her income, because she is required to pay \$7883.75 instead of \$5968.75. This is an *extremely* problematic result. When *T* won her FDCPA case, she brought home \$1000 in statutory damages, but she suffers an additional tax liability of \$1915 due to the taxation of her attorney's fee award. Therefore, *T* actually *loses* \$915 as a result of bringing her FDCPA lawsuit.²¹³

T, a moderate-income consumer who was pursued by an abusive debt collector, was wronged twice: first by the debt collector, and then by the tax collector. This is costly for *T*, but perhaps even more problematic for the general

211. Based on an adjusted gross income of \$51,000 (\$50,000 in wages plus \$1000 in statutory damages from her FDCPA victory) minus the standard deduction of \$6300.

212. \$5156.25 plus 25 percent of (\$40,700 - \$37,450).

213. In one of the leading pre-*Banks* decisions on the taxation of attorney's fees awarded pursuant to a fee-shifting statute, the court contemplated the possibility that the tax liability for an attorney's fee award would exceed the value of the plaintiff's damages. *Sinyard v. Commissioner*, 268 F.3d 756, 760 (9th Cir. 2001) ("It is possible that where monetary recovery is little or nonexistent . . . , the attorneys' fee award would leave the taxpayer owing more tax than anything he received in his . . . suit."), *aff'g*, 76 T.C.M. (CCH) 654 (1998).

public: the tax consequences of attorney's fee awards severely limits "private attorney general" enforcement of the FDCPA.²¹⁴ Consumers (as advised by their attorneys²¹⁵) may be deterred from bringing FDCPA cases if there is a substantial likelihood that they will only win statutory damages, because in such cases, their tax burden arising from attorney's fees is likely to exceed their damages award.²¹⁶ This is a significant problem because some FDCPA actions are brought for statutory damages only, in order to hold debt collectors accountable for FDCPA violations which are deleterious to the public even if they haven't caused quantifiable harm to an individual plaintiff.²¹⁷ Even plaintiffs with the potential to win actual damages may be deterred from bringing FDCPA cases based on the fear that, in the uncertainty of litigation, the court will only award statutory damages.²¹⁸ Thus, the "private attorney general" function of the FDCPA—a powerful tool for deterring abusive debt collection practices—is severely impaired by the tax code.²¹⁹

IV.

TAXING ATTORNEY'S FEES UNDERMINES THE GOALS OF THE FDCPA

Including attorney's fees in the plaintiff's income undermines the FDCPA's goals of deterring abusive debt collection practices and providing a means of redress for individuals who were harmed by debt collectors. When the FDCPA was developed by the Senate Committee on Banking, Housing and Urban Affairs, the Committee noted that it "views this legislation as primarily self-enforcing; consumers who have been subjected to collection abuses will be enforcing compliance."²²⁰ The Committee recognized widespread abuses in the debt collection industry and noted that existing state and federal regulation was ineffective.²²¹ Legislators were determined to enact a robust civil enforcement scheme, and followed the example of past consumer protection statutes to determine that "a consumer who obtains judgment on his behalf is entitled to

214. *See infra* Part IV(B).

215. *See infra* Part (V)(C)(5) (explaining that, before taking on an FDCPA case, attorneys should advise prospective clients of the potential tax consequences of bringing an FDCPA lawsuit).

216. *See id.*

217. *Gonzales v. Arrow Fin. Servs.*, 660 F.3d 1055, 1067 (9th Cir. 2011) ("Statutory damages under the FDCPA are intended to 'deter violations by imposing a cost on the defendant even if his misconduct imposed no cost on the plaintiff.'") (quoting *Crabill v. Trans Union, L.L.C.*, 259 F.3d 662, 666 (7th Cir. 2001)). *See also* Matthew R. Bremner, *The Need for Reform in the Age of Financial Chaos*, 76 BROOK. L. REV. 1553, 1597 (2011) (explaining that many FDCPA actions are brought for technical violations that cause consumers no actual harm); Carter, *supra* note 39 (describing FDCPA attorney who, instead of pursuing actual damages, induces debt collectors to settle cases for statutory damages plus attorney's fees).

218. *See infra* Part (V)(C)(5).

219. *See id.*

220. S. REP. NO. 95-382, at 5 (1977).

221. *Id.* at 2–3.

attorney's fees and costs."²²² Since the passage of the FDCPA, courts have recognized the importance of the FDCPA's fee-shifting provision: it encourages litigants to bring FDCPA cases when they may not otherwise be able to afford to do so, and thereby promotes the public interest goal of deterring abusive debt collection practices.²²³

The inclusion of attorney's fees in the plaintiff's income undermines the enforcement of the FDCPA by deterring plaintiffs from bringing valid claims against abusive debt collectors and by undermining the economic recovery of plaintiffs who do bring suits. This part will discuss the dual purposes of the FDCPA's civil enforcement scheme: 1) recovery for individual plaintiffs and 2) the "private attorney general" function. It will then describe how the inclusion of attorney's fees in the plaintiff's taxable income undermines these purposes.

A. Recovery for Individual Litigants

The FDCPA allows individual litigants to recover for emotional distress and other actual damages.²²⁴ Individual recovery is a central element of the FDCPA, due in part to Congress' grave concern about the harms inflicted by abusive debt collectors.²²⁵ The Congressional findings and declaration of purpose of the FDCPA states:

There is abundant evidence of the use of abusive, deceptive, and unfair debt collection practices by many debt collectors. Abusive debt collection practices contribute to the number of personal bankruptcies, to marital instability, to the loss of jobs, and to invasions of individual privacy.²²⁶

To this end, compensation for emotional distress is an important component of actual damages awarded under the FDCPA.²²⁷

222. *Id.* at 5.

223. See, e.g., *Gonzales v. Arrow Financial Services, L.L.C.*, 660 F.3d 1055, 1061 (9th Cir. 2011) ("Though the Federal Trade Commission ("FTC") is empowered to enforce the FDCPA, 15 U.S.C. § 1692l, Congress encouraged private enforcement by permitting aggrieved individuals to bring suit as private attorneys general."); *Tolentino v. Friedman*, 46 F.3d 645, 651 (7th Cir. 1995), *cert. denied*, 515 U.S. 1160 (1995); *Palo*, *supra* note 12, § 3 (2013).

224. See *infra* Part II(B) (discussing actual damages under the FDCPA).

225. See *Roots v. Am. Marine Liquidators, Inc.*, No. 0:12-CV-00602-JFA, 2012 WL 3136462, at *1 n.1 (D.S.C. Aug. 1, 2012) ("The Senate Committee noted that abusive debt collectors cause 'suffering and anguish.' S. Rep. 95-382, at 2 The Committee expressed concern about practices that take a primarily emotional toll, such as using 'obscene or profane language, threats of violence, telephone calls at unreasonable hours, . . . [and] disclosing a consumer's personal affairs to friends, neighbors, or an employer.' *Id.*"); *Crossley v. Lieberman*, 90 B.R. 682, 692 (E.D. Pa. 1988) (citing Congress' concern about emotional harms as a reason to give damages to plaintiffs for the emotional harms they suffered, notwithstanding state tort law rules governing emotional distress).

226. 15 U.S.C. § 1692(a).

227. *Palo*, *supra* note 12, at § 51.

Additionally, the traditional tort liability theory of civil recourse may be applied to the FDCPA. Although the FDCPA grants plaintiffs recovery by statute, and not through common law tort frameworks, an FDCPA violation will often meet the definition of a tort: “a civil wrong, other than breach of contract, for which a remedy can be obtained, [usually] in the form of damages; a breach of a duty that the law imposes on persons who stand in a particular relation to one another.”²²⁸ Indeed, many FDCPA lawsuits are joined with claims under state tort laws arising from the same abusive debt collection activity.²²⁹ Therefore, it is appropriate to apply the tort law theory of civil recourse to the FDCPA.

The civil recourse theory is based on the idea that victims are entitled to recourse for civil wrongs.²³⁰ In the FDCPA context, many debt collectors blatantly engage in abusive practices which wreak havoc on consumers’ lives; FDCPA plaintiffs have been forced to dedicate time, emotional energy, and resources to battling debt collectors who harass them incessantly, bring unfounded lawsuits, and otherwise target consumers abusively.²³¹ Under the civil recourse theory, these plaintiffs deserve to be fully compensated—or “made whole”—for their injuries.²³²

Unfortunately, the current tax law governing FDCPA attorney’s fees prevents injured plaintiffs from being made fully whole. In the examples of *M* and *T* discussed above,²³³ the court awarded each plaintiff a certain amount of damages, but their ultimate monetary gain was reduced by the tax law’s treatment of attorney’s fees.²³⁴ Plaintiff *T* suffered especially harshly—she actually *lost* money as a result of bringing her FDCPA action.²³⁵ This frustrates courts’ efforts to award an appropriate amount of damages to FDCPA plaintiffs in order to fully compensate them for their injuries. The taxation of the FDCPA damages themselves does not controvert the purposes of the FDCPA, since such damages are (at least arguably) income that the plaintiff benefits from economically. But the plaintiff does not take home an attorney’s fee award, and

228. BLACK’S LAW DICTIONARY 1717 (10th ed. 2014).

229. See FAIR DEBT COLLECTION, *supra* note 34, § 2.6.

230. KENNETH S. ABRAHAM, THE FORMS AND FUNCTIONS OF TORT LAW 18 (4th ed. 2012).

231. See generally CFPB 2014 FDCPA REPORT, *supra* note 2; RICK JURGENS & ROBERT J. HOBBS, *supra* note 2; BETTER BUSINESS BUREAU, THEY DEAL IN BILLIONS: A BBB STUDY OF THE DEBT COLLECTION INDUSTRY, ITS SOARING GROWTH AND PROBLEMS FOR CONSUMERS (2011), <http://www.bbb.org/Storage/142/Documents/Bill%20Collector%20Study%20%28FINAL%20WITH%20CHANGES%29%2012%2027%202011.pdf>; CAROLYN CARTER & ROBERT J. HOBBS, NAT’L CONSUMER LAW CTR, NO FRESH START: HOW STATES LET DEBT COLLECTORS PUSH FAMILIES INTO POVERTY (2013), <http://www.nclc.org/images/pdf/pr-reports/report-no-fresh-start-bw.pdf>.

232. See ABRAHAM, *supra* note 230, at 18.

233. See *supra* Part III(C).

234. See *id.*

235. See *supra* Part III(C)(2).

some attorney's fees greatly exceed the value of FDCPA damages.²³⁶ Therefore, any taxation arising from attorney's fees is just an extra reduction in the plaintiff's damages, which prevents her from being made fully whole after suffering injury from a debt collector's abusive conduct.

B. The "Private Attorney General" Function of FDCPA Lawsuits

Beyond the recovery that FDCPA actions bring to individuals who were injured by debt collectors, these lawsuits serve a "private attorney general" function of enforcing the FDCPA and thus deterring illegal debt collection activities. The "private attorney general" doctrine is one that was first used by the Supreme Court in 1943,²³⁷ and has since come to refer to a category of cases brought on behalf of individual clients which also serve a greater public interest.²³⁸ Today, the doctrine is defined by Black's Law Dictionary as, "the equitable principle that allows the recovery of attorney's fees to a party who brings a lawsuit that benefits a significant number of people, requires private enforcement, and is important to society as a whole."²³⁹ Hence, the provision of attorney's fees to the winning plaintiff is a central aspect of any cause of action that has a "private attorney general" function.

Private attorneys general are necessary supplements to government enforcement agencies because government agencies may not have the capacity to take action against all abusive conduct, and may be prone to political pressures that prevent them from pursuing extensive enforcement action.²⁴⁰ Private attorneys general also multiply the penalties that wrongdoers face, which is valuable even when such wrongdoers *are* prosecuted by the government.²⁴¹ The private attorneys general thus counterbalance the under-deterrence that would otherwise result from incomplete enforcement of the law.²⁴²

The term "private attorney general" does not encompass *all* plaintiffs—it is not so broad as "one who brings a lawsuit that may benefit third parties."²⁴³

236. See *supra* notes 53–56 and accompanying text (discussing *Tolentino v. Friedman*, an example of an FDCPA case in which attorney's fees greatly exceeded the damages award). Attorney's fees are especially likely to exceed the value of FDCPA damages when an FDCPA plaintiff wins only the statutory damages award of \$1000 and does not win any actual damages. See *supra* note 39 (discussing the frequency of and reasons for FDCPA awards that are limited to statutory damages).

237. Rubenstein, *supra* note 35, at 2130 (citing *F.C.C. v. Nat'l Broad. Co., Inc.*, 319 U.S. 239, 265 n.1 (1943) (Douglas, J., dissenting)).

238. *Id.* at 2134.

239. BLACK'S LAW DICTIONARY 1389 (10th ed. 2014).

240. Rubenstein, *supra* note 35, at 2150–51.

241. *Id.*

242. See ABRAHAM, *supra* note 230, at 18 (describing the general deterrence function of damages).

243. See Jeremy A. Rabkin, *The Secret Life of the Private Attorney General*, 61 LAW & CONTEMP. PROBS. 179, 179, 195–96 (1998) (treating this definition with skepticism and noting that some categories of cases have a partisan motive rather than a true public service role).

Courts have been reluctant to define the private attorney general so broadly, as doing so would authorize fee shifting in every private lawsuit, eliminating the traditional American rule that parties bear their own costs.²⁴⁴ Various definitions of the private attorney general have been offered,²⁴⁵ but a definition with an especially reputable source comes from the common law of the state courts. In the state court context, a private attorney general is a party who vindicates a right that “(1) benefits a large number of people; (2) requires private enforcement; and (3) is of societal importance.”²⁴⁶ State courts have the discretion to award attorney’s fees to such parties.²⁴⁷ Although state common law has no bearing on federal laws like the FDCPA, it demonstrates the widely accepted use of attorney’s fee awards to support litigation with a “private attorney general” function.

The private attorney general is an indispensable element of the FDCPA’s enforcement scheme. The legislative history of the FDCPA shows that legislators explicitly considered individual litigants to be private attorneys general.²⁴⁸ While introducing the legislation in 1975, Hon. Frank Annunzio, House Representative of Illinois, described the litany of horrible practices by debt collectors and stated: “This act does not set up a new bureaucracy. Nor does it involve a complex licensing procedure. Instead, there are stiff civil penalties to permit consumers to take action against debt collectors who violate the act.”²⁴⁹ To the drafters and initial proponents of the FDCPA, the private attorney general was an effective—if not *the most* effective—vehicle for enforcing debt collectors’ obligations.

To the present day, the private attorney general has continued to be a critical partner to government enforcement agencies in their efforts to enforce the FDCPA. In a 2008 FDCPA action, the Second Circuit reversed a denial of attorney’s fees based on its recognition that “the FDCPA enlists the efforts of

244. Rubenstein, *supra* note 35, at 2147–48.

245. *Id.* See also Martin H. Redish, *Class Actions and the Democratic Difficulty: Rethinking the Intersection of Private Litigation and Public Goals*, 2003 U. CHI. LEGAL F. 71, 91 (2003) (favoring a fairly broad interpretation of the term and stating that individual compensatory lawsuits may “be categorized as private attorney general actions, because they may well have the incidental impact—perhaps even intended by the legislative creation of the private right—of exposing and punishing law violations”); Rabkin, *supra* note 243, at 199–202 (concluding that, for the category of cases that can be said to represent partisan interests, the Supreme Court has been “unwilling either to eliminate the [role of the] private attorney general or to license it openly”).

246. Ann K. Wooster, Annotation, *Private Attorney General Doctrine—State Cases*, 106 A.L.R. 5TH 523 § 2[a] (2003).

247. *Id.* Federal courts are prohibited from awarding attorney’s fees unless they have explicit statutory authorization to do so, but state courts have the discretion to award attorney’s fees under the private attorney general doctrine. *Id.* (citing *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240 (1975)).

248. See 121 Cong. Rec. 32,960 (1975) (statement of Rep. Annunzio) (introducing the then-named Debt Collection Practices Act and stating that the act will be enforced in part by “private Attorney General actions”).

249. *Id.*

sophisticated consumers like Jacobson as ‘private attorneys general’ to aid their less sophisticated counterparts, who are unlikely themselves to bring suit under the Act, but who are assumed by the Act to benefit from the deterrent effect of civil actions brought by others.”²⁵⁰ The Court explained that, “by providing for statutory damages and attorney’s fees for successful plaintiffs, the FDCPA permits and encourages parties who have suffered no loss to bring civil actions for statutory violations.”²⁵¹ The FTC and CFPB certainly contribute to the enforcement of the FDCPA, but they are unable to respond to every FDCPA violation. Private attorneys general counteract the massive under-deterrence that would occur if government agencies were solely responsible for enforcing the FDCPA. The FDCPA mandates an award of attorney’s fees “as a means of fulfilling Congress’s intent that the Act should be enforced by debtors acting as private attorneys general.”²⁵² Thus, the provision of attorney’s fees to individual litigants and the encouragement of individual FDCPA actions are both critical to the public interest. By including FDCPA attorney’s fee awards in the plaintiff’s income, potential plaintiffs and their lawyers are deterred from bringing FDCPA cases, thereby undermining the private attorney general function of the FDCPA.

V.

PROTECTING CONSUMERS FROM UNJUSTIFIED TAXATION OF ATTORNEY’S FEE AWARDS

For the foregoing reasons, the inclusion of attorney’s fees in FDCPA plaintiffs’ income undermines the goals of the FDCPA and has unintended negative consequences for individual plaintiffs and the public. This Part will discuss various ways in which advocates can pursue tax reform, so that attorney’s fees in FDCPA cases—and in other fee-shifting cases²⁵³—are not included in the plaintiff’s income. First, advocates may engage in litigation to persuade courts to decline to extend *Banks* to cases in which contingency fees are awarded under fee-shifting statutes. Second, advocates may lobby Congress or regulators to change tax policy. Finally, consumer lawyers may engage in

250. *Jacobson v. Healthcare Fin. Servs., Inc.*, 516 F.3d 85, 90–91 (2d Cir. 2008).

251. *Id.* at 96.

252. *Graziano v. Harrison*, 950 F.2d 107, 113 (3d Cir. 1991) (citing *de Jesus v. Banco Popular de Puerto Rico*, 918 F.2d 232, 235 (1st Cir. 1990). The *Graziano* court goes on to note that “several courts have required an award of attorney’s fees even where violations were so minimal that statutory damages were not warranted.” *Id.* (citing *Pipiles v. Credit Bureau of Lockport*, 886 F.2d 22, 28 (2d Cir. 1989); *Emanuel v. American Credit Exchange*, 870 F.2d 805, 808–809 (2d Cir. 1989); *cf. de Jesus*, 918 F.2d at 233–34). Hence, the attorney’s fee provision is not solely about securing individual recovery, but rather about promoting the public interest in FDCPA enforcement.

253. A variety of other consumer protection statutes, including the federal Truth in Lending Act, 15 U.S.C. § 1640(a)(3), and Electronic Fund Transfer Act, 15 U.S.C. § 1693m(a)(3), and state consumer protection laws, also have fee-shifting provisions akin to that of the FDCPA. The same policy arguments justifying the exclusion of FDCPA attorney’s fees as income would also apply to attorney’s fees awarded in other statutes with fee-shifting provisions.

various self-help strategies—such as crafting retainer agreements in certain ways—to minimize or eliminate their clients’ additional tax burden arising from the inclusion of FDCPA attorney’s fees in income. Although these strategies will be discussed individually, there is a good deal of overlap between them. For example, the decision to use a certain design for a retainer agreement is both a self-help strategy and may lead to possible litigation on whether the retainer agreement eliminates the client’s tax burden arising from attorney’s fees. Advocates may also seek a ruling or regulation from the I.R.S. that advises taxpayers about whether a particular kind of retainer agreement permissibly excludes attorney’s fees from the client’s income. Thus these individual avenues for reform should properly be viewed as a multifaceted strategy for both reforming and working within existing tax policy to ensure that FDCPA litigants will not be adversely affected by attorney’s fee awards.

A. Supreme Court Review

One strategy for changing the rule on the taxation of FDCPA attorney’s fees is to engage in litigation to persuade courts to decline to extend *Banks* to cases in which contingency fees are awarded under fee-shifting statutes. There is an argument that attorney’s fees awarded under fee-shifting statutes, like in FDCPA cases, are different than other contingency-based attorney’s fee awards and therefore should not be taxed as income to the winning plaintiff. Attorney’s fees awarded under fee-shifting statutes are awarded to the attorney regardless of any prior fee agreement between the attorney and client, unlike contingency-based awards, and therefore do not absolve the client of any debt to her attorney.²⁵⁴ By this reasoning, the *Banks* decision should not apply to cases involving fee-shifting statutes, especially where a plaintiff has no pre-existing obligation to pay her attorney.

As discussed above, the Supreme Court left open the possibility that fee-shifting statutes may be treated differently than other contingency-based attorney’s fee awards when it declined to address the issue in *Commissioner v. Banks*.²⁵⁵ The *Banks* court hinted that there might be merit to the claim that the anticipatory assignment of income doctrine should not apply in cases arising under statutes with fee-shifting provisions.²⁵⁶ It noted that, in such cases, “the

254. In many contingency arrangements, a client agrees to pay her attorney a certain percentage of her recovery—say, 30 percent. When the client wins her lawsuit, she is taxed on the full value of her winnings even though 30 percent of it goes to her attorney. In FDCPA cases, however, an attorney for a winning plaintiff is entitled to an attorney’s fee award irrespective of whether the attorney and her client had a contingency agreement. Therefore, the client and her attorney could have a retainer agreement that did not require the client to pay her attorney in any circumstances, but the attorney would still be entitled to attorney’s fees under the FDCPA. In such circumstances, a court-ordered attorney’s fee award is not absolving the client of a debt to her attorney, because she did not owe her attorney anything in the first place.

255. See *supra* Part III(A).

256. *Comm’r v. Banks*, 543 U.S. 426, 438 (2005).

plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court-awarded attorney's fees can exceed a plaintiff's monetary recovery."²⁵⁷

Unfortunately, however, subsequent lower-court decisions have held that attorney's fees awarded under fee-shifting statutes *do* constitute income to the plaintiff. Three Tax Court cases—*Vincent v. Commissioner*,²⁵⁸ *Green v. Commissioner*,²⁵⁹ and *Sanford v. Commissioner*²⁶⁰—referenced *Banks* and an earlier Ninth Circuit case, *Sinyard v. Commissioner*,²⁶¹ to find that attorney's fees awarded pursuant to a fee-shifting statute must be included in the plaintiff's income.²⁶² *Sinyard* is distinguishable, however, because the plaintiff had entered into a retainer agreement with his attorney in which he contracted to pay the attorney one-third of what he might receive in a settlement.²⁶³ Therefore, the *Sinyard* court held that the attorney's fee award under the fee-shifting statute constituted income as a discharge of a debt that the plaintiff agreed to when he signed the retainer agreement.²⁶⁴ Subsequent courts have taken *Sinyard* to stand for the general proposition that attorney's fees awarded pursuant to a fee-shifting statute must be included in the plaintiff's income,²⁶⁵ but this is an unduly broad construction of *Sinyard's* holding. Rather, *Sinyard* stands for the proposition that attorney's fees awarded pursuant to a fee-shifting statute must be included in the plaintiff's income *if* (and perhaps *only if*) the court-awarded attorney's fees relieve the plaintiff of a contractual obligation to pay fees to her attorney.²⁶⁶ It is possible to bring an FDCPA action under a retainer agreement that explicitly waives the client's obligation to pay any attorney's fees,²⁶⁷ and under such a

257. *Id.*

258. 89 T.C.M. (CCH) 1119.

259. 93 T.C.M. (CCH) 917, *aff'd in part and rev'd in part*, *Green v. Comm'r*, 312 F. App'x 929, 930–31 (9th Cir. 2009) (“We agree with the tax court that Marcia Green is required to pay income tax on statutory attorneys’ fees awarded under the California Fair Employment and Housing Act.”).

260. 95 T.C.M. (CCH) 1618 .

261. 58 F.3d 756 (9th Cir. 2001).

262. *Sanford*, 95 T.C.M. (CCH) at *4; *Green*, 93 T.C.M. (CCH) at *3–*4; *Vincent*, 89 T.C.M. (CCH) at *5.

263. *Sinyard*, 268 F.3d at 758.

264. *Id.* at 256 (citing *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929) (“The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.”)). *Sinyard* explicitly recognized the potential unfairness caused by the inclusion of attorney's fees in income, 58 F.3d at 762–763, but stated that this was a problem that must be resolved by Congress, not the courts.

265. *See Sanford*, 95 T.C.M. (CCH) 1618.

266. *See Sinyard*, 268 F.3d at 759 (noting that plaintiffs “bound themselves to pay” their attorneys one-third of damages award, so attorney's fee award made them “so much the richer”).

267. *See* I.R.S. Priv. Ltr. Rul. 2015-52-001 (Dec. 24, 2015); I.R.S. Priv. Ltr. Rul. 2010-15-016 (Apr. 16, 2010); *See infra* Part V(B)(2) (discussing a private-letter ruling in which the I.R.S. advised that a retainer agreement expressly waiving a client's obligation to pay any attorney's fees

retainer agreement, the *Sinyard* rule—that court-awarded attorney’s fees constitute a discharge of a debt—would not apply. Thus, advocates could seek a court decision that, when a client has a retainer agreement that does not obligate her to pay attorney’s fees out of pocket, she is not subject to income tax liability for any attorney’s fees awarded under a fee-shifting statute.²⁶⁸

There are other potential arguments for excluding FDCPA attorney’s fees (and potentially far broader categories of attorney’s fees) from income. First, there is the argument, advanced in but disapproved of by *Banks*, that the attorney-client relationship should be taxed as a partnership.²⁶⁹ Another potential argument—advanced in an amicus curiae brief in *Banks*—is that attorney’s fees are not taxable because they are transaction costs.²⁷⁰ Because both of these

exempted the client from tax liability for attorney’s fees that might be awarded pursuant to the fee-shifting provisions of the FDCPA).

268. See *infra* Part V(C)(1) (describing characteristics of a retainer agreement that clarifies that the client has no obligation to pay attorney’s fees).

269. It may be possible to construe attorney-client relationships as partnerships such that attorney’s fees are taxed only to the attorney, and not to the client. See Robert W. Wood, *Attorney-Client Partnerships With a Straight Face*, 129 TAX NOTES 355, 355-59 (2010) [hereinafter Wood, *Attorney-Client Partnerships With a Straight Face*] (arguing that attorneys and clients should structure their relationship as a partnership in order to avoid subjecting the client to tax liability for attorney’s fee awards). Under federal income tax law, partnerships assign their income proportionately among their partners according to their percentage interests in the partnership. GRAETZ & SCHENK, *supra* note 118, at 515. See I.R.C. § 701 (“Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”). The partnership theory was treated skeptically in *Banks*, however. *Comm’r v. Banks*, 543 U.S. 426, 436 (2005) (“We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes. The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship”). Moreover, creating a partnership and filing taxes pursuant to a partnership arrangement is complex, and requires a partnership agreement, special forms, and special bookkeeping mechanisms. See Wood, *Attorney-Client Partnerships With a Straight Face*, *supra*, at 359 (listing the forms and requirements that attorneys and clients would need to attend to in order to pursue a partnership arrangement). Therefore, the partnership theory of attorney’s fees may cause more problems than it would solve, even if a court were to uphold its legality.

270. This theory was presented to the *Banks* court in an amicus brief filed by Professor Charles Davenport, but the court did not address it because it was not raised by the *Banks* taxpayers. Brief for Professor Charles Davenport as Amicus Curiae in Support of Respondents at 3–12, *Banks*, 543 U.S. 426 (Nos. 03-892 and 03-907); *Banks*, 543 U.S. at 427–428 (“We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories.”). Professor Davenport argued that tort claims are property, and the attorney’s fees awarded in the case are transaction costs necessary to the acquisition and/or disposition of such property. Brief for Prof. Davenport, *supra*, at 9 (“The fees were necessary to the acquisition of property, the causes of action, and the lawyers’ services disposed of this property by obtaining payment from the defendants in the civil lawsuits.”). As transaction costs, attorney’s fees would be offset against the proceeds from the lawsuit and thereby excluded from income. Brief for Prof. Davenport, *supra*, at 10; see also *Helvering v. Union Pacific*, 293 U.S. 282, 286–87 (1934) (holding that commissions paid in the sale of bonds has the effect of “reducing the capital realized,” and should therefore be excluded from net income). The *Banks* court showed interest in Prof. Davenport’s theory during oral argument, but the lawyer for the government argued that attorney’s fees do not constitute

arguments were treated skeptically by the *Banks* court,²⁷¹ they may be less likely to gain traction, but advocates should continue to pursue these and other potential arguments that FDCPA attorney's fees should not be included in the client's income.

As a practical matter, seeking reform within the courts may be a risky process. In order to obtain a favorable court ruling, it would be necessary for a client to first incur tax liability for attorney's fees via an FDCPA award (or a suit under a similar fee-shifting statute), and then challenge that liability with the IRS and ultimately the courts. Because *Banks* and recent Tax Court decisions have tended to be unfavorable to plaintiffs who receive attorney's fee awards in cases with fee-shifting provisions, it would probably be necessary to take an unfavorable tax decision all the way up to the Supreme Court. Meanwhile, that client risks losing money if the case is not decided favorably. Indeed, one of the most sympathetic potential clients for a test case is an individual like T,²⁷² who brought an FDCPA case, won \$1000 in statutory damages and \$17,000 in attorney's fees, but ended with a net loss as a result of the tax consequences of her FDCPA lawsuit. But T also stands to suffer the most from an unfavorable ruling on the tax question, since she would actually lose money by bringing her FDCPA case.²⁷³ Therefore, it would be risky for a client to take on this case kind of case, and perhaps even unethical for a lawyer to promote it, because of the strong probability that the client would end up with an unfavorable tax outcome.²⁷⁴

B. Clarity from Congress or Regulators

1. Congressional Tax Reform

The clearest and most permanent way to ensure that clients will not be held liable for income taxes on attorney's fees awarded pursuant to a fee-shifting statute is for Congress to amend the tax code. Congress should amend the tax code to either exclude or deduct above-the-line any attorney's fees awarded under fee-shifting statutes like the FDCPA. This could be done by deducting attorney's fees from income above-the-line under section 62 of the tax code, such that the plaintiffs' tax burden would not be affected by the attorney's fee award.

The amendment to the tax code could be modeled after the American Jobs Creation Act of 2004's (hereinafter "Jobs Act") amendments to the tax code

transaction costs because no asset is disposed of; the legal claim is never actually transferred to the defendant. Transcript of Oral Argument at 12–15, *Banks*, 543 U.S. 426 (No. 03-907).

271. See *supra* note 94.

272. See *supra* Part III(C)(2).

273. See *id.*

274. See Stephen Cohen & Laura Sager, *Why Civil Rights Lawyers Should Study Tax*, 22 HARV. BLACKLETTER L.J. 1, 24 (2006) (explaining that civil rights lawyers should study tax in order to structure their clients' relief so that it does not cause undesirable tax consequences).

creating I.R.C. § 62(a)(20), which provides for an above-the-line deduction for attorney's fees and court costs paid in connection with any action involving a claim of unlawful discrimination,²⁷⁵ and § 62(a)(21), which provides for a similar above-the-line deduction for attorney's fees and court costs paid in the context of whistleblower suits.²⁷⁶ The Jobs Act was enacted on the eve of the *Banks* decision,²⁷⁷ after years of considering versions of a bill to affect the tax treatment of attorney's fees.²⁷⁸ The Jobs Act provides relief for plaintiffs bringing cases under some—but far from all—fee-shifting statutes; combined with the *Banks* decision, it creates a “patchwork” of protection from taxation on attorney's fee awards that exposes many plaintiffs to the risk of paying taxes on their attorney's fee awards.²⁷⁹ In addition to FDCPA plaintiffs, tax liability for attorney's fee awards may arise for plaintiffs bringing suits under non-discrimination fair labor laws such as the Fair Labor Standards Act (FLSA),²⁸⁰ defamation suits, and suits seeking punitive damages.²⁸¹

Based on the example set by the Jobs Act, a new amendment to the tax code, adding an above-the-line deduction for attorney's fees awarded in fee-shifting cases, could read as follows:

§ 62(a)(22) Attorney's fees and court costs awarded under fee-shifting provisions.

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award under a federal, state, or local statute that grants attorney's fees to a winning plaintiff or defendant as part of a fee-shifting arrangement. The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

275. American Jobs Creation Act of 2004, I.R.C. § 62(a)(20) (amending § 62 of the tax code to allow attorney's fees awarded in discrimination lawsuits to be deducted from adjusted gross income).

276. American Jobs Creation Act of 2004, I.R.C. § 62(a)(21) (amending § 62 of the tax code to allow attorney's fees awarded in whistleblower lawsuits to be deducted from adjusted gross income).

277. Robert W. Wood, *The Federal Income Taxation of Contingent Attorneys' Fees: Patchwork by Congress and the Courts Creates Uncertainty*, 67 MONT. L. REV. 1, 1–2 (2006) [hereinafter Wood, *The Federal Income Taxation of Contingent Attorneys' Fees*]; see also Comm'r v. Banks, 543 U.S. 426, 439 (2005) (“[T]he amendment added by the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.”).

278. Wood, *The Federal Income Taxation of Contingent Attorneys' Fees*, *supra* note 277, at 1–2.

279. See generally Wood, *The Federal Income Taxation of Contingent Attorneys' Fees*, *supra* note 277.

280. 29 U.S.C. §§201–219.

281. Wood, *The Federal Income Taxation of Contingent Attorneys' Fees*, *supra* note 277, at 9–13.

Pursuing Congressional action is always a formidable task,²⁸² but the successful amendment to the tax code in the American Jobs Creation Act of 2004 (hereinafter “Jobs Act”) offers hope that the feat could be repeated with respect to fee-shifting statutes. After more than a decade of controversy over the tax treatment of contingent legal fees, Congress enacted the Jobs Act.²⁸³ On the one hand, this might suggest a long, dark future for attempts to secure an amendment to the tax code, since legislators had been considering versions of a bill to affect the tax treatment of attorney’s fees for years, and only finally enacted one shortly before the Supreme Court was set to rule on the issue in *Commissioner v. Banks*.²⁸⁴ More optimistically, however, the Jobs Act proves that such an amendment is possible.²⁸⁵

Moreover, the very existence of the Jobs Act is a powerful argument in favor of an amendment to the tax code to create an exemption for attorney’s fees awarded under *all* fee-shifting provisions. The main arguments in favor of creating a tax exemption for attorney’s fees awarded in discrimination lawsuits can equally be used to argue in favor of creating an exemption for attorney’s fees awarded under fee-shifting statutes like the FDCPA.²⁸⁶ In both cases, the plaintiff is to be encouraged to act as a private attorney general by advancing litigation that deters harmful activity; and in both, low- and moderate-income plaintiffs would tend to be unable to bring such cases without the attorney’s fee awards, but otherwise receive no other monetary gain as a result of these attorney’s fees. Using the Jobs Act as an example, consumer advocates may lobby Congress to amend the tax code in order to end the taxation of attorney’s fees awarded under the FDCPA and other fee-shifting statutes.

282. See generally Jody Freeman & David B. Spence, *Old Statutes, New Problems*, 163 U. PA. L. REV. 1, 8 (2014); Michael J. Teter, *Gridlock, Legislative Supremacy, and the Problem of Arbitrary Inaction*, 88 NOTRE DAME L. REV. 2217 (2013) (explaining the harms caused by Congressional gridlock).

283. American Jobs Creation Act of 2004; I.R.C. § 62(a)(20)-(21); see Wood, *The Federal Income Taxation of Contingent Attorneys’ Fees*, *supra* note 277, at 1–2.

284. Wood, *The Federal Income Taxation of Contingent Attorneys’ Fees*, *supra* note 277, at 1–2. As Wood explains, “[s]uggesting that Congress acted only to save face might be an exaggeration. Nevertheless, it took many years for Congress to provide any relief on the tax treatment of attorneys’ fees. The provision that was finally passed as part of the Jobs Act had been proposed and re-proposed since 1999, when it was first introduced as the Civil Rights Tax Fairness Act of 1999. However, the issue cried out long before that for attention.” *Id.* at 2.

285. In addition to traditional modes of lobbying, advocates might be able to persuade Congress to act with a compelling media campaign that draws attention to this issue. For example, prior to the Jobs Act’s passage, an article about the adverse tax consequences of attorney’s fee awards in discrimination lawsuits was published in *The New York Times*. Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES (Aug. 11, 2002), <http://www.nytimes.com/2002/08/11/us/tax-bill-exceeds-award-to-officer-in-sex-bias-suit.html>. This article alone probably did little to tip the scales in favor of action, but one or more compelling editorials could be part of a broader strategy to raise public—and therefore, Congressional—awareness of the tax consequences of fee-shifting provisions.

286. See generally Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075 (2000) (pre-Jobs Act article arguing for an amendment to the tax code to exclude discrimination-related attorney’s fees from income).

2. Regulations and Rulings from the IRS and Treasury

Since Congressional reform is challenging, consumer lawyers should also lobby the IRS and its parent entity, the Treasury Department, to issue a regulation or ruling clarifying that, under existing tax law, clients can avoid being held liable for income taxes on attorney's fees in certain circumstances. Under I.R.C. § 7805, the Secretary of the Treasury has the authority to "prescribe all needful rules and regulations for the enforcement" of the tax code.²⁸⁷ Treasury Regulations interpret and implement the Tax Code and are afforded deference by the courts.²⁸⁸ The I.R.S. may also issue revenue rulings, which apply the law to a particular factual situation and state the IRS's conclusions on how the tax code applies to that set of facts.²⁸⁹ Revenue Rulings may legally be relied upon by the general public and are also binding in a court of law.²⁹⁰ A second type of ruling called a Private Letter Ruling is non-binding and intended merely to provide information to an individual taxpayer.²⁹¹ Only the taxpayer to whom it was issued may rely on a Private Letter Ruling to avoid tax liability, although letter rulings may be "considered in determining whether a taxpayer's position is supported by substantial authority and, hence, not subject to penalty for a substantial understatement."²⁹² Advocates may seek to persuade the Treasury to issue new tax regulations or rulings that clarify that attorney's fees awarded under fee-shifting provisions of statutes like the FDCPA will not constitute income to the client.

One way to seek favorable guidance from the IRS would be to craft a model retainer agreement that structures the attorney-client relationship in such a way that attorney's fees awarded pursuant to a fee-shifting statute would not

287. I.R.C. §7805(a).

288. Mitchell Rogovin & Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323, 328 (2008) (citing *Boeing Co. v. United States*, 537 U.S. 437, 447–50 (2003); *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 219 (2001); *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 560–61 (1991)). There are two types of regulations: "legislative regulations," in which a section of the Tax Code delegates specific authority to the Secretary of the Treasury to promulgate detailed rules for enforcing that section, and "interpretive regulations," which are not promulgated under any specific Congressional authorization but interpret the Tax Code for the benefit of IRS personnel and the general public. *Id.* at 326–27. Historically, legislative regulations were given greater force of law than interpretive regulations, but in the modern day, the Supreme Court has consistently ruled that courts must defer to both interpretive and legislative Treasury Regulations so long as they are reasonable. *Id.* at 327–28.

289. Rogovin & Korb, *supra* note 288, at 331–32.

290. *Id.* at 335–36 ("The information transmitted through the revenue ruling program is intended to benefit the taxpayer by not only informing him of the Commissioner's position but also permitting him, in most circumstances, to rely upon the position stated in the revenue ruling in planning and consummating a transaction. Accordingly, the Commissioner has limited the exercise of his power to modify his position retroactively. . . . Even if it is clear that the taxpayer did not rely on a revenue ruling, courts will often hold the Service to the position expressed in the revenue ruling.").

291. *Id.* at 342–343.

292. *Id.* at 347–48.

constitute income to the client.²⁹³ Then, consumer advocates could present a set of factual circumstances to the IRS based on a client with a particular kind of retainer agreement and ask the agency to issue a Revenue Ruling affirming that the retainer agreement does, in fact, exempt the client from tax liability for attorney's fees awarded pursuant to a fee-shifting statute.²⁹⁴ As discussed in *infra* Part V(C)(1), it is possible that attorney-client retainer agreements could be structured in such a way that, even under the current Tax Code, attorney's fees awarded pursuant to a fee-shifting statute would not constitute income to the client. However, as the law currently stands, it is uncertain whether the I.R.S. and the courts would agree that such retainer agreements have the effect of eliminating the client's tax liability for attorney's fees. For this reason, a Revenue Ruling affirming the legality of such a retainer agreement would helpfully clarify that taxpayers may avoid tax liability for attorney's fees awarded pursuant to fee-shifting statutes by structuring their attorney-client relationships in a particular way. Again, a Revenue Ruling is afforded deference in the courts, so attorneys could rely on a favorable Ruling if their attorney-client relationship and retainer agreement are sufficiently similar to the factual circumstances discussed in the Ruling.²⁹⁵

One downside of Revenue Rulings is that they are generally limited by the stated factual basis of the ruling, much in the manner of a judicial decision.²⁹⁶ For this reason, winning a Treasury Regulation²⁹⁷ allowing taxpayers to exclude certain types of attorney's fees from their income would be much better than a Revenue Ruling, since Regulations are "the most authoritative source for determining the meaning of the Code."²⁹⁸

The IRS has already issued two Private Letter Rulings, one in 2010 and one in 2015, identifying an exception to the general rule that attorney's fees are taxable as income.²⁹⁹ A Private Letter Ruling, unlike a Revenue Ruling or regulation, may not be cited as precedent unless a regulation authorizes the taxpayer to do so. Only the taxpayer to whom the letter is addressed may rely on the ruling.³⁰⁰ However, the Private Letter Rulings suggest that the IRS may, in the future, be willing to identify exceptions to the rule that attorney's fees are taxable as income in a regulation or Revenue Ruling.

293. See Telephone Interview with Ayalon Eliach, Director of Tax Initiative, Nat'l Ass'n of Consumer Advocates (Mar. 8, 2015) (author's notes on file with the *N.Y.U. Review of Law & Social Change*). See *infra* Part V(C)(1), for a description of such a retainer agreement.

294. Interview with Ayalon Eliach, *supra* note 293.

295. Rogovin & Korb, *supra* note 288, at 332.

296. See *id.* at 336.

297. Regulations are also afforded deference in the courts, and establish general rules rather than responding to a specific set of facts. See *id.* at 328.

298. *Id.* at 330.

299. I.R.S. Priv. Ltr. Rul. 2010-15-016; see also *Pro Bono Client*, *supra* note 110.

300. Rogovin & Korb, *supra* note 288, at 347-48.

In the 2010 Private Letter Ruling, the IRS found that “attorney’s fees awarded to lawyers representing a client on a pro bono basis” are not includable in the client’s gross income.³⁰¹ The Ruling was issued at the request of a taxpayer whose retainer agreement with a legal aid organization explicitly stated that “taxpayer has no obligation, contractual or otherwise, to pay any fees or other costs” to the taxpayer’s attorneys.³⁰² A second legal aid organization and a law firm also assisted with the lawsuit, and all three received attorney’s fees under the fee-shifting provisions of a statute.³⁰³ However, the second legal aid organization and the law firm did not sign their own retainer agreements with the client, and therefore the client was under no contractual obligation to pay attorney’s fees to any of the attorneys.³⁰⁴ The IRS noted that the two general rationales for including attorney’s fees in income—the anticipatory assignment of income doctrine in *Banks* and *Lucas v. Earl*, and the payment of a liability doctrine in *Old Colony Trust*—do not apply to a case in which a litigant has no “obligation, by express or implied agreement, to pay attorneys [sic] fees.”³⁰⁵ Therefore, *Banks* is not extended to cases involving fee-shifting statutes where the client had no contractual obligation to pay attorney’s fees.³⁰⁶

The IRS reached a similar conclusion in the 2015 Private Letter Ruling, which was issued at the request of a taxpayer who, with the help of two legal aid organizations, brought a successful action for injunctive relief against his state government.³⁰⁷ The taxpayer’s retainer agreement with each legal aid organization provided that the taxpayer would not have to pay for the legal work provided.³⁰⁸ The taxpayer’s lawsuit was brought under two anti-discrimination statutes with fee-shifting provisions, which provided that a prevailing plaintiff could obtain a reasonable attorney’s fee from the defendants.³⁰⁹ Consequently, after the taxpayer successfully obtained an injunction, the taxpayer executed a settlement agreement with the defendants that required the defendants to pay attorney’s fees and costs to the legal aid organizations.³¹⁰ The IRS found that, because the taxpayer had no obligation to pay attorney’s fees to the legal aid organizations, the amount paid to the plaintiff’s attorneys pursuant to the settlement agreement was not includable in the taxpayer’s gross income.³¹¹ Once again, the IRS distinguished the facts of this situation from the anticipatory assignment of income doctrine in *Banks* and *Lucas v. Earl* and the payment of a

301. *Pro Bono Client*, *supra* note 110 (citing I.R.S. Priv. Ltr. Rul. 2010-15-016).

302. I.R.S. Priv. Ltr. Rul. 2010-15-016.

303. *Id.*

304. *Id.*

305. *Id.* at 3.

306. *Id.*

307. I.R.S. Priv. Ltr. Rul. 2015-52-001 (Dec. 24, 2015).

308. *Id.*

309. *Id.*

310. *Id.*

311. *Id.*

liability doctrine in *Old Colony Trust*, finding these doctrines inapplicable to the taxpayer's situation.³¹²

These Private Letter Rulings offer insight into the IRS's thinking, and as a practical matter, attorneys may use it as guidance when crafting retainer agreements. However, it is not binding and taxpayers may not rely on it to avoid tax liability. By contrast, if the conclusion reached in the Private Letter Rulings was affirmed in a Revenue Ruling or regulation, taxpayers could rely on it knowing that the ruling or regulation would receive deference in the courts.

C. Self-Help from Litigants and Counsel

Until tax law is changed by the courts, Congress, or regulators, there may be ways that attorneys can work within existing laws and regulations to minimize the risk that their clients will suffer additional tax liability as a result of an attorney's fee award. By crafting retainer agreements, pursuing litigation, and drafting settlement agreements in strategic ways, attorneys can pursue fees that are not taxable to the plaintiff under existing tax law. Additionally, these new strategies may be used to shift the law in consumers' favor, by getting regulators and/or the courts to affirm the validity and legality of a mechanism for ensuring that attorney's fees are not taxable to an individual litigant.

There are several ways in which attorneys might be able to avoid or mitigate the tax consequences of including attorney's fees as income. First, attorneys may craft retainer agreements that structure the relationship between the client and attorney in such a way that the client will not be held responsible for taxes on attorney's fees.³¹³ An effective retainer agreement would clarify that the client has no obligation to pay any fees to the attorney, and it would assign the legal claim for statutory attorney's fees to the attorney. Second, attorneys may try whenever possible to bring cases in which the underlying *damages* are predominately not considered income, and therefore the attorney's fees would likewise not be considered income to the winning plaintiff.³¹⁴ Third, attorneys may be able to craft settlement agreements that minimize the tax consequences for the winning plaintiff.³¹⁵ Fourth, if the tax consequences of individual FDCPA actions continue to pose a problem for individual litigants, consumer lawyers could shift their focus to bringing class-action FDCPA lawsuits instead, since attorney's fees awarded in class action lawsuits are not taxable to any of the individual class members.³¹⁶ Finally, throughout all of these strategies, attorneys should consult thoroughly with their clients on the tax consequences (and all other considerations) of a potential FDCPA lawsuit in order to ensure that their

312. *Id.*

313. *See infra* Part V(C)(1).

314. *See infra* Part V(C)(2).

315. *See infra* Part V(C)(3).

316. *See infra* Part V(C)(4).

clients are fully informed and prepared to deal with a potential tax dispute if it arises later on.³¹⁷

1. Drafting Retainer Agreements

One strategy for minimizing the likelihood that plaintiffs will be taxed on their attorney's fee awards is to craft a retainer agreement that construes the attorney-client relationship in such a way that attorney's fees would arguably not constitute income to the plaintiff. An effective retainer agreement would: 1) clarify that the client has no obligation to pay any fees to the attorney, and 2) assign the legal claim for statutory attorney's fees (rather than merely the fees themselves) to the attorney. As explained below, under current law, a retainer agreement with these two key features appears to be a permissible way for the client to avoid tax liability for an attorney's fee award.³¹⁸ However, there is presently no guarantee that the I.R.S. would not hold the client liable for taxes on attorney's fees; such a client may need to challenge her tax assessment with the IRS or in court, and there is no guarantee that she would win.³¹⁹ Therefore, in order to fully protect consumers, attorneys should seek to obtain a regulation or ruling from the Treasury and IRS that affirms the legality of this retainer agreement.³²⁰

The first characteristic of an effective retainer agreement is that it would make clear that the clients have no obligation to pay any attorney's fees to the attorney. Then, under the rationale of I.R.S. Private Letter Ruling 2010-015-026 and I.R.S. Private Letter Ruling 2015-52-001,³²¹ the attorney's fees will not constitute income to the plaintiff. This Letter Ruling provides a potential way for attorneys to help their clients avoid liability for attorney's fees paid under the fee-shifting provisions of the FDCPA. However, its reach may be limited: it might be critical to craft retainer agreements that state explicitly that the client is not obligated to pay any attorney's fees.³²² This could pose a problem for clients suing jointly under the FDCPA and statutes or common law rules that do not contain fee-shifting provisions, who may want to provide for the possibility that their attorneys will win a percentage of any award in which attorney's fees are not granted automatically by the court. Moreover, the IRS' determination was

317. See *infra* Part V(C)(5).

318. Interview with Ayalon Eliach, *supra* note 293.

319. *Id.*

320. See *supra* Part V(B)(2) (discussing strategies for obtaining a regulation or ruling that clarifies that an attorney-client relationship may be structured in such a way so as to exempt the client from liability for taxes on a statutory attorney's fee award).

321. See *supra* notes 299–306 and accompanying text.

322. See I.R.S. Priv. Ltr. Rul. 2015-52-001 (letter ruling based on factual scenario in which taxpayer's retainer agreements with two legal aid organizations provided that the taxpayer would not have to pay for legal services); I.R.S. Priv. Ltr. Rul. 2010-15-016 (letter ruling based on factual scenario in which "[t]axpayer has no obligation, contractual or otherwise, to pay any fees or costs to" her attorneys).

reached in a case where the client had only signed a retainer agreement with a Legal Aid organization, and not a law firm.³²³ The IRS might not look so favorably on consumer lawyers who bring FDCPA cases for profit, even though they, too, serve as private attorneys general. Finally, because this is just a Letter Ruling, it may not be cited as precedent in court and the IRS may reverse its position on the issue and hold a taxpayer liable for taxes arising from an FDCPA award.³²⁴ A taxpayer in such a situation might be successful in challenging the tax assessment, either within the IRS or in court, but doing so would be both costly and risky.

Secondly, an effective retainer agreement would fully transfer the underlying *claim* for attorney's fees (rather than the attorney's fees themselves) to the attorney.³²⁵ Under the assignment-of-income doctrine, a taxpayer is not permitted to transfer income to another unless she also transfers the income-producing asset.³²⁶ In the case of attorney's fees paid under fee-shifting statutes, the income-producing asset is the underlying legal claim for attorney's fees.³²⁷ If a retainer agreement effectively transferred the entire claim for attorney's fees from the client to the attorney, the client would transfer the income-producing asset to the attorney and therefore exempt herself from taxation of the income (attorney's fees) generated.³²⁸

Although this second feature of a retainer agreement may be successful in changing the tax treatment of attorney's fees, it is important to consider whether such a feature is permissible under other laws and rules of professional responsibility, and whether it hurts the client or the attorney in any other ways. First, it is unclear whether, under state and federal law, the claim for attorney's fees may be severed from the rest of a statute and assigned to an attorney. On the

323. *Id.*

324. Rogovin & Korb, *supra* note 288, at 347–49 (noting that revocation of a letter ruling is only retroactive in “unusual circumstances”).

325. Interview with Ayalon Eliach, *supra* note 293.

326. *Comm'r v. Banks*, 543 U.S. 426, 433–34 (2005) (“a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party”). See *supra* notes 94–95 and accompanying text (explaining the assignment of income doctrine as applied in *Banks*). The assignment of income doctrine may be understood using the famous metaphor of the “fruits” and the “trees”: a taxpayer may not escape tax liability by transferring the “fruits” (her income) to someone else, unless she also transfers the trees on which they grew (the income-producing asset). See *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (“[N]o distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.”).

327. *Banks*, 543 U.S. at 427 (“In the case of a litigation recovery the income-generating asset is the cause of action derived from the plaintiff's legal injury.”)

328. See Reply Brief for Petitioner at 19–20, *Banks*, 543 U.S. 426 (Nos. 03-892 and 03-907) (“[O]nce [a plaintiff assigns his statutory claim for attorney's fees to his attorney], courts generally permit the lawyer to sue on his own behalf to recover his fees, without the participation or consent of the prevailing party. If such an assignment is viewed as a transfer of the entirety of the attorney's fee claim to the lawyer, such that the prevailing party retains no meaningful interest in or control over the claim, then it may be possible to view any recovery on that claim as income only to the lawyer.”) (internal citations omitted).

federal level, the Ninth Circuit has indicated that “the right to assign the right to seek or waive attorney’s fees” cannot be transferred, although “the right to collect fee awards . . . can generally be freely assigned.”³²⁹ In addition to satisfying federal law, attorneys would have to ensure that such a transfer did not violate state laws regarding barratry, champerty, and maintenance.³³⁰ Even if an assignment is invalid for some purposes (under other statutes or common law provisions), however, it may still be valid for federal income tax purposes. Another concern is that the transfer of a claim for attorney’s fees to the attorney may violate rules of professional responsibility such as Model Rule 1.8(i), which states that “[a] lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may . . . contract with a client for a reasonable contingent fee in a civil case.”³³¹ There is some indication that the transfer of a claim for a statutory attorney’s fee award does not violate Model Rule 1.8(i),³³² but this could vary state-by-state based on individual states’ codification and interpretations of the rules of professional responsibility.

A final concern is that such a retainer agreement may have practical implications, such as an impact on the client’s ability to obtain favorable settlements or Rule 68 offers,³³³ the attorney’s ability to guarantee that she will

329. *United States v. \$186,416.00*, 722 F.3d 1173, 1177 (9th Cir. 2013) (citing *Pony v. Los Angeles*, 433 F.3d 1138, 1144–45 (9th Cir. 2006)).

330. *See O’Brien v. Comm’r*, 38 T.C. 707, 712 (1962) (“[W]e think it doubtful that the Internal Revenue Code was intended to turn upon [the] refinements [of state law].”); *Zeisler v. Neese*, 24 F.3d 1000, 1002 (7th Cir. 1994) (“The lawyer can protect himself, moreover, though not perfectly, by entering into a written contract with his client in which the client assigns his statutory right to attorney’s fees to the lawyer. Then the lawyer can enforce the right without the participation of his client.”) (citing *Samuels v. American Motors Sales Corp.*, 969 F.2d 573, 576–77 (7th Cir. 1992); *Betz v. Diamond Jim’s Auto Sales*, 355 N.W.2d 292, 300–04 (2012) (suggesting that a retainer agreement may assign the right to collect attorney’s fees to the attorney). *But see Report & Recommendation Regarding Plaintiff’s Motion for Attorney Fees*, *Mathews v. Bronger Masonry*, 772 F. Supp. 2d 1004 (S.D. Ind. 2011) (No. 1:09-cv-00478-SEB-DML), ECF No. 146 (finding that, where a statute has an attorney’s fee provision, the attorneys fee claim does not belong to the lawyer, and suggesting that it might be a violation of the Indiana Rules of Professional Conduct for an attorney to have an ownership interest in the attorney’s fee claim).

331. MODEL RULES OF PROF’L CONDUCT R. 1.8(i).

332. *See Lee v. Javitch*, 568 F. Supp. 2d 870, 873–75 (S.D. Ohio 2008) (rejecting defendants’ contention that plaintiff’s attorney had “bargained for the Plaintiffs right to recover the entire statutory fee award for themselves,” which amounts to a “proprietary interest in the cause of action or subject matter litigation the lawyer is conducting for the client.”) (internal quotations omitted). Although there was no assignment of a claim for attorney’s fees in *Lee*, the court’s language may support the permissibility of such an assignment under state rules of professional responsibility. *Id.* at 874–75 (noting that “[m]odern fee-shifting statutes [like the FD CPA] unavoidably create some tension between a plaintiff’s goal of redressing an injury, and her attorney’s desire to be paid for services rendered,” but nonetheless concluding that “[t]his arrangement does not . . . amount to an improper acquisition of a proprietary interest in Lee’s cause of action.”).

333. A Rule 68 offer is a type of settlement offer issued pursuant to Fed. R. Civ. P. 68, which is “intended to encourage settlements and avoid protracted litigation.” W. David Paxton & Michael J. Finney, *Rule 68 Offers of Judgment: A Useful Defense Tool*, 24 VA. ASS’N DEF. ATT’YS J. CIV.

receive her fees, or the client's autonomy in making decisions about her case. Additionally, as discussed above, it is currently ambiguous whether such a retainer agreement is permissible under tax law; a reworked retainer agreement would be less risky and more reliable if it was supported by a favorable regulation or ruling by the IRS and the Treasury Department.³³⁴

Advocates should simultaneously explore new retainer agreement language and lobby the agency for regulations or Revenue Rulings that confirm that the retainer agreement absolves the client of liability for taxes on her attorney's fee award. Until such a regulation or ruling exists, individual taxpayers could seek guidance from the IRS in a Private Letter Ruling, which, like a Revenue Ruling, presents a specific set of facts to the IRS, but, unlike a Revenue Ruling, may not be used or cited as precedent unless a regulation authorizes the taxpayer to do so.³³⁵ Only the taxpayer to whom the letter is addressed may rely on the ruling.³³⁶ If the legal and practical considerations are worked out, a reworked retainer agreement may be an effective way for the client to avoid tax liability for an attorney's fee award.

2. Actions in Which Underlying Damages are Not Taxable

A second, but less broadly useful, option for minimizing the impact of attorney's fees on clients' tax liability is that attorneys could seek to bring more cases in which the underlying *damages* are predominately not considered income. If a client's damages are not considered income, the attorney's fees awarded in conjunction with those damages are not considered income either.³³⁷ Lawyers could strategically select clients in order to pursue FDCPA cases that emphasize physical injuries or personal sickness suffered by their clients as a result of abusive debt collection practices, since physical injury and personal sickness damages do not constitute income to the winning plaintiff.³³⁸ Some portions of an FDCPA case, including statutory damages and any economic

LITIG. 533, 534 (2012) (citing 12 WRIGHT, MILLER & MARCUS, FEDERAL PRACTICE & PROCEDURE, CIVIL 2D § 3001 (1997)).

334. See *supra* Part V(B)(2). If a valid offer of judgment is refused, and the plaintiff fails to obtain a judgment more favorable than the unaccepted offer, then the plaintiff "must pay the costs incurred after the offer was made." FED. R. CIV. P. 68(d). This incentivizes defendants to make reasonable offers of judgment and incentivizes plaintiffs to accept reasonable settlement offers rather than continuing litigation. Paxton & Finney, *supra* note 333, at 535. If an attorney has an independent right to claim attorney's fees, defendants may be less likely to offer favorable settlements or Rule 68 offers because they could later be subject to additional attorney's fee expenses which the attorney would pursue independently.

335. Rogovin & Korb, *supra* note 288, at 338 (citing, e.g., *Minchin v. Comm'r*, 335 F.2d 30 (2d Cir. 1964); *Goodstein v. Comm'r*, 267 F.2d 127 (1st Cir. 1959); *Borenstein v. United States*, 345 F.2d 558 (Ct. Cl. 1965)).

336. Rogovin & Korb, *supra* note 288, at 347–48.

337. Wood, *Can Tax Rules Cut Legal Bills?*, *supra* note 114, at 64, 65.

338. See *supra* notes 90–92 and accompanying text (discussing I.R.C. § 104(a)(2)), which provides that damages for physical injuries or personal sickness are not included in a taxpayer's income).

damages, will always constitute income to the plaintiff, but the attorney's fees awarded will only be considered income in proportion to the breakdown between damages that are and are not income.³³⁹ By minimizing the percentage of an underlying damage award that is included in the client's income, the attorney would also minimize the percentage of an attorney's fee award that is included in the client's income.

This solution has limited utility, however, because many of the forms of actual damages for FDCPA litigants are not damages for physical injuries or personal sickness—including the damages for emotional distress, job loss, and payments made on an invalid claim, and other harms.³⁴⁰ Moreover, this solution will be especially unhelpful for plaintiffs who win only statutory damages (which are considered income under the tax code). Since even plaintiffs who plead actual damages may ultimately be awarded only the statutory damages amount, there is great uncertainty in predicting which types of damages will be awarded, and, consequently, what taxes a potential FDCPA plaintiff might have to pay.

3. Drafting Settlement Language

An important consideration for FDCPA attorneys is that they must be careful when crafting settlements in FDCPA cases. For federal income tax purposes, it is not relevant whether proceeds are received as a result of settlement or judgment.³⁴¹ Therefore, a plaintiff may wish to seek a settlement in order to craft the terms of the settlement favorably to the plaintiff's tax burden.³⁴² For example, the settlement could stipulate that the damages are due to personal injury, such that the majority of damages—and therefore, the majority of attorney's fees—are not included as income.³⁴³ However, it is important to be cautious about drafting precise settlement language, so as to avoid inadvertently subjecting plaintiffs to tax liability. In particular, confidentiality agreements are common features of settlements that can be

339. *Id.*; Wood, *Can Tax Rules Cut Legal Bills?*, *supra* note 114, at 65.

340. *See, e.g.*, Patrick Lunsford, *Jury Awards Plaintiff \$1.26 million in FDCPA Violation Lawsuit*, INSIDEARM (July 31, 2011), <http://www.insidearm.com/opinion/jury-awards-plaintiff-1-26-million-in-fdcpa-violation-lawsuit/> (FDCPA plaintiff wins actual damages for emotional distress); Dan Margolies, *Jury Awards KC Woman \$83 Million in Debt Collection Case*, KCUR 89.3 (May 14, 2015), <http://kcur.org/post/jury-awards-kc-woman-83-million-debt-collection-case#stream/0> (FDCPA plaintiff wins actual damages based on fear and stress suffered while under pursuit by abusive debt collector). *See supra* notes 40–46 (discussing different types of actual damages).

341. Brett A. Bluestein, *Tax Aspects of Settlements and Judgments*, 15 S. CAROLINA LAWYER 15, 16 (2003) (citing *Longino Est. v. Com'n'r.*, 32 T.C. 904 (1959); *Levens v. Com'n'r.*, 10 T.C.M. (CCH) 1083 (1951)). “It is immaterial whether a settlement is reached before a judgment is rendered, after a judgment but prior to the appeals process being exhausted or before a lawsuit is even filed.” *Id.*

342. *Id.*

343. *Id.*

dangerous, because they interfere with the I.R.S.'s certainty of the exact nature (and, hence, taxability) of the damages awarded.³⁴⁴ In cases where part of a plaintiff's damages arise from personal injury or physical sickness, a confidentiality agreement could obscure which portion of the damages arise from injury (and are thus not taxable under § 104(a)(2)).³⁴⁵ Therefore, plaintiffs may want to steer clear of confidentiality provisions altogether, or create contractual provisions holding defendants liable for any additional taxes incurred as a result of confidentiality provisions.³⁴⁶

4. Class Action Lawsuits

Finally, if individual FDCPA actions become increasingly difficult due to the tax consequences of FDCPA attorney's fee awards, consumer lawyers may find it strategic to focus more attention on bringing class-action FDCPA lawsuits. For many years, class actions were not a common type of FDCPA action, but an increasing number of FDCPA actions have been brought as class actions.³⁴⁷ In "opt-out" class actions, in which class members are automatically included as part of the class and notified of their opportunity to affirmatively opt out of the class, attorney's fee awards are not counted as income towards any of the plaintiffs, even the named plaintiffs.³⁴⁸ Since FDCPA class actions are brought as opt-out class actions, FDCPA class actions are a reliable way to hold debt collectors accountable for abusive actions without subjecting individual clients to additional tax burdens arising from attorney's fees.

5. Advising and Assisting Clients

Regardless of which, if any, of the above strategies is employed to minimize a client's income tax liability, attorneys must consult thoroughly with their clients about the tax consequences of a potential FDCPA lawsuit. Attorneys should inform their clients about the potential tax consequences of bringing an FDCPA lawsuit, including the possibility that clients could face a substantial additional tax burden as a result of the taxation of attorney's fees. Attorneys should also inform themselves as much as possible about potential clients' tax situations and the potential effects of an FDCPA lawsuit on a given plaintiff's tax burden. Finally, consumer lawyers should collaborate regularly with tax lawyers and other tax professionals, both to advise potential clients of the potential tax consequences of bringing an FDCPA lawsuit and to potentially help

344. Randall O. Sorrels & Neel Choudhury, *Plaintiffs' Attorneys Beware: Little Known Tax Consequences Associated with Confidentiality Provisions*, 6 Hous. Bus. & Tax L.J. 258, 275 (2006)

345. *Id.* at 268–69.

346. *Id.* at 269–80.

347. FAIR DEBT COLLECTION, *supra* note 34, § 6.2.2.2.

348. Wood, *Attorneys Fees in Class Actions*, *supra* note 34.

former consumer law clients prepare tax returns and, if necessary, contest unfavorable tax outcomes with the IRS or in court.

Unfortunately, the *Banks* rule that attorney's fees are included as income to the plaintiff will continue to govern the tax treatment of attorney's fees until advocates can find a way to change the rule. Therefore, attorneys must find ways to mitigate the consequences of the *Banks* ruling for their clients. Any consumer pursuing an FDCPA claim—or any claim in which attorney's fees might be awarded by the court—must be advised about their potential income tax liability for attorney's fees prior to pursuing the claim, and attorneys should plan in advance to avoid as much tax liability for their clients as possible.³⁴⁹

VI.

CONCLUSION

The taxation of attorney's fees awarded in FDCPA lawsuits is a serious problem that penalizes plaintiffs who have already been harmed and undermines the goals of the FDCPA, making it more difficult for private parties to assist regulatory agencies in combating abusive debt collection practices. Consumer lawyers and other advocates for fair debt collection practices should seek reform of the tax code and regulations, either through Congressional, court, or regulatory action, to clarify that attorney's fees awarded under fee-shifting provisions like that of the FDCPA do not constitute income to the plaintiff. In the meantime, consumer lawyers must be vigilant to inform potential clients of the tax consequences of FDCPA actions and use innovative techniques to mitigate the tax consequences of attorney's fee awards.

In a 2002 interview, an FTC lawyer told the New York Times how important private lawsuits were to preventing illegal debt collection activities.³⁵⁰ The suits are essential to enforcing the FDCPA, he said.³⁵¹ “We can't be everywhere. We believe that the private actions and the threat of private actions are powerful forces in regulating debt collectors.”³⁵² Debt collection abuses are as rampant as ever, and eliminating the unfair tax burden for FDCPA plaintiffs is critical to curbing such violations in the debt collection industry.

349. See FAIR DEBT COLLECTION, *supra* note 34, § 2.1.4.

350. Adam Liptak, *Law to Protect Debtors Can be Windfall for Lawyers*, N.Y. TIMES (Oct. 6, 2002), <http://www.nytimes.com/2002/10/06/national/06DEBT.html>.

351. *Id.*

352. *Id.*