



CONSUMERS CAUGHT IN TAX LAW FLAW

**IRS Undercuts Consumer Protection;
New Tax Law Rubs Salt in the Wound**

Acknowledgements

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About the National Association of Consumer Advocates

The National Association of Consumer Advocates (NACA) is a nonprofit association of attorney members and consumer advocates who represent hundreds of thousands of consumers victimized by fraudulent, abusive, and predatory business practices. Its members are private and public sector attorneys, legal services attorneys, law professors, and law students whose primary focus is the protection and representation of consumers. NACA's members and their clients are actively engaged in promoting a fair and open marketplace that forcefully protects the rights of consumers, particularly those of modest means.

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Introduction and Summary

Every day, thousands of consumers get pushed around and ripped off by banks, predatory lenders, debt collectors, credit reporting agencies, and other big businesses. They get hounded over debts they do not actually owe, face illegal foreclosures, and have their cars wrongfully repossessed. Without the time, money, and other resources their harassers have, consumers often have no choice but to take the abuse. There are laws in place that are supposed to protect consumers from rip-offs, but the existing U.S. tax system is set up in such a way that not even the law is on consumers' side anymore. This situation is only going to get worse now that the 2017 Tax Cut and Jobs Act (TCJA) is in effect.

Most consumer protection laws do not primarily rely on the government to enforce them. Rather, they depend on lawsuits brought by consumers. The idea is that consumers can sue the corporations that cheat them for violating consumer protection laws. Bringing a lawsuit can be a daunting task for a consumer, especially for those who are low income or vulnerable in some other way. Consumers generally do not have the knowledge or experience to successfully navigate the legal system on their own, nor do they have the money to hire a lawyer to help them. But their opponents do. For example, Ocwen Financial Services, one of the largest mortgage servicers in the country, has been repeatedly penalized for consumer abuses including charging illegal fees and misleading consumers about foreclosure alternatives for struggling homeowners.¹ At the same time, Ocwen generates over a billion dollars a year in revenue. Mortgage servicers like Ocwen, as well as banks and lenders, can afford high-priced corporate attorneys to fight consumers in court.

In an attempt to help level the playing field for consumers, lawmakers have historically included attorney “fee-shifting” provisions in most consumer protection laws. Because most consumers cannot afford to pay an attorney to help them when a corporation cheats them, fee-shifting provisions require corporate opponents to reimburse a consumer’s attorney the fees they earn when they help win their cases. In theory, thanks to attorney fee shifting, consumers can actually afford to hire lawyers to help them fight back against powerful businesses when they are ripped off. Unfortunately, the reality is that many consumers still cannot access the legal help these provisions were designed to provide due to serious flaws in tax law. The situation is only going to get worse under the TCJA.

¹ CFPB Sues Ocwen for Failing Borrowers Throughout Mortgage Servicing Process, Mortgage Servicer’s Widespread Errors, Shortcuts, and Runarounds Cost Borrowers Money, Homes, April 20, 2017, <https://www.consumerfinance.gov/about-us/newsroom/cfpb-sues-ocwen-failing-borrowers-throughout-mortgage-servicing-process/>; CFPB, State Authorities Order Ocwen to Provide \$2 Billion in Relief to Homeowners for Servicing Wrongs, Dec. 19, 2013, <https://www.consumerfinance.gov/about-us/newsroom/cfpb-state-authorities-order-ocwen-to-provide-2-billion-in-relief-to-homeowners-for-servicing-wrongs/>.

The root of the problem is that consumers are being unfairly taxed on the legal fees awarded to them under the fee-shifting provisions of consumer protection laws. This occurs despite the fact that this money never reaches the consumers, but is paid directly to their attorneys who performed the work. Essentially, consumers are being taxed on money they never had and will never receive. Such a result is absurd, unjust, and defeats the purpose of consumer protection laws. Consumers who are mistreated by corporations are being ripped off by the Internal Revenue Service (IRS) when they attempt to defend themselves.

In some instances, consumers actually lose money by winning lawsuits due to the unfair tax treatment of their attorneys' earned fees. Consumer cases can be extremely fact intensive and difficult to argue without many hours of work by an experienced attorney. However, the amount of damages the consumer can recover does not necessarily increase in relation to the amount of work the consumer's lawyer puts in.

Often, consumer disputes with banks and lenders are fought over relatively small, set amounts. For example, the Fair Debt Collection Practices Act (FDCPA), the federal law that protects consumers from abusive debt collectors, limits the amount of statutory damages that an individual consumer can recover to \$1,000. When damages are small but cases are labor-intensive—often because of the intentional delays caused by corporate defendants—legal fees can quickly outpace consumers' recoveries to the point where taxes on fees may be greater than the amount ultimately recovered. In such cases, consumers are being punished for standing up for themselves.

Worse still, low-income consumers, who attempt to hold a corporation accountable for its unfair or deceptive behavior, may find themselves ineligible for valuable tax credits as a result. Refundable tax credits like the very popular Earned Income Tax Credit (EITC) provide invaluable financial assistance to hardworking but vulnerable families. Because eligibility for the EITC is determined based on the consumer's adjusted gross income, when reimbursed fees for an attorney's work are counted as income to a consumer, it can artificially inflate the consumer's income making their family ineligible for the EITC.

Stated plainly, even though a consumer never receives any of the reimbursed legal fees, by successfully fighting back against corporate fraud and abuse, they are forced to give up the tax credits they depend on to make ends meet. Just as low-income consumers are being empowered by lawmakers to fight back against predatory lenders, mismanaged credit bureaus, and abusive debt collectors, with the help of qualified attorneys, they are beaten back by the tax system. Even when wronged consumers win, they still lose.

Before the TCJA went into effect, consumers could offset some, but not all, of this tax burden created by successfully going to court against a corporation using a below-the-line tax deduction. With it, some consumers could deduct a percentage of reimbursed fees from

their adjusted gross income, the amount that most taxpayers pay income tax on. Allowing these deductions, however, was far from a perfect solution because of the various limitations attached to them. Most egregiously, below-the-line deductions did not help low-income consumers remain eligible for tax credits.

In other instances, even if a consumer were able to reduce some of the unfair tax burden caused by the treatment of reimbursed fees, they could still find themselves financially worse off than if they had done nothing to protect themselves. While flawed, this limited deduction was better than nothing. The new tax law now leaves consumers with nothing. If and when consumers stop going to court because they are afraid of being penalized by the tax system, consumer protection laws will go unenforced and exploitative businesses will be free to lie and cheat. It will render consumer protection laws largely unenforced and ineffective.

This is not what Congress envisioned when it created consumer protection laws. Congress recognized that consumers need attorneys when going up against big businesses with massive resources in court and addressed that need by providing a fair and reasonable way to cover that expense. Because the IRS unfairly penalizes harmed consumers who attempt to stand up for their rights, congressional intent is being thwarted, and our consumer protection laws are being undermined.

This report includes the stories of consumers who have experienced this inequity in our tax system:

- **Sgt. Patrick Clarke, a New York Army Sergeant whose car was illegally repossessed by a financial institution;**
- **Mr. J., a New Jersey man who successfully fought back against illegal debt collection; and**
- **Russell and Jennie Kinney, a couple in Maine who managed to save their home from an illegal foreclosure.**

These consumers were mistreated, took legal action to enforce their rights, and won their cases, only to find themselves saddled with an unfair tax burden.

Congress has acted before to protect individuals who win cases from harsh and unfair tax penalties. Civil rights and employment laws also allow harmed individuals to get their legal fees reimbursed when they win their cases. But Congress has ensured better tax treatment for them than for consumers.

Unlike consumers, individuals who win cases under civil rights and employment laws can get an above-the-line deduction for their reimbursed fees. Above-the-line deductions do

not have any of the limitations of below-the-line deductions and ensure that none of the reimbursed fees are taxed at all to the individual. Consumers who are ripped off and mistreated by lenders, banks, credit bureaus, and other big businesses should receive the same tax treatment.

It is up to Congress or the IRS to fix the tax treatment of reimbursed earned legal fees in consumer cases. This can be done by reinterpreting the tax code to exclude court-awarded attorneys' fees from taxable income or amending the tax code to give consumers an above-the-line deduction. However it chooses to resolve this problem, the federal government must make it known that it stands with consumers, not with bad corporate actors.

"It is not a minor matter to treat consumers in this country fairly,"² said President Jimmy Carter when he signed the Fair Debt Collection Practices Act (FDCPA) into law. This simple, yet powerful statement still rings true today. So how did we get to the point where big businesses can abuse individual consumers for years at a time with no consequences? While lawmakers have passed dozens of state and federal consumer protection laws like the FDCPA, the tax system has undermined consumer enforcement of these laws. If consumer protection laws cannot be strongly enforced, then it is as if they never existed in the first place.

Servicemember Exercises His Rights Against Lender, Gets Burned by Tax Law

In 2008, Patrick Clarke, a then New York resident, bought a car with his then girlfriend and entered into an installment loan contract to pay for it.³ The loan was assigned shortly thereafter to Hudson Valley Federal Credit Union (HVFCU). Sgt. Clarke and his girlfriend made several timely payments on the loan but started to fall behind after hitting a financial rough patch.⁴

Sgt. Clarke enlisted in the United States Army and graduated at the top of his class from Advanced Individual Training.⁵ In 2009, he received orders to report to active duty, deployed to Iraq, was promoted to sergeant, and deployed a second time.⁶ Sgt. Clarke remains on active duty service. Around the same time that he deployed to Iraq, the credit union began to aggressively attempt to collect on Sgt. Clarke's car loan. The credit union knew that Sgt. Clarke was on active duty which gave him certain rights under the Servicemembers Civil Relief Act, a law intended to provide financial and legal protection to active duty military.⁷ Despite that knowledge, HVFCU wrongfully repossessed Sgt. Clarke's

² 123 Cong. Rec. H10862 (daily ed. Oct. 12, 1977)(statement of Rep. Annunzio).

³ Vildan Teske, Email to Sophia Huang, Sept. 21, 2018.

⁴ Vildan Teske, Memo to Ira Rheingold, Apr. 25, 2017.

⁵ Id.

⁶ Id.

⁷ Id.

car.⁸

Under the SCRA, a creditor cannot begin the repossession process without first obtaining a court order.⁹ After his rights were violated, Sgt. Clarke took the financial institution to court in a New York federal court.¹⁰ As the case progressed, evidence came to light that Sgt. Clarke was not the first servicemember whom the credit union had subjected to similar treatment. It seemed the credit union had not been checking the military status of its borrowers before beginning collection and repossession activities.¹¹

However, since Sgt. Clarke's lawsuit brought these illegal practices to light, HVFCU has changed its internal policies and procedures to ensure it does not happen again.¹² Not only did Sgt. Clarke's lawsuit vindicate his own rights, it exposed a pattern of institutional wrongdoing, and has helped to secure the rights of future servicemember borrowers. In this case, like so many other consumer cases, a win for the individual is also a win for the public good.

After years of litigation, Sgt. Clarke accepted an offer of judgment from HVFCU for \$20,000 in cash and for \$25,000 in debt wiped from his account. Because the SCRA allows successful consumers to recover their legal fees from the corporate wrongdoer, he was also awarded \$110,801.75 in legal fees, which his attorney—not Sgt. Clarke—received for her work.¹³ HVFCU issued him an IRS 1099 Form not only for the cash he received but also for his reimbursed legal fees. Although Sgt. Clarke brought suit to enforce his rights under the SCRA, the tax system undermined the spirit of the law. Under the new tax law, our military men and women may be discouraged from vindicating their rights like Sgt. Clarke did.

What the Tax Law and the Supreme Court Say About Consumers' Litigation Costs

Section 61 of the Internal Revenue Code defines gross income as "all income from whatever source derived."¹⁴ The IRS interprets this definition to include money obtained from court judgments and settlements. Generally speaking then, all money won by a successful litigant is considered part of the litigant's gross income. Whether earned attorneys' fees should

⁸ Id.

⁹ Servicemembers Civil Relief Act, 50 U.S.C. 3943.

¹⁰ Teske, *supra* note 3.

¹¹ Memo to Ira Rheingold, *supra* note 4.

¹² Id.

¹³ Id.

¹⁴ I.R.C. § 61

also be considered income was an open question until the U.S. Supreme Court's 2005 ruling in *Commissioner v. Banks*.¹⁵

In *Banks*, the Court held that “when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.”¹⁶ Since then, the IRS has treated legal fees as taxable income not only for the attorney receiving the fees, but for the consumer, the client, as well.¹⁷ The *Banks* decision did not directly address the issue of how legal fees awarded by a court under a fee-shifting law are to be treated; nevertheless, those fees are generally included in a consumer’s gross income for tax purposes. This means that a victorious consumer may be forced to pay taxes on the legal fees awarded to them even though the money goes to the lawyer, not the consumer.

Some options exist for individuals in certain types of cases to avoid or partially avoid the unfair tax burden from awarded legal fees. However, in cases involving enforcement of consumer protection laws, these options are no longer available.

Below-The-Line Deductions of Attorneys’ Fees Can Create More Problems for Consumers

The two primary ways of reducing the tax burden of attorneys’ fees are above-the-line and below-the-line deductions. Above-the-line deductions allow taxpayers to simply deduct the amount of attorneys’ fees from their gross income to create a new figure called adjusted gross income which taxes are then paid on.¹⁸ These kinds of deductions completely eliminate the negative impacts of treating reimbursed legal fees as income. Unfortunately, above-the-line deductions are usually not available to consumers who bring their cases under consumer protection laws. Instead, itemized below-the-line deductions were typically the only means that consumers have to reduce their tax burden.

In the past, plaintiffs have been able to apply a below-the-line deduction that treats awarded legal fees as expenses occurred to make income.¹⁹ This below-the-line deduction is subject to a number of limitations that make it much less effective than straightforward

¹⁵ *Commissioner of Internal Revenue v. Banks*, 534 U.S. 426 (2005).

¹⁶ *Id.* at 430.

¹⁷ A series of federal tax court cases established this position of the IRS. *See e.g.*, *Sinyard v. Commissioner* 268 F.3d 756 (9th Cir. 2001) (affirming a Tax Court ruling that attorneys’ fees paid by a defendant as part of a settlement agreement should be treated as income to the plaintiffs); *Vincent v. Commissioner*, 89 T.C.M. (CCH) 1119 (2005) (finding that attorneys’ fees awarded under a fee-shifting statute should be included in gross income).

¹⁸ 26 U.S.C. § 62

¹⁹ I.R.C. § 212

above-the-line deductions. While many of these limitations are in place for sensible policy reasons, they do not apply well to reimbursed legal fees in consumer cases.²⁰

A. Low-income families will lose much-needed federal benefits.

For many consumers, the biggest limitation of below-the-line deductions is their impact on consumers' eligibility for various refundable tax credits. Working families with low income may qualify for an Earned Income Tax Credit (EITC), the Hope and Lifetime Learning Credit, or the Child Tax Credit, among others. Each of these credits is an important financial resource for families who may not be able to make ends meet otherwise. For instance, the average EITC received boosted household income by \$265 a month.²¹ For struggling households, losing the EITC could be devastating.

Consumers who would typically qualify for one or more tax credits risk losing them if they win a lawsuit and have their legal fees reimbursed. The amount of a credit and eligibility for the credit is calculated based on a taxpayer's adjusted gross income.²² Reimbursements for earned attorneys' fees can artificially inflate a consumers' adjusted gross income so it looks like they received more money from the lawsuit than they actually did. Below-the-line deductions do not affect a taxpayer's adjusted gross income. For a consumer, this means that even if they were able to partially offset the taxes from legal fees using a below-the-line deduction, they could still become ineligible for a tax credit that they depend on. As a result, vulnerable consumers who stand up for themselves are injured twice: once by an abusive corporation and once again by the IRS.

B. Attorneys' fees give false picture of consumers' income.

Some consumers may have completely lost the benefit of the below-the-line deduction if it was determined that they were subject to the Alternative Minimum Tax (AMT), a separately calculated rate of taxation that was originally intended to ensure the very wealthy were paying their fair share.²³ Taxpayers whose income meets the standards set out in the tax code are required to pay the AMT if their tax liability is higher than it would be under the ordinary taxation system.²⁴ If a taxpayer must pay the AMT rather than the standard tax rate, their attorneys' fees were not deductible at all.²⁵

The Tax Policy Center has reported that close to 30% of households with incomes between \$200,000 and \$500,000 and over 60% of households with incomes between \$500,000 and

²⁰ See Joanna Laine, *Consumer Protection and Tax Law: How the Tax Treatment of Attorney's Fees Undermines the Fair Debt Collection Practices Act*, 40 N.Y.U. Rev. L. & Soc. Change 721, 743-46.

²¹ Id.

²² Id.

²³ Tax Pol'y Ctr, *What is the AMT?*, <https://www.taxpolicycenter.org/briefing-book/what-amt>

²⁴ I.R.C. § 55

²⁵ Id.

\$1,000,000 are subject to the AMT.²⁶ While these income figures are high, it is not unusual for ordinary consumers to win large judgments and even larger legal fees in cases that demand massive amounts of time and work from the consumers' attorneys. In such instances, the consumer would be saddled with an immense tax burden and no way to offset it.

C. Consumers forced to make tough trade on deductions.

Because below-the-line deductions are itemized, only amounts in excess of 2% of a consumer's income can be deducted.²⁷ For a consumer who typically earns \$25,000 a year but wins a case that awards \$25,000 in damages and \$50,000 in reimbursed legal fees, the first \$2,000 of the fees not deductible at all, thus further increasing the consumer's tax burden.

A Win at Trial Against Debt Collection Abuses and Then an Unfair Tax Burden

Mr. J., a New Jersey resident, opened a credit card with a national bank in 2008. After using the card and making regular payments on it, Mr. J fell behind on his payments and defaulted on the card in March 2009. The bank charged off the debt in October 2009, and sold it to Midland Funding LLC. Midland, one of the nation's largest debt buyers, has been accused numerous times of abusive debt collection practices.²⁸

One of its frequently used tactics is suing immediately on old debt which scares consumers into settling.²⁹ Oftentimes, the lawsuits are brought without adequate documentation and for greater amounts than the consumer actually owes.³⁰ The CFPB has taken enforcement actions against Midland and its parent companies over this practice and other deceptive behaviors.³¹

In May 2014, Midland filed a collection suit against Mr. J in state court. The case went to trial later that year where Mr. J and his attorney were able to successfully show that Midland had violated the federal Fair Debt Collection Practices Act. The state court found that Midland was aware that the debt went into default in March 2009 and that because the three year statute of limitation had expired in 2014 when it filed its lawsuit, Midland did not have a legal right to collect the debt.

Based on these facts, the trial court found in favor of Mr. J, dismissed Midland's claim, and awarded him over \$35,000 in attorneys' fees and costs. Midland appealed the decision in

²⁶ Tax Pol'y Ctr, *Who Pays the AMT?*, <https://www.taxpolicycenter.org/briefing-book/who-pays-amt>.

²⁷ Miscellaneous Deductions, I.R.S. Pub. No. 529, Cat. No. 150560 (2018), <https://www.irs.gov/pub/irs-pdf/p529.pdf>.

²⁸ CFPB Takes Action Against the Two Largest Debt Buyers for Using Deceptive Tactics to Collect Bad Debts, CFPB, <https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-the-two-largest-debt-buyers-for-using-deceptive-tactics-to-collect-bad-debts/> (Sept. 09, 2015).

²⁹ Id.

³⁰ Id.

³¹ Id.

April 2015, and the two parties ultimately reached a settlement. By the time the settlement was reached, Midland had wrongfully pursued litigation against Mr. J for a year and a half to collect a debt of less than \$1,000 dollars.

In 2018, Mr. J received a letter from the IRS saying he owed nearly \$15,000 in unpaid taxes and for a several thousand dollar Earned Income Tax Credit he previously received. Mr. J did not realize that the IRS considered the attorneys' fees to be part of his taxable income, especially because Mr. J was not the recipient of the fees. Moreover, he risks losing an Earned Income Tax Credit, which he is otherwise entitled.

The threatened massive tax bill and loss of the EITC is potentially financially devastating to Mr. J and his family. Mr. J defended himself against an illegal attempt to collect debt. He successfully proved his case and now, instead of peace of mind, he has received an ever greater burden for his troubles.

New Law's Suspension of Below-the-Line Deductions Will Make Tax Burdens Unbearable for Consumers with Winning Claims

Below-the-line deductions of attorneys' fees were an imperfect solution to an already troubling tax problem. While they could not offer consumers complete relief when they won or settled cases, they could at least partially offset the tax burden that can accompany reimbursed legal fees. However, even this imperfect solution is now unavailable to consumers who win or settle cases.

The Tax Cut and Jobs Act of 2017 (TCJA) will eliminate the availability of certain below-the-line deductions, including the one for the production of income, between 2018 and 2025.³² During this time, many consumers who are awarded reimbursed legal fees will be stuck paying taxes on the entire amount.

This result has far-reaching implications for consumers and the public at large. First, as discussed above, under the current tax system, consumers already run the risk of actually losing money by winning and settling lawsuits. In some cases, consumers are awarded significantly more in legal fees than damages due to the amount of work a lawyer must perform to successfully bring the cases. When that happens, it is possible that the amount of income tax the consumer must pay on the fees exceeds the amount they receive in damages. So, consumers may be left worse off than they were before despite having winning claims. The new law's suspension of the below-the-line deduction will only increase the likelihood that consumers will be penalized financially for winning lawsuits.

³² Tax Cut and Jobs Act, Pub. L. 115-97, 131 Stat. 2054, 2070 (2017).

As a result, future consumers with valid cases may be discouraged from bringing their claims out of fear that they too may be penalized by the tax system for it. Under these circumstances, an injured consumer's ability to access the courts is determined by their ability to pay out of pocket. Not only do low- and moderate-income consumers lose one of their only means to fight back against unscrupulous business practices, many consumer protection laws will go unenforced. Consequently, the drop in consumer law enforcement could spur an upswing in abusive and deceptive practices by debt collectors, banks, auto dealers, and others.

While the full impact of the recent shift in tax policy is difficult to estimate, a survey of consumer lawyers strongly suggests that the majority of consumer litigants will be adversely affected. Out of 144 survey respondents, close to 80% reported having a client who received an IRS 1099 form that included the attorneys' fees awarded to them. And among those lawyers, 78.57% reported that their clients received IRS 1099 forms that included attorneys' fees regularly or more frequently. These figures indicate that large numbers of consumers are likely already paying the tax price for bringing winning consumer protection claims. Now that the below-the-line deduction has been suspended, the problem will only get worse.

Q2 Have any of your clients ever received an IRS 1099 form that included your attorneys' fees?

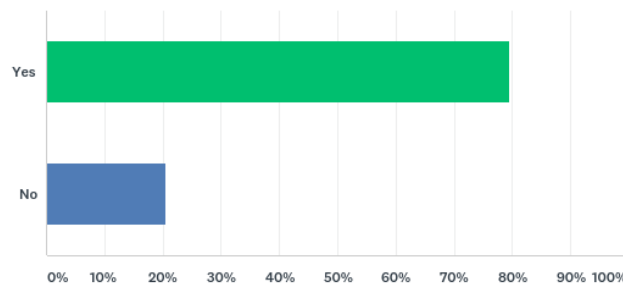


Fig. 1 Percentage of respondents whose clients have received IRS 1099 forms for attorneys' fees

Q3 Of the cases you've litigated in the last two years, how often were IRS 1099 forms that included your attorneys' fees issued to your clients?

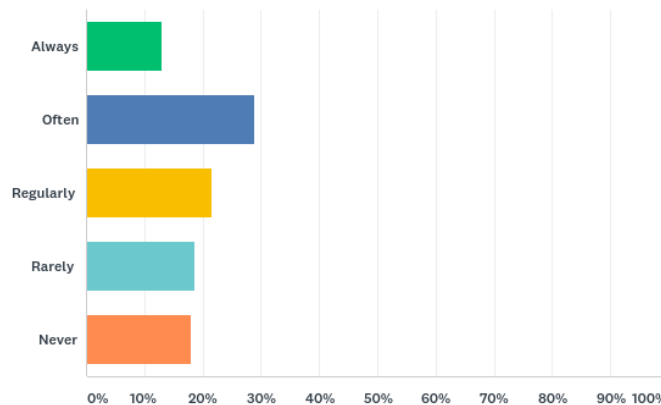


Fig. 2 Reported frequencies of IRS 1099 forms for attorneys' fees

Consumer Protection Laws Lose Their Value Without Private Enforcement

The federal Fair Debt Collection Practices Act (FDCPA) protects consumers from abusive debt collection practices by limiting the actions that can be taken by a debt collector. A series of hearings before Congress were held in 1977 where witnesses testified about the rampant abuses that consumers faced at the hands of debt collectors. These abuses included “harassing or threatening phone calls, employer contact, false threats of arrest or suit...or threats of bodily harm or death.”³³

Based on its findings, Congress determined that debt collection abuses were a serious social problem that “contribute[d] to the number of personal bankruptcies, to marital instability, to the loss of jobs, and to the invasion of personal privacy.”³⁴ By placing limits on debt collectors, the FDCPA was designed as a means to bring about positive social and financial change. Even today, debt collectors’ abusive conduct receives one of the highest numbers of complaints among American consumers.³⁵

Congress envisioned the FDCPA as a primarily self-enforcing law.³⁶ Debt collection abuses are so prevalent that in addition to state and federal public enforcement, the FDCPA

³³ 123 Cong. Rec. H10862 (daily ed. Oct. 12, 1977)(statement of Rep. Annunzio).

³⁴ Id.

³⁵ CONSUMER COMPLAINTS, CONSUMERFINANCE.GOV, https://www.consumerfinance.gov/data-research/consumer-complaints/search/?from=0&searchField=all&searchText=&size=25&sort=created_date_desc (debt collection received the second highest number of consumer complaints)

³⁶ Laine, *supra* note 6, at 754.

empowers harmed consumers to enforce their rights through individual lawsuits. Because the FDCPA served such an important function, it was necessary to enable and encourage as many consumer lawsuits as possible. To do so, Congress included an attorney fee-shifting provision in the FDCPA that would allow winning consumers to have their legal fees reimbursed by their opponents in court. This was not an unusual practice: by the time the FDCPA was passed, several other major federal consumer protection laws also used similar fee-shifting provisions.³⁷ A list of other important state and federal consumer protection laws that allow consumers' legal fees to be reimbursed can be found in Appendix A.

Key Federal Consumer Statutes Containing Fee-Shifting Provisions

- Truth in Lending Act: requires lenders to disclose important information to consumers
- Fair Credit Reporting Act: regulates how credit reporting agencies treat consumer information
- Consumer Leasing Act: requires accurate disclosure of lease terms to consumers
- Fair Debt Collection Practices Act: regulates the actions that can be taken by debt collectors
- Real Estate Settlement Procedures Act: requires transparency by mortgage lenders
- Magnuson Moss Warranty Act: provides disclosure standards for consumer product warranties
- Electronic Funds Transfer Act: creates rights for consumers who transfer money electronically

The FDCPA and dozens of other state and federal consumer protection laws rely on individual consumers to enforce the rights of the many. Consumers must be willing and able to confront large corporations, law firms, and other organizations in court. Such entities usually have significantly more resources than the average consumer and nearly unlimited access to lawyers. They can stretch a lawsuit out for years to avoid paying back a ripped-off consumer.

If consumers want to have any hope of fighting back, they need legal help. However, unlike the corporations they face in litigation, most consumers typically cannot afford to pay for a lawyer's help out of pocket.³⁸ Fee-shifting provisions allow consumers to hire their own lawyers to help them bring their cases and enforce consumer protection laws. Given the importance that Congress has placed on consumer protection and fair dealing, consumers' ability to seek remedies available under these laws is critical.

³⁷ RESPA, TILA, FCRA, CLA, HSLFDA are among the fee-shifting statutes enacted prior to the FDCPA. For a more comprehensive list of federal and state consumer protection statutes that use fee-shifting, see Appendix A.

³⁸ It is estimated that 80% of civil legal needs of those living in poverty and 40–60% of middle-income Americans go unmet. High-income individuals may also forego legal action due to cost, with only 46% pursuing claims to resolve unpaid debts. REBECCA BUCKWALTER-POZA, CTR. FOR AM. PROGRESS, MAKING JUSTICE EQUAL (2016).

Several factors make many consumer cases unfeasible in the absence of fee shifting. As mentioned, most consumers have modest incomes and typically cannot afford to pay their lawyers upfront the way their opponents might. In some instances, consumers may enter into a contingency arrangement with a lawyer where the consumer's legal fees are paid as a percentage of the consumer's recovery. However, many consumer cases involve relatively small-dollar amounts, making contingency fee arrangements impracticable given the amount of work that a lawyer must do to help consumers win. This economic reality was noted by a Michigan appellate court in *Jordan v. Transnational Motors* where the judge found that "if attorney fee awards in these cases do not provide a reasonable return, it will be economically impossible for attorneys to represent their clients."³⁹

Further compounding the problem is the fact that many consumer cases are relatively difficult to litigate. For example, it is estimated that at least 50% of subprime mortgage borrowers could have qualified for lower-cost home loans.⁴⁰ These borrowers would have viable cases under a number of state and federal consumer protection statutes. However, these cases require time-intensive, rigorous work by lawyers because they are fact dependent and often difficult to prove.⁴¹

As a result, the lawyers who help consumers win these cases generate much more in legal fees than many consumers would be able to pay and more than would be possible to recover under a contingency arrangement. But when courts can order consumers' legal fees to be reimbursed by their opponents, it becomes possible for consumers to find legal help and for important consumer protection cases to be brought. A federal judge in *Halecki v. Empire Portfolios, Inc.* said it best when he wrote: "the whole purpose of fee-shifting statutes is to generate fees that are disproportionate to the plaintiff's recovery."⁴²

Because nearly all people are consumers, ensuring their safety is a matter of public interest. The current tax treatment of reimbursed legal fees makes it more difficult for consumers to take action against unfair and illegal business practices, ultimately interfering with Congress' and state legislators' intent and frustrating the purpose of many consumer protection laws. Indeed, the interest of the public and the business community is to shift the burden of the expense of corporate misconduct and fraud to the bad actors whose conduct spurred the litigation in the first place.⁴³

Defeating Mortgage Lending Abuses Led to a Huge Tax Bill

³⁹ *Jordan v. Transnational Motors Inc.*, 212 Mich. App. 94 (1995).

⁴⁰ Debra Pogrud Stark & Jessica M. Choplin, *Does Fraud Pay? An Empirical Analysis of Attorneys' Fees Provisions in Consumer Fraud Statutes*, 56 CLE. ST. L. REV. 483, 491 (2008).

⁴¹ *Id.*, at 492-94.

⁴² *Halecki v. Empire Portfolios, Inc.*, 952 F.Supp.2d 519 (2013).

⁴³ *Gramatan Home Investors Corp. v. Starling*, 470 A.2d 1157 (Ver. S. Ct. 1983).

Russell and Jennie Kinney are a married couple who live in a small town in rural Maine. The two are of modest means and get by on Russell's wages as a mechanic.⁴⁴ Through hard work, they managed to pursue the American Dream and purchased a home together. However, that dream soon came crashing down around them.

The Kinneys financed the purchase of their home through Bank of America. The couple was making timely payments on the mortgage, when suddenly the monthly payment amount skyrocketed. The Kinneys attempted to keep up with the payments at first, but with only one stream of income, they quickly fell behind on payments and were on the verge of foreclosure.⁴⁵

So what caused the unexpected jump in monthly payments? It was revealed that the bank had been unlawfully paying the property taxes on the lot next to the Kinneys' home. To make up for the money the bank had lost on the unlawful payments, the bank raised the Kinneys' mortgage payments.⁴⁶

The Kinneys hired a lawyer and sued the bank. As part of their lawsuit, the Kinneys alleged that the bank had violated a slew of state and federal consumer protection laws by attempting the illegal foreclosure, including the Fair Debt Collection Practices Act and the Maine Consumer Credit Act.⁴⁷ Ultimately, the Kinneys successfully settled their case and managed to avoid foreclosure and save their home.

The Kinneys' successfully enforced their legal rights, but their ordeal was not over. The bank defendant issued an IRS 1099 form to the Kinneys for the full amount of the settlement including their reimbursed legal fees. The taxes on the fees would wipe out the Kinneys' recovery and drain their limited income as well.

A bank attempted to illegally foreclose on Russell and Jennie Kinney's home due to the bank's own carelessness. They successfully took the bank to court, but the tax law essentially penalized them for achieving justice.

Russell and Jennie Kinney are just two of an unknown number of consumers who win lawsuits against corporate bad actors only to be left financially worse off due to the application of the tax laws.

Tax Law Treats Fees in Consumer Cases Differently Than Other Cases

⁴⁴ Memorandum of Chet Randall, Feb. 04, 2016.

⁴⁵ Id.

⁴⁶ Id.

⁴⁷ Id.

Reimbursed legal fees awarded in civil rights and employment cases do not add to a litigant's tax burden. Much like consumer protection laws, civil rights and employment laws often rely on private enforcement through lawsuits and usually also contain fee-shifting provisions. For instance, the Fair Housing Act, which ensures equal housing opportunities for all people, contains a fee-shifting provision.⁴⁸ However, reimbursed legal fees in civil rights and employment cases are deductible above the line, allowing a taxpayer to simply exclude the amount of the deduction from their gross income. Litigants in civil rights and employment cases are therefore effectively not taxed on any legal fees awarded to them.

Like Consumer Laws, Fee-Shifting in Civil Rights and Employment Laws Promotes Fair and Just Treatment

Despite the difference in tax treatment, fee-shifting provisions in consumer protection and civil rights and employment cases were enabled for the same reasons as in consumer cases.⁴⁹ They further important objectives through private enforcement. Consumer protection cases help create a safer marketplace and promote social stability by fighting against unfair, abusive, and deceptive practices targeted at consumers. Civil rights and employment cases similarly promote social stability and fair marketplaces by combatting discrimination and unfair labor practices. Consumer protection laws and civil rights and employment laws are both key to maintaining a functional, healthy society.

Lawmakers have taken essentially the same position on reimbursing earned attorneys' fees in civil rights and employment cases as they have in consumer protection cases. Congress passed the Civil Rights Act of 1866, one of the first civil rights statutes, to affirm that all citizens are equal under the law. Congress amended the statute in 1976 to authorize fee-shifting provisions. In supporting the amendment, Congress said:

In many cases arising under our civil rights laws, the citizen who must sue to enforce the law has little or no money with which to hire a lawyer. If private citizens are to be able to assert their civil rights, and if those who violate the Nation's fundamental laws are not to proceed with impunity, then citizens must have the opportunity to recover what it costs them to vindicate these rights in court.⁵⁰

Congress additionally noted that it relies heavily on fee-shifting provisions in civil rights cases to facilitate compliance and private enforcement. Every piece of civil rights legislation

⁴⁸ 42 U.S.C. §3612(p)

⁴⁹ See e.g., Mark E. Budnitz, *The Development of Consumer Protection Law, The Institutionalization of Consumerism, and Future Prospects and Perils*, 26 GA. ST. L. REV. 1147, 1151-52 (2011) (discussing the emergence of consumer protection lawyering in the context of the civil rights movement);

⁵⁰ Civil Rights Attorney's Fees Awards Act, Pub. L. No. 94-559, 90 Stat. 2641 (1976) (codified at 42 U.S.C. 1988(b)).

passed since 1964 has included a section awarding reasonable legal fees to promote active enforcement of the law.⁵¹ Similarly, nearly all major pieces of federal consumer protection legislation allow legal fees to be reimbursed to winning consumers.⁵² Courts have echoed Congress's sentiments on fee shifting in civil rights and employment cases as well. In a case arising under the Labor-Management Reporting and Disclosure Act, Justice Clark wrote that "not to award counsel fees in cases such as this would be tantamount to repealing the Act itself by frustrating its basic purpose."⁵³

Courts have acknowledged the similar policy rationales underlying civil rights and consumer protection laws. In *Hollis v. Roberts*, the Eleventh Circuit Court of Appeals found that the FDCPA's section on legal fees should be interpreted in accordance with *Blum v. Stenson*, a civil rights case. The court wrote that "[a]lthough *Blum* was decided in the context of the civil rights fee-shifting statute, its principles are equally applicable here."⁵⁴ Given the clear parallels between these two types of cases, it is difficult to justify the different tax treatment that reimbursed legal fees receive in each.

Recommendations

1. IRS should exclude shifted attorneys' fees from consumers' gross income.

To solve the problem, the IRS can take the position that legal fees awarded by courts should not be included in gross income. In *Banks*, the Supreme Court held that legal fees paid as part of a contingency agreement should be considered taxable income within the scope of I.R.C. § 61(a).⁵⁵ However, the Court explicitly declined to address the appropriate tax treatment for attorneys' fees awarded by a court under a fee-shifting statute. This leaves open the possibility for IRS to interpret I.R.C. § 61(a) as excluding such fee awards from gross income. I.R.C § 61(a) has previously been interpreted broadly by the Supreme Court in *Commissioner v. Glenshaw Glass Co.* so the definition of income includes all "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."⁵⁶ The Court would rely on this definition in *Banks* to find that contingent attorneys' fees are income. However, there are numerous instances of the IRS declining to apply this definition of income to certain accessions that should otherwise fall within its scope.⁵⁷ This indicates that I.R.C § 61(a) is treated as a standard, which is open to some degree of interpretation, rather than a rule, which would require statutory authority

⁵¹ Id.

⁵² Of the 13 statutes enforced by the Consumer Financial Protection Bureau, 10 contain fee-shifting provisions.

⁵³ Hall v. Cole, 412 U.S. 1 (1973).

⁵⁴ Hollis v. Roberts, 984 F.2d 1159 (1993) The Eleventh Circuit reiterated this position in Moton v. Nathan & Nathan, P.C., 297 Fed. Appx. 930 (2008).

⁵⁵ Banks, *supra* note 15, at 434-45.

⁵⁶ Comm'r v. Glenshaw Glass, 348 U.S. 426, 431 (1955).

⁵⁷ Among others, the IRS has declined to count employee-retained frequent flyer miles, "swag bags," and support other than alimony as income within I.R.C. 61(a). Alice G. Abreau & Richard K. Greenstein, *Defining Income*, 11 FL. TAX REV. 295, 307, 319 (2011); Alice G. Abreau & Richard K. Greenstein, *The Rule of Law as Standards: Interpreting the Internal Revenue Code*, 64 DUKE L. J. ONLINE 53 (2015).

to deviate from.⁵⁸ As a standard, I.R.C. § 61(a) could feasibly be interpreted by the IRS as excluding statutory fee awards from income.

In addition to the public policy reasons, there is a legal argument for the IRS to exclude attorneys' fees awarded under a statute from income. In his amicus brief in *Banks*, Professor Charles Davenport explained that attorneys' fees represent transaction costs, not income.⁵⁹ Transactions costs, like those involved in real estate sales, are "offset against the recovery they produce,"⁶⁰ and are not included in income. The IRS has treated transaction costs in this way since income tax was first introduced.⁶¹ If the IRS changes its position that statutory fee awards are income and instead classifies them as transaction costs, the negative effects of current tax law and the recent suspension of the below-the-line deduction for consumers could be completely mitigated in many cases.

While taking this approach would put the IRS at odds with the *Banks* decision, there is ample reason to believe that the IRS's current position is contrary to congressional intent and should be revisited.

2. Congress should clarify its intent.

The favorable tax treatment given to reimbursed legal fees in civil rights and employment cases was not guaranteed until the passage of the American Jobs Creation Act of 2004. The Act amended the tax code to include I.R.C. 62(a)(20) which provides for an above-the-line deduction for earned attorneys' fees awarded in actions involving a discrimination claim.⁶² The amendment was perceived as clarifying Congress' existing intent for the provisions.

On the U.S. Senate floor, shortly after the Act's passage, former Senator Max Baucus (D-MT) stated: "it was never the intent of Congress that the attorneys' fees portions of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes."⁶³ Senator Charles Grassley (R-Iowa), then the Chairman of the Senate Finance Committee, also confirmed that "the courts and IRS should not treat attorneys' fees and other costs as taxable income."⁶⁴

Congress should look towards the 2004 Jobs Act as a model to clarify the tax treatment of reimbursed legal fees in consumer cases. Specifically, Congress should amend the tax code to create an above-the-line deduction like the one available in civil rights and employment cases. An amendment would eliminate the unfair tax burden for consumers seeking to

⁵⁸ See generally, The Rule of Law as Standards, *supra* note 71.

⁵⁹ Professor Davenport characterizes the tort claims of plaintiffs as property and attorneys' fees as the transaction costs needed to acquire and dispose of those claims. Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents at 3-5, *Comm'r of Internal Revenue v. Banks*, 534 U.S. 426 (2005) (Nos. 03-892, 03-907).

⁶⁰ *Id.* at 6.

⁶¹ *Id.*

⁶² I.R.C § 62(a)(20)

⁶³ Joint Supplemental Brief for Respondents at 3, *Commissioner of Internal Revenue v. Banks*, 534 U.S. 426 (2005) (Nos. 03-892, 03-907).

⁶⁴ *Id.*, at 4.

enforce legal protections, and would help to fulfill the Congressional intent of the underlying consumer protection statutes.

Sample language for an amendment:

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action arising under a federal, state, or local consumer protection statute that awards attorneys' fees to a prevailing party as part of a fee-shifting provision. 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 a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

If Congress never intended for attorneys' fees awarded to be taxed as income for the consumer and if the 2004 Jobs Act amendment was never intended to be a change in then-existing policy, then there is little justification for the current tax treatment of legal fees awarded under statutes. To fix this issue, Congress should amend the Internal Revenue Code to reaffirm its intent.

Conclusion

The current tax treatment of reimbursed legal fees in consumer cases has created burdensome financial problems for consumers, while undermining the effectiveness of core consumer protection statutes. These issues will only be exacerbated by the provisions of the 2017 TCJA that suspend availability of the miscellaneous itemized deduction.

Consumers may become financially worse off for having prevailed in litigation against bad business actors due to the tax burdens that can be created by an award of earned attorneys' fees. While the below-the-line deduction has been an imperfect solution and is subject to a host of limitations, it provided some relief. A simple clarification in the tax law to guarantee above-the-line deduction for legal fees awarded under consumer protection laws will ensure fair treatment for consumers seeking to enforce their rights.

Glossary of Terms

Above-the-Line Deduction: An adjustment to a taxpayer's gross income. If a taxpayer can claim an above-the-line deduction, then the entire dollar amount of the deduction reduces taxable income in computing "Adjusted Gross Income."

Adjusted Gross Income: A taxpayer's gross income minus above-the-line deductions. This is the amount that most taxpayers will pay income tax on.

Alternative Minimum Tax: A tax rate calculated separately from standard income tax, which generally affects higher income taxpayers. Those affected must calculate their tax liability under the standard rules and the AMT rules and then pay the higher of the two.

Below-the-Line Deduction: An adjustment to a taxpayer's already determined adjusted gross income. Some below-the-line deductions are only available for amounts in excess of 2% of the taxpayer's gross income and cannot be claimed by taxpayers who are subject to the Alternative Minimum Tax.

Fee-Shifting Provision: A statutory allowance in consumer statutes for a winning consumer plaintiff in litigation to be awarded reasonable attorneys' fees.

IRS 1099 Form: A form that reports income other than salary or wages paid by an employer.

Gross Income: An individual's total income before deductions and taxes.

Tax Credit: A sum of money that can be subtracted from the amount of taxes an individual must pay. Eligibility for tax credits depends on the taxpayer's adjusted gross income.

Appendix A

Federal Consumer Protection Statutes with fee-shifting provisions:

- Truth in Lending Act, 15 U.S.C § 1640(a)(3)
- Fair Credit Reporting Act, 15 U.S.C. § 1681n(a)(3)
- Consumer Leasing Act, 15 U.S.C. § 1667d(b)
- Fair Debt Collection Practices Act, 15 U.S.C. § 1692k(a)(3)
- Real Estate Settlement Procedures Act, 12 U.S.C. § 2607(d)(5)
- Interstate Land Sales Full Disclosure Act, 15 U.S.C. § 1709(c)
- Equal Credit Opportunity Act, 15 U.S.C. § 1691e(d)
- Electronic Funds Transfer Act, 15 U.S.C. § 1693m(a)(3)
- Fair Credit Billing Act, 15 U.S.C. § 1640(a)(3) (part of TILA)
- Magnusson Moss Warranty Act, 15 U.S.C. § 2310(d)(2)
- Electronic Communications Privacy Act, 18 U.S.C. § 2707(b)(3)
- Fair and Accurate Credit Transaction Act, 15 U.S.C. § 1681n(a)(3)
- Homeowners Protection Act, 12 U.S.C. § 4907(a)(4)
- Home Ownership and Equity Protection Act, 15 U.S.C. § 1640(a)(3)
- Expedited Funds Availability Act, 12 U.S.C. § 4010(a)(3)
- Consumer Credit Protection Act, 15 U.S.C. § 1640(a)(3)
- Military Lending Act, 10 U.S.C. § 987(f)(5)(B)
- Servicemembers Civil Relief Act, 50 U.S.C. § 4042(b)
- Home Equity Loan Consumer Protection Act, 15 U.S.C. § 1640(a)(3)
- Credit Repair Organizations Act, 15 U.S.C. § 1679g(a)(3)

State Unfair and Deceptive Practices Statutes with fee-shifting provisions:

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| - Ala. Code § 8-19-10(a)(3) | - Neb. Rev. Stat. § 59-1609 |
| - Alaska Stat. § 45.50.537 | - Nev. Rev. Stat. § 41.600(3)(b) |
| - Arkansas: Ark. Code § 4-88-113(f) | - N.H. Rev. Stat. § 358-A:10(1) |
| - Cal. Civ. Proc. Code § 1021.5 | - N.J. Stat. Ann. § 56:8-19 |
| - Colo. Rev. Stat. § 6-1-113(2)(b) | - N.M. Stat. Ann. § 57-12-10(C) |
| - Conn. Gen. Stat. § 110g(d) | - N.Y. Gen. Bus. Law §§ 349(h), 350e(3) |
| - D.C. Code § 28-3905(k)(1)(B) | - N.C. Gen. Stat. § 75-16.1 |
| - Fla. Stat. Ann. § 501.2105 | - N.D. Century Code § 51-15-09 |
| - Ga. Code § 10-1-399(d) | - Ohio Rev. Code § 1345.09(F) |
| - Haw. Rev. Stat. § 480-13(a)(1), (b)(1) | - Okla. Stat. Ann. tit. 15, § 761.1(A) |
| - Idaho Code § 48-608(4) | - Or. Rev. Stat. § 646.638(3) |
| - 815 Ill. Comp. Stat. Ann. § 505/10a(c) | - 73 Pa. Stat. § 201-9.2(a) |
| - Ind. Code § 24-5-0.5-4(a) | - R.I. Gen. Laws § 6-13.1-5.2(d) |
| - Kan. Stat. § 50-634(e) | - S.C. Code § 39-5-140(a) |
| - Ky. Rev. Stat. § 367.220(3) | - Tenn. Code § 47-18-109(e) |
| - La. Stat. Ann. § 51:1409(A) | - Tex. Bus. & Com. Code § 17.(50(d) |
| - Me. Rev. Stat. Ann. tit. 5 § 213(2) | - Utah Code Ann. § 13-11-19(5) |
| - Md. Code Comm. Law § 13-408(b) | - Vt. Stat. Ann. tit. 9, § 2461(b) |
| - Mass. Gen. Laws ch. 93A, § 9(4) | - Va. Code Ann. § 59.1-204(B) |
| - Mich. Comp. Laws Ann. § 445.911(2) | - Wash. Rev. Code § 19.86.090 |
| - Minn. Stat. § 8.31(3a) | - W. Va. Code § 46A-5-104 |
| - Mo. Rev. Stat. § 407.025(1) | - Wis. Stat. Ann. §§ 100.18(11)(b)(2), |
| - Mont. Code § 30-14-133(3) | 100.20(5) |