

SB

300

ALASKA STATE LEGISLATURE
SENATOR BERT K. STEDMAN

SESSION

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MEMORANDUM

DATE: February 6, 2004

TO: Senator Ralph Seekins
Chair, Senate Judiciary Committee

FROM: Senator Bert K. Stedman *for*

SUBJECT: Judiciary Hearing SB 300

Thank you for agreeing to hear SB 300 during the Judiciary Committee Meeting on Monday, February 9th. Attached please find my Sponsor Statement and 3 letters of support for this bill.

I have asked the following individuals to be available to testify Monday morning:

- William B. Schendel, Attorney of Winfree Law Office
- Kevin J. Walsh, CPA, CVA of Walsh, Kelliher & Sharp, Certified Public Accountants
- Jo A. Kuchle, Attorney of Cook Schuhmann & Groseclose, Inc.

There may be a few other member of the public that would like to testify as well.

Thank you again for your time and consideration.

DISTRICT A

*Ketchikan • Sitka • Petersburg • Wrangell
Pelican • Elfin Cove • Port Alexander • Saxman • Meyers Chuck • Thorne Bay • Coffman Cove • Hollis*

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Fax (907) 225-0713

MEMORANDUM

DATE: February 5, 2004

TO: Senator Ralph Seekins
Chair, Senate Judiciary Committee

FROM: Senator Bert K. Stedman 

SUBJECT: Request for Judiciary Hearing (Pending Referral)

Tomorrow, the Senate is scheduled to introduce a bill I'm sponsoring for *an act relating to an attorney's lien, to court actions and to other proceedings where attorneys are employed*. The bill will be numbered at that time.

Pending referral of this bill to the Senate Judiciary Committee, I respectfully request a committee hearing at your earliest convenience.

Thank you for time and consideration.

DISTRICT A

Ketchikan • Sitka • Petersburg • Wrangell
Pelican • Elfin Cove • Port Alexander • Saxman • Meyers Chuck • Thorne Bay • Coffman Cove • Hollis

SENATOR BERT STEDMAN

Senate District A



State Capitol, Room 30, Juneau, Alaska 99801-1182 Phone (907) 465-3873 Fax (907) 465-3922

SPONSOR STATEMENT

SB 300

SB 300 eliminates a double taxation issue affecting many Alaskan taxpayers.

Because of a peculiarity in Alaskan law, Alaskans who win in court may pay federal income tax on phantom income. When Alaskans file their federal tax return, they must report any litigation recovery allocated to attorney fees as gross income, even though they receive no economic benefit from those fees. As a consequence, the federal government taxes that portion of the prevailing side's award twice; once as income to the client and again as income to the client's attorney. Incredibly, there is no federal tax deduction to offset this inequity.

Under current Alaska lien law <AS 34.35.430>, attorneys have a "subordinate lien" or ownership interest in the "cause of action". Other states, like Oregon, use different language to specify that as long as an attorney has filed an appropriate lien and is owed money by the winning client, all fee awards or payments made to the client belong exclusively to the attorney. In so vesting the attorney with the property interests of the award, those states avoid the unfair tax burden currently imposed on Alaskans. Instead, any portion of an award retained to pay attorney contingency fees, isn't reportable income to the client.

SB 300 changes Alaskan law to prevent the IRS from taxing Alaskans on income they don't receive. This bill recognizes that fee awards passing through to one's attorney are income to the attorney. And as such, the attorney is responsible for paying federal income tax on that portion of their income.



DANIEL E. WINFREE
AIMEE ANDERSON ORAVEC
CASSANDRA J. TILLY

WINFREE LAW OFFICE
A Professional Corporation

OF COUNSEL:
WILLIAM B. SCHENDEL
SHELLEY D. EBENAL

301 Cushman Street, Suite 200 • Fairbanks, Alaska 99701-4629 • 907.451.6500 Telephone • 907.451.6510 Facsimile

February 6, 2004

FAX: 907 465-3922

Senate Judiciary Committee
Butrovich 205
State Capitol
Juneau, AK
Attn: Sen. R. Seekins, Chairman

Re: SB 300 – attorney lien amendment

Dear Chairman Seekins and Members,

SB 300 has been favorably reviewed by a broad range of practicing Alaskan attorneys who represent all sides of many different kinds of disputes. Just recently, at the February 4, 2003, regular monthly meeting of the Employment Law Section of the Alaska Bar Association, 22 attorneys from Fairbanks, Anchorage, Juneau, and Kotzebue discussed the draft, after hearing from tax and other experts. While the Section is not permitted to lobby or endorse legislation, I can represent that, of those present, not a single person voiced any objection to the bill;¹ all comments were favorable with regard to passage. A number of participants, in fact, recounted examples of unfair taxation of clients who had received fee awards and who were then obligated to pay over the fees to their attorneys without taking a corresponding deduction from their gross income. Other attorneys commented that the unfair taxation of fee awards drives up the cost of settlement for the opposing party.

This bill, if passed, would eliminate the current double taxation of fee awards, and will make fee awards taxable only to the recipient attorney, and not to the prevailing litigant. The bill makes the Alaska lien statute track the Oregon lien statute, which the federal Court of Appeals has held is effective to eliminate double taxation.² The bill appropriately recognizes that earlier-asserted liens of any origin will prevail over a later-filed attorney lien, and that a later-filed tax lien will even prevail over an earlier attorney

¹ Thus, these comments do not reflect the official position of the Alaska Bar Association. The Association has not taken a position, nor has it been asked to take a position.

² Banaitis v. CIR, 340 F.3d 1074 (9th Cir. 2003).

Schendel letter to Sen.Jud. Comm.

February 6, 2004

Page two

lien. By eliminating double taxation, this bill, if passed, will result in substantial savings to Alaskan citizens, whether plaintiffs or defendants.

I urge the passage of SB 300.

Thank you.

Sincerely yours,



William B. Schendel
Of Counsel

Walsh Kelliher & Sharp

A Professional
Corporation



Certified Public
Accountants

Advisors
to Business



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February 6, 2004

Senator Bert Stedman
Senate Judiciary Committee
State Capitol
Room 30
Juneau, AK 99801

Re: SB 300; Attorney Lien Amendment

Via fax (original in mail): 907-465-3922

Dear Senator Stedman,

I would like to thank you for giving this legislation a hearing. It has the potential to fix what I consider to be grievous miscarriages of justice. Although the proposed legislation is quite simple, the story behind the need for this is a bit more complicated. If you have this information from other sources, please just consider this a message from a citizen speaking in favor of the bill.

If you need to know more about the issue I am happy to be of service. First I would like to give you some background on the Federal income tax consequences of an award to the plaintiff of attorney fees and litigation costs.

Both Alaska and Oregon lie under the jurisdiction of the Ninth Circuit Court of Appeals and the decisions of the Ninth Circuit control the decisions of the United States Tax Court for cases of taxpayers residing in the Alaska and Oregon. I realize you undoubtedly know this but it becomes very relevant to this legislation.

The Ninth Circuit in *Coady vs. Commissioner*, 85 AFTR 2d 2000-2049. (213 F.3d 1187), 06/14/2000 looked at a Federal income tax case, the result of which turned on Alaska law. Nona Coady was an employee of the Alaska Housing Finance Corporation. She lost her job and later prevailed in employment litigation and won an award for back wages and benefits lost as a result of wrongful termination. The issue with respect to their tax return for the year involved whether the Coadys needed to include in income the portion of the award that went to their attorneys. The Ninth Circuit indicated that the plaintiff must include the attorney fees in income.



Businesses that receive damage awards or other lawsuit awards must also include the gross amount in income, but businesses are allowed to deduct all of their legal costs against the award so that they only pay tax on the net proceeds.

If tax law provided that damages in the employment context were taxed only to the extent of net proceeds we would not have a problem and the desperate need for your assistance. Unfortunately, the tax law does not tax the net proceeds of non-business cases, at least in Ninth Circuit cases dealing with Alaska, but rather taxes the entire award to the plaintiff. A limited deduction for attorney fees and litigation costs is allowed for regular tax purposes and no deduction at all is allowed for purposes of the alternative minimum tax. At least one taxpayer has tried to claim, under a reimbursement theory, a direct deduction of legal expenses against the gross award and been rejected by the Ninth Circuit. See *Biehl v. Com*, 92 AFTR 2d 2003-7280, (CA9)12/12/2003.

The alternative minimum tax is a tax computation which parallels the regular tax computation in many respects. All taxpayers are required to compute their tax liability under both systems and pay the government under the computation which produces the highest tax. The courts have repeatedly struck down arguments that the alternative minimum tax is unconstitutional or does not apply on other grounds. See *Banaitis v. Com*, 92 AFTR 2d 2003-5840, 340 F3d1081 (CA9, 8/27/2003)

One important area in which these two systems differ is in the treatment of miscellaneous itemized deductions related to employee business expenses. These deductions, authorized under Internal Revenue Code Section 67, are deductible to as itemized deductions to the extent they exceed 2% of adjusted gross income.

For alternative minimum taxes purposes however, Internal Revenue Code Section 56(b)(1)(A)(i) provides that "No deduction shall be allowed for any miscellaneous itemized deduction."

This means that the payment of attorney fees provides no benefit for purposes of the alternative minimum tax. This can create horrific consequences to a successful plaintiff. We have had situations in our practice where a successful plaintiff, after paying attorney fees and taxes, had paid out more in attorney fees and taxes than they received in gross proceeds.

In addition, we have seen cases where public interest litigants and the disadvantaged have successfully sued to stop illegal behavior. The award often times consists of 90-95% legal fees with a small amount of damages. In these instances the income tax liability greatly exceeds the damages. In some instances the inclusion in income, of money they did not get to keep, ended up causing problems with government programs and scholarships which look at gross income for eligibility. It ends up costing victims in this area more than just the tax bill when they win.

In a good example of this, which is public knowledge, in August 2002, the New York Times reported that a female police officer who was the victim of "reprehensible" sexual

harassment received an award of \$300,000 as well as legal fees of almost \$1 million. According to the story this victim will end up paying all of her \$300,000 award, as well as almost \$100,000 more, to settle income taxes due on the gross award. The defendant surely must have enjoyed reading how the winner in court lost it all plus thousands more to the IRS. See *Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2nd 764 (2002).

For a published case laying this out see *Alexander v. Com* 77 AFTR 2d 96-301 (72 F3d 938) (Ca1 1995) in which the successful (or more appropriately termed, unsuccessful) litigant received an award of approximately \$250,000 out of which \$245,000 was paid in legal costs. The First Circuit upheld the Tax Court and the Internal Revenue Service in finding that this "successful" plaintiff owed over \$57,000 in taxes on his net award of approximately \$5,000 due to the alternative minimum tax disallowing the entire amount of attorney fees as a deduction.

If the plaintiff in a Alaskan case were to succeed, the Internal Revenue Service would have the backing of the Tax Court and the Ninth Circuit Court of Appeals in finding that the plaintiff would be taxable on the entire gross award. A limited deduction for attorney's fees and litigation costs paid would be available for regular tax purposes and no portion of the attorney's fees or litigation costs would be deductible for alternative tax purposes.

Some other circuit courts of appeal have held for the taxpayer in these types of cases but the majority of circuit courts have held for the government.

In spite of a conflict between the Ninth Circuit opinion and those of other circuits (see *Cotnam and Clarks*), the United States Supreme Court denied a petition for certiorari on April 16, 2001. This means that we will not have a "once-and-for-all" decision settling the matter for the entire country.

The Ninth Circuit eliminated any doubt about the steadfastness with which they held their opinion when they subsequently decided the issue several more times in other cases. *Sinyard v. Com.* [88 AFTR 2d 2001-6037, 268 F3d 759 (CA9, 9/25/2001)] and *Benci-Woodward v. Com.*, [86 AFTR 2d, 2000-5404, 219 F3d 942 (CA9, 7/18/2000)]

Now, (Finally!, Thank you for your patience if you are still reading this at this point) we get to the possible solution to the problem.

The Ninth Circuit found that these cases turned on local (state) law. If state law provided that the debt (attorney's fees) was a valid debt of the plaintiff then a payment of this debt by the defendant would result in income to the plaintiff. The court stated their reasoning, perhaps most succinctly, in the *Sinyard* case when they stated that "If A owes B a debt, and C pays the debt on A's behalf, it is elementary that C's payment is income to A as well as to B."

The Ninth Circuit, in reviewing the laws of Alaska (Coady), Arizona (Sinyard) and California (Benci-Woodward) held that the laws of the state(s) made the successful plaintiffs the owners of the entire award. The attorneys with whom the plaintiffs had contingent fee agreements were considered debtors of the plaintiffs.


The importance of this distinction was borne out in *Banaitis v. Com.* 92 AFTR 2d 2003-5840, 340 F3d1081 (CA9, 8/27/2003) where the Ninth Circuit held that, under Oregon law, the attorneys in a successful plaintiff case were the lawful owners of their portion of the award. Therefore the payment of the plaintiff attorney by the defendant **did not** result in income to the plaintiff because the plaintiff did not owe the attorney a portion of the award. The plaintiff was considered to have dominion only over the gross award less the attorney fees and costs. The attorney, under Oregon law, had a sufficient bundle of rights to be deemed the owner of the attorney's portion of the award. Thus, the taxpayer in this Oregon case only paid tax on the net proceeds.

We know that much of Alaska law has been modeled on Oregon law. What we are proposing in this legislation is that Alaska law, in the area of attorney liens, be molded to match Oregon. We are not asking for any more than what Oregon law provides, in fact, we want exactly what Oregon has as law in this area. Since the Ninth Circuit has said that Oregon taxpayers are treated favorably because of the wording of their attorney lien law we hope that Alaskan taxpayers can also get favorable treatment if our law matches that of Oregon exactly.

Keep in mind that the attorney, in all cases, must also include the fees received in income. We are not proposing anything that would change the taxation of the attorney. We are trying to eliminate the double taxation of the same money.

I realize that the Supreme Court or Congress should settle this matter and that would really be my preference. Both the high court and Congress have been made aware of this issue and declined to deal with it. Therefore, I implore you to do for Alaskan taxpayers what the Federal government refuses to do for them. Please allow Alaskan taxpayers to pay income taxes only on what they get to keep and help eliminate the tax penalty for fixing injustices.

Respectfully,


Kevin J. Walsh, CPA, CVA

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February 5, 2004

Sender's e-mail address:
jkuchle@alaskalaw.com

VIA Facsimile 907-465-3922

Sen. Bert Stedman
State Capital Room 30
Juneau, AK 99801

Re: *Senate Bill 300: Attorney Lien Amendment*

Dear Senator Stedman:

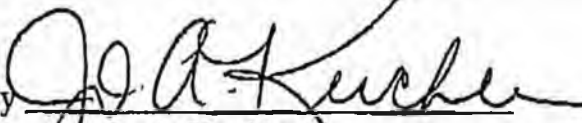
Thank you for introducing this important bill to eliminate the double taxation of fee awards on Alaskan taxpayers. The 9th Circuit Court of Appeals has held that on a recovery in a court proceeding, that portion subject to an attorneys fee award is taxable to the plaintiff/taxpayer. Then when the plaintiff pays the attorney, the income is taxed a second time. The 9th Circuit has recognized an exception in Oregon, where the attorney lien statute makes the portion owed to the attorney a superior lien. Based on that difference, Oregon taxpayers -- who are also in the 9th Circuit -- avoid the double taxation issue. The portion paying the attorney is taxed only to the attorney and not to the plaintiff/taxpayer.

Your legislation will help many Alaskan taxpayers avoid this often disastrous tax result. By amending Alaska's attorney lien statute to match Oregon's, this inequitable tax result should be avoided under the current 9th Circuit rulings. Thank you again.

Should there be any hearings before the Senate Judiciary Committee, please let me know the date and time as I would be willing to testify.

Sincerely,

COOK SCHUHMANN & GROSECLOSE, INC.

By 
Jo A. Kuchle



2/12/04

Tax Report

By Tom Herman

How You Can Lose By Winning a Suit

How much you owe Uncle Sam sometimes can depend on where you live. And sometimes you can get slapped with a hefty tax bill on money you didn't pocket. How so? The answer lies in a string of differing federal appeals-court decisions affecting people who have won awards or received settlements in cases involving charges of racial, sexual or age discrimination, wrongful job termination or other nonphysical personal-injury battles.

This long-simmering subject is back in the news again because of a recent ruling by the U.S. Appeals Court for the Second Circuit. The case involves David Raymond, a Vermont man who sued International Business Machines Corp. alleging wrongful termination. A jury awarded him nearly \$900,000 in the late 1990s. The law firm handling his case received about one-third as a contingency fee.

A federal district-court judge later said Mr. Raymond could exclude the contingency fee when calculating taxable income. But now the second circuit appeals court has overturned that decision. It said Mr. Raymond had to include the entire award in his taxable income -- even the portion that went to his lawyers. James W. Runcie, a Vergennes, Vt., lawyer who handled the case, said he and his client "are likely to ask the Supreme Court to review the case."

Many people in such situations are out of luck because of the vagaries of the alternative minimum tax, which is hitting growing numbers of unsuspecting Americans. Under the AMT, certain miscellaneous itemized deductions such as legal fees aren't deductible. Another problem is known as the "2% haircut": You can only deduct the amount of certain miscellaneous deductions to the extent they exceed 2% of your adjusted gross income.

Numerous other federal appeals courts have issued similar rulings, forcing victims to pay large amounts of taxes on money they didn't actually get. But a few other federal appeals courts have decided that taxpayers can exclude those fees from gross income. Thus, your tax tab can depend on where you live.

It is even possible for someone to win a big court award and come out with a net loss after paying legal bills and taxes, says Nina Olson, the Internal Revenue Service National Taxpayer Advocate.

The Supreme Court hasn't weighed in, but there is a chance taxpayers could get some congressional relief.

Among lawmakers who favor speedy action is Senate Finance Committee Chairman Chuck Grassley, an Iowa Republican. "It remains a high priority for me that we end this terrible policy where individuals are subject basically to double taxation when they receive a settlement payment," Sen. Grassley said in an e-mail. "We passed legislation in the Senate last year to address this, and I hope we can get the bill to the president's desk this year."

The Raymond case and the split among appeals courts drew attention at a recent tax conference in Los Angeles. "This issue really struck me," says Ruth Madrigal, a lawyer at Irell & Manella LLP in Los Angeles. She points to "the complete lunacy of the vast difference in results depending on which state you reside in when the issue goes to court."

This issue has been discussed at length in tax publications such as Tax Notes, an influential weekly from Tax Analysts, based in Arlington, Va. The subject also was analyzed in the IRS National Taxpayer Advocate's report to Congress for fiscal 2002.

"Legislation is needed to resolve the split among the circuit courts of appeal regarding the taxation of attorney fees," the IRS National Taxpayer Advocate's report said. The report outlined several suggestions and recommended this one: Include legal fees in your gross income but allow those fees to be deducted when calculating adjusted gross income, or AGI. That's known as an "above-the-line" deduction since it would appear on your return above the line for AGI.

Such a change "would effect uniform treatment" for all people who receive these awards and settlements, "irrespective of their place of residence," Ms. Olson's report concluded.

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: SB300-ACS-TC-2-19-04
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: _____
 Title Attorney's Liens BRU Alaska Court System
 Component Trial Courts
 Sponsor Senator Stedman
 Requester _____ Component No. _____

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2004) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

The court system does not anticipate any fiscal impact from the passage of SB 300.

Prepared by: Doug Wooliver Administrative Attorney Phone 463-4750
 Division Alaska Court System Date/Time 2/19/04 8:23 AM
 Approved by: Stephanie Cole Administrative Director by Doug Wooliver Date 2/19/2004
 Agency Alaska Court System

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: SB300-LIAW-C&FB-2-9-0
 Bill Version: SB300
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: LAW
 Title "An Act relating to an attorney's lien ... and to RDU CIVIL
other proceedings where attorneys are employed." Component Commercial & Fair Business
 Sponsor Senator Stedman
 Requester Senate Judiciary Component No. _____

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

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Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2004) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: *(Attach a separate page if necessary)*
 This bill amends AS 34.35.430 by allowing an attorney's lien for fees and costs to supersede all other subsequent liens except tax liens.

 Passage of this legislation will have no foreseeable fiscal impact on the Department of Law.

Prepared by: Kathryn A. Daughettee, Director Phone 465-3673
 Division: Administrative Services Date/Time 2/9/04 1:42 PM
 Approved by: Kathryn Daughettee for Gregg D. Renkes, Attorney General Date 2/9/2004
 Agency: Department of Law

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: SB300-DNR-REC-02-19-04
() Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Natural Resources
Title Attorney's Lien RDU Resource Development
Component Recorder's Office
Sponsor Sen. Stedman
Requester Sen JUD Component No. 423

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2004) cost: 0.0
Check this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

There is no fiscal impact to DNR associated with implementation of this legislation.

Prepared by: Vicky Backus Phone 907-269-8882
Division: Recorder's Office Date/Time 2/19/04
Approved by: Thomas Irwin, Commissioner Date 2/19/04
Agency: Natural Resources