

TAX LITIGATION ISSUES

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Question: Who Pays the Tax on Attorney's Fees Awards?

It's hard to answer the question of who pays the tax on attorney's fees awards. After years of disagreement among the circuit courts of appeals, earlier this month the U.S. Supreme Court heard argument in two cases to resolve the issue of whether a taxpayer's gross income from proceeds of litigation include that portion of his recovery that is paid to his attorneys pursuant to a contingency fee agreement.¹ The resolution of this dispute will presumably promote the uniform application of the tax law to similarly situated taxpayers in an area that has been the subject of frequent and disparate analysis by the circuit courts and which, until recently, was overlooked by Congress.

Internal Revenue Code

The Internal Revenue Code provides that certain personal injury recoveries are excludable from gross income. In other actions, however, the plaintiff's recovery will be included in gross income. Where the action seeks damages associated with a trade or business, only the net recovery is included in gross income. In other cases, expenses

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related to the recovery, including attorney's fees, are deductible as an expense subject to limitations such as the 2 percent floor on miscellaneous itemized deductions. When the alternative minimum tax (AMT) is applied, however, no deduction is allowed for such expenses. Under the recently adopted Jobs Act of 2004, a taxpayer obtaining an award in any claim of unlawful discrimination (and certain other claims) may deduct attorney's fees "above the line" to the extent of his or her recovery in the year the fees are paid.² Thus, in these certain cases, only the net award is included in the taxpayer's adjusted gross income. However, in those cases not covered by the Jobs Act, the treatment of attorney's fees awarded to the plaintiff remains a significant issue.

The Internal Revenue Service (IRS) has consistently maintained that contingency fees and awards of attorney's fees under fee-shifting statutes must be included in the client's gross income as well as the income of the attorney actually receiving the funds. This position can (and has) yielded grossly unfair

results for taxpayers. For example, in one pre-Jobs-Act sexual harassment and discrimination case, a plaintiff recovered \$300,000 in damages and almost \$1 million in attorney's fees and costs, only to have the entire fee award included in her gross income, resulting in a tax liability that far exceeded her \$300,000 recovery.³ And in many cases where attorney's fees are includable in gross income, plaintiffs have not been able to deduct those fees either because the fees are subject to limitations on itemized deductions or through application of the AMT.

Anticipatory Assignment of Income

The IRS bases its inclusion of attorney's fees in gross income on the anticipatory assignment of income doctrine which was set forth in two Supreme Court cases, *Lucas v. Earl* and *Helvering v. Horst*.⁴ In *Earl*, the Court found that the taxpayer's act of assigning one-half of his future salary to his wife was an attempt to "attribute fruits to a different tree from that on which they grew" and that the husband could not escape taxation by "anticipatory assignments and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." Similarly, in *Horst*, a taxpayer gave his son the interest coupons from negotiable bonds that he had held prior to the bonds' maturity dates.

Because the taxpayer had earned the right to receive and enjoy the benefit of the income and the interest was guaranteed to the taxpayer at the time he transferred the coupons, the taxpayer was deemed liable for the corresponding taxes.

The majority of circuit courts addressing the issue of how to treat that portion of a litigation recovery that is payable as attorney's fees have held that such sums are includable in the taxpayer's gross income.⁵ These courts have determined that although the attorney may have an interest in the fee under state law, that interest is merely a "security" interest, concluding that the fee is income to the client upon which the attorney has a lien.

By contrast, a minority of circuit courts have taken the position that contingency fee amounts are income only to the attorney, not to the client.⁶ These courts have found that the attorney has a "property" interest in the fee separate from the client's interest, concluding that the fee was never income to the client. Applying the state-by-state approach, the U.S. Court of Appeals for the Ninth Circuit has found that contingency fees are both includable and excludable depending on the state law involved.⁷

While the outcome of these decisions may differ, their analysis is similar. Most of the courts addressing the issue note that in applying a federal revenue act, state law determines the nature of legal interest in property, while federal law determines the tax consequences of the receipt or disposition of such property. Thus, the various circuit court opinions are consistent in the fact that they analyze state law to determine the respective interests in the contingency fee.

There are, however, courts that have refused to rely on state law in analyzing this issue, stating that "whether amounts paid directly to

attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action."⁸

The U.S. Court of Appeals for the Second Circuit recently weighed in on this issue in *Raymond v. United States*,⁹ and its analysis typifies the majority approach. After analyzing the split among the circuits, the Court set forth the principles related to the anticipatory assignment of income doctrine established in *Horst*, noting the distinction between assigning income-producing property and assigning income derived from property still controlled by the taxpayer. When a taxpayer effects the former, he is not properly treated as the recipient of income derived therefrom because he has relinquished control over the disposition of income. Under the latter, he properly is treated as the recipient of income despite having "shifted" it to another because he has retained control of the source of the income.

Concluding that applicable Vermont state law did not provide attorneys with a proprietary interest in their client's claims, the Court reasoned that the analysis of whether something is "gross income" begins with whether it can reasonably be considered a "gain" to the taxpayer under 26 USC §61 (a). Although Mr. Raymond neither received the funds, nor had a right to them given the security lien placed on them under Vermont law, he still realized a gain subject to taxation because he derived value from the assignment of the contingent fee in that it enabled him to procure an attorney to obtain a damages award. Rejecting the district court's arguments that a contingency fee is not the equivalent of an anticipatory assignment of income, the court of appeals found that the judgment flowing to Mr. Raymond was income

to him, and the expense of producing that income — his attorneys' fee — was merely a deductible expense under §212(1) of the Tax Code.

Given that the inclusion of the entire damages recovery in his gross income caused Mr. Raymond's tax liability to be controlled by the AMT, he was not entitled to this deduction. The Court, however, did not view this as changing the result, reasoning "[t]hat the AMT precludes [Mr.] Raymond from taking advantage of that deduction is unfortunate, but it is not a reason to create an artificial contingent-fee exception to the rule that one is taxable on income from a source over which one retains control."

The 'Banks' Case

Unlike *Raymond*, in *Commissioner v. Banks*, one of the cases the Supreme Court recently heard, the U.S. Court of Appeals for the Sixth Circuit rejected the notion that case-by-case determinations were to be made based on distinctions between the lien theories of the various states. Rather, the Court stated that "such a 'state-by-state' approach would not provide reliable precedent ... or provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorney's fees paid from their respective jury awards." In determining that contingency fee amounts should not be included in a taxpayer's gross income, the *Banks* Court relied on *Cotnam v. Commissioner*,¹⁰ in which the U.S. Court of Appeals for the Fifth Circuit concluded that the anticipatory assignment of income doctrine set forth in *Earl* and *Horst* did not apply to the contingency-fee arrangement between the taxpayer and her attorney. Following *Cotnam*, the *Banks* Court found that "(1) the contingency fee never passed through the taxpayer's hands or was controlled by the taxpay-

er, and (2) only the attorney's services resulted in converting the uncertain claim into an item of value."

The *Banks* Court further noted that it had previously rejected the anticipatory assignment doctrine in *Estate of Clarks v. United States*.¹¹ In that case, the U.S. Court of Appeals for the Sixth Circuit distinguished *Earl* and *Horst* on three additional grounds. First, the income assignments in those cases were made for the purpose of avoiding taxes, unlike the situation in a contingency fee arrangement. Second, the assignees in the anticipatory assignment of income cases had done nothing to earn their income, unlike an attorney who provides specialized skills and services to earn the contingency fee. Finally, because the assignees in *Earl* and *Horst* could exclude the income they received as gifts, the income would escape taxation altogether. Conversely, in a contingency fee situation, the income would be taxed twice — once as income to the taxpayer and once as income to the attorney. Relying on these distinctions, the Sixth Circuit in *Banks* rejected the commissioner's argument that the contingency fee portion of the recovered judgment was taxable income to the taxpayer.

Despite the fact that the *Estate of Clarks* holding referred to the nature of lien law in the state of Michigan, the *Banks* Court found that the state law analysis was not its primary rationale in finding that contingency fee amounts should not be included in a client's gross income. Accordingly, the Court held that "we will follow our precedent without protracted inquiries into 'the intricacies of an attorney's bundle of rights.' The nature of Petitioner's attorney's rights notwithstanding, the facts of this case are within the scope *Estate of Clarks* contemplated: By signing the contingency fee agreement, Petitioner transferred some of the trees from the orchard,

rather than simply transferring some of the orchard's fruit."

Unlike the Sixth Circuit's rejection of typical state lien law analysis, in *Commissioner v. Banaitis*, the second case in which the Supreme Court heard argument, the U.S. Court of Appeals for the Ninth Circuit examined the applicable state law in determining that fee amounts paid to the taxpayer's attorney were not includable in the taxpayer's gross income. In addressing the anticipatory assignment of income issue, the court noted that "[a]s a rule, plaintiffs cannot avoid the tax consequences of a personal injury judgment or settlement through an anticipatory assignment of a portion of the proceeds to their attorneys in payment of a contingent fee. In certain contexts, however, state law may operate to provide the plaintiff's attorney greater rights than the lawyer would have under a contingent fee contract." Despite earlier Ninth Circuit opinions determining that contingency fee amounts were includable in a taxpayer's gross income, the court found that "unique features" of Oregon law required them to find the opposite in this case.

As the Second Circuit noted in *Raymond*, while the *Banks* and *Banaitis* cases are the only ones to independently uphold the minority position, they do so on different grounds. Thus, having agreed to review both of these cases, the Supreme Court will be called upon to decide not only whether contingency fees paid to an attorney are includable in the client's gross income, the precise question the Court agreed to hear, but also the appropriate analysis of this question. The resolution of this issue may be important in providing guidance to practitioners in structuring their relations with future clients.

Supreme Opportunity

The inconsistent applications of the

tax law to attorney's fees recovered in litigation have drawn repeated attention from the tax community and increased calls for a more uniform policy with respect to the tax treatment of attorney's fees in damage awards.¹² While Congress has now stepped in to attempt to limit the potential unfair results in certain cases, the Supreme Court has an opportunity to resolve the impasse with its decision in the *Banks* and *Banaitis* cases.



1. *Comm'r of Internal Revenue v. Banks*, 345 F3d 373 (6th Cir. 2003), cert. granted, 124 SCt 1712 (2004); *Comm'r of Internal Revenue v. Banaitis*, 340 F3d 1074 (9th Cir. 2003), cert. granted, 124 SCt 1713 (2004).

2. American Jobs Creation Act of 2004, Pub. L. No. 108-357 (codified as amended in various sections of Title 26).

3. David G. Savage, "A Win-Lose Situation," ABA Journal, November 2004 (discussing *Spina v. Forest Preserve District of Cook County*, 207 FSupp2d 764 (N.D. Ill. 2002)); see also *Alexander v. Internal Revenue Service*, 72 F3d 938 (1st Cir. 1995) (taxpayer recovered \$250,000 in settlement of breach of contract claims, but owed approximately \$245,000 in legal fees; despite fact that outcome "smacks of injustice," First Circuit held that attorney's fees were includable in taxpayer's gross income, resulting in more than \$50,000 in tax liability to client).

4. *Lucas v. Earl*, 281 US 111 (1930); *Helvering v. Horst*, 311 US 112 (1940).

5. See *Raymond v. United States*, 355 F3d 107 (2d Cir. 2004), cert. denied, 4 BNA-USLWSCT 200 (2004); *Campbell v. Comm'r*, 274 F3d 1312 (10th Cir. 2001); *Kenseth v. Comm'r*, 259 F3d 881 (7th Cir. 2001); *Baylin v. United States*, 43 F3d 1451 (Fed. Cir. 1995).

6. See *Davis v. Comm'r*, 210 F3d 1346 (11th Cir. 2000); *Estate of Clarks v. United States*, 202 F3d 854 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F2d 119 (5th Cir. 1959).

7. *Compare Cody v. Comm'r*, 213 F3d 1187 (9th Cir. 2000) (includable under Alaska law), and *Benci-Woodward v. Comm'r*, 219 F3d 941 (9th Cir. 2000) (includable under California law), with *Banaitis v. Comm'r*, 340 F3d 1074 (9th Cir. 2003) (not includable under Oregon law).

8. *Comm'r v. Banks*, 345 F3d 373; *Young v. Comm'r*, 240 F3d 369, 378 (4th Cir. 2001).

9. 355 F3d 107 (2d Cir. 2004).

10. 263 F2d 119 (5th Cir. 1959).

11. 202 F3d 854 (6th Cir. 2000).

12. See David G. Savage, "A Win-Lose Situation," ABA Journal, November 2004; Chris Staton Spicer, Note, "Are Attorney's Fees Income to the Taxpayer? The Inequitable and Inconsistent Result of the Ninth Circuit's State Attorney Lien Law Approach in 'Banaitis v. Commissioner,'" 57 Tax Lawyer 845 (Spring 2004); Robert W. Wood, "Second Circuit Perpetuates Attorney's Fees Snafu," 96 Daily Tax Report J-1, May 19, 2004.

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