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Tax Litigation Issues

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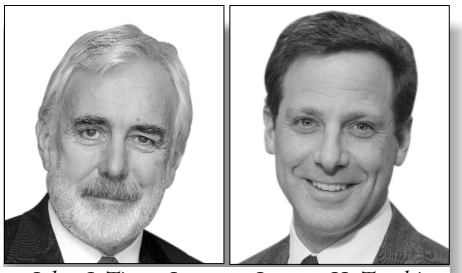
The Supreme Court and Taxes: The 2004-2005 Term

The U.S. Supreme Court issued three tax-related opinions this past term. The first of these is a criminal case holding that the wire fraud statute criminalizes conduct occurring in the United States in an effort to evade foreign taxes. In the second case, the Court rejected the Tax Court's long-standing practice of keeping secret decisions issued by special trial judges, setting off a controversy regarding the fairness of Tax Court proceedings. The third is a classic tax case, concluding that contingent attorney's fees recovered by plaintiffs in civil actions constitute income under the Tax Code.

Schemes to Evade Foreign Taxes

In *Pasquantino v. United States*, the Court held that a plot to defraud a foreign government of tax revenue violated the federal wire fraud statute.[1] This case arose out of the U.S. Court of Appeals for the Fourth Circuit, which had reversed and then affirmed en banc, the conviction of three defendants for violations of the wire fraud statute in connection with a scheme to evade Canadian liquor importation taxes. Over a four-year period, the defendants smuggled liquor purchased in Maryland into Canada by hiding the liquor in their vehicles and not declaring the goods to Canadian customs officials. By doing so, the defendants were able to avoid Canada's weighty taxes on the importation of alcoholic beverages, which were approximately double the purchase price of the alcohol.



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Before trial, defendants moved to dismiss the indictment claiming that it failed to state a violation of the wire fraud statute. Specifically, defendants argued that the wire fraud statute requires the government to prove a scheme to obtain money or property by false or fraudulent means. Arguing that the government lacked a sufficient interest in enforcing the revenue laws of a foreign country, the defendants reasoned that Canada's right to collect taxes was not "money or property" within the meaning of the wire fraud statute. This motion was denied and a jury convicted the defendants.

The defendants appealed to the Fourth Circuit, urging reversal on the same grounds as well as on the ground that the prosecution violated the common-law revenue rule which generally bars courts from enforcing the tax laws of foreign sovereigns. A panel of the Court of Appeals unanimously rejected defendants' argument regarding the meaning of "money or property" within the wire fraud statute, but two judges agreed that the common-law revenue rule mandated reversal. However, on rehearing en banc, the full Court reversed the panel's decision, finding that the common-law revenue rule simply allowed courts to refuse to enforce the tax judgments of foreign nations, but did not preclude the prosecution in this case.[2]

The differing opinions from the Fourth Circuit reflected a larger split among Courts of Appeals over whether a scheme to defraud a foreign government of tax revenue violates the wire fraud statute, and the Supreme Court granted certiorari to resolve this question.[3] Justice Clarence Thomas, writing for a five-justice majority, first addressed defendants' arguments that their conduct did not fall within the literal terms of the wire fraud statute because the government could not establish: (1) that they engaged in a "scheme or artifice to defraud" or (2) that the "object of the fraud…be '[money or] property' in the victim's hands."

With respect to the first element, the Court found that evidence of defendants' repeated concealment of imported liquors from Canadian officials and failure to report the alcohol on customs forms sufficiently demonstrated a "scheme or artifice to defraud" Canada of taxes due on the smuggled goods. In so finding, the Court observed that the fact that federal anti-smuggling statutes and various United States tax treaties overlapped in criminalizing similar conduct did not mean that the defendants' conduct fell outside the terms

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of the wire fraud statute. Further, with respect to the second contested element, the Court held that Canada's right to the uncollected taxes qualified as "property" under the wire fraud statute, stating that this conclusion was consistent with the common law history of fraud.[4]

Finally, the Court turned to the defendants' common-law revenue rule argument. The Court stated that in order to "conclude that Congress intended to exempt the present prosecution from the broad reach of the wire fraud statute, we must find that the common-law revenue rule clearly barred such prosecution," which required an examination of the state of the common law in 1952, the year the wire fraud statute was enacted. In so doing, the Court concluded that no common-law revenue rule case decided as of 1952 had held or implied that the revenue rule barred the government from prosecuting a case involving a fraudulent scheme to evade foreign taxes.[5]

Furthermore, the Court noted that the revenue rule was created primarily to guard against actions seeking to collect the tax obligations of foreign nations. The Court rejected the argument that the revenue rule was implicated by the fact that the Canadian government was the beneficiary of the restitution aspect of the defendants' sentences. Rather, the Court found that "the wire fraud statute advances the Federal Government's independent interest in punishing fraudulent domestic criminal conduct…. The purpose of awarding restitution in this action is not to collect a foreign tax, but to mete out appropriate criminal punishment for the conduct."[6] Finally, the Court said that the prosecution at issue did not promote actions to collect foreign tax obligations, stating that "this prosecution poses little risk of causing the principal evil against which the revenue rule was traditionally thought to guard: judicial evaluation of the policy-laden enactments of other sovereigns."[7]

In her dissent, joined by Justice Stephen Breyer and in part by Justices Antonin Scalia and David Souter, Justice Ruth Bader Ginsburg expressed concern that the majority was ascribing "an exorbitant scope to the wire fraud statute," giving it extraterritorial effect, when defendants' actions were primarily a violation of Canadian tax law and Canada could have availed itself of extradition procedures to enforce its laws if it so wished. The majority objected to this characterization, stating that its interpretation of the wire fraud statute did not give extraterritorial effect because the "offense was complete the moment [the defendants] executed the scheme inside the United States; '[t]he wire fraud statute punishes the scheme, not its success.'"[8] However, the Court's endorsement of the government's prosecution was lukewarm, at best, noting that while "[i]t may seem an odd use of the Federal Government's resources to prosecute a U.S. citizen for smuggling cheap liquor into Canada … the broad language of the wire fraud statute authorizes it to do so and no canon of statutory construction permits us to read the statute more narrowly."

The decision in *Ballard v. Commissioner* is noteworthy because of the repercussions it has had in the tax community. In *Ballard,* the Court struck down the Tax Court's practice of excluding from the record on appeal reports submitted to the Tax Court by special trial judges.[9] These trial judges, appointed by the Tax Court's chief judge, hear certain disputes between taxpayers and the Internal Revenue Service (IRS) and, in cases where the deficiency exceeds $50,000, issue a report containing findings of fact and conclusions of law to the Tax Court. Although these reports frequently are adopted by the Tax Court, since 1983, they have not been made public or even provided to the parties.[10] In examining this practice, the Court held that the concealment of these reports was unwarranted and unauthorized.

In *Ballard,* a Tax Court judge had issued a decision against taxpayers, including the late Burton Kanter, a prominent Chicago tax lawyer, finding that they had engaged in fraud and owed more than $30 million. In his ruling, the judge stated that he "agree[d] with and adopt[ed] the opinion of the Special Trial Judge."[11] However, when the trial judge's opinion was released pursuant to the Supreme Court's decision, it was revealed that the trial judge had, in fact, ruled in favor of the taxpayers, and thus that the Tax Court judge had engaged in what some are calling a "secret reversal." Further, reports reveal that the same judge had reviewed approximately 80 percent of decisions involving special trial judges over the past 14 years.[12] In the wake of *Ballard* and its subsequent revelations, the Tax Court has proposed new rules that would make trial judge's rulings public in pending and future cases. While the proposed changes do not address concerns about past cases, it is a step towards greater transparency.

In *Commissioner v. Banks* and *Commissioner v. Banaitis,* the Supreme Court addressed the question of whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent fee arrangement is income to the plaintiff under the Internal Revenue Code. As we noted in a previous article, this issue had drawn repeated attention from the tax community calling for a more consistent application of the tax laws.[13] Stepping in to resolve a split among the Courts of Appeals, the Court held that when a litigant's recovery constitutes income, that income generally includes the portion of the recovery paid to the attorney as a contingent fee.[14]

In *Banks,* the taxpayer retained an attorney on contingency to sue his employer alleging employment discrimination in violation of various federal statutes. The parties settled the claims for a total of $464,000, $150,000 of which Mr. Banks paid to his attorney pursuant to the fee agreement. Mr. Banks did not include any of the settlement recovery in his gross income and the IRS filed a notice of deficiency. The Tax Court upheld the IRS's determination, finding that Mr. Banks was required to include the entire settlement amount, including that amount paid in attorney's

fees, in his income. The Sixth Circuit reversed in part, finding that the $150,000 that Mr. Banks had paid to his attorney was not income.[15]

In *Banaitis*, the taxpayer retained an attorney on a contingency fee basis to file a suit alleging a number of common-law torts related to his employment contract. After a jury trial, Mr. Banaitis was awarded compensatory and punitive damages. After the resolution of all appeals and post-trial motions, the parties settled. Pursuant to the settlement agreement, defendants paid $4.8 million to Mr. Banaitis and an additional $3.8 million directly to his attorneys pursuant to the contingency fee contract. Mr. Banaitis did not include the amount paid to his attorneys in his gross income and the IRS issued a notice of deficiency for that amount. The Tax Court upheld the IRS's determination, but the U.S. Court of Appeals for the Ninth Circuit reversed.[16]

The majority of circuits, including the Second Circuit,[17] previously had included contingent fees as income to plaintiffs, some in reliance on state law treatment of such arrangements, others imposing a hard-and-fast rule that contingent fee amounts were income to the plaintiff regardless of the applicable state law. The minority of circuits have adhered to the view that the contingent fee portion of a recovery is not included in a plaintiff's gross income. As seen in *Banks* and *Banaitis*, these decisions also were based either on an analysis of state law or on a definitive finding regarding the nature of the contingency fee arrangement.

Writing for a unanimous court, Justice Kennedy made two preliminary observations. First, that the issue of deductibility of contingent attorney's fees had arisen primarily because the alternative minimum tax (AMT) did not allow the taxpayers to take miscellaneous itemized deductions, including deductions for legal expenses. Second, that Congress recently had enacted the American Jobs Creation Act of 1994 (the Jobs Act),[18] which allowed a taxpayer to deduct attorney's fees incurred in connection with any action involving a claim of unlawful discrimination, even where the AMT applies. Thus, the question presented in these cases no longer exists in discrimination cases that have arisen after the passage of the Jobs Act. However, because the legislation was not retroactive, the Court needed to resolve the issue with respect to the discrimination case at hand, as well as nondiscrimination cases.[19]

In reaching its conclusion that the portion of a recovery paid to an attorney under a contingent fee agreement generally constitutes income to a taxpayer, the Court agreed with the IRS that a contingent fee agreement should be viewed as an anticipatory assignment of the plaintiffs' income to the attorney. Under the principle that gains should be taxed to those who earn them, the anticipatory assignment doctrine prevents a taxpayer from excluding economic gain from gross income by assigning it to another party in advance of its receipt. Agreeing with the Second Circuit's conclusion in *Raymond v. United States*, the Supreme Court reasoned that a plaintiff never loses complete dominion over the income at question because the income-generating asset is the underlying cause of action over which the plaintiff has constant control.[20]

Rejecting the taxpayers' argument that a contingency fee arrangement establishes a joint venture or partnership between the client and attorney, the Court found that the attorney was the agent of the client, duty bound to act only in the interests of his principal. In an agency relationship, the Court observed, a principal may rely on an agent to realize an economic gain through the agent's efforts, but that gain is not excludable from the principal's gross income. Finally, the Court held that this was true regardless of whether applicable state law conferred any special rights or protections on the attorney with respect to his contingency fee.[21]

While this holding sufficiently disposed of the *Banaitis* case, it did not completely resolve the question as applied to the *Banks* case, which was brought under a federal statute that authorizes fee awards to prevailing plaintiffs' attorneys. Specifically, the Court noted that its holding did not address the argument that treating the fee award as income to plaintiff in such cases may lead to a "perverse result" on those occasions when the damages awarded are substantially less than the attorney's fees, such as when the plaintiff seeks only injunctive relief or the statute caps the plaintiff's monetary recovery. Despite this possibility, the Court found that it need not address the issue, as the attorney's fee paid in the *Banks* case was calculated solely on the basis of the private contingent fee contract. Furthermore, the Court noted that the Jobs Act "redresses the concern for many, perhaps most, claims governed by fee-shifting statutes."[22]

1. 125 SCt 1766, 1770 (2005).
2. Id. at 1770-71.
3. Id. at 1771. The Court made clear that it "express[ed] no view on the related question whether a foreign government, based on wire or mail fraud predicate offenses, may bring a civil action under the Racketeer Influenced and Corrupt Organizations Act for a scheme to defraud it of taxes." Id. at fn 1.
4. Id. at 1772-1773.
5. Id. at 1773-1774.
6. Id. at 1777.
7. Id. at 1775, 1779.
8. Id. at 1780 (citing *United States v. Pierce*, 224 F.3d 158, 166 (2nd Cir. 2000)); see also id. at 1784-85 (Justice Ginsberg's dissent).
9. 125 S. Ct. 1270 (2005).
10. Id. at 1274-1275 (noting that a rule revision in 1983 "deleted the requirement that, upon submission of the special trial judge's report 'a copy …shall forthwith be served on each party" allowing each party to make exceptions to the report).
11. Id. at 1277.
12. See Maurice Possley, "Tax Court Case Stirs Multiple Questions: Request for Judges' Trial Findings Rebuffed," Chicago Tribune, July 10, 2005.
13. See John J. Tigue and Jeremy H. Temkin, "Question: Who Pays the Tax on Attorney's Fees Awards," New York Law Journal, Nov. 18, 2004.
14. 125 S. Ct. 826, 829 (2005).
15. Id. at 829-830; *Comm'r of Internal Revenue v. Banks*, 345 F.3d 373 (6th Cir. 2003).
16. 125 S. Ct. at 830; *Comm'r of Internal Revenue v. Banaitis*, 340 F. 3d 1074 (9th Cir. 2003).
17. *Raymond v. United States*, 355 F. 3d 107 (2nd Cir. 2004)
18. American Jobs Creation Act of 2004, Pub. L. No. 108-357 (codified as amended in scattered sections of 26 U.S.C.).
19. 125 S. Ct. at 830-31.
20. Id. at 831-832.
21. Id. at 832-833.
22. Id. at 834.