Second Circuit Further Muddies The Water On The Attorneys' Fee Mess

By Robert W. Wood *

The U.S. Court of Appeals for the Second Circuit's recent decision on attorneys' fees in *Raymond v. United States*,[1] is clearly disappointing, though hardly surprising. On the heels of the Sixth Circuit's ruling in *Banks v. Commissioner*,[2] surely one could hope for a bit more fairness and vision from the influential Second Circuit than a hackneyed discussion of the hoary (and frequently misapplied) assignment of income cases.[3]

For those keeping score, we have finally reached the point where every single federal appellate court, except the D.C. Circuit Court of Appeals, has weighed in on the attorneys' fee fiasco.[4] Sadly, their decisions, and even the underlying rationales that supposedly support them, are anything but consistent; the tax treatment of contingent attorneys' fees has become one of the most hotly contested issues in federal tax law.[5] How could a concept which is theoretically so simple turn into such a mess?

On March 29, 2004, the Supreme Court finally decided to resolve the acidic split in the Circuit Courts of Appeal as to the tax treatment of contingent attorneys' fees by granting *certiorari* petitions in *Banaitis v. Commissioner*[7] and *Banks v. Commissioner*.[8] Since then, a petition for *certiorari* has been filed in *Raymond*. It will be interesting to see if *Raymond* is consolidated with *Banks* and *Banaitis*.

A Strong Dose of Reality.

As you may recall, *Banks* found *Horst* and *Earl* to be unpersuasive.[9] Instead, the Sixth Circuit in *Banks* joined the Fifth Circuit in *Srivastava v. Commissioner*,[10] in finding that the strength of the applicable attorneys' lien law is irrelevant in deciding whether recovered contingent attorneys' fees constitute gross income.[11] This allowed the Sixth Circuit to sidestep the otherwise seemingly obligatory *Cotnam*[12] analysis, and, instead, determine that the application of *Cotnam* does not depend on "the intricacies of an attorneys' bundle of rights."[13]

After *Banaitis* and *Banks*, it seemed at least conceivable that cooler heads might prevail, and that the federal circuit courts were heading in the right direction with this run-away train. Sadly, the Second Circuit's decision in *Raymond* is a significant set back.

Raymond started as a garden-variety wrongful termination case. After being fired by IBM in 1993, Raymond hired a contingent fee lawyer and sued for wrongful termination. The lawyer was entitled to receive one-third of the net recovery, plus expenses. Raymond won a jury verdict. IBM appealed and lost, and then paid the roughly $900,000 judgment.

On his 1998 federal income tax return, Raymond included the entire recovery in gross income, including the approximately $300,000 paid to his attorneys. In 1999, Raymond filed an amended return requesting a refund for the taxes relating to the amount paid to his lawyers. Not surprisingly, the IRS denied the refund claim. Undeterred, Raymond filed a refund suit in district court.[14]

The court awarded the refund, allowing Raymond to exclude the portion of the recovery paid to his contingent fee attorneys.

In its holding, the court found that applicable Vermont law gave Raymond's attorneys an equitable lien on his recovery.[15] This equitable lien effectively transferred to Raymond's attorneys a proprietary interest in his claim.[16] The district court found that the portion of the recovery used to pay attorneys' fees already belonged to the attorneys. So the attorneys, not Raymond, had to pay tax on this amount. The government appealed to the Second Circuit.

Through the Looking Glass.

Unfortunately, the Second Circuit launched into a tortured tour of assignment of income lore. The Second Circuit in *Raymond* flopped on its first opportunity to address the attorneys' fee issue by resorting to antediluvian assignment of income cases, namely *Earl* and *Horst*.[17] Unless you've been hiding under a rock, you know that these cases involved assignments of income by persons who had earned the income, but not yet received it. To make matters worse, they "assigned" the income to related parties—family members. In *Earl* and *Horst*, the taxpayers were correctly considered to have taxable income even though they never had actual possession of the funds.

Regrettably, the Second Circuit in *Raymond* does not distinguish *Earl* and *Horst* from the contingent attorneys' fee fact pattern the way the Sixth Circuit did in *Estate of Clarks v. United States*.[18] I think it's fair to argue that the value of Raymond's lawsuit was entirely speculative and dependent on the services of his counsel. I might even go so far as to say that the claims of his counsel amounted to little more than an intangible contingent expectancy.

Although the Second Circuit acknowledged that *Estate of Clarks* analogized a contingent fee agreement to an interest in a partnership or joint venture, the Second Circuit quickly dismissed the analogy. The Second Circuit rejected the *Estate of Clarks* argument that Raymond contracted for the services of his lawyer and assigned his lawyer a one-third interest in the venture so that he might have a chance to recover the remaining two-thirds. Rejecting *Estate of Clarks* and *Cotnam*, the Second Circuit found Vermont's attorneys' lien law too weak to support a *Cotnam*-like result.

The Second Circuit in *Raymond* gives an enormously strong endorsement of *Earl, Horst*, and the assignment of income doctrine. Why not avoid the whole assignment of income mess by joining up with *Banks* and following *Srivastava*?[19] This would have allowed the Second Circuit to sidestep the lien law analysis that has instigated much of this mess. With the possible exception of tax lawyers, few people have pored over attorneys' lien laws for many years. Recently, of course, many cases have focused on the strength of the applicable attorneys' lien law.[20]

Assignment of Income Inconsistencies.

Why should the tax treatment of attorneys' fees be predicated on "the intricacies of an attorneys' bundle of rights," which vary wildly from state to state?[21] This *should* be a rhetorical question, but, sadly, it's not. In a true assignment of income setting, such as the facts involved in *Earl* and *Horst*, only the assignor pays tax on the income. In essence, the purported assignment is disallowed for tax purposes. A taxpayer living in one of the "bad circuits," is taxed on the *entire* recovery, including the recovered contingent attorneys' fees.

Of course, the attorney is *also* taxed on the recovered attorneys' fees. Thus, the plaintiff (particularly when considered in conjunction with the lawyer) is actually *worse* off than the assignor in an abusive assignment of income fact pattern. Put another way, the alleged "assignment" to the attorney in the case of contingent fee recoveries is both disregarded and recognized. It is *disregarded* in the sense that the plaintiff is taxed on the entire recovery. Yet, it is also *recognized* in the sense that the attorney too is taxed on the recovered attorneys' fees.

The assignment of income doctrine, first applied in *Earl*, was *never* designed to tax the same income twice. Rather, it was merely designed to prevent the shifting of income to people in lower tax brackets.[22] There is enough money involved in most of these attorneys' fee cases that plaintiffs and attorneys alike will be paying tax at the highest marginal tax rate. But this is hardly the point. The attorneys' fee fact pattern involves true double taxation, a phrase that used to be seen as undermining fundamental tax fairness.

In the near-term, direct payment of attorneys' fees still seems an appropriate course of action as one element of an attempt to avoid the pitfalls of assignment of income cases such as *Horst* and *Earl*.[23] The Sixth Circuit in *Banks* and *Estate of Clarks* distinguishes *Horst* and *Earl* on the grounds that the income assigned to the assignees in those cases was already earned, vested, and relatively certain to be paid to the assignor.

In a good number of cases involving the attorneys' fee issue, the value of the taxpayer's lawsuit is speculative and dependent on the services of counsel. Unfortunately, many courts do not agree and have not distinguished *Horst* and *Earl* in this context.[24] It is generally easy to facilitate direct payment of attorneys' fees, and it certainly seems to be a good idea to do so whenever possible. It may help preserve tax arguments, and may even help to avoid malpractice liability.[25]

Beyond mere direct payment, it also may be possible to petition the court to award the attorneys' fees. Where attorneys themselves are directly entitled to the attorneys' fees a strong argument exists that the recovered attorneys' fees are not income to the plaintiff.[26]

No doubt this will continue to be a volatile area of the tax law. Taxpayers and litigators alike should proceed with caution. Obtain tax advice *before* any settlement is reached. Make sure the settlement payments are made properly. And, be certain that every settlement agreement specifies who is going to get any Internal Revenue Service Forms 1099 or W-2 issued by the defendant.

While my concerns are solely the tax consequences of this conundrum, malpractice liability may also loom. In *Jalali v. Root*,[27] a California jury found a litigator liable for malpractice where he had mistakenly advised his client with respect to the tax consequences of his recovery. Luckily for the attorney, the judgment was reversed on appeal. In the end, the attorney was successful in refuting his former client's claims, but only after expending substantial time, energy, expense, and aggravation.

Unanswered Questions.

What will happen the next time a court is asked to decide the attorneys' fee issue? Will the lien law analysis be rejected by the Supreme Court when it hears *Banks* and *Banaitis*? Will the Supreme Court side with taxpayers when it hears *Banks* and *Banaitis*, or will it continue to turn a blind eye to the plight of the plaintiff?

On a more local scale, is it possible the Second Circuit may end up splitting itself in two much like the Ninth Circuit?[28] How many more intra-circuit splits will arise while we await the Supreme Court's decision in *Banks* and *Banaitis*?

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ENDNOTES

1. *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415).

2. *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

3. *See Raymond* at 419, citing *Helvering v. Horst*, 311 U.S. 112 (1940) and *Lucas v. Earl*, 281 U.S. 111 (1930).

4. *See Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963);

Young v. Commissioner, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997), *en banc reh'g denied* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. Commissioner*, 43 F.3d 1451 (Fed. Cir. 1995); *compare Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

5. *See* Robert W. Wood and Dominic L. Daher, "Slip Slidin' Away: the Ninth Circuit Welcomes *Cotnam* into the Fold?" (21 BNA EDR 411, 10/1/03).

7. 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907).

8. 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

9. *See Banks*, *supra*, 345 F.3d at 383. *See also* Robert W. Wood and Dominic L. Daher, "Attorneys' Fee Debacle Keeps Going, Going, and Going as Mutinous Sixth Circuit Refuses Reliance on Lien Law Analysis," BNA *Daily Tax Report*, Jan. 20, 2004 (11 DTR J-1).

10. 220 F.3d 353 (5th Cir. 2000).

11. *See Banks*, *supra*, 345 F.3d at 385, *quoting Srivastava*, *supra*, 220 F.3d at 364.

12. *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959).

13. *See Banks*, *supra*, 345 F.3d at 385, *quoting Srivastava*, *supra*, 220 F.3d at 364.

14. *See Raymond v. United States*, 247 F.Supp.2d 548 (D. Vt. 2002).

15. *Id.* at 554, citing *Estate of Button v. Anderson*, 112 Vt. 531, 533 (1942).

16. *Id.*

17. *Earl*, *supra*, note 3, and *Horst*, *supra*, note 3.

18. 202 F.3d 854, 856-57 (6th Cir. 2000).

19. See *Banks*, *supra*, 345 F.3d at 385, quoting *Srivastava*, *supra*, 220 F.3d at 364 (holding that the strength of the applicable attorneys' lien law is irrelevant in deciding whether recovered contingent attorneys' fees constitute gross income).

20. *See, e.g., Banaitis*, *supra*, note 8; *compare Benci-Woodward*, *supra*, 219 F.3d 941; *Coady*, *supra*, 213 F.3d 1187.

21. See *Banks*, *supra*, 345 F.3d at 385 quoting, *Srivastava*, *supra*, 220 F.3d at 364.

22. *Earl*, *supra*, note 3.

23. *Horst*, *supra*, note 3; *Earl*, *supra*, note 3.

24. *See, e.g., Coady*, *supra*, 213 F.3d 1187.

25. *See, e.g., Jalali v. Root*, 109 Cal.App.4th 1768, 1 Cal.Rptr.3d 689 (Cal. App.Ct., 4th Dist., 6/9/03).

26. See *Kenseth*, 259 F.3d 881; *Sinyard*, 268 F.3d 756 (holding that because the prevailing plaintiffs rather than their attorneys were entitled to court-awarded attorneys' fees, they must include the recovered fees in their gross income); compare with *Flannery v. Prentice*, 28 P.3d 860, 862 (Cal. 2001) (holding that under California law absent proof of an enforceable agreement to the contrary, the attorneys' fees belong "to the attorneys who labored to earn them").

27. *See* note 25, *supra*.

28. Compare *Banaitis*, *supra*, note 7 (holding recovered contingent attorneys' fees are not gross income to the plaintiff); with *Benci-Woodward*, *supra*, 219 F.3d 941 (holding recovered contingent attorneys' fees are gross income to the plaintiff); *Coady*, *supra*, 213 F.3d 1187 (same).