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Wood Responds to Contingency Fees Articles

To the Editor:

I feel compelled to comment on two recent articles by a trio of Blacks: Katherine D. Black, Michael D. Black, and Stephen T. Black, ''Taxation of Contingency Fees: Deductions for Expenses?'' *Tax Notes*, Feb. 8, 2010, p. 745, *Doc 2009-23802, 2010 TNT 229-4*; and ''Taxation of Contingency Fees After *Banks* and *Banaitis*,'' *Tax Notes*, Nov. 30, 2009, p. 983, *Doc 2010-1102, 2010 TNT 27-2*. I commend the Blacks for seeing something I had not seen, despite my frequent work in the taxation of lawsuit proceeds and attorney fees. I suspect, however, that some of their comments are made with tongue in cheek. I do not see how it could be otherwise.

Indeed, although I had read the first Black article (which I'll call ''Black I'') with interest, it was not until I read Black II that it occurred to me they might *not* have been tongue in cheek. Black II says that in Black I, the authors ''previously demonstrated that the resolution of a cause of action should give rise to capital gain.''[1] I went back to Black I and, sure enough, they *say* it. (Perhaps it is a trifle strong to say they demonstrate it.) They say all lawsuit proceeds are now dispositions of assets, so all lawsuit proceeds are now capital gain.[2]

As you can imagine, this piqued my interest. Do they mean it? Is this just an exercise in black humor? I don't think so. Even if they do, I do not think others will think they do.

Their ingenious argument is that the Supreme Court in *Banks* got a bit tongue-tied in describing the nature of

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[1]*See* Black II, p. 747, citing Black I.

[2]*See* Black I, p. 949: ''the Supreme Court's statement, that the income-producing asset was the cause of action, changed the nature of the income to capital gain.'' *See also*, Black I, p. 950: ''when the Court said that the income-generating asset was a capital asset, it determined the nature of the gain.''

contingent attorney fee arrangements and the nature of gross income in this area. The authors state — I think cleverly — that to get to the result (on attorney fees) the Supreme Court needed to reach (including the attorney fees in the plaintiff's income), the Court chose to focus on the cause of action *itself* as an income-generating asset. Of course, the Blacks point out that the Supreme Court declined to consider various arguments presented in *amicus* briefs. Among them was the brief filed by the American Trial Lawyers Association (subsequently renamed the more politically correct "American Association for Justice") which had argued that the settlement of a lawsuit is the sale or disposition of property.

Despite the Blacks' ingenious argument (and whether or not made seriously), I think it is clear that the Supreme Court did not do what the Blacks assert. Don't get me wrong. It would be *very* nice if the Supreme Court did actually rule that all lawsuit proceeds are capital. I just don't think it's a reasonable reading. Clearly, the IRS (as the Blacks acknowledge) does not think so, either.

Yet I wholeheartedly agree with the Blacks that the *Banks* court can be credited with gold-plating the principle (in my view already well-established) that a cause of action is a type of property, and one that *can* be the subject of a sale or exchange. This principle is one reason why many of the seminal cases treating lawsuit proceeds as capital gain do not dwell on (or in some cases even mention) the presence of a sale or exchange.[3] Either the execution of a settlement agreement and transfer of legal rights thereupon is *itself* a sale or exchange of the legal rights (the chose in action), or it is a relinquishment of legal rights that is equivalent to a sale or exchange.

But whatever it is, it is a termination (perhaps also a contract termination) that *may* deserve capital gain treatment. But how does one determine whether the proceeds are ordinary or capital? The Blacks argue that, with a stroke of a not-very-steady and not-very-explicit pen, the Supreme Court in *Banks* did away with the origin of the claim doctrine!

And what is behind Door Number Two? The Blacks say the black-robed justices have now ushered in an era in which *all lawsuit proceeds will be treated as capital gain*. Notwithstanding their hyperbole, I'm sure the Blacks don't mean this.

Yet they do make a good point. In some ways, the fact that the Supreme Court went down the assignment of income path (and got tangled in the underbrush) is surely what led to this interesting (but ultimately probably not too momentous) academic argument. Again (I cannot say it too many times), I do not think the Blacks mean it when they say (as they close Black II) that "as it stands, the Court has changed, for better or worse, the nature of lawsuit income."[4]

It must be hard to get those words out with three collective tongues so far into their cheeks. In Black I, the Blacks quote at length from what they term the Supreme Court's "holding." One of the sentences they quote (in my view all *dicta*) is the most critical, for it is the lynchpin of the Blacks' arguments: "in the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury."[5]

However, the Court's semantic choice of the term "asset" is only in the context of its digression into the black hole of anticipatory assignment. As the Court points out in the sentence immediately preceding the one which the Blacks assert single-handedly dismantles the entire edifice of origin of the claim analysis: "Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the *income* and enjoys the consequent benefits."[6]

It is this more general question of who earns the income from a lawsuit that is the Court's focus in this part of the *Banks* opinion.

To be sure, the Blacks note that the question of deductions was not before the Court, which (to me, at least) makes Black II entirely speculative. To their credit, in Black II, they seem more moderate, noting in one passage that: "thus, one must ask if the Supreme Court in *Banks* was overturning the origin of the claim doctrine. It appears the Supreme Court had no such intention."[7] Yet if I read them correctly, the Blacks are saying that the Court did this radical surgery on the income side, but simply didn't do it on the deduction side.

I don't think anyone will call *Banks* the Supreme Court's finest hour. The Supreme Court was even urged by some not to decide the case at all, given the passage in late 2004 of the American Jobs Creation Act of 2004. That imported an above-the-line deduction for the types of cases *Banks* considered, mooting the issue at least prospectively. The Supreme Court, of course, also sidestepped most *amicus* arguments, and came out (in the actual *holding*) with an expressed "general rule" which implied (if it did not downright enunciate) exceptions.

As much as I enjoyed revisiting *Banks* and thinking through the Blacks' creative treatment, I don't think it's a reasonable interpretation that the Supreme Court (wittingly or not) overturned the origin of the claim doctrine for either income or deductions. In any case, I say "bravo" to the Blacks for taking a new (and far out) approach to this area and for taking a forward-looking position that will keep at least some tongues wagging. The Blacks' argument may rival a black hole in its expansiveness, but in the real world, it may be little more than a tempest in a teacup.

Very truly yours,

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[3]*See, e.g., Inco Electroenergy Corp. v. Commissioner*, T.C. Memo. 1987-437 (T.C. 1987); *State Fish Corp. v. Commissioner*, 48 T.C. 465, 473 (T.C. 1967); *Dye v. United States*, 121 F.3d 1399 (10th Cir. 1997).

[4]*See* Black II at p. 991.

[5]*See* Black I, p. 984, quoting *Banks*, 543 U.S. at 426.

[6]*Id.* My emphasis.

[7]*See* Black II, p. 749.

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