Contingent Fees and Tax Burdens: Planning After Commissioner v Banks

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The General Rule of Banks

Before the Supreme Court’s decision in the consolidated cases of Commissioner v Banks and Commissioner v Banaitis (Commissioner v Banks) (2005) ___ US ___, 160 L Ed 2d 859, 125 S Ct 826, the circuits were split on how to tax litigation recovery when the plaintiff’s attorney had a contingent fee interest in the recovery. In the majority of the circuits, a plaintiff who received a gross award of $100, and owed 40 percent to his or her lawyer, had gross income of $100 (not $60 as one might assume), and had to claim a deduction for the $40 paid to the attorney. But the plaintiff often would not get the benefits of the full $40 deduction, because of (1) the 2 percent floor on miscellaneous itemized deductions under IRC §67(a)–(b); (2) the phaseout of deductions and exemptions for high-income taxpayers (see IRC §68(a)); and (3) the alternative minimum tax (AMT) (IRC §§55–59), which, if triggered, requires the plaintiff to pay tax on the entire recovery, including fees and costs, with no offsetting deduction.

In a minority of the circuits (those that decided Banks and Banaitis), attorney liens on the plaintiff’s recovery were held to be so strong that the attorneys themselves were considered to own the fees and the gross income was not considered to pass through the client’s hands at all. Thus, the client did not pay tax on the attorney’s portion.

After the United States Supreme Court’s decision in Banks, many plaintiffs will still be taxed on money they never even receive. The American Jobs Creation Act of 2004 (Jobs Act) (Pub L 108–357, §703, 118 Stat 1418) fixes this problem for some plaintiffs, at least prospectively, by amending IRC §62 to end the Internal Revenue Service’s “double taxation” of attorney fee awards in unlawful employment discrimination cases, among others. (It has been argued that a Senate floor colloquy between Senators Grassley and Baucus shows that the Jobs Act merely enunciates current law and thus might also fix the problem retroactively; Banks doesn’t mention that argument, however, so most tax attorneys assume the Jobs Creation Act is prospective only.)

Although there is bound to be dispute over what the Supreme Court did and did not do in Banks, it is important to realize that all that the Court actually held is: “[A]s a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.” 160 L Ed 2d at 866.

For the most part, the Court adopted the tried and true assignment of income cases, such as the hoary Helvering v Horst (1940) 311 US 112, 85 L Ed 75, 61 S Ct 144, and Lucas v Earl (1930) 281 US 111, 74 L Ed 731, 50 S Ct 241. It dismissed the theory that the attorney/client relationship can be viewed as a kind of business partnership or joint venture for tax purposes, citing liberally from the Restatement (Second) of Agency (1957) to support its conclusion that lawyers are merely agents of their clients. 160 L Ed 2d at 870.

There is much that Banks did not decide. Opportunities still exist for the tax-savvy client and counsel to try to avoid the Banks tax scenario and this article briefly sketches some of them.

Tax Questions After Banks

Does State Law Alter the Character of the Attorney/Client Relationship?

With one sentence, the Banks Court rejected the theory that in contingent fee litigation, client and attorney form a partnership. 160 L Ed 2d at 870. (Later, the Court stated that it was not considering this question at all; see 160 L Ed 2d at 871.) The Court hinted, however, that the conclusion might be different if state attorney lien protections actually “alter the fundamental principal-agent character of the relationship.” 160 L Ed 2d at 871. The Court noted that no state law of which it was aware actually converted the attorney from an agent to a partner, suggesting that the Court did not (and perhaps could not) comment on all state laws.

Thus, it might be that partnership-like language in a contingent fee agreement, e.g., “This agreement will be interpreted as a partnership between lawyer and client to the maximum extent permitted by law,” would be something to consider when drafting fee agreements.

Does Your Case Involve a Question Undecided in Banks?

The Court declined to comment on other theories that would exclude the attorneys’ fees from gross income, or permit their deductibility. 160 L Ed 2d at 871. These include theories that:

- The contingent fee agreement establishes a Subchapter K partnership;
- Litigation recoveries are proceeds from the disposition of property, so that the attorneys’ fees must be subtracted as a capital expense from the proceeds; and
- The fees are deductible reimbursed employee business expenses.

This appears to be a nonexclusive list of unconsidered arguments. If your case falls into one of these categories, at least your arguments are not barred by Banks.
Is the Client a Relator Under the False Claims Act?

The Court also specifically did not reach cases in which a relator pursues a claim on behalf of the United States under the federal False Claims Act. 160 L Ed 2d at 871. Thus, although False Claims Act cases are governed prospectively by the Jobs Act, Banks does not apply to cases resolved on appeal or the subject of a verdict relating back to a date before October 23, 2004, the Jobs Act’s effective date. Because no definitive case deals with the tax implications of a False Claims Act case, it may be that the pre-Banks split in the circuit courts will control.

On the other hand, one could argue that a False Claims Act case is fundamentally different from any other attorney fee situation. A relator in a False Claims Act case serves as a private attorney general and is something like a bounty hunter, something more businesslike than the plaintiff in a typical employment case. Thus, one might argue that a Schedule C treatment for the qui tam recovery would be the appropriate tax treatment, which would permit the natural netting of the attorney fees without running afoul of the 2 percent itemized deduction threshold, the phaseout, or the AMT.

Is There a Fee-Shifting Statute?

The Court noted, but did not address, claims that the assignment of income principle is inconsistent with fee-shifting statutes. As Banks had argued before the Court, the assignment of income principle is inconsistent with the purpose of federal and state laws that encourage compliance with the law by shifting a plaintiff’s attorney fees from the plaintiff to the defendant. 160 L Ed 2d 872. Taxpayers have often argued that the assignment of income analysis should have no bearing in a fee-shifting case.

A fee-shifting statute strengthens the argument that the lawyer (not the client) owns the fees. Because the court awards the fees, it seems difficult to argue that the plaintiff is “paying” his or her lawyer. Taxpayers might take some comfort from a case such as Flannery v Prenstiss (2001) 26 C4th 572, 110 CR2d 809, in which the California Supreme Court held that the attorney, not the client, was entitled to fees awarded under the California Fair Employment and Housing Act. Although not a tax case, Flannery found that, absent proof of an enforceable agreement to the contrary, the attorney fees belonged “to the attorneys who labored to earn them.” 26 C4th at 590.

The Supreme Court took care in Banks to distinguish Banks from a case involving a court-ordered fee: It noted that there was no court-ordered fee award to Banks’ attorney, nor any indication in Banks’ contract with his lawyer (or in the settlement agreement with the defendant) that the contingent fee paid to Banks’ lawyer was in lieu of statutory fees that Banks might otherwise have recovered. See 160 L Ed 2d at 872. The Court’s care suggests that the result in Banks might have been different had there been such a fee award, or if Banks’ contract with his lawyer had indicated that the contingent fees were in lieu of statutory fees, or if there had been a statement in the settlement agreement to this effect.

Counsel should consider adding to the settlement agreement a statement that the lawyer is receiving his or her money directly from the defendant and in lieu of statutory fees that would be awarded in the case had the case gone to trial. This might also be addressed in the contingent fee agreement between lawyer and client. Consider whether it is appropriate to amend and clarify a contingent fee agreement before the case settles, even if the amendment comes on the eve of settlement.

What About Injunctive Relief?

The last point the Supreme Court does not address is that involving injunctive relief. The Court notes that sometimes court-awarded attorney fees can exceed a plaintiff’s monetary recovery, e.g., when the plaintiff seeks only injunctive relief, a statute caps the dollar amount of a plaintiff’s recovery, or damages are less than fees for some other reason. See 160 L Ed 2d at 872. Treating the fee award as income to the plaintiff in such a case can lead to the perverse result that the plaintiff loses money by winning the case.

That the Supreme Court sidesteps this issue suggests that counsel may be able to avoid the Banks result in a case of this sort. Counsel might allocate the attorney fees between the injunctive relief and the cash compensation, or the settlement agreement might mandate that the defendant pay the attorney fees directly to the attorney, making sure that a Form 1099 goes directly (and only) to the lawyers.

Is the Case a Class Action?

The Banks decision does not mention or address the tax treatment of attorney fees in class actions, a difficult area that has resulted in distinctions between opt-in and opt-out classes (with opt-in plaintiffs more likely to be forced to pay attorney fees) and between class members who sign a fee agreement with class counsel and those who don’t. These issues remain undecided.

Is a Settlement or Structured Settlement Possible?

The Jobs Act applies to fees and costs paid after its enactment (October 23, 2004) “with respect to any judgment or settlement occurring after such date.” Pub L 108–357, 118 Stat 1418, 1548. Thus, successful litigants whose cases are on appeal have a strong incentive to “settle” the case; a settlement (unlike having the verdict affirmed on appeal) would bring their cases within the Jobs Act provision. For example, a verdict that was reached in September 2004 (before the Jobs Act) and upheld on July 1, 2005 (after the Jobs Act), would not qualify for attorney fee relief because the judgment occurred before the Jobs Act. But if the case “settles”
on appeal after passage of the Jobs Act (even if for $1 or less), then settlement is post-Jobs Act and should qualify for treatment under that Act.

Structures of attorney fees themselves may also become more popular after Banks. In a structured settlement, a third party (an assignment company) assumes liability for the future payments to the plaintiff; if the future payments are excludable from the plaintiff’s gross income (e.g., personal injury damages), the assignment is “qualified”; if the payments are not excludable, the assignment is nonqualified. Some insurance companies have taken the view that in a true personal physical injury case, the lawyers’ portion of the recovery also can be structured because it, too, represents IRC §104 damages, at least to the plaintiff.

Structured settlements may also appeal to the plaintiffs in nonpersonal injury cases who will continue to have AMT tax problems caused by contingent attorney fees (e.g., plaintiffs in defamation, false imprisonment, intentional or negligent infliction of emotional distress, and insurance bad faith cases). Other cases that raise the AMT problem are those with punitive damages (even in true personal physical injury cases), or employment claims that resulted in a verdict before the enactment of the Jobs Act on October 23, 2004. A nonqualified structure that stretches out tax consequences can ameliorate the AMT problems caused by attorney fees. Other insurance companies representing defendants have preferred not to use a tax-qualified assignment company, but have used nonqualified assignment companies instead. Because Banks more firmly solidifies the view that damages (outside the statutory fee area) belong to the client, more insurance companies may be comfortable in using qualified assignment companies for structured settlements of attorney fees, which should increase the number of providers.

The structuring of attorney fees should also benefit from the implications that Banks has for IRC §72(u), which taxes the cash build-up in value of a life insurance policy in certain cases. A notable exception to IRC §72(u) is a “qualified funding asset” as defined in IRC §130(d). By suggesting that contingent attorney fees “generally” belong to the client first, Banks suggests that even the attorneys’ portion of the award can be structured with a domestic assignment company.

**Conclusion**

Although it will take time for the impact of Banks to become clear, counsel can begin now to explore the tax planning opportunities suggested here and to begin to fashion their own solutions to the problems Banks poses. The future may not be so bleak as many first thought.

**Editor’s Note:** For a full discussion of the pre-Banks split in the circuit courts and the Banks decision itself, see California Attorney’s Guide to Damages, chap 7 (2d ed Cal CEB 2004).