Another Bite at the Apple? Ninth Circuit Takes Another Look at the Attorneys' Fee Fiasco and Changes Its Tune

By
Robert W. Wood
and
Dominic L. Daher

Robert Wood and Dominic Daher look at the most recent Ninth Circuit opinion on the tax treatment of attorneys' fees paid by a plaintiff, discussing how it differs from previous opinions and possible future actions by the courts.

It is well known that the tax treatment of attorneys' fees paid by a plaintiff in many types of actions (such as employment actions) has not been harmonized around the country. Due to a variety of oddities in our tax system (most notably the alternative minimum tax (AMT)), there is a dramatic tax difference between the result obtained when a plaintiff is taxed on the gross amount of a settlement rather than on an amount net of recovered attorneys' fees.

This sad reality is perhaps best illustrated by way of example. Let's assume that a taxpayer recovers a $1 million settlement, inclusive of attorneys' fees. If the taxpayer is required to recognize the gross amount, he will be taxed on the entire $1 million recovery, and he will be entitled to a miscellaneous itemized deduction (subject to two percent of AGI floor) for the amount of the legal fees recovered (assume $400,000). This results in the taxpayer owing $276,500 in federal income tax on the recovery (assuming the taxpayer is married filing jointly). Of this amount, over $75,000 stems from the AMT. In stark contrast, if the taxpayer is only required to include the net amount of $600,000 in gross income, he will owe a mere $181,881.50 in federal income tax. That is a whopping $94,618.50 difference!

Nonetheless, the fact that some people are aware of this oddity is hardly a balm to those taxpayers who wake up on April 15 to find that they owe additional tax on monies paid directly to their contingent fee lawyer. Tax periodicals have long noted the split in the

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco.

Dominic L. Daher is a Senior Tax Manager with Robert W. Wood, P.C., in San Francisco (www.robertwwood.com).

circuits and the legislative efforts that have thus far failed to correct the problem.[1]

Go West, Young Man

The most recent iteration of the controversial attorneys' fee problem came in *S. Banaitis*.[2] This case started as a garden-variety wrongful termination case. Banaitis was a vice president of the Bank of California. He was fortunate enough to have access to extensive confidential financial information relating to the Portland, Oregon, grain industry, which enabled him to develop specialized financing products for it. In 1984, Mitsubishi Bank acquired a controlling interest in the Bank of California. After learning of this, several of Banaitis' clients contacted him and reiterated their desire to keep their confidential financial information secret. Banaitis complied with this request, but his employer cried dirty pool.

Subsequently, Banaitis received a far-from-flattering performance review, which apparently caused him to suffer a host of physical maladies (including headaches, insomnia and gastrointestinal disorders). After retaining an attorney, Banaitis sued his former employer for constructive discharge. After considerable procedural wrangling, Banaitis and his former employer entered into a settlement, which paid $4.8 million to Banaitis (only $1.4 million was reported by Banaitis on his tax return) and $3.8 million to his contingent-fee attorneys. On his 1995 return, Banaitis excluded the remainder of the settlement from his gross income under Code Sec. 104(a)(2) (including the $3.8 million paid to his attorneys).

Not surprisingly, the IRS did not agree with Banaitis' characterization of the recovery. The Tax Court had to determine whether any of Mr. Banaitis' settlement amount was excludible. More significantly, the court had to determine whether the amount paid to his attorneys was includible in gross income.

The court dispensed fairly easily with the taxpayer's arguments that the economic and punitive damages he had received under the terms of the settlement agreement were excludible. The court, citing *Glenshaw Glass Co.*,[3] found both amounts to be fully includible. On the other hand, the court found that his recovery for emotional distress was excludible under Code Sec. 104(a)(2) (as it applied in 1995). The real meat of the decision, though, lies in the treatment of the recovered attorneys' fees. The Tax Court followed what it assumed to be the applicable Ninth Circuit precedent,[4] and held that the attorneys' fees were includible in Banaitis' gross income.

The Ninth Circuit, citing *E.W. Cotnam*,[5] disagreed, finding that the attorneys' fees were excludible from Banaitis' gross income. *Cotnam*, as most readers know, involved the Fifth Circuit holding that the amount of a contingent fee paid out of a judgment to the plaintiff's attorneys was not income to the plaintiff. Under Alabama state law, which applied in *Cotnam*, a contingency fee contract operates as a lien on the recovery. The Alabama code provided that attorneys at law will have the same right and power over suits, judgments and decrees to enforce their liens as their clients had or may have for the amount due. That gave the *Cotnam* court solid ground to say there had been a transfer of part of the plaintiff's claim and that any recovery by the lawyers on that portion of the claim was simply gross income to them.

Noting that Oregon's attorneys' lien law mirrors Alabama's, the Ninth Circuit held that attorneys in Oregon were entitled to generous property interests in judgments and settlements. Indeed, the Ninth Circuit found that an attorneys' lien in Oregon is superior to all other liens (except tax liens). The court found that, like Alabama law, Oregon law provides that attorneys have the same right and power over suits, judgments, decrees, orders and awards to enforce the liens as the clients have in the judgment. Relying on the unique features of Oregon law on attorneys' fees, the Ninth Circuit found that the fees paid directly to Banaitis' attorneys were *not* includible in Banaitis' income.

Law? Whose Law?

The Ninth Circuit sounds quite different in *Banaitis* than it did in such notable cases as *F.P. Coady* and *I.F. Benci-Woodward*.[6] In fact, the Ninth Circuit in *Banaitis* sounded overwhelmingly different than it did in *Sinyard v. Rossotti*.[7] Here, the Ninth Circuit said unexceptionally that whether a contingent fee contract for the plaintiff results in fees includible in the plaintiff's gross income involves two related questions: (1) how state law defines the attorneys' rights in the action; and (2) how federal tax law operates in light of this state law definition of interests.

Referring to the hoary assignment of income cases such as *Helvering v. Horst* and *Lucas v. Earl*,[8] the Ninth Circuit went on to talk about state law and the "state-law-specific analysis." It was such an analysis that led the Ninth Circuit to conclude in *Coady* that under Alaska law,

attorneys' fees are includible in the plaintiff's gross income, and that the same rule applies under California law (*Benci-Woodward*). Other circuits have been faced with similar decisions, and have based their state-specific holdings on similar logic.

The court trotted out the "good states" in which the unique features of applicable state law allow plaintiffs to exclude recovered attorneys' fees from gross income, including Alabama law,[9] Texas law[10] and Michigan law.[11] Incidentally, the Ninth Circuit cites *M. Foster*[12] for the proposition that *Cotnam*'s Alabama-law-based holding is imported into the law of the entire Eleventh Circuit. While it is true that *Cotnam* is binding precedent on the Eleventh Circuit, it is *Bonner v. City of Prichard* that carries the day here and not *Foster*.[13]

The Oregon Trail

Distinguishing Oregon law on attorneys' liens from California and Alaska law, the Ninth Circuit found that the Oregon attorneys' lien law was quite strong. In fact, the Ninth Circuit found that Oregon went even further in some respects than Alabama law, the law considered in the seminal *Cotnam* case. Relying upon Oregon state cases, the Ninth Circuit found that the attorneys' lien is a charge on the action.

Indeed, the parties to the action cannot extinguish or affect the attorneys' lien by any means (such as a settlement) other than by satisfying the underlying claim of the attorney for the fees incurred in connection with the action.[14] Finding that Oregon clearly recognized the strength of the attorneys' lien law and that the attorney in all events had the right to the money, the Ninth Circuit concluded that the attorneys' fees "paid directly" to the lawyer were not includible in Mr. Banaitis' gross income.

Relevance of Paid Directly

Most readers will notice the "paid directly" limitation slipped cleverly into its holding by the Ninth Circuit. Does it really matter if the attorneys' fees are paid directly to the attorney, or if they are lumped together with the amounts paid to the plaintiff? Should it matter? Probably not, especially if one believes the seemingly myopic focus the courts have taken on attorneys' lien laws. Still, some clearly believe direct payment is a must, so why take a chance?

To avoid the pitfalls of assignment of income cases such as *Helvering v. Horst* and *Lucas v. Earl*, direct payment of attorneys' fees is still the best course of action. *Estate of Clarks* and its progeny distinguish *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. This is not true in most cases involving the attorneys' fee issue. In these cases, the value of the taxpayer's lawsuit is arguably entirely speculative and dependant on the services of counsel. Even so, many other courts have not distinguished *Horst* and *Earl* in this context.[15] As easy as it is to facilitate direct payment of attorneys' fees, it is probably a good idea to take a page out of Nike's book and "just do it."

Importing State Law

Some imports are attractive. Just as Oregon likes to import California wines (they tend to be better than Oregon wines), might California plaintiffs import Oregon's law on attorneys' liens? The Ninth Circuit in *Benci-Woodward* made it abundantly clear that California's attorneys' lien law was not sufficiently strong to justify importing *Cotnam.*

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Under the *Golsen* rule, the Tax Court must follow a Court of Appeals decision that is "squarely on point" where an appeal lies to that particular Court of Appeals.[16] Conversely, the Tax Court is not bound by a decision which is not "squarely on point."

A similar rule applies to a refund claim filed in a U.S. District Court. In such cases, the court is bound by decisions issued by the Court of Appeals in the circuit in which it sits. The doctrine of *stare decisis* provides that "a decision on an issue of law embodied in a final judgment is binding on the court that decided it and such other courts as owe obedience to its decision, in all future cases."[17] Consequently, "like facts will receive like treatment in a court of law."[18] Decisions from other Circuits are not binding on the U.S. District Court or the U.S. Court of Appeals, although they are persuasive.

What is going to happen the next time the Tax Court or a U.S.

District Court is asked to decide the attorneys' fee issue where the appeal lies to the Ninth Circuit? Is it fair to say that the Ninth Circuit is now divided on the attorneys' fee issue? Will the Tax Court and/or the U.S. District Courts within the Ninth Circuit follow *Sinyard,* or will they instead follow *Banaitis*? Will it matter whether the taxpayer is a resident of California rather than Oregon? Will it matter if the parties agree that the entire attorney-client relationship is governed by Oregon law?

Frankly, these questions may have obvious answers, but we don't think so. At this stage of the game, who's to say how a given court might rule on the attorneys' fee issue?

The Big Finish

The Supreme Court has recently granted *certiorari* in *Banaitis* and consolidated it with *J.W. Banks II,*[19] which arrived at a similar holding, albeit through markedly different analysis.[20] As things are shaping up, it looks like the Supreme Court's decision will be released sometime in 2005. This is going to be a very important decision with far-reaching consequences. While we wait for corrective action (and we may be waiting a while), advisors and taxpayers alike should be alert to some of the traps.

For example, it is vitally important (for an argument to exist that the client doesn't have the income) that the fees be "direct paid" from the defendant to the attorney. It is also vitally important that the contingent fee agreement specify in strong terms when the interest in the case is assigned. The attorneys' lien law in the state can be helpful in some cases (but clearly not all). Taxpayers and their advisors (and certainly litigators, too) should be very careful. They should obtain tax advice *before* any settlement is reached. They should be careful how the payments are made. Of course, they should also be careful what the settlement agreement specifies about who is going to get any 1099 or W-2 forms. The forms issue (with its audit risk controls) can have an enormous impact on the ultimate result of the case.

ENDNOTES

1 *See* Robert W. Wood, *Tax Treatment of Attorneys' Fees,* TAX NOTES, May 13, 2003 (Doc. 2003-11996); *see also* Robert W. Wood, *More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?* TAX NOTES, June 5, 2003 (Doc. 2003-13768).

2 *S. Banaitis,* CA-9, 2003-2 USTC ¶50,638, 340 F3d 1074.

3 *Glenshaw Glass Co.*, SCt, 55-1 USTC ¶9308, 348 US 426, 429, 75 SCt 473.

4 *Sinyard v. Rossotti*, CA-9, 2001-2 USTC ¶50,645, 268 F3d 756, *cert. denied,* SCt, 536 US 904 (2002).

5 *E.W. Cotnam*, CA-5, 59-1 USTC ¶9200, 263 F2d 119.

6 *F.P. Coady,* CA-9, 2000-1 USTC ¶50,528, 213 F3d 1187, *cert. denied,* SCt, 532 US 972 (2001); *I.F. Benci-Woodward,* CA-9, 2000-2 USTC ¶50,595, 219 F3d 941, *cert. denied,* SCt, 531 US 1112 (2001).

7 *Sinyard v. Rossotti, supra* note 4.

8 *Helvering v. Horst,* SCt, 40-2 USTC ¶9787, 311 US 112, 61 SCt 144; *Lucas v. Earl,* SCt, 2 USTC ¶496, 281 US 111, 50 SCt 241 (1930).

9 *Cotnam, supra* note 5.

10 *S.P. Srivastava,* CA-5, 2000-2 USTC ¶50,597, 220 F3d 353.

11 *A.L. Clarks Est.*, CA-6, 2000-1 USTC ¶50,158, 202 F3d 854, 856.

12 *M. Foster,* CA-11, 2001-1 USTC ¶50,392, 249 F3d 1275, 1278.

13 *L. Bonner v. City of Prichard,* CA-11, 661 F2d 1206, 1209 (1981) (which imported all holdings of the Fifth Circuit prior to its split into the Fifth and Eleventh Circuits, not just *Cotnam*) (upheld in *W.M. Barlow-Davis,* CA-11, 2000-1 USTC ¶50,431, 210 F3d 1346, 1347).

14 *Citing Potter v. Schlesser Co.*, 335 Ore. 209, 63 P3d 1172 (2003).

15 *See e.g., Coady, supra* note 6.

16 *J.E. Golsen,* 54 TC 742, 747, Dec. 30,049 (1970), *aff'd on other issue,* CA-10, 71-2 USTC ¶9497, 445 F2d 985.

17 *Cabot Corp.*, 694 FSupp 949, 953, note 5 (1988) (*quoting* 1 B.J. MOORE, J. LUCAS & T. CURRIER, MOORE'S FEDERAL PRACTICE, ¶0.401 (2d ed. 1988)).

18 *Id.*

19 *J.W. Banks II,* CA-6, 2003-2 USTC ¶50,675, 345 F3d 373.

20 *See Banaitis,* 2004 U.S. LEXIS 2385 and *Banks,* 2004 U.S. LEXIS 2384.