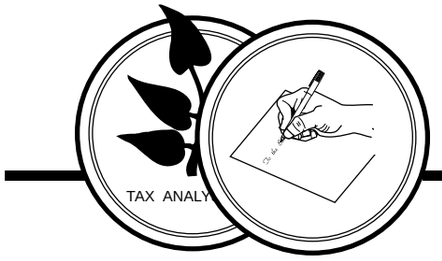

letters to the editor

Problems With the Government's Position on Taxing Attorneys' Fees

To the Editor:

It was frustrating to me to read Professor Timothy R. Koski's article, "Should Clients Escape Taxation on Lawsuit Proceeds Retained by Attorneys?" *Tax Notes*, July 2, 2001, p. 43, and Professor James Serven's article, "Oral Argument in *Hukkanen-Campbell:* Taxpayers' Last Stand?" *Tax Notes*, Nov. 5, 2001, p. 854. I am thankful to Mr. Robert Wood, who has written letters to the editor commenting on these articles. *Tax Notes*, July 16, 2001, p. 434, and Nov. 19, 2001, p. 1115.

I generally agree with Mr. Wood's remarks and disagree with most of what Professors Koski and Serven espouse. Professor Koski reflects his predisposition on the issue with the title of his article. The article could just as easily been entitled, "Should Clients Be Required to Pay Tax on Lawsuit Proceeds Earned by an Attorney?"

I believe neither Professor Koski nor Professor Serven has written an objective analysis of the controversy. Reading their articles is like reading the government's brief. I disagree with many of Professor Serven's statements. However, in the interest of time and space I will address only a few.

At page 858 Professor Serven states that under the ADEA attorney's fees are available to the prevailing plaintiffs, not to plaintiff's counsel. I disagree. Justice McKeown's dissent in *Sinyard* (88 AFTR 2d Par. 2001-5350, *Doc 2001-24862 (15 original pages), 2001 TNT 188-11* (9th Cir. 2001)) states the following:

> The statute [ADEA] provides for two separate forms of recovery. First, there is the "judgment awarded to the plaintiff or plaintiffs." 29 U.S.C. section 216(b). Separate, and "in addition to" the plaintiff's recovery, "[t]he court . . . shall . . . allow a reasonable attorney's fee to be paid by the defendant." Id. So under the statute, the attorney's fees are treated separately from the judgment itself.

Further, if the client did not hire an attorney there would be no separate award for attorney fees. It is the attorney who earned the fee and is the only person who should report the fee as taxable income.

At page 859 Professor Serven states that there is no justification for allowing taxpayers who pay their lawyers under contingent fee agreements to be treated better for tax purposes than those who do so under hourly or fixed fee agreements. There are several reasons to treat a contingent fee agreement different from an hourly or fixed fee agreement. A few that come to mind are:

1. Hourly fees are usually paid by defendant corporations not plaintiffs who are usually individuals.

2. Many plaintiffs who enter into contingency fee agreements do not have the resources to fund the litigation. Therefore, if there is no recovery there is no personal liability. With an hourly fee or fixed fee agreement, even if there is no recovery, the client is still personally liable.

3. Many contingency fee cases continue for several years. It is less likely that an hourly client's legal deductions would be limited as much as a client who has hired an attorney under a contingency fee agreement where such fees are usually paid in the year of recovery.

4. The amount of attorney fees with a contingency fee arrangement is unknown until the case is finally resolved. With an hourly fee agreement, the attorney fees become fixed obligations as the attorney spends time on the case.

5. A contingency fee agreement is much more akin to an ownership interest in the recovery than an hourly or fixed fee agreement.

6. There is much more risk to the attorney in a contingency fee case. Therefore, the attorney and client have an agreement which is much more akin to a joint venture or partnership than an hourly or fixed fee agreement.

7. From a policy standpoint, the AMT was designed to ensure that wealthy individuals pay a certain minimum tax. Plaintiffs that enter into contingency fee agreements generally are not the type of wealthy taxpayers Congress sought to subject to the AMT.

Some other reasons a taxpayer should not pay tax on recovery proceeds earned by an attorney are as follows:

1. The attorney's work adds value to the claim.

2. The attorney earns the contingent fee by the attorney's personal skill and judgment. There is no assignment of income.

3. The assignment of income doctrine has been cited as the main support for taxing the client on the recovery earned by the attorney. However, as discussed by the Tax Court's dissenters in *Kenseth*, 114 T.C. 399, *Doc 2000-14845 (98 original pages), 2000 TNT 102-6*, (2000), and by Wood in his letters, the assignment of income doctrine is a judicial concept that has previously been applied to related-party or interfamily

transactions. Contingency fee agreements are usually between unrelated parties and the attorney is providing services by which the attorney earns a right to share in any recovery.

As pointed out in Mr. Wood's July 16 letter, in LTR 200107019, *Doc 2001-4799 (13 original pages), 2001 TNT 34-19*, I believe the IRS signaled its own admission that the assignment of income doctrine does not apply. In the ruling the taxpayer assigned an interest in his recovery to a charitable trust after a jury verdict but before the appeal was finalized. The IRS held there was no anticipatory assignment of income because the claim was contingent and doubtful. How then could there be an anticipatory assignment of income at the beginning of the case when the claim was even more contingent and doubtful? Further, the attorney is providing services and earning his fee if there is a recovery. The charitable trust is providing no services and is not earning any income.

Another concession by the IRS was pointed out by Tim Larason, a partner of the author, in his letter to the editor (*Tax Notes*, July 16, 2001, p. 433). Mr. Larason reports on an opt-out class action case in which the IRS agreed that contingent attorney fees were not taxable to the plaintiffs.

At pages 860-61 Professor Serven states that *Hukkanen-Campbell* should be decided in favor of the government and then asserts that such a decision for the government would support the government's positions taken in pending proposed regulations under sections 6045(f) and 6041.

I believe there is an inconsistency in the government's positions. If the government wants to take the position that the right of recovery including the attorney fees earned by the attorney belongs to the client and is taxable to the client then it should not require Form 1099 reporting of the gross recovery, or even the attorney fee portion, as income to the attorney. Such double reporting of income was heavily criticized by the ABA Section of Taxation in its letter to William Roth, Chairman of the Committee on Finance, dated June 19, 1998, *98 TNT 131-29.*

Sincerely,

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