

## **Subject: Taxation of Damage Awards 3:01**

### **CONTINGENT FEE AWARD TO LAWYER: TAXED TO LAWYER OR CLIENT?**

Okay, okay, I know this title sort of begs the question. We all know that the plaintiff's lawyer is taxable on contingent legal fee awards. It hardly takes a glance at the newspapers over the last year or so to see that lawyers (tobacco lawyers perhaps most egregiously) have racked up billions of dollars in contingent legal fees, some payable over their lifetimes. (Is that lifetime reduced by smoking, or what?). The tax question, of course, is whether there are any circumstances these days in which the IRS would admit that contingent legal fees being separately paid to a lawyer (sometimes pursuant to a court order) ought to be taxable only to the plaintiff's lawyer, and not to the client with whom the plaintiff's lawyer has a fee agreement.

As we have written here in many prior installments of this discussion group, the consequences to the plaintiff of what happens to the legal fee award can be quite severe. The difference between a \$100 gross recovery being taxed 60% to the client and 40% to the lawyer, versus 100% to the client with a 40% deduction to the client, is pretty severe. We are talking, of course, about the 2% miscellaneous itemized deduction threshold, the phase-out of exemptions and miscellaneous deductions due to high income, and most importantly, about the alternative minimum tax.

I have long thought (despite the obvious difficulties with assignment of income doctrine and various other hoary tax concepts), that structuring and pre-planning in this area (and even the vicissitudes of state law, attorney lien filing, etc.), can make a difference in the attractiveness of a particular taxpayer's case. However, I have also long thought that this is a very difficult area that needs statutory fixing. We've been saying a statutory change was on the way for quite some time.

#### **Supreme Court?**

Now, one particularly watched case is in the Fifth Circuit Court of Appeals, *Srivastava, et ux. v. Commissioner*, 5th Cir. Dkt. No. 99-60437. In the Fifth Circuit, the Texas Trial Lawyers Association (not a group of slackers by any means) has filed an *amicus* brief arguing that *Srivastava* cannot be taxed on the settlement proceeds attributable to the portion of his cause of action assigned to his attorneys under a contingent fee agreement. In the Tax Court below, *Sudhir Srivastava, et ux. v. Commissioner*, T.C. Memo 1998-362 (1998), Tax Notes Doc. No. 9829917, a 40% contingent fee was not reported by a couple who recovered a substantial judgment in a libel suit. The plaintiffs in the case, Sudhir Srivastava and Elizabeth Pascual alleged in Tax Court that they have never received 40% of the \$8.5 million settlement in a libel suit, because they assigned a 40% ownership interest in the case to their attorneys. However, the Tax Court looked to Texas law, and found that an attorney does not have a general lien on a cause of action until a judgment is

collected. Thus, said the court, the two plaintiffs did not convey an ownership interest in any settlement proceeding.

The court found that these Texas attorneys operating under a contingent fee agreement do not have rights in the cause of action, and would not be entitled to pursue the action if the client were dismissed. Finding that a contingent fee agreement is an executory contract under Texas law, the Tax Court held that any assignment to the attorneys was anticipatory and could not be effective for federal tax purposes.

While the Tax Court judge did find that a substantial portion of the award (which was made under pre-1986 law) was excludable under Section 104 (\$4.7 million was excludable), the court also found that the balance was taxable interest (both pre-judgment and post-judgment interest) plus punitive damages. The original judgment, before settlement, was for \$11.5 million in actual damages, \$17.5 million in punitive damages, and \$2.6 million in pre-judgment interest. The two plaintiffs argued that because they originally pleaded only for \$8.5 million in actual damages, the entire settlement would logically be allocated to actual damages.

This allocation of an award following a verdict has come up in many cases before, and there is no easy answer. On the one hand, it is easy to understand the government's generally *pro rata* approach to this situation, saying that a settlement amount must represent equally the amounts that were awarded at trial. On the other hand, it would be appropriate for taxpayers to keep evidence about the strength of various claims. Frequently, it can be demonstrated which claims were likely to withstand scrutiny on appeal, and which claims were not. Some planning can often be done here. In this case, the Tax Court found it incredible that the \$8.5 million settlement would be allocated all to excludable damages, so ruled that it simply could not. As to the legal expenses, finding that the attempted assignment of the legal fees to the Texas plaintiffs' attorneys was ineffective, the Tax Court went on to find that the plaintiff couple could not deduct any portion of the legal expenses as business expenses under Section 162. After all, defamation results in personal injury (even if it may no longer be excludable under Section 104). Thus, the expenses of litigating a defamation action are not business expenses. This seemed especially injurious from a tax viewpoint since the defamation in the underlying litigation related to Srivastava's performance as a surgeon!

Nonetheless, the court found that the legal expenses attributable to the taxable punitive damages and to the taxable interests (being a portion of the settlement) could be deducted as Section 212 expenses for the production of income. These, of course, would be miscellaneous itemized deductions, incurring the wrath of the various limitations (including the alternative minimum tax) alluded to above.

After all this, the IRS also determined an accuracy-related penalty for substantial understatement. Fortunately, the court sustained only part of this penalty. The court denied the portion of the penalty for underpayment attributable to the punitive damages portion of

the settlement, finding that the plaintiff couple had substantial authority for their reporting position on this point.

As noted above, the basic holding in the Tax Court was that, under applicable Texas law, the attorneys had no ownership interest in the cause of action. Thus, the Tax Court said the portion of the settlement proceeds paid to the attorneys was includable in the gross income of the Srivastavas. For a summary of the *Tax Notes* memo opinion, see *Tax Notes*, Oct. 12, 1998, p. 207. The full text of the opinion appears at Tax Analysts Doc. No. 98-29917 or 98 TNT 194-6.

### **Not So Fast...**

The Texas Trial Lawyers Association has pulled out its six-gun and said that under Texas law, Srivastava did (and could) transfer a 40% interest in the cause of action to the attorneys. The Texas Trial Lawyers Association argues that a property interest was created from the day the contingent fee agreement was signed. Of course, they are not also arguing that *they* were taxable *then* on that property interest! The *amicus* brief thus concludes that the couple cannot be taxed on the receipt of settlement proceeds that they did not own.

We'll keep you posted about *Srivastava*. It is particularly interesting that this is occurring in the Fifth Circuit. The Fifth Circuit and the Eleventh Circuit are the two circuits that generally hold to the *Cotnam* rule, which is the most favorable rule for contingent fee recoveries. Given that virtually all of the other circuit courts that have considered the matter (albeit on varying facts) have gone against the taxpayer, I still think it is conceivable that the Supreme Court may end up looking at one of these cases in the not-too-distant future.

After all, there does seem to be an appalling lack of equity in any circumstances where a plaintiff (by virtue of the AMT) is taxable on more than he or she receives. Either we get this issue solved, or I predict there will be a lot of Schedule Cs filed by people who are effectively claiming that they are in the business of suing someone (yes, that's been tried, too).