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*CORPORATE AND BUSINESS TAX PLANNING:* Taxation of Attorneys' Fees Altered by the Jobs Act and the Supreme Court; S Corporation Acquisitions: Planning Opportunities and Traps for the Unwary; Executive Compensation 2005: A New World Order Under New Code Section 409A; Tax Issues Related to Family Disputes

*PARTNERSHIP AND REAL ESTATE TAX PLANNING:* Recent Developments in Partnership Taxation; The Economic Substance Doctrine in the Current Tax Shelter Environment; Dealing With Individual and Corporate Tax Claims and Litigating With Taxing Authorities in Bankruptcy Court; Reportable Transactions: A Comprehensive Disclosure Regime to Combat Tax Shelters; Current Developments in Individual Income Tax Planning (Including AMT); Our Favorite Charitable Planning Ideas©; C.E.O. Divorce

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CHAPTER 4

**TAXATION OF CONTINGENT  
ATTORNEYS' FEES ALTERED BY  
THE JOBS ACT AND THE  
SUPREME COURT**

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## ¶ 402.7 Continuing Controversy

## ¶ 400 INTRODUCTION

Late 2004 and early 2005 saw two extremely significant developments in the evolving area of the taxation of attorneys' fees. The first development was Congress' enactment of the American Jobs Creation Act of 2004<sup>1</sup> ("Jobs Act") on October 22, 2004. Although legislators had been considering versions of this bill in one form or another for years, Congress finally decided to act upon the bill only after it had knowledge that the Supreme Court might beat it to the punch. This second significant development began with the Supreme Court's grant of *certiorari* in two attorneys' fees cases in 2004, *Commissioner v. Banks*<sup>2</sup> and *Commissioner v. Banaitis*<sup>3</sup> (which were consolidated for briefing and argument). It culminated with the Supreme Court's unanimous opinion issued on January 24, 2005.<sup>4</sup>

Suggesting that Congress might have acted only to save face might be an exaggeration. Nevertheless, it has taken many years to get Congress to provide *any* relief on the tax treatment of attorney fees. The provision that was finally passed as part of the Jobs Act had been kicking around since 1999, when it was first introduced as the Civil Rights Tax Fairness Act of 1999.<sup>5</sup> Of course, the issue had cried out for attention long before that.<sup>6</sup>

The issue addressed by the enactment of the Jobs Act and the Supreme Court decision in *Banks* is how the Code should treat contingent attorneys' fees and costs paid by successful plaintiffs. This issue arises when lawsuit proceeds in a settlement or judgment are taxable income. Of course, most lawsuit

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<sup>1</sup> P.L. 108-357.

<sup>2</sup> 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 2004 U.S. Lexis 2384 (March 29, 2004).

<sup>3</sup> 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 2004 U.S. Lexis 2385 (March 29, 2004).

<sup>4</sup> *Commissioner v. Banks* and *Commissioner v. Banaitis*, 175 S.Ct. 826; 2005 U.S. Lexis 1370 (2005).

<sup>5</sup> H.R. 1997, 106<sup>th</sup> Cong. (1999).

<sup>6</sup> For example, Nina Olsen, the National Taxpayer Advocate, had noted the deplorable extent of this problem in several of her annual reports to Congress.

proceeds received via settlement or judgment represent taxable income. Logic suggests that all expenses to achieve this income, including lawyers' fees and costs, would be deductible against that income.

Yet, prior to the Supreme Court decision in *Banks* and *Banaitis*, a majority of circuit courts had held that a plaintiff cannot simply net legal fees against a recovery. The plaintiff must generally include the gross recovery in income, even if the legal fees are paid directly to the contingent-fee lawyer. In contrast, a minority of circuits had allowed plaintiffs to report gross income measured only by their net recovery, usually based on the theory that the plaintiff's attorney had an underlying interest in his percentage portion of the case, and would in any case be taxable on the attorneys' fees. In *Banks*, the Supreme Court agreed with the majority of the circuit courts, albeit only as a general rule.

The difference between the net and gross approach to reporting of attorneys' fees can be significant. Under net reporting, a successful plaintiff only reports in gross income the net amount he eventually keeps. Under gross reporting, the plaintiff reports the entire settlement or judgment amount in gross income and then takes a deduction for the amount of attorneys' fees and costs paid to counsel. Although the plaintiff can deduct his attorneys' fees, the deduction is a miscellaneous itemized deduction which can be claimed only to the extent it exceeds 2 percent of the plaintiff's adjusted gross income.<sup>7</sup> Overall limits also apply to itemized deductions.<sup>8</sup> Most draconian of all, the alternative minimum tax ("AMT") allows no deduction at all for miscellaneous itemized deductions. As will be discussed in detail below, the Jobs Act eliminates these historical concerns in some cases. Yet, for other cases, these problems will continue to plague taxpayers.

The problem may best be shown by example. Suppose a plaintiff receives a gross award of \$100, owing 40% to his lawyer. He might logically assume he has \$60 of gross income.

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<sup>7</sup> See Internal Revenue Code ("IRC") Section 67. All references to the IRC or Section or Code refer to the Internal Revenue Code of 1986, as amended.

<sup>8</sup> See IRC Section 68. This limitation is generally referred to as "phaseout."

However, historically, a majority of circuits had held that the plaintiff actually has \$100 of gross income, and must claim a deduction for the \$40 paid to his attorney (even if his attorney is paid directly out of the proceeds of the case, and the money never passes through the plaintiff's hands).<sup>9</sup> In the minority of circuits, the plaintiff only had \$60 of gross income.<sup>10</sup> Although it may appear the taxpayers in both majority and minority circuits would eventually reach the same result, nothing could be further from the truth.

The minority circuit taxpayer would have gross income and taxable income of \$60. On the other hand, the majority circuit taxpayer would have gross income of \$100 and a miscellaneous itemized deduction of \$40, of which the first 2% of adjusted gross income (or \$2) would not be deductible. While a 2% limit may not seem like much, when one considers the fact that seven figure settlement and judgements are practically the norm these days, the 2% limit takes on a whole new importance. On top of this 2% limit, taxpayers also face phaseouts of other deductions. But perhaps the most drastic of all is the alternative minimum tax (AMT). Attorneys' fees are not deductible for AMT purposes.

The application of the AMT can be so catastrophic that it has turned litigation winners into financial losers. For example, an often cited *New York Times* article highlights the plight of a Chicago law enforcement officer who won a sex discrimination suit, only to find that her recovery resulted in

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<sup>9</sup> *Alexander v. Comr.*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *O'Brien v. Comr.*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963); *Young v. Comr.*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Comr.*, 259 F.3d 881 (7th Cir. 2001); *Bagley v. Comr.*, 121 F.3d 393 (8th Cir. 1997), *en banc reh'g denied*, 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward v. Comr.*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Comr.*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Comr.*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904, (2002); *Hukkanen-Campbell v. Comr.*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. Comr.*, 43 F.3d 1451 (Fed. Cir. 1995).

<sup>10</sup> *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Davis v. Comr.*, 210 F.3d 1346 (11th Cir. 2000); *Srivastava v. Comr.*, 220 F.3d 353 (5th Cir. 2000); *Banailis v. Comr.* 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS (No. 03-907, Mar. 29, 2004); *Banks v. Comr.*, 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (No. 03-892, Mar. 29, 2004).

her *paying* \$99,000 more in taxes than she recovered in the suit (so she actually *lost* money on the suit).<sup>11</sup>

An extreme case such as that of the Chicago law enforcement officer shrieks of inequity, and bears no relationship to fundamentals of a fair tax system, since normally one is not taxed on something one does not receive. The problem has led to endless academic debates, numerous legislative assaults from various taxpayer groups, a strident position announced by the Taxpayer Advocate, and ultimately, to passage of the attorneys' fee provision of the American Jobs Creation Act of 2004.<sup>12</sup> The Jobs Act focused solely on employment claims and federal False Claims Act cases. Even though attorneys' fees cases also arise in many nonemployment cases, employment cases traditionally have served as the poster child of inequity.

Although a taxpayer going out-of-pocket to pay taxes on a settlement or judgment may be unusual, successful plaintiffs often face a disproportionate tax burden on their recoveries as compared to the tax burden borne by other income. Just how serious the problem can be varies with the numbers involved and the percentage of contingent fees. When you consider that contingent attorney fees may be 40 percent or 50 percent of a recovery, and sometimes are much higher (I have seen contingent attorney fees as high as 73 percent), the problem is manifest.

Prior to the Supreme Court decision in *Banks*, the tax treatment of attorneys' fees had generated a decade of bitterly fought litigation which left a deep rift in the circuit courts around the United States.<sup>13</sup> The lack of uniformity and the

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<sup>11</sup> See Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Case," *New York Times* (August 11, 2002), Section 1, p. 18 discussing *Spina v. Forest Preserve District of Cook County*, 207 F.Supp. 764 (N.D.Ill. 2002).

<sup>12</sup> For discussion of the above-the-line attorneys' fee deduction created by the Jobs Act, see Wood, "Jobs Act Attorney Fee Provision: Is It Enough?" Vol. 105, No. 8, *Tax Notes* (Nov. 15, 2004), p. 961.

<sup>13</sup> *The majority included: Alexander v. Comr.*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *O'Brien v. Comr.*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963); *Young v. Comr.*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Comr.*, 259 F.3d 881 (7th Cir. 2001); *Bagley v. Comr.*, 121 F.3d 393 (8th Cir. 1997), *en banc reh'g denied*, 1997 U.S. App. LEXIS 27256 (8th

injustice of the rule which prevailed in the majority of circuits lead to forum shopping and frequent gerrymandering of attorneys' fees arrangements, though arguably that made the situation even worse, underscoring the lack of equity.<sup>14</sup> All this, in an attempt to avoid the plaintiff being taxed on money he never sees.

This article reviews the changing landscape of contingent attorneys' fees presented by the Jobs Act and the U.S. Supreme Court decision in *Banks*. Although the Jobs Act represents a step in the right direction, eliminating the attorneys' fee problem in at least some cases, its scope (as should become clear below) is quite limited. Many cases will escape its relief. Moreover, the Supreme Court's announced general rule in *Banks* makes clear that some broader form of relief is needed. In the meantime, the various self-expressed limitations of the *Banks* opinion (since there are various points the Supreme Court expressly did not reach) should give some taxpayers hope that they may be able to distinguish their case from the negative holding in *Banks*.

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Cir. 1997); *Benci-Woodward v. Comr.*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Comr.*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Comr.*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904, (2002); *Hukkanen-Campbell v. Comr.*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. Comr.*, 43 F.3d 1451 (Fed. Cir. 1995). The minority included: *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Davis v. Comr.*, 210 F.3d 1346 (11th Cir. 2000); *Srivastava v. Comr.*, 220 F.3d 353 (5th Cir. 2000); *Banaitis v. Comr.* 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS (No. 03-907, Mar. 29, 2004); *Banks v. Comr.*, 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (No. 03-892, Mar. 29, 2004). See also Wood and Daher, "IRS's MSSP on Lawsuit Awards, Settlements: Useful as a Gelding at a Stud Farm?," *BNA Daily Tax Report*, Dec. 22, 2003 (245 DTR J-1). Wood, "Second Circuit Perpetuates Attorneys' Fee Snafu," *BNA Daily Tax Report*, Mar. 19, 2004 (96 DTR J-1); Wood and Daher, "Attorneys' Fee Debacle Keeps Going, Going, and Going As Mutinous Sixth Circuit Refuses Reliance on Lien Law Analysis," *BNA Daily Tax Report*, Jan. 20, 2004 (11 DTR J-1); Wood and Daher, "Another Bite at the Apple? Ninth Circuit Takes Another Look at the Attorneys' Fee Fiasco and Changes Its Tune," *J. of Tax Prac. and Proc.*, Vol. 6, No. 2, p. 45 (April-May 2004); Wood and Daher, "Contingent Attorney's Fees in Class Action Cases-From Bad to Worse for Taxpayer-Plaintiffs," 99 *J. Tax'n* 228 (Oct. 2003).

<sup>14</sup> See Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?," Vol. 20, No. 21, *BNA's Employment Discrimination Report* (May 21, 2003), p. 701.

## ¶ 401 JOBS ACT PROVISION

The Jobs Act, signed by President Bush on October 22, 2004, provides much needed relief.<sup>15</sup> It allows an above-the-line deduction for amounts attributable to attorney fees and costs received by individuals on account of claims of unlawful discrimination or specified claims against the government. The identified claims against the government are those brought under the False Claims Act<sup>16</sup> and those brought under section 1862(b)(3)(A) of the Social Security Act<sup>17</sup>. As to unlawful discrimination, the law identifies the types of qualifying “unlawful discrimination” by reference to a long list of laws that provide for employment claims. Specifically enumerated are:

- (1) the Civil Rights Act of 1991;
- (2) the Congressional Accountability Act of 1995;
- (3) the National Labor Relations Act;
- (4) the Fair Labor Standards Act of 1938;
- (5) the Age Discrimination in Employment Act of 1967;
- (6) the Rehabilitation Act of 1973;
- (7) the Employee Retirement Income Security Act of 1974;
- (8) the Education Amendments of 1972;
- (9) the Employee Polygraph Protection Act of 1988;
- (10) the Worker Adjustment and Retraining Notification Act;
- (11) the Family and Medical Leave Act of 1993;
- (12) Chapter 43 of Title 38 (relating to employment rights of uniformed service personnel);
- (13) Sections 1981, 1983 and 1985 cases;

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<sup>15</sup> See section 703 of P.L. 108-357 which amends IRC Section 62(a)(19).

<sup>16</sup> 31 U.S.C. 3721 *et seq.*

<sup>17</sup> 42 U.S.C. 1395y(b)(3)(A).



- (14) the Civil Rights Act of 1964;
- (15) the Fair Housing Act;
- (16) the Americans With Disabilities Act of 1990;
- (17) any provision of federal law (known as whistleblower protection provisions) that prohibits the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law; or
- (18) any provision of federal, state or local law, or common law claims permitted under federal, state or local law, that provides for the enforcement of civil rights, or regulates any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

The list is noteworthy in that it covers two basic groups: employment claims and federal False Claims Act claims.

#### ¶ 401.1 False Claims Act

False Claims Act cases are generally brought to expose fraud and to recover monies for the federal government. Many states have their own versions of the False Claims Act to recover monies for their state. While the Jobs Act applies to federal False Claims Act cases, claims brought under state counterpart legislation would not be entitled to attorneys' fee relief under the Jobs Act.

A whistleblower under the False Claims Act who uncovers fraud serves in the capacity of a private attorney general, and on the successful prosecution of the case is entitled to a relator's share. The government may or may not choose to intervene in the case. Litigation is often protracted, and attorney fees and costs tend to be very high. The latter fact

exacerbates the already difficult attorney fee deductibility problem.

Congress has now granted relief for the attorney fee problem in the employment litigation context and for federal False Claims Act cases, but relators in cases brought under state counterparts to the False Claims Act get no relief. That omission, like some others noted below, does not alter the fact that it is vitally important that the legislation passed. However, it does suggest that there is a premium on form. The tax treatment of certain claims may be quite different from the tax treatment accorded other similar claims.

### ¶ 401.2 Employment Nexus

The Jobs Act contains a list of sixteen federal statutes that entitle plaintiffs to relief.<sup>18</sup> All sixteen are related to employment. Also included on the list entitled to protection are whistleblower provisions. This covers provisions of federal law (thus omitting state whistleblower protections) that prohibits the discharge of (or discrimination or reprisal against) an employee for blowing a whistle.<sup>19</sup> There is also the last catchall category, but that applies only to employment cases, too.<sup>20</sup> Most whistleblowers are employees or former employees who have access to information. A federal False Claims Act (or a state one) in which the relator is seeking a recovery for the government (with a share to the relator) might *also* need to rely on some whistleblower protection statute, but that would generally be a separate action.

It is not uncommon to find in this age of increasing legal specialization that a whistleblower may use one law firm to bring a False Claims Act action and another law firm to bring an employment action if the employee/whistleblower is fired or discriminated against on the job. Suppose a whistleblower receives a \$300,000 recovery in the employment action that, after the date of enactment of the Jobs Act, would be protected from double taxation of attorney fees, and a \$3 million relator's share under a state counterpart to the False Claims Act.

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<sup>18</sup> See section 703 of P.L. 108-357 which amends IRC Section 62(e).

<sup>19</sup> See section 703 of P.L. 108-357 which amends IRC Section 62(e)(17).

<sup>20</sup> See section 703 of P.L. 108-357 which amends IRC Section 62(e)(18).

The latter would not be brought within the ambit of the Jobs Act, and thus may be subject to the general rule of inclusion of attorney fees, as expressed by the Supreme Court in *Banks*.

### ¶ 401.3 Scope of the "Catchall"

At the bottom of the list of provisions under which attorney fee relief is provided is a catchall basket. An above-the-line deduction for attorney fees is provided for actions relying on any provision of federal, state or local law, or common law claims permitted under federal, state or local law, that provides either (a) for the enforcement of civil rights; or (b) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.<sup>21</sup>

As noted above, federal False Claims Act cases are entitled to attorney fee relief, while state False Claims Act cases are not. Perhaps one could argue that the catchall is broad enough to bring within it claims under state counterparts to the False Claims Act. However, that seems a stretch. Indeed, after the litany of specific statutes that are all employment related, the catchall basket appears to affect *employment* cases only and would seem not to bring other things within it. While it does scoop up state and local laws (and even common law claims made under federal, state or local law), it is hard to imagine exactly what goes into the catchall.

There are various other claims that would not appear to be within the catchall, such as defamation claims. For example, if a taxpayer is defamed and successfully brings an action through a contingent fee lawyer, the taxpayer will suffer the same kind of attorney fee problems with which taxpayers have been dealing for years. If the taxpayer's recovery is small in relationship to the attorney fees, he may face the wrath of the various limitations, particularly the AMT. Is a vicious

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<sup>21</sup> IRC Section 62(e)(18).

defamation not deserving of the type of tax relief that an act of employment discrimination deserves?

The Jobs Act arguably suggests that defamation claims are not as deserving of protection. Defamation, a tort under the common law, is not entitled to attorney fee tax relief unless it occurs in the context of employment. That suggests one set of rules if a taxpayer is defamed outside of the employment context and quite another if he is defamed by his employer.

#### ¶ 401.4 Other Causes of Action

False imprisonment is another tort that deserves mention. Using the same logic as that applied above to defamation claims, it would seem that if a false imprisonment case occurs in the context of employment, then there might be attorney fee tax relief. Conversely, if the false imprisonment occurs outside of that context, then presumably no relief exists. Thus, if an employer locks an employee up in his office and won't let him leave, the employee does not incur extra tax on any later recovery; on the other hand, if the police lock him up, having arrested him in error, he would pay more tax on the later recovery of any claim.

If a taxpayer actually suffers physical injuries in the false imprisonment, he may be able to obviate some or all of the attorney fee problem by claiming a section 104 exclusion. Yet, Section 104 is also a hot button with the IRS. The IRS has given very little guidance on the scope of section 104 as it was amended in 1996.<sup>22</sup> We still do not know precisely how serious something must be before it is considered a physical injury. The IRS evidently wants to see bruises before it places a halo of excludability on the injured plaintiff.<sup>23</sup>

Other causes of action excluded from this list are claims of negligence and intentional infliction of emotional distress. While emotional distress claims are often brought in the employment context, they are also often brought *outside of*

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<sup>22</sup> See Wood, "Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?," Vol. 105, No. 1, *Tax Notes* (October 4, 2004), p.68.

<sup>23</sup> PLR 200041022.

this context. As with the defamation example (where a defamation claim inside the employment arena may be treated differently, and better, for tax purposes from a defamation claim occurring outside that context), emotional distress claims would seem favored for attorney fee tax relief under the Jobs Act only if they occur in the employment context.

Nonetheless, it may be that ancillary emotional distress claims made in the context of an employment action (a sexual harassment suit, for example) would not be entitled to relief. With this example and the others noted above, it would not be surprising to find that the IRS would seek to allocate attorney fees between various claims. If the IRS does choose to allocate attorney fees between the claims, that would seem to be extremely difficult to administer.

What about invasion of privacy claims? That tort action has become popular in recent years. Does it matter if the tort occurs in the employment context? What about interference with contractual relations (such as contacting prospective employers)? What about claims for investment losses? On the latter, perhaps if your broker has made bad investment decisions on your behalf and you recover from him, you have an attorney fee problem. Conversely, if your employer makes the bad investment decisions for you, and the investment claim is made in the context of your employment litigation, presumably you do not.

### ¶ 401.5 Noncovered Employment Cases

The Code now contains a long list of types of employment claims that qualify for an above-the-line deduction.<sup>24</sup> Then, there is the catchall category at the end.<sup>25</sup> Nevertheless, some employment lawyers bring employment cases that are not true discrimination cases. In fact, some lawyers may be concerned that at least some of their cases will not fall within the group of claims enumerated, even given the long list and its catchall. Some of the claims an employment lawyer may bring may not be within this list.

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<sup>24</sup> IRC Section 62(e)(1) through (e)(17).

<sup>25</sup> IRC Section 62(e)(18).

Consider ERISA claims. ERISA, which applies to pension and welfare benefit cases, preempts state law. Of course, the new law enumerates ERISA cases as one of the categories to which the attorney fee fix applies. Yet it refers only to ERISA cases under section 510 of ERISA.<sup>26</sup> That section deals with discrimination claims.

Furthermore, that section, some employment lawyers assert, is nearly impossible to use under current case law and, in any case, accounts for only a small fraction of successful ERISA claims. The more typical ERISA claim is one for benefits (pension or long-term disability, for example). This makes one wonder whether these other ERISA claims are entitled to the above-the-line deduction under the catchall basket.

Overtime pay is another example of the problem. Overtime pay claims are generally not regarded as discrimination claims. At the same time, the Jobs Act seems to suggest that any unlawful act that is pursued under the Fair Labor Standards Act ("FLSA") should give rise to relief (the above-the-line deduction for attorneys' fees in such a case). Practitioners can only assume that the IRS will probably interpret the term "discrimination" narrowly. That would suggest that only true discrimination claims under the FLSA (such as retaliation claims and Equal Pay Act claims) would qualify. Again, the public can only hope for now that the catchall provision would bring many cases under its protection, including overtime, minimum wage, and benefit cases.

#### ¶ 401.6 Punitive Damages

The term "punitive damages" may seem out of place in this article. Since the 1996 Act (and the almost contemporaneous *O'Gilvie*<sup>27</sup> decision handed down by the Supreme Court), punitive damages are clearly taxable. Perverting that intended clarity, it is extremely common for cases that settle to be unclear what is punitive and what is not. The Service

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<sup>26</sup> IRC Section 62(e)(7).

<sup>27</sup> *O'Gilvie v. United States*, 519 U.S. 79 (1996).

has done nothing to address that ambiguity.<sup>28</sup> Increasingly, though, the states are getting in on the action and *themselves* taking a portion of punitive awards. Many states require that in a civil action in which punitive damages are paid to a private party, the state automatically gets a share.<sup>29</sup>

Suppose that a taxpayer receives a punitive damage award for a willful defamation in California. The taxpayer recovers \$1 in actual damages and \$1 million in punitive damages. Under current California law, 75 percent of that punitive damage award (or \$750,000) goes to the state of California.<sup>30</sup> The taxpayer would receive the remaining 25 percent. How is this distribution to be taxed, particularly when contingent attorney fees are thrown into the mix?

Back in 2003, when the Senate version of the Jobs bill was being considered, Sen. Orrin Hatch, R-Utah, tried to address the increasing popularity of state punitive damage splitting laws. Hatch had introduced a last-minute amendment to the Senate bill to deal with punitive damage awards.<sup>31</sup> The Hatch amendment indicated that even though punitive damages are now always taxable to the recipient, even if the award is not taxable under Section 104, (and that was made clear back in 1996), punitive damages that must be paid to a state under a split-award statute would be excluded from taxable income. In such a state, that amendment would have made clear that even though the punitives received by the plaintiff will be taxable to the plaintiff, those going to the state will not. It should not be otherwise.

Perhaps more pertinent to this topic of attorney fees is the second portion of the Hatch amendment, which said that in such a case, any attorney fees or other costs that are incurred

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<sup>28</sup> See Wood, "Will Courts Import Punitive Characterization?," *Tax Notes*, March 3, 1997 (97 TNT 41-84); Wood, "Proposed Nondeductibility for Punitive Damages: Will it Work?," *Tax Notes*, July 7, 2003 (2003 TNT 130-43).

<sup>29</sup> See California Civil Code Section 3294.5 (2005). Note, however, that this provision which will automatically be repealed on July 1, 2006. Other states which have enacted similar punitive damage taking statutes include Alaska, Georgia, Illinois, Indiana, Iowa Missouri, Oregon and Utah.

<sup>30</sup> California Civil Code Section 3294.5 (2005).

<sup>31</sup> S. Amdt. 627 to S. 1054, 108<sup>th</sup> Cong. (2003).

by the taxpayer in connection with obtaining an award of punitive damages would also not be taxable.<sup>32</sup> Unfortunately, the Hatch amendment was not included in the Jobs Act. It is unclear whether the amendment, having been proposed and not adopted, suggests anything about how this provision of the tax law will be interpreted when the IRS or the courts are faced with this punitive damage awards question.

### ¶ 401.7 Prospective Relief

The effective date of the Jobs Act has caused a stir. The Jobs Act provides attorney fee tax relief only on a prospective basis. The amendments apply only to fees and costs paid after the date of enactment (October 22, 2004), with respect to any judgment or settlement occurring *after* that date. So the fees and costs must be paid *after* October 22, 2004, and they must be paid thereafter on a settlement or judgment that occurs *after* that date.<sup>33</sup>

Although the Jobs Act states that it applies only prospectively, a Senate floor debate suggests that the Senate (or at least Senators Baucus and Grassley) believed that the Jobs Act provision merely reaffirmed then existing (good Circuit) law on the tax treatment of attorneys' fees. The floor debate leading up to passage of the Jobs Act included the following:

Mr. Baucus:

As I understand it, the case law with respect to the tax treatment of attorney's fees paid by those that receive settlements or judgments in connection with a claim of unlawful discrimination, a False Claims Act, 'Qui Tam,' proceeding or similar actions is unclear and that its application was questionable as interpreted by the IRS. Further, it was never the intent of Congress that the attorneys' fees portions of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes.

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<sup>32</sup> *Id.*

<sup>33</sup> Section 703 of P.L. 108-357. See also Wood, "Jobs Act Attorney Fee Provision: Is it Enough?," Vol. 105, No. 6, *Tax Notes* (November 1, 2004), p. 760.



It is the understanding of the chairman that it was the conferees' intention for Section 703 [which provides an above-the-line deduction for attorneys' fees] to clarify the proper interpretation of the prior law, and any settlements prior to the date of enactment should be treated in a manner consistent with such intent?

Mr. Grassley:

The Senator is correct. The conferees are acting to make it clear that attorneys' fees and costs in these cases are not taxable income, especially where the plaintiff, or in the case of a Qui Tam proceeding, the relator, never actually receives the portion of the award paid to the attorneys. Despite differing opinions by certain jurisdictions and the IRS, it is my opinion that this is the correct interpretation of the law prior to enactment of Section 703 as it will be going forward. In adopting this provision, Congress is codifying the fair and equitable policy that the tax treatment of settlements or awards made after or prior to the effective date of this provision should be the same. The courts and IRS should not treat attorneys' fees and other costs as taxable income.

As I stated in my May 12, 2004 press release summarizing this and other provisions passed by the Senate as part of S. 1637.

Tax relief gets the headlines, but part of tax relief is tax fairness. It's clearly a fairness issue to make sure people don't have to pay income taxes on income that was never theirs in the first place. That's common sense.

Section 703 will help in well known cases, such as that of Cynthia Spina, an Illinois police officer that secured a settlement in a sexual discrimination case that left her owing \$10,000 or more. There are literally dozens of others like her in similar situations and it is my strong belief that the courts and the IRS should apply the guidelines of Section 703 not only after the date of enactment but also to settlements put in place prior to that time.<sup>34</sup>

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<sup>34</sup> Congressional Record S11036, October 10, 2004.

Of course, it can be argued that this floor debate is not terribly helpful in light of an express effective date in the Jobs Act itself. Moreover, one can argue that the Supreme Court's *Banks* decision, in which the Court stated that the Jobs Act was prospective only (without mentioning the floor debate) is another point against the relevancy of this discussion.<sup>35</sup>

#### A. *Effective Date Reduction*

One can question the slightly different technical approach to the issue historically provided by the more taxpayer friendly Circuits (where the attorneys' fees pre-*Banks* did not represent income to the plaintiff) compared with the Jobs Act (the attorneys' fees represent gross income, but qualify for an above-the-line deduction). In any case, despite the appeal of a retrospective effective date based on Senate floor discussion, the language of the statute itself calls for a prospective effective date. It will be interesting to see if, when and how this effective date debate will raise its head in the future. However, on a considerably more fundamental level, the Jobs Act provision itself raises legitimate questions as to how one determines what settlements or judgments are covered by the new law.

Settlements seem to be straightforward. Both the execution of the settlement agreement and the payment of the money must occur after October 22, 2004 to qualify for the protection of the new above-the-line deduction.<sup>36</sup> Judgments, however, are not so simple. Relying upon common sense (which may be dangerous with tax law), it would seem that in the case of a judgment, the new law would apply to any judgment that becomes final after the date of enactment (October 22, 2004). After all, a verdict may be appealed, and this may prevent a judgment from becoming final and enforceable for years.

Some judgments predating the enactment of the Jobs Act may be on appeal and may not get resolved until 2005 or 2006. Consider the following example:

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<sup>35</sup> In the oral arguments for *Banks*, Justice Scalia commented, wondering who wrote the colloquy between Senators Baucus and Grassley. The oral argument transcript for *Banks* is located on the Supreme Court website at [www.supremecourt.us/oral\\_arguments/argument\\_transcripts/03-892.pdf](http://www.supremecourt.us/oral_arguments/argument_transcripts/03-892.pdf) at p. 30.

<sup>36</sup> Section 703 of P.L. 108-357.

**Example:** Taxpayer A brings suit for employment discrimination and recovers a verdict of \$800,000 in 2003. Judgment is entered, but the defendant appeals. The Court of Appeals affirms in November of 2004. On December 15, 2004, the date for petition for rehearing to the state Supreme Court expires and the defendant prepares to pay the judgment. When the defendant pays the judgment, is the plaintiff governed by the old attorneys' fee law (split in the circuits, etc.), or is the plaintiff entitled to the above-the-line deduction available under the Jobs Act?

The Jobs Act's amendment to Section 62 (allowing an above-the-line deduction for attorneys' fees) specifically states that the new law applies to: "*fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date.*" The triggering event here is when the judgment can be said to "occur."

#### *B. When Does a Judgment Occur?*

No ready answer exists in the statute or its legislative history to the question when a judgment is considered to "occur." Presumably, this generic layman-like language refers to something different than the time at which a judgment is entered, or the time at which a judgment becomes final. The entry of judgment has a legal meaning and can be ascertained with accuracy. The same can be said for the time at which a judgment becomes final.

Granted, there have been some similar effective date provisions in related areas in the past. However, many of these have been more clear-cut. For example, when the 1996 Act added the physical modifier to Section 104, it did so for all amounts received after the date of enactment (August 20, 1996), except for amounts received under a written binding agreement, court decree or mediation award in effect on (or issued on or before) September 13, 1995.<sup>37</sup>

The time at which a judgment "occurs," on the other hand, is not too precise. This language of the statute suggests analogizing other areas of the tax law. In the context of the

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<sup>37</sup> H. Conf. Rept. 104-737, at 301 (1996), 1996-3 C.B. 741, 1041.

priority of a federal tax lien, a judgment "occurs" when the judgment is first rendered by the court.<sup>38</sup> In *United States v. Dishman Independent Oil Co., Inc.*,<sup>39</sup> the court reviewed the procedural history of the litigation finding that the judgment occurred when the bankruptcy court first entered its final decision, notwithstanding an appeal to the Federal District Court and ultimately to the Court of Appeals. The court stated:

Dishman was granted judgment by the bankruptcy court on April 27, 1992. The IRS tax lien seeks to collect \$2,851,910.09 which is owed to the United States by the debtors for unpaid taxes from the third quarter of 1987 through the third quarter of 1988.

On May 29, 1992, the IRS was permitted to intervene in the proceeding to seek a determination by the court that its federal tax lien was valid and prior to any interest held by Dishman in the debtors' property. The IRS eventually filed a motion for summary judgment which the bankruptcy court denied.

Dishman then filed its own motion for summary judgment against the IRS. The bankruptcy court granted Dishman's motion for summary judgment, after finding that Dishman's attachment lien was perfected by the judgment entered in its favor on April 27, 1992, and was therefore prior to the federal tax lien against the debtors. *In re Dishman Indep. Oil Corp.*, Nos. 91-00057, Adv. No. 91-0078, 1993 WL 110032 (Bankr. E.D. Ky. Jan. 8, 1993). The district court affirmed the bankruptcy court's order granting Dishman's motion for summary judgment.<sup>40</sup>

The Service appealed the case to the Sixth Circuit, and that court recognized that the taxpayer's judgment occurred on April 27, 1992, notwithstanding the appeals. The court stated:

We believe this issue is controlled by the holding of *United States v. Acri*, 348 U.S. 211 (1955), which supports the IRS's

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<sup>38</sup> See *In Re Crocker National Bank v. Trical Manufacturing Co*, 37 AFTR 2d 76-592 (9th Cir. 1975); *United States v. Morrison*, 247 F.2d 285 (5th Cir. 1957).

<sup>39</sup> 46 F.3d 523 (6th Cir. 1995).

<sup>40</sup> *Dishman*, 46 F.3d 523, 525 (1995).

position. In *Acri*, the Supreme Court unequivocally held that a federal tax lien filed after an attachment lien was executed had priority over the attachment lien because judgment on the attachment lien *did not occur* until after the filing of the tax lien. *Id.* at 214. In *Acri*, the Court was not persuaded by the recognition of the attachment lien as perfected under Ohio law. *Id.* at 213. Rather, for “federal tax purposes” the lien was *Ainchoate . . .* because, at the time the attachment issued, the fact and the amount of the lien were contingent upon the outcome of the suit for damages.<sup>41</sup> [Emphasis Added.]

These lien authorities may not necessarily be controlling for fixing when a judgment occurs for purposes of Section 62. Nevertheless, these authorities do appear to give the IRS authority to conclude that a judgment occurs when it is first rendered. They also suggest that the IRS would probably interpret this “occurring” term in a general way, rather than by reference to some technical lapsing of appeal periods, or to a judgment somehow otherwise becoming final. There may well be other areas of the body of federal tax law where this kind of spadework should also be done.

The rudimentary formulation of the statute’s effective date, with its almost simplistic concept of the occurrence of a judgment as a trigger for the effective date of this important provision, would seem to preclude the new law applying to many cases.

### C. *Settlements Preferred*

The author has not yet faced a case where a thorough and painstaking answer to this judgment “occurring” question has had to be given. Fortunately, in many cases, it should be possible to enter into a settlement agreement to make the timing of the judgment irrelevant. Thus, if a judgment would otherwise not be covered by the new above-the-line deduction because the judgment occurred prior to October 23, 2004, a settlement of the dispute between plaintiff and defendant after October 22, 2004 would seem to work. A binding settlement agreement dated after October 22, 2004 would serve as

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<sup>41</sup> *Id.* at 214.

the vehicle for the payment, not the judgment. As long as there is some procedural possibility for keeping the case alive — a writ, an appeal, a proceeding to attempt to set aside the judgment — a settlement should be effective.

Indeed, even if there is no appeal or other action still possible, a settlement may still be effective in invoking the new law. The plaintiff who needs the settlement for tax purposes may be willing to give up some of the consideration that would be paid via the judgment. Alternatively, the plaintiff may be willing to make other concessions, perhaps agreeing to confidentiality obligations, or other non-monetary items. Given the procedural wranglings (and just plain delays) that are often encountered in enforcing a judgment, a consensual resolution would seem appropriate. A settlement should not be regarded as a sham if any material term in the settlement differs from those in the judgment.

There may conceivably be cases in which the defendant insists on paying the judgment and not settling a case. Conceivably, there may also occasionally be defendants who are willing to settle but who insist on extracting a hefty price for their cooperation, perhaps seeking to split what they perceive as tax benefits. However, in the vast majority of cases, a settlement should be possible which hopefully will secure the plaintiff's above-the-line deduction.

#### **¶ 401.8 Allocating Among Claims**

Congress was clearly right to enact the Jobs Act, even if it does not solve everything. Still, an approach that differentiates some claims from others may prompt taxpayers to attempt to pigeonhole their claims within the list of "good" attorney fees — those paid or incurred to pursue federal False Claims Act cases and claims of employment discrimination.

In the real world, the vast majority of lawsuits have multiple causes of action and a mixture of messy factual details. What will happen if someone sues for six different causes of action based on a set of facts? Assume that only one of these causes of action is for employment discrimination, and that

the other claims include defamation arising out of employment. Will the IRS try to allocate the attorney fees? Will it be like the situation so often occurring in the context of divorce (where attorneys commonly allocate their fees between regular divorce legal fees and tax legal fees, the latter being deductible)?

## ¶ 402 **BANKS AND BANAITIS**

While the Jobs Act has brought tremendous statutory change to this area, almost simultaneously, the Supreme Court has brought about judicial change. The January 24, 2005 Supreme Court decision in *Commissioner v. Banks* and *Commissioner v. Banaitis*<sup>42</sup> (which was consolidated for briefing and argument) attempted to resolve the bitter attorney fee dispute raging in the circuit courts.

### ¶ 402.1 **Supreme Court “Fix”**

After previously denying certiorari in five attorneys' fees cases,<sup>43</sup> the Supreme Court finally agreed to resolve all of this fuss. Commentators were pessimistic about how helpful the Supreme Court would be on this question, precisely because the Supreme Court had denied certiorari in five cases in which taxpayers cried out for help, on a tax issue that seemed to cry out for resolution. These five cert petitions were all filed by *taxpayers* who had been whipsawed by the limitations on deductions in the majority circuits. Five times the Supreme Court refused to help.

Then came *Banks*<sup>44</sup> and *Banaitis*.<sup>45</sup> These two cases involved what sometimes is referred to as the “good” circuits,

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<sup>42</sup> *Commissioner v. Banks* and *Commissioner v. Banaitis*, 175 S.Ct. 826; 2005 U.S. Lexis 1370 (2005).

<sup>43</sup> *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *O'Brien v. Commissioner*, 319 F.2d 532 (3rd Cir. 1963), *cert. denied*, 375 U.S. 930 (1963).

<sup>44</sup> 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 2004 U.S. Lexis 2384 (U.S. March 29, 2004).

<sup>45</sup> 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 2004 U.S. Lexis 2385 (March 29, 2004).

where attorneys' liens were held to have been strong enough that the attorneys *themselves* owned the fees, and the gross income was not considered to pass through the client's hands. As such, the lower courts allowed both Mr. Banks and Mr. Banaitis to net attorneys' fees in their gross income. Even though the Supreme Court had five times refused to hear a case on attorneys' fees where the *taxpayer* had lost, in both *Banks* and *Banaitis*, it was the IRS who lost and asked the Supreme Court to intervene. After granting cert in both cases, the Court combined them for briefing and argument.

One last procedural point before getting to the holding. A bit of foreshadowing occurred on enactment of the Jobs Act. As discussed above, the Jobs Act included an attorneys' fee provision that eliminated limitations on deductions for attorneys' fees in several classes of cases (federal False Claims Act cases and most, if not all, employment litigation claims).<sup>46</sup> The taxpayers in *Banks* and *Banaitis* asked the Supreme Court not to decide the cases, literally about a week before the oral argument was scheduled.<sup>47</sup>

The Jobs Act was enacted on October 22, 2004. Oral argument in *Banks* and *Banaitis* was scheduled for November 1, 2004. After the enactment of the Jobs Act, the taxpayers filed a supplemental brief, arguing that the Jobs Act had mooted their case, so it was not necessary for the Court to make this tough decision. Since Mr. Banks and Mr. Banaitis had both won their cases, they clearly wanted to have the Court treat their cases as moot. Underlying the request, of course, was the assumption that taxpayers would be better off at least knowing that the law in *some* circuits was favorable on the attorneys' fee point, rather than having the door shut entirely. That was a prescient filing by the taxpayers, one that the Supreme Court did not heed.

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<sup>46</sup> See Wood, "Jobs Act Attorney Fee Provision: Is it Enough?," Vol. 105, No. 8, *Tax Notes* (November 15, 2004), p. 961.

<sup>47</sup> See Supplemental Brief of *Banks* and *Banaitis*, filed October 25, 2004 (Nos. 03-892 and 03-907).



**¶ 402.2 The Holding**

The Supreme Court rendered its decision on January 24, 2005. The actual holding is brief and succinct, though much of the Court's opinion is not. The holding bears quoting, particularly since there will be much speculation about what this opinion does and does not do. All — and it is fair to say that this truly means *all* — that the Supreme Court rules is that:

We hold that, as 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.<sup>48</sup>

On first glance, more than a few taxpayers will be comforted by the fact that the Supreme Court has announced this concept “as a general rule,” thus implicitly endorsing the notion that there will be exceptions. Moreover, as one peruses the rest of the opinion, this optimism grows.

The opinion is written by Justice Kennedy, and all members of the Court agreed except Chief Justice Rehnquist, who was ill. There was no dissent. The lack of dissent — and discernable lack of compassion for taxpayers in the opinion — seems surprising.

This seems odd, particularly since some Justices in oral argument expressed concern about the possibility of confiscatory taxation. Justice O'Connor made more than a passing point about this during oral argument, saying the tax on attorneys' fees might even raise Constitutional questions.<sup>49</sup> Justices Breyer and Ginsburg made similar suggestions.<sup>50</sup>

Justice Kennedy does not write a particularly convincing tax decision. After stating the holding “as a general rule,” the Court recites the *Banks* and *Banaitis* facts, explains the problem of deducting legal fees as a miscellaneous itemized

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<sup>48</sup> *Banks*, slip opinion at 2005 U.S. Lexis 1370.

<sup>49</sup> The oral argument transcript for *Banks* is located on the Supreme Court website at [www.supremecourtus.gov/oral\\_arguments/argument\\_transcripts/03-892.pdf](http://www.supremecourtus.gov/oral_arguments/argument_transcripts/03-892.pdf) at p. 28.

<sup>50</sup> *Id.* at p. 24.

expense, and then notes that Congress has prospectively fixed the problem for many cases (and in particular, for cases like *Banks* and *Banaitis* that arose in the employment context). The prospective fix in the Jobs Act caused the Court to say that had the Jobs Act been in force for the transactions in question in *Banks* and *Banaitis*, there would have been no case before it.

The Supreme Court notes, though, that the Jobs Act is not retroactive, so that the taxpayers in *Banks* and *Banaitis* still need a decision. As noted above, some have argued that the Senate floor colloquy between Senators Grassley and Baucus is support for the argument that the Jobs Act is retroactive — that is, that it merely enunciated current law. Perhaps the Court's explicit notation that the Jobs Act is *not* retroactive is meant to squelch this argument. Moreover, the Jobs Act itself notes that its application is prospective only.<sup>51</sup>

In large part, the Supreme Court adopts the tried and true assignment of income cases, referring to such hoary cases as *Helvering v. Horst*<sup>52</sup> and *Lucas v. Earl*.<sup>53</sup> Most of this discussion appears in many of the underlying Circuit Court cases in the “bad” circuits. The Supreme Court finishes with its assignment of income analysis, and that's where the opinion becomes puzzling.

In fairly strident language, the Court goes on to address the theory that the attorney/client relationship can be viewed as a kind of business partnership or joint venture for tax purposes. This was the subject of a raging academic debate before the case was decided. Giving it short shrift, the Supreme Court says that it rejects this partnership suggestion, dismissing it with one sentence. Later in the opinion, however, the Supreme Court states that it is not considering this question at all. The Court then talks about the lawyer as an agent, and cites liberally from the Restatement of Agency.<sup>54</sup>

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<sup>51</sup> Section 703 of P.L. 108-357.

<sup>52</sup> 311 U.S. 112 (1940).

<sup>53</sup> 281 U.S. 111 (1930).

<sup>54</sup> *Banks* at pp. 8-9.

If the reader of the opinion hasn't already concluded that the taxpayer is in trouble, the fact that the Court cites favorably from Judge Posner's stinging opinion in *Kenseth*<sup>55</sup> makes it all quite clear. The Court dispenses with the notion that state law might confer special benefits on attorneys that might influence ownership and therefore taxation. Instead, the Court concludes that lawyers are mere agents, and again cites liberally from the Restatement of Agency.

However, the Supreme Court then seems to hold up the possibility that state law *might* make a difference, stating that "[t]his rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship."<sup>56</sup> Although the Court notes that state law varies on the strength of attorneys' security interests in a contingent fee, the Court says that *no state laws of which the Court is aware* actually converts the attorney from an agent to a partner.<sup>57</sup>

This suggests that the Court does not (and perhaps *cannot*) comment on *all* state laws. As but one example, the recent enactment of a Washington attorneys' lien law (which, appears to be is far stronger than any of the state laws considered by the Supreme Court), should give one pause.<sup>58</sup> Consequently, it is unclear just how far the "general rule" announced by the Court goes.

### ¶ 402.3 All Things Considered — Not!

What the Supreme Court does next is a real zinger. The Court notes that the taxpayers, and particular the amicus briefs, propose various other theories that would exclude the attorneys' fees from gross income, or permit their deductibility. The Supreme Court refers to many of these as "novel propositions," stating that these arguments are being presented for the first time in the Supreme Court, were not

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<sup>55</sup> 259 F.3d at 881 (7th Cir. 2001).

<sup>56</sup> *Banks* at pp. 9-10.

<sup>57</sup> *Banks* at p. 10.

<sup>58</sup> For discussion of the Washington law, see Wood, "Washington's Attorneys' Lien Law," *The Tax Adviser* (December 2004), p. 729.

advanced in the earlier stages of the litigation, and therefore were not examined by the Courts of Appeal. Therefore, the Supreme Court says that it declines comment on these supplementary theories. The Court says that these suggestions include the theory 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.

Noting that it is not considering *any* of these arguments (and this is apparently a nonexclusive list of what the Court is not considering), the Court also says that it does not reach the fact pattern where a relator pursues a claim on behalf of the United States under the Federal False Claims Act. That means that while False Claims Act cases are covered prospectively by the Jobs Act, prior False Claims Act cases are *not* impacted by the *Banks* opinion.

As if these carveouts were not enough, the Supreme Court gives another zinger when it addresses statutory fee shifting provisions, as well as injunctive relief. The Court notes that Mr. Banaitis argued that the assignment of income principle would be inconsistent with the purpose of statutory fee shifting provisions. Statutory fees may be available to the plaintiff's lawyer under either state or federal law, the idea being that fee shifting (so a defendant bears the plaintiffs' attorneys' fees) is important to encourage proper compliance with the law. Taxpayers have often argued that the assignment of income analysis frequently applied by the IRS and the courts ought to have no bearing in a fee shifting case.

After all, a fee shifting statute makes the argument for lawyer ownership of the fees considerably stronger. It seems hard to argue in such a case that the client is "paying" the plaintiffs' lawyer anything, since the court is awarding them.

Taxpayers have sometimes taken comfort from cases such as *Flannery v. Prentiss*,<sup>59</sup> a California decision involving whether a statutory fee award is really the property of the client or the lawyer. Taxation, after all, ought to be about who is entitled to the income. The question in *Flannery* was whether attorney or client was entitled to fees awarded under the California Fair Employment and Housing Act. Although not a tax case, the court rejected *Sinyard*<sup>60</sup> and found that, absent proof of an enforceable agreement to the contrary, the attorneys' fees belonged "to the attorneys who labored to earn them."<sup>61</sup>

Quite significantly, the Supreme Court dodges the fee shifting issue entirely, stating that "we need not address these claims."<sup>62</sup> The Supreme Court notes that after Banks settled his case, the fee paid to his attorney was calculated solely on the basis of his contingent fee contract. There was no court-ordered fee award to Banks' attorney, nor, said the Supreme Court, was there 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 been entitled to recover.

All of these explanations are quite important. The Court suggests that the result in *Banks* might well have been different if there was a court-ordered fee award. The Court also suggests that the result might be different if there was any indication in Banks' contract with his lawyer that the contingent fees were in lieu of statutory fees. Finally, the Court suggests that the result might be different if there were a statement in the settlement agreement to this effect.

Presumably it would be necessary for only one of these important differences from the *Banks* facts to be present for the result in *Banks* to have been different. If one had *all* of

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<sup>59</sup> 26 Cal.4th 572, 28 P.3d 860 (2001).

<sup>60</sup> *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), cert. denied, 536 U.S. 904 (2002). When *Flannery* was decided, *Sinyard* was the controlling case in the 9th Circuit regarding the attorneys' fees.

<sup>61</sup> *Flannery v. Prentice*, 28 P.3d at 862.

<sup>62</sup> *Banks* at p.11.

these facts present (a court ordered fee award, plus a provision in the contingent fee agreement obviating a percentage fee when there's a court awarded fee, plus a statement in the settlement agreement that the plaintiffs' lawyer is receiving a statutory fee) Banks' case would have been a home run — perhaps even a grand slam.

The last point the Supreme Court does *not* address is the situation prevailing where there is injunctive relief. Although related to the fee shifting point, it is distinct. The Supreme Court notes that sometimes — as where the plaintiff seeks only injunctive relief, or where the statute caps the dollar amount of a plaintiff's recovery, or where for other reasons damages are substantially less than attorneys' fees — court-awarded attorneys' fee can *exceed* a plaintiff's monetary recovery. The Supreme Court notes that treating the fee award as income to the plaintiff in such cases can lead to the perverse result that the plaintiff loses money by winning the suit.<sup>63</sup> This, of course, was the deplorable situation in the now famous *Spina* decision.<sup>64</sup> The Supreme Court once again says that it need not address these claims.

#### ¶ 402.4 Class Actions

The tax treatment of attorneys' fees in class actions has long been confused. The authorities have often drawn distinctions between opt-in and opt-out classes (opt-in plaintiffs being more likely to be tagged with attorneys' fees), and even between those class members who sign vs. those who don't sign a fee agreement with class counsel. Such niceties still haven't made sense of the area.<sup>65</sup> Some class members get stuck with a tax bill on lawyers' fees.<sup>66</sup> Because of the nature of class actions, fees can be especially high, with *Spina*-like results.<sup>67</sup> The *Banks/Banaitis* case, with its side-stepping of

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<sup>63</sup> *Banks* at p.11.

<sup>64</sup> See footnote 8 above.

<sup>65</sup> See Wood and Daher, "Class Action Attorneys Fees: Even Bigger Tax Problems," Vol. 101 No. 4 *Tax Notes* (Oct. 27, 2003), p. 507.

<sup>66</sup> See *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002).

<sup>67</sup> See footnote 8 above.

the statutory fee issue, does nothing to help clarify this morass.

### ¶ 402.5 Insurance Industry

There may be a silver lining or two in *Banks* for the insurance industry. First, the mere fact that it is an adverse decision on the attorneys' fees issue is likely to prompt some plaintiffs to structure fees that they otherwise would not. There is a growing trend of structured settlements outside the personal injury field.<sup>68</sup> A nonqualified structure, with its stretching out of tax consequences, can ameliorate the AMT problems caused by attorneys' fees.

For some plaintiffs, *Banks* means that there will continue to be tax problems caused by contingent attorneys' fees. For example, claims for defamation, false imprisonment, intentional or negligent infliction of emotional distress, and insurance bad faith will still give rise to attorneys' fee AMT problems. Any case with punitive damages (even true personal physical injury cases) can raise this problem, too.

Even employment claims that resulted in a verdict prior to October 23, 2004 may still be caught with this problem when they are resolved on appeal, since the pertinent effective date of the Jobs Act provision is judgments "occurring" after October 22, 2004. Even successful litigants whose cases are on appeal will have a strong incentive to "settle" the case, since a settlement (unlike having the verdict affirmed on appeal) would bring the case within the Jobs Act provision.

Structures of attorneys' fees themselves may become more popular after *Banks*. Some insurance companies have accomplished attorneys' fees structures with a Section 130 qualified assignment. Such 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 Section 104 damages, at least to the plaintiff.

Some insurance companies, on the other hand, have shied away from using a qualified assignment company, and have

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<sup>68</sup> See Wood, "Structured Settlements in Non-Physical Injury Cases: Tax Risks?," Vol. 104, No. 5, *Tax Notes* (August 2, 2004), p. 511.

generally used a nonqualified assignment company.<sup>69</sup> The decision in *Banks* more firmly solidifies the view that damages (outside the statutory fee area) first and foremost belong to the client. This should make more insurance companies comfortable in using qualified assignment companies for structured settlements of attorneys' fees. That should mean that there will be more structures of attorneys' fees, since the number of providers will be growing.

A related point is that structures of attorneys' fees should get a boost from the implications *Banks* has on Section 72(u) of the Code. That Code Section taxes the cash build-up in value of a life insurance policy in certain cases. A notable exception is a "qualified funding asset" as defined in Section 130(d) of the Code. This provision therefore favors qualified structured settlements (within the meaning of Sections 104 and 130) as opposed to unqualified (meaning taxable) ones. It has led some insurance companies to position assignment companies outside the United States in cases of nonqualified structures. The *Banks* decision suggests that contingent attorneys' fees "generally" belong to the client first, so that even the attorneys' portion of the award can be structured with a domestic assignment company. The fact that structures of attorneys' fees can be domestic in light of *Banks* suggests that there may be more attorneys' fees structures.

#### ¶ 402.6 Other Misconceptions

It is perhaps a sign of how widely the Supreme Court's decision was anticipated that there was much confusion when it was handed down. Even the *Los Angeles Times*, once a great paper, initially reported that *Banks* meant that all personal injury recoveries might be taxable.<sup>70</sup> Such a misunderstanding is likely to arise where there is more hysteria than tax rules usually generate.

This misunderstanding led to a quick reaction from the National Structured Settlement Trade Association ("NSSTA"),

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<sup>69</sup> See Wood, "Structured Settlements in Non-Physical Injury Cases: Tax Risks?," Vol. 104, No. 5, *Tax Notes* (Aug. 2, 2004), p. 511.

<sup>70</sup> See David G. Savage, "Lawsuit Winner Lose the Tax Battle," *Los Angeles Times* (January 25, 2005), p. A14.



which pointed out the error to the *Los Angeles Times*, and that, in turn, generated a retraction.<sup>71</sup> All this is a good deal of hubbub, more than one usually sees with a tax case.

### ¶ 402.7 Continuing Controversy

Perhaps practitioners were wrong to think that the Supreme Court, already materially aided by Congress and the Jobs Act, would clear up the attorneys' fees mess in a tidy way. In fact, the Supreme Court decision is underwhelming, though perhaps its lack of precision and several announced no fly areas will allow for some taxpayer planning.

There are some cases that are not resolved by the Jobs Act, and also not resolved by the Supreme Court's *Banks* opinion. First, False Claims Act cases are expressly not covered by the *Banks* opinion. False Claims Act cases that *predate* the Jobs Act (or False Claims Act cases that are resolved on appeal and the subject of a verdict relating back to a date prior to October 23, 2004) are governed by old law. Since there is no definitive case dealing with the tax implications of a False Claims Act case, it would appear that the old circuit court split controls. At the same time, one could argue that a False Claims Act case is fundamentally different from any other attorneys' fee situations.

A relator in a False Claims Act case serves as a private attorney general and is in the nature of a bounty hunter. This simply sounds more trade or businesslike than the typical employment case. Therefore, one might argue that a Schedule C treatment for the *qui tam* recovery would be the appropriate tax treatment. On a Schedule C, of course, there would be a natural netting of the attorneys' fees without running afoul of the 2% itemized deduction threshold, phase out or AMT.

Another big area left open by the *Banks* case is the statutory fees issue. The Supreme Court seems to invite structures to avoid the *Banks* result by noting that in *Banks*, there was no suggestion that there was a court award of attorneys' fees,

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<sup>71</sup> See "For the Record," *Los Angeles Times* (January 26, 2005), p. A2.

and no statement as to the contingent fee award being obviated when there was a statutory award in either the fee agreement or in the settlement agreement. Perhaps it would be fairly simple to add one of these elements. It might make for a better tax result.

Practitioners might consider adding a statement in a settlement agreement that the lawyer is receiving his money directly from the defendant and in lieu of statutory fees that would be awarded in the case had the case gone to trial. Likewise, perhaps this can be addressed in the contingent fee agreement between lawyer and client. Remember that contingent fee agreements can be amended. It may be appropriate to amend and clarify a contingent fee agreement before the case settles, even if such an amendment comes on the eve of settlement.

Such an amendment can presumably be made effective "as of" the date of the original agreement. This is not backdating. If this kind of planning is all it takes to avoid the result in *Banks*, then the *Banks* decision will not have as significant an impact on well-informed taxpayers as some might assume.

Another huge area left open by *Banks* is the situation prevailing where there is injunctive relief. A taxpayer who is seeking injunctive relief may end up with a huge amount of attorneys' fees and a relatively small award. That was the situation in *Spina*.<sup>72</sup> The fact that the Supreme Court side-steps this fact pattern suggests, once again, that perhaps one can obviate the *Banks* result in a case of this sort. Allocating the attorneys' fees between the injunctive relief and the cash compensation might be one alternative. Mandating the direct payment of the attorneys' fees, providing the appropriate language in the settlement agreement, and making sure that a Form 1099 goes directly (and only) to the lawyers, may all help to carry the day.

Yet another open area concerns the theory that lawyer and client may be in partnership, thus obviating the gross income to the client. Although the Supreme Court devotes one sentence to rejecting the partnership theory at the beginning of

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<sup>72</sup> See footnote 8 above.

the *Banks* opinion, it later says that it is not considering the question at all. That leads one to wonder whether partnership-like language in a contingent fee agreement might carry the day.

Attorneys may wish to consider adding something like the following to a fee agreement: "This agreement will be interpreted as a partnership between lawyer and client to the maximum extent permitted by law." Presumably such language can't hurt, particularly since the Supreme Court seems to invite this kind of planning.

There are probably other planning opportunities that may surface. Taxpayers, tax advisers, the IRS and the courts will all need time to digest the Supreme Court's ruling and the impact it will have. Bear in mind, too, that all this comes on the heels of the Jobs Act, which itself isn't a model of clarity.

This article has speculated whether the employment claim focus of the Jobs Act means that in the typical mixed-claim litigation the IRS will want to allocate fees between "good" employment claims (that give rise to an above-the-line attorneys' fee deduction) and "bad" other claims. If the IRS does raise this bifurcation point, then it means that the *Banks* decision, albeit looking a bit like Swiss cheese with the planning holes that the Supreme Court drilled, will become that much more important.