Viewpoint

Second Circuit Perpetuates Attorneys' Fee SNAFU

BY ROBERT W. WOOD

For those keeping score, we have finally reached the point where every single federal appellate court, except the U.S. Court of Appeals for the D.C. Circuit, has weighed in on the attorneys' fee fiasco.

Sadly, their decisions, and even the underlying rationales that supposedly support them, are anything but consistent.[1]

Tsunami of Litigation?

The tax treatment of contingent attorneys' fees has become one of the most hotly contested issues in federal tax law.[2]

How could a concept which is theoretically so simple turn into such a mess?

Believe it or not, there are cases where taxpayers have actually ended up owing more in taxes than they recovered in their lawsuits.[3]

How does such an Alice in Wonderland result like this occur? The alternative minimum tax is the primary (though not the only) culprit. Let us see how this might work out where a disproportionately small amount of damages are recovered along with a substantial amount of attorneys' fees.

The tax treatment of contingent attorneys' fees has become one of the most hotly contested issues in federal tax law. How could a concept which is theoretically so simple turn into such a mess?

Assume that a plaintiff recovers a $100 million judgment, inclusive of attorneys' fees. If the plaintiff lives in one of the "bad circuits" and is required to recognize the gross amount (including the attorneys' fees) he will be taxed on the entire $100 million recovery. Of course, the plaintiff is entitled to a miscellaneous itemized deduction for the amount of the recovered attorneys' fees (assume $80 million). But this deduction is disallowed entirely for AMT purposes (and is also subject to a 2 percent-of-adjusted gross income floor for regular tax purposes).

This results in the plaintiff owing just shy of $28 million in federal income tax on the recovery. Of this amount, more than $19 million stems from the AMT. The appalling result here is that the plaintiff will actually end up losing almost $8 million because of this "recovery."

That is right, the plaintiff will actually end up in the hole almost $8 million after "winning" this lawsuit! How does this happen?

While the plaintiff is allocated $100 million in gross income, he actually receives only $20 million in cash. From a cash-flow standpoint, the plaintiff is left with roughly a $28 million tax bill and only $20 million with which to pay it. It does not seem fair to receive a favorable verdict in a lawsuit and then end up paying more in federal income tax than you recovered.

[1] *See Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997), *en banc reh'g denied* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (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); *Baylin v. Commissioner*, 43 F.3d 1451 (Fed. Cir. 1995); *compare Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

[2] See, e.g., Robert W. Wood and Dominic L. Daher, *IRS's MSSP on Lawsuit Awards, Settlements: Useful as a Gelding at a Stud Farm?*, BNA Daily Tax Report (245 DTR J-1, 12/22/03).

[3] See *Spina v. Forest Preserve District of Cook County, Ill.*, 207 F.Supp. 2d 764 (N.D. Ill. 2002) (where a Chicago woman who won a sex discrimination suit against her former employer ended up paying $99,000 more in federal income tax than she recovered in her suit).

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A Strong Dose of Reality

Late in 2003, after taking it on the chin in its last two outings, the government decided it was time for the gloves to come off, and it filed petitions for certiorari in two attorneys' fee cases.[4] Although it seems plain that taxpayers in the ''bad circuits'' will continue to get lambasted on the attorneys' fee issue, the IRS wants more.

The Supreme Court finally decided March 29 to resolve the acidic split in the circuit courts of appeal as to the tax treatment of contingent attorneys' fees by granting *certiorari* petitions in *Banaitis v. Commissioner*[5]and *Banks v. Commissioner*.[6] Since then, a petition for *certiorari* has been filed in *Raymond*[7]. It will be interesting to see if *Raymond* is consolidated with *Banks* and *Banaitis*.

It is not foolish to ask the simple question: Why? After all, more than half a century ago the Supreme Court stressed the importance of avoiding inequities in the administration of federal tax law.[8] One would be hard pressed to imagine anything in the federal tax law rivaling the inequity of this attorneys' fee issue.

Disparate treatment of similarly situated taxpayers directly contradicts equity and fairness in our tax system, which are essential elements of any tax system.

It seems high time for the Supreme Court to end the pervasive and irreconcilable divergence among the federal circuit courts of appeal on this issue. At least it has finally agreed to address the matter. In my mind, Congress has been just as much of a slacker on the issue. Such disparate treatment of similarly situated taxpayers directly contradicts equity and fairness in our tax system, which are essential elements of any tax system.

I can only hope the Supreme Court sides with taxpayers when it decides *Banks* and *Banaitis*.

The United States once observed the simple yet enlightened notion of taxing similarly situated people in a similar fashion.[9] *The Wealth of Nations* was published in 1776, the same year as the Declaration of Independence. Yet it seems doubtful that our forefathers would approve of the whole attorneys' fee quagmire with the shabby treatment a majority of taxpayers must endure because of it.

[4] See *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *petition for cert. filed*, 72 U.S.L.W. 3428 (U.S. Dec. 24, 2003) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003), *petition for cert. filed*, 72 U.S.L.W. 3427 (U.S. Dec. 19. 2003) (No. 03-892).

[5] 345 F.3d 373 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907).

[6] 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

[7] 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415).

[8] *Commissioner v. Sunnen*, 333 U.S. 591, 599 (1948).

[9] See Adam Smith, *The Wealth of Nations* (1776, reprinted 1994 Modern Library).

Ridiculous Redux

The Second Circuit's recent decision in *Raymond v. United States*[10] is clearly disappointing, though hardly surprising.

On the heels of *Banks v. Commissioner*,[11] surely one could hope for a bit more fairness and vision from the influential Second Circuit than a hackneyed discussion of the hoary (and frequently misapplied) assignment of income cases.[12]

As you may recall, *Banks* found *Horst* and *Earl* to be unpersuasive.[13] Instead, the Sixth Circuit in *Banks* joined the Fifth Circuit in *Srivastava v. Commissioner*[14] in finding that the strength of the applicable attorneys' lien law is irrelevant in deciding whether recovered contingent attorneys' fees constitute gross income.[15]

This allowed the Sixth Circuit to sidestep the otherwise seemingly obligatory *Cotnam* analysis and instead determine that the application of *Cotnam* does not depend on ''the intricacies of an attorneys' bundle of rights.''[16]

Basking in the Warm Afterglow

After *Banaitis* and *Banks*, it seemed at least conceivable that cooler heads might prevail, and that the circuit courts were heading in the right direction with this runaway train. Sadly, the Second Circuit's decision in *Raymond v. United States*[17] is a significant enough setback that it could provoke a kind of tax equivalent of Michael Douglas in *Falling Down*.

Raymond started as a garden-variety wrongful termination case. After being fired by IBM in 1993, Raymond hired a contingent fee lawyer and sued for wrongful termination. The lawyer was entitled to receive one-third of the net recovery, plus expenses. Raymond won a jury verdict. IBM appealed and lost, and then paid the roughly $900,000 judgment.

On his 1998 federal income tax return, Raymond included the entire recovery in gross income, including the approximately $300,000 paid to his attorneys. In 1999, Raymond filed an amended return requesting a refund for the taxes relating to the amount paid to his lawyers. Not surprisingly, the Internal Revenue Service denied the refund claim.

Undeterred, Raymond filed a refund suit in district court.[18] The court awarded the refund, allowing Raymond to exclude the portion of the recovery paid to his contingent fee attorneys.

In its holding, the court found that applicable Vermont law gave Raymond's attorneys an equitable lien

[10] 2004 U.S. App. LEXIS 417 (2d Cir. Jan. 13, 2004).

[11] 345 F.3d 373 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

[12] See *Raymond* at 419, *citing Helvering v. Horst*, 311 U.S. 112 (1940) and *Lucas v. Earl*, 281 U.S. 111 (1930).

[13] See *Banks* at 383. See also, Robert W. Wood and Dominic L. Daher, *Attorneys' Fee Debacle Keeps Going, Going, and Going as Mutinous Sixth Circuit Refuses Reliance on Lien Law Analysis*, BNA Daily Tax Report (11 DTR J-1, 1/20/04).

[14] 220 F.3d 353 (5th Cir. 2000).

[15] See *Banks* at 385 *quoting Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000).

[16] Id.

[17] 2004 U.S. App. LEXIS 417 (2d Cir. Jan. 13, 2004).

[18] See *Raymond v. United States*, 247 F. Supp. 2d 548 (D. Vt. 2002).

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on his recovery.[19] This equitable lien effectively transferred to Raymond's attorneys a proprietary interest in his claim.[20] The district court found that the portion of the recovery used to pay attorneys' fees already belonged to the attorneys—so the attorneys, not Raymond, had to pay tax on this amount. The government appealed to the Second Circuit.[21]

Through the Looking Glass

Unfortunately, the Second Circuit launches into a tortured tour of assignment of income lore. The Second Circuit in *Raymond* flopped on its first opportunity to address the attorneys' fee issue by resorting to antediluvian assignment of income cases, namely *Lucas v. Earl*[22] and *Helvering v. Horst*.[23]

Unless you have been hiding under a rock, you know that these cases involved assignments of income by persons who had earned the income, but not yet received it. To make matters worse, they ''assigned'' the income to related parties—family members. In *Earl* and *Horst*, the taxpayers were correctly considered to have taxable income even though they never had actual possession of the funds.

Regrettably, the Second Circuit in *Raymond* does not distinguish *Earl* and *Horst* from the contingent attorneys' fee fact pattern the way the Sixth Circuit did in *Estate of Clarks*.[24] I think it is fair to argue that the value of Raymond's lawsuit was entirely speculative and dependent on the services of his counsel. I might even go so far as to say that the claims of his counsel amounted to little more than an intangible contingent expectancy.

Although the Second Circuit acknowledged that *Estate of Clarks* analogized a contingent fee agreement to an interest in a partnership or joint venture, the Second Circuit quickly dismissed the analogy.

The Second Circuit rejected the *Estate of Clarks* argument that Raymond contracted for the services of his lawyer and assigned his lawyer a one-third interest in the venture so that he might have a chance to recover the remaining two-thirds. Rejecting *Estate of Clarks* and *Cotnam*, the Second Circuit found Vermont's attorneys' lien law too weak to support a *Cotnam*-like result.

In what arguably amounts to mental genocide, the Second Circuit in *Raymond* gives an enormously strong endorsement of *Earl*, *Horst*, and the assignment of income doctrine. Why not avoid the whole assignment of income mess by joining up with *Banks* and following *Srivastava*?[25]

This would have allowed the Second Circuit to sidestep the lien law analysis that has instigated much of this mess.

Raymond's attorney has now petitioned the U.S. Supreme Court for certiorari.[26]

With the possible exception of tax lawyers, few people have pored over attorneys' lien laws for many years. Recently, of course, many cases have focused on the strength of the applicable attorneys' lien law.[27]

Assignment of Income Inconsistencies

Why should the tax treatment of attorneys' fees be predicated on ''the intricacies of an attorneys' bundle of rights,'' which vary wildly from state to state?[28]

This should be a rhetorical question but sadly it is not. In a true assignment of income setting, such as the facts involved in *Earl* and *Horst*, only the assignor pays tax on the income. In essence, the purported assignment is disallowed for tax purposes. A taxpayer living in one of the ''bad circuits'' is taxed on the entire recovery, including the recovered contingent attorneys' fees.

The alleged ''assignment'' to the attorney in the case of contingent fee recoveries is both disregarded and recognized. It is disregarded in the sense that the plaintiff is taxed on the entire recovery. Yet it is also recognized in the sense that the attorney too is taxed on the recovered attorneys' fees.

Of course, the attorney is also taxed on the recovered attorneys' fees. Thus, the plaintiff (particularly when considered in conjunction with the lawyer) is actually worse off than the assignor in an abusive assignment of income fact pattern.

Put another way, the alleged ''assignment'' to the attorney in the case of contingent fee recoveries is both disregarded and recognized. It is disregarded in the sense that the plaintiff is taxed on the entire recovery. Yet it is also recognized in the sense that the attorney too is taxed on the recovered attorneys' fees.

The assignment of income doctrine, first applied in *Earl*, was never designed to tax the same income twice. Rather, it was merely designed to prevent the shifting of income to people in lower tax brackets.[29] There is enough money involved in most of these attorneys' fee cases that plaintiffs and attorneys alike will be paying tax at the highest marginal tax rate. But this is hardly

[19] Id. at 554 *citing Estate of Button v. Anderson*, 112 Vt. 531, 533 (1942).

[20] Id.

[21] *Raymond v. United States* , 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415).

[22] 281 U.S. 111 (1930).

[23] 311 U.S. 112 (1940).

[24] See *Estate of Clarks* at 856-57.

[25] See *Banks* at 385 *quoting Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000) (holding that the strength of the applicable attorneys' lien law is irrelevant in deciding whether recovered contingent attorneys' fees constitute gross income).

[26] *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *petition for cert. filed*, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415).

[27] See, e.g., *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); compare with *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001).

[28] See *Banks* at 385 *quoting Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000).

[29] See *Lucas v. Earl*, 281 U.S. 111 (1930).

the point. The attorneys' fee fact pattern involves true double taxation, a phrase that used to be seen as undermining fundamental tax fairness.

Stayin' Alive

With one of the Bee Gees dying this past year, it may be strained to rely on the title and lyrics of one of their platinum disco hits. Yet, would it not be grand if the Supreme Court in *Banaitis* and *Banks* (or even *Raymond*) resolved this injustice in favor of taxpayers? Clearly one should not hold out much hope.[30] In fact, Elton John's *Goodbye Yellow Brick Road* may be a more fitting theme song here.

In the near term, direct payment of attorneys' fees still seems an appropriate course of action as one element of an attempt to avoid the pitfalls of assignment of income cases such as *Helvering v. Horst*[31] and *Lucas v. Earl*.[32] The Sixth Circuit in *Banks* and *Estate of Clarks* distinguishes *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.

In a good number of cases involving the attorneys' fee issue the value of the taxpayer's lawsuit is speculative and dependant on the services of counsel. Unfortunately, many courts do not agree and have not distinguished *Horst* and *Earl* in this context.[33] It is generally easy to facilitate direct payment of attorneys' fees, and it certainly seems to be a good idea to do so whenever possible. It may help preserve tax arguments, and may even help to avoid malpractice liability.[34]

Beyond mere direct payment, it may also be possible to petition the court to award the attorneys' fees. Where attorneys themselves are directly entitled to the attorneys' fees a strong argument exists that the recovered attorneys' fees are not income to the plaintiff.[35]

No doubt this will continue to be a volatile area of the tax law. Taxpayers and litigators alike should proceed with caution. Obtain tax advice before any settlement is reached. Make sure the settlement payments are made properly. And be certain that every settlement agreement specifies who is going to get any Forms 1099 or W-2 which will be issued by the defendant.

While my concerns are solely the tax consequences of this conundrum, malpractice liability may also loom. In *Jalali v. Root*,[36] a jury found a litigator liable for malpractice where he had mistakenly advised his client with respect to the tax consequences of his recovery. Luckily for the attorney, the judgment was reversed on appeal.[37]

In the end, the attorney was successful in refuting his former client's claims, but only after expending substantial time, energy, expense, and aggravation.

Unanswered Questions

What will happen the next time a court is asked to decide the attorneys' fee issue? Will the lien law analysis be rejected by the Supreme Court when it hears *Banks* and *Banaitis*?

On a more local scale, is it possible the Second Circuit may end up splitting itself in two much like the Ninth Circuit?[38] How many more intra-circuit splits will arise? Only time will tell.

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

[31] 311 U.S. 112 (1940).

[32] 281 U.S. 111 (1930).

[33] See, e.g., *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001).

[34] See, e.g., *Jalali v. Root*, Orange Co. Super. Ct., No. 810531, *rev'd* 109 Cal. App. 4th 1768, 1 Cal. Rptr. 3d 689 (4th Dist., 6/9/03).

[35] See *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Sinyard v. Rossotti*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002) (holding that because the prevailing plaintiffs, rather than their attorneys, were entitled to court-awarded attorneys' fees, they must include the recovered fees in their gross income); compare with *Flannery v. Prentice*, 28 P.3d 860, 862 (2001) (holding that under California law absent proof of an enforceable agreement to the contrary, the attorneys' fees belong "to the attorneys' who labored to earn them").

[36] Orange Co. Super. Ct., No. 810531.

[37] *Jalali v. Root*, 109 Cal. App. 4th 1768, 1 Cal. Rptr. 3d 689 (4th Dist. 6/9/03), *as modified on denial of rehearing* 7/8/03).

[38] Compare *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907) (holding recovered contingent attorneys' fees are not gross income to the plaintiff); with *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied,* 531 U.S. 1112 (2001) (holding recovered contingent attorneys' fees are gross income to the plaintiff); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied,* 532 U.S. 972 (2001) (holding the same).

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