

Viewpoint

IRS's MSSP on Lawsuit Awards, Settlements: Useful as a Gelding at a Stud Farm?

BY ROBERT W. WOOD AND DOMINIC L. DAHER

Way back in 2001, with a better economy and a slimmer budget deficit, the Internal Revenue Service issued its Market Segment Specialization Program Audit Guide for Lawsuit Awards and Settlements (MSSP).

The MSSP essentially serves as a guidebook for IRS auditors looking to target taxpayers in this area. In the MSSP, the IRS looks to attorneys' fee agreements and to state attorneys' lien laws to resolve the attorneys' fee taxation issue.

This issue appears deceptively simple. Must a plaintiff include in gross income (and then deduct as a miscellaneous itemized deduction) the amount of contingent attorneys' fees paid to the his lawyer? Or, can the plaintiff net the attorneys' fees and report only his share of the loot? Simple, right? Not really.

Admittedly, the service has had some success with arguments based on these state law and lien law factors (who really owns the attorneys' fees, blah, blah, blah . . .). Consider for example, *Alexander v. Commissioner*,¹ *Young v. Commissioner*,² *Kenseth v. Commissioner*,³ *Bagley v. Commissioner*,⁴ *Benci-Woodward v. Commissioner*,⁵ *Coady v. Commissioner*,⁶ *Hukkanen-Campbell v. Commissioner*,⁷ and *Baylin v. Commissioner*.⁸

¹ 72 F.3d 938 (1st Cir. 1995).

² 240 F.3d 369 (4th Cir. 2001).

³ 259 F.3d 881 (7th Cir. 2001).

⁴ 121 F.3d 393 (8th Cir. 1997), *en banc reh'g denied* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997).

⁵ 219 F.3d 941 (9th Cir. 2000), *cert. denied* 531 U.S. 1112 (2001).

⁶ 213 F.3d 1187 (9th Cir. 2000), *cert. denied* 532 U.S. 972 (2001).

⁷ 274 F.3d 1312 (10th Cir. 2001), *cert. denied* 535 U.S. 1056 (2002).

⁸ 43 F.3d 1451 (Fed. Cir. 1995).

Robert W. Wood practices law with Robert W. Wood P.C., in San Francisco (<http://www.robertwood.com>). He is the author of 26 books, including *Taxation of Damage Awards and Settlement Payments* (2d Ed. © 1998 with 2001 supplement), published by Tax Institute (info@taxinstitute.com).

Dominic L. Daher is a senior tax manager with Robert W. Wood P.C. He writes for various scholarly and professional journals, and teaches federal taxation at the University of San Francisco School of Business and Management.

How many times have we seen the service do the all-too-familiar *Cotnam*⁹ shuffle? How many times have we seen the service trot out the usual hoary assignment of income cases, namely *Helvering v. Horst*¹⁰ and *Lucas v. Earl*¹¹ in this context?

Fair Winds? On the brighter side, some more recent cases, such as *Srivastava v. Commissioner*¹² and *Banks v. Commissioner*¹³ provide credible arguments that the developments in this area have caused this MSSP to become obsolete. At the very least, winds of change are blowing.

It is high time for the IRS to stop playing kids' games on this issue and give practitioners some guidance that is straightforward and indicative of recent developments in this area of the law.

The MSSP states that taxpayers are generally required to include recovered attorneys' fees in their gross income. However, the MSSP carves out a three-state exception—it indicates that in “cases arising under Alabama, Michigan and Texas law” taxpayers are not required to include recovered attorneys' fees in gross income.

Even in those cases, the MSSP advises field agents to “consult with the appropriate local Office of Chief Counsel for the current status of this issue.” Gee, wonder what they might have to say? This language is a little hokey, even if it may be well intentioned. As an IRS field agent, would you not want to receive clear and concise audit directives so you do not have to consult the Office of Chief Counsel every time this issue rears its ugly head? Sure you would. Why not provide the field agents with an MSSP they can actually use?

'Arising Under' What? Unfortunately, it is not clear to what specific matters the “arising under” language refers. In fact, we've thought about this a lot, and we are not sure anyone really knows what is meant by this phrase.

Does the language refer to the law governing the retainer agreement? Does it refer to the state in which the

⁹ *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959).

¹⁰ 311 U.S. 112 (1940).

¹¹ 281 U.S. 111 (1930).

¹² 220 F.3d 353 (5th Cir. 2000).

¹³ 2003 WL 22232331, 2003 Fed. App. 0347P (6th Cir. Sept. 30, 2003).

lawsuit was filed? Does it refer to the state in which the taxpayer resides? Heck, does it refer to where the taxpayer walks his dog? Does the service even know what it is referring to by this language?

Might it refer to the state law under which the claims arose? A plain reading of this “arising under” language would not seem to encompass the state of residency of the taxpayer, but perhaps that is what it means. It is high time for the service to stop playing kids’ games on this issue and give practitioners some guidance that is straightforward and indicative of recent developments in this area of the law.

We have long hoped that the Supreme Court would get involved. Barring that (or action by Congress), perhaps it is time for the service to at least give its field agents updated audit directives to use when they are tackling this issue.

We also question whether the MSRP’s reference to Texas (rather than the entire Fifth Circuit) is too narrow. Indeed, it is not an overstatement to say that *Srivastava v. Commissioner* is applicable to the entire Fifth Circuit, which includes not merely Texas, but also Louisiana and Mississippi.

In *Srivastava*, the Fifth Circuit established that the strength of the applicable attorneys’ fees statute is not relevant for determining whether the taxpayer must include recovered attorneys’ fees in gross income. *Srivastava* clearly suggests that a taxpayer is entitled to exclude contingent attorneys’ fees from gross income in the entire Fifth Circuit.

Did the MSSP miss the boat by listing Texas as the only state within the Fifth Circuit that is taxpayer-friendly? Presumably this position would not extend to the entire 11th Circuit (even though the 11th Circuit was split from the Fifth), since *Srivastava* occurred long after that split. While we would still have the same nettlesome “arising under” conundrum (what does this mean?), at least we would add Louisiana and Mississippi to the list of “good” states to be under, to be arising under, or whatever . . .

Bank on ‘Banks.’ As if all of this was not enough, there are still further developments which also merit revisions to the MSSP. After *Banks v. Commissioner*, consider how the MSSP would (or should) apply in the Sixth Circuit. In *Banks*, the Sixth Circuit adopted *Srivastava*. In doing so, it found that resolution of the attorneys’ fee issue does not depend on “the intricacies of an attorneys’ bundle of rights.”¹⁴ This allowed the Sixth Circuit to follow *Estate of Clarks v. Commissioner*¹⁵ without protracted inquiries into “the intricacies of an attorney’s bundle of rights.”¹⁶

Does the rule of *Banks* now apply to the entire Sixth Circuit? This seems to be the correct result, and the service should arguably embrace it. But there is a larger (albeit perhaps a bit cynical) question here. Given the current state of affairs, is the MSSP worth the paper it is printed on, or is it yesterday’s news?

Why hasn’t the service gotten around to updating its audit directives on this issue? What is going to happen the next time the Tax Court or a U.S. District Court is asked to decide the attorneys’ fee issue where the appeal lies to the Sixth Circuit? Is it not fair to say that the Sixth Circuit has unequivocally adopted the Fifth Circuit’s holding in *Srivastava*? Is state-law-specific analysis a thing of the past in the Sixth Circuit?

Rhetorical questions? Hardly. Indeed, at this stage of the game, who is to say how a given court might rule on the attorneys’ fee issue. We have long hoped that the Supreme Court would get involved. Barring that (or action by Congress), perhaps it is time for the service to at least give its field agents updated audit directives to use when they are tackling this issue. God forbid the service acknowledge that the tide may be turning against it.

Time to Reinvent the Wheel. Given *Srivastava* and *Banks*, this MSSP should do more than merely list the “good” states that the circuit courts have blessed (such as Alabama, Michigan, Texas, and most recently Oregon). At a minimum, under *Srivastava* and *Banks*, the MSSP should list all of the states in the Fifth and Sixth Circuits as “good” states.

If you truly believe the *Srivastava* and *Banks* courts, you might even be able to make a plausible argument that the MSSP should list all of the states in any circuit where there has been a favorable holding. In any case—however you read these cases—the MSSP just does not do this area justice. Taxpayers and IRS personnel both deserve better.

¹⁴ *Id.* at p. 21 quoting *Srivastava* at 364.

¹⁵ 202 F.3d 854 (6th Cir. 2000).

¹⁶ *Id.*