Supreme Court Attorney Fees Decision Leaves Much Unresolved

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The Supreme Court's decision in *Commissioner v. Banks* and *Commissioner v. Banaitis* (which were consolidated for briefing and argument) was widely anticipated. Those cases, on the treatment of attorney fees, followed a decade of bitterly fought litigation, leaving a deep rift in the circuit courts around the United States. The lack of uniformity and injustice of the rule prevailing in the majority of circuits led to forum shopping and frequent gerrymandering of attorney fees arrangements — all in an attempt to avoid plaintiffs being taxed on money they never see.

That extreme case, of course, shrieks of inequity and bears no relationship to fundamentals of a fair tax system, because normally one is not taxed on something one does not receive. The problem has led to endless academic debates, numerous legislative attacks from taxpayer groups, a strident position announced by the National Taxpayer Advocate, and, ultimately, passage of the attorney fee provision of the American Jobs Creation Act of 2004 (P.L. 108-357).[1]

The problem, of course, is that a plaintiff who receives a gross award of $100, owing 40 percent to his lawyer, might logically assume he has $60 of gross income. Most circuits, however, held that the plaintiff actually has $100 of gross income and must claim a deduction for the $40 paid to the attorney (even if the attorney is paid directly out of the proceeds of the case and the money never passes through the plaintiff's hands). A plaintiff in that jurisdiction does not get the benefit of a full $40 deduction, generally because of three factors: (1) the 2 percent floor on miscellaneous itemized deductions, (2) phaseout of deductions and exemptions for high-income taxpayers, and (3) the alternative minimum tax.

How serious the problem can be varies with the numbers involved and the percentage of contingent fees. There have, however, been cases in which plaintiffs have actually lost money after tax when those deduction tax rules are taken into account.[2] A few circuits had allowed plaintiffs to report gross income measured only by their

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[1]For discussion of the above-the-line attorney fees deduction created by the Jobs Act, see Wood, ''Jobs Act Attorney Fee Provision: Is It Enough?'' *Tax Notes*, Nov. 15, 2004, p. 961.

[2]*See Spina v. Forest Preserve District of Cook County*, 207 F. Supp.2d 764 (N.D. Ill. 2002), as reported in 2002 National Taxpayer Advocate Report to Congress at 166. *See* Adam Liptak, ''Tax Bill Exceeds Award to Officer in Sex Bias Case,'' *The New York Times*, Aug. 11, 2002, section 1, p. 18.

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 attorney fees. One of the cases advanced a kind of partnership theory of attorney fee taxation.[3]

Supreme Court 'Fix'

After denying certiorari in five attorney fee cases,[4] the Supreme Court finally agreed to resolve all the fuss. I was pessimistic about how helpful the Court would be on the question, because it had denied certiorari in those five cases in which taxpayers cried out for help on a tax issue that seemed to cry out for resolution. They were all cert. petitions filed by taxpayers who had been whipsawed by the limitations on deductions.

Then came *Banks*[5] and *Banaitis*.[6] Those two cases involved what I like to refer to as the ''good'' circuits, in which attorney 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. Even though the Supreme Court had five times refused to hear a case on attorney fees in which the taxpayer had lost, in both *Banks* and *Banaitis* it was the IRS that lost and asked the Supreme Court to intervene. After granting certiorari in both cases, the Court combined them for briefing and argument.

One last procedural point before we get to the holding. Some foreshadowing occurred on enactment of the Jobs Act. It includes an attorney fee provision that eliminates limitations on deductions for attorney fees in several classes of cases (Federal False Claims Act cases and most, if not all, employment litigation claims).[7] 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.[8]

The Jobs Act was enacted on October 22, 2004. Oral argument in *Banks* and *Banaitis* was scheduled for November 1, 2004. The taxpayers' supplemental brief argued that the Jobs Act provision had mooted the case, so it was not necessary for the Court to make that tough decision. Because Banks and Banaitis had both won their cases, they wanted to have the Court treat the 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 attorney 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.

The Holding

The Supreme Court rendered its decision on January 24, 2005. The actual holding is succinct, although much of the Court's opinion is not. The holding bears quoting, particularly because there will be much speculation about what the opinion does and does not do. All — and I think it is fair to say that this truly means all — 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.[9]

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

The opinion is written by Justice Kennedy, joined by all members of the Court 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 — may surprise some readers. It did me.

Where are those justices who in oral argument just last November were expressing concern about possible confiscatory taxation? Justice O'Connor made more than a passing point about that during oral argument, saying the tax on attorney fees might even raise constitutional questions. And Justices Breyer and Ginsburg made similar suggestions. Then, nothing. Is there something in the water over there?

I guess we'll never know. The opinion just dodders along. Justice Kennedy (or his clerks, if they are to blame) doesn't write a particularly convincing tax decision — not this time, anyway. After stating its holding ''as a general rule,'' the Court recites the *Banks* and *Banaitis* facts, explains the problem of deducting legal fees as a miscellaneous itemized expense, and 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 that act been in force for the transactions in *Banks* and *Banaitis*, there would have been no case before it.

The Court notes, though, that the Jobs Act is not retroactive, so that the taxpayers in *Banks* and *Banaitis* still need a decision.[10] Interestingly, some have argued

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[3]*See Estate of Clarks v. U.S.*, 202 F.3d 854, *Doc 2000-1776, 2000 TNT 10-21* (6th Cir. 2000).

[4]*Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766, 2000 TNT 117-9* (9th Cir. 2000), *cert. denied* 532 U.S. 972 (2001); *Benci-Woodward v. Commissioner*, 219 F.3d 941, *Doc 2000-20007, 2000 TNT 144-8* (9th Cir. 2000), *cert. denied* 531 U.S. 1112 (2001); *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862, 2001 TNT 188-11* (9th Cir. 2001), *cert. denied* 536 U.S. 904 (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455, 2001 TNT 247-75* (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).

[5]345 F.3d 373, *Doc 2003-21492, 2003 TNT 190-11* (6th Cir. 2003), *cert. granted* 2004 U.S. Lexis 2384 (U.S. March 29, 2004).

[6]340 F.3d 1074, *Doc 2003-19359, 2003 TNT 167-5* (9th Cir. 2003), *cert. granted* 2004 U.S. Lexis 2385 (March 29, 2004).

[7]*See* Wood, *supra* note 1.

[8]*See* supplemental brief of *Banks* and *Banaitis*, filed October 25, 2004 (Nos. 03-892 and 03-907).

[9]*Banks*, slip op. at 2005 U.S. Lexis 1370 (*Doc 2005-1418, 2005 TNT 15-10*).

[10]For the argument that the Jobs Act provision is merely a clarification of existing law despite its prospective effective date, see the Senate floor debate discussed in Wood, ''Effective Date of Attorneys' Fee Deduction Misses Many Judgments,'' *Tax Notes*, Dec. 20, 2004, p. 1643.

that a Senate floor colloquy between Senate Finance Committee Chair Charles E. Grassley, R-Iowa, and committee ranking minority member Max Baucus, D-Mont., is support for the argument and that the Jobs Act is retroactive — that is, that it merely enunciates current law. Presumably, the Court's notation that the Jobs Act is not retroactive is meant to squelch that argument.

In large part, the Supreme Court adopts the tried and true assignment of income cases, referring to such hoary chestnuts as *Helvering v. Horst*[11] and *Lucas v. Earl*.[12] Most of that 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 when the opinion becomes puzzling.

In strident language, the Court addresses the theory that the attorney-client relationship can be viewed as a kind of business partnership or joint venture for tax purposes. That was the subject of a raging academic debate before the case was heard. The Court says it rejects that partnership suggestion, dismissing it with one sentence. Later in the opinion, however, the Court says it's not considering that question at all. The Court then talks about the lawyer as an agent, and it cites liberally from the *Restatement of Agency*.

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*[13] makes it all clear. The Court dispenses with the notion that state law might confer special benefits on attorneys who might influence ownership and therefore taxation. Instead the Court concludes that lawyers are mere agents, and it 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 ''this 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.''[14] 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 it is aware actually converts the attorney from an agent to a partner.

That suggests the Court does not (and perhaps cannot) comment on all state laws. As one example, the recent enactment of a Washington attorneys' lien law (which in my opinion is far stronger than any of the state laws considered by the Supreme Court) should give one pause.[15] So it is unclear just how far the ''general rule'' announced by the Court goes.

[11] 311 U.S. 112 (1940).

[12] 281 U.S. 111 (1930).

[13] 259 F.3d at 881, *Doc 2001-21203, 2001 TNT 154-9* (7th Cir. 2001).

[14] *Banks* at 9-10.

[15] For discussion of the Washington law, see Wood, ''Washington's Attorneys' Lien Law,'' *The Tax Adviser* (December 2004), p. 729.

All Things Considered — Not!

What the Supreme Court does next is a real zinger. The Court notes that the taxpayers, and particularly the *amicus* briefs, propose other theories that would exclude the attorney fees from gross income or permit their deductibility. The Court refers to many of those as ''novel propositions,'' stating that those arguments are being presented for the first time in the Supreme Court, were not advanced in the earlier stages of the litigation, and therefore were not examined by the courts of appeal. The Supreme Court says it declines comment on those supplementary theories. The Court says that those suggestions include the theories that:

- the contingent fee agreement establishes a subchapter K partnership;
- litigation recoveries are proceeds from the disposition of property, so that the attorney fees must be subtracted as a capital expense from the proceeds; and
- the fees are deductible reimbursed employee business expenses.

Noting that it is considering none of those arguments (and that is apparently a nonexclusive list of what the Court is not considering), the Court also says it does not reach the fact pattern in which a relator pursues a claim on behalf of the United States under the Federal False Claims Act. That means that although False Claims Act cases are covered prospectively by the Jobs Act, the False Claims Act cases of the past are not affected by the *Banks* opinion. That is good news.

As if those carveouts were not enough, the Supreme Court delivers another zinger when it addresses statutory fee shifting provisions, as well as injunctive relief. The Court notes that 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' attorney fees) is important to encourage 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 that case that the client is ''paying'' the plaintiffs' lawyer anything, because the court is awarding the fees. Taxpayers have sometimes taken comfort from cases such as *Flannery v. Prentice*,[16] 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 the attorney or the client was entitled to fees awarded under the California Fair Employment and Housing Act. The court found that, absent proof of an enforceable agreement to the contrary, the attorney fees belonged ''to the attorneys who labored to earn them.''[17]

[16] 26 Cal.4th 572, 28 P.3d 860 (2001).

[17] *Flannery v. Prentice*, 28 P.3d at 862.

Significantly, the Supreme Court dodges the fee-shifting issue, stating that "we need not address these claims."[18] 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's attorney, nor, said the Court, was there any indication in Banks's contract with his lawyer — or in the settlement agreement with the defendant — that the contingent fee paid to Banks's lawyer was in lieu of statutory fees that Banks might otherwise have been entitled to recover.

All of those explanations are important. The Court suggests that the result in *Banks* might well have been different if there were a court-ordered fee award. The Court also suggests that the result might be different if there were any indication in Banks's 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 that effect.

Presumably, it would be necessary for only one of those important differences from the *Banks* facts to be present for the result in *Banks* to have been different. If one had all of those 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's 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 when there is injunctive relief. Although it is related to the fee-shifting point, I see it as distinct. The Court notes that sometimes — as when the plaintiff seeks only injunctive relief, or when the statute caps the dollar amount of a plaintiff's recovery, or when for other reasons damages are substantially less than attorney fees — court-awarded attorney fees can exceed a plaintiff's monetary recovery. The Court notes that treating the fee award as income to the plaintiff in those cases can lead to the perverse result that the plaintiff loses money by winning the suit. That, of course, was the deplorable situation in the now famous *Spina* decision.[19] The Supreme Court once again says it need not address those claims.

Class Actions

The tax treatment of attorney 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 attorney fees), and even between class members who sign versus those who don't sign a fee agreement with class counsel. Those niceties still haven't made sense of the area.[20] Some class members get stuck with a tax bill on lawyer fees.[21] Because of the nature of class actions, fees can be especially high, with *Spina*-like results. The *Banks/Banaitis* case, with its sidestepping of the statutory fee issue, does nothing to help clarify that morass.

Insurance Industry

There may be a silver lining or two in *Banks* for the insurance industry. First, the fact that it is an adverse decision on the attorney 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.[22] A nonqualified structure, with its stretching of tax consequences, can ameliorate the AMT problems caused by attorney fees.

For some plaintiffs, *Banks* means there will continue to be tax problems caused by contingent attorney fees. For example, claims for defamation, false imprisonment, intentional or negligent infliction of emotional distress, and insurance bad faith will still give rise to attorney fee AMT problems. Any case with punitive damages (even true personal physical injury cases) also can raise the problem. Even employment claims that resulted in a verdict before October 23, 2004, may still be caught with the problem when they are resolved on appeal, because the pertinent effective date of the Jobs Act provision is judgments "occurring" after October 22, 2004.[23] Even successful litigants whose cases are on appeal will have a strong incentive to "settle" the case, because a settlement (unlike having the verdict affirmed on appeal) would bring the case within the Jobs Act provision.

Structures of attorney fees themselves may become more popular after *Banks*. Some insurance companies have accomplished attorney fee structures with a section 130 qualified assignment. Those companies have argued 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, however, have shied away from using a qualified assignment company and have generally used a nonqualified assignment company.[24] The decision in *Banks* more firmly solidifies the view that damages (outside the statutory fee area) first and foremost belong to the client. That should make more insurance companies comfortable in using qualified assignment companies for structured settlements of attorney fees. That should mean there will be more structures of attorney fees, because the number of providers will be growing.

A related point is that structures of attorney fees should get a boost from the implications *Banks* has on section 72(u). That section taxes the cash buildup in value of a life insurance policy in some cases. A notable exception is a "qualified funding asset" as defined in section 130(d). That provision therefore favors qualified structured settlements (under sections 104 and 130) as opposed to unqualified (meaning taxable) ones. It has led

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[18] *Banks* at 11.

[19] *See supra* note 2.

[20] *See* Wood and Daher, "Class Action Attorneys Fees: Even Bigger Tax Problems," *Tax Notes*, Oct. 27, 2003, p. 507.

[21] *See Sinyard v. Commissioner*, *supra* note 4.

[22] *See* Wood, "Structured Settlements in Non-Physical-Injury Cases: Tax Risks?" *Tax Notes*, Aug. 2, 2004, p. 511.

[23] *See* Wood, *supra* note 10.

[24] *See* Wood, *supra* note 22.

some insurance companies to position assignment companies outside the United States for nonqualified structures. The *Banks* decision suggests that contingent attorney 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 attorney fees can be domestic in light of *Banks* suggests that there may be more attorney fee structures.

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, suggested that all personal injury recoveries would be taxable.[25] That misunderstanding is likely to arise when there is more hysteria than tax rules usually generate.

This misunderstanding led to a quick reaction from the National Structured Settlement Trade Association, which pointed out the error to the *Times* and generated a retraction.[26] All that is much hubbub, more than one usually sees with a tax case.

Where Do We Go Now?

Perhaps many of us were wrong to think that the Supreme Court, already materially aided by Congress in the Jobs Act, would clear up the whole attorney fee mess. I guess we were very wrong. In fact, the decision is underwhelming, though perhaps its lack of precision will allow for some taxpayer planning.

I'm tempted to try to create a chart about the kinds of cases that are not resolved by the Jobs Act and also not resolved by the Supreme Court's *Banks* opinion. However, my skills with graphics are poor, so I'll just try to describe what I think are the open areas.

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 before October 23, 2004) are governed by old law.[27] Because there is no definitive case concerning the tax implications of a False Claims Act case, I suppose 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 attorney fee situation.

A relator in a False Claims Act case serves as a private attorney general and is in the nature of a bounty hunter. That 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 attorney fees without running afoul of the 2 percent itemized deduction threshold, deduction phaseout, or AMT.

Another big area left open by *Banks* 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 attorney fees 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 simple to add one of those elements. It might make for a better tax result.

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 it gone to trial. Likewise, perhaps that 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 the amendment comes on the eve of settlement. The amendment can presumably be made effective as of the date of the original agreement. That is not backdating. If that kind of planning is all it takes to avoid the result in *Banks*, the *Banks* decision will not have as significant an effect 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 attorney fees and a relatively small award. Think *Spina*.[28] The fact that the Supreme Court sidesteps that fact pattern suggests once again that perhaps one can obviate the *Banks* result in a case of this sort. Allocating the attorney fees between the injunctive relief and the cash compensation might be one alternative. Mandating the direct payment of the attorney fees, providing the appropriate language in the settlement agreement, and making sure that a Form 1099 goes directly (and only) to the lawyers, might all help to carry the day.

Yet another open area concerns the whole partnership theory. As noted above, although the Supreme Court devotes one sentence to rejecting the partnership theory at the beginning of the *Banks* opinion, it later says it is not considering the question at all. That leads me to wonder whether partnershiplike language in a contingent fee agreement might carry the day. 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 that language can't hurt, particularly because the Supreme Court seems to invite that kind of planning.

There are probably other planning opportunities I'm missing here. I think we all need time to digest the Supreme Court's decision and the effect 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. I have 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 attorney fees deduction) and "bad" other claims.[29] If I'm right that the

[25]*See* David G. Savage, "Lawsuit Winner Loses the Tax Battle," *Los Angeles Times*, Jan. 25, 2005, p. A14.

[26]*See* "For the Record," *Los Angeles Times*, Jan. 26, 2005, p. A2.

[27]Regarding cases on appeal, see Wood, *supra* note 10.

[28]*See supra* note 2.

[29]*See* Wood, *supra* note 1.

IRS may raise this bifurcation point, it means that the *Banks* decision, albeit looking a bit like Swiss cheese with the planning holes that the Supreme Court drilled for us, will become that much more important.

Stay tuned. And you thought the attorney fee debate was over. . . .