IRS Audit Guide on Damage Awards Misses the Mark

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Way back in 2001, with a better economy and a slimmer budget deficit, the IRS issued its Market Segment Specialization Program Audit Guide for Lawsuit Awards and Settlements (*Doc 2001-2574 (72 original pages), 2001 TNT 18-6*). The publication essentially serves as a guidebook for IRS auditors looking to target taxpayers in this area. In the audit guide the IRS looks to attorney fee agreements and to state attorneys' lien laws to resolve the attorney fee 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 attorney fees paid to his lawyer? Or can the plaintiff net the attorney fees and report only his share of the loot? Simple, right? Not really. See Robert W. Wood and Dominic L. Daher, "Class Action Attorney Fees: Even Bigger Tax Problems?" *Tax Notes*, Oct. 27, 2003, p. 507.

Admittedly, the IRS has had some success with arguments based on the state law and lien law factors (who *really* owns the attorney fees, blah, blah, blah . . .). Consider, for example, *Alexander v. Commissioner*, 72 F.3d 938, *Doc 96-602 (21 pages), 96 TNT 1-74* (1st Cir. 1995); *Raymond v. United States*, 2004 U.S. App. LEXIS 417, *Doc 2004-760 (17 original pages), 2004 TNT 10-11* (2nd Cir. Jan. 13, 2004); *Young v. Commissioner*, 240 F.3d 369, *Doc 2001-5150 (21 original pages), 2001 TNT 36-11* (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, *Doc 2001-21203 (4 original pages), 2001 TNT 154-9* (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393, *Doc 97-23130 (9 pages), 97 TNT 153-8* (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, *Doc 2000-20007 (7 original pages), 2000 TNT 144-8* (9th Cir. 2000), *cert. denied* 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766 (7 original pages), 2000 TNT 117-9* (9th Cir. 2000), *cert. denied* 532 U.S. 972 (2001); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455 (4 original pages), 2001 TNT 247-75* (10th Cir. 2001), *cert. denied* 535 U.S. 1056 (2002); and *Baylin v. Commissioner*, 43 F.3d 1451, *Doc 95-342, 95 TNT 4-23* (Fed. Cir. 1995).

How many times have we seen the IRS do the all-too-familiar *Cotnam* Shuffle? See Robert W. Wood and Dominic L. Daher, "Attorneys' Fee Saga Continues: Maverick Circuit Says, 'Oregon Good, California Bad,'" *Tax Notes*, Oct. 6, 2003, p. 91. How many times have we seen the Service trot out the usual assignment-of-income cases, namely *Helvering v. Horst*, 311 U.S. 112 (1940), and *Lucas v. Earl*, 281 U.S. 111 (1930), in this context?

Fair Winds?

On the brighter side, some more recent cases, such as *Srivastava v. Commissioner*, 220 F.3d 353, *Doc 2000-20090 (16 original pages), 2000 TNT 145-9* (5th Cir. 2000), and *Banks v. Commissioner*, 345 F.3d 373, *Doc 2003-21492 (15 original pages), 2003 TNT 190-11* (6th Cir. 2003), *petition for cert. filed* 72 U.S.L.W. 3427 (U.S. Dec. 19, 2003) (No. 03-892), provide credible arguments that the developments in this area have caused this audit guide to become obsolete. At the very least, winds of change are blowing.

The audit guide states that taxpayers are generally required to include recovered attorney fees in their gross income. However, the guide 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 attorney fees in gross income. Even in those cases, the audit guide 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? That language is a little hokey, even if it may be well intentioned. If you were an IRS field agent, wouldn't you want to receive clear and concise audit directives so you don't 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 a guide 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're not sure *anyone* really knows what is meant by that phrase. Does the language refer to the law governing the retainer agreement? Does it refer to the state in which the 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 IRS 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's what it means. It's 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 also question whether the audit guide's reference to Texas (rather than the entire Fifth Circuit) is too narrow. Indeed, it is not an overstatement to say that *Srivastava* 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 attorney fees statute is not relevant for determining whether the taxpayer must include recovered attorney fees in gross income. *Srivastava* clearly suggests that a taxpayer is entitled to exclude contingent attorney fees from gross income in the *entire* Fifth Circuit.

Did the audit guide miss the boat by listing Texas as the only state within the Fifth Circuit that is taxpayer-friendly? Presumably that position would not extend to the entire Eleventh Circuit (even though the Eleventh 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 that wasn't enough, there are still further developments that also merit revisions to the audit guide. After *Banks v. Commissioner*, consider how the guide would (or should) apply in the Sixth Circuit. In *Banks* the Sixth Circuit adopted *Srivastava*. In doing so it found that resolution of the attorney fee issue does not depend on "the intricacies of an attorney's bundle of rights." *Banks* at 385 *quoting Srivastava* at 364; see also Robert W. Wood and Dominic L. Daher, "Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law," *Tax Notes*, Dec. 22, 2003, p. 1427.

This allowed the Sixth Circuit to follow *Estate of Clarks v. United States*, 202 F.3d 854, *Doc 2000-1776 (7 original pages), 2000 TNT 10-21* (6th Cir. 2000), without protracted inquiries into "the intricacies of an attorney's bundle of rights." *Id.*

Does the rule of *Banks* now apply to the entire Sixth Circuit? That seems to be the correct result, and the IRS should arguably embrace it. But there's a larger (albeit perhaps a bit cynical) question here. Given the current state of affairs, is the audit guide 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's going to happen the next time the Tax Court or a U.S. district court is asked to decide the attorney fee issue when 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's to say how a given court might rule on the attorney fee issue? We have long hoped that the Supreme Court would get involved in the attorney fee issue. Barring that (or action by Congress) perhaps it's time for the IRS 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.

It's Time to Reinvent the Wheel

Given *Srivastava* and *Banks*, the audit guide 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 guide 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 guide should list all of the states in any circuit where there has been a favorable holding. In any case — however you read the cases — the audit guide just doesn't do this area justice. Taxpayers and IRS personnel both deserve better.

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