Taxation of Settlements And Judgments

By Robert W. Wood

Since 1996, Tax Analysts has published (and I have written) an electronic newsletter on the taxation of damage awards and settlement payments. This monthly column replaces that newsletter. This first column discusses several current developments in the taxation of damage awards and settlement payments.

First we'll examine some important recent developments in the contingent attorney fee debate, particularly *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). From there, we'll look at the petitions for certiorari that have been filed in two of the attorney fee cases, *Banaitis v. Commissioner*, 345 F.3d 373, *Doc 2003-19359 (16 original pages)*, *2003 TNT 167-5* (9th Cir. 2003), *petition for cert. filed* 72 U.S.L.W. 3428 (U.S. Dec. 24, 2003) (No. 03-907), 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). We'll conclude with a brief discussion of a tax case that arose out of Dennis Rodman's peculiar behavior.

Second Circuit on Attorney Fees

While I can't say I'm surprised by the Second Circuit's decision in *Raymond*, I can say I'm disappointed. *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 IRS denied the refund claim. Undeterred, Raymond filed a refund suit in district court. See *Raymond v. United States*, 247 F. Supp.2d 548, *Doc 2003-7274 (17 original pages)*, *2003 TNT 55-6* (D. Vt. 2002). 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 on his recovery. *Id.* at 554 citing *Estate of Button v. Anderson*, 112 Vt. 531, 533 (1942). This equitable lien effectively transferred to Raymond's attorneys a proprietary interest in his claim. *Id.* The district court found that the portion of the recovery used to pay attorney 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. *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).

The Second Circuit started by trotting out the "usual suspects," in each case, being careful to segregate the "good circuits" from the "bad circuits." See *Raymond* at 418 citing, for example, *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); *Estate of Clarks v. United States,* 202 F.3d 854, *Doc 2000-1776 (7 original pages), 2000 TNT 10-21* (6th Cir. 2000). See also Robert W. Wood and Dominic L. Daher, "Class Action Attorney Fees: Even Bigger Tax Problems?" *Tax Notes,* Oct. 27, 2003, p. 507.

Unfortunately, the Second Circuit then launched into a tortured tour of assignment-of-income lore. The Second Circuit in *Raymond* failed on its first opportunity to address the attorney fee issue by resorting to antediluvian assignment-of-income cases, namely *Lucas v. Earl,* 281 U.S. 111 (1930), and *Helvering v. Horst,* 311 U.S. 112 (1940). Unless you've been hiding under a rock, you know that those 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* did not distinguish *Earl* and *Horst* from the contingent attorney fee fact pattern the way the Sixth Circuit did in *Estate of Clarks.* See *Estate of Clarks* at 856-57. I think it's 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 as 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.

It's a shame that the Second Circuit in *Raymond* gives such 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*? See *Banks* at 385 *quoting Srivastava v. Commissioner,* 220 F.3d 353, 364, *Doc 2000-20090 (16 original pages), 2000 TNT 145-9* (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).

This would have allowed the Second Circuit to sidestep the otherwise seemingly obligatory *Cotnam* analysis and all the shenanigans that are inextricably packaged with it. Instead, the Second Circuit chose to open this Pandora's Box, which led it to find for the government. Alas, there's always next time. . . .

Banaitis and *Banks* Petitions for Certiorari

It's no secret that the attorney fee dilemma has become one of the most hotly contested issues in federal tax law. See, for example, 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 could a concept which is theoretically so simple turn into such a mess?

More importantly, how can the Supreme Court continue to sit on the sidelines while there is blood in the streets? It has had more than its fair share of chances to weigh in on this issue. See *O'Brien v. Commissioner,* 319 F.2d 532 (3rd Cir. 1963), *cert. denied* 375 U.S. 930 (1963); *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); *Sinyard v. Commissioner,* 268 F.3d 756, *Doc 2001-24862 (15 original pages), 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 (4 original pages), 2001 TNT 247-75* (10th Cir. 2001), *cert. denied* 535 U.S. 1056 (2002).

Yet despite cases in which taxpayers have ended up owing more in taxes than they recovered in their lawsuits, the Supreme Court has continued to ignore this increasingly inequitable area of the law. See *Spina v. Forest Preserve District of Cook County,* 207 F. Supp.2d 764 (N.D. Ill. 2002) (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). See also Robert W. Wood, "Civil Rights Tax Relief Fails: How Do You Spell Relief?" *Tax Notes,* July 21, 2003, p. 401.

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 attorney fee cases. See *Banaitis v. Commissioner,* 345 F.3d 373, *Doc 2003-19359 (16 original pages), 2003 TNT 167-5* (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, *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). See also Wood and Daher, "Attorneys' Fee Saga," *supra*; Wood and Daher, "Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law," *Tax Notes,* Dec. 22, 2003, p. 1427.

Undoubtedly, it is going to be some time before we know whether the Supreme Court will agree to hear either case. Although it seems plain that taxpayers in the "bad circuits" will continue to get lambasted when it comes to attorney fees, the IRS wants more.

It is not foolish to ask a 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. *Commissioner v. Sunnen,* 333 U.S. 591, 599 (1948). One would be hard pressed to imagine anything in the federal tax law rivaling the inequity of the attorney fee issue.

It seems time for the Supreme Court to end the pervasive and irreconcilable divergence among the circuits on this issue. The disparate treatment of similarly situated taxpayers directly contradicts equity and fairness in our tax system, which are essential elements of any tax system. See Robert W. Wood and Dominic L. Daher, "Class Action," *supra.*

Rodman's Boorish Behavior Costs Him a Bundle

It seems like only yesterday that the Chicago Bulls were NBA champions. Back in the glory days of the 90s, Michael Jordan led the Bulls to championship after championship. Jordan was aided by a colorful cast of characters, including Dennis Rodman. Apparently when Rodman isn't otherwise preoccupied modeling wedding dresses or marrying Carmen Electra, he occasionally resorts to kicking cameramen at NBA games.

In January 1997, during a game with the Minnesota Timberwolves Rodman ran out of bounds and landed on a group of cameramen. During the incident, Rodman twisted his ankle, and then took it on himself to kick the nearest cameraman, Eugene Amos. Within a matter of days, apparently before any lawsuit was filed, Amos and Rodman entered into a settlement agreement. Under its terms, Amos agreed to keep his lips zipped and Rodman agreed to pay him $200,000.

Relying on section 104(a)(2), Amos excluded the entire amount from his gross income as money received on account of personal physical injury. The IRS disagreed on audit, and the matter wound up in Tax Court. In *Amos v. Commissioner,* T.C. Memo. 2003-329, *Doc 2003-25600 (16 original pages), 2003 TNT 231-8,* the IRS contended that this payment was not made for Amos's physical injuries but rather for his silence. The IRS even went so far as to say that Rodman himself was skeptical about the nature and extent of Amos's alleged physical injuries.

Of course, allocations of settlement payments between elements of damages are common. But with no allocation included in the settlement agreement, the IRS somehow convinced itself that only $1 out of the $200,000 should be excludible as a payment received on account of personal physical injuries. Not surprisingly, the Tax Court disagreed with this rather freehanded assertion. It instead found that absent an allocation of the settlement payment in the settlement agreement, $120,000 should be excludible under section 104(a)(2) and $80,000 should be included in Amos's gross income as a taxable recovery.

As I frequently (and repeatedly) tell clients, always, always, always allocate. See *Robinson v. Commissioner,* 102 T.C. 116, *94 TNT 23-18* (1994), *aff'd in part and rev'd in part on another issue* 70 F.3d 34, *95 TNT 238*-7 (5th Cir. 1995), *cert. denied* 519 U.S. 824 (1996). At least then you have a fighting chance!

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