Attorneys' Fees: Maverick Circuit Says, 'Oregon Good, Calif. Bad'

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It is well known that the tax treatment of attorneys' fees paid by a plaintiff in many types of actions (such as employment actions) has not been harmonized around the country. Due to a variety of oddities in our tax system (most notably the alternative minimum tax), there is a dramatic tax difference between the result obtained when a plaintiff is taxed on the gross amount of a settlement rather than on an amount net of recovered attorneys' fees.

This sad reality is perhaps best illustrated by way of example. Let's assume that a taxpayer recovers a $1 million settlement, inclusive of attorneys' fees. If the taxpayer is required to recognize the gross amount, he will be taxed on the entire $1 million recovery, and he will be entitled to a miscellaneous itemized deduction (subject to a 2-percent-of-AGI floor) for the amount of the legal fees recovered (assume $400,000). This results in the taxpayer owing $276,500 in federal income tax on the recovery (this assumes the taxpayer is married filing jointly). Of this amount, more than $75,000 stems from the AMT. In stark contrast, if the taxpayer is required to include only the net amount of $600,000 in gross income, he will owe a mere $181,881.50 in federal income tax. That is a whopping $94,618.50 difference!

Nonetheless, the fact that some people are aware of this oddity is hardly a balm to those taxpayers who wake up on April 15 to find that they owe additional tax on monies paid directly to their contingent-fee lawyer. Tax Analysts' publications have long noted the split in the circuits and the legislative efforts that have thus far failed to correct the problem. See Robert W. Wood, "Tax Treatment of Attorneys' Fees," *Doc 2003-11996 (10 original pages)*, *2003 TNT 94-128*; see also Robert W. Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?," *Tax Notes*, June 16, 2003, p. 1651.

Despite the violent split in the circuits, the Supreme Court has done nothing to enter the fray, denying certiorari in a number of these cases, presumably reasoning that these tax decisions could be based on the vagaries of how attorneys' liens are treated under applicable state law. See *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); *Sinyard v. Rossotti*, 268 F.3d 756, *Doc 2001-24862 (15 original pages)*, *2001 TNT 188-11* (9th Cir. 2001), *cert. denied* 536 U.S. 904 (2002).

Is the Supreme Court right to sidestep this? Well, using a phrase that aging members of the tax bar may recall from Rowan & Martin's "Laugh-In," this is simply a copout. No one (apart from industrious tax lawyers) has focused on attorneys' lien laws for scores of years.

Go West, Young Man

The most recent iteration of the controversial attorneys' fee problem came in *Banaitis v. Commissioner*, 2003 U.S. App. LEXIS 17913, *Doc 2003-19359 (16 original pages)*, *2003 TNT 167-5* (9th Cir., Aug. 27, 2003). This case started as a garden-variety wrongful termination case. Banaitis was a vice president of the Bank of California. He was fortunate enough to have access to extensive confidential financial information relating to the Portland, Oregon, grain industry, which enabled him to develop specialized financing products for it. In 1984, Mitsubishi Bank acquired a controlling interest in the Bank of California. After learning of this, several of Banaitis's clients contacted him and reiterated their desire to keep their confidential financial information secret. Banaitis complied with this request, but his employer cried dirty pool.

Subsequently, Banaitis received a far-from-flattering performance review, which apparently caused him to suffer a host of physical maladies (including headaches, insomnia, and gastrointestinal disorders). After retaining an attorney, Banaitis sued his former employer for constructive discharge. After considerable procedural wrangling, Banaitis and his former employer entered into a settlement, which paid $4.8 million to Banaitis (only $1.4 million was reported by Banaitis on his tax return) and $3.8 million to his contingent-fee attorneys. On his 1995 return, Banaitis excluded the remainder of the settlement from his gross income under section 104(a)(2) (including the $3.8 million paid to his attorneys).

Not surprisingly, the IRS did not agree with Banaitis's characterization of the recovery. The Tax Court had to determine whether any of Mr. Banaitis's settlement amount was excludible. More significantly, the court had to determine whether the amount paid to his attorneys was includible in gross income.

The court dispensed fairly easily with the taxpayer's arguments that the economic and punitive damages he had received under the terms of the settlement agreement were excludible. The court, citing *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955), found both amounts to be fully includible. On the other hand, the court found that his recovery for emotional distress was excludible under section 104(a)(2) (as it applied in 1995). The real meat of the decision, though, lies in the treatment of the recovered attorneys' fees. The Tax Court followed what it assumed to be the applicable Ninth Circuit precedent, *Sinyard v. Rossotti*, and held that the attorneys' fees were includible in Banaitis's gross income.

The Ninth Circuit, citing *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), disagreed, finding that the attorneys' fees were excludible from Banaitis's gross income. *Cotnam*, as most readers know, involved the Fifth Circuit holding that the amount of a contingent fee paid out of a judgment to the plaintiff's attorneys was not income to the plaintiff. Under Alabama State law, which applied in *Cotnam*, a contingency fee contract operates as a lien on the recovery. The Alabama code provided that attorneys at law will have the same right and power over suits, judgments, and decrees to enforce their liens as their clients had or may have for the amount due. That gave the *Cotnam* court solid ground to say there had been a transfer of part of the plaintiff's claim and that any recovery by the lawyers on that portion of the claim was simply gross income to them.

Noting that Oregon's attorneys' lien law mirrors Alabama's, the Ninth Circuit held that attorneys in Oregon were entitled to generous property interests in judgments and settlements. Indeed, the Ninth Circuit found that an attorneys' lien in Oregon is superior to all other liens (except tax liens). The court found that, like Alabama law, Oregon law provides that attorneys have the same right and power over suits, judgments, decrees, orders, and awards to enforce the liens as the clients have in the judgment. Relying on the unique features of Oregon law on attorneys' fees, the Ninth Circuit found that the fees paid directly to Banaitis's attorneys were *not* includible in Banaitis's income.

Law, Whose Law?

The Ninth Circuit sounds quite different in *Banaitis* than it did in such notable cases as *Coady v. Commissioner* and *Benci-Woodward v. Commissioner*. In fact, the Ninth Circuit in *Banaitis* sounded overwhelmingly different than it did in *Sinyard v. Rossotti*. Here, the Ninth Circuit said unexceptionally that whether a contingent fee contract for the plaintiff results in fees includible in the plaintiff's gross income involves two related questions: (1) how state law defines the attorneys' rights in the action, and (2) how federal tax law operates in light of this state law definition of interests.

Referring to the hoary assignment of income cases such as *Helvering v. Horst*, 311 U.S. 112 (1940), and *Lucas v. Earl*, 281 U.S. 111 (1930), the Ninth Circuit went on to talk about state law and the "state-law-specific analysis." It was such an analysis that led the Ninth Circuit to conclude in *Coady* that under Alaska law, attorneys' fees are includible in the plaintiff's gross income, and that the same rule applies under California law (*Benci-Woodward*). Other circuits have been faced with similar decisions, and have based their state-specific holdings on similar logic.

The court trotted out the "good states" in which the unique features of applicable state law allow plaintiffs to exclude recovered attorneys' fees from gross income, including Alabama law (*Cotnam*), Texas law (*Srivistava v. Commissioner*, 220 F.3d 353, *Doc 2000-20090 (16 original pages), 2000 TNT 145-9* (5th Cir. 2000)), and Michigan law (*Estate of Clarks v. United States*, 202 F.3d 854, 856, *Doc 2000-1776 (7 original pages), 2000 TNT 10-21* (6th Cir. 2000)). Incidentally, the Ninth Circuit cites *Foster v. United States*, 239 F.3d 1275 (11th Cir. 2001), for the proposition that *Cotnam*'s Alabama-law-based holding is imported into the law of the entire Eleventh Circuit. While it is true that *Cotnam* is binding precedent on the Eleventh Circuit, it is *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (which imported all holdings of the Fifth Circuit before its split into the Fifth and Eleventh Circuits, not just *Cotnam*) (upheld in *Davis v. Commissioner*, 210 F.3d 1346, 1347, *Doc 2000-12246 (5 original pages), 2000 TNT 86-7* (11th Cir. 2000)), that carries the day here and not *Foster*.

The Oregon Trail

Distinguishing Oregon law on attorneys' liens from California and Alaska law, the Ninth Circuit found that the Oregon attorneys' lien law was quite strong. In fact, the Ninth Circuit found that Oregon went even further in some respects than Alabama law, the law considered in the seminal *Cotnam* case. Relying on Oregon state cases, the Ninth Circuit found that the attorneys' lien is a charge on the action.

Indeed, the parties to the action cannot extinguish or affect the attorneys' lien by any means (such as a settlement) other than by satisfying the underlying claim of the attorney for the fees incurred in connection with the action (citing *Potter v. Schlesser Co.*, 63 P.3d 1172 (Oregon 2003)). Finding that Oregon clearly recognized the strength of the attorneys' lien law and that the attorney in all events had the right to the money, the Ninth Circuit concluded that the attorneys' fees "*paid directly*" to the lawyer were not includible in Mr. Banaitis's gross income.

Relevance of 'Paid Directly'

Most readers will notice the "paid directly" limitation the Ninth Circuit slipped cleverly into its holding. Does it really matter if the attorneys' fees are paid directly to the attorney, or if they are lumped together with the amounts paid to the plaintiff? Should it matter? Probably not, especially if one believes the seemingly myopic focus the courts have taken on attorneys' lien laws. Still, some clearly believe direct payment is a must so why take a chance?

To avoid the pitfalls of assignment of income cases such as *Helvering v. Horst* and *Lucas v. Earl*, direct payment of attorneys' fees is still the best course of action. *Estate of Clarks* and its progeny distinguish *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. This is not true in most cases involving the attorneys' fee issue. In these cases the value of the taxpayer's lawsuit is arguably entirely speculative and dependent on the services of counsel. Even so, many other courts have not distinguished *Horst* and *Earl* in this context. See, for example, *Coady v. Commissioner*. As easy as it is to facilitate direct payment of attorneys' fees, it is probably a good idea to take a page out of Nike's book and "just do it."

Importing State Law

Some imports are attractive. Just as Oregon likes to import California wines (they tend to be better than Oregon wines), might California plaintiffs import Oregon's law on attorneys' liens? The Ninth Circuit in *Benci-Woodward v. Commissioner* made it abundantly clear that California's attorneys' lien law was not sufficiently strong to justify importing *Cotnam*.

Under the *Golsen* rule, the Tax Court must follow a Court of Appeals decision that is "squarely on point" where an appeal lies to that particular Court of Appeals. *Golsen v. Commissioner*, 54 T.C. 742, 747 (1970), *aff'd on other issue* 445 F.2d 985 (10th Cir. 1971). Conversely, the Tax Court is not bound by a decision that is not "squarely on point."

A similar rule applies to a refund claim filed in a U.S. District Court. In those cases, the court is bound by decisions issued by the Court of Appeals in the circuit in which it sits. The doctrine of *stare decisis* provides that "a decision on an issue of law embodied in a final judgment is binding on the court that decided it and such other courts as owe obedience to its decision, in all future cases." *Cabot Corp. v. United States*, 694 F. Supp. 949, 953 n. 5 (1988) (*quoting* 1B J. Moore, J. Lucas, and T. Currier, *Moore's Federal Practice* par. 0.401 (2d ed. 1988)). Consequently, "like facts will receive like treatment in a court of law." *Id.* Decisions from other circuits are not binding on U.S. District Courts or U.S. Courts of Appeals, although they are persuasive.

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 Ninth Circuit? Is it fair to say that the Ninth Circuit is now divided on the attorneys' fee issue? Will the Tax Court and/or the U.S. District Courts within the Ninth Circuit follow *Sinyard* or will they instead follow *Banaitis*? Will it matter whether the taxpayer is a resident of California rather than Oregon? Will it matter if the parties agree the entire attorney-client relationship is governed by Oregon law?

Frankly, these questions may have obvious answers, but we don't think so. At this stage of the game, who's to say how a given court might rule on the attorneys' fee issue?

The Big Finish

It is our hope that these questions will prompt the Supreme Court (a/k/a the Sleeping Giant) to finally get involved in the attorneys' fee issue (wishful thinking?). As it stands, it is shaping up to be an interesting year for this issue. Will the Second Circuit finally weigh in on this issue? While a district court in Vermont has weighed in on the attorneys' fee issue, the influential Second Circuit has thus far stayed on the sidelines. See *Raymond v. United States*, 247 F. Supp. 2d 548, *Doc 2003-7274 (17 original pages), 2003 TNT 55-6* (D. Vt. 2002). While we wait for corrective action (and we may be waiting a while), advisers and taxpayers alike should be alert to some of the traps.

For example, it is vitally important (for an argument to exist that the client doesn't have the income) that the fees be "direct paid" from the defendant to the attorney. It is also vitally important that the contingent-fee agreement specify in strong terms when the interest in the case is assigned. The attorneys' lien law in the state can be helpful in some cases (but clearly not all). Taxpayers and their advisers (and certainly litigators, too) should be very careful. They should obtain tax advice *before* any settlement is reached. They should be careful how the payments are made. Of course, they should also be careful what the settlement agreement specifies about who is going to get any Forms 1099 or W-2. The forms issue (with its audit risk controls) can have an enormous impact on the ultimate result of the case.

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