Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law

By Robert W. Wood and Dominic L. Daher

Unless you've been in a Rip Van Winkle-like slumber for the last 20 years, you probably know that the U.S. Circuit Courts of Appeal do not agree on the federal tax treatment of contingent attorney fees recovered by plaintiffs. The First, Fourth, Seventh, Eighth, Ninth, Tenth, and Federal Circuits have held that contingent attorney fees constitute gross income to the recovering plaintiff. See *Alexander v. Commissioner*, 72 F.3d 938, *Doc 96-602 (21 pages), 96 TNT 1-74* (1st Cir. 1995); *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 (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 (5 pages), 95 TNT 4-23* (Fed. Cir. 1995).

Ever the harbinger of disagreement (it encompasses left coast states after all), the Ninth Circuit, now seems to be split on this issue. See *Banaitis v. Commissioner*, 2003 U.S. App. LEXIS 17913, *Doc 2003-19359 (16 original pages), 2003 TNT 167-5* (9th Cir. Aug. 27, 2003) (holding that under Oregon law recovered attorney fees are not gross income to the plaintiff); compare *Benci-Woodward* and *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862 (15 original pages), 2001 TNT 188-11* (9th Cir. 2001), *aff'g* 76 TCM 654, *Doc 98-29997 (14 pages), 98 TNT 195-10* (1998), *cert. denied* 536 U.S. 904 (2002).

On the other side of the fence, the Fifth, Sixth, and Eleventh Circuits have held that contingent attorney fees do not constitute gross income to the recovering plaintiff. See *Srivastava v. Commissioner*, 220 F.3d 353, *Doc 2000-20090 (16 original pages), 2000 TNT 145-9* (5th Cir. 2000); *Estate of Clarks v. Commissioner*, 202 F.3d 854, *Doc 2000-1776 (7 original pages), 2000 TNT 10-21*(6th Cir. 2000); and *Davis v. Commissioner*, 210 F.3d 1346, *Doc 2000-12246 (5 original pages), 2000 TNT 86-7* (11th Cir. 2000).

Gross vs. Net: Who Cares and Why

Because of several 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 attorney fees. 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. Tax periodicals have long noted the split in the circuits and the legislative efforts that have 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 having been invited to the party on myriad occasions, the Supreme Court has repeatedly declined the invitation, denying certiorari in several of the cases; presumably, it has reasoned 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, supra*; *Coady v. Commissioner*, *supra*; *Hukkanen-Campbell v. Commissioner*, *supra*; *Sinyard v. Commissioner*, *supra*.

Is the Supreme Court right to sidestep this? It doesn't seem fair that just because you live in one of the "good circuits" you end up paying substantially less federal income tax than the poor slobs who live in one of the "bad circuits" (much to our chagrin, we count ourselves among the latter). Whatever happened to equity in our federal tax system? Whatever happened to uniform application of the federal tax laws? Do we really want to encourage people to move to a different part of the country for the sole purpose of achieving markedly different federal income tax consequences? We think not.

Much like the Energizer Bunny, the attorney fees saga keeps going and going and going. We realize that Adam Smith has long been dead, but is his fairness canon of taxation also dead? See Adam Smith, *The Wealth of Nations* (Modern Library 1994). Smith proffered, and we agree, that similarly situated individuals ought to pay a similar amount of taxes. *Id.* That sounds fair to us. Why can't the circuits get on board with Smith's ideas? Heck, they've been around for over two centuries.

No one (with the possible exception of industrious tax lawyers) has pored over attorneys' lien laws for many years. Nonetheless, there are countless holdings in this area of the tax law that focus on the strength of the applicable attorneys' lien law. See, e.g., *Banaitis v. Commissioner*, *supra*; compare with *Benci-Woodward v. Commissioner*, *supra*; *Coady v. Commissioner*, *supra*.

Gentlemen, Start Your Engines

Despite those holdings focusing on the strength of the applicable attorneys' lien laws, the Sixth Circuit in *Banks v. Commissioner*, 2003 FED App. 0347P, *Doc 2003-21492 (15 original pages), 2003 TNT 190-11* (6th Cir. Sept. 30, 2003), has chosen to follow the road less traveled. In doing so, it has joined the Fifth Circuit in finding that the strength of the applicable attorneys' lien law is irrelevant in deciding whether recovered attorney fees constitute gross income. See *Srivastava v. Commissioner*, *supra*.

This case started as a run-of-the-mill employment case. For more than a decade Banks toiled as an educational consultant with the California Department of

Education (CDOE). In 1986 he was terminated by the CDOE. Banks filed suit in the federal district court for the Eastern District of California. The suit alleged employment discrimination in violation of Title VII of the Civil Rights Act of 1964. In bringing his suit, Banks retained California attorneys and signed a contingent-fee agreement governed by California law. After considerable procedural clamoring, in May 1990 Banks and the CDOE entered into a settlement for $464,000, which was characterized in the settlement agreement as payment for personal injury damages. Of the $464,000, Banks paid his California contingent-fee attorneys $150,000 (hence, his net recovery was $314,000).

On his 1990 return, Banks excluded the entire $464,000 from his gross income under section 104(a)(2) (including the $150,000 paid to his attorneys). In May 1997 the IRS took issue with Banks's characterization of the recovery (boy, didn't see that one coming). Banks, then a resident of Benton Harbor, Mich., sought relief in the Tax Court. Inauspiciously, the Tax Court sided with the IRS and dismissed Banks's characterization of the recovery. *Banks v. Commissioner*, T.C. Memo. 2001-48, *Doc 2001-6006 (27 original pages), 2001 TNT 41-17.*

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." *Id.*

Although the *Golsen* rule arguably required the Tax Court to look to Sixth Circuit law, the court declined to follow the law of that circuit, *Estate of Clarks v. Commissioner*, *supra*. Instead, the Tax Court distinguished *Estate of Clarks* and reasoned that at issue in the case were California attorneys, a California fee agreement, and a settlement that resulted from a lawsuit filed in a California federal court.

In doing so it found that *Estate of Clarks* was not "squarely on point" because it dealt with Michigan law rather than California law. The Tax Court decision was, at a minimum, deeply troubling. See Wood, "More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?" *supra*. Given the opportunity to apply the law of a favorable state (in this case, Michigan), the Tax Court declined (some people are so predictable). Instead it applied the unfavorable precedent of the Ninth Circuit, *Benci-Woodward v. Commissioner*, *supra*.

Undeterred Perseverance

Undeterred, Banks appealed to the Sixth Circuit. *Banks v. Commissioner*, 2003 FED App. 0347P, *supra*. The Sixth Circuit made short work of Banks's arguments that the damages he had received under his settlement agreement with the CDOE were excludable under section 104(a)(2) (as it applied in 1990). The Sixth Circuit applied the *Greer v. United States*, 207 F.3d 322, *Doc 2000-15424 (21 original pages), 2000 TNT 106-2* (6th Cir. 2000), "disaggregated" incarnation of the two-prong *Schleier* test (*Commissioner v. Schleier*, 515 U.S. 323, 329-30, *Doc 95-5972 (27 pages), 95 TNT 116-8* (1995)), which breaks down the *Schleier* test into its four disparate elements.

To satisfy *Schleier*, says the Sixth Circuit, you must prove that (1) there was an underlying claim sounding in tort; (2) the claim existed at the time of the settlement; (3) the claim encompassed personal injuries; and (4) the agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" personal injury. *Banks v. Commissioner*, 2003 FED App. 0347P, *supra*, quoting *Greer v. United States*, *supra*, citing *Commissioner v. Schleier*, *supra*. See also Robert W. Wood, "Scope of Personal Injury Exclusion Still Clouded," *Tax Notes*, December 28, 1998, p. 1675, discussing *Greer* and *Schleier*.

When the dust settled, the Sixth Circuit sided with the IRS and confirmed the Tax Court's earlier decision on the issue. The court found that Banks failed the *Schleier* test because he failed to establish a causal connection between the settlement payment and any personal injuries he may have suffered. Instead, said the court, citing *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955), the entire $314,000 net recovery is fully includable in Banks's gross income.

The *Cotnam* Shuffle

The Sixth Circuit, however, was not as enamored with the Tax Court's resolution of the attorney fees issue. In *Banks v. Commissioner*, T.C. Memo 2001-48, *supra,* the Tax Court had, of course, declined to follow *Estate of Clarks*. Instead it alleged that *Estate of Clarks* was not "squarely on point," as it applied Michigan law rather than California law (and thus sidestepped the *Golsen* rule). The Sixth Circuit says hogwash. The Sixth Circuit, citing *Estate of Clarks*, disagreed with the Tax Court and held that the recovered attorney fees were excludable from Banks's gross income.

In deciding *Banks*, the Sixth Circuit relied on its holding in *Estate of Clarks*, where it had gone through what has become the standard *Cotnam* analysis — it did the all-too-familiar *Cotnam* Shuffle. As most readers know, the Fifth Circuit in *Cotnam* held that the amount of a contingent fee paid out of a judgment to a plaintiff's attorneys was not income to the plaintiff. Under Alabama state law, which applied in *Cotnam*, a contingent-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, says the Sixth Circuit in *Estate of Clarks*, 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.

The Sixth Circuit in *Banks* notes that in its *Estate of Clarks* holding it found that Michigan's attorneys' lien law mirrors Alabama's, in that attorneys in Michigan are entitled to generous property interests in judgments and settlements. Indeed, the Sixth Circuit in *Estate of Clarks* found that an attorneys' lien in Michigan is superior to all other liens (except tax liens). The court found that, like Alabama law, Michigan 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 Michigan law on attorney fees, the Sixth Circuit found that the fees paid to Clarks's attorneys were *not* includable in gross income.

Lien Law, We Don't Need No Stinkin' Lien Law

In *Banks* the Sixth Circuit, as it had done in *Estate of Clarks*, again dismissed the usual hoary assignment of income cases, *Helvering v. Horst*, 311 U.S. 112 (1940), and *Lucas v. Earl*, 281 U.S. 111 (1930). The Sixth Circuit in *Banks* went on to talk about state law and the "state-law-specific analysis" that led it to conclude in its *Estate of Clarks* holding that recovered attorney fees are not gross income to the taxpayer. Other circuits have been faced with similar decisions and have based their state-specific holdings on similar logic. See, for example, *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959) (Alabama law); *Benci-Woodward v. Commissioner*, *supra* (California law); *Coady v. Commissioner, supra* (Alaska law).

The real shocker in *Banks* came when the court found that *Estate of Clarks* — and, indeed, the entire attorney fees issue — does not "primarily rest" on the rationale that separate state lien laws governing attorneys' rights determine the proper characterization of recovered attorney fees. See *Banks v. Commissioner*, 2003 FED App. 0347P *supra* at 21. In doing so the Sixth Circuit held *Estate of Clarks* to be controlling precedent in *Banks*, regardless of the differences between Michigan's and California's attorneys' lien laws. *Id.*

The Sixth Circuit went on to take up arms with the Fifth Circuit by adopting *Srivastava v. Commissioner*, *supra*. In *Srivastava* the Fifth Circuit declined to distinguish *Cotnam* based on differing state attorneys' lien laws. See *Banks v. Commissioner*, 2003 FED App. 0347P *supra* at 21, quoting *Srivastava v. Commissioner*, 220 F.3d 353 *supra* at 364. Instead the Fifth Circuit determined that the application of *Cotnam* does not depend on "the intricacies of an attorneys' bundle of rights." *Id.* That allowed the Sixth Circuit to follow *Estate of Clarks* without protracted inquiries into "the intricacies of an attorney's bundle of rights." *Id.*

Splitting Hairs With a Machete

For those keeping score at home, let's review. *Banks* involves a California contingent-fee agreement, a recovery made by California attorneys, and a suit that was filed in a California federal court (and later settled). But by hook or by crook, the Sixth Circuit in *Banks* appeared bound and determined to side with the taxpayer on the attorney fees issue. We applaud this result. When all was said and done, the *Banks* court found that *Estate of Clarks* is not distinguishable based on the differences between Michigan's and California's attorneys' lien laws. The Sixth Circuit reversed the Tax Court on the attorney fees issue and held that the recovered contingent attorney fees are not gross income to the taxpayer.

Despite all this discussion, there is something else notable about the *Banks* decision. It's a little like one of those infomercials for Ginsu knives — but wait, there's more! Here it appears that the attorney fees were not "directly paid" — they were paid to Banks, who in turn paid his attorneys. Does it really matter if the attorney fees are paid directly to the attorney? Should it matter? Clearly, the Sixth Circuit in *Banks* doesn't appear to believe it should.

Nevertheless, to avoid the pitfalls of assignment of income cases such as *Helvering v. Horst* and *Lucas v. Earl*, we believe direct payment of attorney fees is still the best course of action. The Sixth Circuit in *Banks* and *Estate of Clarks* distinguishes *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.

That, of course, is not true in most cases involving the attorney fees issue. In those cases the value of the taxpayer's lawsuit is arguably 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*, *supra*. As easy as it is to facilitate direct payment of attorney fees, it is probably a good idea to continue to do so whenever possible.

Hit the Showers

What is going to happen the next time the Tax Court or a U.S. district court is asked to decide the attorney fees issue when the appeal lies to the Sixth Circuit? Is it 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? What about the other circuits? Will the music finally run out on the *Cotnam* Shuffle? Will it be shown the door? For that matter, given Banks's ties to California, what's going to happen the next time the Ninth Circuit tackles the attorney fees issue? Will the Ninth Circuit adopt *Banks*?

Believe us when we tell you that we'd love to see this result. But at the same time, we're not going to hold our breath (well, one of us might). Frankly, these queries may have obvious answers, but we don't think so. Rhetorical questions? Not hardly. Indeed, at this stage of the game, who's to say how a given court might rule on the attorney fees issue?

It is our hope that these questions will prompt the Supreme Court to finally get involved. It's high time for the Court to grab the laboring oar and resolve the issue. Perhaps we are too optimistic. As it stands, it is shaping up to be an interesting year for the attorney fees quagmire.

Will the Second Circuit finally weigh in? Although a district court in Vermont has done so, the influential Second Circuit has so 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) (holding that recovered contingent attorney fees are not gross income to the taxpayer). 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.

Despite the favorable holding in *Banks*, for now it is still vital (for an argument to exist that the client has no rights to the income) that the fees be "direct paid" from the defendant to the attorney. It is also vital 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 useful in some cases — but clearly not all, as illustrated by *Banks*.

Who's to say if the standard lien-law analysis will soon become a thing of the past? Taxpayers and their advisers (and certainly litigators, too) should be very careful. This area of the tax law has quickly become akin to skating on thin ice with hot blades. 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 any later dispute with the IRS.

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