



# letters to the editor

## Tax Treatment of Legal Fees: The Debate Continues

To the Editor:

In his article "Why Tort Legal Fees Are Not Deductible,"<sup>1</sup> Charles Davenport contends that the issue of deductibility has no application to legal fees incurred in reducing a legal cause of action in tort to a monetary settlement or judgment. Instead, Davenport argues that these expenses are capital in nature. Specifically, he likens the expenses of tort litigation to the costs of acquiring and perfecting title to property, which are typically capitalized into the property's basis.<sup>2</sup>

Davenport's argument rests on more than the determination that certain legal fees must be capitalized — many capitalized expenses are recovered through a deduction taken in a later year.<sup>3</sup> Davenport's theory also depends on the proceeds of litigation being taxed as a return of capital. In other words, the gross recovery constitutes an amount realized that is reduced by expenses capitalized into the basis of the underlying cause of action in arriving at the amount to be included in gross income. Davenport contends that the return of capital approach is required because the cause of action constitutes property under state law.

I am writing because I question the application of sale or exchange principles in this context. Even if we assume that a cause of action in tort constitutes property for state law purposes, it does not follow that the conversion of that property into a damages recovery must be taxed as a return of capital. This point was made clear by the Supreme Court in *Hort v. Commissioner*.<sup>4</sup> In *Hort*, the taxpayer-lessor attempted to treat a lease cancellation payment as a gain realized on the disposition of its interest in the lease.<sup>5</sup> The Supreme Court rejected this approach:

<sup>1</sup>Tax Notes, Nov. 4, 2002, p. 703.

<sup>2</sup>See reg. section 1.263(a)-2(a), (c).

<sup>3</sup>Attorney's fees paid by a plaintiff in Years 1 and 2 in pursuit of a taxable recovery obtained in Year 3 may have to be capitalized under *INDOPCO*. That determination, however, does not govern the manner in which the capitalized expenses will be recovered for tax purposes in the year the settlement or judgment is obtained — that is, through a deduction or through a basis offset.

<sup>4</sup>313 U.S. 28 (1941).

<sup>5</sup>*Id.* at 29-30. Actually, the taxpayer contended that it realized a loss on the transaction. The taxpayer mistakenly believed that the present value of the rent payments called for under the lease provided it with a basis in the lease. *Id.* at 29.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property," whatever that signifies abstractly. . . . Simply because the lease was "property" the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which section 22(a) [the 1932 Act predecessor to the 1986 Code section 61(a)] expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital."<sup>6</sup>

While *Hort* did not present the specific issue of whether recovery on a cause of action should be taxed as a return of capital, the Court noted that the treatment of the lease cancellation payment as accelerated rental income would have applied even if the payment had been recovered through litigation to recover damages for breach of contract.<sup>7</sup>

In *Hudson v. Commissioner*,<sup>8</sup> the Tax Court similarly determined that the existence of property does not necessitate taxing a payment made in respect of such property as a sale or exchange. In *Hudson*, the taxpayer sought to treat a payment received in satisfaction of a judgment as a sale of the judgment to the judgment debtor. The Tax Court rejected that characterization as follows:

We cannot see how there was a transfer of property, or how the judgment debtor acquired property as the result of the transaction wherein the judgment was settled. The most that can be said is that the judgment debtor paid a debt or extinguished a claim so as to preclude execution on the judgment outstanding against him. In a hypothetical case, if the judgment had been transferred to someone other than the judgment debtor, the property transferred would still be in existence after the transaction was completed. However, as it actually happened, when the judgment debtor settled the judgment, the claim arising from the judgment was extinguished without the transfer of any property or property right to the judgment

<sup>6</sup>*Id.* at 31.

<sup>7</sup>*Id.* at 30-31.

<sup>8</sup>20 T.C. 734 (1953).

debtor. In their day-to-day transactions, neither businessmen nor lawyers would call the settlement of a judgment a sale: We can see no reason to apply a strained interpretation to the transaction before us.<sup>9</sup>

Therefore, just because a cause of action in tort may constitute a property interest under state law, it does not follow that the reduction of the cause of action into a monetary sum should be taxed as a return of capital under section 1001(a). Simply put, nothing is being sold. Rather, payment is being made in recognition of certain legal rights, and those legal rights are extinguished by reason of the payment. If the case were otherwise — that is, if section 1001(a) applied to a payment made in discharge of a legal cause of action — then a whole host of receipts that generally are thought to constitute items of gross income (e.g., wages, interest, dividends) could be converted to gain under section 1001(a) on grounds that the payment was received on disposition of the legal right to payment. In this manner, section 62 and the limitations on itemized deductions under sections 67 and 68 could be gutted. Many itemized deductions could be converted into effective above-the-line deductions by capitalizing them into the basis of the underlying legal right to payment, which would offset the amount realized in full in determining the gain to be included in gross income.<sup>10</sup>

Rather than constituting an item of gain under section 1001(a), damages received on the prosecution of a cause of action in tort simply constitute an item of gross income under the general rule of section 61(a). This approach is consistent with section 104(a), which operates to exclude certain types of damages from “gross income.”<sup>11</sup> If the tort damages are by their nature an item of gross income as opposed to an item that could give rise to gain, then at a minimum section

<sup>9</sup>*Id.* at 736. See also *Fairbanks v. United States*, 306 U.S. 436 (1939) (payment in discharge of discharge of bond held not to be a sale or exchange); *Bingham v. Commissioner*, 105 F.2d 971, 972 (2d Cir. 1939) (payment in discharge of promissory note held not to be a sale or exchange).

<sup>10</sup>For instance, the services I perform for the University of South Carolina give rise to a contractual right to payment. Each month, I could capitalize the unreimbursed employee business expenses which I incur into the basis of my contractual cause of action. When I receive my paycheck at the end of the month, I would treat the wages received as an amount realized on disposition of my contractual rights, and fully offset the amount realized by the expenses capitalized into basis in arriving at the gain to be included in gross income. In this manner, I would circumvent the 2 percent floor on miscellaneous itemized deductions imposed by section 67(a).

<sup>11</sup>If tort damages were properly included in gross income as an item of gain under section 1001(a) through section 61(a)(3), then one would expect section 104 to be phrased in terms of excluding the gain realized on the disposition of the cause of action. See, e.g., section 121 (excluding from gross income “gain from the sale or exchange of property” used as the taxpayer’s principal residence).

212(1) would apply to provide a deduction for the legal fees incurred to obtain the damages recovery.<sup>12</sup> The damages constitute income, and the legal fees were necessary to produce that income. Davenport contends that section 212(1) is inapposite in this case, on grounds that legal fees come after the “‘production’ (that is, the tort).” Yet section 212(1) pertains to the production of *income* as opposed to the production of the income-producing asset.

Thus, I believe that the treatment of legal fees incurred to produce a recovery that is not excluded under section 104(a) is properly analyzed as a deduction as opposed to a basis offset.<sup>13</sup> This is by no means a popular position to take. It leads to a result that no one likes — the taxation (at AMT rates) of successful plaintiffs on their gross income. I believe the problem requires a legislative remedy, a conclusion that does not and should not depend on the prospects of such legislation. Davenport takes the opposite view:

[T]here is no strong legislative advocate for these taxpayers, and little legislation is enacted without a strong legislative advocate.

Besides, the proper treatment of legal fees in these cases is not properly a legislative matter. This question is uniquely one of the dysfunction of our tax administrators, bar, and judiciary. It should be settled by them.

As far as having the judiciary solve the matter, I disagree that the courts should fail to apply provisions that are directly on point in favor of picking others off the rack that don’t quite fit to produce an equitable result. The role of the judiciary is to interpret and not make law.<sup>14</sup> As Judge Posner recently noted in *Kenseth v. Commissioner*,<sup>15</sup> achieving global equity in taxation is not a feasible judicial undertaking and in any event would not be a proper one.

As far as having the issue solved through nonenforcement by the tax administrators, I am not necessarily adverse. It is the responsibility of the executive branch to enforce the law. If the Service were to pull the reins back on its enforcement efforts in this area, it certainly would be within its province to do so. I appreciate Davenport’s comments that there are other areas of noncompliance worthier of the Service’s limited resources, which is true not only from a cost-

<sup>12</sup>If the cause of action were sufficiently related to a trade or business of the taxpayer, then section 162 would supply the deduction. For cases applying section 162 to a deduction for legal fees incurred by a plaintiff pursuing employment-related litigation, see *Biehl v. Commissioner*, 118 T.C. 467, *Doc 2002-13103* (36 original pages), 2002 TNT 105-4 (2002); *McKay v. Commissioner*, 102 T.C. 465, *Doc 94-3399* (53 pages), 94 TNT 60-9 (1994).

<sup>13</sup>For a full argument in favor of treating the issue as a deduction matter, see Deborah A. Geier, “Some Meandering Thoughts on Plaintiffs and Their Attorneys’ Fees and Costs,” *Tax Notes*, July 24, 2000, p. 531.

<sup>14</sup>I made this argument in a related context in “Judicial Activism Is Not the Solution to the Attorney’s Fee Problem,” *Tax Notes*, Nov. 4, 2002, p. 693.

<sup>15</sup>259 F.3d 881, 885, *Doc 2001-21203* (4 original pages), 2001 TNT 154-9 (7th Cir. 2001).

benefit standpoint but from a public relations one as well. I also appreciate the views of Robert Wood, a strong advocate for fair treatment of taxpayers in this context who is not content to wait around for legislation of dubious prospects to correct the situation. My hesitation regarding selective nonenforcement, however, relates to the impact it would have on the health of the tax system as a whole. The taxpayer not only would have the task of determining what the code provides, but would have the additional charge of interpreting various winks and nods from the Service regarding which provisions actually have teeth. In addition, pressuring the Service to apply laws that are not necessarily fair and equitable in a manner to achieve fairness and equity takes the pressure off Congress to enact reasonable legislation in the first place.

At the end of the day, I am not persuaded that the responsibility for rectifying the tax treatment of legal fees does not fall on the legislature. The proper solution to the attorney's fee problem is for Congress to amend section 62(a) to grant above-the-line status to expenses attributable to prosecuting a cause of action that results in a taxable recovery. If Congress did so, would anyone doubt that the attorney's fee issue is ultimately a deduction matter?

Sincerely,

Brant J. Hellwig  
Assistant Professor  
University of South Carolina  
School of Law  
hellwig@law.sc.edu  
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