

## **Subject: Taxation of Damage Awards 3:01**

### **CONTINGENT FEE AWARD TO LAWYER: TAXED TO LAWYER OR CLIENT?**

Okay, okay, I know this title sort of begs the question. We all know that the plaintiff's lawyer is taxable on contingent legal fee awards. It hardly takes a glance at the newspapers over the last year or so to see that lawyers (tobacco lawyers perhaps most egregiously) have racked up billions of dollars in contingent legal fees, some payable over their lifetimes. (Is that lifetime reduced by smoking, or what?). The tax question, of course, is whether there are any circumstances these days in which the IRS would admit that contingent legal fees being separately paid to a lawyer (sometimes pursuant to a court order) ought to be taxable only to the plaintiff's lawyer, and not to the client with whom the plaintiff's lawyer has a fee agreement.

As we have written here in many prior installments of this discussion group, the consequences to the plaintiff of what happens to the legal fee award can be quite severe. The difference between a \$100 gross recovery being taxed 60% to the client and 40% to the lawyer, versus 100% to the client with a 40% deduction to the client, is pretty severe. We are talking, of course, about the 2% miscellaneous itemized deduction threshold, the phase-out of exemptions and miscellaneous deductions due to high income, and most importantly, about the alternative minimum tax.

I have long thought (despite the obvious difficulties with assignment of income doctrine and various other hoary tax concepts), that structuring and pre-planning in this area (and even the vicissitudes of state law, attorney lien filing, etc.), can make a difference in the attractiveness of a particular taxpayer's case. However, I have also long thought that this is a very difficult area that needs statutory fixing. We've been saying a statutory change was on the way for quite some time.

#### **Supreme Court?**

Now, one particularly watched case is in the Fifth Circuit Court of Appeals, *Srivastava, et ux. v. Commissioner*, 5th Cir. Dkt. No. 99-60437. In the Fifth Circuit, the Texas Trial Lawyers Association (not a group of slackers by any means) has filed an *amicus* brief arguing that *Srivastava* cannot be taxed on the settlement proceeds attributable to the portion of his cause of action assigned to his attorneys under a contingent fee agreement. In the Tax Court below, *Sudhir Srivastava, et ux. v. Commissioner*, T.C. Memo 1998-362 (1998), Tax Notes Doc. No. 9829917, a 40% contingent fee was not reported by a couple who recovered a substantial judgment in a libel suit. The plaintiffs in the case, Sudhir Srivastava and Elizabeth Pascual alleged in Tax Court that they have never received 40% of the \$8.5 million settlement in a libel suit, because they assigned a 40% ownership interest in the case to their attorneys. However, the Tax Court looked to Texas law, and found that an attorney does not have a general lien on a cause of action until a judgment is

collected. Thus, said the court, the two plaintiffs did not convey an ownership interest in any settlement proceeding.

The court found that these Texas attorneys operating under a contingent fee agreement do not have rights in the cause of action, and would not be entitled to pursue the action if the client were dismissed. Finding that a contingent fee agreement is an executory contract under Texas law, the Tax Court held that any assignment to the attorneys was anticipatory and could not be effective for federal tax purposes.

While the Tax Court judge did find that a substantial portion of the award (which was made under pre-1986 law) was excludable under Section 104 (\$4.7 million was excludable), the court also found that the balance was taxable interest (both pre-judgment and post-judgment interest) plus punitive damages. The original judgment, before settlement, was for \$11.5 million in actual damages, \$17.5 million in punitive damages, and \$2.6 million in pre-judgment interest. The two plaintiffs argued that because they originally pleaded only for \$8.5 million in actual damages, the entire settlement would logically be allocated to actual damages.

This allocation of an award following a verdict has come up in many cases before, and there is no easy answer. On the one hand, it is easy to understand the government's generally *pro rata* approach to this situation, saying that a settlement amount must represent equally the amounts that were awarded at trial. On the other hand, it would be appropriate for taxpayers to keep evidence about the strength of various claims. Frequently, it can be demonstrated which claims were likely to withstand scrutiny on appeal, and which claims were not. Some planning can often be done here. In this case, the Tax Court found it incredible that the \$8.5 million settlement would be allocated all to excludable damages, so ruled that it simply could not. As to the legal expenses, finding that the attempted assignment of the legal fees to the Texas plaintiffs' attorneys was ineffective, the Tax Court went on to find that the plaintiff couple could not deduct any portion of the legal expenses as business expenses under Section 162. After all, defamation results in personal injury (even if it may no longer be excludable under Section 104. Thus, the expenses of litigating a defamation action are not business expenses. This seemed especially injurious from a tax viewpoint since the defamation in the underlying litigation related to Srivastava's performance as a surgeon!

Nonetheless, the court found that the legal expenses attributable to the taxable punitive damages and to the taxable interests (being a portion of the settlement) could be deducted as Section 212 expenses for the production of income. These, of course, would be miscellaneous itemized deductions, incurring the wrath of the various limitations (including the alternative minimum tax) alluded to above.

After all this, the IRS also determined an accuracy-related penalty for substantial understatement. Fortunately, the court sustained only part of this penalty. The court denied the portion of the penalty for underpayment attributable to the punitive damages portion of

the settlement, finding that the plaintiff couple had substantial authority for their reporting position on this point.

As noted above, the basic holding in the Tax Court was that, under applicable Texas law, the attorneys had no ownership interest in the cause of action. Thus, the Tax Court said the portion of the settlement proceeds paid to the attorneys was includable in the gross income of the Srivastavas. For a summary of the *Tax Notes* memo opinion, see *Tax Notes*, Oct. 12, 1998, p. 207. The full text of the opinion appears at Tax Analysts Doc. No. 98-29917 or 98 TNT 194-6.

### **Not So Fast...**

The Texas Trial Lawyers Association has pulled out its six-gun and said that under Texas law, Srivastava did (and could) transfer a 40% interest in the cause of action to the attorneys. The Texas Trial Lawyers Association argues that a property interest was created from the day the contingent fee agreement was signed. Of course, they are not also arguing that *they* were taxable *then* on that property interest! The *amicus* brief thus concludes that the couple cannot be taxed on the receipt of settlement proceeds that they did not own.

We'll keep you posted about *Srivastava*. It is particularly interesting that this is occurring in the Fifth Circuit. The Fifth Circuit and the Eleventh Circuit are the two circuits that generally hold to the *Cotnam* rule, which is the most favorable rule for contingent fee recoveries. Given that virtually all of the other circuit courts that have considered the matter (albeit on varying facts) have gone against the taxpayer, I still think it is conceivable that the Supreme Court may end up looking at one of these cases in the not-too-distant future.

After all, there does seem to be an appalling lack of equity in any circumstances where a plaintiff (by virtue of the AMT) is taxable on more than he or she receives. Either we get this issue solved, or I predict there will be a lot of Schedule Cs filed by people who are effectively claiming that they are in the business of suing someone (yes, that's been tried, too).

### **ANOTHER STOCK REDEMPTION CASE**

Although it is not yet a final decision, a case pending in the Eleventh Circuit Court of Appeals bears watching by discussion group members. The case is *Linda Karen Brownlow Craven v. United States*, 11th Cir. Dkt. No. 99-12803-BB. The taxpayer's brief has been filed (Tax Notes Doc. No. 1999-36795), as has the government's brief (Tax Notes Doc. No. 1999-34130). In the two briefs, the taxpayer (an ex-wife) and the Justice Department are disagreeing whether her redemption of stock in a corporation that she jointly owned with her ex-husband resulted in recognizable gain. Section 1041 you say?

Not so fast. The Cravens were the sole owners of a pottery company and commenced a divorce in 1999. Linda Craven named the company as a defendant in the divorce. In 1999, the divorce case settled, with the corporation pledging to redeem her stock for \$4.8 million.

The amount was to be repaid commencing in 2000, without interest. The agreement permitted prepayments. The divorce required Billy Joe Craven to guarantee the payments to Linda.

The payments commenced. In fact, Linda received prepayments from both Billy Joe and the company. The company reported imputed interest on the note for 1992 through 1994. Linda did not report imputed interest as taxable income on her return, nor did she report capital gain on the stock redemption. She filed disclosure statements with her tax return, asserting that the interest was not taxable. Her reasoning was that she is a cash basis taxpayer, and that any imputed interest was nontaxable under Section 1041.

Predictably, the IRS determined that Linda recognized a capital gain on the stock redemption when the company made prepayments, and that she had interest income for 1992 through 1994. Linda paid the assessments and sued for a refund in district court. The district court found that the stock redemption was entitled to nonrecognition under Section 1041 as a transfer to a former spouse incident to divorce. However, the district court couldn't help her on the imputed interest question, finding that to be taxable income.

Linda, however, was not about to give up yet. She is now arguing in the Eleventh Circuit that the redemption was purely divorce driven, and that under Section 1041 it could not give rise to any tax liability. She asserts in her brief that the redemption arose solely from Billy Joe's insistence that she sever her connections to the company as an essential element of the divorce. She also argues that the redemption provided her ex-husband with a means to satisfy his marital property obligations and protect his assets.

### **Government Response**

Equally predictably, the government is arguing that Linda is all wrong. In fact, the government is not limiting its response to the notion that the interest is taxable. The government is arguing that the entire redemption of Linda's stock simply does not qualify under Section 1041. The reason? The transfer was to a third party rather than to Billy Joe. Thus, says the Justice Department, it was not an interspousal transaction. The Justice Department also points out that the transfer was not made on Billy Joe's behalf because it gave Linda the right to collect \$4.8 million from the company, and her ex-husband did not have a primary obligation to buy the stock. The redemption, thus, says the Justice Department, is not shielded from recognition under Section 1041.

**Caution:** I feel like a broken record, saying that the entire divorce field is wrought with difficulties (tax difficulties, I mean). Not only is the alimony and child support area often entirely fouled up, but something that seems as straightforward as Section 1041 is often the subject of controversy. This is an example of something where the parties probably thought that they had agreement on economic terms and now the ex-wife has probably already spent sizable sums fighting the applicability of Section 1041. And that fight isn't over. We'll keep you posted. But, planning should be much better than this!

## THE WORST KIND OF LEGAL FEES

We spend much of our time looking at the recipient's side of the litigation equation. And, it normally follows that the tax treatment of attorneys' fees should be based on the tax treatment of the underlying settlement or judgment. In the case of a payor, payors typically may assume that all legal fees are deductible. But from a very early time, we knew that all attorneys' fees were not deductible. Those associated with purely personal matters, for example, are not. The most famous example of this is *United States v. Gilmore*, the 1961 Supreme Court case in which the Court found that the origin of Mr. Gilmore's legal fees was his divorce from his spouse (a purely personal concern), not his desire to save his business (which was one of the assets over which there was substantial expense in litigating the divorce).

The origin of the claim analysis does provide help. But unfortunately, the result that is achieved is not always the one that the taxpayer wants. In the case of *Ruby Jean Stephens v. Commissioner*, T.C. Memo 1999-259, Tax Analysts Doc. No. 1999-26049 (Aug. 4, 1999), the Tax Court found that legal fees incurred in connection with litigation involving a trust of which she was the trustee and beneficiary were nondeductible capital expenditures under Section 263. (At least they were not treated as purely personal expenses). The case arose out of the establishment of a revocable grantor trust in 1990 by the taxpayer's husband, Red.

Red died in 1991, at which time the trust became irrevocable and Ruby (the taxpayer) became the successor trustee. She made two required distributions to children, and the remaining trust property was distributed to her as trustee of a marital trust for her benefit. As beneficiary of this marital trust, she was entitled to receive net income plus discretionary distributions of corpus. She also had a general testamentary power of appointment. Failing her exercise of that power, all trust income and corpus would be distributed on her death to Red and Ruby's daughter, Sedra.

A son from a prior marriage popped into the scene and sued Ruby in 1993, both individually and as a beneficiary and trustee of the marital trust. His complaint even named Sedra as defendant. Garland alleged that his father lacked mental capacity and that the defendants misled or unduly influenced him into signing the documents. Ruby was advised by lawyers that it was her duty as trustee to defend against the lawsuit, and Ruby did so successfully—but she racked up a large legal bill.

So, on her 1993 and 1994 tax returns, she deducted the professional fees that she incurred in connection with the lawsuit. The IRS disallowed all of them, determining that they were capital expenditures.

### Tax Court Speaks

The Tax Court agreed with the IRS that the fees were not deductible under Section 212.

The Tax Court reasoned that Ruby's defense of the lawsuit was to protect the trust's title to the property, and not to protect, safeguard or maintain physical assets. Ruby asserted that none of Garland's claims for relief related the acquisition or defense of title to property, and in fact she insisted that she defended the lawsuit in her capacity as income beneficiary to prevent the impairment of the production and collection of trust income.

### **“Origin of the Claim” Lives On**

I've said before that the origin of the claims test is easy to recite, but not always easy to apply. Sometimes, one scratches one's head trying to figure out precisely what the origin of the claim truly is. Judge Marvel in *Ruby Jean Stephens v. Commissioner*, tried to apply the origin of the claim analysis here. He relied upon *Estate of Kincaid v. Commissioner*, T.C. Memo 1986-543 (86 TNT 226-37), a case in which the legal claim alleged mismanagement and waste of trust assets by the trustee. In *Ruby Jean Stephens*, though, the court found that the lawsuit did not allege abuses in the administration of the trust. Rather, the lawsuit questioned the validity of the trust from the get-go. Garland sought to invalidate the trust from the beginning. Thus, the Tax Court found that the origin of the claim was capital, and had to be considered capital expenditures under Section 263.

### **SETTLEMENT PROCEEDS NOT EXCLUDABLE**

Yet another employment action has been the subject of a Tax Court memo decision. In *Steven P. Cade, et ux. v. Commissioner*, T.C. Memo 1999-394, a corporate officer received an amount to settle all his claims against his former employer. The amount was held not to be excludable under Section 104 because it was not attributable to personal injury. The court specifically found that \$2.3 million of Mr. Cade's \$4.5 million settlement constituted compensation for economic damages (future compensation and benefits arising from the breach of his employment contract).

Obviously, said the Tax Court, that portion of the recovery could not have been for personal tort-like injuries. Noting that Mr. Cade only claimed damages for nonpersonal injuries with respect to the breach of contract claim, Judge Laro of the Tax Court pointed out that the other portions of the settlement were excludable because they involved claims arising in tort. (Of course, this case considers the law prior to the enactment of the August 20, 1996 changes to Section 104 requiring a “physical” component.)

### **TENTH CIRCUIT FINDS NO EXCLUSION**

In *David R. Green, et ux. v. Commissioner*, No. 98-9037, Tax Notes Doc. No. 1999-38127, 1999 TNT 233-53 (10th Cir., Nov. 30, 1999), the Tenth Circuit affirmed (in an unpublished opinion) the Tax Court's decision that payments an individual received under a settlement agreement were for breach of contract and not for a tort-type claim. Therefore, no 104 exclusion applied.

There was an interesting procedural element to this case, since David Green argued that

the IRS was estopped from asserting the taxability of the settlement based on the IRS' concession of this issue for an earlier year. The Tax Court said that *res judicata* applies only to the relitigation of exactly the same claim in the same tax year. The doctrine of collateral estoppel also did not apply, because the issue was resolved for the earlier tax year without adjudication by the Tax Court.

Turning to the merits, the Tax Court view of the case was upheld by the Appeals Court, the case being related to contract claims not personal injury claims. Mr. Green was an insurance salesman and sued the insurer when his position was terminated. A jury found that Mr. Green was terminated without just cause and he was awarded damages based on lost earnings. The case settled while an appeal was pending.

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