Tax Treatment of Attorneys' Fees: Whose Law Applies?

By Robert W. Wood

I have often written with some frustration on the unresolved (but largely unfavorable) tax treatment of attorneys' fees arising in contingent fee litigation.[1] Over and over, the courts have confronted these issues, yet only a tiny percentage of these cases make it to Tax Court or beyond. The attorneys' fee problem has recently generated a fair amount of publicity even in the popular press.[2] However, there is still enormous ignorance and misinformation, and many taxpayers are subjected to the unpleasant surprise of alternative minimum tax treatment.

As it stands now, nine circuit courts have considered the tax treatment of attorneys' fees, though it is by no means clear that each of these cases represents the last word in the particular circuit in question. Even if it does, these nine circuit courts are not in harmony, as is discussed below. And some courts have yet to weigh in, such as the important Second Circuit, although recently, a district court case in the Second Circuit (one of the few circuits not to have ruled on the issue) was decided for the taxpayer.[3]

Thus, the matter continues to generate great controversy and confusion. Regrettably, despite a vehement split in the circuits that ought to invite high court resolution, the Supreme Court has denied certiorari in a number of these cases, presumably believing that state law on attorneys' rights to payments (and specifically attorneys' lien law) will be the basis for decision in these cases. The Internal Revenue Service apparently thinks so, too. National Taxpayer Advocate Nina Olson has recommended a uniform approach nationwide.[4]

With these premises (even though I agree one could argue with them), this article examines how one determines which state's law will govern the attorneys' fee issue, since that state law, in turn, will apparently govern the tax treatment of the attorneys' fees.

Sizing Up the Circuits

There is a well-publicized split in the circuits whether contingent attorneys' fees are includible in the plaintiff's income. The First, Fourth, Seventh, Eighth, Ninth, and Tenth Circuits (the Majority) have ruled that the plaintiff's gross income includes attorneys'

[1] *See* Wood and Flora, "New (Final!) Form 1099 Reporting Regs: Attorneys' Fee Regs in Drag?" *Tax Notes,* Oct. 14, 2002, p. 265; *see also* Wood, "Proposed Attorney Fee Reporting Regulations: Déjà Vu?" *Tax Notes,* July 15, 2002, p. 409.

[2] *See* Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Suit," *New York Times,* August 11, 2002.

[3] *Raymond v. U.S.*, D. Vt. No. 2:01-cv-142 (Dec. 17, 2002), *Doc 2003-7274 (17 original pages), 2003 TNT 55-6.*

[4] *See* FY 2002 National Taxpayer Advocate's Annual Report to Congress, *Doc 2003-568 (416 original pages), 2003 TNT 12-11,* section 2, p. 160-171.

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fees.[5] In contrast, the Fifth Circuit has ruled that a plaintiff's gross income does not include the contingent fee portion of an award.[6] The Sixth Circuit reached the same conclusion.[7] The Fifth Circuit was divided to create the Eleventh Circuit, and both the Eleventh Circuit and the new Fifth Circuit have followed *Cotnam*.[8] Thus, the Fifth, Sixth, and Eleventh Circuits are mavericks (the Minority.)

A primary rationale used (so far) in determining whether the attorneys' fees constitute income to the plaintiff is the assignment of income doctrine. Does the assignor retain sufficient power and control over the assigned property (or over receipt of the income) to make him the recipient for tax purposes? It is often difficult to determine whether a plaintiff has assigned away the claim itself, or merely income from the claim. Most courts have looked to state attorney lien law to resolve the question, since attorney lien law may resolve ownership, in turn contraindicating an assignment of income.

However, after the seminal *Cotnam* case in the Fifth Circuit,[9] a more modern Fifth Circuit appears to have suggested that state law is irrelevant. More about this important topic below, since it could conceivably add two more states to the list of "good states." For now, however, let's turn to how one determines choice of law.

Determining Choice of Law

Given the split in the federal circuits, what law applies to reporting attorneys' fees paid in a contingent fee recovery? Neither the Minority nor the Majority cases on this attorneys' fee point address how one determines the applicable law. Rather, the cases seem to *assume* that the attorney-client relationship (and all issues surrounding the recovery) will be governed by a particular state's law, but how we figure out the appropriate state in a particular case is a mystery.

Indeed, there is no litmus test for determining which law applies, and there is considerable ambiguity in the court decisions and IRS rulings in even identifying relevant factors. However, it is possible to identify several guiding principles, including the following factors:

(a) *Residency*. A taxpayer's residency when he files a Tax Court petition will be relevant. Under the so-called *Golsen* rule, the Tax Court is required to look to the law of the circuit to which an appeal would lie.[10] The relevant circuit for an appeal is also determined by the taxpayer's residency at the time the Tax Court petition is filed. As a result, the Tax Court will follow the law of a circuit only if the taxpayer is residing in a state within that circuit when he files a Tax Court petition.

The *Golsen* rule requires the Tax Court to follow only decisions from the applicable court of appeals that are "squarely on point." The Tax Court has employed this limitation to decline to follow decisions on the fee inclusion issue where a fee agreement was governed by the law of another state. See *Banks II,* discussed below. Thus, although appropriate residency is required to invoke a circuit's law on the fee inclusion issue, it may not be enough by itself for the Tax Court to conclude it is bound by a decision issued by a court of appeals within that circuit.

For example, in *Banks II v. Commissioner (Banks II)*,[11] the taxpayer was a Michigan resident when he filed his petition, and he was a party to a fee agreement governed by California law. Although the *Golsen* rule required the Tax Court to look to Sixth Circuit law, the court declined to follow the law of that circuit. It distinguished *Estate of Clarks v. Commissioner*,[12] since California law applied to the fee agreement in *Banks II,* but Michigan law applied to the fee agreement in *Estate of Clarks.* Thus, the Tax Court ruled that *Estate of Clarks* was not "squarely on point." *Banks II* is a disturbing case. The applicability of a favorable state (in this case, Michigan) attorneys' lien law did not save this taxpayer from facing much less favorable California law.

(b) *Engagement Agreement.* State law governing an engagement or retainer agreement will often be explicitly stated in it. If not stated, it will generally be construed to be the state in which the lawyer is practicing. The IRS and the courts place substantial weight on the retainer agreement when determining whether the taxpayer/plaintiff must include the attorneys' fees in his gross income, even if the attorneys' fees are paid directly to the attorney.

The issue typically has arisen when a court is analyzing whether a fee agreement operates to assign either a right to income or an interest in the claim itself. State attorneys' fee lien laws have sometimes affected this analysis. However, at least two courts of appeal have rendered decisions (discussed below) that do not appear to rely on state law in analyzing the assignment of income issue.

(c) *Situs of Underlying Suit.* The state in which the underlying lawsuit was filed may be a logical situs on which to base the applicable law. It appears that the state in which the taxpayer filed suit (and possibly

[5] *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); *Benci-Woodward v. Commissioner,* 219 F.3d 941, *Doc 2000-20007 (7 original pages), 2000 TNT 144-8* (9th Cir. 2000); *Hukkanen-Campbell v. Commissioner,* 274 F.3d 1312, *Doc 2001-31455 (4 original pages), 2001 TNT 247-75* (10th Cir. 2001); and *Baylin v. Commissioner,* 43 F.3d 1451, *Doc 95-342, 95 TNT 4-23* (Fed. Cir. 1995).

[6] *See Srivastava v. Commissioner,* 220 F.3d 353, *Doc 2000-20090 (16 original pages), 2000 TNT 145-9* (5th Cir. 2000).

[7] *See Estate of Clarks v. U.S.,* 202 F.3d 854, *Doc 2000- 1776 (7 original pages), 2000 TNT 10-21* (6th Cir. 2000).

[8] *See Srivastava v. Commissioner,* note 6 *supra at* 357-58; *Davis v. Commissioner,* 210 F.3d 1346, 1347, *Doc 2000-12246 (5 original pages), 2000 TNT 86-7* (11th Cir. 2000).

[9] 263 F.2d 119 (5th Cir. 1959).

[10] *See Golsen v. Commissioner,* 54 T.C. 742 (1970), *aff'd on another issue* 445 F.2d 985 (10th Cir. 1971).

[11] T.C. Memo. 2001-48, *Doc 2001-6006 (27 original pages), 2001 TNT 41-17.*

[12] Note 7 *supra.*

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even the state law providing the basis for claims alleged in the complaint) may impact the choice of law on the fee inclusion issue. Notably, in its audit directives, the IRS allows for the possibility of netting fees in "cases arising under" the laws of Michigan, Alabama, and Texas. Yet, these audit directives contain no guidance about what cases are considered to "arise under" Texas, Michigan, or Alabama law.

In federal law cases, such as those brought under the federal False Claims Act, the situs of filing seems unlikely to be significant. The lawyer representing the "relator" (the term for a whistleblower in a federal whistleblower case under the False Claims Act) may be practicing in one state but file suit in the federal district court in another state, and the latter situs would probably not be viewed as dispositive (or perhaps even relevant) to the attorneys' fees inclusion question.

(d) *Distinguishing Facts.* Finally, any facts that distinguish the taxpayer's situation from decisions in the Minority cases may be relevant. It is disturbing that the Tax Court has declined to follow a Minority decision when it found that the decision was not "squarely on point." The Service also appears willing to distinguish the Minority decisions based on the particular facts present. Thus, it is possible that other distinguishing factors may affect the Tax Court in applying the *Golsen* rule. These factors may include the taxpayer's residency when the underlying cause of action accrued, residency when the recovery was awarded, or even residency when the award was ultimately paid.

The *Golsen* Rule

Venue for an appeal from the Tax Court is determined by the taxpayer's legal residence at the time the Tax Court petition is filed.[13] 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.[14] Thus, the taxpayer's residence ***at the time a Tax Court petition is filed*** is a critical factor in determining the applicable circuit law for resolving the fee inclusion issue. If a decision by the court of appeals for the circuit to which an appeal lies is "squarely on point," it is controlling on the Tax Court. 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 such a case, 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."[15] Consequently, "like facts will receive like treatment in a court of law." *Id.* Decisions from other circuits are not binding on the U.S. district court or the court of appeals, although they are persuasive.

For example, in *Gibraltar Financial Corp. v. United States,*[16] the court addressed a complicated tax issue, one that had previously been dealt with by the Ninth Circuit. It indicated that "uniformity among the circuits is particularly desirable in tax cases," but went on to state that "we are not inclined to reach a result in conflict with the Ninth Circuit unless the statute or precedent of this court gives us, in our view, no alternative."

Effect of State Law on Fee Inclusion

In court of appeals decisions on the fee inclusion issue, the analysis employed by the courts at times (though not always, as explained below) relies on state law and the impact it has on an attorney's rights conveyed by a fee agreement. Although the reasoning varies throughout the decisions, generally, the Minority tends to view a contingent fee agreement as an assignment of a property right, while the Majority tends to view the arrangement as an assignment of income.

The courts have generally looked to state attorney lien law to resolve these fundamental assignment of income issues. For example, in *Cotnam v. Commissioner,*[17] the court relied heavily on state attorney lien law to conclude the attorneys had "the same right and power over [claims] as their client had . . . for the amount due thereon to them." In *Estate of Clarks v. Commissioner,*[18] the Sixth Circuit relied on Michigan attorney lien common law (there was no attorney lien statute) to conclude that it "operate[d] more or less the same way as the Alabama lien in *Cotnam.*"

It is worth noting that some of the fee inclusion decisions do not hinge on state law, even though they reach contrary holdings. For example, in *Srivastava v. Commissioner,*[19] the Fifth Circuit backed away from state law analysis in *Cotnam*, stating that state attorney lien law was irrelevant to its conclusion that the contingent fee agreement assigned a part of the claim. It stated:

> These [state law] distinctions, however, should not affect the analysis required by the anticipatory assignment of income doctrine, which looks to the taxpayer's degree of control and dominion over the asset. . . . Whatever are the attorney's rights against the *defendant* under Texas law as opposed to Alabama law, the discrepancy does not meaningfully affect the economic reality facing the *taxpayer-plaintiff.* We therefore agree with the Tax Court that, irrespective of whether it is proper to tax contingent attorney's fees under the anticipatory assignment doctrine, ***the answer does not depend on the intricacies of an attorney's bundle of rights against the***

[13] Section 7482(b).

[14] *Golsen v. Commissioner,* 54 T.C. 742, 747 (1970), *aff'd on other issue* 445 F.2d 985 (10th Cir. 1971).

[15] *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)).

[16] 825 F.2d 1568 (Fed. Cir. 1987).

[17] 263 F.2d 119 (5th Cir. 1959).

[18] Note 7 *supra* at 856.

[19] Note 6 *supra*.

opposing party under the law of the governing state (Emphasis added).

In addition, in *Young v. Commissioner,*[20] the court stated:

> Nor do we agree with *Cotnam* and *Clarks's* . . . reliance on state law to settle this federal tax issue. Indeed, there is no relevant distinction between the state common law discussed in *Clarks* and *Baylin,* yet those courts reached opposite conclusions. As the Fifth Circuit itself has now recognized, whether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income *should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action.* (Emphasis added.)

When Residence Doesn't Count

The Tax Court's decision in *Banks II v. Commissioner*[21] is especially relevant to this quandary since the Tax Court there considered the *Golsen* rule, but nevertheless declined to follow a decision issued by the circuit in which the taxpayer resided. In *Banks II,* the Tax Court applied the *Golsen* rule to a Michigan taxpayer who received a recovery from a California lawsuit.

The taxpayer received a recovery in a lawsuit against the California Department of Education for unlawful discrimination and for other claims arising under California law, including intentional infliction of emotional distress and slander. When he filed Tax Court petitions, the taxpayer resided in Michigan. The decision is unclear on the taxpayer's state of residency during other time periods. For example, it does not specify his state of residency during the discrimination lawsuit, although it may not have been Michigan (since he was both employed and filed suit in California).

The taxpayer filed the underlying suit in the U.S. District Court for the Eastern District of California, asserting claims under federal and California law. The taxpayer also filed for bankruptcy in a court in Sacramento, California. The Tax Court noted (without explanation) that California law applied to the fee agreement.

In his return, the taxpayer excluded the attorneys' fee payment from gross income, and the IRS challenged this reporting position. The taxpayer contended the fee inclusion issue was controlled by *Cotnam* "and its progeny." The Tax Court, however, considered and rejected the *Golsen* rule.

The court acknowledged that the *Golsen* rule required it to follow the law of the circuit to which a case is appealable. It also acknowledged that the Sixth Circuit (in *Estate of Clarks*) allowed a taxpayer to report a recovery net of attorneys' fees in gross income. The Tax Court, however, noted the *Golsen* rule applied only "where the holding is squarely on point." It distinguished and thus declined to follow *Estate of Clarks,* stating:

> For the reasons stated by the Court of Appeals for the Ninth Circuit in *Benci-Woodward* and *Coady,* we conclude, as did the Court of Appeals in those cases, that *Estate of Clarks* is distinguishable. Whereas the applicable State law in *Estate of Clarks . . .* was that of Michigan, the applicable State law here is that of California. (Citations omitted.)

Thus, the critical distinguishing factor for the Tax Court was the "applicable state law." Unfortunately, the court did not identify the reason it concluded California law applied. For example, it did not specify whether California law applied because California was the state in which the taxpayer filed suit, California was the state in which the claims arose, or because California was the state whose law governed the fee agreement. Despite this lack of explicit analysis, however, state lien law is implicitly a basis for the court's ruling. In fact, its reasoning focused exclusively on California's attorney lien statute.

The Tax Court quoted at length from *Isrin v. Superior Court.*[22] There (according to the Tax Court), the California Supreme Court concluded that under California law, a contingent fee agreement creates a lien on a recovery but does not transfer a part of the claim to the attorney. The Tax Court then sided with *Benci-Woodward* (although under *Golsen* it was not bound by that decision), in which the Ninth Circuit also relied on *Isrin* to distinguish *Estate of Clarks*, and it held that the taxpayer must include the fees in his gross income.

Notably, the California Supreme Court recently held that attorneys' fees belong to the attorney in fee awards under the fee-shifting provisions of the California Fair Employment and Housing Act (FEHA), at least when there is no contingent fee agreement providing otherwise.[23] It is not yet clear what effect this case will have on the development of the attorneys' fee cases, although I have had some success at the audit and appeals levels of the IRS with arguments that these laws are relevant.

IRS Positions on Choice of Law

Although there is limited authority on the issue, the IRS appears to look to the fee agreement and to state attorney lien law to resolve the fee inclusion issue. The IRS also may consider the state in which the underlying suit was filed, and the state law of the underlying claims.

The IRS provides audit directives on lawsuit awards and settlements.[24] The guidelines require taxpayers to include fees in their gross income except in the states of Alabama, Michigan, and Texas. Although the guidelines carve out a three-state exception, they indicate this exception applies only to "cases *arising under* Alabama, Michigan and Texas law." (Emphasis added.) Even in those cases, the guidelines advise the agent to "consult with the appropriate local Office of Chief Counsel for the current status of this issue."

[20] Note 5 *supra* at 378.

[21] Note 11 *supra.*

[22] 403 P.2d 728 (Cal. 1965).

[23] *Flannery v. Prentice*, 26 Cal.4th 572, 575 (2001).

[24] *See* MSSP, "Lawsuits Awards and Settlements," *Doc 2001-2574 (72 original pages), 2001 TNT 18-6.*

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Unfortunately, it is not clear to what specific matters the "case arising under" language refers. For example, does the language refer to the law governing the retainer agreement? Does it refer to the state in which the lawsuit was filed? Does it refer to the state law under which the claims arose? On a plain reading, this "cases arising under" language would not seem to encompass the state of residency of the taxpayer, but perhaps that's what it means.

Interestingly — although it certainly cannot be relied on as precedential — at least some who are knowledgeable about this issue at the IRS National Office think that the audit guidelines are incorrect in mentioning only Alabama, Michigan, and Texas law. Instead, some believe that the reference to Texas is too limited, and that *any* case from the Fifth Circuit should be receiving the favorable netting treatment. IRS Attorney Adviser Keith Aqui indicated informally that he believes the *Srivistava* case in the Fifth Circuit established that state law was not important to this determination (at least in that circuit).

That suggests that a taxpayer would be entitled to exclude contingent attorneys' fees from his income in the *entire* Fifth Circuit (Texas, Louisiana, and Mississippi). Presumably, this favorable position would not extend to the entire Eleventh Circuit (even though the Eleventh Circuit was split from the Fifth), since the *Srivistava* case occurred long after that split. And, of course, one would still face the same "arising under" law issues that suggest it still may not be easy to decide whether Fifth Circuit law applies — even if Texas, Mississippi, and Louisiana all qualify.

The fee inclusion issue also arose in LTR 200107019, *Doc 2001-4799 (13 original pages), 2001 TNT 34-19,* in which the Service addressed a taxpayer's claim that fees should not be included in his gross income. The Service reasoned that the relevant state lien law did not transfer an interest in the judgment or the claim. The Service based its rulings on both the fee agreement and state law. It first found that the fee agreement created an employment relation rather than a joint venture. Next, it considered state lien law and concluded that under the fee agreement, the attorney had a right to be paid out of the proceeds of the recovery. The Service ruled:

> The Contingency Fee Agreement that you entered into with your attorney . . . did not transfer any interest in the judgment or the cause of action to your attorney. Instead, you used the proceeds of that portion of the judgment you had not previously transferred to the Trust to pay your attorney. Both the Contingent Fee Agreement itself and the law of *** support this conclusion.

As a consequence, the Service ruled the fees must be included in the taxpayer's gross income.

Interestingly, Mike Montemurro of the IRS National Office was involved in issuing LTR 200107019. I believe he adopts the view the Service has taken in most of these cases, that the applicability of attorney lien laws controls.

Conclusory Ponderings

All of this raises some interesting questions. Will an attorneys' fee agreement importing (by agreement) the law of another state on attorneys' liens (or the entire attorney-client relationship) be respected for attorneys' lien purposes, and thus also for tax purposes? Does it matter if the state whose laws are desired has "minimum contacts" within the meaning of the conflicts of law cases? Does it matter if the fee agreement is *amended* to import this law? Does it matter if the fee agreement is amended to do so shortly before settlement? Does the attorney have to be qualified to practice in the state whose law is to be invoked? Does the lawyer need to have an office there? Does the taxpayer need to reside there?

Taxpayers who seek to resolve their attorneys' fee tax questions surely ought not to have to go through these mental gymnastics. Indeed, just thinking through these questions (even without trying to answer the questions) calls to mind Charles Dickens's statement in *Oliver Twist* that "the law is a[n] ass." Still, the fact is that the Service itself has recognized that at least three (and possibly five) states will yield a favorable attorneys' fee exclusion from gross income. Plus, the fact that the Tax Court recently added Vermont to the list (so a total of six states) leaves one with some hope.

The murkiness surrounding how (and when) one invokes a state law should leave at least some taxpayers with more latitude on this issue than some might think. Of course, latitude is not certainty. What is clearly called for is a full and final solution by Congress.

What if Congress cannot or will not act? Even if the individual AMT cannot be repealed just now because of revenue concerns, this attorneys' fee issue cries out for attention. I believe the Internal Revenue Service has the power itself to treat all taxpayers the same on this issue. Procedurally, couldn't an AOD be issued by the Service following the *Srivistava* opinion? I think it is the right thing to do.

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