



The Plight of the Plaintiff: The Tax Treatment of Legal Fees

by Robert W. Wood

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The tax treatment of legal fees has generated enormous controversy over the years. Nearly 40 years ago, the legal expenses Mr. Gilmore attempted to deduct after a bitter divorce battle culminated in the landmark tax case, *U.S. v. Gilmore*, 372 U.S. 39 (1963). There, the Supreme Court held that the substantial legal fees of Mr. Gilmore's divorce action were nondeductible personal expenses, even though he quite credibly argued that the expenses were necessary to protect and preserve his business property from the claims of his wife. In Mr. Gilmore's mind, the expenses should have been deductible as business expenses under section 162, or at least as expenses for the preservation and protection of property under section 212. The Supreme Court found both types of deduction inappropriate, giving a narrow (and perhaps prophetic) reading to the "origin of the claims" test.

The tax treatment of legal fees has been important ever since. Of course, in the vast majority of cases in a business context, legal fees and costs will be fully deductible. The big controversy has been under what circumstances legal expenses must be capitalized instead of deducted. After the Supreme Court's decision in *INDOPCO, Inc v. Commissioner*, 503 U.S. 79, 92 TNT 44-1 (1992), this debate about when legal fees need to be capitalized instead of deducted has grown more hearty.

Contingency Fees

What I view as the most problematic issue with legal fees, however, arises primarily in the contingent fee context. The issue relates to legal fees paid or incurred for the production of income, regular old section 212 expenses. In tax parlance these are so-called "below the line" deductions, as opposed to above the line. That

means they create a good deal of unexpected taxes, and possibly even malpractice cases.

The way in which these rules work is not always fair. It would seem that a litigant who recovers an amount and pays out significant lawyers' fees should be taxed only on the net amount that person receives.

Example: Plaintiff Paul recovers \$10,000 in his suit against XYZ Corporation. Paul recovers \$10,000, but needs to pay his lawyer \$4,000 under the contingent fee agreement. Paul nets \$6,000. Let's assume this is not taxable as wages, but Paul receives a 1099 for his \$10,000 recovery. Does Paul claim only a miscellaneous itemized deduction for \$4,000?

The above example should show that by operation of the miscellaneous itemized deduction rules, Paul will not be in the same position he would be in had he merely netted \$6,000. First, he will lose 2 percent of those deductions because of the 2 percent floor on miscellaneous itemized deductions. Second, because of the phaseout of miscellaneous itemized deductions and personal exemptions, Paul may lose further amounts depending on his tax bracket.

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Finally, and most insidiously, if Paul is subject to the alternative minimum tax, then he may lose a huge portion of his attorneys' fee deduction. If one multiplies the numbers in this example by several hundred times to have a truly big case, one can virtually guarantee that the alternative minimum tax will apply. Although there have been legislative efforts over the years to correct this unfortunate result, it remains a problem today.

The conventional response for attempting to work around this problem involves so-called netting of attorneys' fees. In the above example, if Paul never sees the \$4,000 in attorneys' fees (the \$10,000 is paid to his lawyer, or perhaps by joint check to him and his lawyer) and Paul receives only a check for \$6,000, should this change the result? The answer may well depend on state law, and on the way in which the settlement documents are written. It also may depend on who receives Forms 1099 and for which amounts.

Circuits Split

The tax treatment of contingent fee payments has generated a spate of recent authority. The recent case of *Willa Mae Barlow Davis v. Commissioner*, T.C. Memo. 1998-248, Doc 98-21750 (8 pages), 98 TNT 130-5, followed the result in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959) (Alabama attorneys with a contingent fee agreement had an equitable lien on a portion of the funds recovered), to hold that a plaintiff had to report only the net amount received in the case (net of attorneys' fees). This avoided the plaintiff having to take the gross amount into income and claim a miscellaneous itemized deduction for the attorneys' fees.

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In *Willa Mae Barlow Davis*, the Tax Court noted both that the taxpayer's attorney retained his fees (never paying them over to the plaintiff), but more significantly, the court relied on the applicable Alabama state law, which gave the attorney a direct interest in the case. With relatively little discussion (unfortunately), the Tax Court relied on the decision in *Cotnam*. The court admitted that it felt constrained to follow the Fifth Circuit's rule in *Cotnam*, since decisions of the former Court of Appeals for the Fifth Circuit are binding precedent for courts in the Eleventh Circuit. (*Willa Mae Barlow Davis* was appealable to the Eleventh Circuit.) See *Bonner v. City of Prichard, Alabama*, 661 F.2d 1206 (11th Cir. 1981). Ultimately, then, the *Willa Mae Barlow Davis* case does not resolve the advisability of the netting of attorneys' fees, at least not outside the state of Alabama.

Unfortunately, the IRS does not believe netting is appropriate. For example, the IRS recently released LTR 9809053, Doc 98-7633 (4 pages), 98 TNT 40-15. There, the IRS considered whether legal fees that were withheld from an individual's damage award for gender and age discrimination were includable in the plaintiff's gross income. The settlement payment (for back pay and personal injuries) was delivered to the plaintiff's attorney. The attorney withheld legal fees from the award so that (as is normally the case), the plaintiff never actually saw the portion of the award that was owing to the attorney. LTR 9809053 concludes that the individual is taxable on the full amount (and must claim a miscellaneous itemized deduction for any attorneys' fees).

LTR 9809053 mentions some of the important authorities in this area, authorities that make the split in the circuits painfully clear. The ruling relies on *Baylin v. U.S.*, 43 F.3d 1451, 95 TNT 4-23 (Fed. Cir. 1995), which held that a taxpayer was required to include in income the gross amount of the award, even though a portion was paid directly to his or her attorney. The letter ruling also mentioned *Alexander v. Commissioner*, 72 F.3d 938, 96 TNT 1-74 (1st Cir. 1995), where the First Circuit held that the legal fees could not be offset against settlement proceeds. The *Alexander* court found the legal fees to be a below-the-line miscellaneous

itemized deduction, thus subject to the 2 percent floor on such deductions. The *Alexander* court even applied the alternative minimum tax, resulting in the taxpayer losing almost all of the legal fee deduction. It is perhaps this last element for which *Alexander* is most known, an element that has generated substantial controversy among the plaintiffs' employment bar.

Recent Authorities

Recently, two more cases have been decided that help shed light on this important area. The first case, *Sudhir Srivastava, et ux. v. Commissioner*, T.C. Memo. 1998-362, Doc 98-29917 (39 pages), 98 TNT 194-6, is a Tax Court case in which a 40 percent 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 never received 40 percent of their \$8.5 million settlement in a libel suit because they assigned a 40 percent ownership interest in the case to their attorneys. 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.

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While the Tax Court judge did find that a substantial portion of the *Srivastava* award was excludable under pre-1986 section 104 (\$4.7 million was held excludable), the court also found that the balance was taxable interest (both pre-judgment and post-judgment interest) plus punitive damages. The original judgment was for \$11.5 million in actual damages, \$17.5 million in punitive damages, and \$2.6 million in pre-judgment interest. The case settled on appeal for only \$8.5 million. The two plaintiffs argued that because they originally pleaded for only \$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 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 the *Srivastava* case, though, the Tax Court found it incredible that all of the \$8.5 million settlement would be allocated to excludable damages. The court ruled that this allocation was unreasonable. 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 plaintiffs 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 interest portions of the settlement could be deducted as section 212 expenses for the production of income. These are 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 plaintiffs had substantial authority for their reporting position on this point.

Sinyard Case

In the next episode in this continuing attorneys' fee battle, *James D. Sinyard, et ux. v. Commissioner*, T.C. Memo. 1998-364, Doc 98-29997 (14 pages), 98 TNT 195-10, the Tax Court again held that a portion of settlement proceeds allocable to attorneys' fees was includable in the couple's income. Again, the attorneys' fees could be deducted only as miscellaneous itemized deductions. This case involved two class action lawsuits against IDS Financial Services, Inc. alleging age discrimination. Mr. Sinyard was one of the plaintiffs in the class and signed a contingent fee agreement providing that the plaintiff law firm would receive one-third of any recovery.

In 1992, pursuant to the class action settlement, Mr. Sinyard received \$862,900, of which \$252,600 was allocable to attorneys' fees attributable to the taxable portion of his award. Mr. Sinyard did not include this \$252,600 in his income.

The Tax Court noted that in age discrimination actions under the ADEA, only the prevailing parties have standing to seek attorneys' fees. The attorneys (as distinguished from the actual prevailing parties in the case) have no such right according to the court. Judge Swift of the Tax Court specifically distinguished this case from *Cotnam*.

Deciding this *Sinyard* case under Arizona law, the Tax Court found nothing in Arizona statutes giving attorneys substantive rights in funds recovered on behalf of their client. Instead, the court found that under Arizona law, the total funds recovered are the property of the client, not the lawyer.

Mr. Sinyard nevertheless argued that the attorneys' fees were not awarded to him personally, and he emphasized that payment was made directly to the law firm, which then distributed the plaintiffs' portions (the typical joint check scenario described above). The Tax Court nevertheless found it clear from all of the class action documentation that the amounts allocated for attorneys' fees were to be awarded to the class plaintiffs.

Looking Ahead

Clearly, this is an area in which many more cases will be decided. Arguments that attorneys' fees should not be taxable to the plaintiffs (however forceful they may be) could certainly be based on claims for attorneys' fees made by the attorneys (whether the claims have come to fruition in a judgment or not) and certainly should be supported by language in the settlement agreement requiring direct payment to the attorneys. Cases such as *Sinyard*, where joint checks have been employed and the facts are therefore even more difficult to argue, should be avoided.

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Ultimately, the tax cases seem to be looking not only for the presence of a direct payment of attorneys' fees (so that the plaintiff never touches the contingent fees that are owed to the lawyer), but also for either: (a) a court-ordered mandate of attorneys' fees to the plaintiff's attorney, so that it does not appear that there is any discharge of debt to the plaintiff; or (b) a strong state law lien that gives the plaintiff's attorney a right in and to the fees, negating any constructive receipt by the plaintiff. Since much of the determination here will be based on state law, the Tax Court (and other courts deciding tax issues) will be forced to interpret the state law however it has been accumulated.

Thus, in both the *Srivastava* and *Sinyard* cases, the Tax Court struggled with interpretations of Texas and Arizona law, respectively. Bear in mind, of course, that the development of state attorneys' lien laws did not contemplate tax treatment, and the state of these lien laws is often somewhat antiquated. Generally speaking, attorneys in many states (at least in my experience) are not even aware of what their state attorneys' lien law says. They may have a general sense that they have a lien for fees on a case, but beyond that, their knowledge is often slim.

Given what now appears to be the importance of state law regarding attorneys' liens, it would behoove lawyers to brush up on this important nontax area of law, which seems to have significant tax implications for their clients. Finally, one hopes that in the not too distant future Congress will grapple with the alternative minimum tax, which at one time listed as tax preferences only rather arcane items, and certainly was not originally intended to include everyday deductions such as attorneys' fees. For the short term, however, Congress cannot be counted on to deal with this issue. Taxpayers and their lawyers must.