Everybody Loves Raymond? Second Circuit Further Fouls Tax Treatment of Attorney Fees

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For those keeping score, we've finally reached the point where every single federal appellate court has weighed in on the attorney fee fiasco; sadly, their decisions, and even the underlying rationales that supposedly support them, are anything but consistent. See Alexander v. Commissioner, 72 F.3d 938, Doc 96-602 (21 pages), 96 TNT 1-74 (1st Cir. 1995); Raymond v. United States, 2004 U.S. App. LEXIS 417, Doc 2004-760 (17 original pages), 2004 TNT 10-11 (2nd Cir. Jan. 13, 2004); O'Brien v. Commissioner, 319 F.2d 532 (3rd Cir. 1963), cert. denied, 375 U.S. 930 (1963); 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, Doc 97-23130 (9 pages), 97 TNT 153-8 (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); Sinyard v. Commissioner, 268 F.3d 756, Doc 2001-24862 (15 original pages), 2001 TNT 188-11 (9th Cir. 2001), cert. denied, 536 U.S. 904, (2002); 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); Baylin v. Commissioner, 43 F.3d 1451, Doc 95-342, 95 TNT 4-23 (Fed. Cir. 1995); compare with Estate of Clarks v. United States, 202 F.3d 854, Doc 2000-1776 (7 original pages), 2000 TNT 10-21 (6th Cir. 2000); Davis v. Commissioner, 210 F.3d 1346, Doc 2000-12246 (5 original pages), 2000 TNT 86-7 (11th Cir. 2000); Srivastava v. Commissioner, 220 F.3d 353, Doc 2000-20090 (16 original pages), 2000 TNT 145-9 (5th Cir. 2000); Banaitis v. Commissioner, 345 F.3d 373, Doc 2003-19359 (16 original pages), 2003 TNT 167-5 (9th Cir. 2003), petition for cert. filed, 72 U.S.L.W. 3428 (U.S. Dec. 24, 2003) (No. 03-907); Banks v. Commissioner, 345 F.3d 373, Doc 2003-21492 (15 original pages), 2003 TNT 190-11 (6th Cir. 2003), petition for cert. filed, 72 U.S.L.W. 3427 (U.S. Dec. 19. 2003) (No. 03-892).

Tsunami of Litigation?

The tax treatment of contingent attorney fees has become one of the most hotly contested issues in federal tax law. See, for example, 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. How could a concept that is theoretically so simple turn into such a mess?

More importantly, how can the Supreme Court continue to sit on the sidelines? It has had more than its fair share of chances to weigh in on this issue. See O'Brien v. Commissioner, 319 F.2d 532 (3rd Cir. 1963), cert. denied 375 U.S. 930 (1963); 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); Sinyard v. Commissioner, 268 F.3d 756, Doc 2001-24862 (15 original pages), 2001 TNT 188-11 (9th Cir. 2001), cert. denied 536 U.S. 904, (2002); 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).

Yet, despite cases in which taxpayers have actually ended up owing more in taxes than they recovered in their lawsuits, the Supreme Court has continued to ignore this increasingly inequitable area of the law. See Spina v. Forest Preserve District of Cook County, 207 F. Supp.2d 764 (N.D. Ill. 2002) (in which a Chicago woman who won a sex discrimination suit against her former employer ended up paying $99,000 more in federal income tax than she recovered in her suit).

How does such an Alice in Wonderland result like that occur? The alternative minimum tax is the primary (though not the only) culprit. Let's see how this might work out when a disproportionately small amount of damages are recovered along with a substantial amount of attorney fees.

Assume that a plaintiff recovers a $100 million judgment, inclusive of attorney fees. If the plaintiff lives in one of the "bad circuits" and is required to recognize the gross amount (including the attorney fees) he will be taxed on the entire $100 million recovery. Of course, the plaintiff is entitled to a miscellaneous itemized deduction for the amount of the recovered attorney fees (assume $80 million). But that deduction is disallowed entirely for AMT purposes (and also subject to a floor of 2 percent of adjusted gross income for regular tax purposes).

That results in the plaintiff owing just shy of $28 million in federal income tax on the recovery. Of that amount over $19 million stems from the AMT. The appalling result is that the plaintiff will actually end up losing almost $8 million because of his "recovery"! That's right, the plaintiff will actually end up in the hole almost $8 million after "winning" his lawsuit! How does that happen?

While the plaintiff is allocated $100 million in gross income, he receives only $20 million in cash. From a cash flow standpoint, the plaintiff is left with roughly a $28 million tax bill and only $20 million with which to pay it. It doesn't seem fair to receive a favorable verdict in a lawsuit and then end up paying more in federal income tax than you recovered.

The saddest part about this mess is that virtually everyone knows about it, and has known about it for years. Nonetheless, nobody has yet been willing to do anything to resolve it. See 2002 National Taxpayer Advocate Annual Report to Congress at p. 166. See also 2003 National Taxpayer Advocate Annual Report to Congress at p. 347.

A Strong Dose of Reality

Late in 2003, after taking it on the chin in its last two outings, the government decided it was time for the gloves to come off, and it filed petitions for certiorari in two attorney fee cases. See Banaitis v. Commissioner and Banks v. Commissioner. Although it seems plain that taxpayers in the "bad circuits" will continue to get lambasted on the attorney fee issue, the IRS wants more.

It is not foolish to ask a simple question: Why? After all, over half a century ago the Supreme Court stressed the importance of avoiding inequities in the administration of federal tax law. Commissioner v. Sunnen, 333 U.S. 591, 599 (1948). One would be hard pressed to imagine anything in the federal tax law rivaling the inequity of this issue.

It seems high time for the Supreme Court to end the pervasive and irreconcilable divergence among the circuits on this issue. In my mind, Congress has been just as much of a slacker. The disparate treatment of similarly situated taxpayers directly contradicts equity and fairness, which are essential elements of any tax system. See Robert W. Wood and

Dominic L. Daher, "Class Action Attorney Fees: Even Bigger Tax Problems?" Tax Notes, Oct. 27, 2003, p. 507.

America once observed the simple yet enlightened notion of taxing similarly situated people in a similar fashion. See Adam Smith, The Wealth of Nations (1776, reprinted 1994 Modern Library). The Wealth of Nations was published in 1776. Yet it seems doubtful that our forefathers would approve of the attorney fee quagmire and the shabby treatment a majority of taxpayers must endure because of it.

Ridiculous Redux

The Second Circuit's recent decision in Raymond v. United States is disappointing, though hardly surprising. On the heels of Banks v. Commissioner, surely one could hope for a bit more fairness and vision from the influential Second Circuit than a hackneyed discussion of the old (and frequently misapplied) assignment of income cases. See Raymond at 419, citing Helvering v. Horst, 311 U.S. 112 (1940), and Lucas v. Earl, 281 U.S. 111 (1930).

As you may recall, Banks found Horst and Earl to be unpersuasive. See Banks at 383; see also Robert W. Wood and Dominic L. Daher, "Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law," Tax Notes, Dec. 22, 2003, p. 1427. Instead, the Sixth Circuit in Banks joined the Fifth Circuit in Srivastava v. Commissioner in finding that the strength of the applicable attorney lien law is irrelevant in deciding whether recovered contingent attorney fees constitute gross income. See Banks at 385, quoting Srivastava. That allowed the Sixth Circuit to sidestep the otherwise seemingly obligatory Cotnam analysis and instead determine that the application of Cotnam does not depend on "the intricacies of an attorneys' bundle of rights." Id.

Basking in the Afterglow

After Banaitis and Banks, it seemed at least conceivable that cooler heads might prevail and that the circuits were heading in the right direction. Sadly, the Second Circuit's decision in Raymond is a significant enough setback that it could provoke a kind of tax equivalent of Michael Douglas in Falling Down.

Raymond started as a garden-variety wrongful termination case. After being fired by IBM in 1993, Raymond hired a contingent fee lawyer and sued for wrongful termination. The lawyer was entitled to receive one-third of the net recovery, plus expenses. Raymond won a jury verdict. IBM appealed, lost, and then paid the roughly $900,000 judgment.

On his 1998 federal income tax return, Raymond included the entire recovery in gross income, including the approximately $300,000 paid to his attorneys. In 1999 Raymond filed an amended return requesting a refund for the taxes resulting from the amount paid to his lawyers. Not surprisingly the IRS denied the refund claim. Undeterred, Raymond filed a refund suit in district court. See Raymond v. United States, 247 F. Supp.2d 548, Doc 2003-7274 (17 original pages), 2003 TNT 55-6 (D. Vt. 2002). The court awarded the refund, allowing Raymond to exclude the portion of the recovery paid to his contingent fee attorneys.

In its holding, the court found that applicable Vermont law gave Raymond's attorneys an equitable lien on his recovery. Id. at 554, citing Estate of Button v. Anderson, 112 Vt. 531, 533 (1942). That equitable lien effectively transferred to Raymond's attorneys a proprietary interest in his claim. Id. The district court found that the portion of the recovery used to pay attorney fees already belonged to the attorneys. So the attorneys, not Raymond, had to pay tax on that

amount. The government appealed to the Second Circuit. Raymond v. United States, 2004 U.S. App. LEXIS 417, Doc 2004-760 (17 original pages), 2004 TNT 10-11 (2nd Cir. Jan. 13, 2004).

Through the Looking Glass

Unfortunately, the Second Circuit launched into a tortured tour of assignment of income lore. The Second Circuit in Raymond flopped on its first opportunity to address the attorney fee issue by resorting to Lucas v. Earl and Helvering v. Horst. Unless you've been hiding under a rock, you know that those cases involved assignments of income by persons who had earned the income, but not yet received it. To make matters worse, they "assigned" the income to related parties -- family members. In Earl and Horst, the taxpayers were correctly considered to have taxable income even though they never had actual possession of the funds.

Regrettably, the Second Circuit in Raymond did not distinguish Earl and Horst from the contingent attorney fee fact pattern the way the Sixth Circuit did in Estate of Clarks. See Estate of Clarks at 856-57. I believe it's fair to argue that the value of Raymond's lawsuit was entirely speculative and dependent on the services of his counsel. I might even go so far as to say that the claims of his counsel amounted to little more than an intangible contingent expectancy.

Although the Second Circuit acknowledged that Estate of Clarks analogized a contingent fee agreement to an interest in a partnership or joint venture, the Second Circuit quickly dismissed the analogy. The Second Circuit rejected the Estate of Clarks argument that Raymond contracted for the services of his lawyer and assigned his lawyer a third interest in the venture so that he might have a chance to recover the remaining two-thirds. Rejecting Estate of Clarks and Cotnam, the Second Circuit found Vermont's attorney lien law too weak to support a Cotnam-like result.

The Second Circuit in Raymond could have avoided the whole assignment of income mess by joining up with Banks and following Srivastava v. Commissioner. See Banks at 385, quoting Srivastava (holding that the strength of the applicable attorney lien law is irrelevant in deciding whether recovered contingent attorney fees constitute gross income). That would have allowed the Second Circuit to sidestep the lien law analysis that has instigated much of this mess.

With the possible exception of tax lawyers, few people have pored over attorney lien laws for many years. Recently, of course, many cases have focused on the strength of the applicable attorney lien law. See, for example, Banaitis v. Commissioner; compare with Benci-Woodward v. Commissioner and Coady v. Commissioner.

Assignment of Income Inconsistencies

Why should the tax treatment of attorney fees be predicated on "the intricacies of an attorneys' bundle of rights," which vary wildly from state to state? See Banks at 385, quoting Srivastava. That should be a rhetorical question, but sadly it's not. In a true assignment of income setting, such as the facts involved in Earl and Horst, only the assignor pays tax on the income. In essence, the purported assignment is disallowed for tax purposes. A taxpayer living in one of the "bad circuits" is taxed on the entire recovery, including the recovered contingent attorney fees.

Of course, the attorney is also taxed on the recovered attorney fees. Thus, the plaintiff (particularly when considered in conjunction with the lawyer) is actually worse off than the assignor in an abusive

assignment of income fact pattern. Put another way, the alleged "assignment" to the attorney in the case of contingent fee recoveries is both disregarded and recognized. It is disregarded in the sense that the plaintiff is taxed on the entire recovery. Yet, it is also recognized in the sense that the attorney too is taxed on the recovered attorney fees.

The assignment of income doctrine, first applied in Earl, was never designed to tax the same income twice. Rather, it was merely designed to prevent the shifting of income to people in lower tax brackets. See Lucas v. Earl. There is enough money involved in most of the attorney fee cases that plaintiffs and attorneys alike will be paying tax at the highest marginal tax rate. But that is hardly the point. The attorney fee fact pattern involves true double taxation, a phrase that used to be seen as undermining fundamental tax fairness.

Stayin' Alive

With one of the Bee Gees dying last year, it may be strained to rely on the title and lyrics of one of their platinum disco hits. Yet, wouldn't it be grand if the Supreme Court granted certiorari in either Banaitis or Banks and resolved this injustice in favor of taxpayers? Clearly one should not hold out much hope. See O'Brien v. Commissioner, Benci-Woodward v. Commissioner, Coady v. Commissioner, Hukkanen-Campbell v. Commissioner, and Sinyard v. Rossotti. In fact, Elton John's "Goodbye Yellow Brick Road" may be a more fitting theme song here.

In the near term, direct payment of attorney fees still seems an appropriate course of action as one element of an attempt to avoid the pitfalls of assignment of income cases such as Helvering v. Horst and Lucas v. Earl. The Sixth Circuit in Banks and Estate of Clarks distinguishes Horst and Earl on the ground that the income assigned to the assignees in those cases was already earned, vested, and relatively certain to be paid to the assignor.

In a good number of cases involving the attorney fee issue the value of the taxpayer's lawsuit is speculative and dependent on the services of counsel. Unfortunately, many courts do not agree and have not distinguished Horst and Earl in this context. See, for example, Coady v. Commissioner. It is generally easy to facilitate direct payment of attorney fees, and it certainly seems to be a good idea to do so whenever possible. It may help preserve tax arguments, and may even help to avoid malpractice liability. See, for example, Jalali v. Root, Orange Co. Super. Ct., No. 810531, rev'd 109 Cal. App. 4th 1768, 1 Cal. Rptr.3d 689 (4th Dist. June 9, 2003), as modified on denial of rehearing July 8, 2003) (discussed below).

Beyond mere direct payment, it may also be possible to petition the court to award the attorney fees. When attorneys themselves are directly entitled to the fees a strong argument exists that the recovered fees are not income to the plaintiff. See Kenseth v. Commissioner, Sinyard v. Rossotti (holding that because the prevailing plaintiffs, rather than their attorneys, were entitled to court-awarded attorney fees, they must include the recovered fees in their gross income); compare with Flannery v. Prentice, 28 P.3d 860, 862 (2001) (holding that under California law absent proof of an enforceable agreement to the contrary, the attorney fees belong "to the attorneys who labored to earn them").

No doubt this will continue to be a volatile area of the tax law. Taxpayers and litigators alike should proceed with caution. Obtain tax advice before any settlement is reached. Make sure the settlement payments are made properly. And be certain that every settlement agreement specifies who is going to get any Forms 1099 or W-2 that will be issued by the defendant.

While my concerns are solely the tax consequences of this conundrum, malpractice liability may also loom. In Jalali v. Root, a jury found a litigator liable for malpractice when he had mistakenly advised his client on the tax consequences of his recovery. Luckily for the attorney, the judgment was reversed on appeal. In the end, the attorney was successful in refuting his former client's claims, but only after expending substantial time, energy, expense, and aggravation.

Unanswered Questions

What will happen the next time a court is asked to decide the attorney fee issue? Will the lien law analysis be rejected by the Supreme Court if it decides to hear either Banks or Banaitis? Will the Supreme Court ever grant certiorari on this issue or will it continue to turn a blind eye to the plight of plaintiffs?

On a more local scale, is it possible the Second Circuit may end up splitting itself in two much like the Ninth? Compare Banaitis v. Commissioner (holding recovered contingent attorney fees are not gross income to the plaintiff) with Benci-Woodward v. Commissioner (holding recovered contingent attorney fees are gross income to the plaintiff), and Coady v. Commissioner (same). How many more intracircuit splits will arise?

Those queries may have discernible answers, but it certainly doesn't seem that they do. Certiorari petitions are pending in Banks and Banaitis. Perhaps the Supreme Court (or Congress) will finally resolve the attorney fee issue. Regrettably, I don't see that happening anytime soon.

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