Will the IRS Pursue Attorney Fees Post-*Banks*?

By Robert W. Wood

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In the wake of the Supreme Court's *Banks* decision in January 2005, many plaintiffs are voicing understandable concern over the effect the decision and the American Jobs Creation Act of 2004 (P.L. 108-357) may have on them. The Jobs Act provisions are positive. *Banks* clearly isn't. Under the Jobs Act, plaintiffs in employment cases and federal False Claims Act cases now receive a full above-the-line deduction for contingent attorney fees.

However, not only is that law limited to those two types of cases, but it is effective only for cases resolved by judgment or settlement after October 22, 2004. Thus, even cases on appeal involving a pre-October 23, 2004, verdict would have to be settled to come within the new rule, because a judgment on appeal evidently relates back to the date of the underlying verdict.[1] As for the Supreme Court's announcement in *Banks*, it offered only a ''general rule'' that plaintiffs must now include in income their contingent attorney fees.

I. Mixed Messages

The Supreme Court put to the side for later the applicability of that general rule to: (1) cases in which injunctive relief is also sought by the plaintiff in addition to or in lieu of monetary damages; (2) federal False Claims Act cases arising before the effective date of the Jobs Act; and (3) cases in which the attorney receives fees under a fee-shifting statute or statutory fee award. That third category is an exception from the *Banks* decision that will probably prove to be of enormous impact — particularly because the Supreme Court suggests that there need not be an actual statutory fee award, but merely a recognition that statutory fees might be available and that an attorney is receiving a fee in the nature of (perhaps in lieu of) a statutory fee.

I believe it is hard to draw a different conclusion judging from the fact that in *Banks*, the Supreme Court says the tax treatment of statutory attorney fees is an issue for another day and then notes that a fee-shifting statute was involved in *Banks*. Yet the Supreme Court states that it does not consider the statutory fee issue to be pertinent in *Banks* because under those facts: (1) there was no actual fee award from a court, since the case settled but did not proceed to judgment; (2) the contingent attorney fee agreement did not specify that there were statutory fees available, how they would be divided, or even that a contingent fee would be payable ''in lieu of'' statutory fees; and (3) the settlement agreement also did not recount anything about the contingent fee being in lieu of statutory fees.

Those statements by the Court seem to be a road map for future planning by plaintiffs and their lawyers involved in fee-shifting statute litigation. Considering that fee-shifting statutes are implicated in all types of employment litigation (which may be solved prospectively by the Jobs Act, but was not solved retroactively), that is important. More significantly, that the universe of litigation is wide and that employment cases and federal False Claims Act cases represent the only two kinds of claims protected by the Jobs Act suggests there will be many plaintiffs who will continue to incur the wrath of the AMT (which prevents deductions for attorney fees) outside the context of employment and federal False Claims Act cases.

That the Jobs Act relief was limited and that the general rule of the *Banks* case is unfavorable to taxpayers suggest that many plaintiffs will be looking for ways around the attorney fees problem. The statutory fee-shifting argument, which could be equally effective pre- and post-*Banks*, and pre- and post-Jobs Act, is an important avenue. Unfortunately, there is at least one post-*Banks* decision in which the statutory fee-shifting argument failed.

In *Nancy J. Vincent*, T.C. Memo. 2005-95, *Doc 2005-9343*, *2005 TNT 85-6*, the Tax Court rejected the argument that a fee-shifting statute altered the *Banks* landscape. It is unclear if the taxpayer followed the Supreme Court's fee-shifting road map, though apparently she did not, and, of course, the facts in the case long predate *Banks*. The *Vincent* case may be a blemish on the fee-shifting argument, but it lives on.

It is clear that attorney fee issues will continue to plague taxpayers — and perhaps the IRS and the courts — for years to come. Neither the Jobs Act nor *Banks*, nor the two of them together, fix the problem for volumes of litigation. In this article I will confine my thoughts to plaintiffs who have already resolved litigation and who wonder whether the IRS will come back to haunt them and their recoveries, given that the Jobs Act wasn't retroactive and that the *Banks* decision is.

II. Different Categories of Cases

There are several different categories worth examining. One is cases in which there has already been an audit and the matter is concluded. Another category includes cases in which there has been no examination but taxpayers are understandably fearful that there will be one. Because of the split in the circuits pre-*Banks* and the IRS's recognition of that split, taxpayers in different localities may well be situated differently.

In fact, in an industry specialization paper, the IRS said its revenue agents shouldn't raise attorney fee issues

[1] *See* Wood, ''Effective Date of Attorney Fee Deduction Misses Many Judgments,'' *Tax Notes*, Dec. 20, 2004, p. 1643.

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in Texas, Michigan, or Alabama.[2] That paper was released at a time when the IRS had lost cases in the Fifth, Sixth, and Eleventh Circuits and was trying to recognize the applicability of state lien statutes and how they had been differently treated in the circuit courts. There has been no revision of the industry specialization paper since *Banks*.

A. Closed Cases

In cases that have already been examined but would be hurt by the *Banks* case, one can hope the IRS will do nothing. The IRS has a well-defined policy against reopening closed cases unless there are strong reasons to justify it. The policy derives from section 7605(b), which prohibits an ''unnecessary examination'' and restricts the IRS to one inspection of a taxpayer's books for any one tax period, unless the taxpayer is notified of the need to make the additional examination. The purpose of that curb is not to limit the number of examinations, but to shift the discretion for a reexamination of the taxpayer's books to higher management personnel from the field agent.[3]

1. Notice in writing. A threshold issue is what is considered a closed case. Under IRS reopening procedures, for an agreed case to be considered closed, the local office must have notified the taxpayer in writing of the final proposal of adjustments of tax liability or acceptance of the return as filed.[4] The term ''notified in writing'' means transmittal to the taxpayer of a ''Report of Individual Income Tax Audit Changes'' (Form 1902-E), subject to the conditions on the form. The term also includes a letter telling the taxpayer that his claim for refund has been disallowed in whole or in part.[5] And it includes a letter to the taxpayer stating that the revenue agent's audit report has been accepted.[6] That result applies in other cases in which the revenue agent's examination report is sent to the taxpayer.

2. Reopening. The IRS's policy is not to reopen a closed case to make an adjustment unfavorable to the taxpayer unless one of the following circumstances applies:

- There is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact;
- The prior closing involved a clearly defined substantial error based on an established IRS position existing at the time of the previous examination; or
- Other circumstances exist that indicate that failure to reopen would be a serious administrative omission.[7]

a. Substantial error. Reopening because of substantial error includes three situations: (i) cases in which the reopening will result in a deficiency of $10,000 or more, in which case reopening is mandatory; (ii) cases in which reopening will result in a deficiency between $1,000 and $10,000, in which case approval to reopen depends on the facts and circumstances of the case; and (iii) cases in which the reopening will result in a deficiency of less than $1,000, in which case approval to reopen generally is not granted unless fraud is involved or the failure to reopen would constitute a ''serious administrative omission.''[8]

b. Serious administrative omission. Reopening because of a serious administrative omission covers situations in which a failure to do so could: (i) result in serious criticism of the IRS's administration of the tax laws; (ii) establish a precedent that would seriously hamper subsequent attempts by the IRS to take corrective action; and (iii) result in inconsistent treatment of similarly situated taxpayers who have relatively free access to information about the way the IRS treated items on other taxpayers' returns.[9] One commentator believes the type of situation the IRS seems to have in mind could arise in the examination of stockholders of a closely held corporation.[10] The commentator provides the following example:

A, an officer/stockholder of a corporation, was previously examined and a deficiency determined and paid. As a result of a subsequent examination of the corporation, adjustments to income are made on the returns of other individual stockholders (B and C). In this case, the Service would consider it a serious administrative omission not to open A's return regardless of the amount of the tax deficiency.

c. Contact by the IRS. Contacts by the IRS with the taxpayer after the tax return has been filed do not always constitute an examination or reopening and thus do not require a reopening letter. Under IRS procedures, contacts that do not constitute examination or reopening include: (i) a contact to correct a mathematical error; (ii) a contact to verify a discrepancy between the taxpayer's tax return and an information return; (iii) adjustment of an unallowable item; and (iv) reconsideration of a case involving the mitigation provisions, deduction of a carryback, failure to replace involuntarily converted property, and Joint Committee cases on taxation (overpayments of more than $2 million).[11]

When the examination of a return is to be reopened to make an adjustment unfavorable to the taxpayer, the

[2]*See* IRS Market Segment Specialization Program, *Lawsuit Awards and Settlements*, Chapter 3, located at http://www.irs.gov/businesses/page/0,,id%3D7051,00.html#Chap3.
[3]*United States v. Powell*, 379 U.S. 48, 54-55 (1964).
[4]Rev. Proc. 85-13, 1985-1 C.B. 514.
[5]Letter 569 (SC/DO/IO).
[6]Letter 987 (DO/IO).
[7]26 CFR section 601.105(j); Rev. Proc. 85-13, 1985-1 C.B. 514.
[8]*Id*.
[9]*Id*.
[10]Michael Saltzman, *IRS Practice and Procedure*, Section 8.08[2] (WGL 2002).
[11]*Id.*

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action must be approved by the IRS chief of the Examination Division or the chief of the Compliance Division for cases under that chief's jurisdiction.[12]

Although a Supreme Court decision is important, and *Banks* changed the law of attorney fees taxation in at least three circuits, that doesn't appear to be the kind of circumstance in which a reexamination is appropriate. Yet the IRS may believe differently. There were doubtless cases in Texas, Michigan, and Alabama that the IRS may have known about but previously chose not to examine because of the ''adverse'' (to the IRS) authority presented by the *Cotnam*,[13] *Estate of Clarks*,[14] and *Srivastava*[15] cases. The *Banks* decision raises the specter that the IRS may now examine taxpayer returns from those states.

Unfortunately, the IRS has yet to say whether it will apply *Banks* retroactively. However, some at the IRS have said *Banks* did no more than clarify existing law. In other words, *Banks* may provide the green light to the IRS to begin examining returns from Texas, Michigan, and Alabama. Whether the IRS will actually do that, before the statute of limitations expires, is another question.

B. Cases Not Yet Audited

It is far more likely that a taxpayer will have substantial concern over a case not yet audited. That category may be further divided into cases in which taxpayers were comfortable in excluding attorney fees and cases in which they weren't. I would include in the former category cases in Texas, Alabama, or Michigan, where favorable case law plus the IRS's own industry specialization paper indicated that the exclusion of attorney fees would not be examined. In the second category would be plaintiffs who excluded attorney fees based on other arguments (for example, taxpayers who sought to distinguish their fact pattern from the case law in their own circuits). In those cases, the question will be whether — and when — *Banks* may be applied retroactively.

Let's first address the temporal question. The general statute of limitations for federal tax purposes is three years following the filing of a return.[16] Of course, substantial understatements of tax (generally considered 25 percent) can be examined for six years.[17] Because contingent attorney fees are customarily one-third, 40 percent, or even more (and costs are typically on top of that and generally lumped in with the contingent attorney fees for tax purposes), it is safe to assume that most taxpayers in this now leaky boat will be concerned about those tax issues for six years following the filing of a return, not just for three.

On the other hand, the IRS has done a poor job of policing the six-year statute. Mechanically, nearly all cases are pegged to the three-year statute, because that's the one the IRS carefully monitors. I've seen the six-year statute invoked only a few times in my career, and each time it was invoked for tax issues that were already under examination in a year that was open under the three-year statute.

When I have seen that happen, it has been as part of an examination in which the IRS expanded the inquiry beyond years open under the three-year statute into years that were still open under the six-year statute. That commonly occurs with business taxpayers, for example, for which a net operating loss or other multiyear issues can carry over from one year to the next. The fact that the six-year statute of limitations does not seem to be monitored by the IRS may give plaintiffs some comfort that in all likelihood the issue will surface within three years from the filing of the return. Technically, though, they won't be out of the woods for another three years.

Estoppel is another matter. Taxpayers who have unquestionably Texas cases and who relied in good faith on the IRS's industry specialization paper (not to mention the favorable Fifth Circuit law) may have an estoppel argument. First let me clarify what I mean by unquestionably Texas cases. It was never clear what one had to do to come within Texas law for purposes of attorney fee rules. The variables include whether: (a) the attorney was located in Texas; (b) the case was prosecuted in Texas; (c) the taxpayer resided in Texas when the money was paid; (d) the taxpayer resided in Texas when the tax dispute occurred, and particularly when the matter went to Tax Court; and (e) Texas law applied to the attorney fee relationship. In other words, there are many possibilities for how good a connection one must have with one of the favorable state laws (Texas, Alabama, Michigan). Oregon, of course, was a good state too, until the Supreme Court decided *Banaitis* (which had been consolidated with *Banks*).

Regrettably, the estoppel argument may not be all that convincing, and may not succeed despite the equities. The government is generally neither bound nor estopped by the acts of its officers and agents who have entered into agreements that cause to be done what the law doesn't sanction or permit.[18] There is authority to the effect that reliance by the taxpayer on statements made by an agent is irrelevant to estoppel. Thus, the fact that a taxpayer acts in reliance on statements of a government agency that income from a particular source is not subject to taxation does not estop the government.[19]

Further, the government isn't estopped because the taxpayer relied to his detriment on statements made by a revenue agent and either failed to take deductions, failed to file a return, failed to file a refund claim, filed the wrong return, used an improper basis for reporting income, took improper deductions, or paid fraud penalties.[20]

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[12]*Id*.

[13]263 F.2d 119 (5th Cir. 1959).

[14]202 F.3d 854, *Doc 2000-1776*, *2000 TNT 10-21* (6th Cir. 2000).

[15]220 F.3d 353, *Doc 2000-20090*, *2000 TNT 145-9* (5th Cir. 2000).

[16]Section 6501(a).

[17]Section 6501(e).

[18]*See Wilbur Nat. Bank v. U.S.*, 294 U.S. 120 (1935).

[19]*See U.S. v. Stewart*, 311 U.S. 60 (1940) (explaining that there was no authority for making a representation that no income would be included in the taxpayer's gross income, and as such, the United States was not estopped).

[20]*See Searles Real Estate Trust v. Commissioner*, 25 BTA 1115 (1932), *Biggers v. Commissioner*, 39 BTA 480 (1939).

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All of that seems to indicate that a taxpayer is unlikely to succeed when asserting an argument based on the taxpayer's reliance on a prior court case or even an IRS administrative announcement based on court cases. Nevertheless, thanks to the Taxpayer Bill of Rights, a taxpayer may rely on IRS written advice. If the advice provided by the IRS in writing is erroneous and results in an addition to the tax for the taxpayer or the imposition of a penalty, the addition to the tax or the penalty is to be abated. Abatement occurs only if the written advice was reasonably relied on by the taxpayer and was in response to a specific written request of the taxpayer.[21] Although it is possible for the addition to tax or penalty to be abated, it appears that that erroneous written advice given by the IRS won't affect the original amount of taxes.[22]

III. To Amend or Not to Amend?

Taxpayers from Texas, Michigan, Alabama, or any other state that took positions contrary to *Banks*, may now be wondering if they should amend their returns to conform to *Banks*. Of course, the IRS has applied numerous Supreme Court cases retroactively. There appears to be no definitive answer on whether a taxpayer must amend a return based on a Supreme Court decision handed down after the filing of a return. It seems hard to imagine that the courts or the IRS haven't addressed that topic.

Perhaps one of the causes of that uncertainty is the noticeably brief tax rules that relate to amended returns. The code contains an overall mandate that taxpayers should file complete and accurate returns.[23] One of the few rules discussing amending a return is found in the area of accrual basis taxpayers. That rule provides that if an accrual-basis taxpayer later determines that there was unreported income on a previously filed return, that taxpayer "should" file an amended return to correct the error.[24]

That rule shouldn't apply to individual taxpayers who are on the cash basis (and not the accrual basis). Even assuming for a moment that an individual taxpayer was on the accrual basis, that regulation might still not apply, because arguably its intent is for a taxpayer to file an amended return to correct a mistake, not to change a filing position. Further, that regulation requires no mandatory action, because it provides only that a taxpayer "should" amend. Nothing I have found suggests that the code, regulations, or any other authority imposes an affirmative duty on a taxpayer to file an amended return because of a court decision rendered after his return is filed.

On a related subject, the *Banks* decision shouldn't affect whether the IRS could assess penalties for taking a position on a prior return. In general, a negligence penalty is determined based on the taxpayer's knowledge at the time the return was filed.[25] Information discovered after filing should be irrelevant.

Tax return preparers — including attorneys — are ethically obligated to advise taxpayers that they should amend their returns when errors are later discovered. And if a taxpayer with knowledge of a previous error files an amended return for that same year but on unrelated grounds (such as a claim for a refund), the taxpayer would be under an affirmative legal duty to correct the error (that is, to file an amended return that is accurate in all respects). That comes merely from the general obligation to file an accurate return, because any amendment effectively reaffirms the return except for the specific items corrected. In other words, a taxpayer would need to report attorney fees on an amended return, even if the taxpayer amended for some other reason.

Taxpayers can obviously choose to amend prior returns. However, because it doesn't appear that there is an affirmative obligation to do so, most taxpayers will wait it out. Taxpayers who have made it through an audit seem unlikely to be reaudited, and neither *Banks* nor any other authority appear to impose any obligation to amend previously filed returns.

IV. Choice of Law

For taxpayers who are unsure whether they have a good (or a weak) case for applying the law of Texas, Michigan, Alabama, or Oregon, the so-called good states pre-*Banks*, there is no litmus test for determining which law applies, and there is much 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 *Golsen* rule, the Tax Court must look to the law of the circuit to which an appeal would lie.[26] 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 used that limitation to decline to follow decisions on the fee inclusion issue when a fee agreement was governed by the law of another state. See discussion below of the tax court's *Banks* decision. 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.

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[21]Section 6404(f).
[22]Treas. reg. section 301.6404-3(f) (Example 1).
[23]Section 6011.
[24]Treas. reg. section 1.461-1(a)(3).
[25]*Broadhead v. Commissioner*, 14 T.C.M. 1284 (1955), *aff'd* 254 F.2d 169 (5th Cir. 1958).
[26]*See Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd on another issue* 445 F.2d 985 (10th Cir. 1971).

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For example, in *Banks v. Commissioner*,[27] the taxpayer was a Michigan resident when he filed his petition and 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 Tax Court declined to follow the law of that circuit. It distinguished *Estate of Clarks v. Commissioner*,[28] because California law applied to the fee agreement in *Banks*, but Michigan law applied to the fee agreement in *Estate of Clarks*. Thus, the Tax Court held that *Estate of Clarks* was not squarely on point. In *Banks*, in the Tax Court, the applicability of the then-favorable Michigan attorney lien law did not save the taxpayer from facing much less favorable California law.

B. Engagement Agreement

State law governing an engagement or retainer agreement will often be stated in the agreement. If not stated, the agreement will generally be construed to be the state where the lawyer is practicing. The IRS and the courts used to place substantial weight on the retainer agreement when determining whether the taxpayer or plaintiff must include the attorney fees in gross income, even if the 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 attorney fee lien laws have sometimes affected that analysis.

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 even the state law providing the basis for claims alleged in the complaint) may affect the choice of law on the fee inclusion issue. Notably, in its (now outdated) audit directives, the IRS allowed for the possibility of netting fees in cases arising under the laws of Michigan, Alabama, and Texas. Yet those 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 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 attorney fee inclusion question.

D. Distinguishing Facts

Finally, any facts that distinguish the taxpayer's situation from the authorities, making those authorities less than "squarely on point," may be relevant. Before the Supreme Court's decision in *Banks*, the Tax Court has declined to follow the attorney fee rule from a favorable circuit when it found that the decision was not squarely on point. Thus, it is possible that other distinguishing factors may affect the Tax Court in applying the *Golsen* rule. Those 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.

1. 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.[29] 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.[30] 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 that 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 owe obedience to its decision, in all future cases."[31] 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*,[32] the court addressed a complicated tax issue that had previously been dealt with by the Ninth Circuit. It indicated that "uniformity among the circuits is particularly desirable in tax cases," but 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."

2. When residence doesn't count. The Tax Court's decision in an early iteration of *Banks*[33] is especially relevant to this quandary because the Tax Court there considered the *Golsen* rule but still declined to follow a decision issued by the circuit in which the taxpayer resided. In *Banks*, the Tax Court applied the *Golsen* rule to a Michigan taxpayer who received a recovery from a California lawsuit. Although reading the Tax Court's opinion may seem pointless after the Supreme Court's decision, there still should be some interest. It may still be relevant to determine which state law applies, because, given the IRS's Market Segment Specialization Program for lawsuit awards and settlements (even though it is now outdated), some post-*Banks* cases may be treated more favorably than others.

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[27]T.C. Memo. 2001-48, *Doc 2001-6006*, *2001 TNT 41-17* (2001), *aff'd in part, rev'd in part* 345 F.3d 373 (6th Cir. 2003), *rev'd and remanded* 125 S.Ct. 826 (2005).

[28]*Supra* note 14.

[29]Section 7482(b).

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

[31]*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)).

[32]825 F.2d 1568 (Fed. Cir. 1987).

[33]*Supra* note 27.

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In *Banks*, 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. The taxpayer resided in Michigan when he filed Tax Court petitions. The decision is unclear on the taxpayer's state of residency during other time periods. For example, it doesn't 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 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. The Tax Court noted without explanation that California law applied to the fee agreement.

In his return, the taxpayer excluded the attorney fee payment from gross income, and the IRS challenged that reporting position. The taxpayer argued that 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 attorney fees in gross income. The Tax Court, however, noted that the *Golsen* rule applied only "where the holding is squarely on point." It distinguished and therefore 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 say why it concluded that California law applied. For example, it didn't 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 California was the state whose law governed the fee agreement. Despite that lack of analysis, however, state lien law is implicitly a basis for the court's decision. In fact, its reasoning focused exclusively on California's attorney lien statute.

The Tax Court quoted at length from *Isrin v. Superior Court*.[34] 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 held in *Flannery v. Prentice*[35] that attorney fees belong to the attorney in fee awards under the fee-shifting provisions of the California Fair Employment and Housing Act, at least when there is no contingent fee agreement providing otherwise. It is not yet clear what effect that case will have on the development of the attorney fee cases, though I've had success at the audit and appeals levels of the IRS in arguing that those laws are relevant. However, the Tax Court in at least one post-*Banks* tax case has not found *Flannery v. Prentice* relevant.[36]

E. Unanswered Questions

We'll now return to the IRS audit directives on lawsuit awards and settlements.[37] The guidelines require taxpayers to include fees in their gross income except in Alabama, Michigan, and Texas. Although the guidelines carve out that three-state exception, they indicate that the exception applies only to "cases *arising under* Alabama, Michigan and Texas law." (Emphasis added.) "Arising under" is not defined. Even in cases arising under those states' laws, the guidelines advise the agent to "consult with the appropriate local Office of Chief Counsel for the current status of this issue."

All of that raises interesting questions, even if only for taxpayers who are hurt by *Banks* and who are hoping this issue won't come up. Will an attorney fee agreement importing (by agreement) the law of another state on attorney liens (or the entire attorney-client relationship) be respected for attorney lien purposes, and thus also for tax purposes? Does it matter if the state whose laws are desired has "minimum contacts" under the conflicts of law cases? Does it matter if the fee agreement is amended to import that law? Does it matter if the fee agreement is amended to do so shortly before settlement? Must the attorney be qualified to practice in the state whose law is to be invoked? Must the lawyer have an office there? Does the taxpayer have to reside there?

V. Conclusion

Although the Supreme Court in *Banks* resolved the split in the circuits, it didn't answer all extant questions. There will be plenty of plaintiffs going forward who will seek to distinguish *Banks*. I believe that is true despite the Tax Court's recent *Vincent* decision.

And there will be plenty of plaintiffs who will be watching carefully to see whether the IRS audits pre-*Banks* settlements and judgments. Perhaps the most egregious cases will be those from Texas, Michigan, and Alabama, where taxpayers relied on good circuit court authority and even on the IRS's own statements that it

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[34]403 P.2d 728 (Cal. 1965).

[35]26 Cal.4th 572, 575 (2001).

[36]*See Vincent v. Commissioner*, T.C. Memo. 2005-95, *Doc 2005-9343, 2005 TNT 85-6*.

[37]*See* Market Segment Specialization Program, *Lawsuits Awards and Settlements, Doc 2001-2574, 2001 TNT 18-6*.

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wasn't examining attorney fees issues in those jurisdictions. There has been no official statement from the IRS whether it will now examine those returns in light of *Banks*. I suspect some will be examined. For those and other taxpayers, the attorney fee debate is far from over.

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