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To Tax Contingent Fees or Not to Tax?

It's a question snagging the interest of many: Can a taxpayer lawfully exclude from gross income contingent fees paid to an attorney upon the resolution of litigation under a contingent fee agreement? Over the years, federal circuit courts of appeal have reached different conclusions on the issue—although not always because they have been at loggerheads about the underlying premises. Now, the United States Supreme Court will provide some direction when it entertains and decides *Comm'r v Banks*[1] and *Comm'r v Banaitis*[2] as part of its upcoming October term.

The Germ of the Issue—The Definition of Gross Income

At the heart of *Banks/Banaitis* is the comprehensive definition of "gross income" stated in IRC 61(a):[3]

> *Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony and separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust.*

Case law addressed to the composition of "gross income" for federal income tax purposes confirms that "gross income" of "whatever kind and in whatever form paid:"

- is fully taxable to the person who earns it, even in the face of an assignment agreement[4]
- includes amounts paid to a taxpayer in satisfaction of the taxpayer's obligation[5]
- embraces income that is within the taxpayer's control[6]
- is taxable to the income receiver, even if assigned[7]
- can be derived "from any source whatsoever"[8]

A Peripheral Issue—Uniform Application of the Tax Laws

A peripheral issue looks to uniform application of federal tax law throughout the states, inasmuch as some appellate courts have applied state law precepts to decide the taxability issue. The Supreme Court has addressed the uniformity issue in several cases that may invigorate its decision in *Banks/Banaitis*.[9] As an example, the Court has stated that "the constitutional requirement of uniformity is not intrinsic, but geographic . . . And differences of state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity."[10]

Upping the Ante—The Alternative Minimum Tax

The stakes of this issue changed considerably after implementation of the Alternative Minimum Tax (AMT).[11] Under the AMT—a system of taxation that parallels the regular income tax structure—some typically nontaxable items are subject to tax, while some usually allowable deductions are eliminated. In the contingent fee context, once the IRS includes contingent fees in the taxpayer's gross income, the taxpayer's income routinely is inflated to a level that triggers imposition of the AMT, which allows no deduction for attorney fees and substantially increases tax owed. The Ninth Circuit, in *Sinyard v Comm'r,* expressed its reservations with the AMT, but ultimately viewed the matter as one for Congressional attention.[12]

Banks/Banaitis' Ancestry

The path to *Banks/Banaitis* is strewn with a series of conflicting—although some arguably not—opinions out of the United States Circuit Courts of Appeals considering whether contingent attorney fees must be included in a taxpayer's gross income.

Cotnam v Comm'r,[13] a 1959 case, involved a taxpayer who sued an estate, recovered $120,000, and paid 40 percent of that amount to her attorneys as a contingent fee. The IRS treated the full amount of the judgment as taxable and determined a deficiency. The Fifth Circuit, which entertained the taxpayer's appeal of the Tax Court's adverse decision, examined the law of the state in which the fee obligation arose, Alabama. According to the court, because the Alabama Code provided the taxpayer's attorneys with "a lien superior to all liens but tax liens," the taxpayer realized no taxable income with respect to that portion of the award paid as attorney fees.

A different result—although using the same analysis—was obtained in *O'Brien v Comm'r.*[14] The taxpayer in this Third Circuit case was a Pennsylvania resident who received a back-pay award in a wrongful termination suit and was obligated to pay his attorney half of the award under a contingent fee arrangement. The IRS, disagreeing with the taxpayer's "no taxable income" treatment of the attorney fees, issued a notice of deficiency, and the taxpayer appealed the deficiency to the Tax Court, which, using the Fifth Circuit's analysis in *Cotnam,* reached a different conclusion applying Pennsylvania law.[15] On appeal, the Third Circuit succinctly affirmed both the decision and reasoning of the Tax Court. Note that it may well be said that the different results in *Cotnam* and *O'Brien* did not actually manifest a split on the "contingent fees as gross income" issue, as the courts applied the same state law analysis to determine the outcomes.

The issue has been considered on a number of occasions after *Cotnam* and *O'Brien,* with varied rationales and results.[16]

Banks and *Banaitis*

The taxpayer in *Banks,* a Michigan resident who had been employed as an educational consultant by a California entity, initiated suit under federal provisions against his former employer. The matter was settled, and Banks paid a contingent fee to his attorneys that he excluded from gross income in computing his income tax liability.

Fast Facts:

- Under the AMT, some typically nontaxable items are subject to tax, while some usually allowable deductions are eliminated.
- In *Banks* and *Banaitis* the Tax Court did not believe that a contingent fee agreement resulted in an excludable assignment of income from the taxpayer.
- The commissioner, in his Supreme Court submission, emphasizes that it is these taxpayers, not the taxpayers' attorneys, who received and controlled their awards.

On audit, the IRS recomputed his gross income to include the attorney fee portion; this spawned application of the AMT, precluding Banks from taking a miscellaneous itemized deduction for the fees. Banks challenged the IRS' deficiency in the Tax Court, which determined that the issue turns on the collection rights of attorneys under applicable state law (here California, the state in which the litigation arose, which characterized the attorney's lien as "no more than a security interest") and viewed the issue as coming squarely within the "assignment of income" doctrine.[17] The Sixth Circuit reversed, rejecting the Tax Court's dependency "on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state."[18] The United States Supreme Court granted the commissioner's petition for a writ of certiorari on March 29, 2004.[19]

In *Banaitis,* the taxpayer brought a wrongful discharge/tortious interference with contract suit against his former employers, prevailed on both claims, and paid contingent fees to his attorneys. Banaitis did not include any portion of the settlement award balance in his gross income, positing that only taxable interest from the settlement must be included. The IRS recomputed Banaitis' federal income tax liability to include the entire settlement proceeds within gross income, thereby increasing his federal income tax liability by $288,798 through application of the AMT. Banaitis filed a petition for redetermination in the Tax Court, challenging, among other things, the inclusion, in gross income, of attorney fees paid from the settlement under his contingent fee agreement.

As in *Banks,* the Tax Court did not believe that a contingent fee agreement resulted in an excludable assignment of income from the taxpayer. The Tax Court determined that Oregon law did not provide attorneys with property interests amounting to anything more than a common creditor's right to compensation.[20] On appeal, the Ninth Circuit disagreed, ruling that under applicable Oregon law, attorney fees are not a constituent part of gross income.[21] The United States Supreme Court granted the commissioner's petition for a writ of certiorari on March 29, 2004, and consolidated the case with *Banks.*[22] The cases are scheduled to be argued on November 1, 2004.

The Lay of the Land per the Parties

In support of his assertion that contingent attorney fees are part of a taxpayer's gross income, the commissioner, in his Supreme Court submission, emphasizes that *it is these taxpayers, not the taxpayers' attorneys,* who received and controlled their awards.[23] It matters not that the value of the taxpayers' claims and their corresponding contingent fee responsibilities were uncertain at the time the fee agreements were executed—the taxpayers nevertheless retained the authority to determine whether, and for how much, to settle, thereby exercising control over the amount and payment of the fee. The relationship between taxpayer and attorney is not that of a partner or joint venture participant, but instead is that of debtor/creditor. Even if state law is determinative, reversal nevertheless is required because the lower courts misinterpreted state law.

Before the Supreme Court, Banks claims that no Internal Revenue Code provision specifically requires that litigation plaintiffs include contingent fees retained by, and taxed to, their attorneys. Banks contends that he relinquished control of the contingent fee portion to his attorney, and had no right to divest the attorney of the fee. Banks also asserts that, because his employment claims were brought under federal civil rights laws with fee-shifting provisions, the contingent fees must be treated as if they had been paid under a judgment awarding fees under the federal statutes, a characterization that affects the identity of the income recipient. Attention must be paid to the unjust amount of tax liability borne by the taxpayer if the commissioner's position is adopted. Finally, Banks contends that the assignment of income doctrine is inapplicable to a contingent attorney fee contract.

In addition to the similar contentions he makes regarding assignments of income, Banaitis urges the Court to determine that a contingent fee arrangement between attorney and client establishes a joint venture or partnership. Also, contrary to Banks' position, Banaitis submits that state law precepts should determine an attorney's property interests in contingent fees.

Amici Curiae Have Their Say

Two law school professors, Gregg D. Polsky of the University of Minnesota Law School and Brant J. Hellwig of the University of South Carolina School of Law, filed an amici curiae brief on behalf of the commissioner, offering a wholly new argument in favor of including contingent fee amounts in the taxpayers' gross income. Professors Polsky and Hellwig contend that IRC 83[24] mandates taxation of transfers of property in connection with the performance of services. Whether the contingent fee arrangement entails a promise to pay made in exchange for legal services, or transfer of a portion of a claim in exchange for legal services, IRC 83 would require imposition of tax that is not different in amount or timing.[25]

In addition to the seven other amici curiae briefs filed in support of Banks' and Banaitis' positions is the amicus presentation of Professor Stephen B. Cohen of the Georgetown University Law Center, which presents a new justification for excluding contingent attorney fees from a taxpayer's gross income. Under Professor Cohen's analysis, contingent attorney fees constitute "reimbursed employee business expenses" under IRC 62(a)(2)(A)[26] that are excludable from gross income under Treasury Regulation 1.62-2(c)(4) in accordance with strict requirements.[27] Cohen views this treatment as consistent with Congressional intent, as allowing for the computation of tax liabilities that are more fair than those that result from application of the AMT, and as having no chilling effect on the enforcement of civil rights violations. There is a glitch—the only federal case to have considered IRC 62(a)(2), *Biehl v Comm'r,*[28] interprets the provision as inapplicable to the expenses of a former employee.

What Will the Supreme Court Do?

Obviously, a variety of theories have been laid at the Supreme Court's doorstep, theories that could prompt an uncomplicated "hands-off" resolution or a relatively complex and judicially active determination. The Court could decide to:

Include contingent attorney fees in the taxpayer's gross income under the assignment of income doctrine.

This solution is attractive from the perspectives of facility, its allegiance to precedent, and its maintenance of uniform application of federal tax law.

Adhere to a state-by-state analysis.

This determination certainly would have negative aspects: It likely would spawn criticism that the Supreme Court has sidestepped the assignment of income doctrine, and would encourage tax-motivated contingent fee arrangements. It could even prompt some states to legislate reductions in federal income tax liability by giving attorneys proprietary interests in client claims. Critics would object that this approach needlessly burdens the administrative workload of the IRS, and diminishes tax law enforcement.

Exclude contingent attorney fees from the taxpayer's gross income.

In the most judicially active result, the Supreme Court could rule that contingent attorney fees are never to be included in gross income, or may be excluded only in certain types of cases, e.g., cases in which the cause of action arises under federal law. The Court could achieve this result for many different reasons, among them (1) that the claim, at the time the contingent fee agreement was signed, was "an intangible, contingent expectancy;" (2) that the taxpayer's claim was akin to a partnership or joint venture; (3) that no tax-avoidance purpose fueled the contingent fee arrangement; or (4) that double taxation concerns require this determination. Of course, Professors Polsky and Hellwig's IRC 83 analysis (which is inapplicable if the taxpayers are determined to be partners or joint venture participants) could generate a Phyrric victory for Banks and Banaitis, for having prevailed on their claims that the fees are not part of gross income, they then may be subject to an equivalent tax on the transfer.

The other legitimate (and perhaps best) reason the Supreme Court could use to exclude contingent attorney fees from gross income is that offered by Professor Cohen—that contingent attorney fees qualify as reimbursed employee business expenses under IRC 62(a)(2)(A). IRC 83 would not apply in this context; civil rights litigation would not be discouraged; the strict qualification requirements for this exclusion would adequately safeguard against abuse; and no established doctrine would have to be explained and differentiated.

Whatever the outcome in *Banks/Banaitis,* the Supreme Court's decision is certain to have a significant impact on taxpayers, attorneys, and tax professionals throughout the United States. Should the outcome sustain the imposition of unfair tax burdens, perhaps the best one can hope for is that Congress will take notice of the inequities and act to resolve them. ✦

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Footnotes

1. ___ US ___; 124 S Ct 1712; 158 L Ed 2d 398 (2004).
2. ___ US___; 124 S Ct 1713; 158 L Ed 2d 398 (2004).
3. 26 USC 61(a).
4. See, *Lucas v Comm'r;* 281 US 111; 50 S Ct 241; 74 L Ed 731 (1930).
5. See, *Old Colony Trust Co v Comm'r,* 279 US 716; 49 S Ct 499; 73 L Ed 918 (1929).
6. See, *Corliss v Bowers,* 281 US 376; 50 S Ct 336; 74 L Ed 916 (1930); see also *Helvering v Clifford,* 309 US 331; 60 S Ct 554; 84 L Ed 788 (1940).
7. See, *Helvering v Horst,* 311 US 112; 61 S Ct 144; 85 L Ed 75 (1940); see also, *Helvering v Eubank,* 311 US 122; 61 S Ct 149; 85 L Ed 81 (1940).
8. See, *Comm'r v Glenshaw Glass Co,* 348 US 426; 75 S Ct 473; 99 L Ed 483 (1955).
9. See, *Poe v Seaborn,* 282 US 101; 51 S Ct 58; 75 L Ed 239 (1930). See also *United States v Bess;* 357 US 51; 78 S Ct 1054; 2 L Ed 2d 1135 (1958); *Aquilmo v United States;* 363 US 509; 80 S Ct 1277; 4 L Ed 2d 1365 (1960); *United States v National Bank of Commerce;* 472 US 713; 105 S Ct 2919; 86 L Ed 2d 565 (1988).
10. *Poe* supra, 117–118 (citations omitted).
11. 26 USC 56(b)(1)(A)(i).
12. 268 F3d 756 (CA 9, 2001).
13. 263 F2d 119 (CA 5, 1959).
14. 319 F2d 532 (CA 3, 1963).
15. 38 TC 707 (1962).
16. See, *Baylin v United States,* 43 F3d 1451 (CA Fed, 1995) (includable); *Estate of Clarks v United States,* 202 F3d 854 (CA 6, 2000) (not includable); *Davis v Comm'r,* 210 F3d 1346 (CA 11, 2000) (not includable); *Coady v Comm'r,* 213 F3d 1187 (CA 9, 2000) (includable); *Benci-Woodward v Comm'r,* 219 F3d 941 (CA 9, 2000) (includable); *Srivastava v Comm'r,* 220 F3d 353 (CA 5, 2000) (not includable); *Young v Comm'r,* 240 F3d 369 (CA 4, 2001) (includable); *Foster v United States,* 249 F3d 1275 (CA 11, 2001) (not includable); *Kenseth v Comm'r,* 259 F3d 881 (CA 7, 2001) (includable); *Sinyard,* 268 F3d 756 (CA 9, 2001) (includable); *Hukkanen-Campbell v Comm'r,* 274 F3d 1312 (CA 10, 2001) (includable); *Raymond v United States,* 355 F3d 107 (CA 2, 2004) (includable).
17. *Banks v Comm'r,* TC Memo 2001-48 (2001).
18. *Banks v Comm'r,* 345 F3d 373, 385 (CA 6, 2003).
19. www.supremecourtus.gov/docket/03-907.htm.
20. *Banaitis v Comm'r,* TC Memo 2002-5 (2002).
21. *Banaitis v Comm'r,* 340 F3d 1074 (CA 9, 2003).
22. www.supremecourtus.gov/docket/03-907.htm.
23. *Brief for the Petitioner Commissioner of Internal Revenue,* 2003 US Briefs 892, 11 (2004).
24. 26 USC 83.
25. *Brief for Amici Curiae Professor Gregg D. Polsky and Professor Brant J. Hellwig In Support of Petitioner,* 2003 US Briefs 892, 14 (2004).
26. 26 USC 62(a)(2).
27. 26 CFR 1.62-2(c)(4).
28. 351 F3d 982 (CA 9, 2003).