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Only Congress Can Create Deductions

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POINT & COUNTERPOINT: PLAINTIFF'S ATTORNEYS' FEES AND COSTS

INTRODUCTION: A series of recent and controversial cases has raised the issue of how plaintiffs must treat attorneys' fees and costs that are paid out of otherwise includable settlement or litigation awards. Plaintiffs facing this problem include civil rights litigants, employees in employment-related litigation, defrauded consumers, and those who recover punitive damages and interest as well as excludable awards under section 104(a)(2). For all of these and others, attorneys' fees and costs are deductible only as itemized deductions that are reduced under the regular tax (under both sections 67 and 68) and completely disallowed under the alternative minimum tax. As Judge Beghe's dissent in *Kenseth v. Commissioner*, 114 T.C. No. 26 (May 24, 2000), demonstrated, if a contingent fee exceeds 50% of the recovery, the effective overall tax rate on the net recovery actually received exceeds 50% and if the aggregate fees exceed 72-73% of the recovery, the tax can exceed the amount of the net recovery. Everyone seems to agree that under tax policy and theory plaintiffs should not be saddled with this burden. Many have expressed the desire that Congress amend the Code to correct the problem. As Deborah Geier and Maxine Aaronson debate below, the more difficult question is whether courts can act to protect these plaintiffs in the absence of Congressional action.

POINT: ONLY CONGRESS CAN CREATE DEDUCTIONS

*By Deborah A. Geier, Cleveland, OH**

In the series of recent cases involving attorney's fees, plaintiffs have resorted to creative arguments to get their desired result via the backdoor by arguing that the portion of the award paid to the attorneys for their fees and litigation costs is "excludable" by them in the first place.[1] The impetus driving these cases on the part of both plaintiffs and judges is understandable. As described above, plaintiffs have a legitimate beef. But judges cannot alter the Code sections under which certain categories of deductions for individuals have been increasingly and severely "devalued." Judges have, however, long exercised a robust power to create common law in the area of what constitutes "gross income" under the ambiguous catch-all provision in section 61: "gross income from whatever source derived." Since an "exclusion" from income is the economic equivalent of an inclusion coupled with a full deduction, plaintiffs permitted by judges to exclude the portion of the award equal to their attorneys' fees and costs would avoid the onerous deduction restrictions that currently apply to them under the Code but (under tax theory and policy, at least) *should not* apply to them.

The plaintiffs in these cases make three arguments, the first two of which can be raised *only* if the contract under which the attorneys' fees and costs are paid is of a contingent-fee nature, rather than a pay-by-the hour contract or a flat-fee contract, win or lose. First, the plaintiffs argue that they have successfully assigned, under the assignment-of-income doctrine, their property rights to a portion of the recovery equal to their attorneys' fees and costs because they gave up all control over that portion of their recovery under the contingent-fee contract.[2] The notion is that the contingent-fee contract transmutes the nature of their relationship to that of "joint venturers," with each pursuing a return on their portion of the "joint venture." Second, they

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1 *See, e.g.*, Srivastava v. Commissioner, No. 99-60437 (5th Cir., July 21, 2000); Coady v. Commissioner, No. 98-71358 (9th Cir., June 14, 2000); Kenseth v. Commissioner, 114 T.C. No. 26 (May 24, 2000); Estate of Arthur Clarks v. Commissioner, 202 F.3d 854 (6th Cir. 2000); Foster v. U.S., 2000-1 U.S.T.C. (CCH) ¶50,353 (N.D. Al); Baylin v. U.S., 43 F.3d 1451 (Fed. Cir. 1995), Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959).

2 Under the assignment-of-income doctrine, developed in such hoary cases as Lucas v. Earl, 281 U.S. 111 (1930), Poe v. Seaborn, 282 U.S. 101 (1930), Helvering v. Horst, 311 U.S. 112 (1940), Blair v. Commissioner, 300 U.S. 5 (1937), Harrison v. Schaffner, 313 U.S. 579 (1941), Helvering v. Clifford, 309 U.S. 331 (1940), Helvering v. Eubank, 311 U.S. 122 (1940), and others, the Supreme Court developed a common-law doctrine that prevents the shifting of income for tax purposes from one taxpayer to another in many circumstances. Taken together, the cases might be summarized (if somewhat simplified) to mean that an assignor cannot shift the tax burden with respect to income produced by a mechanism over which she retains control. Because services income is created by one's body, it is just about impossible to shift services income to another, since one cannot effectively give up control over one's own body; the assignor can turn the income spigot on and off at will by performing services or not. Thus, services income is essentially always taxed to the person who provided the services that earned the income, whether the services income attempted to be assigned is already earned or to be earned in the future (Lucas v. Earl, Helvering v. Eubanks).

Just as services income is typically taxed to the person who owns the body that created it, income earned with respect to property is generally taxed to the person who owns (for "tax" purposes rather than for state law purposes) the property that created it (Poe v. Seaborn). Unlike one's own body, the property owner can give up control over property producing income. Thus, assignments of income from property can be successful for tax purposes if the assignor gives up sufficient control over the property producing the income to the assignee (Blair, Horst, Harrison v. Schaffner, Clifford). The disputes in this area typically center around the issue of whether sufficient control over the property producing the income was surrendered to the assignee

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argue that the *Old Colony Trust* doctrine does not apply[3] because, under the contingent-fee nature of the contract, the plaintiffs had no obligation to pay the attorneys for their services. Third, they argue that, because state attorney lien statutes can give the attorneys a prior right to the portion of any recovery equal to fees and costs owed to them, the attorneys "own" this portion of the award from the beginning, not the plaintiffs.

I have written about the arguments themselves at greater length elsewhere.[4] My chief interest is not in the rejoinders themselves but in the larger points illustrated by them: that the gross-income doctrine does not fit the problem at hand very well (but is used only because it's the only game available to achieve the desired end result) and, more important, can allow inappropriate "deduction" of nondeductible capital expenditures.

One rejoinder deals with the only argument that would apply equally to contingent-fee contracts and other hourly contracts: the one based on the existence of state attorney lien statutes. What about payments to attorneys in states in which there is no similar attorney lien statute or in which the statute is worded in such a way as to create for the attorneys only a security interest in the recovery? Should taxpayers really be treated differently based on such a tenuous distinction? Most defendants pay contingent-fee awards directly to the trust account of the plaintiff's attorneys, so the attorney lien statute has little real-world effect other than-if this distinction is accepted-make some plaintiffs in the country pay tax on gross awards while others pay tax on only the net awards actually received.

With respect to the arguments applicable only in the cases involving contingent-fee contracts, what about fees paid under the occasional hourly or flat-rate contract? On the theoretical and policy merits described above, it should make no difference how the fee payment is structured; the fees should be fully deductible in any event. It is a distinction without a difference on the ultimate merits.

With respect to contingent-fee contracts themselves, it is not at all clear that they operate to "assign" a portion of assignable "property" income. Nor is it clear that plaintiffs have no obligation to "pay" the attorneys under a contingent-fee contract. It is just as reasonable to argue that the relationship between the parties is that of service recipient to service provider, and that the plaintiffs simply agreed to measure the worth of their attorneys' services by reference to the gross recovery under the lawsuit. The fact that the attorneys "control" how the suit is prosecuted is neither here nor there; they are independent contractors to their clients, and *all* independent contractors retain control over the means by which they attain the end result for which they have been hired. That is the very nature of an "independent contractor." Moreover, no actual tax partnership is, in fact, created here, which would (if one *were* deemed created with every contingent-free contract) raise a host of other issues (such as attorneys claiming a distributive share of excludable section 104(a)(2) damages). That a relationship might be "conceptualized" as a partnership does not mean that it should be so treated for tax purposes, and it particularly does not mean that it should be so treated for one purpose only but not for any other tax purposes. The relationship between the attorneys and the plaintiffs is respected as one of service provider to service recipient for literally every other tax characterization of the relationship, and a "for-this-purpose-only" departure from that model is a baldly manipulative one engineered to reach a specific result on one tax issue of the plaintiffs, which is the type of "selective" legal argumentation that breeds cynicism in the law.

Moreover, the fact that the assignment-of-income cases arose in the family context, and that only the donor or donee—but not both—were taxed under those cases, does not mean that attempted "assignments" of income should be respected outside those contexts. Sometimes *both* should be taxed, and taxation of the assignor should not be allowed to be evaded through distinguishing away the assignment-of-income doctrine. This point can be most clearly illustrated with *Baylin v. United States*,[5] which is a great case to demonstrate that it might not be a such a good idea to jump on the bandwagon and allow all litigants to exclude the portion of an award equal to the amount paid to the attorneys under any of these theories.

The *Baylin* litigation was brought by a partnership challenging what it considered to be a low valuation of property seized by the state of Maryland under its condemnation power. When the partnership hired an attorney to appeal the amount of the condemnation award, it entered into a contingent-fee contract under which the attorney would receive a percentage of any increase obtained over the previous valuation. The parties eventually settled at a valuation of more than $16 million, which was significantly higher than the original valuation of the property by the state of Maryland of nearly $4 million.

The fee, if not excludable by the partnership, would not be considered a deductible "expense" but rather a nondeductible capital expenditure pertaining to the condemned property, reducing the amount of capital gain realized by the partnership on the property transfer. The partners

3 In Old Colony Trust v. Commissioner, 279 U.S. 716 (1929), an employee's employment contract required his employer to pay the employee's federal income tax liability directly to the IRS. The Supreme Court held that the employee was deemed to have received the amount of taxes paid on his behalf (includable) and then paid them himself (nondeductible), even though under his employment contract he had no right to demand payment of those amounts directly to himself.

4 *See* Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531 (2000).

5 43 F.3d 1451 (Fed. Cir. 1995)

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would be better off, taxwise, if they could exclude the portion of the award paid as attorneys' fees, since that would be equivalent to garnering an ordinary deduction. The Federal Circuit rejected an exclusion, however, concluding both that the assignment-of-income doctrine prevents it and that the presence of an attorney lien statute does not change the result. Its language also evoked the *Old Colony Trust* paradigm, though it did not cite the case.

It seems to me that the facts of this case demonstrate why this issue really is properly a "deduction" issue, and relief for the appropriate cases should therefore by legislated on the "deduction" side of the ledger. Though we might sympathize with the plight of the litigants unfairly denied full deduction of what properly is characterized as an "expense" in other litigation-and thus we might be tempted to rule in their favor under any one, or a combination of, the arguments posited for "exclusion"-this case demonstrates how trying to resolve the problem favorably for the sympathetic class in this manner can wreak havoc in a case such as *Baylin*, where the taxpayer would effectively be allowed to deduct a nondeductible capital expenditure. Collapsing the "income" and "deduction" into a single-step "exclusion" can lead to results that would be wrong if we gave each step tax significance. If, for example, a civil rights litigant succeeds in excluding the portion of the attorneys' fees paid to his attorneys under the arguments discussed here, I can see no grounds on which to differentiate the plaintiff in *Baylin*, who *should* be denied deduction of the attorney's fees (in favor of capitalization) and should not be able to avoid that result through the back door.

One would be hard pressed to make a distinction under the assignment-of-income doctrine itself between attorneys' fees that constitute expenses (successfully assigned) and attorneys' fees that constitute capital expenditures (unsuccessfully assigned). The doctrine turns on the income right itself, which would not seem to be different in the two scenarios. I do not think that one could reasonably say that the reason why Baylin should lose even though an employee suing for back wages or a civil rights plaintiff should win is that Mr. Baylin was trying to avoid taxation on attorney fees that would not be deductible under the Code if paid directly. The bald fact is that the same is true of these other plaintiffs. The only difference between the two is that these other plaintiffs *should* be able to deduct their fees under income tax theory (because they were "expenses" directly connected to includable income), even though they

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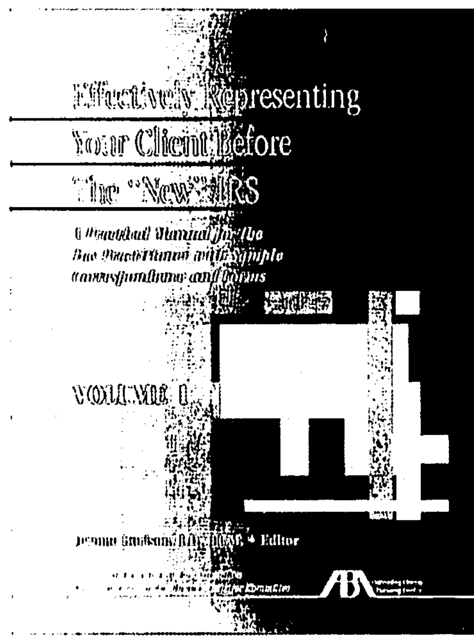

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are not under the current alternative minimum tax, while Mr. Baylin *should not* under income tax theory (because they were "capital expenditures" that had to be capitalized into the cost basis of the asset in litigation). Curing the problem on the deduction side of the ledger would ensure that only those attorneys' fees that are properly deductible (because they are "expenses" rather than "capital expenditures") would escape taxation.

Moreover, these doctrines are not particularly well suited to the problem at hand; the cases have been shoehorned into them *only* because there is no other plausible arguments that would relieve these plaintiffs of the deduction restrictions that would otherwise apply. The doctrines provide many dark corners in which to make distinctions that might, on first reading, sound superficially plausible under a strict construction of the doctrine itself (such as the distinction between services income and property income under the assignment-of-income doctrine and the difference between contingent-fee and pay-by-the-hour contracts) but which make no sense in the larger context of the problem at hand. The results should not be affected by whether the recovery consists of compensation income or recovery on a "claim" that is tantamount to a property right; by whether the attorneys are paid on a contingency basis, by the hour, or under a flat fee; by whether the attorneys' fees are paid for trial work or appellate work;[6] and, finally, by the happenstance of the language in any state attorney lien statute that exists in the plaintiff's jurisdiction. Yet, under the three-pronged analysis in these cases, these immaterial differences have affected outcomes.

Congress, not the courts, should act now to fix the problem—and do so retroactively for all open tax years.

COUNTERPOINT: **LET'S NOT FORGET THE FOREST** WHILE EXAMINING THE TREES

*by Maxine Aaronson, Dallas, TX**

First, it is important to point up areas of agreement with Professor Geier. Virtually no one (except perhaps 535 elected officials in Congress) actually believes that it is appropriate or good tax policy to fail to allow some sort of credit for attorneys fees against the AMT. A close reading of the *Kenseth* opinion and dissent leads me to believe that the Tax Court was split, not on whether attorneys fees should be somehow removed from the gross income calculation, but on whether or not they had the power to do anything about it. My favorite illustrative case is *Faraghar v. City of Boca Raton*, 524 U.S. 775 (1998). Fortunately for her, Ms. Faraghar lives in the Eleventh Circuit, which has followed the *Cotnam* rule. Assume though, that she lived elsewhere: what would her tax consequences be in, say, the Ninth Circuit? *Faraghar* was a sexual harassment case clarifying that employers can be vicariously liable for the actions of their employees. She was awarded one dollar in actual damages and recovered her attorneys fees, which reportedly ran some $325,000. Does anyone really think that Ms. Faraghar should be privileged to pay more than $80,000 in taxes out of her own pocket for having the courage to pursue what was clearly unpleasant, but important, litigation?

The alternative minimum tax was originally passed to deal with a small number of very wealthy individuals who were paying little or no tax. Disallowing any offset or allowance for attorneys fees simply does not hit the "target market" of the AMT. Instead, it penalizes middle class taxpayers who collect taxable damages for once-in-a-lifetime events as recompense for an occurrence that most taxpayers would just as soon not repeat, regardless of the net economic gain. If the purpose of the AMT is to influence the behavior of taxpayers who use certain deductions on a recurring basis, then the position of the Service penalizes the innocent while missing the real target. About this, most tax professionals agree. The debate is about what to do about it, and who can do it. Professor Geier believes that the solution must come from Congress, and nowhere else, because she views the issue as a deduction issue. Clearly, her solution is one way to solve the problem. But is it the only way? *Cotnam and Estate of Clarks* take the view that the attorneys fee portion is never the income of the litigant to begin with. Therefore, it is not includable under section 61 and a corresponding offsetting deduction is not necessary. The fact that this theory neatly sidesteps the mismatch of income and expense under the AMT is not a reason to discard it, if it is otherwise justifiable.

Stepping back from the specific problem and analyzing the "economic deal" between the parties is often useful in tax matters, where substance triumphs over form. What then is the economic deal between lawyer and client in a traditional contingent fee arrangement? At its most basic, a traditional contingency fee arrangement is a transfer of an economic interest in the end product in exchange for services necessary to produce the end result. On what theory should one party have to report as gross income 100% of the product, and the second party report a portion as well? Section 61 defines income broadly, but not so broadly as to include picking up the income of another.

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6 *See* Foster v. U.S., 2000-1 U.S.T.C. (CCH) ¶ 50,353 (N.D. Ala.) (contingent fees for trial-level work successfully assigned because right to the income was not sufficiently ripened but contingent fees for appellate-level work after a jury held in favor of plaintiff not successfully assigned since claim was then too ripe to assign).

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