Point & Counterpoint - Plaintiff's Attorney Fees and Costs

Deborah A. Geier
Cleveland-Marshall College of Law, Cleveland State University, d.geier@csuohio.edu

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By Deborah A. Geier and Maxine Aaronson

series of recent and controversial cases has raised the issue of how plaintiffs must treat attorney fees and costs that are paid out of otherwise includable settlement or litigation awards.

Point: Only Congress can create deductions. In these cases, plaintiffs contended that the portion of the award paid to the attorneys is "excludable" by them in the first place. The plaintiffs made three arguments, the first two of which can be raised only if the contract with the attorney is of a contingent-fee nature. First, plaintiffs argue that they have assigned their property rights to a portion of the recovery equal to their attorney fees and costs because they gave up control over that portion of their recovery under the contingent fee contract. Second, they argue that the Old gross-income doctrine does not fit the problem at hand and 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 existence of state attorney lien statutes. What about payments to attorneys in states in which there is no similar statute or in which the statute creates for the attorneys only a security interest in the recovery? Most defendants pay contingent-fee awards directly to the trust account of the plaintiffs' attorneys, so the statute has little effect other than to make some plaintiffs pay tax on gross awards while others pay tax on only the net awards.

With respect to the arguments applicable only in the cases involving contingent-fee contracts, what about the assignment-of-income doctrine? This point is illustrated in Baylin v. United States, which demonstrates that it might not be a good idea to allow all litigants to exclude the portion of an award equal to the amount paid to the attorneys under any of these theories. In Baylin, a partnership challenged a $4 million valuation of property seized by the state under its condemnation power. The partnership entered into a contingent-

Colony Trust doctrine does not apply because, under the contingent-fee contract, plaintiffs had no obligation to pay the attorneys for their services. Third, they argue that, because 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.

The rejoinders illustrate that the The court concluded that this method of repayment places taxpayer's funds at risk.

Deborah A. Geier is a law professor at Cleveland-Marshall College of Law, Cleveland, Ohio. Maxine Aaronson is a solo practitioner in Dallas, Texas.

fees paid under the occasional hourly or flat-rate contract? It should make no difference how the fee payment is structured; the fees should be fully deductible in any event. With respect to contingent-fee contracts themselves, it is not clear that they operate to "assign" a portion of assignable "property" income, or 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 fee contract under which its attorney would receive a percentage of any increase obtained over the previous valuation. The parties settled at a valuation of more than $16 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. The court rejected an exclusion, concluding that the assignment-of-income doctrine pre-

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Finally, the issue of being able to
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capital expense raised by Professor
Geier should be addressed. Damages for destruction of capital
assets are capital in nature. Under
the origin of the claim theory, a
deemed sale or exchange occurs and
the capitalized expense is taken into
account at the time of payment.
Capitalize expenses are, in effect,
neted out at the time of disposition
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litigation in Buylin was a condemnation
case. Settlement of the matter,
whether at the courthouse or before
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plete disposition of the asset, since
the settlement fixed the amount
realized in exchange for the property
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TAXATION

This article is an enlarged and edited version of
the that originally appeared on page 13 of The ABA
Section of Taxation Newsletter, Fall 2000 (101).

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What then is the economic deal
between lawyer and client in a tradi­
tional contingency fee arrangement?
At its most basic, a traditional con­
tingency fee arrangement is a trans­
fer 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
percent of the product, and the sec­
dary party report a portion as well?
Section 61 defines income broadly,
but no so broadly as to include pick­
ing up the income of another.
A typical attorney contingency
fee contract transfers an interest in
property if consideration is present.
The attorney's lien issue is a red herring,
as is the argument that the
attorney cannot proceed without the
client's consent. The rules in this
area exist to avoid the common law
crime of baratry, not to determine
and guide the tax consequences of
the transaction. The reality is no dif­
ferent from that involving the share­
cropper, commercial fisherman,
vending machine owner, or mineral
lease. Neither party can proceed
without something from the other—
and that is the essence of a joint ven­
ture, which may or may not be a
"partnership" for tax purposes.

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