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Point & Counterpoint - Plaintiff's Attorney Fees and Costs

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POINT & COUNTERPOINT PLAINTIFF'S ATTORNEY FEES AND COSTS

By Deborah A. Geier and Maxine Aaronson

A 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

by reference to the gross recovery under the lawsuit.

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 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 by distinguishing away 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-

“ The court concluded that this method of repayment places taxpayer's funds at risk. ”

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

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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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vents it and that the presence of an attorney lien statute does not change the result.

The case demonstrates why this issue is properly a deduction issue, and that relief for the appropriate cases should be legislated on the deduction side of the ledger. 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.

Counterpoint: Let's not forget the forest while examining the trees. Virtually no one actually believes that it is appropriate or good tax policy to fail to allow some sort of credit for attorney fees against the alternative minimum tax (AMT). My favorite illustrative case is *Faragher v. City of Boca Raton*, which was a sexual harassment case

clarifying that employers can be vicariously liable for the actions of their employees. Plaintiff was awarded one dollar in actual damages and recovered her attorney fees, which reportedly ran some \$325,000. Does anyone really think that Ms. Faragher 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 AMT 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 attorney 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 IRS penalizes the innocent while missing the real target. The debate is about what to do about it, and who can do it. Professor Geier believes that the solution must come from Congress 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? Some courts take the view that the attorney fee portion is never the income of the litigant to begin with. Therefore, it is not includable under § 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 contingency 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 percent of the product, and the second party report a portion as well? Section 61 defines income broadly, but no so broadly as to include picking 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 barratry, not to determine and guide the tax consequences of the transaction. The reality is no different from that involving the sharecropper, 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 venture, which may or may not be a "partnership" for tax purposes.

Finally, the issue of being able to somehow deduct a nondeductible 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. Capitalized expenses are, in effect, netted out at the time of disposition of the capital asset. The underlying litigation in *Baylin* was a condemnation case. Settlement of the matter, whether at the courthouse or before trial, effected either a partial or complete disposition of the asset, since the settlement fixed the amount realized in exchange for the property taken.

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