Is the Contingent Legal Fee Tax Controversy Over?*

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I. INTRODUCTION

The Supreme Court of the United States recently ruled 8 to 0¹ that where a litigant’s recovery constitutes income under I.R.C. § 61(a), such income includes the total amount of any recovery including any contingent legal fees.² The Court’s ruling³ came in the consolidated cases of Commissioner v. Banks,⁴ on writ of certiorari to the Sixth Circuit, and Commissioner v. Banaitis,⁵ on writ of certiorari to the Ninth Circuit. The government appealed the circuit court decisions in both these cases. These cases were representative of the view held by a minority of the circuits that allowed successful litigants to exclude from gross income for income tax purposes the amount of any contingent legal fees paid to counsel.⁶ The Supreme Court reversed the circuit courts and remanded the cases for further proceedings consistent with their decision.

This essay discusses the recent Supreme Court decisions, the relevant statutory change from the American Jobs Creation Act of 2004,⁷ and provides a summary analysis of the current state of the law on this issue.

II. THE SUPREME COURT’S DECISION

In both Banaitis and Banks, the Supreme Court held that the proper characterization of the attorney-client relationship, including contingency fee arrangements, is that of an agency relationship. The Court applied the anticipatory assignment doctrine,⁸ prohibiting the assignment of income away from one

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² For a discussion of this issue and the state of the law before the recent statutory changes and the Supreme Court decision, see Richard Mason, Will the Ninth Circuit be Reversed in Banaitis v. Commissioner?, 5 Nev. L.J. 284 (2004).
³ Banaitis, 125 S.Ct. 826.
⁴ 345 F.3d 373 (6th Cir. 2003).
⁵ 340 F.3d 1074 (9th Cir. 2003).
⁶ Settlements or awards that relate to personal injury or sickness are excluded from income for tax purposes under I.R.C. § 104(a)(2). It is only with respect to taxable litigation proceeds that the issue of contingent legal fees arose.
⁸ The anticipatory assignment doctrine comes from a series of Supreme Court cases beginning with Lucas v. Earl, 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940).
taxpayer to another where the first taxpayer controls the underlying property from which the income is derived. The Court asserted that the motive behind the taxpayer assignment is irrelevant.  

Applying this anticipatory assignment doctrine to the attorney-client agency relationship, the Court held that the principal, i.e., the litigant, must recognize income to the full extent realized. This application of the anticipatory assignment doctrine was not surprising. The Court, in agreeing with the Appellant, followed the rationale of the majority of the circuits, and in particular the reasoning of the Second Circuit in Raymond v. United States.  

Banaitis arose out of a wrongful termination action brought under state law, while Banks emerged from a federal employment discrimination suit. In Banks, the court addressed an additional issue raised by the respondent. As the cause of action in Banks arose under federal statutes which allow fee awards to prevailing litigant's attorneys, Banks asserted that not permitting exclusion of the attorney's contingency from gross income would undermine the very purpose of the fee-shifting statutes. These statutes are designed in part to encourage claimants to act as private attorneys general and the potentially onerous results of the IRS position would discourage such action.  

Respondent asserted that, in some circumstances, including the fee in the litigant's income could result in a litigant prevailing in their suit, but losing money. The Court did not reach a conclusion on these arguments but relied upon the fact that in Banks the case was settled and the contingent legal fee paid by the Banks to his attorneys was paid solely under the private contingency fee arrangement. The Court indicated that, as there was no court-ordered fee-shifting and that neither the private contingency arrangement nor the settlement agreement provided that the fees were in lieu of any court-ordered fees, there was no need to address the fee-shifting argument.  

Three arguments advanced by the respondents or in amici briefs were not addressed by the Court, with the court noting:

These arguments, it appears, are being presented for the first time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories.

This doctrine has been called by the Court "the first principle of income taxation." Comm'r v. Culbertson, 337 U.S. 733, 739-40 (1949).

9 Lucas, 281 U.S. at 115.
10 Banks, 125 S. Ct. at 829.
11 355 F.3d 107 (2d Cir. 2004).
13 Banks, 125 S. Ct. at 834.
14 Id.
15 Id.
16 Id.
17 Id.
18 Id.
19 Id. at 833.
The arguments to which the Court referred were: (1) that the contingency fee arrangement created a partnership under Subchapter K I.R.C. §§ 702, 704, and 761 for tax purposes, (2) that litigation recoveries represented dispositions of property and that the legal fees were properly treated as capital expenses under §§ 1001, 1012, and 1016, and (3) that the legal fees represent deductible employee business expenses under I.R.C. § 62(a)(2)(A). Each of these alternative arguments ultimately leads to the exclusion by the litigant of contingent legal fees from the computation of gross income. It is not clear how the appellate courts would have responded to these arguments if they had been raised at the trial level.

The first of these arguments asserts that the attorney and client establish a partnership for tax purposes when they enter into a contingent fee arrangement. The attorney agrees to contribute his expertise, while the claimant contributes his claim, or property, to the partnership that has as its purpose the realization of value from the claim. Although the Court stated it did not consider this argument, the Court’s determination that the attorney-client relationship is a principal/agent relationship appears to implicitly address or subsume this argument. Logically, a claimant must be either a principal or a partner with respect to his counsel, but not both. If presented with the partnership argument, the Court likely would have rejected the partnership interpretation in favor of the agency view adopted, because traditionally the attorney-client relationship has been viewed as an agency relationship. Adding weight to this argument, the Sixth Circuit in Banks based its decision largely on a partnership or joint venture theory it had initially articulated in Estate of Clarks v. United States. Accordingly, if the partnership argument is raised in future cases it would appear to have, at best, only a modest chance of success.

The second argument advanced is that the contingent legal fees are capital expenses under the I.R.C. and should be recovered off-the-top in any disposition of a claim. This argument incorporates the Supreme Court’s view that the attorney-client relationship is an agency relationship. Essentially, this argument treats the claimant as one disposing of capital property akin to a real estate seller. The underlying claim would be the capital property subject to the disposition. The commissions paid to a real estate agent are recovered off-the-top in determining whether there is a gain or loss on the disposition of the property. The contingent legal fees for a claimant that is disposing of their claim should then be recovered off-the-top in the same manner as the commissions paid to a real estate agent, i.e., before the computation of gain or loss. This argument has not been addressed yet in the courts. This argument has some merit, but also poses some problems in wide applicability. For instance,
some claims may not survive the claimant and those claims are difficult to characterize as a property right.\textsuperscript{25}

The third argument would treat the contingent legal fees as reimbursed employee business expenses resulting in the off-the-top deduction to the claimant. This theory would likely apply only to claims made in the context of an employment relationship. However, there is a question about whether the employment relationship exists once an employee is either terminated or voluntarily leaves employment. For new awards or settlements, the broad wording of the new statutory changes would cover these claims. But for existing claims that pre-date the new statute, the question of whether the employment relationship exists after termination of voluntary or involuntary employment is unclear.

\section*{III. The new statutory regime – I.R.C. § 62(a)(19)[20]\textsuperscript{26}}

The American Jobs Creation Act of 2004 added an off-the-top deduction for attorney’s fees and related litigation costs for a broad array of discrimination and employment-related claims. The amount of the recovery limits the deduction. This new provision means that successful litigants' income can include only the net proceeds, if any, of a settlement or award for the covered types of claims. The new provisions are effective for all covered claims settled or awarded after October 22, 2004.\textsuperscript{27}

The new provisions are:

\begin{itemize}
  \item 62(a)(19)(20) COSTS INVOLVING DISCRIMINATION SUITS, ETC. — Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer’s gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.
  \item 62(e) UNLAWFUL DISCRIMINATION DEFINED. — For purposes of subsection (a)(19)[20], the term “unlawful discrimination” means an act that is unlawful under any of the following:
    \begin{itemize}
      \item 62(e)(2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).
    \end{itemize}
\end{itemize}


\textsuperscript{26} The legislation denominated the new I.R.C. deduction as § 62(a)(19), but as there already was a § 62(a)(19) CCH has denominated this new provision as I.R.C. § 62(a)(19)[20] under the expectation that this will actually become subsection twenty. In this essay, the CCH denomination of this new sub-section has been followed.

\textsuperscript{27} H.R. CONF. REP. NO. 108-755 (2004), reprinted in 2005 U.S.C.C.A.N. 1341. It was noted that this was a Senate provision and that in the Senate version it would be effective for fees and cost paid after December 31, 2002. The compromise was to enact the legislation with a later effective date.
62(e)(8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).
62(e)(10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
62(e)(12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).
62(e)(15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
62(e)(16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
62(e)(17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.
62(e)(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law —
62(e)(18)(i) providing for the enforcement of civil rights, or
62(e)(18)(ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.28

In writing the statute, a clear effort has been made to list all possible federal anti-discrimination provisions. Besides applying federal discrimination statutes, I.R.C. § 62(e)(18) applies to civil rights and employment-relationship claims raised under state, local, or common law. The employment-relationship section of the new law is very broad and covers many types of, if not all, legal claims by employees against employers. According to the text of the statute, the new off-the-top deduction for legal fees applies to any federal discrimination claim, as well as any employment-related litigation, however founded.

28 I.R.C. § 62(a)(19)[20].
IV. CASES SUBSEQUENT TO THE SUPREME COURT DECISION

The Tax Court has decided three contingent legal fee cases since the Supreme Court’s decision in *Banks*. In these cases, the Tax Court included the total amount of the settlement or award, with legal fees, in income. In *Williams v. Commissioner*, a case arising out of employment discrimination and tort claims and that had been settled, the Tax Court granted summary judgment to the Internal Revenue Service (IRS), relying on *Banks*. Chief Judge Gerber did note that the petitioners did not raise any of the arguments not considered by the Supreme Court. Petitioners argued only that they neither earned nor had sufficient control of the portion of the settlement representing contingent legal fees to require the inclusion of the legal fees in their income. An argument that is clearly erroneous under *Banks*.

In *Valia v. Commissioner*, petitioner accepted a settlement from a former employer and signed a release for all claims, including discrimination claims. The litigant unsuccessfully tried to claim that a portion of the settlement related to personal injuries, but the evidence did not support this claim. Relying on *Banks*, the Tax Court held that the portion of the settlement paid as contingent legal fees was includable in income. Again, the petitioner raised none of the arguments that left unanswered by the Supreme Court in *Banks*.

In the third case, *Vincent v. Commissioner*, the Tax Court also held that the portion of the settlement that represented legal fees was includable in gross income. However, in this case the Tax Court addressed the fee-shifting argument that the Supreme Court in *Banks* did not reach. In *Vincent*, the agreement between Vincent and her attorney stated that the attorney “would be entitled to a defined percentage of any recovery, unless, as occurred, the attorney received his fees and costs pursuant to a fee-shifting statute.” The Tax Court relied on *Sinyard v. Commissioner*, a case in which the Ninth Circuit found that, despite the payment of legal fees under a fee-shifting statute, the claimant was in constructive receipt of the legal fees. Accordingly, the claimant was required to include an amount in gross income equal to the fees the defendant paid directly to the attorneys.

V. THE CURRENT STATE OF THE LAW ON THE CONTINGENT LEGAL FEE ISSUE

Four basic categories exist into which litigation proceeds and contingent legal fees can be placed:

1. Claims for which proceeds are excluded from income under I.R.C. § 104(a)(2).
3. Other claims where only net proceeds of the litigation are reportable as income.

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30 Id.
32 T.C.M. 2005-17 (Feb. 1, 2005).
33 Id.
34 T.C.M. 2005-95 (May 3, 2005).
35 Id.
36 268 F. 3d 756 (9th Cir. 2001).
4. Claims which are fully includable in income and not subject to the off-the-top deductions under I.R.C. § 62(a)(19)[20].

A. Personal Injury Exclusion Under I.R.C. § 104(a)(2)

Proceeds resulting from claims for personal injury or sickness are totally excluded under I.R.C. § 104(a)(2). Although a discussion of the claims for which awards are excluded from income under this provision is beyond the scope of this essay—essentially, only awards arising out of claims relating to physical injury and sickness are covered. The contingent legal fees paid for recovery of claims which fall fully under this exclusion are not in issue, because the exclusion of any income received renders the contingent legal fee question irrelevant. However, punitive damage awards are not excluded under I.R.C. § 104(a)(2), and when there is an allocation of legal fees paid for the punitive component of any award or settlement, the fees allocable to the includable amounts would place that portion of the fees into category 4 described above.

To make things worse, taxpayers are unable to get an advance ruling from the IRS on the issues of excludability or allocation of damage awards. Uncertainty regarding treatment of particular claims and the advantage afforded by exclusion has led many taxpayers to attempt to exclude damage awards and settlements under I.R.C. § 104(a)(2) and has resulted in much litigation over the propriety of these attempted exclusions. The new off-the-top deduction afforded by I.R.C. § 62(a)(19)[20] may reduce some of the litigation, but so long as the advantage to taxpayers of exclusion remains, and the IRS will not give advance determinations, it is likely there will continue to be some volume of litigation in this area.

B. Claims covered by I.R.C. § 62(a)(19)[20]

I.R.C. § 62(a)(19)[20] covers many categories of claims. I.R.C. § 62(e) defines “discrimination,” but in a way that appears to be far broader than one would expect to apply in discrimination claims. Specifically, any legal claim under federal, state, common, or local law that relates to employment may be covered, as per I.R.C. § 62(e)(18)(ii), for: “regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits . . . any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.” On its face, the statute appears to cover almost any litigation between employer and employee. In dicta, the Supreme Court interpreted this statute as covering the wrongful termination claim in Banaitis. It is easy to envision litigation to determine which claims fall under I.R.C. § 62(a)(19)[20] for the off-the-top deduction of legal fees just as there has been litigation to determine which claims fall under

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38 For a discussion of those awards that are excludable, see Brent B. Nicholson, Recent Developments Concerning the Taxation of Damages Under Section 104(a)(2) of the Internal Revenue Code, 61 ALB. L. REV. 215 (1997).
40 Banks, 125 S.Ct. at 831.
I.R.C. § 104(a)(2). However, if a claim is covered under I.R.C. § 62(a)(19) [20], the proceeds of the litigation minus the legal fees and costs, but not less than zero, are includable in income. Although Congress' discussion of present law concentrated on the contingent legal fee issue, all legal fees are now deductible if the claim is covered under I.R.C. § 62(a)(19)[20]. Hence, any distinction between contingent legal fees and other legal fees is now moot.

C. Other Claims Where Only the Net Proceeds of the Litigation are Reportable as Income.

Additional claims fall outside of I.R.C. § 62(a)(19)[20] and I.R.C. § 104(a)(2) but remain under either fee-shifting statutes where the court awards legal fees directly to counsel or under "qualified settlement funds" covered by C.F.R. § 1.468B-141 and the taxability of distributions under Reg. § 1.468B-4.42 Consider a claim in the securities class-action area with a large number of plaintiffs. The damages in such a case would not be excludable under I.R.C. § 104(a)(2) nor would they be discrimination or employment-related under I.R.C. § 62(a)(19)[20]. Accordingly, the damages would be includable in income. However, the majority of securities class-action cases result in the establishment of a "qualified settlement fund." Legal fees are paid directly from the settlement fund to the attorneys and only the net amount distributed to claimants is taxed under C.F.R. § 1.468B-4. Thus, for a claim in this category the contingent legal fees are effectively deducted off-the-top by operation of the relevant treasury regulations.

D. Claims Not Covered in Other Categories

Any claims not falling into the three previous categories must fall into the remaining category where the proceeds of the claim are includable in income and the legal fees are either not allowed an off-the-top deduction as employment or discrimination-related or effectively deducted by operation of regulation. This category includes many traditional non-personal injury tort claims, such as slander or libel, as well as all other non-discrimination, non-employment-related, and non-personal injury claims. For claims in this category the ruling in Banks applies, requiring the inclusion of the total amount of proceeds in income and deducting the legal fees as a miscellaneous itemized deduction under I.R.C. § 212 as an expense incurred for the production of income. Such deductions are subject to the two-percent of adjusted gross income floor and are disallowed for alternative minimum tax purposes effectively negating the value of the deductions for many taxpayers.43

42 26 C.F.R. § 1.468B-4 (2004). Taxability of distributions to claimants. — Whether a distribution to a claimant is includible in the claimant's gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor. For example, to the extent a distribution is in satisfaction of damages on account of personal injury or sickness, the distribution may be excludable from gross income under section 104(a)(2). Similarly, to the extent a distribution is in satisfaction of a claim for foregone taxable interest, the distribution is includible in the claimant's gross income under section 61(a)(4).
43 See, e.g., Mason, supra note 2, at 286-89.
VI. Conclusion

Congress took a big step in resolving the contingent legal fee tax conundrum with the enactment of I.R.C. § 62(a)(19)[20], but did not fully resolve the issue. There remains yet some uncertainty as to exactly which claims are covered under I.R.C. §62(a)(19)[20] and which claims are left out of the categories that either exclude the income or provide for either a stated or de facto off-the-top deduction for contingent legal fees.

Despite Banks, there is still uncertainty remaining as to how the courts will react to the three aforementioned arguments which the Supreme Court declined to address. These three arguments: that the contingency fee arrangement created a partnership for tax purposes, that litigation recoveries represented dispositions of property for which legal fees were properly treated as capital expenses, and that the legal fees represent deductible employee business expenses under I.R.C. § 62(a)(2)(A) have yet to be directly addressed at the trial court, or any other, level. The merits of these arguments are briefly discussed above, but with the exception of the implicit rejection of the partnership argument in Banks, these arguments have not been truly tested.

There are probably some cases for which the third alternative argument is applicable which have not yet come to light. There are also likely many cases that fall in the fourth category still to come to the courts on this issue that will advance the first two of the alternative arguments. Given the Supreme Court’s message with regard to these alternative arguments they probably will be raised by counsel at the appropriate level where there is even a chance of applicability. Due diligence would seem to require counsel to do so. Although these arguments were not seen in the two Tax Court cases since Banks, it would seem to be only a matter of time until they appear.

Having inconsistent tax consequences regarding attorney’s contingency fees produces a landscape which fails to provide horizontal equity for taxpayers and can only result in additional litigation over the contingent legal fee issue. The Supreme Court heard Banks in order to resolve a division in the circuit courts. There may again develop a circuit split once the alternative arguments reach the several appellate courts. Of course, Congress may choose to resolve this issue by statute. Since Congress was willing to address this issue for discrimination and employment-related claims, it is not hard to envision additional legislation providing for a broader base of claims to receive the off-the-top deduction. This would be preferable to continued litigation. To answer the question posed in the title of this piece, until such time as the tax consequences to all legal claimants are the same, the controversy will likely continue.