Tax Accounting

By James E. Salles

Taxpayers normally report income when they receive (or "constructively receive") cash or other valuable property. Sometimes, the receipt can be indirect, as when someone pays off a liability that the taxpayer owes a third party. A heavily litigated issue in recent years has been when judgment or settlement proceeds paid to a lawyer represent income to the client. The basic principle is that the client will have income if the lawyer's right to payment is derivative rather than direct and the payment represents an amount for which the client would otherwise be obligated. However, the courts have exhibited much confusion both about the nature of attorneys' rights under different states' law and the effect of the well-established doctrine that prohibits recognizing "assignments of income" for federal tax purposes. The Supreme Court may shortly resolve some of the issues on which the circuit courts have split.

The ongoing controversy, and the very unfavorable treatment accorded individual nonbusiness taxpayers if they have to deduct large legal fees, has also prompted Congress to act. The American Jobs Creation Act of 2004 ("2004 Jobs Act") includes a provision that gives individuals an "above-the-line" deduction for attorneys' fees and court costs in most civil rights and employment cases.[1] An "above the line" deduction reduces adjusted gross income (AGI) rather than being subtracted from AGI to arrive at taxable income, and normally produces much the same result as excluding the same amount from income. The new provision and its limitations are likely to be of keen interest to trial lawyers and employers alike.

James E. Salles is a member of Caplin & Drysdale in Washington, D.C.

Background

Recoveries and settlement proceeds are generally taxable, with certain exceptions, such as for amounts "paid on account of" personal physical injury and physical sickness.[2] The amount potentially taxable to claimants generally includes their attorneys' fees, because taxpayers have income when expenses are paid on their behalf. Attorneys' fees are generally considered not to create income to members of an "opt-out" class or union members who would not be personally liable.[3] Traditionally, however, other successful claimants have recognized the full recovery as income and deducted the fees.[4]

The income-plus-deduction treatment creates a big problem for some individual taxpayers under current law. Unless the legal costs relate to a business (other than being an employee), the corresponding deductions are allowed only "below the line" as a "miscellaneous itemized deduction" from AGI. This classification has several important consequences:

- The deduction is only allowable to the extent that it, together with certain other deductions, exceeds a "floor" of two percent of AGI.
- For regular tax purposes, up to 80 percent of the deduction is potentially "phased out" in the higher income ranges.
- Finally, the deduction is not allowed at all under the alternative minimum tax (AMT).[5]

These rules can work together to produce an ef-

fective tax rate above 80 percent. In extreme cases, a successful plaintiff may lose by "winning." The problems began when the AMT deduction rules were tightened in 1982,[6] and grew worse with enactment of the two-percent "floor" in 1986[7] and then the deduction phaseout in 1990.[8] More individuals also have taxable recoveries now that the "personal injury" exclusion is limited to *compensatory* damages relating to *physical* injuries and sickness. Even in physical injury cases, proceeds that represent interest are taxable.[9]

The future outlook is clouded. The two-percent "floor" is likely to stay, but by itself has relatively modest impact. The provision that phases out deductions for regular tax purposes is slated for gradual elimination starting in 2006,[10] and if the tax cuts enacted in 2001 are made permanent, should disappear after 2009.[11] The biggest problem for most taxpayers, however, is the AMT, for which no comprehensive solution is yet in sight. While the AMT may be revamped or eliminated in the forthcoming spasm of tax reform, it is too early to tell what may happen.

Litigation

In the meantime, some taxpayers have been arguing that a contingency fee makes the lawyer a co-owner of the cause of action. This characterization, if accepted, would mean that claimants would not have to report their lawyers' share as income in the first place, making the treatment of their deduction beside the point.

The IRS objects that this "co-ownership model" violates the well-established "assignment of income" doctrine. That doctrine denies tax effect to taxpayers' attempts to alienate future income from their personal efforts or from property that they continue to own. The Supreme Court has compared such agreements to selling future fruit while keeping the tree, and held that the income should be taxed to the person whose efforts or property produced it.[12]

Somewhat simplified, the IRS reasons that the client is the tax owner of the whole cause of action because (s)he retains sole control over the case, while a "true" part owner would have to account to co-owners or partners. If that is true, the contingency agreement just grants the lawyer an interest in future "fruit" from that "tree" and should be disregarded.

The government has been successful with this argument more often than not. The Sixth Circuit has respected a contingency agreement as assigning part of the cause of action.[13] The Fifth and Ninth Circuits have held Texas, Alabama and Oregon law grant lawyers sufficient rights to create an independent property interest[14] (although the Ninth Circuit has also held that California and Alaska law do not[15]). However, other circuits and the Tax Court, with varying nuances and degrees of attention to state law, have held that the prohibition on assigning income trumps the "co-ownership model."[16] The Supreme Court recently heard appeals from two taxpayer victories,[17] and will likely shed light on whether the "co-ownership model" ever works and how much state law matters.

The 2004 Jobs Act

Congress did not address the basic problem, which is that limitations designed for "cat and dog" deductions are unfair as applied to large outlays relating to one-time income items. New Code Sec. 62(a)(20) instead grants a limited above-the-line deduction for legal fees and court costs that applies in cases involving certain federal employee claims, claims under the Medicare Secondary Payer statute, and claims for "unlawful discrimination" under assorted civil rights and "whistleblower" laws, or any law "providing for the enforcement of civil rights or regulating any

aspect of the employment relationship." The new law generally applies to judgments and settlements after the date of enactment.[18]

The new provision was drafted to meet the immediate concerns of the civil rights lawyers and employers who teamed up to press for action, and certainly does not represent simplification. Disputes about which claims are covered, and how to allocate costs between covered and non-covered claims, are likely. The deduction is more generous than the potential "self-help" relief in that it covers fees not computed on a contingency basis and court costs, but the annual limitation is likely to limit relief for any fees and costs paid out of pocket while the case is ongoing and may also complicate structured settlements. Probably the most important limitation on the new law, however, is that it does not cover the general run of tort and contract cases that do not relate to employment or civil rights. The deduction limitations are still going to pose a problem in those cases, except to the extent that the recovery can be excluded from income.

[1] Act Sec. 703(e) of the American Jobs Creation Act of 2004 (P.L. 108-357), *codified at* Code Sec. 62(a)(20) (the statute refers to subparagraph (19), (e)).

[2] Code Sec. 104(a)(2).

[3] *E.g.*, Rev. Rul. 80-364, 1980-2 CB 364; *see also, e.g., J.T. Sinyard*, 76 TCM 654, Dec. 52,910(M), TC Memo. 1998-364, *aff'd*, CA-9, 2001-2 USTC ¶50,645, 268 F3d 756, *cert. denied*, SCt, 536 US 904.

[4] *E.g., J.K. Alexander*, CA-1, 2001-2 USTC ¶50,645, 72 F3d 938; *Sinyard, supra* note 3; *L.E. Fredrikson*, 73 TCM 2287, Dec. 51,933(M), TC Memo. 1997-125, *aff'd in unpublished opinion*, CA-9, 99-1 USTC ¶50,167, 166 F3d 342; *R. Martinez*, 73 TCM 2289, Dec. 51,934(M), TC Memo. 1997-126, *aff'd in unpublished opinion*, CA-9, 99-1 USTC ¶50,168, 166 F3d 343.

[5] Code Secs. 56(b)(1)(A), 67 and 68.

[6] Act Secs. 201 and 204 of the Tax Equity and Fiscal Reform Act of 1982 (P.L. 97-248), *codified at* former Code Secs. 55(a), 57(a)(1), (b).

[7] Act Sec. 132(a) of the Tax Reform Act of 1986 (P.L. 99-514), *codified at* Code Sec. 67.

[8] Act Sec. 11103(a) of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508), *codified at* Code Sec. 68.

[9] *E.g., J.S. Rozpad*, CA-1, 98-1 USTC ¶50,672, 154 F3d 1; *M. Brabson*, CA-10, 96-1 USTC ¶50,038, 73 F3d 1040, *cert. denied*, SCt, 519 US 1039; *R.S. Kovacs*, 100 TC 124, Dec. 48,871 (1993), *aff'd without published opinion*, CA-6, 25 F3d 1048, *cert. denied*, SCt, 513 US 963.

[10] Code Sec. 68(f), added by Act Sec. 103(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-16).

[11] As enacted, Code Sec. 68(f) sunsets after 2010. Act Sec. 901 of EGTRRA (P.L. 107-16).

[12] *P. R.G. Horst*, 40-2 USTC ¶9787, 311 US 112, 61 SCt 144; *G.C. Earl*, SCt, 2 USTC ¶496, 281 US 111, 50 SCt 241 (1930).

[13] *J.W. Banks*, CA-6, 2003-2 USTC ¶50,675, 345 F3d 373, *cert. granted*, SCt, 124 SCt 1712 (2004); *A.L. Clarks Est.*, CA-6, 2000-1 USTC ¶50,158, 202 F3d 854.

[14] *S. Banaitis*, CA-9, 2003-2 USTC ¶50,638, 340 F3d 1074, *cert. granted*, SCt, 124 SCt 1713 (2004); *M. Foster*, CA-11, 2001-1 USTC ¶50,392, 249 F3d 1275; *S. Srivastava*, CA-5, 2000-2 USTC ¶50,597, 220 F3d 353; *W. Davis*, CA-11, 2000-1 USTC ¶50,431, 210 F3d 1346.

[15] *I.F. Benci-Woodward*, CA-9, 2000-2 USTC ¶50,595, 219 F3d 941, *cert. denied*, SCt, 531 US 1112; *F.P. Coady*, CA-9, 2000-1 USTC ¶50,528, 213 F3d 1187.

[16] *D. Raymond*, CA-2, 2004-1 USTC ¶50,124, 355 F3d 107; *E.R. Kenseth*, CA-7, 2001-2 USTC ¶50,570, 259 F3d 881, *aff'g*, 114 TC 399, Dec. 53,895 (2000) (reviewed); *L.F. Young*, CA-4, 2001-1 USTC ¶50,244, 240 F3d 369; *N.J. Hukkanen-Campbell*, CA-10, 2002-1 USTC ¶50,351, 274 F3d 1312, *cert. denied*, SCt, 535 US 1056; *J.L. Baylin*, CA-FC, 95-1 USTC ¶50,023, 43 F3d 1451; *W.F. O'Brien*, 38 TC 707, Dec. 25,625 (1962), *aff'd per curiam*, CA-3, 63-2 USTC ¶9633, 319 F2d 532.

[17] *J.W. Banks* and *S. Banaitis, supra* notes 13 and 14, *respectively*.

[18] American Jobs Creation Act of 2004 (P.L. 108-357).