Contingency Fee Agreements:

Remedying the Enormous Tax Burden of the AMT to Clients.

by Andrew J. Foti, JD Candidate

Many civil injustices exist in the world today and normally citizens attempt to remedy these before a court of law. A plaintiff comes before this body in hopes of being made whole or at least put in a more favorable situation. Recently, however, situations have arisen where a plaintiff's recovery is unfairly diminished as the jury award he receives is subject to unjust taxation.[1] This treatment arises because of the effect of two federal tax provisions. The Alternative Minimum Tax (AMT)[2] and Limitations on Itemized Deductions[3] together cancel out personal itemized deductions and tax the client's gross income at a flat 26-28 percent. The combination of these rules no longer allows attorney's fees to be deductible by the client as miscellaneous itemized deductions. As a result, the client's gross income is largely inflated and the effective income tax rate on that client's jury award can be as high as 60 percent. It is hard to rationalize such a result when considering the 60 percent tax is 25 percentage points more than the highest tax rate and a little over double the standard AMT tax rate. Because of the differing views over the fairness of this taxation, discrepancies now exist among the Appellate Courts over what should constitute a successful plaintiff's taxable income with respect to his jury award.

The Sixth Circuit Court of Appeals recently reaffirmed in *Banks v. Commissioner*[4] that legal fees paid under a contingency fee arrangement should be excluded from a client's gross income. In all, nine appellate courts have considered whether the portion of an award that comprises an attorney's fee should constitute taxable income to the plaintiff. Six circuits require this amount to be part of the client's taxable income. These circuits are condemning a successful plaintiff to pay over half of her award as income tax. Of the remaining amount, the client, who could not otherwise afford an attorney, must relinquish two-thirds to her lawyer via a contingency fee agreement. Only the minority of circuits, comprising of the Fifth, Sixth, and Eleventh, fully understand the tax burden placed on a plaintiff when she is forced to include as income amounts of money which belong to her attorney. Thus, these circuits have taken steps to alleviate the economic loss by ruling that a plaintiff shall not be taxed on such amounts.

The divergent opinions among the Circuits highlight the growing disparate tax treatment. This incongruency can be eradicated if the Supreme Court grants certiorari and rules on the issue, optimally by supporting the *Banks* decision. Alternatively, Congress could enact legislation that would either allow an attorney's fee to be excluded from a client's gross income, or, if the fee is included in gross income, allow it to be treated as a deduction not subject to disallowance or AMT treatment. Regardless of the means, a solution is necessary to stop the unjust taxation that has plagued plaintiffs throughout the country.

Federal Tax Inequity: The AMT Route

Congress originally enacted the AMT to ensure that high-income earners paid sufficient income taxes by placing limits on allowable deductions.[5] Under the AMT, a taxpayer must first calculate his tax liability according to the regular tax system, and then calculate his tax liability under the AMT. In making this second calculation, the taxpayer is precluded from deducting expenditures classified as miscellaneous itemized deductions, state income tax, mortgage interest, standard deductions, and personal exemptions. The effect of such exclusions increases the taxpayer's gross income, resulting in higher taxes.

When determining taxable income, there is a fundamental concern over which items the government determines should be included in gross income. The Internal Revenue Code (Code) defines gross income as "all income from whatever source derived."[6] While the Code does not give specific guidance on the inclusion of damage awards, courts have construed gross income as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[7] Thus, except

> "When contingency fees are taxed as part of a client's gross income . . . the balance that the progressive tax system was supposed to attain is greatly skewed, and inequity arises."

for personal injury, courts have included damage awards, which include an attorney's fees, as part of a client's gross income.

If a plaintiff's damage award is considered part of his gross income, the concern then revolves around whether a successful plaintiff can deduct the contingency-based attorney's fees as an expense. Some plaintiffs can deduct this expense as an ordinary and necessary expense incurred while conducting trade or business.[8] Most people, however, cannot sue in the business capacity and are left with the only option of deducting this expense as a miscellaneous itemized deduction. This regulation has limitations that require the deduction to be reasonable in amount, and bear proximate relation to the production of income.[9] In addition, the expense must exceed 2 percent of the client's gross income in order to qualify as a deduction. An example that fits these requirements is contingency-based attorney's fees that are deemed employee-related expenses, where the fees are considered a miscellaneous itemized deduction, provided the taxpayer is not subject to the AMT. The difficult issue, however, is when the AMT denies such deductions to an individual who exceeds a certain income threshold.

Suppose an individual sues a former employer for wrongful termination in a jurisdiction that includes contingency-based attorney's fees as taxable income, and the award consists of back wages, interest, and punitive damages in the amount of $10 million. In this situation, the client will have $10 million in gross income, and, applying the current AMT rate of 28 percent, the client will pay $2.8 million in taxes. Assuming that the average state tax imposed on this award equals 8 percent, the taxpayer pays an additional $800,000 in state taxes, for a total of $3.6 million in state and federal taxes.[10] Finally, using a typical contingency fee percentage of 40 percent, the plaintiff's lawyer will be entitled to $4 million of the original $10 million award, for a net total of $7.6 million in taxes and attorney's fees.[11] So in reality, the employee will pay an astonishing $3.6 million in taxes out of the $6 million he was entitled to, meaning that the taxpayer pays 60 percent of the net damage award in taxes. Had the attorney's fees been excluded from gross income, the client's taxable income would drop to $6 million, resulting in $1.68 million in taxes. Moreover, the effective tax rate would fall to 36 percent, a difference of 24 percentage points and $1.44 million.[12]

The "injustice" of this inequitable result is more readily visible when the damage award is relatively modest. For a client who recovers a $500,000 award in back wages for the previous five years, the attorney will receive $200,000, and the client's tax liability will be $180,000, or 60 percent of the damage award in federal and state taxes. This leaves the client with only $120,000 of his original award. In this example, excluding the attorney's fees would have reduced the effective tax rate from 60 percent to 36 percent, thereby placing an additional $72,000 into the hands of the person trying to recover his lost wages. This result seems less equitable, considering that had he not been wrongfully discharged, his wages would have been taxed over five years at a more reasonable rate probably not exceeding 30 percent per year.

The current tax system attempts to balance the monetary needs of the federal government without placing too heavy a burden on the individual taxpayer through a progressive tax system, which limits the maximum tax rate to 35 percent. In addition, Congress implemented the AMT, which basically acts as a flat tax of 28 percent on income earned above the $45,000 threshold. When contingency fees are taxed as part of a client's gross income, however, the balance that the progressive tax system was supposed to attain is greatly skewed, and inequity arises. Taxing a damage award up to 60 percent when the highest personal income tax level is 35 percent is unjust. While some courts have provided a judicial remedy by ruling that contingency fees should be excluded from a taxpayer-client's gross income, action by the Supreme Court or Congress is necessary to ensure consistent and financially sound application of the tax law.

Case Law: Excluding Contingency Fees from a Client's Gross Income

RECOGNIZING THAT THE AMT can subject clients to excessive tax burdens, the Fifth, Sixth, and Eleventh Circuit courts interpreted the relevant tax provisions in a manner that avoids inequitable results.[13] In doing so, these courts run counter to the majority of Circuit courts who treat legal fees as part of gross income based on the application of their states' attorney's lien provision and the Anticipatory Assignment of Income Doctrine (AAID).[14]

The Supreme Court developed the AAID to establish that the dominant purpose of revenue laws is to tax the income of those who earn or otherwise create the right to receive that income. In *Lucas v. Earl*,[15] the Supreme Court held that a taxpayer who contracted with his wife to give her half of his earnings could not avoid paying taxes on that income. The Court stated that "the tax could not be escaped by anticipatory arrangements and contracts howev-

er skillfully devised to prevent the salary when paid from vesting even for a second in the taxpayer who earned it."[16] Similarly, in *Helvering v. Horst*,[17] the Court held that a taxpayer could not avoid paying tax on interest earned from bonds by transferring the bond interest coupons to his son before they matured. Thus, in both *Lucas* and *Horst*, the Court found that the taxpayers earned and created the right to receive and enjoy the benefit of the income before any assignment commenced. The assignment was deemed a gift of accrued income to a family member, and so the tax was properly assessed to the assignor. The Court recognized, however, that the gift should not be included in the gross income of the family member who received it.

In light of this jurisprudence, the issue reduces to whether a client owns or controls the amount of money that is paid directly to the attorney as part of a contingency agreement. This determination is essential in deciding whether the client bears the tax burden. In *Banks,* the Sixth Circuit found that the client did not. The taxpayer in *Banks,* a former educational consultant for the California Department of Education, sued the department for employment discrimination, intentional infliction of emotional distress and slander. Mr. Banks settled out of court for $464,000, and his attorney received $150,000 out of that settlement agreement pursuant to his contingency fee contract. Although the contingency fee agreement was created in California, the court chose not to apply California's attorney's lien provision, which conferred no ownership interest in attorneys. Instead, the court applied its own attorney's lien provision that followed the common law lien theory that protected attorneys against the knavery of their clients by disabling clients from receiving the fruits of recoveries without paying for the valuable services by which the recoveries were obtained. In doing so, the court held that the contingency fee never passed through the taxpayer's hands and was, therefore, not controlled by the taxpayer; only through the attorney's services did the taxpayer convert his uncertain claim into an item of value. In addition, the court extended its ruling to exclude contingency fees even where the agreement arose in another state where the attorney's lien did not operate because a "state-by-state" approach would not provide reliable precedent or provide sufficient notice to taxpayers as to the tax treatment of contingency-based attorney's fees paid from their awards.

> "[T]he issue reduces to whether a client owns or controls the amount of money that is paid directly to the attorney as part of a contingency agreement."

The *Banks* court also looked to precedent set by the Fifth Circuit, which was the first circuit to address the tax treatment of contingency fee arrangements. In *Cotnam v. Commissioner*,[18] the Fifth Circuit analyzed Alabama's attorney's lien statute and decided that the AAID did not apply to the contingency fee paid to Ms. Cotnam's legal counsel. Specifically, the Alabama statute provided in relevant form that "attorneys have a lien superior to all liens but tax liens... and attorneys-at-law shall have the same right and power over action or judgment to enforce their liens as their clients had or may have for the amount due thereon to them."[19] Applying this lien statute, the court reasoned that an attorney had an equitable lien in the cause of action and the judgment. In contrast to *Lucas* and *Horst*, the *Cotnam* court also found that the AAID did not apply because Ms. Cotnam had a doubtful claim with no fair market value, and could only realize any benefit from this claim by assigning a portion of it to her attorney. The only economic benefit she received from this assignment was the aid in the collection of her portion of an otherwise worthless claim. In such a transaction, a taxpayer does not earn or create the right to receive or enjoy the benefit of income before assigning it to an attorney. Rather, recovery is contingent on the attorney successfully converting a claim into a judgment. Under Alabama's lien theory, the assignment to Ms. Cotnam's lawyer operated as a lien on a portion of the judgment sought to be recovered, thus transferring ownership of that portion of the judgment to the attorney. In the court's opinion, it was as illegal as it was unjust to tax Ms. Cotnam on an amount that did not pass through her hands and of which she never had control.

The *Banks* court turned to another Fifth Circuit case to aid in its decision not to rely on individual state lien theories regardless of where the fee agreement arose. In *Srivastava v. Commissioner*,[20] the court declined to distinguish *Cotnam* based on differing state attorney's lien laws and found that the distinctions between Texas and Alabama laws should not affect the analysis required by the AAID, which looks to a taxpayer's degree of control and dominion over an asset. The court also reasoned that the discrepancies of laws regarding an attorney's rights did not meaningfully affect the economic reality facing a taxpayer. Thus, the *Banks* court decided not to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated.

Ultimately, the *Banks* court relied on its own precedent in *Estate of Clarks v. United States.*[21] In *Estate of Clarks*, the court adopted the *Cotnam* lien theory doctrine, but only as one rationale for excluding an attorney's fees from gross income. In addition, the court distinguished *Lucas* and *Horst* on three other grounds. First, the attorney's fees were analyzed in terms of a division of property.

The court reasoned that a client, as an assignor, transfers "some trees in his orchard, not merely some fruit from the trees," and so he essentially gives up control and dominion over part of his claim, and it is the skill of his attorney that produces the fruit on his own trees. Put into business terms, the plaintiff's claim is like a joint venture in which he assigns away one-third of his interest in hopes of recovering two-thirds. By contrast, in *Lucas* and *Horst*, no such joint venture existed. The assignees in those cases performed no service in order to receive the income, because the income was already earned and vested. A second distinction made by the *Cotnam* court was that the assignors in those two cases split their income with family members to avoid the donors' higher tax rate under the progressive tax system. In *Estate of Clarks*, the Court found no facts to indicate any tax avoidance motivation because, as opposed to an assignment between family members, an assignment to an attorney is an arm's length transaction. Finally, since an attorney pays taxes on his assigned income, the court properly recognized that double taxation would occur by including the contingency fee in the taxpayer's gross income. In *Lucas* and *Horst*, however, only the assignor was taxed because tax provisions exclude gifts from an assignee's gross income. Based on these analyses, the *Banks* court held that the $150,000 paid in contingency fees to Mr. Bank's attorney could be excluded from his gross income.

Supreme Court: Aligning Circuits under the *Banks* Doctrine

THE SPLIT IN THE CIRCUIT COURT holdings opens the door for the Supreme Court to grant certiorari of the *Banks* case and establish that the *Banks* doctrine be universally applicable to all jurisdictions. This stance follows prior Supreme Court jurisprudence, which has held that people should only be taxed on income that they have made, have the rights to, or have the requisite control over. With respect to money paid by the opposing party directly to a prevailing attorney, the requisite control and tax burden should rest with the attorney and not the client.

Admittedly, this argument contradicts the majority of circuit courts, which found that a petitioner's judgment was a recovery of lost income, and that the attorney's fees he paid represented expenses incurred in generating that income. In addition, these circuits relied on their respective attorney's lien statutes, which did not create a proprietary interest in the award on the attorney's behalf. Under this type of lien theory, a client never relinquishes control or beneficial ownership of the funds paid directly to his attorney. Although the majority agreed with the minority that a client never actually possesses the funds awarded to the attorney, they still held that the amount paid should be included in a client's gross income because a client receives the fund's benefit when it discharges his obligation owed to the attorney.

The theory behind contingency fees is to allow plaintiffs, who otherwise lack the necessary financial resources, to have their day in court. Allowing them their day in court, however, is not a tax avoidance scheme, but rather a joint venture, whereby the client seeks to recover from some wrongful act against him, and the attorney aids in this process. Each party to the venture should have tax liabilities consistent with their share of the judgment, and thus the Supreme Court should align the Circuits under the *Banks* doctrine to provide more equitable tax treatment and eliminate the harsh effects of the AMT.

Congressional Approach: Rethinking the Simple Solution of the AMT

THE DEBATE ABOUT THE EXCLUDABILITY of contingency fees could also be resolved if Congress passes legislation to allow taxpayers to deduct the entirety of fees and expenses associated with litigation. In fact, the majority of appellate courts have conceded that but for the AMT, a client would be entitled to a deduction of the amount paid to his attorney, since legal expenses and costs to a recovery are deductible as miscellaneous itemized deductions in the pursuit of generating income under 26 U.S.C. § 212. Although the majority can claim that their hands are bound by the AMT, Congress has the power to remedy the inequality. One advantage of legislation, as opposed to judicial action, is that it would provide a uniform rule that achieves appropriate levels of taxation. Indeed, the majority of appellate courts and commentators believe that the duty to decide this issue rests in the hands of the Legislature.

One possible solution would be for Congress to draft legislation to include contingency fees as part of a taxpayer's gross income, but allow for some expenses to be immune from the AMT and other deduction phase-outs. Otherwise, taxpayers will still be liable for taxes on contingency fees. Moreover, without this immunity, courts like those in the Fifth, Sixth, and Eleventh Circuits will

continue to construe common law in such a way as to allow taxpayers to exclude attorney's fees from their gross income. A more effective solution, however, would be for Congress to exclude contingency fees from gross income all together in order to attain uniform treatment of attorney's fees throughout the jurisdictions. Moreover, the taxpayer would not be subject to the 2 percent floor for miscellaneous itemized deductions, the AMT, or the phase-out of itemized deductions.

Conclusion

THE AMT HAS CREATED an almost insurmountable obstacle on contingency-based damage awards. The intent behind the AMT was simply to insure that high income taxpayers paid adequate income tax. However, this seemingly simple solution to a complex problem has resulted in heavy tax burdens on successful plaintiff-taxpayers. The exclusion of an attorney's contingency fee is hardly the type of abusive transaction that Congress was trying to prevent.

The *Banks* case gives the Supreme Court and Congress the opportunity to remedy this inequitable tax treatment. By excluding contingency fees from a client's gross income, the Supreme Court can acknowledge the attorney's equity interest in a cause of action and judgment and thus establish that the tax burden should only be imposed on the person who has the requisite control over the money. Such a holding would also bring the effective tax rate on a taxpayer's award down from an astounding 60 percent to a more reasonable 36 percent in the most common cases. Moreover, the excludability of contingency fees is consistent with previous Supreme Court jurisprudence. Alternatively, the Legislature could amend the tax code or the AMT to allow for either the excludability or deductibility of attorney's fees.

Until such measures are taken, disparate tax treatment will continue to flourish, allowing savvy attorneys and clients to forum shop to obtain more desirable treatment of the clients' judgment or settlement agreements. The Fifth, Sixth, and Eleventh Circuit courts will effectively become tax havens for those fortunate enough to be subject to their jurisdiction or capable enough to have their cases heard there. There is an inherent injustice in taxing a client on the part of an award attributable to the attorney's hard work and skill that is directly paid to him or her. Nevertheless, so long as the inequity continues to exist, Circuit courts should follow the *Banks* doctrine so that future plaintiffs will not be subjected to the harsh effects of the AMT on their judgment or settlement awards. BLB

Andrew J. Foti is a second-year JD candidate at American University Washington College of Law. In 2002, he graduated Magna Cum Laude *from the University of Miami, dual-majoring in Finance and Business Law, and receiving departmental honors in both. Mr. Foti published his senior honors thesis on consumer bankruptcy reform and substantial abuse in the bankruptcy system in the Boston University Public Law Journal. Currently, Mr. Foti is pursuing a career in civil litigation or general corporate law.*

ENDNOTES: *Andrew J. Foti*

[1] Personal injury cases are excluded from this analysis because such jury awards are taxed exempt. See 26 U.S.C. § 104(a)(2) (2003) (stating gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness).

[2] Alternative Minimum Tax, 28 U.S.C. § 55 (2003).

[3] 28 U.S.C. § 68 (2003).

[4] *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003).

[5] S. Rep. No. 91-552, pt. 1, at 1 (1969).

[6] 26 U.S.C. 61 (2003).

[7] *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[8] *See* 26 U.S.C. § 162(a) (2003).

[9] *See* 26 U.S.C. § 212(1) (2003).

[10] Because the AMT phases out additional deductions that would otherwise be allowable, such as state and local taxes under 26 U.S.C. § 56(B)(1)(a)(i), a plaintiff's actual tax payments are higher. Thus, in this example, the effective state tax percentage can be calculated by reducing the taxpayer's gross income for federal tax purposes by $800,000. The difference in the overall tax paid by a person who cannot deduct his state taxes and a person who can is 3 percent; by subtracting the 6 percent from 8 percent, the taxpayer becomes subject to an effective rate of 5 percent and an additional savings of $300,000 in taxes.

[11] The net amount of $ 7.6 million was calculated by subtracting $3.6 million in federal and state taxes and $4 million in attorney's fees from the $10 million damage award. Actual litigation costs were not included which would reduce the earnings even more.

[12] The $1.44 million in savings was calculated by subtracting the AMT savings of $1.68 million (28 percent x $6 million) and the state tax savings of $480,000 (8 percent x $6 million) from the original $3.6 million in taxes, thus resulting in savings of 24 percent.

[13] *See Foster v. U.S.*, 249 F.3d 1275 (11th Cir. 2001); *Srivastava v. Comm'r*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks v. U.S.*, 202 F.3d 854 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

[14] The majority is made up of the Third, Fourth, Seventh, Ninth, Tenth, and the Federal Circuit. *See Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young v. Comm'r,* 240 F.3d 369 (4th Cir. 2001); *Benci-Woodward v. Comm'r*, 219 F.3d 941 (9th Cir. 2000); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Baylin v. U.S.,* 43 F.3d 1451 (Fed. Cir. 1995); *O'Brien v. Comm'r*, 38 T.C. 707, 1962 W.L. 1147 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (*per curiam*).

[15] *Lucas v. Earl*, 281 U.S. 111 (1930).

[16] *Lucas,* 281 U.S. *at* 113.

[17] *Helvering v. Horst*, 311 U.S. 112 (1940).

[18] *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

[19] Ala. Code § 34-3-61 (2000).

[20] *Srivastava v. Comm'r,* 220 F.3d 353 (5th Cir. 2000).

[21] *Estate of Clark v. U.S.*, 202 F.3d 854 (6th Cir. 2000).