[Oklahoma Law Review](https://digitalcommons.law.ou.edu/olr)

Volume 64 | Number 3

2012

Making Plaintiffs Whole: A Tax Problem of Interest

William E. Foster
University of Arkansas, wfoster@uark.edu

MAKING PLAINTIFFS WHOLE: A TAX PROBLEM OF INTEREST

William E. Foster[*]

Abstract

This article illustrates the dramatic tax impact of interest awards in otherwise non-taxable litigation recoveries and proposes two alternative legislative solutions for the over-taxing of plaintiffs in these cases. While plaintiffs who recover personal injury awards typically receive favorable tax treatment, those who receive interest on such awards are taxed on the interest and often are not able to utilize deductions for attorney's fees and other costs paid to obtain the award. Further, the attorney's portion of the recovery in a contingency fee arrangement will be included in the plaintiff's gross income. The result is that the plaintiff recovers less of the interest than the Treasury or her attorney, preventing the plaintiff from truly being made whole. After reviewing the historical and theoretical framework that produces these results, I suggest previously proposed judicial solutions to the problem are impracticable and a legislative solution is necessary. I conclude with a proposal for two alternative legislative solutions: an expanded deduction and an exclusion to provide relief for plaintiffs recovering partially taxable awards and to achieve the policy of fully compensating injured plaintiffs.

Table of Contents

∗ Associate Professor, Washburn University School of Law, LL.M. (Taxation), 2006, New York University, J.D., 2005, University of Arkansas. I would like to thank Raquel Alexander, Johnny Rex Buckles, Michael Hatfield, Tamara Larre, Leandra Lederman, Lori McMillan, Janie Whiteaker Poe, and the other participants in the 2011 Washburn University Tax Law Colloquium for their thoughtful comments on this article. I would also like to thank Brad Borden, Sarah Cotton Patterson, Brian Florea, Emily Grant, Joe McKinney, and David Rubenstein for their valuable input, Brandon Barros, Diane Lautt, Asel Mukeyeva and Stuart Symmonds for their excellent research assistance, and Washburn University School of Law for its generous support of this article. All errors are my own.

Introduction

Ever since the sinking of the Lusitania, taxpayers and courts have struggled with the proper tax treatment of interest added to otherwise non-taxable litigation awards.[1] Today, non-taxable compensatory awards and settlement payments (such as for personal injury damages)[2] are often

1. In *Riddle v. Commissioner*, 27 B.T.A. 1339 (1933), the taxpayer recovered, among other amounts, $15,000.00 from the Mixed Claims Commission, United States and Germany, as a result of personal injuries suffered during the sinking of the steamship Lusitania in 1915. *Id.* at 1339-40. In addition to the personal injury damages, the taxpayer received $3,422.61 of interest on the recovery. *Id.* at 1341. The personal injury damages were excluded from gross income under section 22(a)(5) of the Revenue Act of 1928, but the taxpayer and the Treasury disagreed about the taxability of the interest received. The Board of Tax Appeals concluded that the interest award was indeed a separate item from the excluded damages award, and was itself taxable absent a separate exclusion. *Id.* at 1340-41. Perhaps ironically, it was the sinking of the Lusitania that accelerated the United States' entry into World War I, the funding of which required the first significant expansion of the applicability of the modern federal individual income tax. *See generally* ROBERT M. WILLAN, INCOME TAXES CONCISE HISTORY AND PRIMER 9-13 (1993); David Frederick, *Historical Lessons from the Life and Death of the Federal Estate Tax*, 49 AM. J. LEGAL HIST. 197, 205 (2007) (citing PAULINE MAIER ET AL., INVENTING AMERICA: A HISTORY OF THE UNITED STATES 527, 719 (2003)).

2. *See, e.g.*, I.R.C. § 104(a)(2)(2010) ("[G]ross 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

coupled with taxable interest[3] or punitive damages.[4] These bifurcated awards create a host of taxation issues, both theoretical and practical. One of the most significant problems for recovering plaintiffs in contingency cases is that they must pay the attorney's fee based on the *entire* taxable and non-taxable amount of the payment, but generally enjoy a deduction only to the extent such fees relate to the taxable portion of the award.[5] Generally, there is no deduction for attorney's fees or other costs that relate to non-taxable awards.[6] Additionally, even when such attorney's fees are deductible,[7] the deductions are typically miscellaneous itemized deductions ("MID"), limited to amounts exceeding two percent of the taxpayer's adjusted gross income ("AGI").[8] Of perhaps even greater concern, the plaintiff's alternative minimum tax ("AMT") liability, which would be triggered by any significant award or settlement, must be computed without miscellaneous itemized deductions, including the deduction for attorney's fees that produce taxable income.[9]

---

physical injuries or physical sickness . . . .").

3. I.R.C. § 61(a)(4) includes "[i]nterest" in gross income of taxpayers.

4. *See, e.g.*, McCann v. Comm'r, 87 F. App'x. 359, 360-61 (5th Cir. 2004) (involving a settlement payment of $839,000, $400,000 of which was for excludable personal injury damages and $439,000 of which was for taxable interest); Kovacs v. Comm'r, 100 T.C. 124 (1993) (settlement after extensive appeal for $2,254,741.70, of which $995,000 was for tax-free wrongful death damages and $1,253,607.17 was for taxable interest).

5. I.R.C. § 212(1) provides a deduction for "ordinary and necessary expenses paid or incurred . . . for the production or collection of income."

6. "No deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income." Treas. Reg. § 1.212-1(e)(2010); *see also* I.R.C. § 265(a)(1) ("No deduction shall be allowed for . . . [a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income . . . wholly exempt from the taxes imposed by this subtitle.").

7. For example, when such fees relate to recovering taxable awards, they can be considered "ordinary and necessary expenses paid or incurred . . . for the production or collection of income" for purposes of I.R.C. § 212(1).

8. "[M]iscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." I.R.C. § 67(a). The deduction for attorney's fees provided in I.R.C. § 212 is not included in the list of deductions in I.R.C. § 67(b), which are excluded from the miscellaneous itemized deductions category. For example, assuming a taxpayer had an AGI of $100,000 and wanted to offset her income with a $2100 MID, two percent of the AGI, or $2000, would be a wasted deduction and would not reduce her tax liability. Only the $100 of the MID that exceeds the $2000 threshold is potentially useable by the taxpayer to offset her income.

9. I.R.C. § 56(b)(1)(A).

Congress has seemingly recognized these problems but has cherry-picked the contexts for redress. Specifically, Congress has provided limited relief in the form of an above-the-line deduction for expenses incurred in obtaining certain employment and civil rights recoveries,[10] but not in the more pervasive personal injury context. This gap in tax treatment is normatively unjustified and under-theorized. This article provides a much-needed analysis of the problem and proposes a legislative solution.

One might well object to the inclusion of the attorney's portion of an award or settlement payment in the plaintiff's gross income based on the fact that the money never actually passes through the plaintiff's hands. That is, in most cases involving a contingency fee, the plaintiff's attorney is compensated directly by the defendant with the plaintiff never actually possessing the attorney's portion of the recovery.[11] When coupled with the fact that the underlying award or settlement payment may be excluded from tax because it results from a personal injury or other harm that Congress has determined should result in a tax-free recovery, the taxation of the plaintiff on the interest and punitive damages portion of the attorney's fee is even more difficult to accept. Indeed, in many cases, had the defendant's actions not triggered liability for either interest or punitive damages, then no portion of the plaintiff's recovery, and thus no portion of the amounts paid to the plaintiff's attorney, would be taxable to the plaintiff.

These are important concerns, but current doctrine seems to reject them. Following the Supreme Court's decision in *Commissioner v. Banks*,[12] it is now clear that the plaintiff must include in her income amounts paid to her attorney through contingent fee arrangements.[13] With such a potentially substantial tax liability lurking after payment, it is imperative that all parties to a lawsuit and their respective attorneys and advisors fully understand and communicate the tax consequences of such

---

10. I.R.C. § 62(a)(20) provides an "above the line" deduction (i.e., the items deducted will not be included in adjusted gross income and will therefore not be subject to the two percent floor of I.R.C. § 67) 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 [certain claims against the U.S. government, and certain claims under the Social Security Act]," but only to the extent such amounts are includible in the taxpayer's gross income.

11. *See, e.g.*, Kenseth v. Comm'r, 114 T.C. 399, 405 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001) (plaintiff received a $229,501.37 cash settlement, of which $91,800.54 was paid directly to the plaintiff's attorney).

12. 543 U.S. 426 (2005).

13. *Id.* at 430; *see infra* notes 43-45 and accompanying text.

payments in order to assess with accuracy settlement possibilities and prudent management of any funds received.

Recent scholarship in the area has focused on alternate views of the contingent fee arrangement and even the nature of the taxpayer's asset (i.e., the lawsuit).[14] It has become apparent in the seven years since the *Banks* decision, however, that a more pragmatic approach is necessary to provide relief to taxpayers ensnared by the combination of inclusion of the entire award in the plaintiff's income and the limitations on the deductibility of fees and costs when recoveries are obtained pursuant to contingent fee arrangements.[15] Additionally, previous academic treatment has focused primarily on taxpayers that received entirely taxable awards. This article, by contrast, attempts to bring to light the role of interest and the significant deductibility and AMT limitations faced by taxpayers recovering amounts that are partially non-taxable and partially taxable.

This article proposes expanding Internal Revenue Code ("I.R.C." or "Code") §§ 62(a)(20) and 212 to provide an above-the-line deduction for all fees and costs incurred in connection with any action involving a claim having a recovery which is excluded from gross income under I.R.C. § 104(a) (i.e., personal injury or sickness recoveries) to the extent that such claim results in a recovery that includes a taxable interest component. Alternatively, the same relief could be accomplished through enactment of a new exclusion in the amount of attorney's fees (and perhaps other costs) paid by a taxpayer in connection with any action involving a personal injury or sickness claim, recovery of which is otherwise excluded from gross income under Code § 104(a). Although the process of revising the tax code itself can be challenging and fraught with political contention,[16] once a legislative solution is achieved, taxpayers and their advisors will have a greater degree of certainty with respect to the potential tax liability flowing from a settlement or award.

Part I of this article describes the problem presented by the inclusion in the plaintiff's income of the attorney's portion of the recovery and the historical background leading to such inclusion. Part II explains the theoretical basis for the tax treatment of litigation interest, the challenges facing plaintiffs and their advisors in allocating fees and costs associated

---

14. *See infra* Part II.

15. *See supra* notes 8-10 and accompanying text.

16. One need only look to the extension of the "Bush Tax Cuts" in December 2010 for an example of how politically divisive tax reform can be. *See, e.g.*, David M. Herszenhorn & Sheryl Gay Stolberg, *Obama Defends Tax Deal, but His Party Stays Hostile*, N.Y. TIMES, Dec. 7, 2010, http://www.nytimes.com/2010/12/08/us/politics/08cong.html?_r=1.

with partially taxable and partially non-taxable awards, and gives an illustration of the dramatically different tax results that follow various interest and deductibility scenarios. Part III reviews some of the previously proposed solutions to the problem of inclusion of the attorney's fee in the plaintiff's taxable income. Part IV suggests two alternative legislative approaches — a deduction and an exclusion — intended to address the unique tax issues presented to plaintiffs who recover non-taxable awards with taxable components, and presents policy arguments in favor of a legislative solution. This article concludes with a call for action to adopt a legislative solution for the problems presented here.

I. The Problem

A. Inclusion of Attorney's Portion of the Award and AMT Issues

Certain recoveries are not taxable from the outset. For example, the Internal Revenue Code specifically excludes from a successful litigant's gross income compensatory recoveries resulting from personal injuries. Code § 104(a)(2) provides that "gross income does not include . . . the amount of 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 personal sickness[.]"[17] On the other hand, interest is taxable even if it arises out of and is computed on an otherwise non-taxable award. Code § 61(a)(4) states that "gross income means all income from whatever source derived, including (but not limited to) . . . interest."[18] Despite taxpayers' initial assertions that interest should be construed as part and parcel of the non-taxable recovery from which it grew, the Treasury and the courts established the separate nature of interest apart from the underlying compensatory recovery from the early days of the modern federal individual income tax.[19] Adhering to this paradigm which separates interest from the underlying award requires all recoveries that include an interest (or other taxable) component to be analyzed on a piecemeal basis.

The reduction of the plaintiff's recovery due to the taxability of the interest portion of an otherwise non-taxable award is only the beginning of the plaintiff's burden. In personal injury cases, plaintiffs almost

17. I.R.C. § 104(a)(2) (2010).
18. *Id.* § 61(a)(4).
19. *See* Riddle v. Comm'r, 27 B.T.A. 1339, 1939-41 (1933).

always retain attorneys pursuant to a contingency fee contract.[20] This arrangement allows plaintiffs access to the courts without much, if any, upfront cost.[21] The tradeoff is that the plaintiff must pay her attorney a percentage of the ultimate recovery when received. This percentage may range from twenty percent of the recovery if the claim is settled easily and early to fifty percent or more if trial and appeal work are involved.[22] Moreover, the contingent attorney's fee is typically determined based on the plaintiff's entire recovery, including both the non-taxable personal injury recovery and any interest received.[23]

The depletion of the plaintiff's recovery could be mitigated somewhat by an effective deduction for the fees incurred to procure the recovery. In fact, Code § 212(1) provides a deduction for "ordinary and necessary expenses paid or incurred . . . for the production or collection of income[.]"[24] The plaintiff's attorney's fees and other costs paid to obtain certain recoveries no doubt are "for the production or collection of income." The deduction of such amounts, however, is limited to the extent they relate to only the taxable portion of the recovery.[25] According to the regulations, no § 212 deduction is allowed "for any amount allocable to the production of one or more classes of income which are not includible in gross income, or for any amount allocable to the

20. "Virtually all tort claiming is financed by plaintiff lawyers through the medium of contingent fees." Lester Brickman, *The Market for Contingent Fee-Financed Tort Litigation: Is It Price Competitive?*, 25 CARDOZO L. REV. 65, 68 (2003). A 1989 report by the Federal Trade Commission reported that 97% of injury cases were taken on a contingency fee basis, regardless of generous offers for an hourly rate. WALTER K. OLSON, THE LITIGATION EXPLOSION 47 (1991).

21. *See* Sharon Reece, *Lemonade from Lemons: The Solution to Taxation of the Contingent Fee Portion of Damage Awards*, 37 CREIGHTON L. REV. 305, 337 (2004).

22. Bradley L. Smith, Note, *Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlements Incentives*, 90 MICH. L. REV. 2154, 2164 n.37 (1992) ("Typically, the contingency percentage is one third of all proceeds, although it reportedly reaches 50% in some cases.") (citing OLSON, *supra* note 20, at 47). While a common practice is to have a constant percentage (typically one-third of the recovery), "some attorneys vary the percentage depending on the stage of litigation, e.g., 30% of settlement proceeds and 50% of trial judgment proceeds." *Id.* (citing John J. Donohue, *The Effects of Fee Shifting on the Settlement Rate: Theoretical Observations on Costs, Conflicts, and Contingency Fees*, LAW & CONTEMP. PROBS., Summer 1991, at 210 n.55).

23. *See, e.g.*, Kovacs v. Comm'r, 100 T.C. 124, 126 (1993) (plaintiff recovered $2,254,741.70 of which $1,253,607.17 was interest and $749,535.72 was paid directly to the attorney under a one-third contingency fee).

24. I.R.C. § 212(1) (2010).

25. *Id.* § 265(a)(2).

management, conservation, or maintenance of property held for the production of income which is not included in gross income."[26] Further, Code § 265(a)(2) provides that "[n]o deduction shall be allowed for . . . [a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income . . . wholly exempt from taxes imposed by this subtitle . . . ."[27] This result was confirmed in *Church v. Commissioner*, in which the Tax Court stated: "[t]o the extent [the attorney's fees and costs] are allocable to the interest portion of the award, however, they are deductible under section 212(1) as an expense incurred for the production of income. To the extent they are allocable to exempt income, they are nondeductible under section 265(1)."[28]

Furthermore, the deductions that are allowed to a plaintiff for fees and costs incurred to produce taxable income are severely limited, and in many cases worthless. The § 212 deduction for the production or collection of income is a miscellaneous itemized deduction, as it is not referenced in Code § 67(b), which contains the list of itemized deductions that are excluded from the miscellaneous itemized category.[29] The miscellaneous itemized deduction designation means that until such amounts exceed two percent of the taxpayer's adjusted gross income, no deduction is available.[30]

More drastically, the alternative minimum tax ("AMT") requires taxpayers to calculate their taxes on an alternative tax system without the use of any miscellaneous itemized deductions, including the deduction for attorney's fees that produce taxable income.[31] While originally enacted to address perceived inequities attributable to the fact that some high-income taxpayers paid almost nothing in taxes, the AMT now ensnares individuals with a wide range of incomes.[32] Taxpayers will be subject to the AMT if the tax liability on their alternative minimum taxable income ("AMTI") is greater than the tax liability on their regular taxable income.[33] Individuals are subject to twenty-six percent (up to $175,000 for joint returns and $87,500 for single returns) or twenty-eight percent

26. Treas. Reg. § 1.212-1(e)(2010).
27. I.R.C. § 265(a)(2).
28. 80 T.C. 1104, 1110-11 (1983).
29. I.R.C. § 67(b).
30. *Id.* § 67(a). See *supra* note 8 for an example of the operation of the cap on miscellaneous itemized deductions.
31. I.R.C. § 56(b)(1)(A).
32. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 208-09 (11th ed. 2009).
33. I.R.C. § 55(a).

(on amounts exceeding $175,000 for joint returns and $87,500 for single returns) rates on the AMTI.[34] For 2011, there were separate AMT exemptions in the amount of $74,450 for married taxpayers filing jointly and $48,450 for single individuals.[35] These exemptions are subject to a twenty-five percent phase-out, however, beginning when joint return taxpayers' AMTI exceeds $150,000 and when a single taxpayer's AMTI exceeds $112,500.[36] The result is that the AMT exemption is effectively eliminated for joint return taxpayers at AMTI of $447,800[37] and for single taxpayers at AMTI of $306,300.[38] Accordingly, plaintiffs with even relatively modest recoveries will be subject to the highest AMT rates and will have no use of the miscellaneous itemized deduction for attorney's fees incurred to generate their recovery income.[39] As such, the non-deductibility of fees and expenses related to non-taxable recoveries and the severe limitations on deductibility of fees and expenses related to taxable recoveries combine to form an extremely unfavorable tax environment for plaintiffs recovering partially taxable and partially non-taxable awards.

B. Historical Background on Inclusion

Although it was only recently settled by the Supreme Court that a taxpayer cannot exclude from income the recovered amounts paid directly to the attorney through contingent fee arrangements, the development of the issues in play hearkens back to seminal tax case law and well-worn doctrine. The Supreme Court's 2005 decision in *Commissioner v. Banks*[40] resolved a split among the circuit courts of appeals[41] by determining that

---

34. *Id.* § 55(b)(1)(A).

35. *Id.* § 55(d)(1). Because the AMT exemption is not automatically adjusted for inflation, after 2011 these exemption amounts are scheduled to return to the statutory $45,000 for joint returns and $33,750 for single individuals. *Id.*

36. *Id.* § 55(d)(3).

37. $74,450 x 4 + $150,000.

38. $48,450 x 4 + $112,500.

39. *See generally* Brant J. Hellwig & Gregg D. Polsky, *Litigation Expenses and the Alternative Minimum Tax*, 6 FLA. TAX REV. 899 (2004); Ilir Mujalovic, *Yet Another Alternative Minimum Tax Disaster: How a Recovery of Damages Turns into a Liability*, 47 N.Y.L. SCH. L. REV. 355 (2003).

40. 543 U.S. 426 (2005).

41. The split divided the Second, Fourth, Seventh, some Ninth Circuit courts, and the Federal Circuits (requiring inclusion of the plaintiff's entire recovery in its gross income) from the Fifth, Sixth, Eleventh, and other Ninth Circuit courts (allowing plaintiffs to reduce gross income by amounts not actually received by the plaintiff). *See* Leah Witcher Jackson, *Won the Legal Battle, but at What Tax Cost to Your Client: Tax Consequences of*

even if a portion of the plaintiff's taxable award is paid directly to his or her attorney under a contingency fee arrangement, that amount is taxed to the plaintiff.[42] In sustaining the Commissioner's objection to the taxpayers' exclusion of the portion of the award paid directly to the taxpayers' attorneys, the Court held that "[a]s a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."[43] The Court relied heavily on the anticipatory assignment of income doctrine to reach this conclusion in *Banks*, stating that it agreed with the Commissioner's position "that a contingent-fee arrangement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery."[44] Accordingly, a brief review of the origins of the anticipatory assignment of income doctrine is in order.

The assignment of income doctrine traces its roots to the venerable Supreme Court decision in *Lucas v. Earl*.[45] In *Earl*, the taxpayer, Guy Earl, and his wife entered into an agreement in 1901 that provided that all property (including salaries, fees, etc.) then owned or thereafter acquired by either spouse would be deemed held by both spouses as joint tenants with rights of survivorship.[46] This was intended simply to avoid probate for a portion of their property, as no federal individual income tax was in effect at the time of the 1901 agreement.[47] Mr. Earl was a successful attorney in California and a man of substantial means.[48] By the time of the final decision in 1930, the 1901 agreement would have given the Earls a significant break from the progressive income tax rates, as both spouses could have utilized lower marginal rates.[49] In holding that, notwithstanding the couple's agreement, all income earned by Mr. Earl was taxable to him alone, Justice Holmes set forth one of the most recognizable tenets in all of tax law:

Contingency Fee Arrangements Leading up to and after Commissioner v. Banks, 57 BAYLOR L. REV. 47, 53 (2005).

42. *Banks*, 543 U.S. at 430.

43. *Id.* at 430.

44. *Id.* at 434.

45. 281 U.S. 111 (1930).

46. *Id.* at 113-14; *see also* Patricia A. Cain, *The Story of Earl: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*, *in* TAX STORIES 305 (Paul A. Caron ed., 2d ed. 2009).

47. WILLAN, *supra* note 1, at 4.

48. Cain, *supra* note 46, at 313-15.

49. *Id.* at 315.

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory assignments . . . and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.[50]

In other words, although the assignment of Mr. Earl's future earnings may have been an effective transfer under state law, it would not serve to bifurcate his taxable income.[51] Consequently, taxpayers and their advisors have spent much of the last eighty-two years trying to ensure their fruit does not wander to another's tree.

Building on the pronouncement in *Earl* of the anticipatory assignment of income doctrine in the context of income derived from services (i.e., Mr. Earl's legal fees), the 1940 Supreme Court decision in *Helvering v. Horst*[52] applied the assignment of income doctrine to income derived from property. In *Horst*, the taxpayer owned corporate bonds with detachable interest coupons.[53] The taxpayer detached several of the coupons prior to maturity and gifted them to his son, in essence assigning away the interest from the bonds while retaining the underlying bond instrument.[54] When the son cashed the coupons at maturity, the Internal Revenue Service ("IRS"), and subsequently, the Supreme Court, determined that the father, rather than the son, should be taxed on the interest.[55] In reaching this conclusion, the Court ruled that direction of disposition of the right to receive interest while retaining ownership was equivalent to an exercise of ownership over the interest itself.[56] Accordingly, this transfer should produce the same result as the father's first receiving the income and then transferring it to his son.

Earl and *Horst* laid a foundation for a rather expansive view of the anticipatory assignment of income doctrine, whether addressing income derived from property or services. There may be no more liberal interpretation of that doctrine than that employed in *Commissioner v. Banks*.[57] The Supreme Court's *Banks* decision was a consolidation of two

50. *Earl*, 281 U.S. at 114-15.
51. *Id.* at 114.
52. 311 U.S. 112 (1940).
53. *Id.* at 114.
54. *Id.*
55. *Id.* at 114, 120.
56. *Id.* at 116-18.
57. 543 U.S. 426 (2005).

cases: *Commissioner v. Banaitis*,[58] and *Commissioner v. Banks*.[59] Both cases involved underlying awards or settlements that were taxable at the time of recovery.[60] In *Banaitis*, a loan officer had settled with his employer on a wrongful discharge complaint, of which $4,864,547 was paid to the plaintiff and $3,864,012 was paid directly to his attorneys.[61] The Ninth Circuit determined that the plaintiff was allowed to exclude from his taxable income the portion of the recovery paid directly to his attorneys.[62] This decision was based largely on the applicable state's attorney lien law, which was interpreted essentially to transfer to the attorney a portion of the plaintiff's cause of action.[63] The satisfaction of the attorney's portion of the claim at settlement was construed as merely a recovery by the attorney on the attorney's separate property interest, essentially as a co-tenant with the plaintiff.[64]

Similarly, *Banks* involved a settlement in the amount of $464,000 for an alleged employment discrimination and civil rights violation, of which $150,000 was paid to the plaintiff's attorney.[65] The Sixth Circuit refused to apply the assignment of income doctrine of *Earl*, giving the following reasons: (1) the claim was merely a contingent expectancy at the time the attorney was retained; (2) the lawsuit was tantamount to a partnership or joint venture, two-thirds owned by the plaintiff, and one-third owned by the attorney; (3) the agreement was not motivated by tax avoidance; and (4) application of the doctrine would result in double taxation.[66]

The Supreme Court overturned the Ninth Circuit's decision in *Banaitis* and the Sixth Circuit's decision in *Banks* in a consolidated case, holding that the taxpayer plaintiffs should include in their income the portion of litigation recovery paid to their attorneys pursuant to contingent fee

---

58. 340 F.3d 1074 (9th Cir. 2003).
59. 345 F.3d 373 (6th Cir. 2003).
60. *Banks*, 543 U.S. at 430-31.
61. 340 F.3d at 1078.
62. *Id.* at 1081.
63. *Id.* at 1081-82.

> Oregon law . . . affords attorneys generous property interests in judgments and settlements . . . . Put simply, Oregon law vests attorneys with property interests that cannot be extinguished or discharged by the parties to the action except by payment to the attorney . . . . Because of the unique features of Oregon law, we conclude that fees paid directly to [the attorney] were not includable in Banaitis' gross income for the relevant year."

Id. at 1082-83.

64. *Id.* at 1083.
65. Comm'r v. Banks, 345 F.3d 373, 376 (6th Cir. 2003).
66. *Id.* at 386.

agreements.[67] The Court based its reasoning, in large part, on the assignment of income doctrine initially set forth in *Earl*.[68] The Court stated, "[t]he Commissioner maintains that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. We agree with the Commissioner."[69] Accordingly, gains should be taxed to those who earn them, and taxpayers should be prevented from avoiding taxation through arrangements and contracts devised to prevent income when paid from vesting (even for a second) in the one who earned it. The Court likewise drew comparison to *Horst*,[70] a more analogous case than *Earl*,[71] in that it addressed assignment of income from property rather than services (assuming one views the income-producing asset in *Banks* as property in the form of the lawsuit or cause of action).[72] The *Banks* Court cited *Horst* for the proposition that the taxpayer who owns or controls the source of income also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants.[73] The Court in *Banks* determined that the income-generating asset in that case was the cause of action itself, which clearly remains in the dominion and control of the plaintiff until recovery, despite the plaintiff's suggestion that the attorney-client relationship should be viewed as a sort of business partnership or joint venture for tax purposes.[74] The application of the assignment of income doctrine by the Supreme Court in *Banks* has been persuasively criticized in subsequent scholarship,[75] but is unlikely to be overturned in the near future.

---

67. Comm'r v. Banks, 543 U.S. 426, 430 (2005).

68. *Id.* at 434 ("As *Lucas* explained, 'no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." (citations omitted)).

69. *Id.*

70. 311 U.S. 112 (1940).

71. 281 U.S. 111 (1929).

72. *See generally* Katherine D. Black, Michael D. Black & Stephen T. Black, *Taxation of Contingency Fees: Deductions for Expenses?*, TAX NOTES, Feb. 8, 2010, at 1.

73. 543 U.S. at 434-35.

74. *Id.* at 435-36.

75. *See* Brant J. Hellwig, *The Supreme Court's Casual Use of the Assignment of Income Doctrine*, 2006 U. ILL. L. REV. 751 (arguing against the Supreme Court's expansion of the assignment of income doctrine to arm's length assignments for consideration, and noting that the same conclusion could have been reached in *Banks* simply by finding that taxpayers realize a taxable benefit when their obligations to compensation their attorneys is discharged). See *infra* Part III.B. for a discussion of the criticism of the assignment of

The precise tax issue involved in *Banks* was addressed by legislation even before the case was decided. After the controversies comprising *Banks* arose, Congress enacted the American Jobs Creation Act of 2004.[76] The Act added current Code § 62(a)(20), allowing a taxpayer, in computing adjusted gross income, to deduct attorney's fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination.[77] Because these are so-called "above-the-line" deductions, they may be taken even when the AMT applies and are not subject to the two percent of adjusted gross income ("AGI") floor.[78] Since this amendment effectively eliminated much of the concern of potentially overreaching taxation in the *Banks* case, the attention of practitioners, and perhaps scholars, has been somewhat diminished.

However, the *Banks* opinion still stands for the proposition that a plaintiff, whose award is otherwise taxable, will not be able to exclude that portion of the recovery that is directly paid to the attorney.[79] As described above, interest paid on a taxpayer's non-taxable recovery (e.g., for physical injuries) is taxable itself.[80] When combined with the holding of *Banks*, this means that the prevailing plaintiff is really paying tax on the attorney's portion of the interest recovery as well.

The post-Code § 62(a)(20) enactment issues unique to partially taxable and partially non-taxable awards are illuminated by the facts of *Estate of Clarks v. United States*,[81] which is directly referenced in *Banks*.[82] On June 28, 1988, the family of Arthur Clarks received a jury verdict in the amount of $9,400,000 against K-Mart for injuries Mr. Clarks incurred when he was unloading a truck at a K-Mart facility.[83] Arthur Clarks' portion of the award was $5,600,000, plus interest, and the remainder was

income doctrine.

76. Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546 (2004).

77. I.R.C. § 62(e)(2010) defines "unlawful discrimination" to include any act that is unlawful, for example, under certain provisions of the Americans with Disabilities Act, the Family and Medical Leave Act, the Fair Housing Act, and numerous other federal, state, and local laws.

78. I.R.C. § 56(b)(1)(A).

79. 543 U.S. at 430.

80. I.R.C. § 61(a)(4).

81. No. 96-CV-60446-AA, 1998 WL 839415, at *1 (E.D. Mich. Nov. 23, 1998), *rev'd*, 202 F.3d 854 (6th Cir. 2000).

82. 543 U.S. at 431.

83. *Clarks*, 1998 WL 839415, at *1.

awarded to his wife and children on their claims.[84] After an extensive appeals process, K-Mart paid Clarks $11,307,837.55 in satisfaction of his portion of the judgment in 1991.[85] This amount consisted of $5,600,000 for the jury award and $5,707,837.55 in interest.[86] Clarks paid his attorneys a total fee of $3,766,471.21 ($1,901,314.67 based on the interest portion of the award, and $1,865,156.54 based on the damages award) and costs in the amount of $8,432.90.[87] It was undisputed that the $5,600,000 resulting from the jury's award was not taxable.[88] Clarks died in 1992, and his estate was assessed a deficiency of $254,298 because it failed to report the interest used to pay attorney's fees and the portion of the costs that related to judgment interest.[89] The IRS argued that the interest paid on a personal injury judgment was taxable, whether paid to an attorney under a contingency agreement or not.[90] The amounts payable to the attorney with respect to the interest award would, however, be a below-the-line miscellaneous itemized deduction, subject to the two percent AGI limitation and not allowed in computing the alternative minimum tax.[91] While the district court agreed with the IRS, the Sixth Circuit held that the amounts paid directly to the attorney were not taxable.[92] Looking to the fruit-and-tree metaphor of *Lucas v. Earl*, the Sixth Circuit concluded with the following analogy:

> The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should

84. *Id.*
85. *Clarks*, 202 F.3d at 855.
86. *Id.*
87. *Clarks*, 1998 WL 839415, at *1.
88. *Clarks*, 202 F.3d at 855. "At no time has the non-interest portion of the award ($5,600,000) been at issue since it is clearly not taxable as income pursuant to 26 U.S.C. § 104(a)(2)." *Id.*
89. *Id.*
90. *Id.*
91. *See supra* note 9 and accompanying text.
92. *Clarks*, 202 F.3d at 858.

> be charged to the one who earned it and received it, not as under the government's theory of the case, to the one who neither received it nor earned it.[93]

While this distinction was particularly compelling in the *Clarks* case, which involved an underlying non-taxable award, the Sixth Circuit's ruling was overturned by the Supreme Court in *Banks*.[94] Accordingly, under current Supreme Court doctrine, amounts paid directly to attorneys under contingent fee arrangements, even when the underlying claim is exempt from tax, are taxable to the plaintiff.[95]

II. The Role of Interest in Litigation

A. The Theory of Litigation Interest

A brief review of the policies supporting the taxation of interest and disallowing deductions for expenses related to procuring non-taxable interest as well as the purposes served by interest in the litigation context reveals how, in the context of partially taxable and partially non-taxable recoveries, the current tax regime frustrates those policies. In 1967, the Eighth Circuit Court of Appeals effectively described the policy behind disallowing deductions for tax-exempt income in concluding that deductions should not be allowed for a fiduciary's fee to the extent such fee is related to the management of municipal bonds that produced tax-exempt interest.[96] The court stated:

> Not only does the language of the statute suggest that both §§ 212(1) and (2) expenses must be apportioned between taxable and nontaxable income; the policy underlying the statute also suggests the same result . . . . [I]n 1941 the Supreme Court held [in Higgins v. Commissioner, 312 U.S. 212 (1941)] that investment counseling expenses were not deductible because the then applicable section of the Code only allowed deductions for "trade or business expenses." However, since nonbusiness income was included in gross income, Congress enacted what is now §§ 212(1) and (2) which provides that

93. *Id.* at 858.

94. Comm'r v. Banks, 543 U.S. 426, 431 (2005). Indeed, the Supreme Court cited *Clarks* twice as the opinion on which the Sixth Circuit relied in achieving its decision in *Banks*. *Id.* at 431.

95. *Id.* at 429-30.

96. Whittemore v. United States, 383 F.2d 824, 833-34 (8th Cir. 1967).

> certain nonbusiness expenses are deductible. Thus, by providing for nonbusiness expenses, Congress furthered the underlying philosophy of a tax on net income rather than on gross income.[97]

The court bolstered this historical context by including a statement of Representative Wesley Disney:

> The Internal Revenue Code provides that expenses incurred in the trade or business of the taxpayer may be deducted in arriving at net income. The law also provides that personal, living or family expenses may not be deducted. There is left a great border-land of doubt . . . . Since the income from such investments is clearly taxable it is inequitable to deny the deduction of expenses attributable to such investments.[98]

Accordingly, the enactment of Code §§ 212(1) and (2) provided matching of nonbusiness expenses with nonbusiness income.[99] Likewise, to the extent that the nonbusiness income was excluded from the gross taxable income, the corresponding expense should not be allowed. Otherwise, "the taxpayer would receive a double advantage in that he could take a deduction against other taxable income and yet receive tax free the income to which the expense related. The purpose of § 265(1) is to eliminate this double advantage."[100]

The "double advantage" would certainly accrue if a deduction were allowed for expenses paid or incurred to obtain tax-exempt bond interest. Likewise, a plaintiff recovering an entirely tax-exempt amount would be doubly advantaged if she were allowed to offset other taxable income (e.g., her salary) by the legal expenses and court costs incurred to obtain the non-taxable amount. The figures that follow, however, will

---

97. *Id.* at 833.

98. *Id.* at 834 (citing H.R. REP. NO. 77-2333, at 46, 74-76 (1942)). The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable. H.R. REP. NO. 77-2333, at 74-76.

99. *Whittemore*, 383 F.2d at 834.

100. *Id.*

demonstrate that no such advantage is likely when a plaintiff's recovery includes a taxable interest component. Instead, the plaintiff recovering taxable interest on top of an otherwise non-taxable award will usually have significant costs involved, tied to both the taxable and non-taxable components of the award, and an often worthless deduction for those costs. Therefore, it is at least not inconsistent with the policy behind the limitation of Code § 265 to allow a deduction for expenditures made to procure such recoveries to the extent income is ultimately taxed.

As to the purpose of interest in litigation, the primary consideration seems to be one of making the plaintiff whole for the plaintiff's losses by compensating the plaintiff for the lost time value of money when the plaintiff had no access to the ultimate recovery. This theory is applicable to both pre-judgment interest and post-judgment interest:[101] "The award of interest is founded on the theory that there has been a deprivation of use of money or its equivalent and that the sole function of interest is to

---

101. *See generally* City of Milwaukee v. Cement Div., Nat'l Gypsum Co., 515 U.S. 189, 195 (1995) ("The essential rationale for awarding prejudgment interest is to ensure that an injured party is fully compensated for its loss."). This purpose has been expressed by a number of courts in both the pre-judgment and post-judgment contexts.

> The purpose of the award of prejudgment interest is to make the plaintiff whole from the date of the loss once the jury determines the defendant's liability for damages and their amount. Once the jury sets the amount of damages to be awarded, the damages are retroactively considered liquidated damages, and the plaintiff is entitled to prejudgment interest back to the date that the damages were due.

Capitol Env't. Servs., Inc. v. Earth Tech., Inc., 25 So.3d 593, 597 (Fla. Dist. Ct. App. 2009) (citing *Argonaut Ins. Co. v. May Plumbing Co.,* 474 So.2d 212, 215 (Fla. 1985)).

> [T]he purpose of postjudgment interest is to compensate the successful plaintiff for being deprived of compensation for the loss from the time between the ascertainment of the damage and the payment by the defendant . . . . The verdict assesses damages up to the time that it is rendered; however, payment does not occur immediately upon return of the verdict. Postjudgment interest represents the cost of withholding the amount owed the plaintiff once that sum has been determined in a court proceeding.

Poleto v. Consol. Rail Corp., 826 F.2d 1270, 1280 (3d Cir. 1987) (citing Turner v. Japan Lines, Ltd., 702 F.2d 752, 756-57 (9th Cir. 1983); Hooks v. Wash. Sheraton Corp., 642 F.2d 614, 618-19 (D.C. Cir. 1980)); *see also* Brian P. Miller, Comment, *Statutory Post-Judgment Interest: The Effect of Legislative Changes After Judgment And Suggestions for Construction*, 1994 B.Y.U. L. REV. 601, 609-10 (1994) (stating, "[t]here are two discernible purposes for post-judgment interest: 1) compensation to the judgment creditor for not having use of the money owed; and 2) punishment of the judgment debtor to encourage him or her to pay the judgment without undue delay. . . . Judicial decisions in very few states have viewed post-judgment interest as a measure designed to punish the judgment debtor for not paying the amount of the judgment." (citations omitted)).

make whole the party aggrieved. It is not to provide a windfall for either party."[102] Again, "The allowance of interest rests on an attempt by courts to award compensation to the plaintiff for the delay involved between the date of the injury (the time that the plaintiff was entitled to compensation) and the date of the award or judgment."[103]

If one accepts that interest awarded on personal injury recoveries is simply designed to keep the plaintiff in the same position economically as when the original judgment was awarded or the injury was suffered, then tax policy should promote this purpose and not punish the taxpayer whose personal injury award is coupled with interest. This policy would possibly support exclusion of the interest entirely from income of the plaintiff. However, I do not go that far. Instead, I propose that, because in most cases the assignment of income doctrine requires inclusion of both the plaintiff's recovery and the attorney's recovery in the plaintiff's income, the plaintiff should be allowed either a deduction to the extent of income inclusion or the ability to exclude interest income to the extent of the plaintiff's out-of-pocket expenditures incurred in the case (not just expenditures incurred to produce the taxable income). This approach best approximates the amount necessary to make the plaintiff whole when the plaintiff's entire tax situation is considered, yet prevents a complete windfall for the plaintiff by limiting the deduction or exclusion to her actual expenses.

B. Allocation of Fees and Costs Related to Interest

Having established that the portion of a successful plaintiff's recovery paid directly to the attorney under a contingent fee arrangement must be included in the plaintiff's gross income and that the plaintiff is only allowed a deduction under Code § 212 for attorney's fees and court costs to the extent that such expenses relate to the recovery of taxable income, one must determine how to allocate the amount of the expenses between those that relate to taxable recoveries and those that relate to non-taxable

---

102. Joseph L. Marino, *Judgments and Their Enforcements, in Civil Practice Law and Rules*, *in* 3 WEST'S MCKINNEY'S FORMS CIVIL PRACTICE LAW AND RULES § 8:3 (2011) (citing 155 Henry Owners Corp. v. Lovlyn Realty Co., 647 N.Y.S.2d 30 (1996); *Kaiser v. Fishman,* 590 N.Y.S.2d 230 (1992); 5 WEINSTEIN-KORN-MILLER, N.Y. CIV. PRAC. ¶ 5001.10)).

103. Jacob A. Stein, *Attorney's Fees and Interest*, *in* 3 STEIN ON PERSONAL INJURY DAMAGES TREATISE § 17:58 (3d ed. 2011).

recoveries.[104] There are at least two alternative approaches that could apply to this allocation: (1) divide the expenses between taxable and non-taxable amounts according to the split of the ultimate recovery between such amounts (a proportionate approach) or (2) divide the expenses based on the amount of the work or nature of costs actually related to the respective recoveries (an "origin of the claim"[105] approach).[106]

Case law appears to support a proportionate division of the expenses based on the relative amounts of the ultimate recovery that are taxable and non-taxable. In *Church v. Commissioner*,[107] the plaintiff taxpayer recovered $250,000 of excludable compensatory personal injury damages, $235,000 of punitive damages (also excludable under the Commissioner's concession), and $140,872.71 of taxable interest.[108] The taxpayer also paid $253,568.85 in attorney's fees and court costs pursuant to a contingent fee arrangement.[109] The Tax Court determined that "due to [its] holding that part of the total award is exempt from income, the $253,568.85 in attorney's fees . . . must be allocated between the exempt portion and the non-exempt portion of the award."[110] The court decided that the appropriate allocation formula was to multiply the total attorney's

104. *See, e.g.*, Kovacs v. Comm'r, 100 T.C. 124, 133 (1993) ("The parties have agreed that if we hold that petitioners' interest award is includable in income, the attorney's fees attributable to interest are deductible under section 212(1). Because we have held that the interest is includable in income, petitioners will be allowed to deduct the portion of their attorney's fees attributable to interest.") (citing Stocks v. Comm'r, 98 T.C. 1, 18 (1992); Metzger v. Comm'r, 88 T.C. 834, 860 (1987), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988); Church v. Comm'r, 80 T.C. 1104, 1110-11 (1983)).

105. *See* Black, Black, & Black, *supra* note 72, at 2 (citing I.R.S. Priv. Ltr. Rul. 200823012 (Mar. 10, 2008)).

106. While these approaches appear to carry the day, there are occasional cases in which the IRS appears to concede that the portion of the attorney's fee relating to the non-taxable recovery could simply be excluded from the plaintiff's income. For example, in *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), the court noted that "legal fees and costs of $63,152 were allocated to the nontaxed personal injury damages and *by agreement with the Commissioner* excluded from income." *Id.* at 758 (emphasis added). The $63,152 of excluded legal fees and costs was exactly 20 percent of the $315,760 total attorney's fees. The plaintiff's non-taxable personal injury award was exactly 20 percent of his total settlement ($109,429 excluded personal injury component/$547,146 total settlement). *Id.* This may have been a strategic concession on the part of the IRS in order to avoid litigation of the IRS's then-uncertain (i.e., pre-*Banks*) position that the attorney's fees could be included in the plaintiff's income in a contingent fee situation.

107. 80 T.C. 1104 (1983).

108. *Id.* at 1106.

109. *Id.*

110. *Id.* at 1111.

fee by a fraction, the numerator of which was the non-exempt (i.e. taxable) income and the denominator of which was the total award.[111] Following that approach, "[t]he proper allocation result[ed] in a section 212(1) deduction of \$57,073.80[,]"[112] determined as follows:

"\$253,568.85[attorney's fees and costs] x $\frac{\$140,872.71 \text{ (non-exempt income)}}{\$625,872.71 \text{ (total award)}}$ = \$57,073.80"[113]

While this approach is perhaps the most intuitive and straightforward, it focuses on the ultimate result of the award or settlement instead of the nature of the expenses incurred to produce the recovery.[114] An argument could be made that legal expenses paid in pursuit of a partially taxable recovery should only be deductible to the extent that such expenses related specifically to the taxable portion of the recovery and not to the non-taxable recovery. This would be similar to the origin-of-the-claim analysis employed in determining the deductibility of expenses that are partially personal and partially business related. For example, in *United States v. Gilmore*,[115] the Supreme Court was tasked with determining the deductibility of a husband's legal expenses incurred in divorce proceedings against his wife related to a division of assets, some of which were the husband's business ventures.[116] The *Gilmore* Court found

> in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortune of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not.[117]

This approach is likewise utilized to allocate legal expenses between deductible business expenses and capital expenditures.[118]

Although the origin-of-the-claim approach is appealing for consistency, allocating the attorney's fees and court costs between amounts related to

111. *Id.*
112. *Id.*
113. *Id.* at 1111 n.8.
114. *See* Black, Black, & Black, *supra* note 72, at 2-3.
115. 372 U.S. 39 (1963).
116. *Id.* at 40.
117. *Id.* at 49.
118. *See, e.g.*, Clements v. Comm'r, T.C. Memo 1981-530 (1981) ("Whether legal fees are deductible business expenses or capital expenditures depends on the 'origin-of-the-claim.'") (citing Redwood Empire Sav. & Loan Ass'n v. Comm'r, 68 T.C. 960, 977 (1977)).

recovery of non-taxable and taxable portions would be difficult, if not impossible, in many cases. In particular, in contingent fee arrangements, attorneys often do not track hours worked on the case.[119] Because the fee agreement is not based on hourly rates, contingent fee compensated attorneys do not have the same need to allocate hours worked to particular clients that hourly-compensated attorneys have. Further, even if the plaintiff's attorney did track time spent on the case, it may be extremely difficult to allocate time between work performed to produce the taxable interest (or punitive) damage award and that done in furtherance of the non-taxable personal injury award.[120] Indeed, the interest or punitive award in most cases would not exist without the personal injury award, so the amounts are inextricably tied to each other. Consider an attorney representing a personal injury plaintiff who won a judgment at the trial court level that carried post-judgment interest, and was required to defend that judgment on appeal. The attorney would undoubtedly have a difficult time distinguishing hours spent advocating for the affirmation of the underlying award from those spent arguing to retain the interest component of the award. Although there will be clear cases where the amount or computation of interest is the only issue on appeal, those cases will likely be rare, and any requirement to allocate hours or other work product would be fraught with technical hurdles and extreme confusion.

C. Illustration

To illustrate the potential impact of interest over time on the litigant taxpayer as well as the different allocation of expense approaches, let us explore the following fact pattern: Plaintiff is injured in a commercial vehicle accident and ultimately awarded $3,000,000 in compensatory damages. Post-judgment interest runs at ten percent per annum beginning the day after the judgment is rendered. To isolate the deduction problem

---

119. *See, e.g.*, Mardirossian & Assocs. v. Ersoff, 153 Cal. App. 4th 257, 270 (2007) ("Although none of M & A's contingency fee lawyers kept billing records, each planned to testify that he or she could recall the amount of time spent in total on Ersoff's case, albeit not the amount of time spent preparing each piece of correspondence, discovery or pleading.").

120. Whether a pro rata approach accurately reflects the costs of producing the taxable and tax-exempt portions is questionable. An allocation of fees based on the actual time spent on each claim may present a more accurate alternative. However, rigorous records of hourly fees are typically not maintained in litigation governed by contingent fee agreements. Moreover, overlapping benefits from efforts to pursue taxable and tax-exempt claims may make it difficult to trace attorney time to a particular claim over another. Edward A. Morse, *Taxing Plaintiffs: A Look at Tax Accounting for Attorney's Fees and Litigation Costs*, 107 DICK. L. REV. 405, 490-91 (2003) (citations omitted).

and to simplify the calculation, assume that the plaintiff is unmarried, has no dependents, and has no additional sources of income or itemized deductions.[121] The plaintiff has entered into a contingent fee arrangement with the attorney which entitles the attorney to forty-five percent of the gross recovery at any stage of the litigation beyond the jury trial.[122] Finally, assume litigation expenses incurred to obtain the award will be approximately ten percent of the recovery. All figures are based on tax liability for 2011.

If the plaintiff were paid immediately after the jury trial, the plaintiff would pocket approximately $1,350,000 after paying her attorney $1,350,000 and litigation costs of $300,000.

Figure 1
Immediate Payment Following Jury Trial

$3,000,000	Non-taxable recovery
($1,350,000)	Attorney's Fee (45%)
($300,000)	Costs
$1,350,000	Net to Plaintiff

However, let us assume (very realistically) that in addition to the commercial vehicle driver and the driver's employer or contracting firm, several insurance carriers are named as parties, and appeals and additional proceedings continued for at least five years following the jury verdict. After five years, with interest compounding monthly, the interest component is $1,935,000 and the gross recovery has grown from $3,000,000 to $4,935,000. At this point, the plaintiff would be responsible for an attorney's fee of approximately $2,220,000 at forty-five percent. Although it is likely the attorney might have negotiated for a higher percentage of the recovery by this time, and that litigation costs

121. While not the subject of this article, the state tax impact is too significant to completely ignore. To this end, I have included calculations reflecting some very typical state tax consequences for the plaintiff. Assume for these purposes that the plaintiff is a resident of Kansas and pays Kansas state income tax on any taxable portion of the award. Kansas has compressed marginal individual income tax rates similar to the federal individual income tax system. For an individual (non-joint) filer, a tax rate of 3.5% applies to the first $15,000 of Kansas income; a rate of 6.25% applies to income between $15,000 and $30,000 and a rate of 6.45% applies to any excess of $30,000. KAN. STAT. ANN. § 79-32,110 (2008).

122. Again, this number would likely vary between one-third and fifty percent at various points during the litigation, but for the sake of simplicity and isolating the tax issues, I have maintained a forty-five percent attorney's fee throughout the illustration.

would have risen as well, we will keep the contingent fee percentage and total amount of expenses constant in order to appreciate more easily the tax consequences.

Figure 2 **After 5 years (pre-tax)**	
Gross Recovery	$4,935,000
Attorney's Fee	($2,220,000)
Costs	($300,000)
Recovery before taxes	$2,415,000

If the plaintiff is able to claim the entire amount of the attorney's fee and costs as a deduction, presumably by allocating those amounts entirely to procuring taxable interest,[123] she would still face federal tax liability of $538,300 (arising from the $1,935,000 of interest).[124] On the other hand, if the plaintiff is able to deduct the attorney's fees and costs only to the extent that the award or settlement is taxable,[125] her deduction would be limited to thirty-nine percent of such costs because only thirty-nine percent ($1,935,000/$4,935,000) of the total recovery is taxable.

Because of the operation of the AMT, this has no impact on the federal tax liability,[126] but in most cases results in a significant increase in state

123. This is an extremely unlikely, if not impossible, scenario, but one that demonstrates the limited utility of the deduction for the attorney's fees and costs, even if fully available.

124. The 100% deductibility scenario is calculated as follows: the plaintiff has $1,935,000 of interest income, which is also her adjusted gross income ("AGI"). Her deductible expenses would be $2,200,000 of attorney's fees and $300,000 of other litigation costs, which combined would be reduced by two percent of her AGI, or $38,700, to $2,481,300. When added to the $3,700 personal exemption, her total deductions from AGI are $2,485,000, resulting in a taxable income of ($550,000), obviously giving rise to no regular tax. However, the AMT liability would be computed without the deduction for attorney's fees and expenses. The AMT exemption of $48,450 would be completely phased out and therefore the taxable excess would be $1,935,000 on which a tentative minimum tax of $538,300 would be due.

125. This approach is consistent with the *Church v. Commissioner*, 80 T.C. 1104, 1111 n.8 (1983), formula for allocating deductible and non-deductible attorney's fees. *See supra* text accompanying note 113.

126. The thirty-nine percent deductibility scenario is calculated as follows: the plaintiff still has $1,935,000 of interest income, which is also her AGI. Her deductible expenses, however, would be $866,000 of attorney's fees (approximately thirty-nine percent of $2,220,000 of fees paid) and $117,000 of other litigation costs (thirty-nine percent of $300,000 of other litigation costs paid), which combined would be reduced by two percent of her AGI, again $38,700, to $944,300. When added to the $3,700 personal exemption, her

tax liability.[127] Finally, if the plaintiff is only allowed to deduct the portion of the fees and costs that could be traced to work actually performed in furtherance of recovering taxable interest (under the origin-of-the-claim doctrine), perhaps ten percent or less of the expenses could be deducted. In other words, under the ten percent deductibility scenario, we are assuming that the plaintiff can only show that ten percent of the attorney's fees and other litigation costs relate to the recovery of taxable interest, the remainder being disallowed as a deduction under § 212 because it relates to the non-taxable income from the personal injury recovery. The ten percent deductibility scenario results in only a slightly higher federal tax liability of $578,614.[128]

Figure 3
After 5 Years (Tax Impact)[1]

	If 100% deductible	**If deduction tied to recovery**	**If 10% deductible**
		(39% taxable/ deductible)	(origin-of claim)
Recovery before Taxes	$2,415,000	$2,415,000	$2,415,000
Federal Tax	$538,300	$538,300	$578,614
State Tax	$0	$63,283	$110,432
Net to Plaintiff	$1,876,700	$1,813,417	$1,725,954

total deductions from AGI are $948,000, resulting in a taxable income of $987,000. This taxable income gives rise to $322,764 of regular tax and $215,536 of alternative minimum tax, for a total of $538,300 in total federal income taxes.

127. Kansas does not have an alternative minimum tax. In states like California that have an alternative minimum tax, this calculation would obviously be different. CAL. REV. & TAX. CODE § 17062 (West 2010).

128. But note the significantly higher state tax liability of $110,432. The ten percent deductibility scenario is calculated as follows: the plaintiff still has $1,935,000 of interest income, which is also her AGI. Her deductible expenses, however, would be $222,000 of attorney's fees (ten percent of $2,220,000 of fees paid) and $30,000 of other litigation costs (ten percent of $300,000 of other litigation costs paid), which combined would be reduced by two percent of her AGI, again $38,700, to $213,300. When added to the $3,700 personal exemption, her total deductions from AGI are $217,000, resulting in a taxable income of $1,718,000. This taxable income gives rise to $578,614 of regular tax and no alternative minimum tax.

After seven years, the award has grown to approximately $6,000,000 due to accruing interest, which now is half of the award ($3,000,000 of $6,000,000). Using the assumptions listed above, the successful plaintiff would now be liable for $2,700,000 of the attorney's fees (forty-five percent of $6,000,000). To account for two additional years of proceedings and filings, assume a modest increase in litigation expenses of $50,000, bringing total costs to $350,000.

Figure 4 **After 7 years:**	
Gross Recovery	$6,000,000
Attorney's Fee	($2,700,000)
Costs	($350,000)
Recovery before Taxes	$2,950,000

After seven years, the federal tax liability would be $836,500 if the fees and costs were either completely deductible[129] or deductible to the extent of taxable recovery (fifty percent)[130] and $940,269 if the expenses were only ten percent deductible.[131]

129. The 100% deductibility scenario is calculated as follows: the plaintiff has $3,000,000 of interest income, which is also her AGI. Her deductible expenses would be $2,700,000 of attorney's fees and $350,000 of other litigation costs, which combined would be reduced by two percent of her AGI, or $60,000, to $2,990,000. When added to the $3700 personal exemption, her total deductions from AGI are $2,993,700, resulting in a taxable income of $6300, which gives rise to $630 of regular tax. However, the alternative minimum taxable income would be $3,000,000 (unreduced for personal exemptions or miscellaneous itemized deductions), which generates an alternative minimum tax of $835,870 and a total of $836,500 in federal income taxes.

130. The fifty percent deductibility scenario is calculated as follows: the plaintiff has $3,000,000 of interest income, which is also her AGI. Her deductible expenses would be $1,350,000 of attorney's fees (fifty percent of $2,700,000 of fees paid) and $175,000 of other litigation costs (fifty percent of $350,000 of other litigation costs paid), which combined would be reduced by two percent of her AGI, or $60,000, to $1,465,000. When added to the $3700 personal exemption, her total deductions from AGI are $1,468,700, resulting in a taxable income of $1,531,300. This taxable income gives rise to $513,269 of regular tax. Again, the $3,000,000 of alternative minimum taxable income generates $323,231 of alternative minimum tax, for a total of $836,500 in total federal income taxes.

131. This scenario produces an even more significant variation of the state tax liability, up to $177,080. The ten percent deductibility scenario is calculated as follows: the plaintiff still has $3,000,000 of interest income, which is also her AGI. Her deductible expenses

Again, we arrive at this result because although compensation (whether by settlement or judgment) for personal injuries is excluded from income,[132] interest earned or accrued with respect to such payments is not excludable from income.[133] Following the Supreme Court's ruling in *Commissioner v. Banks*,[134] even if a portion of the plaintiff's award is payable directly to his or her attorney under a contingency fee arrangement, that amount is taxable to the plaintiff.[135] While a taxpayer is allowed to deduct his or her attorney's fees attributable to the taxable portion of the recovery,[136] the deduction is a miscellaneous itemized deduction, limited to the amount that exceeds two percent of the taxpayer's adjusted gross income,[137] and will be subject to the AMT, which disallows the use of miscellaneous itemized deductions, including attorney's fees, in computing the tax liability.[138]

Figure 5
After 7 Years (Tax Impact)

	If 100% deductible	**If deduction tied to recovery**	**If 10% deductible**
		(50% taxable/ deductible)	(based on origin-of claim)
Recovery before Taxes	$2,950,000	$2,950,000	$2,950,000
Federal Tax	$836,500	$836,500	$940,269
State Tax	$271	$96,423	$177,080
Net to Plaintiff	$2,113,229	$2,017,077	$1,832,651

would be $270,000 of attorney's fees (approximately ten percent of $2,700,000 of fees paid) and $35,000 of other litigation costs (ten percent of $350,000 of other litigation costs paid), which combined would be reduced by two percent of her AGI, or $60,000, to $245,000. When added to the $3700 personal exemption, her total deductions from AGI are $248,700, resulting in a taxable income of $2,751,300. This taxable income gives rise to $940,269 of regular tax. There is no alternative minimum tax liability under this scenario.

132. I.R.C. § 104(a)(2)(2010).
133. *Id.* § 61(a)(4).
134. 543 U.S. 426 (2005).
135. *Id.* at 430.
136. *See* I.R.C. § 212 (2006).
137. *Id.* § 67.
138. *Id.* § 56(b)(1)(A).

A few points are readily apparent when examining the life cycle of the hypothetical lawsuit involving a significant interest component. Perhaps most important, the plaintiff benefits less than almost any other party as the lawsuit drags on through years of litigation. Using the pro rata (thirty-nine percent) deductibility scenario, the plaintiff's net recovery grew by $463,417 (from $1,350,000 to $1,813,417) during the five years following the jury verdict, or approximately 34.33%. During this same time, the IRS's portion has increased from nothing (as the initial award was not taxable) to $538,300. The attorney's share has increased by $870,000 (from $1,350,000 to $2,220,000), or 64.44%.

Between years five and seven, still using the pro rata (now fifty percent) deductibility scenario, the plaintiff's net recovery has increased only $203,660 (from $1,813,417 to $2,017,077), or approximately 11.23%. Of course, the plaintiff has had no access to the award or settlement funds in the meantime. In contrast, the federal government's take has increased by $298,200 (from $538,300 to $836,500), or approximately 55.40%. Finally, the attorney's portion has increased by $480,000 (from $2,220,000 to $2,700,000), or approximately 21.62%.

In other words, after five years from the date of the jury award, under the pro rata (thirty-nine percent) deductibility scenario, the plaintiff is ultimately receiving only $463,417 of $1,935,000 of interest, or approximately twenty-four cents of every dollar of interest recovered. The federal government is getting approximately twenty-eight cents of every dollar of interest ($538,300 of $1,935,000) and the plaintiff's attorney is entitled to approximately forty-five cents of every dollar of interest ($870,000 of $1,935,000). Between years five and seven, the plaintiff is receiving approximately nineteen cents of every dollar of interest recovered ($203,660 of $1,065,000). The IRS receives approximately twenty-eight cents of every dollar of interest ($298,200 of $1,065,000) and the plaintiff's attorney retains approximately forty-five cents of every dollar of interest recovered ($480,000 of $1,065,000).

During the seven year post-judgment period, the plaintiff is ultimately receiving only $667,077 of $3,000,000 of interest, or approximately twenty-two cents of every dollar of interest recovered. The Treasury is getting approximately twenty-eight cents of every dollar of interest ($836,500 of $3,000,000) and the plaintiff's attorney maintains forty-five cents of every dollar of interest ($1,350,000 of $3,000,000).

The results clarify the point that the plaintiff's attorney and the federal government have much to gain from the lawsuit continuing for years while the plaintiff's relative recovery steadily diminishes. Clearly, the policy served by post-judgment interest of making the plaintiff whole for injuries is not promoted in this context.

Additionally, litigation strategy may be impacted by these tax results. While no one is suggesting that a plaintiff's lawyer would intentionally drag out a personal injury recovery unnecessarily,[139] a new and perhaps unnecessary strain on the attorney-client relationship is introduced when the economic interests of the parties are not in accord, if not at odds.[140] More likely, an astute defense counsel could suggest that it is in the plaintiff's best interest to settle for a lesser amount than the jury award and accumulated interest early since the plaintiff will not be adequately compensated for the time value of money as the lawsuit drags on. When the plaintiff ultimately nets twenty percent or less of the interest paid, while the IRS gets thirty percent and the plaintiff's attorney continues to receive forty-five percent, the relative motivation for an informed plaintiff to settle earlier is obvious.

III. Previously Proposed Solutions to the Inclusion Problem

Courts and tax scholars have previously addressed the tax issues presented by inclusion of the attorney's portion of the plaintiff's recovery in the plaintiff's gross income, but have primarily focused on the wholly-taxable award context. Also, the solutions proposed have, for the most part, been foreclosed by the *Banks* decision or present significant conceptual or logistical hurdles. This part addresses some of those proposals and examines their shortcomings in the partially non-taxable recovery context.

A. Minority View Prior to Banks: Contingent Fee Arrangement Results in Immediate Transfer of a Portion of the Claim to the Attorney

One minority view in the circuit split that existed prior to the Supreme Court's decision in *Commissioner v. Banks*[141] characterized contingent fee arrangements as resulting in an immediate transfer of a portion of the

139. The lawyer has an obvious incentive to settle as soon as possible to recover costs fronted for litigation and free up resources tied to the case.

140. Scholars have acknowledged a similar tension between the attorney's interests and the interests of the client brought about by the alternative minimum tax trap. Hellwig & Polsky, *supra* note 39, at 922 ("[B]ecause of the AMT trap, it may actually be in the plaintiff's best interests to not petition for fees. In contrast, it would obviously be in the attorney's best interests for the plaintiff to file the petition, as it would increase his fees.").

141. 543 U.S. 426 (2005).

plaintiff's claim to the attorney.[142] This was the position taken by the Ninth Circuit interpreting Oregon law in *Banaitis v. Commissioner*,[143] which was consolidated into the Supreme Court's decision in *Banks*.[144] In *Banaitis*, the Ninth Circuit held that "Oregon law vests attorneys with *property interests* that cannot be extinguished or discharged by the parties to the action except by payment to the attorney."[145]

The assignment or immediate transfer view appears to have originated with the 1959 Fifth Circuit case, *Cotnam v. Commissioner*,[146] in which a plaintiff retained an attorney under a contingent fee arrangement to pursue a contract claim relating to a promise to provide for the plaintiff in a will.[147] The *Cotnam* court relied upon an Alabama attorney's lien law that provided that attorneys had the same "right and power" over suits and judgments to enforce their liens as their clients.[148] In this sense, the court determined that "[a]ttorneys have the same rights as their clients[,]" and accordingly, "[u]nder Alabama law, [the plaintiff] could never have received the [the attorney's portion of the recovery], even if she had settled the case directly with the Bank."[149] Therefore, "[t]his sum was income to the attorneys but not to [the client]."[150]

Likewise, in *Foster v. United States*,[151] the Eleventh Circuit found it inappropriate to tax the plaintiff on amounts due immediately to her attorney under a contingency fee arrangement. In that case, "[a]fter the jury verdict, but before an appeal was filed, Foster negotiated with her attorneys that, if they represented her on appeal, they could take all of the post-judgment interest, if any, rather than just the half they were entitled

142. Jackson, *supra* note 41, at 69-72. *See generally* Foster v. United States, 249 F.3d 1275 (11th Cir. 2001), *overruled by* Comm'r v. Banks, 543 U.S. 426 (2005); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959), *overruled by* Comm'r v. Banks, 543 U.S. 426 (2005).

143. 340 F.3d 1074 (9th Cir. 2003), *rev'd*, Comm'r v. Banks, 543 U.S. 426 (2005); *see supra* note 63 and accompanying text.

144. 543 U.S. at 431.

145. 340 F.3d at 1083 (emphasis added).

146. 263 F.2d 119 (5th Cir. 1959).

147. *Id.* at 120-21, 125.

148. *Id.* at 125 (citing 46 ALA. CODE § 64 (1940)).

149. *Id.* (citing Denson v. Ala. Fuel & Iron Co., 73 So. 525 (Ala. 1916); W. Ry. of Ala. v. Foshee, 62 So. 500 (Ala. 1913)).

150. *Id.* at 125.

151. 249 F.3d 1275 (11th Cir. 2001), *overruled by* Comm'r v. Banks, 543 U.S. 426 (2005).

to based on the pre-trial contingency fee agreement."[152] The Eleventh Circuit refused to look simply to the assignment of income doctrine, and instead found the arrangement "more like a division of property than an assignment of income."[153]

Professors Brant Hellwig and Greg Polsky have published extensively in the areas of taxation of litigation expenses, the alternative minimum tax ("AMT") implications on awards, and structuring settlements from a tax perspective.[154] Their 2004 article, *Litigation Expenses and the Alternative Minimum Tax*,[155] described the AMT trap that faces successful litigants and evaluated the then-current arguments and proposals for ameliorating the effects of the AMT on recoveries.[156] Hellwig and Polsky criticized the immediate transfer approach taken by the pre-*Banks* minority circuits, arguing against construing the contingent fee arrangement as an immediate transfer of anything for tax purposes.[157] Instead, in their view, the contingent arrangement was merely a promise to pay on the part of the plaintiff upon disposition of the claim.[158] In that case, the plaintiff would include the entire recovery in gross income and then deduct the fees once paid.[159] Further, even if the contingent fee arrangement were deemed an immediate transfer, tax law would still require inclusion and deduction.[160]

---

152. *Id.* at 1279.

153. *Id.* at 1280 (quoting Estate of Clarks v. United States, 202 F.3d 854, 857-58 (6th Cir. 2000)).

154. *See, e.g.*, Hellwig & Polsky, *supra* note 39; Hellwig, *supra* note 75; Gregg D. Polsky & Brant J. Hellwig, *Taxing Structured Settlements*, 51 B.C. L. REV. 39 (2010).

155. Hellwig & Polsky, *supra* note 39.

156. *Id.* at 901-02, 912-21, 931-38.

157. *Id.* at 906-07.

158. *Id.* at 906.

159. *Id.*

160. *Id.* at 907-08; Jackson, *supra* note 41, at 95.

> The granddaddy of those cases, Cotnam v. Commissioner, supra, a 2-1 opinion (so far as relates to the issue in our case) with Judge Wisdom dissenting, states its rationale as follows: 'The amount of the contingent fee was earned, and well earned, by the attorneys. True, in a remote rather than a proximate sense, the entire amount of the judgment had also been earned by Mrs. Cotnam, but she could never have collected anything or have enjoyed any economic benefit unless she had employed attorneys, and to do so, she had to part with forty per cent of her claim long before the realization of any income from it.' 263 F.2d at 126. This rationale badly flunks the test of neutral principles. It is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion from income.

Kenseth v. Comm'r, 259 F.3d 881, 885 (7th Cir. 2001).

Code § 83 would govern the transfer in connection with services, and because the lawyer's interest would be "subject to a substantial risk of forfeiture" until liquidation of the claim, the tax consequences would be held in abeyance until the risk of forfeiture lapsed (i.e., upon liquidation).[161] At liquidation, however, the plaintiff would realize gain on the disposition of the attorney's portion of the claim.[162]

Another concern with the immediate transfer approach is whether an attorney could ethically receive a property interest in the underlying cause of action.[163] The immediate interest transfer approach relies in large part on state attorney lien laws, which can give an attorney a priority creditor status with respect to litigation proceeds.[164] When this priority is

---

161. Hellwig & Polsky, *supra* note 39, at 907.

162. *Id.*

> A brief consideration of the tax ramifications of treating a plaintiff who is party to a contingent fee agreement as realizing the benefit of the attorney's services upon assigning a portion of the claim proceeds to the attorney illustrates the fallacy of treating the fee agreement as effecting a present assignment of anything for tax purposes. It is far more likely that the plaintiff and attorney each viewed the fee agreement as memorializing the plaintiff's conditional promise to compensate the attorney based on a predetermined formula, a characterization which would not yield tax consequences unless and until the attorney was actually paid the contingent fee. Furthermore, this must have been what the Court had in mind in *Banks*, as it regarded the taxpayers as realizing gross income from the payment of their attorney's fees in the year of payment . . . . Specifically, the Court did not view the fee agreement as effecting a completed assignment, but rather as constituting a promise to pay in the future. This leap of faith negates the relevance of the assignment of income doctrine to the transaction. This reconciliation of the *Banks* decision seems appropriate, as the assignment of income doctrine is best understood as an equitable doctrine to be used to attribute gratuitously assigned income to the assignor when necessary to achieve a reasonable and fair imposition of the tax burden.

Hellwig, *supra* note 75, at 789-90 (citations omitted).

163. *See* Jackson, *supra* note 41, at 123 (noting ethical concerns arising from the assignment of income doctrine and stating that treating lawyers and their clients as partners undermines a lawyer's objectivity, independence and the obligation to act as an agent of the client for the exclusive benefit of the client); Reece, *supra* note 21, at 332-33.

164. *See supra* text accompanying notes 127-33.

> Prior to the Supreme Court decision in *Banks*, several United States circuit courts in their discussions of whether or not to include contingent attorney fees in the taxpayer's gross income had included in their opinions the effect of state attorney lien statutes. As described in *Estate of Clarks*, the common law attorney's lien is unlike 'any other lien known to the law' because it creates a property right in the judgment without the attorney having possession of the judgment awarded. 'It is a peculiar lien, to be enforced by peculiar methods.' In fact, the United States Circuit Court of Appeals for the Second Circuit in

construed as a property interest such that it removes the portion of the recovery paid directly to the attorney from the plaintiff's taxable income, one can legitimately question the propriety of the arrangement.[165] If the attorney actually acquires a portion of the underlying cause of action, even with diminished rights to the ultimate disposition of such a property interest, the attorney may run afoul of the letter, if not the intent, of the ABA's Model Rules of Professional Conduct ("MRPC").[166]

MRPC 1.8 provides that an attorney "shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client."[167] The attorney may, however, "acquire a lien authorized by law to secure the lawyer's fee or expenses; and . . . contract with a client for a reasonable contingent fee in a civil case."[168] Although the model rule clearly allows the attorney to contract with the client for a contingent fee, which is precisely the arrangement at issue, any attempt to construe the relationship or the relative ownership of the property (i.e., the cause of action) as something beyond a contingent promise to pay is at least arguably in conflict with the attorney's ethical responsibility to refrain from interfering with the client's proprietary rights in the action.[169] Given this ethical framework, it may be wise for lawyers to avoid future attempts to persuade courts that their rights in the case exceed anything other than those of a priority creditor.

Another practical consideration regarding the attempt to adopt an immediate transfer approach to the contingent fee arrangement is that reliance on state attorney lien statutes requires a state-by-state analysis[170]

> *Raymond* even went so far as to say that 'to the extent that most courts to consider the issue have indicated that the analysis of state law is determinative, this is perhaps not a true 'circuit split.''

Jennifer J. Loomis, *The Taxation of Contingent Attorney Fees: Did the Supreme Court Correctly Decide* Commissioner v. Banks*?*, 33 N. KY. L. REV. 115, 148 (2006) (citations omitted).

165. *See* Reece, *supra* note 21, at 332 ("[A]ssignment of a legal interest to an attorney handling that interest as the client's agent, carries unmistakable ethical twists," and "'[a]lthough the rules of ethics require attorneys to zealously advocate for their clients, allowing an attorney to become a 'partner' in a client's cause of action creates ethical problems.'") (alteration in original) (quoting Bernard J. Grant, III, *No Taxation Without Realization:* Srivastava v. Commissioner*, The Fifth Circuit's Answer to Tax Treatment of Attorney's Fees Under a Contingency Agreement*, 32 ST. MARY'S L.J. 363, 376 (2001)).

166. *Id.* at 332-33.

167. MODEL RULES OF PROF'L CONDUCT R. 1.8(i) (2011).

168. *Id.* 1.8(i)(1)-(2).

169. *See* Reece, *supra* note 21, at 333-34.

170. *See id.* at 319-20 ("[I]ncome to a particular taxpayer depends strictly on state law

and produces disparate results depending on the exact wording of a state's particular law.[171] It is beyond question that property rights and the priority of an attorney/creditor are primarily determined under state law.[172] It is also clear that minor distinctions in a state's attorney lien statute can produce dramatically different assessments of the relative rights of the attorney and client with respect to the underlying cause of action.[173] For example, the Ninth Circuit in *Banaitis* found Oregon attorney lien law unique:

---

definition of property or property interests. The *Cotnam* court and others argued that state statutes creating attorney's liens actually create a proprietary interest in the claim." (citation omitted)).

171. *Id.* at 331 ("The interpretations of state equitable lien statutes create a serious problem of non-uniformity in the taxation of awards to clients.").

172. The Ninth Circuit in *Banaitis v. Commissioner* viewed the question of whether the attorney's portion of a recovery under a contingency fee agreement should be included as part of the plaintiff's gross income as a two-part inquiry: "(1) how state law defines the attorney's rights in the action, and (2) how federal law operates in light of this state law definition of interests." 340 F.3d 1074, 1081 (2003) (citations omitted), *reversed by* Comm'r v. Banks, 543 U.S. 426 (2005); *see* Reece, *supra* note 21, at 326 ("The attorney lien which is important for the discussion herein is the 'charging lien.' An attorney's charging lien is a common law, sometimes a statutory, equitable lien, like a mechanic's lien."); *see also* Thad Austin Davis, Cotnam v. Commissioner *and the Income Tax Treatment of Contingency–Based Attorneys' Fees The Alabama Attorney's Charging Lien Meets* Lucas v. Earl *Head-On*, 51 ALA. L. REV. 1683, 1688, 1690 (2000) ("The attorney's charging lien exists in both statutory and common law form. . . . The charging lien often has priority over other liens and can even take priority over a defendant's right of setoff.").

173. Reece explains:

> In a state where an attorney's lien is interpreted as an equitable property interest, the courts could view the contingent fee agreement as an assignment of property right . . . and hold that part of the award is not taxable to the client. In a state where an attorney's lien is deemed a security interest, the anticipatory assignment of income doctrine will require clients to pay taxes on the full amount of the award because attorney lien statutes in those states are interpreted to provide no proprietary right in the claim.

Reece, *supra* note 21, at 331-32; *see also* Jackson, *supra* note 41, at 81-82 ("The court agreed with the Fifth Circuit's reasoning in *Srivastava*, that 'the answer [as to whether to apply *Cotnam*] does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state.' The court recognized that such a state-by-state approach would not provide uniformity of result in tax consequences throughout the country." (alteration in original) (quoting Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003)); Reece, *supra* note 21, at 330 ("First, the dependence upon state interpretation of attorney lien statutes creates a lack of uniformity between the states and may violate the Constitutional pronouncement of uniformity in taxation.").

> Oregon law . . . affords attorneys generous property interests in judgments and settlements. . . . Put simply, Oregon law vests attorneys with property interests that cannot be extinguished or discharged by the parties to the action except by payment to the attorney. . . . Because of the unique features of Oregon law, we conclude that fees paid directly to [the attorney] were not includable in Banaitis' gross income for the relevant year.[174]

Moreover, courts analyzing state lien statutes would likely make a wide range of determinations of these relative rights and as a result, lend great uncertainty to the plaintiff's tax situation for a number of years until a consensus could be reached by the courts or uniform laws enacted. More importantly, there remains a serious question about whether there is any substantive distinction among the state attorney lien laws or whether, instead, the "economic reality facing the *taxpayer-plaintiff*" is not meaningfully affected.[175]

Although many of these issues were not directly addressed by the Supreme Court in *Banks*, the ruling in *Banks*, relying on the anticipatory assignment of income doctrine to place the income initially in the plaintiff's hands for tax purposes, forecloses the immediate transfer argument for the foreseeable future.[176] Those seeking aid for plaintiffs shouldering the tax burden of the attorney's share of their recovery will have to look elsewhere for a realistic possibility of relief.

B. Attacking the Use of the Anticipatory Assignment of Income Doctrine

The majority of circuit courts[177] prior to *Commissioner v. Banks*, and ultimately the Supreme Court in *Banks*, required the plaintiff to include the recovery in whole and then take a deduction for the amounts paid to the attorney pursuant to the contingent fee arrangement.[178] These courts relied, to one degree or another, on the anticipatory assignment of income

---

174. 340 F.3d at 1082-83. Similar state law specific determinations were made applying Alabama law in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), and *Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001).

175. Hellwig & Polsky, *supra* note 39, at 910 (quoting Srvivasava v. Comm'r, 220 F.3d 353, 364 (2000)).

176. 543 U.S. 426, 435 (2005) ("In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation.").

177. *See supra* note 41 and accompanying text.

178. *Banks*, 543 U.S. at 430, 434.

doctrine enunciated in *Lucas v. Earl*[179] and applied to income from property in *Helvering v. Horst*.[180] In 2004, Hellwig and Polsky argued that the majority view of the circuits at that time inappropriately applied the assignment of income doctrine to arm's-length commercial transactions like contingent fee arrangements.[181] This position was reiterated in Professor Leah Witcher Jackson's 2005 article, *Won the Legal Battle, but at What Tax Costs to Your Client: Tax Consequences of Contingency Fee Arrangements Leading up to and After* Commissioner v. Banks.[182] In her article, Jackson explored the inclusion and deductibility landscape immediately following the *Banks* decision.[183] According to Jackson, because the contingent fee agreement is an arm's-length agreement, with the attorney using her skill, training, and expertise to earn a portion of the award, the shift of income cannot be considered to be gratuitous and thus does not fall under the umbrella of the anticipatory assignment of income doctrine.[184]

Hellwig revisited this position following the *Banks* decision in 2006 and again concluded that the assignment of income doctrine was inappropriately applied outside of the gratuitous transfer context.[185] Hellwig noted that a significant justification for applying the assignment of income doctrine rests on preventing taxpayers from undermining the progressive tax system through intra-family or otherwise friendly

179. 281 U.S. 111 (1929); *see supra* notes 45-50 and accompanying text. The Supreme Court first invoked the assignment of income doctrine in the context of an arm's-length transaction in *United States v. Basye*, 410 U.S. 441, 447 (1973). *See* Hellwig, *supra* note 75, at 795-96.

180. 311 U.S. 112 (1940); *see supra* notes 52-56 and accompanying text.

181. Hellwig & Polsky, *supra* note 39, at 908-09 (describing the majority view in which the courts determined that contingent fee arrangements transferred only the right to the proceeds of the attorney's fee portion of the recovery, and not that portion of the recovery, and noting that because this would be a transfer of "income" rather than a transfer of "property," the transfer would be wholly ignored under the assignment of income doctrine and instead taxed entirely to the plaintiff, who could then possibly deduct her costs to produce the income).

182. Jackson, *supra* note 41.

183. *Id.* at 102-05.

184. *Id.* at 102.

185. Hellwig, *supra* note 75, at 780-81; *see also* Reece, *supra* note 21, at 315 (citing Kathryn J. Ball, *Horizontal Equity and the Tax Consequences of Attorney-Client Fee Agreements*, 74 TEMP. L. REV. 387, 406 (2001); Stanislava B. Kimball, *Explaining a Circuit Split: Contingency Fees May Constitute Clients' Gross Income Depending on Whether the State Law Permits the Assignment of a Cause of Action to Create a Property Ownership Interest*, 51 CATH. U. L. REV. 583 (2002)).

transactions.[186] Without the existence of this tax rate contravention motivation in arm's-length transactions, the normal principles of income realization should be applied, and there is no need to assert the assignment of income doctrine.[187] Indeed, in Professor Hellwig's view, *Banks* expands the assignment of income doctrine to property transactions far beyond the original utility of the doctrine and obfuscates the transactional analysis of taxpayers in otherwise bona fide and straightforward arrangements.[188]

Notwithstanding this criticism, it is clear that in the wake of *Banks*, the Supreme Court will now view a contingent fee arrangement between an attorney and a client as an anticipatory assignment of income,[189] with the result that the plaintiff will be unable to exclude from income the attorney's portion of a taxable award or payment.[190] This again suggests that a legislative solution will be necessary in order to provide plaintiffs with relief from the tax burden resulting from inclusion of the attorney's contingent share of the recovery in the plaintiff's taxable income.

C. Other Approaches

1. Partnership or Joint Venture

Another approach cited in the plaintiff's argument in the *Banks* case was to treat the contingent attorney fee arrangement as a type of partnership agreement or joint venture.[191] This argument suggests that in

---

186. Hellwig, *supra* note 75, at 772-73.

187. *Id.*; *see also* Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 633 (1993) ("The vice of a gratuitous assignment of income is that, if respected for tax purposes, it would enable the assignor to *shift* the incidence of tax on the assigned income to one or more other taxpayers. . . . If, however, the assignor assigns his earned income for full and adequate consideration, that is, if he 'sells' his right to the earned income for its full value, the incidence of taxation will not be shifted since the taxpayer will receive, and report as taxable income, one dollar for every dollar of income he assigns. Since the vice which the doctrine seeks to prevent does not exist in this case, there is no reason to apply the doctrine.").

188. Hellwig, *supra* note 75, at 781-82. The assignment of income doctrine's original purpose was to "plug[] statutory gaps" in the I.R.C. and provide guidance to parties as to which should report income in ambiguous situations. *Id.* at 781.

189. 543 U.S. 426, 434 (2005).

190. Black, Black & Black, *supra* note 72, at 1 ("The Supreme Court said that the income-generating asset is the cause of action. The full value of the recovery from the cause of action will be included in the taxpayers' income under the assignment of income doctrine.").

191. *Id.* at 436 ("We further reject the suggestion to treat the attorney-client relationship

agreeing to the contingent fee contract, the plaintiff enters into a partnership or joint venture with the attorney in which the attorney contributes services and the plaintiff contributes a portion of either the cause of action itself or the ultimate recovery. If this arrangement is indeed a partnership under Subchapter K of the I.R.C., then the plaintiff's contribution of property (the cause of action) in exchange for a partnership interest and the attorney's contribution of services in exchange for a partnership interest would be initially tax-free under Code § 721.[192] At the point when the cause of action, combined with the attorney's services, is reduced to a cash judgment, the income would be allocated among the partners in accordance with the partnership agreement (i.e., the contingency fee) according to Code § 704(a).[193] That is, the attorney would be allocated her portion of the recovery for tax purposes, and the plaintiff would not be subject to tax on the attorney's portion.[194] The Sixth Circuit favorably referenced this view, among others, in its holding for the taxpayer in the portion of *Banks* that was ultimately appealed to the Supreme Court from that circuit.[195] Hellwig and Polsky reviewed this argument in 2004 and found that this approach leads quickly back to Code § 83, as a transfer of property in exchange for services similar to those approaches discussed above.[196]

Perhaps an even simpler analysis could dispose of this argument. According to the Revised Uniform Partnership Act (1997) ("RUPA"), a "partnership" is "an association of two or more persons to carry on as co-owners a business for profit."[197] It strains reason to construe as "profit" the award or settlement that a plaintiff and her attorney are seeking to

---

as a sort of business partnership or joint venture for tax purposes.").

192. *Id.* at 437; *see also* I.R.C. § 721(a) (2006) ("No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."); Brief for the Respondent at 15-16, Comm'r v. Banks, 543 U.S. 426 (2005) (No.03-892).

193. Brief for the Respondent Banaitis at 5, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-907), 2004 WL 183536; Hellwig & Polsky, *supra* note 39, at 913.

194. I.R.C. § 704(a); Brief for the Respondent Banaitis, *supra* note 193, at 5-6.

195. Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003) (citing to that court's earlier findings in Estate of Clarks v. United States, 202 F.3d 854, 857-58 (6th Cir. 2000)) ("[W]e found other factors persuasive in distinguishing contingency fees from *Lucas* and *Horst*, including . . . taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds."), *reversed by* Comm'r v. Banks, 543 U.S. 426 (2005).

196. Hellwig & Polsky, *supra* note 39, at 913-14.

197. REVISED UNIF. P'SHIP ACT § 101(6) (1997).

recover in a personal injury lawsuit. Even the interest component of such an award, which is taxable, could not easily be construed as a "profit" in any usual or legal sense of the term.[198] The policy behind most post-judgment and other interest payments is to compensate the recipient for the lost time value of the money that has been awarded.[199] It is difficult to construe as a venture for "profit" a partnership whose sole business purpose is to recover amounts that compensate a plaintiff for a personal injury or address a deferred economic entitlement.

Similarly, the Code defines a partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on."[200] Again, two parties working together to recover compensatory damages and even interest resulting from harm done to one of the parties could hardly be construed as a business or financial operation.[201] Perhaps such an endeavor could be considered a "venture," but not in any traditional sense of the term. It is clear that the arrangement between a personal injury plaintiff and her attorney under a contingency fee contract would

---

198. *See* Bradley T. Borden, *Taxing Shared Economies of Scale*, 61 BAYLOR L. REV. 721, 755 (2009). Although Professor Borden examines the definition of "profit" in the tax definition context, he explores the broader meaning and origins of the term:

> Three potential definitions of profit exist: (1) an accounting definition, (2) a balance sheet definition, and (3) a dictionary definition. The accounting definition of profits is "net income, or the difference between revenues and expenses, for a given accounting period." . . . The balance sheet definition refers to profits as money that remains after a partnership pays all liabilities and returns partner contributions. . . . The dictionary definition is the "benefit or advantage accruing from the management, use, or sale of property from the carrying on of any process of production, or from the conduct of business."

Id. at 755-56 (citations omitted) (quoting City of Englewood v. Commercial Union Assurance Cos., 940 P.2d 948, 957 (Colo. App. 1996), which utilized the definition of profit set forth in Webster's Third New International Dictionary as "[a]n advantage, benefit, accession of good, gain, or valuable return especially in financial matters. . . . [a] benefit or advantage accruing from the management, use, or sale of property from the carrying on of any process of production, or from the conduct of business.")). All of these definitions seem to imply some sort of gain or advantage from the starting point and not merely restitution.

199. *See supra* Part II.A.; *see, e.g.*, Turner v. Japan Lines, Ltd., 702 F.2d 752, 756 (9th Cir. 1983) ("The purpose of awarding interest to a party recovering a money judgment is, of course, to compensate the wronged person for being deprived of the monetary value of the loss from the time of the loss to the payment of the money judgment.").

200. I.R.C. § 761 (2006).

201. *See generally*, Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 984-91 (2006) (describing the joint-profit motive required for recognition of a tax partnership under federal law).

not be a business or tax law partnership even from a platonic or definitional perspective.

The partnership or joint venture approach raises some of the same ethical considerations as the concept of an immediate transfer of a property interest in the cause of action to the plaintiff's attorney upon entering into the contingent fee arrangement.[202] In theory, perhaps it is possible that one partner could retain control of the ultimate disposition over the properties of the partnership while the other partner merely contributes services and waits for a potential distribution of cash from the partnership. That view, however, represents a terribly strained understanding of the attorney-client relationship (the typical principal-agent relationship as discussed below) and presents a host of challenges to identifying the actual parameters of the respective contributions, rights, and duties of the "partners."

Further, while listing Subchapter K treatment of the contingent fee arrangement among those theories of exclusion that must be developed further by lower courts, the Supreme Court in *Banks* all but foreclosed this path elsewhere in its opinion.[203] Although no intent is necessary to create a partnership, the principal difference between the partnership or joint venture and the attorney-client relationship is that the client maintains ultimate control over the case at all times.[204] Indeed, the attorney-client relationship, in the words of the Court, is the "quintessential principal-agent relationship."[205] In the Court's view, "[t]he attorney is an agent who is duty-bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal."[206] The Court also cited Judge Posner's observation that "'the contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts

---

202. *See* Jackson, *supra* note 41, at 123; Reece, *supra* note 21, at 330 ("Second, attorneys taking an ownership interest in the claim is a per se violation of the ethical rules of professional conduct.").

203. Jackson, *supra* note 41, at 119, 123.

204. *Id.* at 123 ("In an attorney-client relationship, the client maintains control. The attorney may take certain steps on behalf of the client; however, the client maintains ultimate control over the critical decisions, more like a principal-agent relationship than partners." (citing Comm'r v. Banks, 543 U.S. 426 (2005) (citing RESTATEMENT (SECOND) OF AGENCY §§ 13, 39, 387 (1957)))).

205. *Banks*, 543 U.S. at 436.

206. *Id.*

receivable.'"[207] Accordingly, "the [p]ortion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income."[208] This language leaves little doubt that a partnership or joint venture approach is far from adoption in the highest level of the judiciary.

2. Transaction Cost

The *Banks* decision also specifically declined to address a theory in which litigation recoveries are viewed as proceeds from the disposition of property under Code §§ 1001, 1012, and 1016.[209] This approach was advocated by Jackson in her 2005 article.[210] The transactional cost approach views the attorney's fee as a cost incurred in the realization of the income from the claim, which allows the individual taxpayer to pay taxes only on what she actually realized.[211] The Seventh Circuit in *Kenseth v. Commissioner*[212] applied a transactional-cost method.[213] Jackson analogized this approach to that followed for securities vending in Treasury Regulation § 1.263(a)-2(e), which specifically allows for the offset of commissions against the selling price.[214]

According to Jackson, "[a]pplication of the transactional-cost theory begins with the recognition that [a] client's claim is . . . property[,]" which has been acknowledged by the Supreme Court in *Banks*.[215] The amount realized would be offset by the basis, which would be adjusted for the costs and expenditures connected to the claim.[216] The plaintiff in this situation would be analogous to a seller of a block of stock or parcel of real estate. In both of these situations, the seller is allowed to offset the proceeds with the costs incurred to produce those proceeds.[217] According to Jackson, the transactional-cost or capital-cost method would be equitable and would ensure that the parties pay tax just on what they have

207. *Id.* at 436-37 (alteration in original) (quoting Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001)).
208. *Id.* at 437.
209. *Id.* at 437-38.
210. Jackson, *supra* note 41, at 126.
211. *Id.*
212. 259 F.3d 881 (7th Cir. 2001).
213. *Kenseth*, 259 F.3d at 883; Jackson, *supra* note 41, at 126.
214. Jackson, *supra* note 41, at 127.
215. *Id.* at 129.
216. *Id.* at 130.
217. *Id.* at 130-31.

earned.[218] Finally, she argued that the approach would work equally well for hourly and contingency fees and suggested that application of the transactional cost approach would make changes to § 62(a) unnecessary.[219]

Although Hellwig and Polksy agreed that this approach is sound from a policy standpoint and would produce an equitable result for the plaintiff, they determined that "there simply exists too much established doctrine standing in its way."[220] This position was articulated earlier in *Alexander v. IRS*,[221] in which the court found that the Code simply does not provide for the offsetting of basis in cases where a litigant sues to recover his due compensation, except in limited circumstances involving capital assets.[222] Instead, the Code provides for deductions for such litigation expenses. Accepting the transaction cost argument, according to Hellwig and Polsky, would not only entail overturning court-made doctrine, "it would [] require either ignoring or marginalizing Treas. Reg. Section 1.212-1(k)[223] . . . and would override settled expectations of those taxpayers who pay their business-related litigation costs by the hour."[224]

218. *Id.* at 133-34.

219. *Id.* at 134.

220. Hellwig & Polksy, *supra* note 39, at 921.

221. 72 F.3d 938 (1st Cir. 1995).

222. *Id.* at 944.

223. "Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income) . . . constitute a part of the cost of the property and are not deductible expenses." Treas. Reg. § 1.212-1(k) (as amended in 1975).

224. Hellwig & Polksy, *supra* note 39, at 921. The 2004 Hellwig and Polsky article wraps up with an analysis of Section 62(a)(19) (now (a)(20)) as adopted at the time:

> The need to correct the improper tax treatment of legal fees exists for all cases that are currently subject to the AMT trap – not just those relating to unlawful discrimination or broader claims arising in the employment context. There is no justifiable reason why legal fees paid or incurred to prosecute claims for defamation, intentional infliction of emotional distress, or punitive damages should be relegated to the status of miscellaneous itemized deductions that are subject to complete disallowance under the AMT. Accordingly, the AMT trap should be corrected for all possible situations in which it would otherwise arise. This could be accomplished rather easily by amending section 62(a) to add to its list of above-the-line deductions the following: *deductions allowed under sections 162 or 212 which consist of expenses paid or incurred in connection with the prosecution of a cause of action*.

Id. at 938-39. I am essentially advocating an expansion of this solution, directed instead at the taxable components of otherwise non-taxable awards.

Suffice it to say that each of these approaches presents unique and troublesome implementation issues, not the least of which is overcoming the Supreme Court's edict in *Banks*.

IV. Potential Legislative Solutions

In light of the Supreme Court's application of the anticipatory assignment of income doctrine to the contingent fee arrangement in *Commissioner v. Banks* and its refusal to adopt any of the novel attempts to re-characterize the attorney-client relationship advocated by the taxpayers in *Banks*, a legislative solution to overtaxing plaintiffs may be the only possibility for fulfilling the policy of making injured plaintiff's whole.[225] A statutory revision could provide the successful plaintiff in partially non-taxable cases (e.g., personal injury and sickness cases) with the ability to either exclude or deduct above-the-line taxable portions of the recovery which are paid to her attorney as well as court costs.[226] This approach would eliminate any need to resort to a state-by-state analysis of attorney lien statutes in order to determine what property interests, if any, the attorney had in a cause of action. It would likewise foreclose the potential for ethical questions that could be raised as a result of construing the attorney's lien as a property interest or anything beyond merely a grant of preferred creditor status.[227] A legislative solution would also remove from the domain of the judiciary the responsibility for identifying unique property rights or otherwise implementing creative theories designed to avoid the arguably unjust result of taxing clients on their attorney's share of the gross recovery. Without the need to allow these theories to work their way through the judiciary, a statutory approach provides for immediate and consistent implementation and, most importantly, for predictable results for litigants and their advisors.

A. Additional Deduction under Code § 212

Code § 212 provides for a deduction of expenses incurred in connection with the production or collection of income.[228] The Regulations interpreting § 212 explain that this deduction will not be available when the income produced is not taxable: "[N]o deduction is

225. 543 U.S. 426, 434-37 (2005).

226. Others previously have suggested or evaluated similar legislative solutions at various times. *See, e.g.*, Hellwig & Polsky, *supra* note 39, at 931-38; Jackson, *supra* note 41, at 133-34; Reece, *supra* note 21, at 338-42.

227. *See supra* notes 164-70 and accompanying text.

228. I.R.C. § 212(1) (2006).

allowable under section 212 for any amount allocable to the production . . . of income which [is] not includible in gross income . . . ."[229] Further, I.R.C. § 265(a)(1) states that "[n]o deduction shall be allowed for . . . [a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income . . . wholly exempt from the taxes imposed by this subtitle . . . ."[230] Accordingly, a special provision would be required to allow for the deduction for expenses paid (including attorney's fees and court costs) with respect to the recovery of non-taxable amounts. Below is a suggested revised Code § 212, which would provide such a deduction for cases involving personal injury or sickness (i.e., excludable under Code § 104(a)), but only to the extent that the claim produces taxable interest or punitive damages. This limit would prevent the deduction of attorney's fees and costs when none of the recovery is taxable, and therefore, the issue of overtaxing a litigant is not in play.

<u>Sample Revised § 212:</u>

<u>Section 212: Expenses for the Production of Income.</u> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

(1) For the production or collection of income;

(2) For the management, conservation, or maintenance of property held for the production of income;

(3) In connection with the determination, collection, or refund of any tax; *or*

(4) For the production or collection of amounts received in any action involving a claim whose recovery is excluded from gross income under Section 104(a), but only to the extent that such claim results in recovery of taxable interest.

Two simple examples demonstrate how this provision would apply:

Example A: If X is awarded $3,000,000 compensatory damages excludable under I.R.C. § 104(a) for personal injury and $1,500,000 in taxable interest, and X pays $2,000,000 in attorney's fees and court costs, X would be allowed a deduction in the amount of $1,500,000.

Example B: If X is awarded $5,000,000 compensatory non-taxable damages and $500,000 in taxable interest and pays $200,000 to attorney under an hourly fee arrangement, X would be allowed a $200,000 deduction.

229. Treas. Reg. § 1.212-1(e) (as amended in 1975).
230. I.R.C. § 265(a)(1).

Obviously, § 265 would have to be revised to reflect any changes allowing deductions. This could be done with a simple preface to § 265 stating "[e]xcept as provided in Section 212 . . . ." To complete the circle, Code § 62 would have to be revised as well to make the deduction an above-the-line deduction, which would be available notwithstanding the application of the AMT. This revision is almost identical to the language added by the American Jobs Creation Act of 2004,[231] which provided a useable deduction for recovering plaintiffs in certain employment and civil rights cases.

Sample Addition to § 62(a):

Section 62(a) General Rule. . . . the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions . . . (20) 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 described in 212(4) . . . ."*

Of course, even if limited, this approach does not offer a perfect parallel for the expenses incurred to recover taxable interest or punitive damages. In effect, it allows offsetting of taxable amounts related to non-taxable amounts to the extent that expenses are incurred, whether directly attributable to the taxable or non-taxable recovery. Such an offset of taxable and non-taxable amounts could potentially run afoul of generally accepted accounting principles and could provide opportunities for abuse. However, because a similar revision[232] was previously enacted to alleviate the problem of overtaxing recoveries in certain employment and civil rights cases, at least some variation of the modified above-the-line deduction for attorney's fees and costs could be politically viable.

B. Alternative Approach: a New Exclusion

Alternatively, a different legislative approach could partially nullify the use of the assignment of income doctrine as applied in *Banks* to certain contingent fee arrangements: simply add a new exclusion for amounts that would be includable as a result of the *Banks* case in otherwise non-taxable settings. This would require perhaps a new Code section, which is drafted below as Code § 105 and is intended to address personal injury or sickness recoveries excludable under Code § 104(a):

---

231. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546.

232. *See supra* note 76 and text accompanying note 77.

> **[New] Section 105. Attorneys' fees incurred with respect to certain recoveries.** Gross income does not include amounts recovered, including interest, by a taxpayer in connection with any action involving a claim the recovery of which is excluded from gross income under I.R.C. Section 104(a), but only to the extent of attorney's fees or court costs paid by, or on behalf of, a taxpayer in connection with such action.

Although neither of these legislative approaches is flawless, they do provide a mechanism by which a successful plaintiff could avoid the depletion of the value of her recovery that would otherwise occur because of the application of the assignment of income doctrine to the contingent fee arrangement. A legislative solution is attractive primarily because it provides immediate and consistent implementation without having to persuade the judiciary once again to address the context and content of the attorney-client relationship in contingent fee cases. Simplicity and predictability are particularly important in the area of taxation and our law should reflect those goals.

C. Policy Implications of Revising the Code to Provide Relief to Plaintiffs

While advocating in favor of any additions to the Internal Revenue Code at this point is perhaps akin to carrying coals to Newcastle, policy does in large part support revising the Code to provide relief for plaintiffs who have recovered partially taxable and partially non-taxable payments. Typical review of tax policy revolves around equity and efficiency arguments. For the equity analysis, one looks at both vertical equity, which compares the tax burden of taxpayers of different levels of economic well-being, as well as horizontal equity, which compares taxpayers of the same level of economic well-being.[233] In simple terms, vertical equity is an expression of the thought that taxpayers having different levels of economic well-being should shoulder different tax burdens.[234] That is, all other things being the same, an individual with $100,000 of income generally should pay more taxes than an individual with $25,000 of income.[235] On the other hand, horizontal equity is an expression of the idea that taxpayers with equal economic well-being

---

233. JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 59-60 (4th ed. 2008).

234. *Id.* at 59.

235. *See id.*

should face similar tax burdens.[236] Accordingly, two individual taxpayers each with $100,000 of income should pay the same amount in taxes, everything else being equal.[237] Closely related to vertical and horizontal equity is the so-called "ability to pay" principle. The ability to pay principle provides that a taxpayer's tax burden should be related to that taxpayer's level of economic well-being.[238] Under this norm, one would consider the declining marginal utility of money to determine that an additional dollar of tax burden on a wealthy family is less of a sacrifice than it would be for a poor family.[239]

In conjunction with equity, tax policy is also concerned with the impact of changes on the efficiency of the tax system. In this sense, an efficiency analysis looks at whether a particular tax impacts taxpayer decisions in a way that makes those decisions different from what they would be absent the tax.[240] An efficient tax has little or no impact on a taxpayer's decision-making. The concept of efficiency also touches on the complexity of a system. To the extent tax rules become so complex that excessive time and energy are devoted to discerning the application of the system to a taxpayer or to enforcing the rules, the tax regime is inefficient.[241]

Equity, whether couched in vertical or horizontal terms, most strongly favors altering or amending the Code to allow plaintiffs with partially taxable and partially non-taxable recoveries to exclude or deduct their attorneys' portions of the recovery from their taxable income.[242] If a major goal of a tax system is to treat similarly-situated taxpayers similarly,[243] and differently-situated taxpayers differently, then the tax

---

236. *Id.* at 60; *see also* Reece, *supra* note 21, at 335.

237. Some have expressed the sentiment that horizontal equity is not a distinct concept from vertical equity. In other words, if the system taxes those with unequal means with appropriate distinction, the similar tax treatment of those with equal means naturally follows. Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 362-63 (1993).

238. SLEMROD & BAKIJA, *supra* note 233, at 64.

239. *Id.*

240. LAURIE L. MALMAN, LINDA F. SUGIN, LEWIS D. SOLOMON, & JEROME M. HESCH, THE INDIVIDUAL TAX BASE: CASES, PROBLEMS AND POLICIES IN FEDERAL TAXATION 9 (2d ed. 2010).

241. *See id.* at 12.

242. *See, e.g.*, Matthew Williams, Comment, *The Taxation of Contingent Attorney's Fees: Is the Capitalization Theory a Viable Solution to Prevent Taxpayer Inequity?*, 37 TEX. TECH L. REV. 1173 (2005).

243. *See* Steve R. Johnson, *An IRS Duty of Consistency: The Failure of Common Law Making and a Proposed Legislative Solution*, 77 TENN. L. REV. 563, 565 (2010).

regime applicable to recovering plaintiffs is a significant policy blemish. Litigants are subject to a vast array of tax implications depending upon, among many other things, the nature of the cause of action, the timing of their recovery, and the structure of the settlement or award.[244]

As a matter of social policy and in recognition of the fact that physically injured persons receiving compensation will not truly be enriched economically by their litigation recoveries, Congress has allowed such litigants to exclude personal injury recoveries from their gross incomes.[245] Other plaintiffs, like those pursuing employment discrimination and civil rights claims in the *Banks* case, will be taxed on their recoveries.[246] Likewise, a plaintiff receiving a lump-sum immediate payment will have different tax consequences from a plaintiff who accepts a structured settlement arrangement.[247] These distinctions can easily be justified because the personal injury litigant or the lump-sum payment litigant is in a different economic position than the employment discrimination plaintiff and the structured settlement litigant. A plaintiff who must spend much of her recovery on hospital bills and therapy does not have the same economic benefit from the recovery as a plaintiff who will not necessarily incur those same expenses. Further, a plaintiff who has the immediate use of the entire settlement is in arguably a better position economically than one who must receive payments over a period of years.[248]

---

244. *See generally* Polsky & Hellwig, *supra* note 154, at 44.

245. I.R.C. § 104(a)(2) (2006).

> Although the original legislative history is scant, it suggests that Congress viewed compensation received for personal injuries or sickness as beyond the reach of the income tax. One of the theories supporting the exclusion is that personal injury awards represent a return of "human capital" and thus simply make the victim whole by restoring him to the position he was in prior to the tortious injury. Hence, the recipient has no taxable gain inasmuch as he is no better off than he was prior to the injury. Another view is that the exclusion of personal damages is grounded in compassion for the victim. . . . However, the compassion justification has no sound theoretical foundation in tax policy. Compassion for the victim of personal injury is not a tax reason for excluding damages from gross income. Instead, the exclusion stems from supervening nontax notions that tort victims should be compensated for pain and suffering and other damages and costs arising from personal injuries or sickness, including lost wages and punitive damages, without paying tax on the recovery.

Kovacs v. Comm'r, 100 T.C. 124, 150-51 (1993) (citations omitted).

246. Comm'r v. Banks, 543 U.S. 426, 430-31 (2005); *see also* text accompanying notes 77-81.

247. *See* Polsky & Hellwig, *supra* note 154, at 46-47.

248. However, any interest on the structured settlement would be taxable. The deferral

Although disparate tax treatment of claims based on the nature of the recovery and timing of the recovery are justifiable, disparate treatment of the deductibility of their attorney's fees and litigation costs is not so easy to accept. Plaintiffs who utilized an attorney under a contingent fee arrangement will have to treat the costs of recovering on their claims differently based on the underlying cause of action at issue. It is certain in the aftermath of *Commissioner v. Banks* that all plaintiffs will have to include their attorney's portion of the recovery in the plaintiffs' income even if the contingent attorney's fee is paid directly to the attorney.[249] However, pursuant to Code § 62(a)(20), added in 2004 in response to cases similar to *Banks*, certain employment discrimination and civil rights plaintiffs are allowed to deduct their attorney's fees above-the-line, giving them a break from the harsh tax consequences of the miscellaneous itemized deduction characterization and consequent alternative minimum tax liability.[250] Although the plaintiff in an employment discrimination suit will be taxed on the entire award, the above-the-line deduction for attorney's fees paid to recover those taxable amounts could potentially place that plaintiff in a better economic position than a personal injury plaintiff whose identical total dollar amount recovery consists of a non-taxable compensatory recovery as well as a sizeable interest component.[251] To achieve a horizontally equitable system of taxing these plaintiffs, a personal injury plaintiff should be allowed to deduct her attorney's fees and litigation costs above-the-line, or exclude the fees and costs, from gross income at least to the extent the recovery includes taxable interest or punitive damages. The deduction or exclusion advocated in this article would move us closer to a tax system that treats similarly situated litigants similarly.

The potential trade-off from a policy perspective is on the efficiency end. Generally speaking, plaintiffs, whether pursuing a personal injury or employment discrimination claim, are likely to retain an attorney pursuant to a contingent fee arrangement. The contingent fee arrangement is so ingrained in the culture of plaintiff-side litigation, that it is difficult to imagine a situation in which the tax consequences alter a plaintiff's options, much less her choice.[252] Further, litigation costs are likely

---

of income may, however, spread the plaintiff's tax consequences over several years, reducing the marginal rate applicable to the recovery in any given year.

249. *Banks*, 543 U.S. at 430.

250. *See supra* Part I.A; *see also supra* text accompanying notes 77-81.

251. *See* calculations in Illustration, Part II.C.

252. *See supra* notes 20-22.

outside of the plaintiff's control, or at least expertise, in most cases. In this respect, the tax system would not alter a plaintiff's decision-making, and could therefore be considered efficient.[253] Nonetheless, it would be difficult for one who has railed against the complexity of the Code in both practice and the classroom to advocate in favor of additions to the Code without at least acknowledging the increased complexity and concomitant rule inefficiency such additions bring. In this case, it is clear that the magnitude of the relief provided to plaintiffs outweighs the slight additional complexity brought about by providing an above-the-line deduction for attorney's fees and litigation costs incurred by plaintiffs with partially taxable and partially non-taxable awards or for an exclusion to overcome the assignment of income doctrine applicable to contingent fee arrangements. Further, such additions bring the system closer to equity by treating taxpayers who incur similar expenses in recovering on their claims with similar deductions or exclusions.

Conclusion

Through a series of illustrations, this article is designed to shed some light on the dramatic and disproportionate tax consequences that face plaintiffs who recover compensatory personal injury damages coupled with a taxable interest component.[254] In light of this tax burden on a successful plaintiff, a burden which amplifies over time as taxable interest accrues, it is only equitable to provide such plaintiffs with some measure of relief that brings their tax burden closer to that of a plaintiff with a wholly taxable employment discrimination or civil rights recovery.[255] It is becoming increasingly evident in the seven years following the Supreme Court's decision in *Commissioner v. Banks*, that the judiciary is unlikely to adopt any of the previously proposed solutions to the problem of requiring a plaintiff to include her attorney's portion of her recovery in the plaintiff's gross income pursuant to the anticipatory assignment of income doctrine. Further, many of the non-legislative solutions to this dilemma that have been advocated create significant conceptual problems or problems in application.[256]

---

253. *See* MALMAN ET AL., *supra* note 240, at 9.

254. *See supra* Part II.C.

255. *Cf.* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546 (allowing deductions for recovering plaintiffs in certain employment and civil rights cases).

256. *See supra* Part III.

Accordingly, the Internal Revenue Code should be amended to provide an expanded deduction for the attorney's fees and litigation costs incurred to obtain such an award.[257] To be useful, such deduction would have to be above-the-line in order to provide a reduction from taxable income that is not diminished by the restrictions on miscellaneous itemized deductions and would not trigger alternative minimum tax liability. Alternatively, the Code could be revised to allow a plaintiff to exclude from the plaintiff's gross income the attorney's fee and other litigation costs paid under a contingent fee or other arrangement that is delivered directly to the attorney and bypasses the plaintiff's hands altogether.[258] Either of these legislative approaches would give relief to a successful personal injury plaintiff who also receives a taxable interest or punitive damages recovery, and bring such a litigant more on par tax-wise with litigants who incur attorney's fees and other litigation expenses in pursuing wholly taxable recoveries. Further, compared to judicial approaches, legislative solutions have the potential to provide more immediate implementation of relief and more consistency in application. It is no longer prudent to stand by and wait for the judiciary to adopt a new approach to viewing the contingent fee arrangement in light of *Banks*' application of the anticipatory assignment-of-income doctrine to such contracts. Instead, consistent with the long-standing policy of making harmed litigants whole, real plaintiffs with real injuries need more immediate and consistent action to provide relief from an unpalatable tax result.

257. *See supra* Part IV.A.
258. *See supra* Part IV.B.