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U.S. Supreme Court Weighs in on Issue of Taxability of “Contingent Attorney Fees” Portion of Plaintiff’s Judgment/Settlement Award

The United States Supreme Court, in *Commissioner v. Banks* and *Commissioner v. Banaitis*, has now spoken on the issue of the taxability of the “contingent attorney fees” portion of a plaintiff’s judgment/settlement award. In general, the issue involved is whether such fees should be includable in a plaintiff’s gross income for tax purposes, even though payable to the plaintiff’s attorney. If includable, then the plaintiff would only be able to avoid being subject to income tax on any of these fees if they were fully deductible by the plaintiff for both regular and alternative minimum tax (AMT) purposes; often times, however, this was not the case due to the “2% of adjusted gross income” limitation on miscellaneous itemized deductions and the disallowance of miscellaneous itemized deductions altogether for AMT purposes. The United States Courts of Appeal previously had been split both as to the proper tax treatment of contingent attorney fees and the proper analysis to apply to determine such treatment.

The Supreme Court subscribed to an “anticipatory assignment of income” analysis so as to hold that the contingent attorney fees portion of the plaintiff’s/respondent’s settlement/judgment recovery constituted taxable income to the plaintiff. In so holding, the Supreme Court rejected both the argument that the contingent fee arrangement should be viewed for tax purposes as an arrangement akin to a joint venture or partnership between the plaintiff and the attorney (referring to the arrangement instead as a “quintessential principal-agent relationship”) and the additional argument that the “anticipatory assignment of income” doctrine was somehow inapplicable due to the value of the legal claim being speculative at the time the arrangement was entered into. Addressing “lien law” analysis, the Supreme Court noted that the fact that state law may confer a specific right/protection on the attorney for his/her fees did not alter the fundamental principal-agent character of the relationship.

The attorney fees that were the subject of the Supreme Court's decision would likely have been fully deductible by the plaintiff for both regular tax and AMT purposes under the recently-enacted American Jobs Creation Act of 2004 (Act), had the Act applied to these fees. The Act included a provision that allows an "above-the-line" deduction for attorneys' fees and court costs (which are otherwise deductible) paid by, or on behalf of, a taxpayer in connection with certain actions and claims. This provision is, in general, effective for fees and costs paid after the enactment date of the Act with respect to any judgment or settlement occurring after such date.

To view the full version of this Memo, which includes the case law and full citations, please go to <http://209.75.26.33/seyfarth/MGMTTAX020705.pdf> or CLICK HERE.

For more information or to find out how this ruling could affect you, please contact Marc Kushner at mkushner@seyfarth.com or any member of the Seyfarth Shaw Tax Group on our website.



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