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Could One Simple Election Solve The Attorney Fee Issue?

By Jeffrey H. Kahn

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One current hot topic in tax law is the proper treatment of a plaintiff who recovers taxable damages in which a portion of his award is paid to his attorney pursuant to a contingent fee arrangement.1 At issue is whether the plaintiff is taxed on the portion of the award that is payable to the attorney. The Supreme Court has agreed to resolve a circuit split on this issue.2

To demonstrate the problem, assume Paula Plaintiff hires Larry Lawyer to represent her in a discrimination lawsuit against Defendant Corp. Larry agrees to represent Paula, and they sign a contingent fee contract whereby Larry is entitled to 40 percent of any proceeds derived from the suit. Paula and Defendant Corp. settle the lawsuit for $1 million. As a result, Larry is entitled to, and is paid, $400,000.

There are two possible treatments of the above transaction: Either Paula has $600,000 in gross income (excluding the amount paid to Larry), or Paula has $1 million in gross income and receives a $400,000 deduction for the payment to Larry. Although the results seem identical, the tax consequences are very different. If Larry’s fee is excluded from Paula’s gross income, Paula is taxed on only $600,000. However, if she includes the full award in her gross income, the deduction for the payment to Larry is classified as a miscellaneous itemized deduction. Therefore, the deduction is subject to the limitations of sections 67 (the 2 percent of adjusted gross income floor on miscellaneous itemized deductions) and 68 (the overall limitation on itemized deductions).3 Even worse, the alternative minimum tax system completely disallows all miscellaneous itemized deductions thereby all but ensuring she will be taxed under that system. Thus, Paula would be taxed on the full $1 million under the AMT.

A majority of the courts that have examined this issue have held that the plaintiff must include the entire amount of the award in income.4 However, a few cases have held that the plaintiff may exclude the contingent fee from gross income.5 In his article discussing the issue, Prof. Polsky argues that there are two possible tax characterizations for the contingent fee arrangement and under either scenario, the plaintiff must include the full amount in income.6

One view of the transaction is that the contingent fee arrangement does not result in any immediate transfer of property. Under that scenario, the contingent fee agreement is merely an executory contract, and there is no tax consequence until the case is resolved.8 Once resolved, the plaintiff must include the full amount in income and may take a miscellaneous itemized deduction for the attorney fee expense.9

Prof. Polsky’s alternative view of the contingent fee arrangement is that the contract “results in an immediate transfer of property under [section] 83.”10 This is crucial because section 83 provides that a transfer of property for services is disregarded for tax purposes if there is a

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3See, e.g., Banks, supra note 2, and Bansaitis, supra note 2.

4Prof. Polsky correctly notes that theoretically, the plaintiff should be taxed on only the net amount of income from the case and therefore proposes that Congress provide a fix for the unwarranted tax result. Polsky, “Fruits and Trees,” supra note 1, at 120.

5Polsky, “Fruits and Trees,” supra note 1 at 93.

6Id. at 94. As noted by Prof. Polsky, it makes no difference whether the plaintiff or the defendant writes the check. See Old Colony Trust Co. v. Comm’r, 279 U.S. 716 (1929).

7Id. at 95.
substantial risk of forfeiture until that time as the interest vests. As Prof. Polsky notes:

Assuming that the contingent fee agreement results in an immediate transfer of property, is the property transferred subject to a substantial risk of forfeiture? The answer is yes. The general rule is that regardless of the specific language of the contingent fee agreement, an attorney forfeits any right to a fee if the attorney withdraws from the case or is discharged for cause prior to final disposition of the matter. As a result, the attorney’s receipt of property upon execution of a contingent fee agreement is subject to a substantial risk of forfeiture until final disposition of the case.11

Thus, regardless of which of Prof. Polsky’s views applies, there is no transfer for tax purposes on execution of the contract. Once the case has been finalized and the risk of forfeiture is removed, the transfer officially occurs for tax purposes. Because the plaintiff transferred property in exchange for services, the plaintiff must recognize the difference between the value of the services received from the attorneys and the plaintiff’s basis in the property transferred. As the plaintiff will have a zero basis in the property, she will recognize the full amount as income.12

An interesting issue arising out of Prof. Polsky’s theory regarding the application of section 83 is the possible application of section 83(b). Taxpayers can elect, under section 83(b), to include in income property that is still subject to substantial risk of forfeiture. So the attorney could elect under section 83(b) to include her portion of the claim in income on execution of the contract, rather than wait until the final disposition of the case. That election has been described as a “tax gamble” because the taxpayer will not be able to take a deduction for the amount included in income if the property is subsequently forfeited. In the usual situation, the benefit for a taxpayer in making the election is that the property typically will be valued at a lower amount at the time of the election; and, if the property vests at a higher value, the taxpayer will not have to include the difference in income. The taxpayer’s subsequent gain on the sale of the property will also be converted from ordinary services income to the lower capital gains rate.13 However, in the attorney fee example, neither of those advantages of a section 83(b) election applies to the attorney. On resolution of the case, the attorney would include in income any amount she received on the claim over her basis in the interest. Also, the excess amount will be characterized as ordinary income.14

For example, assume Peter Plaintiff, who has a claim for damages that will be taxable income to him, signs a contingent fee agreement with Leslie Lawyer, and Leslie makes a section 83(b) election. Leslie will have income equal to the value of the transferred claim as payment for services and will have a basis equal to that amount. At that time, Peter will recognize income of the same amount because his basis in the transferred property is zero, and it is assumed that transfers in an arm’s-length exchange are of equal value. Because the execution of the contract occurs early in the lawsuit process, there is uncertainty as to whether they will win their case, and so the value of the claim (and therefore of Leslie’s services) may be greatly discounted. Peter will be allowed a miscellaneous itemized deduction for the payment to Leslie for her services,15 but the limitations on that deduction likely will prevent it from offsetting all of Peter’s income.

If they win, Peter will receive his portion of the award and will be taxed on that amount. Leslie will be required to recognize the difference between the amount she received and her basis in her portion of the claim (which will equal the amount she included in income when she made the section 83(b) election). Thus, the usual section 83(b) election advantages would not apply to Leslie.

Not only is there no advantage to Leslie to make the election, but there are several disadvantages. Specifically, by making the election, she will recognize income for receiving an interest in a claim that may be disallowed. Even if the claim is sustained, she will have recognized some of her income at an earlier point of time (that is, when the election was made). While Leslie likely can deduct the loss she suffers if the claim is disallowed and proves to be worthless (becoming worthless is not a forfeiture16), the time value of money principle will still leave her at a disadvantage.

So why would Leslie make such an election? The answer is that it might help Peter. Once Leslie makes the section 83(b) election, that portion of the claim belongs to her for tax purposes. Therefore, when the case reaches a final disposition and the claim is sustained, Peter can argue that he had already sold that portion of the claim to Leslie for adequate consideration and therefore is not taxable on the amount paid to her. Peter was taxed at the time of the election on the value of his right to Leslie’s services, but that value likely will be much less than the amount ultimately collected by Leslie if the claim is sustained.

1Polsky, “Fruit and Trees,” supra note 1 at 109. See section 83(c)(1), which states, “The rights of a person in property are subject to a substantial risk of forfeiture if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.”

12Polsky, “Fruits and Trees,” supra note 1 at 110. See also Treas. reg. section 1.83-6(b) (“At the time of a transfer of property in connection with the performance of services, the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor’s basis in the property.”).


14Because there was no sale or exchange and because the claim is not a debt instrument under section 1271, the gain the attorney recognized by collecting on the claim is ordinary income.

15Section 212(1). The payment to Leslie equals the value of the portion of the claim that was assigned to her.

16See Treas. reg. section 1.83-2(a). If Leslie were to quit representation of Peter, she would not be able to take a deduction for the amount she included in income.
However, to make the election is a bit of a gamble because Peter could be slightly disadvantaged by it. If the claim is denied, Peter will have reported and paid tax on the "sale" of part of the claim; and while Peter will have been allowed a miscellaneous itemized deduction for the payment to Leslie for her services, the limitations on that deduction will not fully compensate him.

It does not appear that any plaintiff taxpayer has attempted to use section 83(b) in the attorney fee scenario, so it is unresolved whether a court would accept that treatment when it proves favorable to the taxpayer. It may become a moot issue if the Supreme Court or Congress fixes the problem. However, attorneys should certainly consider the possibility of making a section 83(b) election when their clients are facing the possible harsh tax result currently imposed on many taxpayers.