

Tax Treatment of Settlements and Judgments: Attorney Fees and Section 104 Cases

Author: Wood, Robert W., Robert W. Wood, PC

I have four topics I want to cover, and I begin this installment of my column on developments in the tax treatment of settlements and judgments by observing that a petition for certiorari has been filed in *Raymond v. Commissioner*.¹

Next I'll examine *Lindsey v. Commissioner*,² in which the Tax Court found that a recovery (which stemmed from a failed joint venture) for tortious interference with contract, injury to reputation, and emotional distress was not excludable under section 104(a)(2).

Third, I'll cover Washington state's new attorneys' lien law, which is akin to Oregon's attorneys' lien law, the lien law at issue in *Banaitis v. Commissioner*.³ Those in the Evergreen State certainly are clever ones; fashioning an attorneys' lien law that purports to render the attorney fee dispute moot is a capital idea -- even if that approach solves the attorney fee problem only one state at a time.

Last but not least, I'll discuss *Murray v. Commissioner*, in which the Tax Court found amounts received for emotional distress to be fully taxable, even though legitimate claims for damages on account of personal physical injuries may have existed but were not made.⁴

Raymond Petition for Certiorari

The attorney fee quandary has proven to be one of the most contested issues ever tackled by the IRS -- and the courts.⁵ Devoted

¹ 355 F.3d 107, Doc 2004-760, 2004 TNT 10-11 (2^d Cir. 2004), petition for cert. filed, 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415).

² T.C. Memo. 2004-113, Doc 2004-10134, 2004 TNT 92-13.

³ 340 F.3d 1074, Doc 2003-19359, 2003 TNT 167-5 (9th Cir. 2003), petition for cert. granted, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907).

⁴ T.C. Summ. Op. 2004-60, Doc 2004-10354, 2004 TNT 94-11.

⁵ See, e.g., Robert W. Wood, "Everybody Loves Raymond? Second Cir. Weighs In on Att'y Fees," *Tax Notes*, Mar. 29, 2004, p. 1639 (hereinafter *Raymond*); Robert W. Wood, "Tax Treatment of Settlements and Judgments," *Tax Notes*, May 31, 2004, p. 1134 (May Settlements and Judgments); Robert W. Wood, "Taxation of Settlements and Judgments," *Tax Notes*, Mar. 1, 2004, p. 1120 (March Settlements and Judgments); Robert W. Wood and Dominic L. Daher, "IRS Audit Guide on Damage Awards Misses the Mark," *Tax Notes*, Feb. 23, 2004, p. 1013 (Misses the Mark); Robert W. Wood and Dominic L. Daher, "Attorney Fees: Rebellious Circuit Don't Need No

readers (if I have any!) know that on March 29, 2004, the Supreme Court decided to resolve the widening split in the circuit courts as to the proper tax treatment of contingent attorney fees. Lo and behold, the Supreme Court granted certiorari in *Banaitis v. Commissioner*⁶ and *Banks v. Commissioner*.⁷ Not to look a gift horse in the mouth, but I'm still scratching my head as to why the Supreme Court decided to hear both *Banks* and *Banaitis*; after all, it declined to opine on the attorney fee issue on five prior occasions.⁸ One might ask what makes *Banks* and *Banaitis* so special.

Through the years, the circuit courts have repeatedly squabbled over whether contingent attorney fees represent gross income to the plaintiff (as well as to the attorney).⁹ The majority has held that

Stinkin' Lien Law," *Tax Notes*, Dec. 22, 2003, p. 1427 (Rebellious Circuit); Robert W. Wood, "Tax Treatment of Attorneys' Fees: Whose Law Applies?," *Tax Notes*, June 16, 2003, p. 1651 (Whose Law Applies); Robert W. Wood, California State Bar Section of Taxation Report, "Tax Treatment of Attorneys' Fees," *Doc 2003-11996*, 2003 TNT 94-128 (California State Bar Report).

⁶ *Supra*, note 3. See also Wood, May Settlements and Judgments, *supra* note 5; Wood, March Settlements and Judgments, *supra* note 5; Robert W. Wood and Dominic L. Daher, "Attorneys' Fees: Maverick Circuit Says 'Oregon Good, Calif. Bad'" *Tax Notes*, Oct. 6, 2003, p. 91 (Maverick Circuit).

⁷ 345 F.3d 373, *Doc 2003-21492*, 2003 TNT 190-11 (6th Cir. 2003), *petition for cert. granted*, 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892). See also Wood, May Settlements and Judgments, *supra* note 5; Wood, March Settlements and Judgments, *supra* note 5; Wood and Daher, Rebellious Circuit, *supra* note 5.

⁸ See *O'Brien v. Commissioner*, 319 F.2d 532 (3^d Cir. 1963), *cert. denied*, 375 U.S. 930 (1963); *Benci-Woodward v. Commissioner*, 219 F.3d 941, *Doc 2000-20007*, 2000 TNT 144-8 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766*, 2000 TNT 117-9 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862*, 2001 TNT 188-11 (9th Cir. 2001), *cert. denied*, 536 U.S. 904, (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455*, 2001 TNT 247-75 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002). See also Wood, May Settlements and Judgments, *supra* note 5; Wood, March Settlements and Judgments, *supra* note 5.

⁹ See, e.g., Wood, May Settlements and Judgments, *supra* note 5; Wood and Daher, Maverick Circuit, *supra* note 6; Wood, Raymond, *supra* note 5; Wood and Daher, "Class Action

contingent attorney fees are gross income to both the attorney and the plaintiff.¹⁰

On the other side of this barbed-wire fence (which is probably electrified, too), the minority has held that contingent attorney fees are not gross income to the plaintiff, but are merely taxable to the attorney.¹¹

Attorney Fees: Even Bigger Tax Problems?" *Tax Notes*, Oct. 27, 2003, p. 507 (Class Action); Wood, *March Settlements and Judgments*, *supra* note 5; Wood, "Davenport's Solution for the Attorney's Fee Mess: A Capital Idea," *Tax Notes*, Nov. 18, 2002, p. 969 (Davenport's Solution); Wood, "The Energizer Bunny Has Nothing on the Attorneys' Fee Debate," *Tax Notes*, Aug. 21, 2000, p. 1059 (Energizer Bunny); Wood, "Schleier Strikes Taxpayers Three Times," *Tax Notes*, July 24, 1995, p. 475 (Three Times); Wood, "New Law Radically Changes Tax Rules in Employment Litigation," *Tax Notes*, Aug. 19, 1996, p. 1045 (New Law); Wood and Daher, *Rebellious Circuit*, *supra* note 5; Wood, "Navigating the Tax Maze of Workplace Winnings," *Tax Notes*, Mar. 24, 1997, p. 1605 (Tax Maze); Wood, "The Plight of the Plaintiff: The Tax Treatment of Legal Fees," *Tax Notes*, Nov. 16, 1998, p. 907 (Plight of the Plaintiff); Wood, "Taxing Discrimination Recoveries: Bucking *Burke*," *Tax Notes*, July 20, 1992, p. 363 (Discrimination Recoveries); Wood, "Even Tax Court Itself Divided on Attorneys' Fees Issue!," *Tax Notes*, July 24, 2000, p. 573 (Tax Court Divided); Wood, "Leave Section 83 Out of This Mess," *Tax Notes*, Nov. 27, 2000, p. 1187 (Section 83); California State Bar Report, *supra* note 5; Deborah A. Geier, "Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs," *Tax Notes*, Jul. 24, 2000, p. 531 (Meandering Thoughts).

¹⁰ See *Alexander v. Commissioner*, 72 F.3d 938, Doc 96-602, 96 TNT 1-74 (1st Cir. 1995); *Raymond*, *supra* note 1; *O'Brien*, *supra* note 8; *Young v. Commissioner*, 240 F.3d 369, Doc 2001-5150, 2001 TNT 36-11 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, Doc 2001-21203, 2001 TNT 154-9 (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393, Doc 97-23130, 97 TNT 153-8 (8th Cir. 1997), *en banc reh'g denied* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward*, *supra* note 8; *Coady*, *supra* note 8; *Sinyard*, *supra* note 8; *Hukkanen-Campbell*, *supra* note 8; *Baylin v. Commissioner*, 43 F.3d 1451, Doc 95-342, 95 TNT 4-23 (Fed. Cir. 1995); *Lansill v. Burnett*, 58 F.2d 512 (D.C. Cir. 1932).

¹¹ See *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks v. United States*, 202 F.3d 854, Doc 2000-1776, 2000 TNT 10-21 (6th Cir. 2000); *Davis v. Commissioner*,

On April 9, 2004, the taxpayer in *Raymond v. Commissioner* expressed his dissatisfaction with the Second Circuit's recent pro-government holding by filing a petition for certiorari.¹² Certiorari hasn't been granted in *Raymond*, at least not yet.

As readers will likely recall, *Raymond* arose from a wrongful termination case. After being fired by IBM in 1993, Raymond hired a contingent fee lawyer and sued for wrongful termination. The lawyer was entitled to receive one-third of the net recovery, plus expenses. Raymond won a jury verdict. IBM appealed and lost, and then paid the roughly \$900,000 judgment.

On his 1998 federal income tax return, Raymond included the entire recovery in gross income, including the approximately \$300,000 paid to his attorneys. In 1999 Raymond filed an amended return requesting a refund for the taxes concerning the amount paid to his lawyers. Not surprisingly, the IRS denied the refund claim. Undeterred, Raymond filed a refund suit in district court.¹³ The court awarded the refund, allowing Raymond to exclude the portion of the recovery paid to his contingent fee attorneys.

In its holding, the court found that applicable Vermont law gave Raymond's attorneys an equitable lien on his recovery.¹⁴ That equitable lien effectively transferred a proprietary interest in Raymond's claim to his attorneys.¹⁵ The district court found that the portion of the recovery used to pay attorney fees already belonged to the attorneys, so they, not Raymond, had to book that amount as gross income. The government appealed to the Second Circuit.¹⁶

The Second Circuit in *Raymond* trotted out the usual suspects, being careful to segregate the "good circuits" from the "bad circuits."¹⁷ But unfortunately, the Second Circuit in *Raymond* really dropped the ball on its first brush with the attorney fee issue by resorting to antediluvian (nearly medieval) assignment of income cases,

210 F.3d 1346, *Doc 2000-12246*, 2000 TNT 86-7 (11th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353, *Doc 2000-20090*, 2000 TNT 145-9 (5th Cir. 2000); *Banaitis*, *supra* note 3; *Banks*, *supra* note 7.

¹² 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415).

¹³ See *Raymond v. United States*, 247 F. Supp. 2d 548, *Doc 2003-7274*, 2003 TNT 55-6 (D. Vt. 2002).

¹⁴ *Id.* at 554 citing *Estate of Button v. Anderson*, 112 Vt. 531, 533 (1942).

¹⁵ *Id.*

¹⁶ *Raymond*, *supra* note 1. See also Wood, *Raymond*, *supra* note 5.

¹⁷ See *Raymond*, *supra* note 1, at 108 citing, e.g., *Young*, *supra* note 7; *Kenseth*, *supra* note 7; *Bagley*, *supra* note 7; *Estate of Clarks*, *supra* note 11. See also Wood and Daher, *Class Action*, *supra* note 9.

chiefly *Lucas v. Earl*¹⁸ and *Helvering v. Horst*.¹⁹ Those cases involved assignments of income by persons who had actually earned the income, but had not yet received it. To make matters worse, the taxpayers in those cases "assigned" the income to related parties -- family members. In *Earl* and *Horst*, the taxpayers were correctly considered to have taxable income, even though they never had actual possession of the funds.

Regrettably, the Second Circuit in *Raymond* failed to distinguish *Earl* and *Horst* from the contingent attorney fee fact pattern the way the Sixth Circuit did in *Estate of Clarks*.²⁰ I think it's fair to argue that at many -- probably most -- points in the process, the value of Raymond's lawsuit was entirely speculative, and dependent on the services of his counsel, as well as on the vicissitudes of any lawsuit. I might even go so far as to say that the claims of his counsel amounted to little more than an intangible contingent expectancy.

Although the Second Circuit acknowledged that *Estate of Clarks* analogized a contingent fee agreement to an interest in a partnership or joint venture, the Second Circuit quickly dismissed the analogy. The Second Circuit refused to adopt the *Estate of Clarks* rationale. The court rejected the argument that Raymond contracted for the services of his lawyer and assigned his lawyer a one-third interest in the venture so that he might have a chance to recover the remaining two-thirds. Rejecting *Estate of Clarks* and *Cotnam*,²¹ the Second Circuit found Vermont's attorneys' lien law too weak to support a *Cotnam*-like result.

We'll have to sit back and wait to see if the Supreme Court will grant Raymond's petition for certiorari. The Supreme Court should have addressed the attorney fee issue years ago. The disparate treatment of similarly situated taxpayers directly contradicts equity and fairness in our tax system -- essential elements of any tax system.²²

¹⁸ 281 U.S. 111 (1930).

¹⁹ 311 U.S. 112 (1940). See also Wood, Raymond, *supra* note 5.

²⁰ See *Estate of Clarks*, *supra* note 11, at 856-57.

²¹ 253 F.2d 119 (5th Cir. 1959).

²² See Wood, May Settlements and Judgments, *supra* note 5; Wood and Daher, Maverick Circuit, *supra* note 6; Wood, Raymond, *supra* note 5; Wood and Daher, Class Action, *supra* note 9; Wood, March Settlements and Judgments, *supra* note 5; Wood, Davenport's Solution, *supra* note 9; Wood, Energizer Bunny, *supra* note 9; Wood, Three Times, *supra* note 9; Wood, New Law, *supra* note 9; Wood and Daher, Rebellious Circuit, *supra* note 5; Wood, Tax Maze, *supra* note 9; Wood, Plight of the Plaintiff, *supra* note 9; Wood, Discrimination, *supra* note 9; Wood, Tax Court Divided, *supra* note 9; Wood, Section 83, *supra* note 9; Wood, May Settlements and Judgments, *supra* note 5; Geier, Meandering Thoughts, *supra* note 9.

I'm pleased that the Supreme Court has chosen to hear *Banks* and *Banaitis* in its October 2004 term, and I hope the Court will agree to add *Raymond* to its fall lineup.

Damages From Failed Joint Venture Taxable

In a recent Tax Court case, *Lindsey v. Commissioner*,²³ the Tax Court found that settlement payments received for tortious interference with contract, injury to reputation (both personal and professional), and emotional distress were fully taxable absent proof of personal physical injury or physical sickness.

Lindsey arose from a corporate joint venture run amok. In 1994 Lindsey, the majority shareholder, CEO, and COB of Empire Gas Corp., entered into an agreement with Northwestern Growth Co. to acquire Synergy, a propane company. To effectuate that agreement, Empire and Northwestern formed SYN Inc. as a prospective holding company for Synergy. The plan in the agreement was for Empire to supply management expertise to the new entity and for Northwestern to supply capital. Empire and Northwestern also agreed that Empire would manage any other propane companies later acquired through their holding company, SYN.

In December 1996, after myriad disagreements with Empire and Lindsey, Northwestern breached the 1994 joint venture agreement by attempting to usurp a corporate opportunity by purchasing and managing Coast Gas without Empire's or Lindsey's participation. Empire obtained a temporary restraining order against Northwestern to stop it from going ahead with the Coast Gas acquisition. So that it could move ahead with its acquisition of Coast Gas and rid itself of Lindsey and Empire, Northwestern entered into a termination agreement with Lindsey. Under the agreement, Lindsey was paid \$2 million in settlement of his claims against Northwestern for tortious interference with contract, injury to reputation (both personal and professional), and emotional distress.

On his 1996 tax return Lindsey failed to report any portion of the \$2 million settlement he received from Northwestern. At trial, Lindsey took an interesting tactical approach -- he attempted to challenge the effective date of the 1996 Small Business Job Protection Act. As the Tax Court noted, before the 1996 act, section 104(a)(2) excluded from gross income amounts received on account of personal injuries or sickness (including emotional distress recoveries) without any evidence or requirement of physical injuries or physical sickness.

As we know, on August 20, 1996, the 1996 act became effective and amended section 104(a)(2) to exclude from gross income only those amounts received on account of personal physical injuries or physical sickness. In fact, section 104(a)(2) now excludes emotional distress recoveries except when coupled with personal physical injuries or physical sickness.²⁴

²³ *Supra* note 2.

²⁴ See section 1605 of the 1996 Act, 110 Stat. 1838.

I expect the IRS would not even agree with my loose "coupled with" phrase here, or my failure to mention bruises (and broken bones?),²⁵ or, for that matter, my mention at all of the term "sickness" -- something the IRS evidently does not like, understand, or think (from what little I can tell) belongs in the statute. Anyone see litigation on the "or physical sickness" wing of section 104(a)(2) in the future? I sure do.

Unfortunately for Lindsey, the Tax Court had little trouble dispensing with his argument that the pre-1996 incarnation of section 104(a)(2) should apply to his settlement with Northwestern. Finding that Lindsey's settlement with Northwestern occurred several months (December 1996) after the effective date of the 1996 act, the Tax Court applied the amended (post-1996 act) version of section 104(a)(2). As it has done frequently in recent years, the Tax Court invoked the *Schleier*²⁶ test.

Regrettably, *Schleier* was not the Supreme Court's best work.²⁷ *Schleier* requires that for a recovery to be excludable under section 104(a)(2), it must be based on tort or tort-type rights, and the damages must be received "on account of personal injuries or sickness." Citing *Shaltz v. Commissioner*,²⁸ the Tax Court noted that the *Schleier* test has since been extended to apply to the post-1996 incarnation of section 104, with the corresponding second prong now requiring proof that the personal injuries or sickness for which the damages were received were physical in nature.

Although the Tax Court found that some of Lindsey's claims might satisfy the first prong of *Schleier*, Lindsey was unsuccessful in convincing the court that he also satisfied the second prong of *Schleier*. Unfortunately for Lindsey, the clear language of the settlement agreement stated that the \$2 million he received was on account of tortious interference with contract, injury to reputation (both personal and professional), and emotional distress. Nowhere in the settlement documents were any alleged personal physical injuries or physical sickness ever mentioned. Accordingly, the Tax Court found the entire \$2 million recovery to be taxable.

Washington's New Attorneys' Lien Law

²⁵ See LTR 200041022, Doc 2000-26382, 2000 TNT 201-10 (in which the IRS ruled that "direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under Section 104(a)(2)." See also Wood, "Were Sex Abuse Payments for Physical Injuries or Sickness?," *Tax Notes*, July 5, 2004, p. 56.

²⁶ 515 U.S. 323, Doc 95-5972, 95 TNT 116-8 (1995).

²⁷ See Wood, *Three Times*, *supra* note 9; Wood, *New Law*, *supra* note 9; Wood, *Tax Maze*, *supra* note 9.

²⁸ T.C. Memo. 2003-173, Doc 2003-14203, 2003 TNT 113-9.

In *Banaitis v. Commissioner*,²⁹ the Ninth Circuit found that contingent attorney fees are not gross income to the taxpayer.³⁰ Hallelujah! The court sounded markedly different from its collective voice in *Benci-Woodward v. Commissioner*,³¹ *Coady v. Commissioner*,³² and *Sinyard v. Commissioner*.³³

In *Banaitis* the taxpayer sued his former employer for constructive discharge. After considerable procedural wrangling, Banaitis and his former employer entered into a settlement that paid \$4.8 million to Banaitis and \$3.8 million to his contingent fee attorneys. On his tax return for the year in question, Banaitis failed to include the \$3.8 million in attorney fees in his gross income. The IRS assessed a deficiency, which the Tax Court upheld.

The Ninth Circuit, citing *Cotnam v. Commissioner*,³⁴ found that the attorney fees were excludable from Banaitis's gross income. In *Cotnam* the Fifth Circuit held that contingent fees paid out of a judgment to the plaintiff's attorneys were not income to the plaintiff. Under Alabama law, which applied in *Cotnam*, a contingent fee contract operates as a lien on the recovery.

In *Cotnam* the Alabama code provided that attorneys at law will have the same right and power over suits, judgments, and decrees to enforce their liens as their clients had or may have for the amount due. That gave the *Cotnam* court solid ground to say there had been a transfer of part of the plaintiff's claim, and any recovery by the lawyers on that portion of the claim was simply gross income to them. In *Banaitis*, noting that Oregon's attorneys' lien law mirrors Alabama's, the Ninth Circuit held that attorneys in Oregon were entitled to generous property interests in judgments and settlements.

Indeed, the Ninth Circuit in *Banaitis* found that an attorneys' lien in Oregon is superior to all other liens (except tax liens). The court found that, like Alabama law, Oregon law provides that attorneys have the same right and power over suits, judgments, decrees, orders, and awards to enforce the liens as the clients have in the judgment. Relying on the unique features of Oregon law on attorney fees, the Ninth Circuit found that the fees paid directly to Banaitis's attorneys were not includable in Banaitis's income.

Referring to hoary (sorry, but I love that word, especially when the IRS keeps misusing these cases in this area) assignment of income cases such as *Helvering v. Horst*³⁵ and *Lucas v. Earl*,³⁶ the Ninth Circuit went on to talk about state law and "state-law-specific analysis." It

²⁹ 340 F.3d 1074, Doc 2003-19359, 2003 TNT 167-5 (9th Cir. 2003), petition for cert. granted, 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907).

³⁰ See Wood and Daher, Maverick Circuit, *supra* note 6.

³¹ *Supra* note 8.

³² *Supra* note 8.

³³ *Supra* note 8.

³⁴ *Supra* note 11.

³⁵ 311 U.S. 112 (1940).

³⁶ 281 U.S. 111 (1930).

was that analysis that led the Ninth Circuit to conclude in *Coady* that under Alaska law, attorney fees are includable in the plaintiff's gross income and that the same rule applies under California law (*Benci-Woodward*).

Distinguishing Oregon law on attorneys' liens from California and Alaska law, the Ninth Circuit found that Oregon's attorneys' lien law was strong. The Ninth Circuit found that it went even *further* in some respects than Alabama law, the law considered in the seminal *Cotnam* decision. Relying on Oregon case law, the Ninth Circuit found that an Oregon attorneys' lien is a charge on the action.

Want an example? Well, in Oregon the parties to the action cannot extinguish or affect the attorneys' lien by any means (such as settlement) other than by satisfying the underlying claim of the attorney for the fees incurred in connection with the action.³⁷ Finding that Oregon clearly recognized the strength of the attorneys' lien law and that the attorneys in all events had the right to the money, the Ninth Circuit concluded that the attorney fees "paid directly" to Banaitis's attorneys were not includable in his gross income.

Apparently, the Washington Legislature has been following the attorney fee issue closely. On June 10, 2004, Washington's new attorneys' lien law went into effect. Its stated purpose is to:

[E]nd double taxation of attorneys' fees obtained through judgments and settlements, whether paid by the client from the recovery or by the defendant pursuant to a statute or a contract. Through this legislation, Washington law clearly recognizes that attorneys have a property interest in their clients' cases so that the attorney's fee portion of an award or settlement may be taxed only once and against the attorney who actually receives the fee. This statute should be liberally construed to effectuate its purpose. This act is curative and remedial, and intended to ensure that Washington residents do not incur double taxation on attorneys' fees received in litigation and owed to their attorneys.³⁸

The new statute provides that Washington attorneys' liens are "superior to all other liens." That attorneys' lien law was designed to be akin to those attorneys' lien laws discussed in *Cotnam v. Commissioner*³⁹ and *Banaitis v. Commissioner*.⁴⁰ Washington's new attorneys' lien law not only mirrors Alabama's and Oregon's in that it provides attorneys with generous property interests in settlements and judgments, but it seems to surpass them.

³⁷ See *Potter v. Schlessner Co.* 63 P.3d 1172 (Oregon 2003).

³⁸ See Wash. Rev. Code Ann. section 60.40.010 (West 2004) (Historical and Statutory Notes) *citing* 2004 Wash. Laws ch. 73, section 1.

³⁹ *Supra* note 11.

⁴⁰ *Supra* note 3.

Attorneys' liens in Washington are now superior to all other liens, including tax liens.⁴¹ At first blush some might even go so far as to question whether this superpriority lien statute is even legal (or constitutional). As it turns out, section 6323(b)(8) of the Internal Revenue Code specifically recognizes the superpriority of attorneys' liens in most circumstances.⁴²

It's important to note that section 6323(b)(8) recognizes the validity of superpriority attorneys' lien statutes only to the extent the attorney fees result from a favorable recovery for the taxpayer. Hence, attorney fees resulting from defending title to assets (or otherwise not adding value to a taxpayer's assets) do not receive that superpriority status.⁴³ The idea is that the government is happy to allow an attorney to maintain a superpriority lien for attorney fees when the attorney is adding value to the taxpayer's assets that are ultimately available to satisfy the IRS's claims.⁴⁴

It appears that Washington's new attorneys' lien law may provide the strongest protection yet under the *Cotnam* line of reasoning. Not only does it provide that attorneys have the same right and power over suits, judgments, decrees, orders, and awards to enforce the liens as the clients have in the judgment, but it also provides that attorneys' liens are superior to all other liens. If you believe the Ninth Circuit in *Banaitis*, taxpayers in Washington should be able to rely on the unique features of Washington's law on attorney fees and exclude from their income any amounts paid to their contingent fee attorneys.

Admittedly, the IRS has had success with arguments based on those state law and lien law factors (who really owns the attorney fees, blah, blah, blah . . .).⁴⁵ I hope more states, including California, adopt attorneys' lien laws to mirror Washington's new statute. If they did, references to the frequently misapplied assignment of income cases such as *Helvering v. Horst*⁴⁶ and *Lucas v. Earl*⁴⁷ might become a thing of the past -- at least in this context. Of course, I'm worried about effective dates here, about choice of law provisions, about non-Oregon cases, non-Oregon lawyers, and lots of other things. I worry a lot.

I think there is a solid argument that Washington's law on attorneys' liens is very strong. In fact, I think it's the strongest attorneys' lien law I've run across in my 25 years of practice as a tax lawyer. Washington's attorneys' lien law goes even further in some

⁴¹ Wash. Rev. Code Ann. section 60.40.010(3) (West 2004).

⁴² See also Treas. Reg. section 301.6323(b)-1(h).

⁴³ See *United States v. Kuss*, 69-2 USTC para. 9492 (E.D. P.A. 1969).

⁴⁴ See H.R. Rep. No. 1884, 89th Cong., 2d Sess. (1966), reprinted in, 1966-2 C.B. 815, 818.

⁴⁵ See e.g., *Alexander*, supra note 10; *Young*, supra note 10; *Kenseth*, supra note 10; *Bagley*, supra note 10; *Benci-Woodward*, supra note 8; *Coady*, supra note 8; *Hukkanen-Campbell*, supra note 8; and *Baylin*, supra note 10.

⁴⁶ 311 U.S. 112 (1940).

⁴⁷ 281 U.S. 111 (1930).

respects than Alabama's, the law considered in *Cotnam*. For that matter, Washington's attorneys' lien law goes even further in some respects than Oregon's, the law considered more recently in *Banaitis* and found to be even more favorable than Alabama's attorneys' lien law. Indeed, under Washington's law the parties to the action cannot extinguish or affect the attorneys' lien by any means (such as a settlement) other than by satisfying the underlying claim of the attorney for the fees incurred in connection with the action.

That is akin to the favorable Oregon lien law that was at issue in *Banaitis*. Considering that Washington clearly recognizes the strength of the attorneys' lien law and that the attorneys in all events have the right to their fees, the Ninth Circuit -- should it ever have reason to review Washington's attorneys' lien law -- would have ample authority to justify finding that attorney fees in Washington should be taxed solely to the attorney who labored to earn them, and not to the plaintiff.

But, as I have cautioned, I'm worried about effective dates, about non-Washington lawyers and non-Washington cases trying to bootstrap, about the IRS MSSP Audit Guide for Lawsuit Awards and Settlements and what it means (specifically, how it lists only Alabama, Michigan, and Texas as "good states"), about states of residence when cases are settled, money is paid, about the *Golsen* rule, and so on.⁴⁸ Perhaps I overthought this, but I don't think so.

Recovery for Sex Discrimination and Sexual Harassment Is Taxable

In *Murray v. Commissioner*,⁴⁹ the Tax Court found a recovery for sex discrimination and sexual harassment to be taxable absent a showing of personal physical injury or physical sickness. In 1996 Murray accepted employment with May Co. as a loss prevention agent in one of its California stores. During her employment, Murray suffered an injury to her hand when she tried to apprehend a disabled shoplifter who used a wheelchair.

Soon after, her employment with May Co. ceased, and she filed a complaint alleging sexual harassment, sex discrimination, wrongful termination, and intentional infliction of emotional distress. Murray further claimed that she was forced to abandon any possible workers' compensation claim she may have had because the individual responsible for handling the claim was one of the individuals who had been harassing her. In a settlement agreement between May Co. and Murray, the physical injuries that Murray suffered in apprehending the disabled shoplifter were not allocated any portion of the settlement payment.

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⁴⁸ See *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd on other grounds*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971). See also Wood and Daher, *Misses the Mark*, *supra* note 5; Wood, *Whose Law Applies*, *supra* note 5; David B. Porter, "Where Can You Litigate Your Federal Tax Case?," *Tax Notes*, Jan. 27, 2003, p. 558.

⁴⁹ *Supra* note 4.

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Instead, the settlement agreement allocated the entire settlement amount to "alleged emotional distress." Of course, that is less than ideal tax planning. Had the settlement agreement been drafted in a more tax-friendly manner, perhaps at least some (maybe all?) of the settlement funds could have been allocated to the personal physical injuries sustained by Murray.

Some courts have found that the most important factor in determining the tax consequences of a settlement payment is the express language of the settlement agreement.⁵¹

Murray is reminiscent of *Durrett v. Commissioner*.⁵² In *Durrett* the taxpayer received a settlement in a dispute with his employer that made no reference to potentially excludable claims. Holding the settlement to be nonexcludable, the court noted that the taxpayer's belief that he was settling particular claims not delineated in the settlement agreement was not sufficient to support a claim of excludability.⁵³

Unfortunately for Murray, the Tax Court had little trouble dispensing with her argument that the settlement funds were paid on account of personal physical injuries. As has become par for the course, the Tax Court invoked *Schleier*,⁵⁴ which requires that a recovery be based on tort or tort-type rights and must be received "on account of personal injuries or sickness" to be excludable under section 104. Citing *Prasil v. Commissioner*,⁵⁵ the Tax Court noted that the *Schleier* test has since been extended to apply to the post-1996 incarnation of section 104, with the corresponding second prong now requiring proof that the personal injuries or sickness for which the damages were received were physical personal injuries or physical sickness.

Although the Tax Court found that some of Murray's claims might satisfy the first prong of *Schleier*, Murray was unsuccessful in convincing the court that she also satisfied the second prong of *Schleier*. Unfortunately for Murray, the clear language of the settlement agreement stated that the settlement funds she received were on account of "alleged emotional distress." Nowhere in the settlement documents were any alleged personal physical injuries or physical sickness ever allocated any portion of the settlement payment.

⁵¹ *Glynn v. Commissioner*, 76 T.C. 116, 120 (1981), *aff'd without published opinion*, 676 F.2d 1013 (3^d Cir. 1988); *Metzger v. Commissioner*, 88 T.C. 834, 847, Doc 87-2385, 87 TNT 71-6 (1987), *aff'd without published opinion*, 845 F.2d 1013 (3^d Cir. 1988). The importance of the settlement agreement cannot be stressed enough. See *Robinson v. Commissioner*, 102 T.C. 116, 94 TNT 23-18 (1994), *aff'd in part and rev'd in part on another issue* 70 F.3d 34, 95 TNT 238-7 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996).

⁵² T.C. Memo. 1992-682, Doc 92-10771; 92 TNT 239-15.

⁵³ See also *Foster v. Commissioner*, T.C. Memo. 1996-26, Doc 96-2635, 96 TNT 17-10, *aff'd*, 122 F.3d 1071 (9th Cir. 1997), *cert. denied*, 525 U.S. 879 (1998).

⁵⁴ *Supra* note 26.

⁵⁵ T.C. Memo. 2003-100, Doc 2003-9085, 2003 TNT 69-39.

Accordingly, the Tax Court found the settlement payment to be taxable because emotional distress alone is not excludable under section 104(a)(2).

Robert W. Wood practices law with Robert W. Wood, PC, in San Francisco (www.rwwpc.com). He is the author of 29 books, including *Taxation of Damage Awards and Settlement Payments* (published by the Tax Institute and available at Amazon.com).