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Courts Split on Handling of Contingent Attorney Fees

Attorneys who work on a contingency fee basis are likely aware of the disparity among the federal courts regarding treatment of these fees. Depending on where the client lives, attorneys may be able to secure a favorable outcome for themselves by carefully drafting the original contingency agreement.

Split Among Federal Courts
The question that can arise in contingency fee situations is whether the fees should be included in the client's taxable gross income. The 3rd, 4th, 7th, 9th, 10th, and Federal Circuit Courts of Appeals hold that contingency fees should constitute gross income. This means that the taxpayer must report its entire award, inclusive of the fees, and claim a deduction for the fees, as well as any costs and expenses, as a miscellaneous itemized deduction.

In many cases, including the full award renders the client's adjusted gross income so high that he or she will lose a hefty amount of the itemized deductions the client can claim. Further, because those deductions aren't deductible for alternative minimum tax (AMT) purposes, the client could also find him- or herself in an AMT situation, with no tax benefit from deducting the attorney fees.

The 5th, 6th, and 11th Circuit Courts of Appeals have held, however, that contingency fees should be excluded from taxable income. In the states in those circuits, the client reports net award, with deductions for costs and expenses.

The approach applied can have a significant effect on the amount of taxes the client must ultimately pay.

A New Wrinkle
In the recent case of *Raymond v. U.S.*, 91 AFTR2d 2003-535 (12/17/02), the district court of Vermont addressed this issue. The court held that attorney fees weren't includable in the plaintiff taxpayer's gross income.

Critical to the court's decision was the fact that, under Vermont law, a contingency agreement creates an equitable lien on the taxpayer's recovery. The court ruled that the fee arrangement was thus more like an assignment of income-producing property than an assignment of future income *from* property.

In particular, the court noted that, at the time the agreement was entered, the taxpayer's right to income hadn't ripened. The court stated: "The issue should … be whether the taxpayer-client ever had or could have had control over the portion of the anticipated judgment that was designated to his … attorneys. If, at the time the transfer under the contingent fee agreement was made, the taxpayer's rights had not yet ripened to the point that he … was entitled to the gain, then the taxpayer should not be taxed on the transferred portion."

Drafting Fee Agreement

Attorneys working on a contingency fee basis should determine whether the relevant state law would treat a contingency fee agreement as an equitable lien.

If not, careful drafting may be able to raise the agreement to the level of a lien, allowing the client to exclude the attorney fee from his or her gross income.

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