ing a contingency fee agreement is an attempt to redirect earnings (litigation recovery) from a client to his/her attorney. By holding that the fee portion of recovery is included in the client's gross income, the Court refused to allow this anticipatory assignment of income to succeed.

The holding in *Banks* has very important ramifications for many plaintiffs who hire attorneys on a contingency fee basis. Indeed, as the Court in *Banks* explains, unless the fee is somehow deductible by the plaintiff in computing taxable income, a worst-case scenario is that a plaintiff who wins a lawsuit could end up losing money due to the resulting federal income tax obligation. The problem is that contingency fee payments to an attorney are not always fully deductible. The most likely method for an individual to deduct attorney fees is as an investment or profit seeking expense under section 212, or as an unreimbursed employee business expense under section 162.

Generally, taxpayers may only deduct section 212 expenses and unreimbursed employee business expenses as itemized (or "below-the-line") deductions. Deductions that are not itemized (or "above-the-line") deductions are generally more advantageous than below-the-line deductions because above-the-line deductions are not subject to the many limitations that restrict the tax advantage of below-the-line deductions. Additionally, above-the-line deductions are available even to taxpayers who do not itemize but take the standard deduction. Thus, Congress' 2004 enactment of section 62(a)(19)[20], which provides an above-the-line deduction for "attorney fees and costs" incurred in certain cases, including discrimination cases, means that plaintiffs like the one in *Banks* will likely not suffer any adverse tax impact by including attorney fees in gross income. However, plaintiffs who incur contingency fee obligations in cases not covered by section 62(a)(19)[20] will face the same problems that led the plaintiff in *Banks* to litigate the issue of inclusion. For example, under the Court's analysis in *Banks*, plaintiffs in defamation and invasion of privacy cases who incur contingent attorney fee obligations are not eligible for the section 104(a) exclusion and may not be eligible for the section 62(a)(19)[20] above-the-line deduction. Therefore, these plaintiffs may have gross income upon receipt of the fee portion of the recovery but only a below-the-line deduction for payment of the fee to the attorney.

The most significant problem with characterizing payment of attorney fees as a below-the-line deduction is the alternative minimum tax (AMT). The AMT mandates that individual taxpayers pay at least a 26 percent tax on "alternative minimum taxable income." In computing alternative minimum taxable income, a taxpayer takes into account all gross income used in calculating regular income (including the attorney fee portion of section 104(a) nonexcludable awards), but does not take account of many below-the-line deductions (among other things) such as section 212 deductions or unreimbursed employee business expense deductions for payment of attorney fees. So while fees are treated as income for AMT purposes, they will likely not be allowed as deductions for AMT purposes. On the other hand, the AMT problem does not exist for above-the-line deductions, such as those deductions authorized by section 62(a)(19)[20], because they are taken into account fully when calculating alternative minimum taxable income.

Even though the holding in *Banks* appears comprehensively to address issues concerning whether contingent attorney fees are includable in a client's gross income, several issues remain unresolved. For instance, the Court's holding expressly does not address whether attorney fees awarded pursuant to statutory fee-shifting provisions should be included in gross income. Arguably, application of the anticipatory assignment of income doctrine in these circumstances is inconsistent with the policy rationales that underlie fee-shifting statutes. In addition, the Court in *Banks* declined to comment on three theories proposed by *amici* in support of excluding contingency fees from a client's gross income because those theories were not examined by the courts of appeal and were raised for the first time before the Court. Those theories include: 1) The contingency fee agreement establishes a Subchapter K partnership between the client and the attorney such that the attorney fees represents the attorney's share of partnership income; 2) The attorney fees should be treated as a capital expense incurred in disposing of the "cause of action" asset in exchange for the litigation recovery; 3) The attorney fees should be treated as another type of above-the-line deduction—a reimbursed employee business expense authorized by section 62(a)(2)(A). The Court's assertion that "We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes," 125 S.Ct. at 832, seemingly forecloses further serious consideration of the partnership argument. However, it remains to be seen whether there is any meaningful difference between a "Subchapter K partnership" and a "business partnership or joint venture" which would keep the theory alive.

In conclusion, the Court's decision in *Banks*, while providing welcome certainty in one area, has failed to resolve all of the issues raised by the award of attorney fees since the amendment of section 104(a) in 1996. These issues will be important in a smaller category of cases given the enactment of section 62(a)(19)[20], but they will likely not disappear.

RECENT CODE CHANGES **FAVORABLE TO REITS**

by Eric Mikkelson, Kansas City, MO

Real estate investment trusts ("REITs") offer a tax-advantaged structure, typically by using a domestic corporation or business trust, through which large numbers of investors can own income-producing real estate and real estate mortgages. If REITs comply with several organizational, asset, income, distribution

and record-keeping rules, they can avoid entity-level federal income tax liability. Public Law 108-357 was enacted on October 22, 2004, and is known as the American Jobs Creation Act of 2004 (the "AJCA"). The AJCA contains several tax provisions that directly affect REIT qualification. The changes are generally favorable to REITs and their shareholders, and include some retroactive changes. Some of these new provisions are discussed below.

I. ASSET TEST RELAXATION

To retain its tax-favored status, the REIT must meet several asset-related tests, one of which prohibits the REIT from holding securities having a value of more than 10% of the total value of the outstanding securities of any one issuer. I.R.C. § 856(c)(4)(B)(iii)(III). This rule applies not only to equity securities, but also to debt instruments that constitute securities held by the REIT. There are exceptions for certain kinds of securities and issuers. One such exception is a safe harbor for certain "straight debt."

The AJCA expands the applicable definition of "straight debt" for purposes of qualifying under the safe harbor from the 10%-by-value REIT asset limit. The AJCA also provides that certain additional obligations will not be considered securities for purposes of this test, including loans to an individual or estate, certain loans to governments, and tenant obligations to pay rent. I.R.C. § 856(m). These changes expand the universe of assets that a REIT can hold without violating the 10%-by-value asset test. For example, a REIT can now make substantial loans to REIT employees without risking violation of that test.

The AJCA's expanded definitions of "straight debt" and excluded assets are generally applicable retroactively for tax years beginning after December 31, 2000, although a related provision establishing a new "look-through" rule for determining a REIT partner's share of partnership securities for purposes of the 10%-by-value asset test is effective for tax years beginning after October 22, 2004.

II. LESSER PENALTIES FOR FAILURE TO MEET TESTS

The AJCA also protects a REIT from the draconian penalty of revocation of its REIT tax status for failures to satisfy certain asset tests. Now, in certain cases, lesser sanctions and penalties are instead available for such violations. Accordingly, the potentially financially catastrophic threat of revocation of a REIT election is substantially eliminated for many merely-minor violations or inadvertent violations with reasonable causes, if quickly rectified upon discovery.

For example, if a failure of the 10% or 5% asset tests is due to the ownership of assets the total value of which does not exceed the lesser of i) one percent of the total value of the REIT's assets at the end of the quarter; or ii) $10 million, the REIT will not automatically lose its REIT status, provided that in either case the REIT either disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or such other time period as prescribed by the Service) or otherwise meets the requirements of those asset tests by the end of that period. Further, a failure that exceeds the de minimis thresholds described above will not necessarily cause a REIT to lose its REIT status if: i) the failure was due to reasonable cause (and not willful neglect); ii) the REIT files a schedule describing each asset that caused the failure in accordance with Treasury Regulations; iii) the REIT disposes of the assets within six months after the last day of the quarter in which the REIT identifies the failure (or the tests are otherwise met within such period); and iv) the REIT pays a tax on such failure ($50,000 minimum tax). I.R.C. § 856(c)(7). These new AJCA provisions are effective for tax years beginning after October 22, 2004.

Similar reporting and reasonable cause standards apply now for failures to meet the REIT income tests as well. I.R.C. § 856(c)(6). The old rule that assesses the tax penalty for income test failures based on a fraction of the REIT's disqualified gross income survives, however, although the AJCA slightly modifies the formula for calculating the tax for failure to meet the 95% gross income test. I.R.C. § 857(b)(5). For failure to meet certain other requirements for REIT qualification, the AJCA permits a REIT to retain its REIT qualification if such failure was due to reasonable cause (and not willful neglect) and the REIT pays a $50,000 penalty for each such failure. I.R.C. § 856(g). These new AJCA penalty provisions are also effective for tax years beginning after October 22, 2004.

III. FIRPTA CHANGES FAVOR FOREIGN INVESTMENT

The AJCA also changed the Foreign Investment in Real Property Tax Act ("FIRPTA") in a manner that should promote foreign investment in REITs. Previously under FIRPTA, REIT capital gain distributions to foreign shareholders were treated as effectively connected with a U.S. trade or business, triggering a U.S. return filing requirement for that foreign shareholder as well as possible branch profits tax for foreign corporate shareholders, and corresponding withholding obligations on the REIT.

Under the AJCA, for tax years beginning after October 22, 2004, REIT capital gain distributions will no longer automatically be treated as income effectively connected with a U.S. trade or business (and, thus, a foreign shareholder will no longer have to file a U.S. federal income tax return solely by reason of receiving such a distribution) and will no longer be subject to the branch profits tax. Instead, such distributions will be treated as dividends that are not capital gains (dividend withholding requirements still apply to the REIT, but those rates are often reduced, even eliminated, by the applicable U.S. tax treaty), *provided that* i) the foreign shareholder recipient does not own more than 5% of that class of stock at any time during the tax year in which the distribution is received; and ii) that class of stock is regularly traded on an established U.S. securities market. I.R.C. §§ 897(h)(1), 857(b)(3)(F).

IV. OTHER CHANGES

Other AJCA changes directly affecting REITs include provisions: i) expanding the applicable definition of a "hedging transaction" and providing that certain such hedging transactions entered into to reduce interest rate risk on real estate debt will be disregarded for purposes of the REIT income tests (effective for tax years beginning after October 22, 2004); ii) eliminating a safe harbor from the 100% excise tax on deductions improperly shifted between a REIT and its taxable REIT subsidiary (effective for tax years beginning after October 22, 2004); iii) providing practical clarification of how to test whether rents a REIT receives from its taxable REIT subsidiary will qualify as "good" real estate income under the applicable REIT income tests (effective for tax years beginning after 2000); iv) adding an opportunity for a REIT to pay deficiency dividends for past year failures identified by the REIT (effective for tax years beginning after October 22, 2004); and v) providing a safe harbor for qualifying REIT sales of timber allowing such sales to avoid the prohibited transactions tax on dealer sales (effective for tax years beginning after October 22, 2004). I.R.C. §§ 856(c)(5)(G), 857(b)(7)(B), 856(d)(8)(A), 860(e)(4), and 857(b)(6)(D).

V. CONCLUSION

Notwithstanding these generally favorable changes, REIT tax compliance remains a technical and complex balancing act that must inform virtually everything a REIT does. The failure or violation of one of the myriad applicable tax rules can still lead to significant taxes and penalties. Nonetheless, these changes, to the extent some are retroactive, provide certainty to REITs for past tax years and, prospectively, generally improve the tax landscape for REIT operations and transactions. As a result of the AJCA, REITs now enjoy greater flexibility in how and what they invest in, increased prospects for foreign investment in the REIT, more certainty as to whether REIT operations will comply with tax rules, and less risk for inadvertent violations of those rules. These changes together should, on balance, enhance REITs' comparative attractiveness as real estate investment vehicles.

COBRA'S BITE: RETIREE MEDICAL BENEFITS IN A CHAPTER 11 BANKRUPTCY AND AFTER ACQUISITIONS

by Frank Tripodi, New York, NY

Unlike qualified pension benefits, welfare benefits do not vest automatically. Employee Retirement Income Security Act of 1974 ("ERISA") §201(1); *see also* Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995). Accordingly, an employer must typically perform some affirmative act, such as making an irrevocable promise to employees that such benefits are permanent in order for future benefits to become guaranteed. *See e.g.* In re Unisys Corp. Retiree Med. Benefit ERISA Litigation, 58 F.3d 896, 901 (3d Cir. 1995). Absent such action, an employer may reduce and/or eliminate prospective welfare benefits at virtually any time. Retiree medical benefits typically follow this general rule. However, employers who attempt to eliminate retiree medical benefits within one year before or after the filing of a Chapter 11 bankruptcy petition may find that section 4980B of the Code ("COBRA"), operates to vest this particular welfare benefit without any other affirmative act by the employer. Arguably then, the law permits employers to eliminate retiree medical benefits at anytime, unless the employer's business can no longer afford to provide such benefits. In addition, COBRA could make a purchaser liable for continuing coverage of former employees of a target even if the purchaser never employed those individuals itself.

COBRA

Generally, COBRA requires all employers who employed at least 20 employees in the preceding calendar year to offer continuing health coverage to an employee, the employee's spouse and/or dependent children (a "qualifying beneficiary"), who participate in the employer's group health plan if the employee or qualifying beneficiary loses coverage under the plan after a "qualifying event." I.R.C. § 4980B. A qualifying event occurs if the employee or a qualifying beneficiary loses health coverage as a result of: (a) the employee's death; (b) the employee's termination or reduction of hours; (c) the divorce of the employee from the employee's spouse; (d) the employee becoming eligible to receive Medicare benefits; (e) an employee's dependent child no longer qualifying under the terms of the plan; or (f) a substantial elimination of retiree health coverage occurring within one year before or after the commencement of a bankruptcy proceeding. I.R.C. § 4980B(f)(3)(A)-(F). The continuation coverage offered must be identical to the health coverage offered to similarly situated individuals that remain actively covered under the employer's health plan. I.R.C. § 4980B(f)(2)(A). If the employer alters or eliminates the health coverage provided to its remaining active employees, then the employer can amend the continuation coverage offered under COBRA. *Id.*

COBRA also mandates the period during which the health coverage must be offered to employees after a qualifying event. Regardless of the circumstance of the loss of coverage, an employer will no longer be obligated to offer continuation coverage if the employer does not maintain a health plan for its employees who have not undergone a qualifying event. I.R.C. § 4980B(e)(2)(B)(2). Additionally, COBRA does not require the employer to continue to offer continuation coverage to a participant who obtains coverage under another group health plan after a qualifying event. Treas. Reg. § 54.4980B-7, Q&A #2. If neither of these events occur in the interim, the maximum period of required continuation coverage under COBRA for non-bankruptcy related qualifying events is 18 to 36 months after such qualifying event,