TO INCLUDE OR EXCLUDE? THE CIRCUIT COURT SPLIT ON DOUBLE TAXATION OF CONTINGENT FEES

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You win a big case or achieve a favorable settlement and recover both damages and legal fees for your client. Cause for celebration? The Internal Revenue Service ("IRS") certainly thinks so. Under current law, damages for discrimination or any type of nonphysical injury are taxable, as are the legal fees generated to recover those damages.[1] If the plaintiff and the attorney arranged for contingent fee payment, the IRS will tax the contingent fee portion of the damages twice: once to the plaintiff as part of the total damages received, and once to the plaintiff's attorney as income for services rendered.[2] Including contingent fees in the plaintiff's income can dramatically reduce the plaintiff's recovery. In the worst case scenario, the taxpayer plaintiff could end up paying all of the judgment or settlement proceeds in taxes and attorney fees. This result may occur because contingent fees, as legal fees, are deductible to the taxpayer plaintiff only as a miscellaneous itemized deduction, subject to the 2% floor on miscellaneous itemized deductions.[3] Miscellaneous itemized deductions, in turn, may not be deducted at all under the alternative minimum tax.[4] Thus, if the size of the recovery triggers application of the alternative minimum tax, the taxpayer plaintiff will be barred from deducting any portion of the recovery.

Imagine a case where the plaintiff recovers $1 million in taxable damages. If the attorney receives a 33% contingent fee of $330,000, the plaintiff's recovery is reduced to $770,000. Expert witnesses, travel expenses and other out-of-pocket costs could further reduce the recovery by perhaps as much as $100,000 to $670,000. The amount of the recovery will likely trigger application of the alternative minimum tax, resulting in a denial of deductions for the contingent fee paid. The amount of the recovery will also place the taxpayer in the highest federal and state tax brackets (approximately 39.1% and 9.264%, respectively, for tax year 2001).[5] The IRS and state tax department will proceed to tax the entire $1 million rather than the diminished recovery of $670,000. The combined federal and state tax burden of roughly 48% applied to the $1 million recovery further reduces the remaining $670,000 award by approximately $480,000. The taxpayer plaintiff ultimately is left with a little over $190,000 of the original $1 million award. In the meantime, the plaintiff's attorney must also pay federal and state tax on the $330,000 contingent fee.

Angry taxpayers have challenged this double taxation of contingent fees. A conflict among the circuit courts has ensued. The former Fifth Circuit, the current Fifth Circuit, the Sixth Circuit, and the Eleventh Circuit have all held that a client may exclude contingency fees from income.[6] These courts present two arguments in favor of exclusion. First, if the relevant state attorney lien rule grants attorneys the same power over their clients' suits and judgments as the clients themselves retain, then the contingent fee belongs to the attorney because the attorney controls receipt of his or her fee. Second, the anticipatory assignment of income doctrine does not apply to contingent fees.[7]

Lining up against the exclusion of contingent fees, the Federal, Third, Fourth, Seventh, Ninth and Tenth Circuits, as well as the Tax Court, all require a client to include in gross income any attorney's fees paid from a judgment or settlement.[8] These courts use the converse of the two arguments presented in favor of excluding contingent fees. First, they argue that if the relevant state attorney lien rule does not grant attorneys the same power over their clients' suits and judgments as the clients themselves retain, then the entire judgment award, including any contingent fee, belongs to the client. Second, they argue that irrespective of differences among state attorney liens, the anticipatory assignment of income doctrine applies to contingent fees.

Noticeably absent in the debate is the Second Circuit, which has yet to issue an opinion on the contingent fee dispute. Should it face this question, the Second Circuit may be inclined to follow the growing majority of authority in favor of including contingent fees in income. However, regardless of whether the Second Circuit enters the fray, the uncertainty surrounding the tax treatment of contingent fees will continue unabated until the Supreme Court or Congress chooses to resolve the issue.

Exclusion of Contingent Fees from Client's Income

The "Old" Fifth Circuit

The first case to address the tax treatment of contingent fees, *Cotnam v. Commissioner*,[9] presented an analysis of the issue which all later courts, whether agreeing or disagreeing with *Cotnam*, have used as a basic framework in contending with the issue. In *Cotnam*, the plaintiff successfully sued the promisor's estate to enforce a contract to make a will. The court found that the IRS had properly treated plaintiff's judgment of $120,000 as income for personal services rendered, instead of as a nontaxable bequest. A majority of the court then held that the 40% contingent fee paid to the plaintiff's attorneys was not income to the plaintiff. It based its decision both on the theory that the state statutory attorney lien rule excluded the contingent fee, and on the theory that the anticipatory assignment of income doctrine did not apply.

The court reasoned that Alabama state law would never have allowed the plaintiff to receive the attorney fees, even if she had directly settled the case with the estate. The Alabama Code provided at the time that

> upon suits, judgments, and decrees for money, [attorneys] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.[10]

The court construed the statute to give the attorneys an equitable lien that operated as a transfer of part of plaintiff's claim to the attorney. The attorneys thus held a

40% equity interest in both the cause of action and the judgment, precluding the plaintiff from realizing income as to that 40% interest.

The court then rejected the anticipatory assignment of income doctrine. It noted that the plaintiff's claim had no fair market value, and that it was doubtful and uncertain as to whether the claim had any value. In the court's eyes, the assignment of income doctrine did not apply to contingent fees because the claim would remain entirely worthless absent the aid of the attorneys. The court observed that at the time of entering into the contract, the plaintiff not only had realized no income from the claim, but was helpless to earn any income absent the help of the attorneys. Even with the attorneys' help, nothing guaranteed that the claim would yield income. The court noted that the plaintiff had parted with 40% of her claim long before realizing any potential income therefrom. It also noted that the contingent fee never passed through the plaintiff's hands and that the plaintiff never controlled it. To the court, the contingent fee was earned by the attorneys because only their services resulted in converting the uncertain claim into a judgment and the collection of a judgment. Thus, the court held that the entire contingent fee should not have been included in the plaintiff's income.

The Eleventh Circuit and the "New" Fifth Circuit

After the *Cotnam* decision, in a realignment and expansion of the circuit courts, the Fifth Circuit was divided into two circuits, the Fifth and the Eleventh.[11] The Eleventh Circuit has embraced the essential holding of *Cotnam* in two recent decisions.[12] Both decisions, like *Cotnam*, arose under Alabama law. In the first case, the plaintiff prevailed in a suit against a mortgage company and proceeded to exclude from her income that portion of the judgment paid as attorneys' fees.[13] The court found *Cotnam* directly on point and controlling. In its capacity as the successor to the Fifth Circuit, it followed *Cotnam* and upheld the exclusion of contingent fees from plaintiff's income with little analysis.[14]

In the second decision, issued in April, 2001, the Eleventh Circuit extended the contingent fee exclusion to an appeal fee paid to the taxpayer's attorneys under a post-judgment agreement.[15] The agreement provided for the attorneys to receive all post-judgment interest on the taxpayer's tort judgment.[16] The Eleventh Circuit found that the appeal fee agreement was analogous to a pretrial contingency fee agreement, even though it was signed after the jury award in favor of the taxpayer.[17] Noting Alabama's attorney lien rule and the necessity of the attorney's efforts to earn his fee, the court then rejected the government and district court's reliance on the assignment of income doctrine.[18] The court also awarded the taxpayer litigation costs, and scolded the government for using the split among the circuits to justify its denial of the taxpayer's refund claim.[19] The Eleventh Circuit made clear that, regardless of the outcome in other circuits, it would continue to uphold the exclusion of contingent fees.

The new Fifth Circuit has been more tenuous in its support of *Cotnam*'s underlying holding. In a case arising under Texas law, the Fifth Circuit held that plaintiffs could exclude contingent fees from gross income, but it did so with reservations.[20] The plaintiffs had received a significant judgment from their defamation suit against a Texas television station and its parent corporation. The award included $11.5 million in actual damages, $17.5 million in punitive damages, and pre- and post- judgment interest. During the defendants' appeal, the plaintiffs settled with the station and its insurance carriers for $8.5 million. After receiving the settlement proceeds, the plaintiffs reported no gross income therefrom. They reasoned that the entire amount constituted non-taxable actual damages. The IRS issued a notice of deficiency of tax for that portion of the settlement which it estimated represented taxable interest and punitive damages. The Tax Court rejected the plaintiffs' argument that the settlement award constituted exclusively actual damages. It also rejected plaintiffs' argument that the contingent fee portion of the settlement did not constitute gross income.

The Fifth Circuit reversed the Tax Court's contingent fee ruling, instead holding that plaintiffs may exclude contingent fees from gross income. The court found the issue substantially indistinguishable from *Cotnam*. As successor to the old Fifth Circuit, it felt bound to follow *Cotnam*.

The court did not base its decision on the Texas attorney lien rule.[21] Rather, it dismissed the attorney lien argument as irrelevant to what the court felt the issue should turn on: the applicability of the anticipatory assignment of income doctrine. The court reasoned that attorney lien rules govern the attorney's rights against the opposing party-defendant, but do not change the economic reality facing the taxpayer-plaintiff seeking to exclude contingent fees.

The court closely examined the anticipatory assignment of income doctrine and its application to contingent fee arrangements. In doing so, it found support for both exclusion and inclusion of contingent fees. It noted that the doctrine applies to tax any enjoyment of economic gain, whether monetary or nonmonetary, rather than the exclusive receipt of funds.[22] The court also noted, however, that the doctrine does not apply to a taxpayer who transfers, sells, or otherwise relinquishes an asset or income source to another, because the taxpayer ceases to receive any income from the asset.

The court went on to acknowledge that contingent fee arrangements resemble a division of property and result in a "virtual co-ownership" of the claim. Yet, it also found that the client has not fully divested control of the claim in a way that assures preclusion of the assignment of income doctrine. The court noted that the contingent fee arrangement involves a non-gratuitous, arms-length transaction, in which the attorney must earn his share of any award. It also found, however, that the assignment of income doctrine applies to such transactions, and, if anything, that the taxpayer has obtained economic gain from the attorney's services. The court further acknowledged the uncertainty of the value, and even the fact of recovery in the contingent fee situation. Yet, in the court's eyes, this uncertainty did not exclude the assignment of income doctrine. Finally, the court agreed that tax avoidance does not usually motivate the contingent fee agreement, but nevertheless felt that the client obtains non-monetary gain from not otherwise having to pay for the attorney's services. Such gain, to the court, implicated the assignment of income doctrine. Thus, rather than firmly stating the case for exclusion of contingent fees, the court concluded that the assignment of income doctrine might support either inclusion or exclusion and ultimately rested its deci-

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sion in favor of exclusion on *Cotnam*'s binding precedent.

The Sixth Circuit

The Sixth Circuit, dealing with the contingent fee issue for the first time, adopted the *Cotnam* holding in a January 2000 opinion.[23] The Sixth Circuit addressed the issue of whether a client may exclude the interest portion of an attorney's contingency fee. The attorney had obtained a judgment for the client in a personal injury suit, and the attorney had received a one-third contingent fee based on both the judgment award and on the interest. The client died less than a year after receiving the award. When his estate filed his return, it excluded that portion of the contingent fee attributable to interest.

The court held that the estate properly excluded the interest portion of the attorney's contingency fee. The court, as in *Cotnam*, rested its decision on both the state attorney lien rule and on a repudiation of the anticipatory assignment of income doctrine.

First, the court reasoned that Michigan's common law lien operates in essentially the same way as the Alabama statutory lien examined in *Cotnam*. The lien protects attorneys by assuring payment from clients. The court noted that in Michigan, as in Alabama, the contingent fee agreement amounts to an assignment of a portion of the potential judgment. The court observed that the client originally owned the underlying claim. However, it stated that the client lost his right to receive payment for the lawyer's contingent fee portion of any judgment after signing the contingent fee contract.

The court, again following *Cotnam*, rejected the assignment of income doctrine, as developed in *Lucas v. Earl*[24] and *Helvering v. Horst*.[25] In *Earl*, the taxpayer assigned part of his salary and earned fees to his wife.[26] In *Horst*, the taxpayer gave some of his negotiable bonds to his son shortly before their due date.[27] The son collected the interest when the bonds came due.[28] Highlighting what it considered to be the driving principle behind the *Earl* and *Horst* decisions, the court noted that the anticipatory assignment of income doctrine allows the taxpayer neither to divert income that he earned or otherwise created the right to receive, nor to enjoy the benefit of that income once it is paid.

The court then contrasted the contingent fee arrangement with the income-assignments of the above cases. Unlike the income in *Earl* and *Horst*, it noted, the contingent fee was not already earned, vested, or even relatively certain to be paid to the assignor. Rather, the value of the client's lawsuit amounted to nothing more than an intangible, contingent expectancy. The client completely relied on the attorney to realize any value.

The court compared the contingent fee arrangement to a division of property, like different interests in a partnership or joint venture.[29] It analogized the contingent fee assignment to a partner or joint venture member's assignation of an interest: the client assigns his lawyer a one-third interest in the venture in the hope that he might recover the remaining two-thirds. It also found the contingent fee situation no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant. Each tenant-in-common will receive a portion of the as yet unrealized lease income.

The court also noted that, unlike the true income assignations in *Earl* and *Horst*, no tax avoidance purpose motivated the contingent fee arrangement. Instead, the attorney-client joint venture to reduce the uncertain claim to money evidenced business purpose. The court further observed that the *Earl* and *Horst* assignees performed no services to earn their income. It contrasted the assignee's failure to perform services in those cases with the facts of the case before it (i.e., the attorney had to expend effort to realize income from his interest in the claim). To the court, the attorney earned his income because the income resulted from his own skill and judgment.

Finally, the court observed that application of the assignment of income doctrine would result in double taxation. It noted that in *Earl* and *Horst*, the assignees, as gift-recipients, did not have to pay income tax if the donor-assignor paid the tax. In each case, the IRS taxed the assignor after application of the assignment of income doctrine. It did not tax both the assignor and the assignee. The court noted that in the case before it, the attorney had already paid income tax on the full amount of the contingent fee and rejected the IRS's view that both assignor and assignee should pay tax on the same income.

Inclusion of Contingent Legal Fees in Client's Income

The Tax Court

The Tax Court has repeatedly disagreed with the *Cotnam* decision and will only follow it in very limited circumstances.[30] It illustrated its position on contingent fees in *Kenseth v. Comm'r*, later affirmed by the Seventh Circuit.[31] In *Kenseth*, the plaintiff sought damages under the Age Discrimination in Employment Act and eventually settled with his former employer.[32]

The contingent fee agreement between plaintiff and his attorneys required an attorney lien against the attorney's proportionate share of any damages, proceeds, costs, and fees recovered in the action. The lien provided for satisfaction before or concurrently with the disbursement of the recovery. The agreement also demanded payment from the client for all outstanding costs if the client chose to change attorneys. Under the agreement, the plaintiff and the attorneys were required to disregard any division of a settlement offer between damages and attorney fees.

The settlement agreement did not allocate any amount to attorney fees. It provided that Wisconsin law would govern the settlement. The settlement included lost wages and personal injury damages for the plaintiff. The defendant paid the lost wages directly to the plaintiff, but paid the attorneys the personal injury portion of the award. The attorneys then deducted their fee from this portion and issued a check to the plaintiff for the remainder.

After surveying the existing contingent fee case law, the Tax Court found that the assignment of income doctrine applies to contingent fees. The court observed that an anticipatory assignment of the proceeds of a cause of action does not allow a taxpayer to avoid taxation on those proceeds. Relying on the Supreme Court's liberal interpretation of gross income, the court disregarded the fact that the plaintiff never physically received the portion of the settlement used to pay the attorneys. It also disregarded the speculative, uncertain nature of the claim. Instead, it found that the plaintiff "earned" the entire award because the defendant owed the damages to the plaintiff alone. The court reasoned that the attorneys merely helped the plaintiff to realize the already inherent value in the claim.

The court then rejected characterization of the contingent fee arrangement as a division of property between attorney and client. It noted that the attorney serves the client in a fiduciary capacity. To the court, this fiduciary capacity would seriously hinder any hypothetical conversion of the attorney-client relationship into either a joint venture or a partnership.

The Tax Court also felt that the assignment of income doctrine requires the inclusion of contingent fees irrespective of the applicable state attorney lien rule (Wisconsin in this case). However, it noted that even if the attorney lien rules did matter, attorneys in Wisconsin cannot acquire a proprietary interest in the claims of their clients and do not have the same rights as their clients over the proceeds of suits, judgments, and decrees. Under either line of analysis, the Tax Court came to the same result. Taxpayers must include contingent fees in gross income.

The Federal Circuit

The Federal Circuit, without mentioning the *Cotnam* case, analyzed and ultimately dismissed the reasoning underlying *Cotnam* in its examination of the contingency fee issue.[33] In the case before the Federal Circuit, the plaintiff was the tax matters partner of a partnership that successfully sued the state of Maryland to increase a land-condemnation award. The partnership's contingency fee agreement with its attorney provided the attorney with a percentage of any amount recovered above the previous award. The partnership received an award of $10,625,850 in principal and $6,358,418 in interest. The legal fees amounted to $4,048,424.

The court dismissed the partnership's argument that it could exclude all of the legal fees because of the contingency fee agreement. To the court, the assignment of income doctrine squarely applied. It first noted the Supreme Court's liberal interpretation of gross income to include all gains except those specifically exempted. It then found that though the partnership never took possession of the funds paid to its attorney, the funds nevertheless benefitted the partnership because they discharged the partnership's obligation to the attorney for his legal services. To the court, this indicated the partnership's control of the funds.

The court then stated that the uncertainty of the recovery amount did not change the fact that the partnership controlled the recovery and chose to divert some of it to the attorney. The court noted that the uncertainty of the amount simply meant that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery. However, the court did not address the possibility that the partnership may not have recovered anything.

Finally, the court analyzed the Maryland attorney lien statute. It observed that the statute does not give the attorney an ownership interest in the claim or in any recovery. Instead, it noted that the lien does nothing more than place a charge upon the funds as security for the fees owed by the client to the attorney.

The Ninth Circuit

The Ninth Circuit, in a series of opinions issued in the last two years, has repeatedly required plaintiffs to include contingent fees in gross income.[34] The Ninth Circuit's jurisprudence has incorporated all aspects of the arguments in favor of inclusion of contingent fees. It has distinguished the attorney lien rules applicable in the cases before it from the Alabama and Michigan lien statutes supporting the *Cotnam* and *Clarks* decisions.[35] It has applied the anticipatory assignment of income doctrine,[36] and has further presented an even more basic argument: that if one owes another a debt, and a third person pays the debt, such payment constitutes income to the original debtor.[37] In the context of this argument, the Ninth Circuit has viewed the defendant's payment to the attorney in satisfaction of the contingent fee as a release of the plaintiff's "debt" to the attorney.[38]

The attorney lien argument recently arose in a wrongful termination case where the plaintiff and her husband had won a significant judgment for lost wages and benefits against her former employer.[39] The defendant had issued a check for the entire judgment amount directly to the plaintiff. After receiving this check, the plaintiff then paid the attorneys' fees.

Interpreting Alaska law, the Ninth Circuit first distinguished its case from *Cotnam* and *Clarks*. Instead of disregarding the attorney lien argument made in those cases as the Tax Court did in *Kenseth*, it found that under applicable Alaska law attorneys do not have a superior lien or ownership interest in the claim, as recognized in Alabama and Michigan. The court interpreted the Alaska statute to give the attorney a lien on property belonging to the client, but not as conferring an ownership interest or power over the client's suit and judgment.

The court then applied the assignment of income doctrine. It noted that anticipatory arrangements to prevent earnings from vesting in the taxpayer will not enable that taxpayer to avoid taxation. It also noted that a taxpayer cannot escape taxation simply because he has not received direct payment of income that has otherwise economically benefitted the taxpayer. The court rejected the plaintiff's argument that the uncertainty of the amount or fact of the contingency fee precluded application of the assignment of income doctrine. Rather, it observed that diversion to creditors of even contingent amounts implicates the doctrine.

The court found it significant that the plaintiff had initially received the entire award and only subsequently paid her attorneys from that award. To the court, this payment indicated the plaintiff's control of the funds.

In a later opinion, the Ninth Circuit again rested its holding in favor of the inclusion of contingent fees on the inapplicability of the attorney lien argument.[40] The court reasoned that the applicable California attorney lien arising from a contingent fee contract gives the attorney nothing more than a security interest in the litigation proceeds. The court determined that in spite of some language to the contrary, the lien does not make the attorney the equitable owner of part of the cause of action.

Recent Trends

Recent developments indicate increasing support for the inclusion of contingent fees. In the past year, the Supreme Court denied certiorari in two cases coming from the Ninth Circuit, both of which had ruled that taxpayers may not exclude contingency fees from gross income.[41] The Ninth Circuit then continued its denial of the exclusion in an age discrimination case in which the defendants paid a portion of the plaintiff's settlement award directly to plaintiff's attorneys in satisfaction of their contingency fee agreement.[42]

Also in the past year, the Fourth, Seventh and Tenth Circuits, each facing the matter for the first time, issued opin-

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ions rejecting the exclusion of contingent fees, and together joined what is now a majority of circuits to have done so.[43] The Fourth Circuit relied on the anticipatory assignment of income doctrine and rejected the state attorney lien rule argument altogether.[44] In examining *Cotnam*, it proceeded to disagree with nearly all of the old Fifth Circuit's justifications for exclusion.[45] It found that a contingent fee arrangement does not give an attorney a portion of a client's claim or "property," but rather that the client controls the claim from beginning to end, and ultimately decides whether to forego, pursue or settle the claim.[46]

The Fourth Circuit also found that even if state law was determinative, instead of federal tax law, the relevant North Carolina common law charging lien does not permit an attorney to acquire rights to the cause of action or a right equal to that of the client.[47] The court drew a distinction between the right to recover fees for services rendered, which the attorney has, and the right to obtain a share of the income produced by the client's claim, which he does not have.[48] Noting that clients who pay legal fees at an hourly rate may not exclude the income used to pay such fees, the Fourth Circuit also reasoned that permitting clients to exclude contingent fees would create the inequitable result of favoring clients who arrange for contingency fee compensation over clients who pay an hourly rate.[49]

The Seventh Circuit's later ruling presented many of the same arguments against exclusion.[50] It followed the Fourth Circuit's lead, for example, in finding no difference between the taxpayer who pays a lawyer contingent fees to prosecute a tort claim, and the taxpayer who pays fixed hourly fees for that same claim.[51] Characterizing both fees as expenses paid to generate income for the taxpayer, it found both to be deductible expenses. The court analogized contingent fees to a company's payments to salesmen on a commission basis.[52] Though payments are contingent on sales, the company may only deduct, not exclude, the paid commissions. The court also found no difference between the client's relinquishment of control over the claim in the contingent and fixed fee contexts.[53] In both cases, the client may fire the attorney, effectively ending the attorney's association with the claim, and in both cases, the client would owe the attorney for work done but not paid for.

Taking on the state law attorney lien question, the Seventh Circuit noted that Wisconsin law, which governed the case, does not make the contingent-fee lawyer a joint owner of the client's claim.[54] In fact, it emphasized, Wisconsin law prohibits a lawyer from acquiring a proprietary interest in the cause of action or subject matter of litigation which he or she conducts.[55] The court then noted that this prohibition prevents clients from assigning a portion of their income-generating asset (the claim) to law firms.[56] At most, they can only assign the income generated by the asset, which, the court found, implicates the assignment of income doctrine.[57]

After the opinions by the Fourth and Seventh Circuits approving of contingent fee inclusion, the Tenth Circuit followed suit.[58] In a case arising under Missouri law, the plaintiff prevailed in a Title VII lawsuit against her former employer. The plaintiff had argued that she was entitled to exclude the contingent fee because she lacked control over it and lacked beneficial ownership of it. The court dismissed this argument, noting that no matter how the parties labeled their contract, the recovery of the legal fees ultimately benefited the plaintiff. The Tenth Circuit also rejected the plaintiff's argument based on the Missouri lien statute. It distinguished the Missouri lien statute from the Alabama and Michigan statutes which had supported an exclusion of contingent fees. Unlike those statutes, it noted, the Missouri statute does not give the attorney a proprietary interest in the recovery. Rather, the court stated, it only provides a means of ensuring payment to the attorney.

In addition to the cases discussed above, the IRS also recently released its Market Segment Specialization Program (MSSP) Audit Guide for Lawsuit Awards and Settlements (Training 3123-009 (11-00), TPDS No 86391 G). The guide primarily formalizes the already well-known IRS position on the contingent fee issue. It instructs agents to include a taxpayer's gross award or settlement, undiminished by attorney's fees or costs, in the taxpayer's income. It includes situations in which attorneys receive direct payment from the award or settlement, and applies in all cases other than those arising under Alabama, Michigan or Texas law. In cases arising under the laws of Alabama, Michigan and Texas, jurisdictions where the IRS has litigated the issue and lost,[59] it instructs field agents to consult with the local Office of the Chief Counsel until the circuit court conflict is resolved.

Addressing the Tax Treatment of Contingent Fees in Practice

For practitioners with cases arising under the jurisdiction of the Second Circuit, tax treatment of contingent fees is an uncertain matter. To facilitate a ruling favoring exclusion of contingent fees, practitioners should structure contingent fee agreements to provide that the judgment debtor must pay the attorney's fee directly to the attorney. The agreement should not allow the client to pay the attorney after receiving the litigation proceeds. In addition, if a court could interpret the applicable state attorney's lien to permit a transfer of ownership of part of the claim to the attorney, the agreement should state that it intends such a transfer. The transfer would amount to a portion equivalent to the contingent fee percentage. However, if a court decides that the assignment of income doctrine applies, even such an agreement will probably not preserve favorable tax treatment for the client. With no sure safe harbor until the Second Circuit rules on the issue or until the Supreme Court settles the matter, the client and practitioner must both, for now, live with a measure of uncertainty.

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[1] Section 104(a)(2) of the Internal Revenue Code of 1986 ("I.R.C."), as amended by the Small Business Job Protection Act of 1996, provides an exclusion only for damages received on account of a *physical* personal injury or sickness. I.R.C. §104(a)(2).

[2] *See* IRS Market Segment Specialization Program (MSSP) Audit Guide for Lawsuit Awards and Settlement (Training 3123-009 (11-00), TPDS No. 86391(G).

[3] I.R.C. §67(a). Legal fees allocable to taxable amounts are normally deductible under IRC §162 as a business expense or under IRC §212 as a production of income expense. Note that IRC §68 further limits the total amount of itemized deductions allowed.

[4] I.R.C. §56(b)(1)(A)(i).

[5] *See* I.R.C. §1; 32 V.S.A. §5822 (2001).

[6] Foster v. United States, 249 F.3d 1275 (11th Cir. 2001)(ruling in its capacity as successor to the former Fifth Circuit); Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Cotnam v. Comm'r,

263 F.2d 119 (5th Cir. 1959).

[7] Different courts present different reasons to justify preclusion of the anticipatory assignment of income doctrine, including that: a contingent fee arrangement creates a division of property between attorney and client; the client never has control over the contingent fee if the defendant directly pays the attorney; the client's claim is nothing more than an intangible, contingent expectancy that yields value only when the attorney earns the contingent fee income with his services; tax avoidance is not the primary motivating factor behind contingent fee agreements; and the contingent fee already is subject to income taxation because the attorney must pay tax on the full fee. *See* pages 2-6, *infra*.

[8] Campbell v. Comm'r, No. 00-9030, 2001 WL 1623294 (10th Cir. Dec. 19, 2001); Kenseth v. Comm'r, 114 T.C. 399 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 855 (S. Ct. 2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 1604 (S. Ct. 2001); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); O'Brien v. Comm'r, 38 T.C. 707 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963)(*O'Brien* does not directly address the contingent fee question because the taxpayer-plaintiff had already *included* the contingent fees from his successful wrongful discharge suit in income. The taxpayer merely sought to spread the deductions over several years prior to receipt of the award. The Tax Court held that the plaintiff must deduct the legal fees in full in the year of receipt. In dicta, the court analyzed *Cotnam* and observed that the Internal Revenue Code probably did not turn on differences in states' attorneys' liens. Rather, the court felt that the assignment of income doctrine would require inclusion of contingent fees even if the taxpayer irrevocably assigned a portion of the future recovery to the attorney. The Third Circuit then affirmed the Tax Court's decision in all respects). The First Circuit, addressing only *noncontingent* legal fees, has held that a plaintiff must include such fees in gross income if recovered in a lawsuit. Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995). Note also that the Eighth Circuit, without addressing the issue of contingent fees, affirmed a Tax Court decision which had rejected a client'=s argument that his contingent fee arrangement justified exclusion by creating a "joint venture or partnership" between client and lawyer. Bagley v. Comm'r, 105 T.C. 396 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997).

[9] 263 F.2d 119 (5th Cir. 1959).

[10] *Id.* at 127 (citing Ala. Code §64 (1940)).

[11] P.L. 96-452, dividing the Fifth Circuit into the Fifth and Eleventh Circuits, took effect October 1, 1981.

[12] Foster v. United States, 249 F.3d 1275 (11th Cir. 2001); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000).

[13] *Davis*, 210 F.3d at 1347.

[14] Reasoning that the attorney lien statute gave the attorneys an ownership interest in the litigation, the IRS argued that it could tax the plaintiff on the value of the interest "sold" to the attorneys in exchange for their services at the time of entering into the contingent fee contract. The IRS based its argument on application of the open transaction doctrine, which permits a delay in the assessment of the value of the properties exchanged until both values become apparent. The court rejected this argument, finding instead that the IRS failed to sustain its burden of showing that the values of both properties were unascertainable at the time of the exchange. *Id.* at 1347-48.

[15] Foster v. United States, 249 F.3d 1275, 1279 (11th Cir. 2001).

[16] *Id.*

[17] *Id.* at 1279-80.

[18] *Id.* The *Foster* Court distinguished between contingency fees and income-splitting in the family context, which gave rise to the assignment of income doctrine in Lucas v. Earl, 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940).

[19] *Foster*, 249 F.3d at 1280.

[20] Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000).

[21] The court observed in a footnote that Texas law grants attorneys less power over their client's action than the governing Alabama law in *Cotnam*. In Texas, the court noted, even when the client assigns the attorney an ownership interest in the claim, the attorney's rights remain wholly derivative from those of the client; the client's claim is indivisible and may not be tried for only a percentage of the claim.

[22] Monetary economic gain includes the taxpayer's personal receipt of money or property. *Srivastava*, 220 F.3d at 359 (citing *Horst*, 311 U.S. 112, 115-17 (1940)). Nonmonetary economic gain includes the taxpayer's diversion of income to a different party when such diversion procures the satisfaction of the taxpayer's wants. *Id.* at 359, 361 (citing *Horst*, 311 U.S. 112, 117 (1940)).

[23] Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000). The *Clarks* decision was issued a few months before the Fifth Circuit's critical acceptance of *Cotnam* in *Srivastava*, discussed above.

[24] 281 U.S. 111 (1930).

[25] 311 U.S. 112 (1940).

[26] *Lucas*, 281 U.S. at 113-14.

[27] *Horst*, 311 U.S. at 114.

[28] *Id.*

[29] In making this division of property analogy, the court favorably cited the Second Circuit's decision in Wodehouse v. Comm'r, 177 F.2d 881 (2d Cir. 1949). The parties in *Wodehouse*, before the three-judge panel of Judges Learned Hand, Swan, and Clark, did not address the contingent fee question. However, the *Wodehouse* court did face an assignment of income issue. It refused to apply the doctrine to the plaintiff-author's gift of a half-interest in a story with potential but as yet non-existent royalties. Like partners in a partnership, joint-owners of real estate, or parties to a contingent fee agreement, the parties with royalty rights in the same story each have a right to a share of potential income - income that is not yet earned, vested or even certain.

[30] Kenseth v. Comm'r, 114 T.C. 399 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001); Srivastava v. Comm'r., TC Memo 1998-362 (1998), *rev'd in part*, 220 F.3d 353 (5th Cir. 2000); O'Brien v. Comm'r, 38 T.C. 707 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963). The Tax Court will only follow appellate court decisions with which it disagrees if an appeal would lie to that same appeals court. *See* Golsen v. Comm'r, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[31] *Kenseth*, 114 T.C. 399.

[32] *Id.*, at 403-04.

[33] Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

[34] Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 855 (S. Ct. 2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 1604 (S. Ct. 2001).

[35] *See* Benci-Woodward, 219 F.3d at 943 (distinguishing California law); *Coady*, 213 F.3d at 1190 (distinguishing Alaska law); *but cf.* Sinyard v. Comm'r, 268 F.3d at 759-60 (following *Coady* and *Benci-Woodward* generally but finding attorney lien rule irrelevant).

[36] *See Coady*, 213 F.3d at 1191.

[37] *See Sinyard*, 268 F.3d at 758 (citing Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929)).

[38] *See id.*

[39] *See Coady*, 213 F.3d at 1187-88.

[40] *See Benci-Woodward*, 219 F.3d at 943. In a footnote supporting its prior contingent fee decision in *Coady*, the Ninth Circuit rejected the plaintiff's efforts "to distinguish contingent fees from other anticipatory assignments of income". *See id.*

[41] *Coady*, 213 F.3d 1187, *cert. denied*, 121 S. Ct. 1604 (S. Ct. 2001); *Benci-Woodward*, 219 F.3d 941, *cert. denied*, 121 S. Ct. 855 (S. Ct. 2001).

[42] *Sinyard*, 268 F.3d 756. The *Sinyard* Court found that the Age Discrimination in Employment Act, under which the claim arose, directed attorney's fees to prevailing plaintiffs and not to plaintiff's counsel. This indicated the plaintiff's ownership of the fees. Following *Coady* and *Benci-Woodward*, it then determined that the original defendant's direct payment of fees to plaintiff's counsel could not change the reality that such payment discharged the plaintiff's "debt" to the attorneys, and that this would be so even under the Alabama attorney lien rule which governed in *Cotnam*. *Id.* at 759-60.

[43] Campbell v. Comm'r, No. 00-9030, 2001 WL 1623294 (10th Cir. Dec. 19, 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001).

[44] *Young*, 240 F.3d at 376-79.

[45] The court also simultaneously examined and disagreed with *Clarks*, the Sixth Circuit's decision in favor of exclusion of contingent fees. *Id.*

[46] *Id.* at 378.

[47] *Id.* at 379.

[48] *Id.*

[49] *Id.* at 377-78.

[50] *Kenseth*, 259 F.3d 881.

[51] *Id.* at 883.

[52] *Id.*

[53] *Id.* at 884.

[54] *Id.* at 883.

[55] *Id.*

[56] *Id.* at 884. The court reasoned that absent a rule of law granting a proprietary interest, the lawyer's lien grants nothing more than ownership of a security interest, as opposed to ownership of the security itself. The lawyer does not own the claim itself, only a security interest therein. It is the taxpayer who owns the claim, however secured. The court then pointed out that an individual whose assets are secured by a mortgage can deduct the interest paid on the mortgage, but may not reduce its income by the amount of the interest. *Id.* at 883-84.

[57] *Id.* at 884.

[58] *Campbell v. Comm'r*, No. 00-9030, 2001 WL 1623294 (10th Cir. Dec. 19, 2001).

[59] Foster v. United States, 249 F.3d 1275 (11th Cir. 2001)(arising under Alabama law); *Srivastava* (5th Cir. 2000)(arising under Texas law); *Davis* (11th Cir. 2000) (arising under Alabama law); *Clarks* (6th Cir. 2000)(arising under Michigan law); *Cotnam* (5th Cir. 1959)(arising under Alabama law).

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