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LOSING IN THE TAX SYSTEM AFTER YOU WIN IN THE COURT SYSTEM: SHOULD CONTINGENT FEES PAID TO THE ATTORNEY BE INCLUDED IN THE TAXPAYER-CLIENT'S GROSS INCOME?

I. INTRODUCTION

In recent years, the Courts of Appeal of many circuits have been faced with the question of whether contingent fees paid to attorneys must be included in the taxpayer-client's gross income. This issue arises when a taxpayer-client enters into an agreement with an attorney to pay him or her a contingent fee.[1] The Internal Revenue Service (IRS) contends that the taxpayer-client should include the contingent fee in their gross income but the IRS will allow a deduction for the contingent fee amount.[2] In contrast, the taxpayer-client wants to exclude the contingent fee from their gross income. By excluding the contingent fee from their gross income the taxpayer-client would have a lower tax bill then would be achieved by the deduction allowed by the IRS. The Court of Appeals for the Fifth Circuit stated the problem well, "contingent fee contracts defy easy categorization, standing as they do somewhere in between two poles – on the one hand, an obvious scheme to evade taxation through diversion of future income streams to another, and on the other hand, full and complete divestment of an income source."[3]

In 1959 *Cotnam v. Commissioner* first addressed this issue.[4] In *Cotnam*, Ms. Cotnam previously received a judgment in the amount of $125,620 and had attorney's fees in the amount of $50,365.83.[5] The court found that under Alabama law[6] Ms. Cotnam could never receive the attorney's fees herself because of a lien that was superior to all liens that the attorney had on the judgment proceeds.[7] This lien had to be paid before Ms. Cotnam receive any

1. Black's Law Dictionary defines "contingent fee" as, "A fee charged for a lawyer's services only if the lawsuit is successful or is favorably settled out of court. Contingent Fees are usually calculated as a percentage of the client's net recovery." Black's Law Dictionary 315 (7th ed. 1999).

2. Kenseth v. Commissioner, 114 T.C. 399, 405-06 (2000) (provides a summary of the IRS's position).

3. Srivastava v. Commissioner, 220 F.3d 353, 360 (5th Cir. 2000).

4. 263 F.2d 119 (5th Cir. 1959).

5. *Id.* at 121; *see infra* Part II(A).

6. 46 ALA. CODE § 64(2) (1940).

7. *Cotnam*, 263 F.2d at 125.

of the judgement proceeds.[8] The court held that the contingent fees should not be included in Ms. Cotnam's gross income because she never had a right to receive any of those fees because of the existence of the lien.[9] From this beginning several other Circuits have ruled on this issue, some finding that the contingent fees are included in the gross income of the taxpayer-client[10] and some finding that the fees are not included in the taxpayer-client's gross income.[11]

Those circuits holding that the fees are included in the taxpayer-client's gross income generally rest their holdings on three major arguments: (1) the assignment of income doctrine;[12] (2) the taxpayer-client received the economic benefit of the money;[13] or (3) the "in lieu of" test from *Raytheon Products Corp. v. Commissioner*.[14] In contrast, the arguments used by circuits holding that the fees should not be included in the taxpayer-client's gross income are: (1) the attorney and the taxpayer-client entered into a joint venture when they entered into the contingent fee agreement;[15] (2) the attorney and the taxpayer-client are joint owners in property;[16] or (3) the precedent of *Cotnam*.[17]

The IRS's position of allowing the contingent fees to be deducted rather than of allowing the fees to be excluded from gross income leaves the taxpayer-client in worse position then if they were allowed to exclude the fees from their income. The reason for this is that by excluding the fees the taxpayer-client would have an overall lower tax bill than if they deducted the fees.[18] There is one group of cases in which this issue is not germane. In personal injury cases all proceeds received on account of personal physical injuries or sickness are excluded from gross income.[19]

Part II of this article will discuss *Cotnam* to help understand the origins and history of the issue. Part III will examine the cases holding that the

8. *Id.*

9. *Id.*

10. Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995); Coady v. Commissioner, 231 F.3d 1187 (9th Cir. 2000); Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

11. *Cotnam*, 263 F.2d 119; *Srivastava*, 220 F.3d 352; Estate of Clarks v. United States, 202 F.3d 854, 856 (6th Cir. 2000); Davis v. Commissioner, 210 F.3d 1346, 1347 (11th Cir. 2000).

12. Lucas v. Earl, 281 U.S. 111, 114 (1930); Helvering v. Horst, 311 U.S. 112, 114 (1940).

13. *Baylin*, 43 F.3d at 1454-55; *Alexander*, 72 F.3d at 942-43; *Coady*, 231 F.3d at 1191.

14. *Alexander*, 72 F.3d at 942-43; *Coady*, 231 F.3d at 1190-91. *See* Raytheon Products Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944).

15. *Clarks*, 202 F.3d at 857.

16. *Id.*

17. *Cotnam*, 263 F.2d 119.

18. An exclusion is a guaranteed reduction in the taxpayer's tax liability whereas a deduction is not.

19. IRC § 104(a)(2); Reg. § 1.104-1(c) (IRC § 104(a)(2) applies to funds received through the prosecution or settlement of "tort or tort type rights").

contingent fees are included in the taxpayer-client's gross income. Part IV evaluates and addresses cases finding contingent fees should not be included in the taxpayer-client's gross income. In Parts III and IV both the winning and losing arguments will be examined and traced back to their origins in earlier court opinions. Finally, Part V will consider and examine what the correct analysis of the issue should be and what the future of the issue might be.

II. HISTORY AND HOLDING OF *COTNAM V. COMMISSIONER*

A. Facts

In 1940, Ethel Cotnam entered into an oral arrangement to act as an attendant to T. Shannon Hunter for the rest of his life and in return for this service Mr. Hunter was to give Ms. Cotnam one-fifth of his estate.[20] Mr. Hunter died intestate four and one-half years later.[21] Ms. Cotnam filed suit to receive her payment and after a long lawsuit she was awarded $125,620.[22] Before filing suit Ms. Cotnam entered into a contingent fee arrangement with the law firm of Johnston, McCall & Johnston, of Mobile, Alabama.[23]

The Commissioner of the Internal Revenue Service ("Commissioner") concluded that the entire judgment should properly be included in Ms. Cotnam's gross income.[24] The Commissioner assessed a deficiency of approximately $36,985.[25] Ms. Cotnam challenged the deficiency.[26] The Tax Court found in favor of the Commissioner.[27] That decision was appealed to the Fifth Circuit.[28]

20. *Id*. at 120.

21. *Id*.

22. Cotnam v. Commissioner, 28 T.C. 947, 950 (1957) (The judgment was for $125,620 which included interest of $5,620). *See* Merchants National Bank v. Cotnam, 24 So.2d 122 (Ala. 1948) (this is Ms. Cotnam's original case to receive payment for her services).

23. *Cotnam*, 28 T.C. at 948; *Cotnam*, 263 F.2d at 125. Attorney's fees for Ms. Cotnam's case amounted to approximately $50,365, which left approximately $75,254 remaining for Ms. Cotnam. The IRS did not include the interest in the calculations and the Commissioner prorated Ms. Cotnam's award over the four and one-half years that she worked for Mr. Hunter in accordance with IRC § 107 (1939).

24. *Cotnam*, 28 T.C. at 950 (The IRS did not include the interest in the calculations). The Commissioner prorated Ms. Cotnam's award over the four and one-half years that she worked for Mr. Hunter in accordance with IRC § 107 (1939).

25. *Cotnam*, 263 F.2d at 121.

26. *Cotnam*, 28 T.C. at 948.

27. *Id.* at 954.

28. *Cotnam*, 263 F.2d 119.

B. Arguments Presented

The Commissioner's argument was based on the U.S. Supreme Court case of *Lucas v. Earl*.[29] In *Earl*, the Supreme Court held that even if a taxpayer assigns or contracts away some of his or her earnings or right to income before it is received, those earnings are still included in the taxpayer's gross income.[30] This rule has been referred to as the assignment of income doctrine.[31] The Tax Court found for the Commissioner but did not rest its holding on the Commissioner's argument. The fax Court instead held that the contingent fees paid to Ms. Cotnam's attorneys should be included in her gross income because Ms. Cotnam owned the original claim and she was the party who received the final award and had full right and title to it.[32]

The Fifth Circuit on appeal also addressed the issue of whether Ms. Cotnam received the economic benefit of the money even though it was paid directly to the attorney.[33] The court noted that based on *Helvering v. Horst* any economic benefit Ms. Cotnam received from the contingent fee portion of the award should be included in her gross income.[34] The Fifth Circuit though in *Cotnam* did not follow *Horst* and held that the fees paid to the attorney should not be included in Ms. Cotnam's gross income.[35]

Ms. Cotnam argued that she never received money paid to the attorneys and as such she never had a right to it.[36] Her primary argument was that under Alabama law attorneys have a lien that is superior to all liens against the judgment.[37] Under this Alabama law the judgment cannot be paid to the taxpayer-client until the attorney is paid his or her fees.[38] The Fifth Circuit read the Alabama attorney lien statute as saying Ms. Cotnam never realized as

29. *Id.* at 125; *Cotnam*, 28 T.C. at 953-54. *See Lucas v. Earl*, 218 U.S. 111 (1930).

30. *Id.* at 113-14 (Earl contracted with his wife that she should receive one-half of his earnings, the Court held that despite this contract and the amount of earnings being uncertain the earnings are still apart of Earl's gross income).

31. *See Cotnam*, 263 F.2d at 125.

32. *Cotnam*, 28 T.C. at 954.

33. *Cotnam*, 263 F.2d at 126. *See supra* Part II(C) for explanation of the economic benefit Ms. Cotnam received.

The Supreme Court in *Helvering v. Horst* held that when a taxpayer receives the economic benefit of some income or the right to receive some income the but assigns away the right to receive the income the assignment of income doctrine applies and the income is included in their gross income regardless if they have not received it yet. 311 U.S. 112, 119-20 (1940) (Mr. Horst gave interest coupons from a bond to his son, the Court held that since Mr. Horst had earned the right to the payment of the coupons, he should be taxed on them despite the fact that the money was being paid to his son).

34. 311 U.S. at 120.

35. *Cotnam*, 263 F.2d at 125-26.

36. *Cotnam*, 28 T.C. at 951.

37. *Cotnam*, 263 F.2d at 125; *see* 46 ALA. CODE § 64 (1940).

38. *Id*.

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income the portion of the judgment paid to the attorney because she never had a right to receive it and thus should not be taxed on it.[39]

C. Holding

On appeal the Fifth Circuit agreed with Ms. Cotnam and held that the contingent fees should not be included in her gross income.[40] The court relied heavily upon the Alabama statue and how it had been construed in earlier cases.[41] One of these cases is an earlier Fifth Circuit case, *United States Fidelity & Guaranty Co. v. Levy*, which stated that the Alabama statute created an equitable lien in favor of the attorney that gives the attorney a right to the judgment before the plaintiff.[42] It is this point from Alabama law that the court primarily used to rest their holding.[43]

Judges Rives and Brown, in addition to the majority's reasoning, added that the contingent fees should not be included Ms. Cotnam's gross income since she never had any actual control over the money retained by the attorneys.[44] They state that, "[t]he only income, the only real economic benefit, which Ms. Cotnam ever received was the [amount] she collected . . . In a realistic sense the remaining [amount] was income of the attorneys, not Ms. Cotnam."[45]

Judges Rives and Brown held that the assignment of income doctrine under *Earl* and *Horst* did not apply because Ms. Cotnam was never in a position to realize the income without the aid of her attorneys.[46] The attorney's knowledge and expertise was needed to turn Ms. Cotnam's claim into any type of award. In contrast, in both *Earl* and *Horst*, the taxpayers had a preexisting right to the income and had earned it before they assigned it to a third party.[47]

The *Earl* case bears many factual similarities with the Supreme Court case of *Poe v. Seaborn*, but they can be easily distinguished.[48] In *Seaborn* the Court dealt with the issue of community property and determined that under the laws of Washington State all property owned by husband or wife is community property of the marriage and for tax purposes each spouse can claim half of all

39. *Cotnam*, 263 F.2d at 126.

40. *Id.* at 125-26.

41. *Id.*

42. 77 F.2d 972, 975 (5th Cir. 1935). The court held that the Alabama statue gives the attorney the same rights and powers over the judgment or settlement that their clients have.

43. *Cotnam*, 263 F.2d at 125-26.

44. *Id*. at 126. The addition of Judge Rives and Brown is included in the body of the majority opinion, but is setoff by a separate header.

45. *Id*.

46. *Cotnam*, 263 F.2d at 125-26.

47. *See Earl*, 281 U.S. at 113; *Horst*, 311 U.S. at 117.

48. 282 U.S. 101 (1930).

the income and half of all the expenses for their individual tax returns.[49] The Court in *Seaborn* distinguished *Earl* because in *Earl* the court held that by law the earnings at issue were the husband's property and his own individual income and in *Seaborn* the earnings were by law not the husband's property or individual income but were community property.[50] The community property issue from *Seaborn* will not influence the determination of whether contingent fees should be included in gross income. This is because whether or not contingent fees are included in gross income is an issue of the contents of gross income and community property issue from *Seaborn* is one of allocation of gross income between husband and wife.

III. CASES HOLDING THAT CONTINGENT FEES ARE NOT INCLUDED IN THE CLIENT'S GROSS INCOME

Following the Fifth Circuit's holding in *Cotnam*, the Sixth and Eleventh circuits have also held that contingent fees are not included in gross income.[51] Along with following *Cotnam*, the other circuits have developed other lines of reasoning to support the exclusion of contingent fees from the taxpayer-client's gross income.[52] The most prominent of these alternative lines of reasoning is in the Sixth Circuit case of *Estate of Clarks v. United States*.[53] There the court held that the taxpayer-client and the attorney entered into a joint venture with regard to the taxpayer-client's claim and are, thus, joint owners of the claim.[54] In many ways, this new argument is not different from the attorney lien theory from *Cotnam*, and indeed is merely a logical extension of it. The reason for this similarity is that both of the theories treat the client and attorney as working together in the lawsuit towards a common goal.[55] Also, in *Alexander v. IRS*, the taxpayer-client sets out an additional argument, which the court rejected, that the legal fee is an expenditure that should be charged to the capital account and should be offset by settlement proceeds to determine the

49. *Id.* at 113. The Court was construing sections 210(a) and 211(a) of the Revenue Act of 1926. 83 Stat. 9, 21-22 (1927). The Court notes that other states have similar community property laws as Washington. 282 U.S. at 115.

50. *Id.* at 117. The two cases were applying different laws. In *Earl* the Court was applying the Revenue Act of 1918 and in *Seaborn* the Court was applying the Revenue Act of 1926. *See supra* note 147 and *infra* note 49.

51. Estate of Clarks v. United States, 202 F.3d 854, 856 (6th Cir. 2000); Davis v. Commissioner, 210 F.3d 1346, 1347 (11th Cir. 2000); Srivastava v. Commissioner, 220 F.3d 353, 355 (5th Cir. 2000).

52. *See Estate of Clarks*, 202 F.3d at 857 (the value of the award was entirely speculative and had to be earned and attorney and client entered into a join-venture of sorts).

53. *Id.*

54. *See id*.

55. The similarities between these two theories will be discussed further in Part III(C).

gain.[56] The net effect of this argument would be to exclude the fees paid to the attorney from the taxpayer-client's gross income.

To find for the taxpayer-client, the courts must find ways to avoid the application of the assignment of income doctrine from *Earl* and *Horst*. There are three primary ways that courts have found to avoid the application of the doctrine. They all rest upon a narrow reading of both the *Earl* and the *Horst* cases.

A. Avoidance of the Assignment of Income Doctrine

Before explaining the arguments used to exclude contingent fees from the taxpayer-client's gross income and how they fit in with the holding in *Cotnam*, it seems necessary to explain how the courts avoid the application of the assignment of income doctrine from *Earl* and *Horst*. Simply put, the courts have characterized the contingent fee arrangements as an exception to the doctrine. There have been three primary methods used to skirt the doctrine. The first method used is to argue that the taxpayer has not received any economic benefit. In both *Earl* and *Horst* the Court held that the taxpayer received the economic benefit of the income despite having transferred the income to a third party, but in some of the cases that do not apply the doctrine the courts hold that the taxpayer-client never received any economic benefit of the income.[57] The second method to avoid the doctrine focuses upon the lack of control that the taxpayer-client has over the claim.[58] The third method is a factual distinction that in contingent fee cases the attorney must earn his or her part of the judgment award.[59]

The Supreme Court in both *Earl* and *Horst* hold out that the taxpayer had received the economic benefit of the income assigned.[60] It is a long-standing rule that regardless if the taxpayer receives actual payment of income earned, realization of the income, for tax purposes, can occur when the taxpayer has enjoyed the economic benefit of the income.[61] In cases of assigning the income before it is received, the Supreme Court states in *Horst* that the "power to procure the payment of income to another is the enjoyment [or economic

56. 72 F.3d 941-42.

57. *See Estate of Clarks*, 202 F.3d at 857.

58. *Earl*, 281 U.S. at 114; *Horst*, 311 U.S. at 120; *see Srivastava*, 220 F.3d at 359-60.

59. *See id*. at 360-61; *Estate of Clarks*, 202 F.3d at 858.

60. *See Earl*, 281 U.S. at 114; *Horst*, 311 U.S. at 120 (the taxpayer had enjoyed the fruits or economic benefit of their labor).

61. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929). The taxpayer enjoyed the economic benefit of the money paid by his employer to the Government to pay off his tax bill, thus the amount paid by the company is income to the taxpayer. *See Srivastava*, 220 F.3d at 359. The court agrees what is taxed is not receipt of funds, but instead the economic benefit of the funds whether that be through actual receipt of the funds or some other method.

benefit], and hence the realization, of the income by him who exercises [the power]."[62]

Cotnam and the Sixth Circuit case of *Estate of Clarks* do not disagree with the principle that the enjoyment of the economic benefit of the right to receive some income is realization of that income.[63] But *Cotnam* and *Estate of Clarks* hold that, unlike in *Earl* and *Horst*, the taxpayer-clients did not have an absolute right to any income that could be assigned and absent any absolute right to the income there can be no enjoyment of any economic benefit from it.[64] In sum, the basic reason for the holding in *Estate of Clarks* is that there was no absolute right to any income before the final judgment in the initial case.[65] As the court in *Estate of Clarks* stated, "[h]ere [in this case] there was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury."[66] Based on this absence of an absolute right to receive any earned income, the court held that the assignment of income doctrine does not apply.[67]

The second method to avoid the assignment of income doctrine focuses upon the lack of control that the taxpayer-client has over his or her claim once they have entered into a contingent fee arrangement with an attorney. In *Horst*, the Supreme Court held that so long as the person who earns the income retains control over the income it is taxable to them even if the income is paid to a third party.[68] The court in *Srivastava* did not hold that Dr. Sudir Srivastava had divested complete control over his entire claim to avoid being taxed on the income, but they did state that Dr. Srivastava did divest control of a portion of his claim.[69] The result of this part divesture of control left the court in a "quandary" and could not apply the assignment of income doctrine solely based on factors of control over the future income.[70] The *Srivastava* court did not make it clear if there was a critical amount of control that if

62. *Horst*, 311 U.S. at 118. The result in *Horst* might have been different had Horst given the bond to his son and not just the interest coupons because Horst would have been divesting the source of the income and not just the income.

63. *Cotnam*, 263 F.2d at 126.

64. *Id.* at 126 (she [Ms. Cotnam] could never have . . . enjoyed any economic benefit unless she had employed the attorneys); *Estate of Clarks*, 202 F.3d at 857.

65. *Id.*

66. *Id.*

67. *Id.* at 857-60.

68. *Horst*, 311 U.S. at 119. *See also* Commissioner v. First Sec. Bank, 405 U.S. 394, 403 (1972) (holding that in order to be taxed for income, the taxpayer must have complete dominion over it).

69. *Srivastava*, 220 F.3d at 360.

70. *Id.* ("control over that claim . . . is neither fully divested to the attorney nor fully retained by the taxpayer-client. . . . The control test thus leaves us [the court] in a quandary. In light of this ambiguity, a number of other factors might be considered.").

divested would avoid the application of the assignment of income doctrine or if any divesture would achieve this result.

The final method of skirting the application of the assignment of income doctrine is a factual dissimilarity between *Earl* and *Horst* and the contingent fee cases. In both *Earl* and *Horst* the third party receiving the income performed no services for the taxpayer transferring the income – they were gratuitous transfers.[71] In contrast, both *Estate of Clarks* and *Srivastava* notes that the assignment of income doctrine should not apply since the attorney did not receive a gratuitous transfer from the taxpayer-client, but rather had to use his or her own skills and knowledge to receive the income.[72]

It thus appears that the primary way that courts have been able to avoid the usage of the assignment of income doctrine is by distinguishing *Earl* and *Horst* factually.[73] This allows courts with different factual situations to easily avoid applying the doctrine.

B. Cotnam v. Commissioner as Precedent

Two circuits, the Fifth and the Eleventh, are bound, as a result of the split of the Fifth Circuit,[74] by the holding in *Cotnam* and other circuits have looked to the reasoning found in *Cotnam*.[75] In the Sixth Circuit case of *Estate of Clarks*, the court was not bound to the holding in *Cotnam* but still examined the reasoning from *Cotnam*.[76] In following *Cotnam*, the *Srivastava* court noted some reservations about doing so.[77] These reservations stem from a disagreement with the application of the assignment of income doctrine and the fact that *Cotnam* was decided under Alabama law.[78]

71. *Earl*, 281 U.S. at 113-14 (the taxpayer transferred the income to his wife solely to avoid taxation); *Horst*, 311 U.S. at 114 (taxpayer gave the income as a gift to his son). *See also* Jones v. Commissioner, 306 F.2d 292, 302 (5th Cir. 1962) ("No gratuity or gift is involved here as has been involved in numerous other cases [*Earl* and *Horst*].").

72. *Srivastava*, 220 F.3d at 360-61; *Estate of Clarks*, 202 F.3d at 857 ("The assignee [in *Earl* and *Horst*] performed no services in order to receive the income . . . Here there was . . . only a hope to receive money from the lawyer's efforts").

73. The facts in *Earl* and *Horst* are significant because in both of them there was already a definite right to receive income and there was still some control over the right to receive the income or there was economic benefit received by the taxpayer for the transfer of the right to receive the income.

74. *See* Bonner v. City of Prichard, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc) (the Eleventh Circuit adopted as binding precedent all decisions of the Fifth Circuit handed down prior to the close of business on September, 30 1981).

75. *Davis*, 210 F.3d at 1348 ("Because we [the court] find that *Cotnam v. Commissioner* is controlling . . . we affirm the decision of the Tax Court.").

76. *Clarks*, 202 F.3d 856.

77. *Srivastava*, 220 F.3d at 363.

78. *Id.* at 361-63 (the court was applying Texas law).

The *Srivastava* court appears to believe that the assignment of income doctrine should apply because the taxpayer-client has, in their view, received the economic benefit of the income paid to the attorney.[79] The court declared this view, "[w]ere we ruling on a *tabula rasa,*[80] we might be inclined to include contingent fees in gross income."[81] The *Srivastava* court did not find it persuasive that the value of the claim is uncertain and thus the assignment of income doctrine should not apply.[82] The court in *Srivastava* seems to be saying that the money paid under the contingent fee agreement should be treated the same as money paid out of pocket to an attorney for services and to reach this goal the court cites to the assignment of income doctrine.[83] In the end, despite its reservations, the *Srivastava* court held that the contingent fees are not included in the taxpayer-client's gross income.[84] The court states that *Cotnam* is too factually similar to their case and as a result must be followed.[85] The dissent argues that the contingent fees should be included in gross income because *Cotnam* dealt with an Alabama law that setup a unique superior lien for the attorney against the taxpayer-client's award and under Texas law the attorneys are not granted the same right.[86] The Alabama attorney lien statute will be examined and addressed in Part III(C).

In *Foster v. United States*, a district court case applying Alabama law, the district court followed the precedent of *Cotnam* but noted some limitations on the holding of *Cotnam*.[87] The court limited *Cotnam* by holding that it only applies to contingent fee agreements entered into prior to the final judgment.[88] The *Foster* court held, based on the precedent of *Cotnam*, that the part of Mattie Foster's award paid to the attorney under the contingent fee agreement (entered into prior to the judgment) was not included in her gross income.[89] Mattie Foster entered into a second contingent fee agreement with the attorney after the judgment regarding the provision of appellate services.[90] The court, however, distinguished *Cotnam* and held that the fees paid under the second

79. *Id.*

80. Black's Law Dictionary defines "*tabula rasa*" as, "A blank tablet ready for writing; a clean slate." Black's Law Dictionary 1465 (7th ed. 1999).

81. *Srivastava*, 220 F.3d at 357.

82. *Id.* at 361-63.

83. *Id.* at 363 ("[h]e [the taxpayer-client] should not receive preferential tax treatment from the simple fortuity that he hired counsel on a contingent basis").

84. *Id*. at 357-58. *See supra* Part III(C)(1) for additional grounds for holding that contingent fees should not be included in the taxpayer-client's gross income used by the *Srivastava* court.

85. *Id.* ("Because *Cotnam* is substantially indistinguishable from this case, we reverse the Tax Court and decide that contingent fees governed by Texas law are also excludable.").

86. *Id.* at 367-68.

87. 106 F. Supp.2d 1234, 1239 (N.D. Ala. 2000).

88. *Id.* at 1237-38.

89. *Id.*

90. *Id.*

contingent fee agreement were not excluded from the taxpayer-client's gross income because the contingent fee was entered into post-judgment.[91] The court stated that the assignment of income doctrine[92] would apply because the income had been earned and the value of it was no longer uncertain.[93]

The *Foster* court in dicta reasoned that, in its view, *Cotnam* should be reconsidered based on a misinterpretation of the Alabama law involving contingent fee agreements and attorney lien rights to the judgment.[94] The misinterpretation of the Alabama law is based on the high level of actual control that a taxpayer-client retains over the litigation after the parties have agreed to the contingent fee agreement.[95]

C. Joint-Ownership Theory

Some of the cases have held that contingent fees are not included in the gross income of the taxpayer-client have relied on the joint-ownership theory.[96] This theory is similar to the lien theory used in *Cotnam*.[97] This section will examine the joint-ownership theory and its similarity to the attorney-lien theory used in *Cotnam*.

1. Summary of the Joint Ownership Theory

In order to best explain and summarize this theory the familiar analogy, from *Earl*,[98] of the taxpayer owning an orchard and how both the trees and fruit are distributed to others will be used.[99] In this analogy there is an important difference between the fruit and the trees. The fruit represents the actual monetary award that the taxpayer-client is receiving and all the trees represent the entire claim that is being litigated.

The joint-ownership theory contends that when the contingent fee agreement is signed it transfers to the attorney some of the taxpayer-client's

91. *Id.* ("*Cotnam* did not involve, and should not control, the taxability of attorneys' fees under an assignment made after a chose-in-action had been transformed through a jury trial into a money judgment, a part of which (including post-judgment interest) would constitute gross income if and when received.").

92. *See infra* Part III(A) for a discussion of the assignment of income doctrine.

93. *Foster*, 106 F. Supp.2d at 1238-39.

94. *Id.* at 1239.

95. *Id.* Particularly the court points to the taxpayer-client's power to discharge the attorney at any time during the litigation.

96. *Estate of Clarks*, 202 F.3d at 857-58; *Srivastava*, 220 F.3d at 360.

97. *Cotnam*, 263 F.2d at 125.

98. 281 U.S. at 114-15.

99. In the use of this analogy there is an important difference between the fruit and the trees. The fruit represents the actual monetary award that the taxpayer-client is receiving and all the trees represent the entire claim that is being litigated.

trees and they become tenants-in-common[100] of the orchard.[101] As a result of being tenants-in-common the attorney must assist the orchard owner (the taxpayer-client) in cultivating and caring for the all trees if they hope to receive any fruit.[102] In contrast, the IRS argues that the taxpayer-client only transfers the fruit of the orchard to the attorney at the end of the case (i.e. just pays them).[103] The result of the joint-ownership theory is that the each party will receive the fruit from their own trees that they owned and cultivated. If this is the case, then the income should be included to the gross income of the one who earned it.[104] The result of this it to have the taxpayer-client include in their gross income the income from the portion of the claim that they own and have the attorney include in their gross income the portion that they own.

Based on the joint-ownership theory the court in *Srivastava* held that "[t]he income should be charged to the one who earned it and received it . . . [not] to the one who neither received it nor earned it."[105] In a contingent fee situation under the joint-ownership theory the attorney would pay taxes on the part of the award they receive as fees and the taxpayer-client would pay taxes on the part of the award they receive.

2. Similarity of Joint-Ownership Theory with the *Cotnam* Lien Argument

An issue that many courts, including the Tax Court, have had is that statutes in other states do not give the attorney in a contingent fee arrangement the same type of superior lien as is given under Alabama law.[106] Because other states' statutes are not like Alabama's,[107] non-Alabama courts, must find other ways of justifying their holdings besides state attorney lien laws. The best example of how this is done is the courts giving attorneys the same rights as the taxpayer-client to the award by following the joint-ownership theory.

100. Black's Law Dictionary defines "tenancy in common" as, "A tenancy by two or more persons, in equal or unequal undivided shares, each person having an equal right to possess the whole property but not right of survivorship." Black's Law Dictionary 1478 (7th ed. 1999).

101. *Estate of Clarks*, 202 F.3d at 857-58; *Srivastava*, 220 F.3d at 360.

102. *Id.*

103. *Estate of Clarks*, 202 F.3d at 858.

104. *Estate of Clarks*, 202 F.3d at 856.

105. 220 F.3d at 361.

106. *See Coady*, 213 F.3d 1190 (Alaska law does not give an attorney a superior lien or ownership interest like Alabama law does); *Baylin*, 43 F.3d at 1154 (Maryland law); *Benci-Woodward*, 219 F.3d at 941 (California law); Estate of Gadlow v. Commissioner, 50 T.C. 975, 980 (1968) (Pennsylvania law); Petersen v. Commissioner, 38 T.C. 137, 152 (1962) (Nebraska and South Dakota law); Sinyard v. Commissioner, 76 T.C.M. (CCH) 654, 658 (1998) (Arizona law); Hukkanen-Campbell v. Commissioner, 79 T.C.M. (CCH) 2122, 2126 (2000) (Missouri Law).

107. *See* Hukkanen-Campbell, 79 T.C.M. (CCH) 2122, 2126 ("the Missouri provision [and others], unlike the Alabama provision, does not give attorneys the same right and power over suits, judgments, and decrees as their clients had or may have.").

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If the joint-ownership theory and the Alabama statute are examined side-by-side, they appear to create the same situation between the taxpayer-client and the attorney. Under the Alabama statute, the attorney is given a lien on the recovery that is superior to all other liens and must be paid before the taxpayer-client can receive any of the judgment.[108] The pertinent section of the Alabama statute states:

> Upon suits, judgments, and decrees for money, they [the 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 [or her] fees [are] fully satisfied[109]

The situation that the Alabama statue creates is similar to the way a joint owner cannot take profits from the property without giving the other joint owners their share of the profits. The arrangement of assignment of income in a joint-ownership of property situation is described as, "income [from joint ownership of property] . . . belong[s] in fact and in law to the individuals . . . in the proportions fixed in and by their instruments and dealings."[110]

In a joint-ownership situation each of the owners has a right to a share of the profits generated by the property in accordance with the agreement entered into by the parties. In contingent fee cases the agreement setting the method and amount of the "profit" distribution is the contingent fee contract entered into by the attorney and taxpayer-client. Under the Alabama statue the same situation occurs – the parties are legally entitled to their respective portions of the judgment award.[111]

It appears that the courts that made the analogy between the contingent fee agreements and a situation of joint-ownership reached the same conclusion that was reached in *Cotnam* by means of the Alabama attorney lien statute.[112] In *Cotnam* the court held that the Alabama statue gave attorneys an equitable

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108. 46 ALA. CODE § 64 (1940). The code section has not changed since 1940. *See* ALA. CODE §31-3-61 (1975).

109. *Id.*

110. Scofield v. Mauritz, 206 F.2d 135, 140-41 (5th Cir. 1953) (concerning the allocation of income of a partnership to its partners for tax purposes). *See also* West v. Commissioner, 214 F.2d 300, 303 (5th Cir. 1954) (the court makes the same statement about the distribution of income in a joint-ownership arrangement). It is worth noting that both of these courts held that it was a misapplication of the law for the IRS to attribute all the income of a joint-ownership to only one of the owners.

111. 46 ALA. CODE § 64(1) (1940); ALA. CODE § 34-3-61 (1975).

112. A possible problem with the joint-ownership theory is that it could require the attorney to acquire a proprietary interest in the litigation. This can violate Rule 1.8(j) of the Rule of professional conduct that forbid an attorney from acquiring a proprietary interest in the litigation the attorney is conducting. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(j) (1983); *see also* Missouri Office of the Chief Disciplinary Counsel, Informal Op. 20000238 (2000), *summary reprinted in* THE MISSOURI BAR BULLETIN, March 2001, at 23.

right to their portion of the judgment.[113] Similarly, the courts that followed the joint-ownership theory held that the attorneys have a right to their share of the income from the judgment. In the joint-ownership cases the courts held that the attorney had the same right to the judgment as the client did because the attorney was a joint owner of the taxpayer-client's orchard.[114]

D. Capital Account Argument from Alexander v. IRS

The First Circuit case of *Alexander* dealt with the breach of an employment contract, the breach of implied pension benefits and age discrimination.[115] The case was settled for $350,000 of which $250,000 was allocated to the breach of contract and implied pension benefits claims and the remaining $100,000 was allocated to the age discrimination claim.[116] The argument that the taxpayer-client unsuccessfully used to attempt to avoid taxation of the attorney's fees is interesting and worth mentioning.

The first step in the taxpayer-client's argument was that the attorney's fees should be considered a cost of the disposition of one of taxpayer-clients assets (or property).[117] The asset the taxpayer-client has disposed of is their cause of action. The taxpayer-client next contends that the attorney's fees should be charged to the capital account.[118] Thus the basis of the property will be adjusted to reflect the capital expenditure on the property.[119] Finally, it is stated that the "amount realized" for property is equal to the value of the judgment and that amount will be offset by the basis in the property to determine gain on the disposition of the property under IRC § 1001(a)[120].[121] The net effect of this is that the taxpayer-client should avoid taxation of the attorney's fees because the gain would be limited to the judgment award minus the attorney's fees.

113. *Cotnam*, 263 F.2d at 125.

114. *Estate of Clarks*, 202 F.3d at 857-58; *Srivastava*, 220 F.3d at 360.

115. 72 F.3d at 940.

116. *Id.*

117. *Id.* at 941.

118. The taxpayer contended that since IRC § 1001 and § 1016 do not make any distinction between the basis and gain rules for capital or ordinary assets, there can be a capital account for all assets whether they are ordinary or capital. *Id.* at 941-42. It is unclear how the taxpayer-client was able to avoid the problem of the detailed examples of what a capital expenditure is in Reg. § 1.263(a)-1 and § 1.263(a)-2.

119. IRC § 1011(a) (1988) ("The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis . . . as adjusted as provided in section 1016"); IRC § 1016 (1988); 72 F.3d at 942. Since the property had no basis to begin with, the entire basis of the property will be the capital expenditure of the attorney's fees.

120. IRC § 1001(a) (2000).

121. The gain on dealings in property is included in gross income under IRC § 61(a)(3). IRC § 61(a)(3) (2000).

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The *Alexander* court did reject this argument, but gives no clear reason why.[122] The best possible reason is that legal fees do not fit within the definition of capital expenditure set out in the Treasury Regulations[123] and in cases dealing with what expenditures are considered capital ones.[124] The legal fees do not fit into the definition primarily because they do not fit into any of the examples given in the Treasury Regulations.[125] This argument to not include the contingent fees in the taxpayer-client's gross income does not have much merit because attorney's fees do not fit into any definition or example of capital expenditures.[126] The only type of legal fees that are considered a capital expenditure under the Treasury Regulations are those expended in defending or perfecting title to property.[127]

E. The Golsen Rule

When the Tax Court is faced with this issue and the appeal will go to the Fifth, Sixth or Eleventh Circuits the Tax Court will most likely follow the Golsen Rule, which is set out in the Tax Court case of *Golsen v. Commissioner*.[128] Simply put the Golsen Rule binds the Tax Court to follow the opinions of the Court of Appeals, to which their opinion can be appealed.[129] As a result of the Golsen Rule the Tax Court in these circuits, the Fifth, Sixth and Eleventh, will hold that the attorney fees paid under the contingent fee agreement are not included in the taxpayer-client's gross income.

The Golsen Rule is narrow in the sense that it only applies to the Court of Appeals to which the case can be appealed and none other.[130] The reasoning given for this rule is that it helps to promote more "efficient and harmonious

122. 72 F.3d at 942.

123. *See* Reg. § 1.263(a)-1; Reg. § 1.263(a)-2. *See also supra* note 118 and accompanying text.

124. *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 88-90 (1992) (holding that if the benefit from the expense will last beyond the current tax year then it is most likely a capital expense); United States v. Wehrli, 400 F.2d 686, 689-90 (10th Cir. 1968) (if an expenditure is apart of a general plan of rehabilitation, modernization, and improvement of property it must be a capital expense). *But cf.* Midland Empire Packing, Co. v. Commissioner, 14 T.C. 635 (1950) (an expense incurred to allow taxpayer to continue with a particular use of property and not prepare it for a new use is a ordinary and necessary expense that is currently deductible and will not be a capital expenditure).

125. *See* Reg. § 1.263(a)-1; Reg. § 1.263(a)-2.

126. *Id.*

127. Reg. § 1.263(a)-2(c).

128. 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971). Although the Golsen Rule only applies to these circuits it is generally followed and applied in other circuits.

129. *Id.* at 757.

130. *Id.*

judicial administration."[131] Though the Golsen rule was set down by the Tax Court and could be overruled by an appellate court, it most likely will not be because the Golsen Rule has become an important part of the appeals process for tax cases.[132]

IV. CASES HOLDING THAT CONTINGENT FEES ARE INCLUDED IN THE CLIENT'S GROSS INCOME

There are currently three circuits that include fees paid to attorneys under a contingent fee arrangement in the taxpayer-client's gross income. They are the Federal,[133] First[134] and Ninth[135] circuits. The Tax Court also follows the view that the attorney's fees should be included in the taxpayer-client's gross income.[136] In all but one of these cases[137] the IRS has taken the position that the legal fees are included in the taxpayer-client's gross income and that the legal fees were miscellaneous itemized deductions subject to the two-percent adjusted gross income limitation of miscellaneous deductions[138] and the overall limitation on itemized deductions.[139] Finally, the IRS considers the attorney fees to be subject to the Alternative Minimum Tax.[140] The IRS has also proposed that the attorney's fees be included in the taxpayer-client's gross income because they made a taxable disposition of property.[141]

While they ruled in favor of the IRS' position, the courts relied upon different arguments to support their holdings. Though they used a variety of

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131. *Id.*

132. *See* MICHAEL I. SALTZMAN & ALAN W. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 7.06[3][d] (2001).

133. *Baylin*, 43 F.3d 1451.

134. *Alexander*, 72 F.3d 938.

135. *Coady*, 213 F.3d 1187; *Benci-Woodward*, 219 F.3d 941.

136. Kenseth v. Commissioner, 114 T.C. at 405-06 (2000) (provides a summary of the IRS's position). *See* cases cited *supra* note 106. *But see also* text *supra* Part III(E) (noting a limitation on the IRS's position).

137. *See Baylin*, 43 F.3d at 1453 (the IRS classified the legal fees as a capital expenditure).

138. IRC § 67 (2000). A miscellaneous itemized deduction is only allowed to the extent that it exceeds 2% of the taxpayer's adjusted gross income.

139. IRC § 68 (2000).

140. IRC § 55 (2000); IRC § 56(b) (2000).

The Alternative Minimum Tax (AMT) was originally set-up to tax income that was not originally being taxed because of tax shelter investments. Over the years, the AMT has begun to affect the average taxpayer, as shown by these contingent fee cases, because the AMT deals with personal exemptions, standard deductions, state and local tax deductions, medical expense deductions and miscellaneous itemized deductions. Since the IRS is classifying the attorney's fees as miscellaneous itemized deductions they are subject to the AMT. *See* IRC § 67(b) (2000) (provides definition of "miscellaneous itemized deductions"); Robert P. Harvey & Jerry Tempalski, *The Individual AMT: Why It Matters*, 50 NAT. TAX J. 453 (1997) (explaining how the AMT works currently and what impacts it will be having in the future).

141. *Davis*, 210 F.3d at 1347-48.

arguments, most courts began with the proposition set out in IRC § 61(a) that defines gross income as "all income from whatever source derived."[142] The most widely used support for inclusion of the fees was the assignment of income doctrine from *Earl*[143] and *Horst*.[144] Many courts, though relying primarily on the assignment of income doctrine, have also used another method in conjunction with the assignment of income doctrine to support their holdings. This other method is the "in lieu of" test from *Raytheon*.[145]

A. Assignment of Income Doctrine

The assignment of income doctrine originated in *Earl*[146] as an extension of sections in the Revenue Acts of 1918[147] and 1921.[148] These acts state that a tax is imposed upon all wages, salaries or compensation.[149] The Court in *Earl* held that the taxpayer who earned wages, salaries or compensation is the one who must pay taxes upon it.[150] In the well quoted passage from *Earl* the Supreme Court states,

> "[t]here is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully [sic] devised to prevent the salary when paid from vesting even for a second in the man who earned it."[151]

The Supreme Court in *Horst*, which explained further the assignment of income doctrine set out in *Earl*, dealt with the issue of whether there can be a realization event of income by receiving the economic benefit of the income without actually receiving the income in hand.[152] The Supreme Court acknowledged that income does not need to be received in hand to be credited to the taxpayer's gross income[153] and that the primary purpose of the tax laws is to tax the income of those who earn it or create the right to receive it.[154] The

142. IRC § 61(a) (2000). *See, e.g.*, Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955); James v. United States, 366 U.S. 213, 219 (1961). *See Coady*, 213 F.3d at 1190; *Alexander*, 72 F.3d at 942; *Baylin*, 43 F.3d at 1454; *Hukkanen-Campbell*, 79 T.C.M. at 2124.

143. 281 U.S. at 114.

144. 311 U.S. 112.

145. 144 F.2d 110, 113 (1st Cir. 1944).

146. 281 U.S. at 114.

147. Revenue Act of 1918, ch. 18, 40 Stat. 1065 (1919) ("the term 'gross income' – Includes . . . income derived from salaries, wages or compensation for personal service).

148. Revenue Act of 1921, ch. 136, 42 Stat. 237 (1921) ("the term ' gross income' – Includes . . . income derived from salaries, wages, or compensation for personal service).

149. *Id.*

150. *Earl*, 281 U.S. at 114-15.

151. *Id.*

152. *Id.* at 114-15.

153. *Id.* at 115. *See Old Colony Trust Co.*, 279 U.S. at 729 (holding that at discharge by a third person of a debt owed by the taxpayer was equivalent to the taxpayer receiving the income).

154. *Horst*, 311 U.S. at 119.

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Supreme Court, in *Horst*, finally concluded that if the taxpayer has created a right to receive income (i.e. earned it) and then assigns the income to a third person, but in doing so receives the economic benefit of the income, it is as if the taxpayer has received the income and thus will be taxed on that income.[155]

Before the Courts of Appeals could apply the assignment of income doctrine to contingent fee agreements they must discover what economic benefit that the taxpayer-client has received. The courts that have applied this doctrine determined the economic benefit received was the attorney's work and effort in getting the judgment award for the taxpayer-client.[156] Once the courts found that the taxpayer-client received an economic benefit they could hold that based on the assignment of income doctrine a realization event occurred for the taxpayer.[157] The amount of income that the taxpayer-client realizes in this transaction is the amount of fees the attorney receives under the contingent fee agreement.[158]

B. "In Lieu of" Test

The "in lieu of" test is no so much a test applied to the fees paid to the attorney as it is a test to determine in the first instance if the entire award should be included in the gross income of the taxpayer-client.[159] If the courts find that the award should not be included in the gross income of the taxpayer-client, then the question of including the legal fee in their income is most likely moot.[160] But, if the courts find that the award should be included in the gross

155. *Id.* at 116-17 ("The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect as the means of procuring them.").

156. *Baylin*, 43 F.3d at 1454 ("the [taxpayer-client] received the benefit of those funds [the award] in that the funds served to discharge the obligation of the [taxpayer-client] owing to the attorney as a result of the attorney's efforts to increase the settlement amount."); *Coady*, 213 F.3d at 1189-91 (same).

157. *See Baylin*, 43 F.3d at 1454; *Coady*, 213 F.3d at 1189-90.

158. The transaction referred to consists of the taxpayer-client receiving services from the attorney and then paying them with money the taxpayer-client receives from the judgment. Before final judgment in the case the value of the attorney's fees are unknown. *See infra* Part IV(C).

159. An example of the application of the "in lieu of" test would be a person receiving a judgment against a former employer for back wages. In this case the judgment is being paid "in lieu of" wages. Under IRC § 61 wages are included in gross income. The "in lieu of" test helps to assure that a person does not avoid paying taxes on money that would be gross income had it not been received by means of a court judgment.

160. If the "in lieu of" test indicates that the award should not be included in the taxpayer-client's gross income, it could still be argued that the contingent fees paid to the attorneys should be included in the taxpayer-client's gross income. The basis for this argument would be claiming that the taxpayer-client sold a portion of the claim to the attorney when entering into the contingent fee agreement and had a gain on the sale of the claim in the amount of the attorney fee. The effect of this argument would be to turn the whole judgment into a taxable event; the

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income of the taxpayer-client then the issue of whether or not to include the attorney's fees must be addressed.

The origin of the "in lieu of" test is the First Circuit Court of Appeals case of *Raytheon Production Corp. v. Commissioner*.[161] The court in this case was faced with determining when lawsuit awards should be included in the gross income of the party receiving the award.[162] The test the court developed simply asks the question of if the damages awarded are "in lieu of" some payment that would normally be taxable.[163] If the damages were awarded to replace taxable items of income, such as lost wages or other items listed in IRC § 61[164] then the recovery is taxable.[165] However, if the damage award compensates the taxpayer for non-taxable items, such as pain and suffering and bodily injury, that portion of the award will be excluded from the taxpayer-client's gross income.[166]

The courts have utilized the "in lieu of" test to include the portion of the judgment paid to the taxpayer-client in his or her gross income, but the courts have utilized the assignment of income doctrine[167] (discussed above) to include the portion of the judgment paid to the attorneys in the taxpayer-client's gross income. The utilization of these two doctrines allowed the courts to achieve the goal of including the entire judgment in the taxpayer-client's gross income.

C. Taxable Disposition of Property

In *Davis v. Commissioner*,[168] the court rejected the IRS' taxable dispossession of property argument in favor of following *Cotnam*.[169] The IRS's argument was that the taxpayer-client's original cause of action can be characterized as a type of personal property owned by the taxpayer-client, that the contingent fee agreement is a dispossession of a portion of this property to the attorney, and thus this transaction is a taxable event.[170] The difficulty with

contingent fee portion of the judgment would be the taxpayer-client's gain on the sale of the claim to the attorney and the remainder of the judgment would be income to the taxpayer-client. *See Davis*, 210 F.3d at 1347-48; *see also infra* Part IV(C).

161. 114 F.2d 110, 113 (1st Cir. 1944).

162. *Id.* at 111.

163. *Id.* at 113.

164. IRC § 61(a) (1994) (other sources of income can include rents, royalties, dividends, alimony, life insurance payments, pensions, discharge from indebtedness, income from a partnership and gains from dealings in property).

165. *Raytheon*, 114 F.2d at 113.

166. *Id. See* IRC § 104(a) (1994) (providing that certain types of compensation for injuries or sickness are not included in the taxpayer's gross income).

167. *Coady* 213 F.3d at 1190-91; *Baylin*, 43 F.3d at 1454.

168. 210 F.3d 1346 (11th Cir. 2000).

169. *See infra* note 74. The Eleventh Circuit is bound to follow the precedent of the Fifth Circuit.

170. *Davis*, 210 F.3d at 1347-48.

this argument is that the cause of action did not have a definite value[171] when the contingent fee agreement was signed and thus has no basis.[172] The IRS proposes the solution to this problem is that the open transaction doctrine from *Burnet v. Logan*[173] be applied.[174]

The open transaction doctrine states that when a transaction occurs and the value of the goods or services exchanged cannot be discerned then taxes are not assessed until the values become certain.[175] In these cases the value of the attorney's fees are uncertain until the judgment is given; at that point, however, the value of the attorney's fees becomes apparent and the taxpayer-client should be taxed on the gain received for the sale of the cause of action.[176] The court in *Davis* rejected this argument on the grounds that the IRS did not fulfill its burden of proving that neither the cause of action nor the attorney's fees had an undiscoverable value when the contingent fee agreement was signed.[177] As a result of holding that the open transaction doctrine did not apply the court did not need to address whether there was a taxable disposition of property when the contingent fee agreement was signed.[178] The court in *Davis* does not outright reject the IRS's argument and thus in a later case if the IRS could prove that the cause of action and the attorney's fees do not have a discoverable value when the contingent fee was entered into then this argument might be found persuasive.

E. Final Notes

The use of the "in lieu of" test is of assistance in showing that the portion of the judgment paid to the taxpayer-client should be included in his or her gross income, but the assignment of income doctrine has been used to reach the result that the portion of the judgment paid to the attorneys is included in the taxpayer-client's gross income.[179] It appears clear that the assignment of income doctrine is the most effective argument to hold that the attorney's fees are included in the taxpayer-client's gross income. The combination of these two doctrines helps to keep the taxpayer-client from avoiding taxes by

171. IRC § 1001 (2000). In order to have income from the dispossession of property the property must have a basis that is capable of being determined. Property may have a basis of zero.

172. *Davis*, 210 F.3d at 1347-48.

173. 283 U.S. 404 (1931).

174. *Davis*, 210 F.3d at 1348.

175. *Burnet*, 283 U.S. at 412-13.

176. *Davis*, 210 F.3d at 1348.

177. Proving that the value of the cause of action and the attorney's fees are undiscoverable is a threshold issue that must be met before the open transaction doctrine can be applied. *Id.*

178. *Id.* at 1348 n.5.

179. *See supra* Part IV(A & B)

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disposing of the income he or she receives through some creative scheme before actually receiving it.

V. THE CORRECT ANALYSIS OF THE ISSUE

The analysis of this issue is difficult. There are capable arguments on each side of the issue. The persuasive arguments on the side to include the contingent fees in the taxpayer-client's gross income are the assignment of income doctrine from *Earl*[180] and *Horst*[181] in combination with the "in lieu of" test from *Raytheon*.[182] In contrast, on the side to exclude the fees from the taxpayer-client's gross income is the argument that the attorney and taxpayer-client are joint-owners in a single piece of property is persuasive along with persuasive arguments as to why the assignment of income doctrine should not apply.

Perhaps the best way to look at the current state of this issue is to acknowledge that there is no clear test. Thus, each case must currently be looked at on an individual basis to determine whether the fees should be included in the taxpayer-client's gross income. It is important to note that although the same ultimate issue was being addressed in many of the cases, each of them arose out of different circumstances. For example, in *Srivastava* the original claim was for defamation and related claims.[183] In contrast, in *Cotnam* the original claim was for breach of contract. [184] In that case Ms. Cotnam had already performed her part of the contract and was thus seeking payment for her work.[185] It is clear that had Ms. Cotnam been paid without having to go through the lawsuit the whole amount would be included in her gross income under IRC § 61(a)(1)[186] as compensation for services. In spite of how the money / payment would have been characterized absent the lawsuit, the court still allowed for the exclusion of the attorney's fees from Ms. Cotnam's gross income. The question still remains why did this happen?

It is clear, as previously shown above, that there are significant difficulties and confusion with respect to the current way courts determine if contingent fees should be included in a taxpayer-client's gross income. The primary problem with the current method is that the same income could be included in the taxpayer's gross income or excluded depending on how and when the income is received, as shown by Ms. Cotnam's situation above. The income could always be included if it is paid to the taxpayer absent any judicial

180. 281 U.S. at 114.
181. 311 U.S. at 114.
182. 144 F.2d at 113.
183. 220 F.3d at 355.
184. 263 F.2d at 121-23.
185. *Id.* at 120.
186. IRC § 61(a)(1) (2000).

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proceeding, but the same income might not be included in the taxpayer's gross income if it is received through a judicial means and part of it is used to pay a contingent fee to an attorney. This problem is a result of the current confusion in the law relating to the inclusion or exclusion of contingent fees.

The correct analysis of this issue takes arguments from both sides of the issue and will follow a two-step analysis.[187] The first step is to apply the *Raytheon* "in lieu of" test to the entire judgment award.[188] This will determine if the award is being paid in place of money that would normally be included in gross income. The second step will clarify that the assignment of income doctrine does not apply to contingent fee arrangements.

This two-step analysis does not utilize a per se rule to include or exclude contingent fees in the taxpayer-client's gross income but rather a clear, well proven test to determine whether or not to include the contingent fees in the taxpayer-client's gross income. Since the "in lieu of" test is being applied to the entire judgment award then contingent fees will be included or excluded in the taxpayer-client's gross income depending on the outcome of the "in lieu of" test.

As previously discussed, the *Raytheon* "in lieu of" test does not look at the type of the litigation – whether it is a contract claim or a tort claim – but it does classify the award received based on the nature and the basis of the claim litigated.[189] Simply, the test asks the question, "In lieu of what were the damages awarded?".[190] The second aspect of the *Raytheon* analysis is to determine if the damages are "in lieu of" something normally included in the taxpayer-client's gross income.[191] This is normally a simple exercise of examining the list of items included in gross income under IRC § 61(a)[192] to see if what the award is "in lieu of" is on this list. In some cases it might require more research depending on the nature and basis of the claim.[193]

The second step in the two-step analysis addresses the assignment of income doctrine and its inapplicability to these cases. The primary reason why the doctrine does not apply is that the taxpayer-client has relinquished control over a portion of the ultimate judgment award. The portion that the taxpayer-client has relinquished control over is that portion to be paid to the attorney

187. As noted earlier damages received in personal injury cases on account of personal physical injuries or sickness are not taxable, as such this test will not be applicable to those damages.

188. 144 F.2d at 113.

189. *Id.*; *Alexander*, 72 F.3d at 942.

190. *Raytheon*, 144 F.2d at 113.

191. *Alexander*, 72 F.3d at 942.

192. IRC § 61(a) (2000).

193. *See* Sager Glove Corp. v. Commissioner, 36 T.C. 1173, 1180-82 (1961), *aff'd*, 311 F.2d 210, 212 (7th Cir. 1962) (decision over what the settlement funds were "in lieu of" in an antitrust case).

under the contingent fee agreement. To use the analogy given above, the taxpayer-client has given up entire trees from the orchard and is not just giving up the fruit from some of the trees.[194] Since whole trees have been given-up then the taxpayer-client no longer has any control over those trees. Under *Earl* and *Horst* once total control has been relinquished over the income the taxpayer cannot be taxed on it.[195] In both *Earl* and *Horst* the taxpayers retained control or dominion over the funds that they transferred. In *Horst*, the Court specifically held that so long as the taxpayer has control over the income the income is taxable to them.[196] This divestiture of control is the reason why the assignment of income doctrine should not apply to contingent fee cases.[197]

It is true that under this two-part analysis the same result might be achieved in some cases if the assignment of income doctrine were applied. The reason for this is that the assignment of income doctrine would include the contingent fees in the taxpayer-client's gross income.[198] The problem is that if the assignment of income doctrine were applied as a blanket rule it will cause contingent fees to always be included in the taxpayer-client's gross income, but by applying this two-step analysis contingent fees are only included in the taxpayer-client's gross income when the judgment award is "in lieu of" income that is normally included in gross income.

It is clear from the "rules" of the assignment of income doctrine that it cannot apply. There are two basic requirements of the doctrine, both of which must be met. (1) The taxpayer retains control over the income and (2) That the

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194. *See infra* Part III(C)(1)

195. *See Earl*, 281 U.S. 114-15; *Horst*, 311 U.S. 119. The taxpayer-client has not given up total control over the litigation because under the ABA Model Rules of Professional Conduct the attorney must abide by the decisions and objectives of the client concerning the representation. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1983).

The court in *Srivastava* examined this line of analysis but did not rest its holding on it, but instead followed *Cotnam* and held that contingent fees should be included in the taxpayer-client's gross income. 220 F.3d at 355.

196. 311 U.S. at 119 ("We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee."). *See also* Commissioner v. First Sec. Bank, 405 U.S. 394, 403 (1972) (the Court stating that in order to be taxed for income you must have dominion or control over it).

197. It is true that the taxpayer-client still has some control over the money in contingent fee case (i.e. they can always attempt to withdraw the suit or take other actions to affect the outcome of the suit) but they have divested some control over the claim.

In *Srivastava*, the court stated that the amount of control given up by the taxpayer-client in a contingent fee agreement is enough to put the court in a "quandary" but it is not clear if it is enough to avoid the application of the assignment of income doctrine. 220 F.3d at 364 ("a taxpayer who enters into a contingent fee contract divests some measure of control over a claim but retains the rest, and how much control is sufficient to trigger taxation under the anticipatory assignment of income doctrine is not easily answerable"). *See infra* Part III(A).

198. The "in lieu of" test includes the fees because it is applied to the entire judgment not just the portion paid to the taxpayer-client or the attorney.

taxpayer receives the economic benefit of the income.[199] In contingent fee cases the taxpayer-client does not meet the first requirement because, as noted above, the taxpayer-client has given-up control over a portion of they claim by means of the contingent fee agreement, this divestiture of control is enough to avoid application of the doctrine. The taxpayer-client does fulfill the second requirement because he or she receives the economic benefit of the attorney's work.[200]

For example, if this test were applied Ms. Cotnam's situation. The judgment Ms. Cotnam received was in payment of services rendered to Mr. Hunter during his lifetime. Under IRC § 61(a)(1) money received in payment for services is included in gross income. Thus, under the "in lieu of" test Ms. Cotnam's judgment award should be included in her gross income because it was received "in lieu of" money normally included in gross income. As noted above, the assignment of income doctrine will not apply because Ms. Cotnam divested control over a portion of her claim when she entered in to the contingent fee agreement.

One final issue to be addressed is that in *Srivastava*, the court states that the income should be charged to the party that earned it.[201] Thus, since the taxpayer-client has never earned the money that is paid to the attorney, the legal fees should not be included in the taxpayer-client's gross income.[202] The proper response to this it that the tax system does not allow for a person to avoid taxation on income because of "anticipatory arrangements and contracts however skillfully devised."[203] Had the taxpayer-client not entered into the contingent fee agreement with the attorney but rather was billed by the hour or other method, he or she would have been taxed on the entire amount of the award. This situation should be no different just because of the contingent fee agreement.

VI. CONCLUSION

The question of what should happen next still requires some discussion.[204] Should the Supreme Court grant certiorari and decide the issue, most likely applying the above analysis? Should the IRS give up on this issue, cease litigating it and allow the taxpayer-clients to not include contingent fee attorney fees in their gross income?

199. *See Horst*, 311 U.S. at 117, 119; *Earl*, 281 U.S. at 114-15.

200. *See Srivastava*, 220 F.3d at 360-61; *Estate of Clarks*, 202 F.3d at 858.

201. 220 F.3d at 361.

202. *Id*.

203. *Earl*, 281 U.S. at 114-15.

204. The issue of what will happen next is an important one, but it is outside the scope of this article and could easily be the topic of a separate article.

One of the common reasons that the Supreme Court grants certiorari is the presence of a split among the circuits on an issue, such a split exists on this question.[205] In order for the Supreme Court to grant certiorari to a case, the case needs to be one in which a clear rule can be set down. The problem with many of these cases is that they all have different facts and backgrounds that may make it difficult to find one that can be used to set down a clear rule.

Based on the number of recent cases on this issue it appears that the IRS is not going to change its position or stop litigating this issue in the near future. The risk of continuing with the litigation, however, is that the split among the circuits will expand to include more circuits, creating the dilemma for the IRS of having different portions of the country being governed by the same tax laws but with radically different interpretations of those tax laws.[206] An additional problem will be that similarly situated taxpayers will receive different treatment.[207] On the other hand, if the IRS gives up they could possibly be losing a considerable source of tax revenue.

There are two things that can be said with certainty about this issue. The first is that contingent fee arrangements defy easy categorization. On one hand they look like a scheme to avoid taxation on income; and on the other, they represent a complete divestment of an income source.[208] The second is that as the amount of litigation increases this issue will become increasingly important and the need for it to be addressed will also grow.[209] Exclusions from income are an act of legislative grace. In the case of contingent attorney fees it seems the legislature did not provide enough grace to exclude contingent attorney fees from gross income.

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205. *See* Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) (granting certiorari to resolve a circuit split); Bank of America Nat'l Trust & Savings Ass'n v. 303 North LaSalle St. Partnership, 526 U.S. 434, 443 (1999) (granting certiorari to resolve a circuit split).

206. This situation does not create any constitutional or legal problems; the only problem that it does create is a problem of managing different rules and standards for the IRS.

207. This is an issue of fairness, two taxpayers can bring identical suits in different circuits with the same outcomes, but the their tax bill will be drastically different because one circuit includes contingent fees in the taxpayer's gross income and the other circuit does not include contingent fees in the taxpayer's gross income.

208. 220 F.3d 360.

209. In the past year alone four circuits have handed down decisions on the issue and two others have handed down opinions in the past five years. This number does not include the large number of Tax Court decisions on the issue.

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