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Kristina Maynard

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Comment

The Fruit Does Not Fall Far From the Tree: The Unresolved Tax Treatment of Contingent Attorney's Fees

Kristina Maynard*

I. INTRODUCTION

The Seventh Circuit Court of Appeals recently stated, “[i]t is not a feasible judicial undertaking to achieve global equity in taxation”¹ The importance of this statement becomes apparent when viewed in the context of the continuing controversy surrounding the taxation of contingent attorney's fees.²

The overall goal of the federal government with respect to income taxes is to impose the burden of tax on individuals according to their relative ability to pay.³ To achieve this goal, the federal government employs a progressive tax system.⁴ The federal tax scheme, through the

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1. *Kenseth v. Comm'r*, 259 F.3d 881, 885 (7th Cir. 2001) [hereinafter *Kenseth II*] (holding that the contingent fee portion of a taxpayer's lawsuit settlement was includible in his gross income); see also *Benci-Woodward v. Comm'r*, 219 F.3d 941, 944 (9th Cir. 2000) (acknowledging that equitable arguments cannot overcome the plain meaning of a statute). The traditional theory of tax equity provides that similarly situated taxpayers should pay an equal amount of tax. See Darren J. Campbell, *Wiping the Slate Clean: An Examination of How a Court's Characterization of Contingent Attorney's Fees Implicates Alternative Minimum Tax and Affects the Taxpayers*, 35 U.C. DAVIS L. REV. 171, 172 (2001).

2. See Bernard J. Grant, *No Taxation Without Realization: Srivastava v. Commissioner, The Fifth Circuit's Answer to Tax Treatment of Attorney's Fees Under a Contingency Fee Agreement*, 32 ST. MARY'S L.J. 363, 364-65 (2001) (noting the potential problems with using principles of equity to resolve the question of taxation of contingent attorney's fees).

3. *Id.* (citing Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1906 (1987)).

4. *Id.*

Internal Revenue Code, attempts to achieve neutral taxation by applying graduated tax rates to individuals on the basis of incremental income.⁵ Although this system of taxation is widely accepted, the determination of what constitutes income and to whom such income should be taxed are topics vigorously debated by courts, tax practitioners and commentators.⁶

One such area of debate surrounds the question of the appropriate taxation of contingent attorney's fees.⁷ In joining an already contentious circuit split,⁸ the Seventh Circuit recently affirmed the United States Tax Court in the case of *Kenseth v. Commissioner*, holding that contingent attorney's fees incurred in obtaining a taxable recovery⁹ must be included in the taxpayer's gross income.¹⁰

5. *Id.*

6. See, e.g., *Helvering v. Horst*, 311 U.S. 112, 116-17 (1940) (holding that "realization" may occur prior to actual receipt of gross income); *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930) (defining gross income to include anticipatory transfers by one taxpayer of income earned by him to another taxpayer); *Old Colony Trust v. Comm'r*, 279 U.S. 716, 729 (1929) (discussing the definition of income in the context of payment of federal income taxes by an employer on behalf of his employee); *Comm'r v. Fender Sales, Inc.*, 338 F.2d 924, 928 (9th Cir. 1964) (holding that the payment to employees of non-cash property constitutes "realization" for income tax purposes); see also *infra* Part II.B-C (discussing gross income, realization, and the assignment-of-income doctrine).

7. See Grant, *supra* note 2, at 365. A contingent fee is a "contract for the provision of legal services in which the amount of the lawyer's fee is contingent in whole or in part upon the successful outcome of the case, either through settlement or litigation." See Allison F. Aranson, Note, *The United States Percentage Contingent Fee System: Ridicule and Reform from An International Perspective*, 27 TEX. INT'L L.J. 755, 757 (1992) (quoting Alan A. Paterson, *Contingent Fees and Their Rivals*, 1989 SCOTS LAW TIMES (NEWS) 81, 81).

8. Prior to the decision in *Kenseth II*, a split existed in the Third, Fourth, Fifth, Sixth, Ninth, Eleventh and Federal Circuits. See *Sinyard v. Comm'r*, 268 F.3d 756, 759 (9th Cir. 2001); *Young v. Comm'r*, 240 F.3d 369, 379 (4th Cir. 2001); *Srivastava v. Comm'r*, 220 F.3d 353, 365 (5th Cir. 2000); *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943-44 (9th Cir. 2000); *Coady v. Comm'r*, 213 F.3d 1187, 1190-91 (9th Cir. 2000); *Davis v. Comm'r*, 210 F.3d 1346, 1347 (11th Cir. 2000) (per curiam); *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995); *O'Brien v. Comm'r*, 319 F.2d 532, 532 (3d Cir. 1963); *Cotnam v. Comm'r*, 263 F.2d 119, 126 (5th Cir. 1959); see also *infra* Part III.A-B (discussing the differing tax treatment of contingent attorney's fees among the circuits).

9. The issue concerning the proper tax treatment of contingent attorney's fees does not arise in cases where a client's recovery is not taxable. See Douglas G. Hickel, Comment, *Losing in the Tax System After You Win in the Court System: Should Contingent Legal Fees Paid to the Attorney Be Included in the Taxpayer-Client's Gross Income?*, 20 ST. LOUIS U. PUB. L. REV. 477, 496 (2001). Courts first apply the "in lieu of" test to determine whether a lawsuit recovery should be included in gross income. *Id.* at 494. The "in lieu of" test is applied by determining if the recovery obtained by a taxpayer is meant to replace some amount of income that would normally be taxable. *Id.* at 495. If the recovery was paid in lieu of taxable income, such as back pay, then the recovery is included in gross income. *Id.* If the recovery replaced non-taxable income, like damages for physical injury, then the recovery is excluded from gross income. *Id.*; see also *infra* note 222 (citing I.R.C. § 104(a)(2) which exempts from tax certain lawsuit recoveries related to physical injuries). With regard to legal fees paid to obtain a recovery,

Consistent with the Seventh Circuit, the Third, Fourth, Ninth, Tenth and Federal Circuits all held that a taxpayer's gross income includes contingent legal fees paid to obtain a taxable recovery,¹¹ while the Fifth, Sixth, and Eleventh Circuits determined that such fees are not gross income to the taxpayer.¹²

Despite years of controversy, the proper income tax treatment of contingent attorney's fees remains unclear.¹³ Proponents of inclusion

expenses allocable to tax-exempt income are not deductible. I.R.C. § 265(a)(1) (1994). Therefore, if a taxpayer's recovery is excluded from gross income, both the non-taxable recovery and the related legal fees are not reported on the taxpayer's tax return. See I.R.C. § 265(a)(1). Section 265(a)(1) states:

General rule.—No deduction shall be allowed for—

(1) Expenses.—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

Id.

10. *Kenseth II*, 259 F.3d 881, 883 (7th Cir. 2001).

11. See *Campbell v. Comm'r*, 274 F.3d 1312, 1313-14 (10th Cir. 2001) (holding that a taxpayer must include the contingent fees paid to her attorney resulting from a sexual harassment lawsuit against her former employer); *Sinyard*, 268 F.3d at 759 (holding that a taxpayer must include the contingent fees paid to his attorneys related to a class action age discrimination claim against his former employer); *Kenseth II*, 259 F.3d at 885 (holding that a taxpayer must include the contingent attorney's fees paid resulting from an age discrimination suit against his former employer); *Young*, 240 F.3d at 379 (holding that the taxpayer must include the contingent attorney's fees paid in settling a property dispute incident to a divorce); *Benci-Woodward*, 219 F.3d at 943-44 (holding that a taxpayer must include the contingent fees paid to his attorney resulting from tort and contract claims against his former employer); *Coady*, 213 F.3d at 1190 (holding that a taxpayer must include the contingent fees paid to her attorney related to a wrongful termination suit against her former employer); *Baylin*, 43 F.3d at 1455 (holding that a partnership taxpayer must include the attorney's fees paid in connection with a condemnation lawsuit against the State of Maryland); *O'Brien*, 319 F.2d at 532 (holding that a taxpayer must include the contingent fees paid to his attorney related to a wrongful discharge action against his former employer); see also *infra* Part III.B (discussing the inclusion of contingent fees in gross income).

12. See *Srivastava*, 220 F.3d at 365 (holding that a taxpayer could exclude the contingent fees paid to his attorney in connection with a defamation claim against a television station); *Davis*, 210 F.3d at 1347 (holding that a taxpayer could exclude the contingent fees paid to her attorney for his assistance related to her claims against a mortgage company for fraud, conspiracy, and breach of contract); *Estate of Clarks*, 202 F.3d at 858 (holding that a taxpayer could exclude the contingent attorney's fees paid by a decedent's estate related to a lawsuit against the decedent's former employer); *Cotnam*, 263 F.2d at 126 (holding that a taxpayer could exclude the contingent fees paid to her attorney for his services related her claim to enforce an oral contract against an intestate decedent's estate); see also *infra* Part III.A (discussing the exclusion of contingent fees from gross income).

13. See Benjamin C. Rasmussen, *Taxation of An Attorney's Contingency Fee of a Punitive Damages Recovery: The Srivastava Approach*, 15 BYU J. PUB. L. 301, 301 (2001).

cite the plain language of the Internal Revenue Code ("Code")¹⁴ as well as the judicially defined assignment-of-income doctrine¹⁵ as the basis for their position.¹⁶ Critics argue that the Code deduction provisions, which reduce the efficacy of deductible expenses such as attorney's fees, create harsh and unfair results to taxpayers who must include such fees in their gross income.¹⁷ They propose, instead, that taxpayers reduce any taxable recovery by the amount paid in contingent attorney's fees, and report only the net recovery in gross income.¹⁸

This Comment first considers the nature and usage of the contingent attorney's fee contract.¹⁹ It then provides an overview of basic principles of gross income and realization, including the origin and development of the assignment-of-income doctrine.²⁰ Part II of this Comment next explores the Code limitations on deductions for legal fees that create the harsh tax consequences of inclusion.²¹ It then addresses the unique limitations of the Alternative Minimum Tax ("AMT")²² that often subject unsuspecting taxpayers to additional tax liability.²³ Finally, Part II examines the treatment of contingent attorney's fees in the Tax Court.²⁴ Part III of this Comment then explores the treatment of contingent attorney's fees among the various United States Courts of Appeals, with a particular emphasis on the

14. See I.R.C. § 61(a) (1994) (defining gross income); see also *infra* Part II.B (discussing gross income under the Internal Revenue Code).

15. The assignment-of-income doctrine requires a taxpayer to pay tax on all income owned or controlled by him, regardless of whether the taxpayer received the income directly. See *Helvering v. Horst*, 311 U.S. 112, 117 (1940); see also *infra* Part II.C (discussing the origin and development of the assignment-of-income doctrine).

16. See Grant, *supra* note 2, at 381.

17. See Lauren E. Sheridan, *Trees in the Orchard or Fruit from the Trees?: The Case for Excluding Attorney's Contingent Fees from the Client's Gross Income*, 36 GA. L. REV. 283, 311-13 (2001) (discussing the harsh consequences of the disallowance of some miscellaneous itemized deductions, including legal fees, under I.R.C. § 56(b)(1)(A)(i)).

18. See James Serven, *Tenth Circuit Joins Majority View on Contingent Attorney's Fee Issue*, 94 TAX NOTES 373, 373 (2002), available at LEXIS, 2002 TNT 15-32.

19. See *infra* Part II.A (exploring the nature and application of the contingency fee contract).

20. See *infra* Part II.B-C (discussing gross income and realization as well as the origin and development of the assignment-of-income doctrine).

21. See *infra* Part II.D (examining the limitations on deductions affecting contingent attorney's fees).

22. See I.R.C. §§ 55-58 (1994). For individual taxpayers, the AMT is a separate and parallel tax system computed each year on taxable income after adjustments. See I.R.C. § 55(b); see also *infra* note 124 and accompanying text (examining the computation of the alternative minimum tax).

23. See *infra* Part II.E (discussing the relevant AMT disallowance rules on itemized deductions).

24. See *infra* Part II.F (examining the position of the Tax Court with respect to contingent attorney's fees).

Seventh Circuit's decision in *Kenseth v. Commissioner*.²⁵ Part IV then critically analyzes why the courts requiring the inclusion of contingent attorney's fees in gross income are correct and why the equity-based arguments of the courts holding to the contrary cannot succeed.²⁶ Finally, in light of the absence of a consensus on this issue, Part V proposes that the United States Supreme Court should resolve the current circuit split by requiring contingent attorney's fees to be included in gross income.²⁷ In addition, Part V proposes that Congress should make two technical amendments to the Internal Revenue Code that would allow an unrestricted deduction for contingent attorney's fees incurred in the production of a taxable recovery.²⁸

II. BACKGROUND

The proper income tax treatment of contingent attorney's fees²⁹ can only be resolved through an analysis of the character of such fees, both as an item of income and as a potential deduction.³⁰ While the Internal Revenue Code is the starting point for this analysis, judicial interpretation through case law also plays a crucial role.³¹ Also essential is an understanding of the contingent fee contract and of the basic tax concepts that serve as the foundation for the differing treatment of contingent attorney's fees.³² In addition, an appreciation for the consistent analysis used by the Tax Court is imperative to evaluating the dichotomy that exists among the Circuits.³³

25. See *infra* Part III.A–B (examining the reasoning of the Courts of Appeals with regard to contingent attorney's fees).

26. See *infra* Part IV.A–B (discussing the tax implications of the inclusion and exclusion of contingent attorney's fees).

27. See *infra* Part V.A (suggesting that the Supreme Court resolve the circuit split regarding contingent attorney's fees).

28. See *infra* Part V.B (proposing that Congress amend the Internal Revenue Code to allow preferential deductions for attorney's fees in connection with taxable recoveries).

29. See *infra* Part II.A (explaining the nature of contingent attorney's fee contracts).

30. See *infra* Part II.B–E (discussing the characterization of gross income and deductions).

31. See *infra* Part II.B–F (reviewing the concepts of gross income and deductions as well as the assignment-of-income doctrine).

32. See *infra* Part II.A–E (examining contingent attorney's fee arrangements and basic principles of taxation).

33. See *infra* Part II.F (discussing the view of the Tax Court regarding the taxation of contingent attorney's fees).

A. *The Contingent Attorney's Fee Contract*

For at least a century, attorneys and clients in the United States have used contingent fee contracts for legal services.³⁴ Under a contingent fee contract, an attorney agrees to provide legal services on behalf of a client, and the client agrees to pay the attorney a percentage of whatever recovery is eventually realized from the resolution of his claim.³⁵ If the client does not recover, he is not required to pay for the legal services provided under the contract.³⁶ Thus, for the attorney, the contingent fee arrangement contains an element of risk that the resolution of a claim will not be favorable for the client.³⁷ When a client successfully recovers, however, the arrangement often rewards the attorney with a substantial fee.³⁸ Because a contingent fee arrangement shifts the risk of loss to the attorney, such contracts typically call for the successful client to pay a significant percentage of his claim to his attorney.³⁹ As a result, this arrangement often provides a higher fee to the attorney than he would otherwise receive under the usual hourly fee contract.⁴⁰

The incentive to employ a contingent fee arrangement is not one-sided.⁴¹ A client may also benefit from the use of such a contract.⁴² Under a contingent fee arrangement, a client, who may not otherwise be

34. See CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* 526, 538-41 (1986) (discussing contingent attorney's fees in the context of domestic relations cases); see also *Wylie v. Coxe*, 56 U.S. 415, 418-20 (1853) (recognizing contingent fee contracts by permitting a plaintiff's attorney to recover a contingent fee of five percent on the amount recovered on the client's claim against a foreign government); see also *supra* note 7 and accompanying text (defining the contingent fee contract).

35. The typical contingent fee paid to an attorney ranges from 25% to 50% depending on the stage at which the case is resolved. See Angela Wennihan, *Let's Put the Contingency Back in the Contingency Fee*, 49 SMU L. REV. 1639, 1643 (1996). Although the most common type of contingent fee contract is one which is based on a percentage of the plaintiff's recovery, a contingent fee can also be figured by the hour, meaning that the attorney bills the client for the total hours spent on the claim only if the representation has been successful. See Stewart Jay, *The Dilemmas of Attorney Contingent Fees*, 2 GEO. J. LEGAL ETHICS 813, 814 (1989).

36. See Jay, *supra* note 35, at 814. Generally, the unsuccessful client would still be responsible for court costs. *Id.*

37. See Aranson, *supra* note 7, at 757 (noting that contingent fee contracts shift the risk of loss from the client to the attorney).

38. *Id.*

39. *Id.* The fee is usually based on a percentage of the plaintiff's gross recovery. *Id.* at 760. Alternatively, the fee may be based on the net recovery, which is the gross recovery after litigation expenses. *Id.*

40. *Id.*

41. *Id.* at 757-58.

42. *Id.*

able to afford competent counsel, receives legal assistance without having to pay up-front for the services.⁴³

Although the ability to manipulate risk and reward encourages the widespread use of contingent fee contracts by clients and attorneys, these contracts have important tax implications with regard to gross income and realization.⁴⁴

B. Back to the Basics: Gross Income and Realization

Gross income and realization are foundational tax concepts that are vital to analyzing the proper tax treatment of contingent attorney's fees.⁴⁵ The Code plainly defines gross income as "all income from whatever source derived," except as otherwise provided by law.⁴⁶

43. *Id.*; see also Alfred D. Youngwood, *The Contingent Fee-A Reasonable Alternative?*, 28 MOD. L. REV. 330, 330 (1965) (discussing the advantages of a contingency fee arrangement to a client who may otherwise be unable to afford representation).

44. Youngwood, *supra* note 43, at 331-32; see also Aranson, *supra* note 7, at 760 (noting the acceptance of contingent fee contracts in all fifty states). Although contingent fee contracts may be used in many types of litigation, they are most commonly used in personal injury cases. See Aranson, *supra* note 7, at 760. Because of the concern for corruption of the legal process, however, contingent fees are prohibited in criminal cases, family cases, and in legislative lobbying. *Id.* at 760-61; see also *infra* Part II.B (discussing the principles of gross income and realization).

45. See Grant, *supra* note 2, at 370-72 (discussing gross income and realization in the context of contingent attorney's fees).

46. I.R.C. § 61(a) (1994). While the Code does not specifically mention all items of gross income intended to be included, courts construe the definition of gross income broadly in accordance with Congress' intent to tax income comprehensively. See *Comm'r v. Jacobson*, 336 U.S. 28, 49 (1949). The Supreme Court in *Jacobson* stated that "income taxed is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions, on the other hand, are specifically stated and should be construed with restraint in the light of the same policy." *Id.* The Sixteenth Amendment of the United States Constitution grants Congress the power to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI. Section 61(a) states:

(a) General definition—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Alimony and separate maintenance payments;
- (9) Annuities;
- (10) Income from life insurance and endowment contracts;

Congress intentionally defined gross income broadly so as to encompass any realized economic benefit over which a taxpayer exercises complete control.⁴⁷ Thus, the determination of whether an accrued benefit must be included in a taxpayer's gross income depends upon when he realizes the income and whether he exercises control over the income or its source.⁴⁸

Although, ordinarily, realization occurs when a taxpayer receives income, the obligation to pay tax may accrue even where a taxpayer does not take possession of income directly.⁴⁹ For example, the Supreme Court held that the payment by a third party of a taxpayer's debt, such as an employer who pays the federal income taxes of an employee, is equivalent to receipt of gross income by the taxpayer.⁵⁰ The rationale for this conclusion is that an identical economic benefit is conferred on the taxpayer, whether the third party pays him directly or pays another on his behalf.⁵¹ Thus, the requirement of realization does not mean that a taxpayer, who fully enjoys an economic gain by virtue

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust

I.R.C. § 61(a).

47. See I.R.C. § 61(a); *James v. United States*, 366 U.S. 213, 219 (1961) (defining gross income to include any gain from which a taxpayer derives readily realizable economic value); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding any benefit that accrues to a taxpayer should be included in gross income if it has created an "undeniable accession to wealth, clearly realized, and over which the taxpayer has complete dominion").

48. See *Helvering v. Horst*, 311 U.S. 112, 115-16 (1940). "Realization" occurs when the taxpayer takes the last step necessary to ensure fruition of an economic gain. *Id.* at 115. The concept of realization was founded on a desire for administrative convenience and sets the time at which the taxpayer is taxed as the final event of enjoyment of the income. *Id.* at 116; see also *Srivastava v. Comm'r*, 220 F.3d 353, 358 (5th Cir. 2000) (stating that "income or gain is not taxed until it is 'realized'").

49. *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929). The plaintiff in this case was the President of American Woolen Company. *Id.* at 719. In 1916, the company adopted a resolution whereby it agreed to pay the income taxes due on the salary of all officers of the corporation. *Id.* at 719-20. The plaintiff did not report these tax payments made on his behalf in his gross income in 1919 and 1920. *Id.* The Court held that the form of the payment was irrelevant and that the payment of tax by an employer is in consideration of services rendered by the employee. *Id.* at 729.

50. *Id.*

51. *Id.* The Court reasoned that the discharge by a third party of an obligation owed by a taxpayer is the same as receipt of income by the taxpayer from the third party. *Id.*

of a right to receive income, can avoid taxation merely because he has not taken possession of the income.⁵²

Although realization of income cannot occur until the taxpayer enjoys a benefit, the enjoyment of income may occur prior to its receipt; for example, the taxpayer transfers his right to receive or control income accrued to him in exchange for something of value.⁵³ When a taxpayer realizes such a benefit, it follows that the obligation to pay tax also accrues.⁵⁴ Therefore, the underlying rationale for the concept of realization requires that the person who owns or controls the source of an item of income is responsible for the tax on that income.⁵⁵ This important concept serves as the basis for the assignment-of-income doctrine.⁵⁶

C. *The Evolution of the Assignment-of-Income Doctrine*

An analysis of gross income not only involves whether a transaction generates gross income, it also involves identifying the taxpayer to whom the gross income is attributable.⁵⁷ For example, when a taxpayer earns the right to receive income, but transfers that right to another taxpayer, it is often unclear which taxpayer owes the tax on the income when it is eventually received.⁵⁸ The judicially developed assignment-of-income doctrine provides the framework necessary to answer this

52. *Horst*, 311 U.S. at 117 (holding a donor taxable on interest income from negotiable bond coupons gifted to his son).

53. *Id.* at 116 (stating that a taxpayer realizes income when he “has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth”). The Court listed specific examples of enjoyment that could occur prior to the receipt of income, including the procurement of payment directly to creditors or funding of an irrevocable trust. *Id.*

The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income . . . and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer’s personal receipt of money or property.

Id.

54. *Old Colony Trust Co.*, 279 U.S. at 729.

55. *Horst*, 311 U.S. at 116-17 (stating that “he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as a means of procuring the satisfaction of his wants”); *see also* *Galt v. Comm’r*, 216 F.2d 41, 46 (7th Cir. 1954) (holding that a taxpayer, who distributed a percentage of his betting receipts under a lease to his children, controlled the asset from which the payment arose, and was thus liable for the tax on the income).

56. *See infra* Part II.C (examining the origin and development of the assignment-of-income doctrine).

57. *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930).

58. *See Horst*, 311 U.S. at 116 (examining the question of who should pay tax on an economic gain accrued to one taxpayer, but received by another through a transfer).

question.⁵⁹ From the doctrine's origin in the Supreme Court over seventy years ago, assignment of income principles continue to be applied and developed through case law.⁶⁰

1. Origin of the Assignment-of-Income Doctrine

Utilizing a progressive income tax system, the federal government achieves its goal of taxing individuals in proportion to their relative ability to pay by separating a taxpayer's income into five brackets.⁶¹ The system then taxes the income within each bracket at progressively higher rates.⁶² By doing so, the first dollars earned by a taxpayer are taxed at a lower rate than the last dollars earned.⁶³ This progressive rate structure provides an incentive to reduce income and it did not take long for sophisticated taxpayers to discover that splitting income between two or more individuals would reduce overall tax liability.⁶⁴ The disapproval by the IRS of the allocation of income in this way eventually led the Supreme Court to develop the assignment-of-income doctrine.⁶⁵

The origin of the assignment-of-income doctrine is traceable to the case of *Lucas v. Earl*.⁶⁶ In *Earl*, a husband and wife agreed that all property held or acquired by them during their marriage would be

59. *Id.* (examining the origin and development of the assignment-of-income doctrine as the basis for determining the appropriate taxpayer); see also *supra* note 15 and accompanying text (defining the assignment-of-income doctrine).

60. See *infra* Part II.C.1 (discussing the origin of the assignment of income doctrine); *infra* Part II.C.2 (examining the development of the assignment of income doctrine through case law).

61. I.R.C. § 1 (1994); see also Grant, *supra* note 2, at 364-65 (discussing the goal of proportional taxation).

62. I.R.C. § 1. In 2001, for married persons filing jointly and surviving spouses, the tax rates were: 15% of all income under \$45,200, 27.5% of all income over \$45,200 but less than \$109,250, 30.5% of all income over \$109,250 but less than \$166,500, 35.5% of all income over \$166,500 but less than \$297,350, and 39.1% of all income over \$297,350. See I.R.S. Pub. 17, at 272 (2001). For unmarried individuals, except for surviving spouses and heads of household, the tax rates are: 15% of all income under \$27,050, 27.5% of all income over \$27,050 but less than \$65,550, 30.5% of all income over \$65,550 but less than \$136,750, 35.5% of all income over \$136,750 but less than \$297,350, and 39.1% of all income over \$297,350. See *id.*

63. See I.R.C. § 1.

64. See Sheridan, *supra* note 17, at 290 (citing *Pfluger v. Comm'r*, 840 F.2d 1379, 1384 n.10 (7th Cir. 1988)). "By splitting one's income between two entities or people, a taxpayer gets two trips through the lower brackets, resulting in a lower overall tax bill." *Id.*

65. See *id.* at 291; *infra* notes 66-102 and accompanying text (discussing the history and application of the assignment-of-income doctrine). The doctrine arises from the need to address the question of "who" the taxpayer is with respect to a particular transaction. See *infra* notes 66-79. Because this issue is addressed by statute only in certain circumstances, the doctrine, in its origin and nature, is substantially a judicial one. See *infra* notes 72-73 and accompanying text.

66. *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (holding a husband taxable on wages earned by him despite his contractual arrangement to transfer one-half of the income to his wife).

owned by them equally.⁶⁷ Later, Mr. Earl earned income from services as an attorney.⁶⁸ The couple reported this income separately, one-half each, according to their agreement, and paid a smaller aggregate amount of tax under the graduated tax rates than they would have if Mr. Earl had reported his income in full.⁶⁹

However, the Commissioner of Internal Revenue (“Commissioner”) objected and sought to tax Mr. Earl individually for the entire amount of income earned by him.⁷⁰ The Supreme Court agreed with the Commissioner and required Mr. Earl to pay the entire amount of tax related to his income.⁷¹ The Court’s decision was not based on the plain language of the Code.⁷² Rather, the Court used principles of statutory construction in holding that Congress intended for the Code to impose tax on income to the person who earns it, not to the person who receives it under an assignment.⁷³ The Court concluded that, even where an anticipatory contract provides for an item of income to completely bypass the taxpayer’s possession, that taxpayer is still responsible for

67. *Id.* at 113-14. The contract stated that:

[A]ny property either of us now has or may hereafter acquire . . . in any way, either by earnings . . . or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.

Id.

68. *Id.* at 113.

69. *Id.* Due to the tax rate structure in place today, a husband and wife could rarely achieve a lower aggregate tax by reporting their income separately. *See* I.R.C. § 1(a), (1)(d) (1994) (requiring married taxpayers who file separately to pay tax at higher rates). In 2001, for married persons filing jointly and surviving spouses, the tax rates were: 15% of all income under \$45,200, 27.5% of all income over \$45,200 but less than \$109,250, 30.5% of all income over \$109,250 but less than \$166,500, 35.5% of all income over \$166,500 but less than \$297,350, and 39.1% of all income over \$297,350. *See* I.R.S. Pub. 17, at 272 (2001). By contrast, the tax rates for married persons filing separately are: 15% of all income under \$22,600, 27.5% of all income over \$22,600 but less than \$54,625, 30.5% of all income over \$54,625 but less than \$83,250, 35.5% of all income over \$83,250 but less than \$148,675, and 39.1% of all income over \$148,675. *See id.*

70. *Earl*, 281 U.S. at 113.

71. *Id.* at 114-15. In 1920 and 1921, the years here involved, Mr. Earl earned \$24,839.00 and \$22,946.20, respectively, in wages. *See Earl v. Comm’r*, 30 F.2d 898, 898 (Cal. Ct. App. 1929). He and his wife made separate income tax returns for the years stated, each returning one-half of the above amounts. *Id.* The Commissioner ruled that the entire amount of the petitioner’s earnings was taxable to him, and no part to his wife, and as a result determined that there was a deficiency in the tax paid by the petitioner in the sums of \$2,420 for 1912, and \$2,432 for 1921. *Id.*

72. *Earl*, 281 U.S. at 114-15 (recognizing the absence of a statutory mandate).

73. *Id.* (explaining that the “import” of the statute supported the conclusion that income should be taxed to the person who earned it).

paying tax on that income.⁷⁴ This conclusion was based on the Court's determination that Mr. Earl was the taxpayer who "realized" the income because he was the only person that could take the last step in the performance of the services leading to the production of that income.⁷⁵ In other words, he had exclusive control over whether the income was earned in the first place.⁷⁶

Notably, in defining the assignment-of-income doctrine, the Court held that it would not consider the taxpayer's motive behind a contract.⁷⁷ For example, in *Earl*, the Court assumed that a valid purpose, outside of the avoidance of income tax, existed for Mr. Earl and his wife to enter into a contract allocating his income between them.⁷⁸ The Court held, using a now famous fruit-tree metaphor, that regardless of the motive of the taxpayer in creating an assignment, no anticipatory arrangement attributing income to a different taxpayer than the one who earns it can serve to shift the tax burden with respect to that income.⁷⁹

2. The Continuing Development of the Doctrine

After *Lucas v. Earl*, a second Supreme Court case helped shape the assignment-of-income doctrine.⁸⁰ In *Helvering v. Horst*, the owner of negotiable bonds detached the interest coupons from the bonds shortly before their due date and transferred them to his son as a gift.⁸¹ The son

74. *Id.* at 115 (stating that tax may "not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it").

75. *Id.* at 114.

76. *Id.*

77. *Id.*

78. *Id.* (stating that "the validity of the contract is not questioned").

79. *Id.* at 115. Justice Holmes stated that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.* The Court likened an income-producing asset to a tree, and compared the income earned by that asset to the fruit borne of the tree. *Id.* In this case, the owner of the "tree" was Mr. Earl, the taxpayer earning income from services, and the "fruit" was the salary he earned from his efforts. *Id.* In general, to identify the owner of the "fruit-bearing tree," courts look to the degree of control possessed by the taxpayer over the asset giving rise to the income. See James Serven, *The Federal Income Tax Treatment of Contingent Legal Fees in Personal Injury Cases*, 30 COLO. LAW. 81, 82 (2001). In the context of attorney's fees, an analogy is made as to whether the client is the "owner" of the entire cause of action (the tree) so that the entire recovery (the fruit) is fully taxable to the client irrespective of any amount directed to the attorney under a contingent fee arrangement. *Id.*

80. *Helvering v. Horst*, 311 U.S. 112, 120 (1940) (holding a donor taxable on interest income even though he transferred the right to receive the interest payments to his son as a gift).

81. *Id.* at 114.

collected the interest due on the coupons in the same taxable year.⁸² The Commissioner determined that the interest income from the coupons should be taxed to the donor, rather than to the donor's son.⁸³ The Supreme Court agreed, holding that when the donor transferred the right to receive payments of interest to his son, the donor enjoyed an economic benefit from the income just as if he would have collected the interest payments himself and then used the cash to fund the gift to his son.⁸⁴

The Court noted that the taxpayer held two independent and separable property rights in the bonds.⁸⁵ One was the right to demand and receive at maturity the principal amount of the bond.⁸⁶ The other was the right to demand and receive interim payments of interest on the investment, which he gave to his son.⁸⁷ In contrast to the situation in which a donor makes a gift of income-producing property,⁸⁸ the taxpayer in *Horst* retained an ownership interest in the underlying property.⁸⁹ As a result, the taxpayer realized income when the interest was paid on the coupons.⁹⁰ The Court made clear that there is no meaningful distinction between a taxpayer receiving and using his income to fulfill a desire and him transferring his right to receive that income in order to effectuate the same result.⁹¹

82. *Id.*

83. *Id.*

84. *Id.* at 120.

85. *Id.* at 115.

86. *Id.*

87. *Id.*

88. See *Blair v. Comm'r*, 300 U.S. 5 (1937). The plaintiff transferred his beneficial interest in a testamentary trust to his children. *Id.* at 6. The Court held that the plaintiff transferred his entire interest as a life beneficiary of the trust and that he retained no ownership rights after the transfer. *Id.* at 13. Accordingly, the Court found that the tax that attached to the ownership of the specified interest was appropriately imposed on the person to whom it was assigned and not to the plaintiff. *Id.* at 12.

89. *Horst*, 311 U.S. at 118-19.

90. *Id.* at 120. It is noteworthy that although *Horst* involved a transfer by gift, the Court also cited *Old Colony Trust Co. v. Commissioner* and expressly recognized that a taxpayer can realize income whether he directs a payment to his creditors or directs payment to the "objects of his bounty." *Id.* at 116 (citing *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929)). In *Old Colony Trust*, the taxpayer's employer paid the income taxes on his salary directly to the government. *Old Colony Trust*, 279 U.S. at 719. The Court held that a taxpayer who induces or acquiesces to the payment of an obligation by a third party may not avoid the liability for the corresponding tax. *Id.* at 729. The Court held that the form of the payment did not affect the tax consequences to the taxpayer and that it was immaterial that the taxes were paid directly to the government without first coming into his possession. *Id.* The Court's conclusion was based on the concept that the discharge by a third party of an obligation of the taxpayer is equivalent to receipt of that income by the taxpayer. *Id.*

91. *Horst*, 311 U.S. at 117-18.

In the same year the Supreme Court decided *Horst*, it decided a third influential assignment-of-income case.⁹² In *Helvering v. Eubank*, a former life insurance agent assigned his right to receive renewal commissions that would become payable to him for services rendered during his employment.⁹³ Although Mr. Eubank did not retain an ownership interest in the renewal commissions, the Court found no purpose for the assignment other than to confer power on the assignees to collect the commissions.⁹⁴ As a result, the Court, relying on its reasoning in *Horst*,⁹⁵ concluded that Mr. Eubank could not avoid paying tax on income he earned from services by transferring the right to receive the income through an anticipatory assignment.⁹⁶

Currently, the assignment-of-income doctrine requires that, for purposes of taxation, income is attributable to the person entitled to receive it, even though he assigns his right in advance of receipt.⁹⁷ In the case of income from services, the income is taxed to the individual

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 it as the means of procuring them The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized to him as completely as it would have been if he had collected the interest in dollars and expended them To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned them instead of collecting them himself and then paying them over to the donee, is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

Id.

92. *Helvering v. Eubank*, 311 U.S. 122 (1940).

93. *Id.* at 124. During part of the year 1924, Eubank was employed as a branch manager by Canada Life Assurance Company and received, as part of his compensation, commissions on agency contracts written by him. *Eubank v. Comm'r*, 110 F.2d 737, 738 (2d Cir.), *rev'd*, 311 U.S. 122 (1940). Under the terms of his employment contract, he was entitled to renewal commissions on premiums collected by Canada Life on policies written prior to the termination of his agency, without obligation to provide further services. *Id.* From September 1, 1924 to August 31, 1927, Eubank was a general agent for the Aetna Life Assurance Company. *Id.* His contract with Aetna similarly entitled him to renewal premiums paid after the termination of his agency, without the performance of further services. *Id.* In 1928, Eubank made assignments to a corporate trustee of the renewal commissions that were to become payable to him for services he performed under these separate agency contracts. *Id.*

94. *Eubank*, 311 U.S. at 124.

95. *Horst*, 311 U.S. at 112.

96. *Eubank*, 311 U.S. at 125 (stating that "for the reasons stated at length in the *Horst* case," the commissions were taxable to Mr. Eubank).

97. *Kenseth v. Comm'r*, 114 T.C. 399, 420 (1994) (Chabot, J., dissenting) [hereinafter *Kenseth I*], *aff'd*, 259 F.3d 881 (7th Cir. 2001).

who renders the services.⁹⁸ In the case of income from property, the income is taxed to the individual who beneficially owns the property.⁹⁹

In the context of contingent attorney's fees, courts apply the assignment-of-income doctrine to tax a client on the portion of a judgment or settlement recovered by the client that is paid directly to his attorney under a contingent fee contract.¹⁰⁰ These courts reason that the client receives a benefit by way of a discharge of the otherwise existing obligation to pay legal fees.¹⁰¹ Courts requiring taxpayers to include the attorney's fees paid from the recovery also allow the taxpayer a corresponding deduction for the legal expenses incurred in obtaining the award.¹⁰²

D. The Deduction Dilemma

While the assignment-of-income doctrine limits the anticipatory assignment of taxable income, a taxpayer is generally entitled to statutory deductions for expenses incurred in the production of taxable income.¹⁰³ Although a taxpayer who operates a trade or business¹⁰⁴

98. *Blair v. Comm'r*, 300 U.S. 5, 11-12 (1937).

99. *Id.*

100. *See, e.g., Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (holding that a taxpayer must include contingent attorney's fees in gross income under the assignment-of-income doctrine); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (holding that the assignment of a portion of a lawsuit recovery to an attorney constitutes gross income to the client even though the client never actually received the funds); *see also infra* Part III.B (analyzing the rationale of courts holding that contingent attorney's fees are includable in gross income).

101. *See, e.g., Campbell v. Comm'r*, 274 F.3d 1312, 1313-14 (10th Cir. 2001) (holding that the client's discharge of an obligation to pay legal fees owed by her was a benefit to the client within the definition of gross income); *Kenseth II*, 259 F.3d 881, 884 (7th Cir. 2001) (holding that a taxpayer could not shift his tax liability by assigning a portion of his income to a law firm).

102. *See, e.g., Campbell*, 274 F.3d at 1314 (holding that the taxpayer's judgment was a recovery of gross income and the attorney's fees she paid were expenses incurred in generating that income); *Kenseth II*, 259 F.3d at 883 (holding that the fees paid to the taxpayer's attorney were a deduction from, not a reduction of gross income); *see also infra* Part II.D-E (discussing the deduction provisions applicable to contingent attorney's fees).

103. *See Kenseth I*, 114 T.C. 399, 417 (2000) (holding that contingent legal fees were deductible expenses subject to applicable statutory limitations), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *see also* I.R.C. § 162 (1994) (providing a deduction for ordinary and necessary business expenses); I.R.C. § 212 (1994) (allowing a deduction for expenses incurred in the production of income).

104. Despite the prevalent use of the tax concept of a "trade or business," the Internal Revenue Code has never defined the words for widespread application. *Comm'r v. Groetzinger*, 480 U.S. 23, 27 (1987). Therefore, courts have established a series of objective factors to be analyzed on a case-by-case basis that support a finding that a taxpayer is engaged in a trade or business. *Treas. Reg.* § 1.183-2(a) (1972). These factors include, the manner in which the taxpayer conducts the activity, the expertise of the taxpayer or advisors, the time and effort the taxpayer expends in conducting the activity, the intention to generate a profit, the taxpayer's success in conducting similar activities, the taxpayer's history of profits and losses with respect to

may take a business deduction for legal fees, such fees typically fall under the category of miscellaneous itemized deductions.¹⁰⁵ The Internal Revenue Code, however, places significant limitations on miscellaneous itemized deductions which can dramatically increase the tax burden for unsuspecting taxpayers.¹⁰⁶

1. The Deduction for Legal Expenses

In general, when a taxpayer generates gross income at a cost, the amount of the income is not affected.¹⁰⁷ Rather, the taxpayer may be entitled to a deduction that offsets the income realized from his efforts.¹⁰⁸ If for some reason the cost of generating the income is not deductible, however, the taxpayer is not permitted to net his gross income and expenses.¹⁰⁹ Instead, the taxpayer must report his income in full without regard to the costs incurred to obtain it.¹¹⁰

With respect to legal fees, two Code provisions govern whether a taxpayer is allowed to take a deduction.¹¹¹ First, if the taxpayer is engaged in a trade or business, he may deduct legal fees under § 162, which allows a deduction for all business expenses that are ordinary and necessary to the conduct of the business.¹¹² If a taxpayer is not engaged

the activity, the amount of any profits earned, the taxpayer's financial status, and the extent to which personal pleasure or recreation is involved in the activity. Treas. Reg. §§ 1.183-2(b)(1)-(b)(9) (1972).

105. See *infra* notes 111-14 and accompanying text (discussing the character of deductions under the Code). Miscellaneous itemized deductions are itemized deductions other than those deductions specifically enumerated in I.R.C. §§ 67(b)(1)-(12). I.R.C. § 67(b) (1994).

106. See *infra* notes 119-35 and accompanying text (examining the Internal Revenue Code limitations on miscellaneous itemized deductions).

107. See *Kenseth II*, 259 F.3d at 883 (explaining that taxable income is gross income minus allowable deductions). For example, if a firm pays a salesman on a commission basis for his services, the sales income he generates is income to the firm and any commissions paid to him are a deductible expense. *Id.*

108. *Id.*

109. See *id.*; see also I.R.C. § 161 (1994) (providing that only certain expenses are deductible for income tax purposes). Section 161 states that "[i]n computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to" certain exceptions. I.R.C. § 161.

110. See *Kenseth II*, 259 F.3d at 883.

111. See I.R.C. §§ 162(a), 212 (1994). There is also a third option for legal fees which is less common. See I.R.C. § 263 (1994). Section 263 requires a taxpayer to capitalize, and not currently deduct, legal fees associated with the acquisition of a capital asset or a business. *Id.*; see CHRISTOPHER G. STONEMAN, DEDUCTIBILITY OF LEGAL AND ACCOUNTING FEES, BRIBES AND ILLEGAL PAYMENTS, TAX MANAGEMENT PORTFOLIO NO. 523-2ND, A-14 (2000) (providing a detailed discussion regarding the deductibility of legal fees).

112. I.R.C. § 162(a). Section 162 states that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a). "Necessary" expenses are those that are "appropriate and helpful"

in a trade or business, the more common situation in which contingent fee contracts are used, the taxpayer may instead be able to deduct the legal fees under § 212.¹¹³ To qualify under § 212, the legal fees must be ordinary and necessary expenses and must be incurred in the production of income.¹¹⁴

2. The Importance of Characterizing the Legal Expense Deduction

The distinction between ordinary and necessary business expenses under § 162 and expenses incurred in connection with the production of income under § 212 is significant with respect to contingent legal fees.¹¹⁵ A taxpayer who can deduct legal fees under § 162 takes his

to the carrying on of one's business. *Welch v. Helvering*, 290 U.S. 111, 113 (1933) (holding that payments to creditors were "necessary" in the sense that they were "appropriate and helpful"). "Ordinary" expenses are those that are common within the business community to which the taxpayer belongs. *Id.* at 114. Under *Welch*, legal fees qualify as "ordinary and necessary" business expenses. *Id.*

113. See I.R.C. § 212, which states:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year-

- (1) for the production or collection of income;
- (2) for the management, conservation, or maintenance of property held for the production of income; or
- (3) in connection with the determination, collection, or refund of any tax.

Id.

The purpose of enacting § 212 was to prevent a person receiving income from being charged with his gross receipts without being allowed to set off expenses without which those receipts would not have come to hand at all. *Comm'r v. Heide*, 165 F.2d 699, 701 (2d Cir. 1948).

114. I.R.C. § 212(1). In order for an expense to be deductible under § 212, it must be "ordinary and necessary." *Welch*, 290 U.S. at 113. Thus, the expense "must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income." Treas. Reg. § 1.212-1(d) (1975). An expense for legal fees paid in the pursuit of a taxable lawsuit recovery qualifies as an expense related to the production or collection of taxable income under § 212. See Treas. Reg. § 1.212-1(a)(1) (1975) (allowing a deduction under § 212 for expenses incurred in producing or collecting income that will be subject to federal tax).

115. Robert W. Wood, *Settlement: The Tax Issues*, 2001 CURRENT DEV. EMP. L.: JULY 26-28, 1145, 1158 (ALI-ABA). The determination of whether legal fees are deductible under § 162 or § 212 is made based on the "origin of the claim test." See *Arthur H. DuGrenier, Inc. v. Comm'r*, 58 T.C. 931 (1972). The "origin of the claim test" was first applied by the U.S. Supreme Court in 1941 in *Hort v. Commissioner* and later defined in *United States v. Gilmore*. *United States v. Gilmore*, 372 U.S. 39 (1962); *Hort v. Comm'r*, 313 U.S. 28 (1941). The object of the "origin of the claim test" is to find the transaction or activity from which the taxable event approximately resulted, or the event that led to the tax dispute. See *Gilmore*, 372 U.S. at 49.

In *Hort*, the taxpayer acquired real estate by devise that was subject to a lease. *Hort*, 313 U.S. at 29. A few years later, the taxpayer agreed to cancel the lease in exchange for a lump sum payment of \$140,000 from the lessee. *Id.* The taxpayer reported a loss on his tax return to reflect the difference between the present value of the unmaturing rental payments and the fair rental value of the property for the unexpired term of the lease. *Id.* The IRS disallowed this loss and

deductions “above-the-line” as a direct reduction to gross income.¹¹⁶ In contrast, § 212 deductions are “below-the-line” deductions, or

included the \$140,000 payment in the taxpayer’s gross income. *Id.* The Supreme Court agreed with the IRS, reasoning that any proceeds of a suit to recover damages if the lessee breached the lease contract would have been included in gross income. *Id.* at 30-31. The Court held that the \$140,000 payment received by the taxpayer was essentially a substitute for rent payments due under the lease, and thus ordinary income. *Id.* at 30.

In *Gilmore*, the taxpayer’s wife filed for divorce and asserted a claim against the taxpayer’s stock interests in three corporations, arguing that they were community property. *Gilmore*, 372 U.S. at 41. The taxpayer incurred legal fees associated with a claim he initiated to allegedly defend his stock interests. *Id.* The taxpayer deducted these legal fees as § 212 expenses incurred for the conservation of property. *Id.* The Commissioner disallowed these deductions, classifying them as non-deductible personal or family expenses. *Id.* at 42. The Supreme Court, agreeing with the IRS, held that the character of the claim, rather than its potential consequences, was the controlling test of whether an expense was business or personal. *Id.* at 49. In this case, the Court determined that the claim stemmed from the marital relationship, and thus, the taxpayer’s legal fees were personal expenses which were not deductible. *Id.* at 52.

116. I.R.C. § 62(a)(1) (1994). Above-the-line deductions are those expenses that are subtracted from a taxpayer’s income before arriving at adjusted gross income. *Id.* Section 62 enumerates seventeen types of deductions which qualify for “above-the-line” treatment as follows:

(a) General rule.—For purposes of this subtitle, the term “adjusted gross income” means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions.—The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) Certain trade and business deductions of employees.—

(A) Reimbursed expenses of employees.—The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that the reimbursement may be provided by a third party shall not be determinative of whether or not the preceding sentence applies.

(B) Certain expenses of performing artists.—The deductions allowed by section 162 which consist of expenses paid or incurred by a qualified performing artist in connection with the performances by him of services in the performing arts as an employee.

(C) Certain expenses of officials.—The deductions allowed by section 162 which consist of expenses paid or incurred with respect to services performed by an official as an employee of a State or a political subdivision thereof in a position compensated in whole or in part on a fee basis.

(3) Losses from sale or exchange of property.—The deductions allowed by part VI (sec. 161 and following) as losses from the sale or exchange of property.

(4) Deductions attributable to rents and royalties.—The deductions allowed by part VI (sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.

(5) Certain deductions of life tenants and income beneficiaries of property.—In the case of a life tenant of property, or an income beneficiary of property held in

miscellaneous itemized deductions,¹¹⁷ which do not directly reduce gross income.¹¹⁸

trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by section 167 and the deduction allowed by section 611.

(6) Pension, profit-sharing, and annuity plans of self-employed individuals.—In the case of an individual who is an employee within the meaning of section 401(c)(1), the deduction allowed by section 404.

(7) Retirement savings.—The deduction allowed by section 219 (relating to deduction of certain retirement savings).

[(8) Repealed. Pub. L. 104-188, Title I, § 1401(b)(4), Aug. 20, 1996, 110 Stat. 1788]

(9) Penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits.—The deductions allowed by section 165 for losses incurred in any transaction entered into for profit, though not connected with a trade or business to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or similar class of deposit.

(10) Alimony.—The deduction allowed by section 215.

(11) Reforestation expenses.—The deduction allowed by section 194.

(12) Certain required repayments of supplemental unemployment compensation benefits.—The deduction allowed by section 165 for the repayment to a trust described in paragraph (9) or (17) of section 501(c) of supplemental unemployment compensation benefits received from such trust if such repayment is required because of the receipt of trade readjustment allowances under section 231 or 232 of the Trade Act of 1974 (19 U.S.C. 2291 and 2292).

(13) Jury duty pay remitted to employer.—Any deduction allowable under this chapter by reason of an individual remitting any portion of any jury pay to such individual's employer in exchange for payment by the employer of compensation for the period such individual was performing jury duty. For purposes of the preceding sentence, the term "jury pay" means any payment received by the individual for the discharge of jury duty.

(14) Deduction for clean-fuel vehicles and certain refueling property.—The deduction allowed by section 179A.

(15) Moving expenses.—The deduction allowed by section 217.

(16) Archer MSAs.—The deduction allowed by section 220.

(17) Interest on education loans.—The deduction allowed by section 221.

(18) Higher education expenses.—The deduction allowed by section 222.

I.R.C. § 62 (1994).

117. Treas. Reg. § 1.67-1T (2000). Below-the-line deductions are those expenses that are subtracted, subject to statutory limitations, from the adjusted gross income of the taxpayer to arrive at taxable income. *See id.* (describing some deductions that fall into the category of below-the-line deductions). The term "miscellaneous itemized deductions" describes "the deductions allowable from adjusted gross income in determining taxable income," with certain exceptions. *See* Treas. Reg. § 1.67-1T(b). Section 67(b) describes miscellaneous itemized deductions as itemized deductions other than those deductions specifically enumerated in § 67(b)(1) through (12) as follows:

For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than—

(1) the deduction under section 163 (relating to interest),

The categorization of deductions plays an important role for individual taxpayers because miscellaneous itemized deductions carry with them several statutory disadvantages.¹¹⁹ First, miscellaneous itemized deductions are deductible only to the extent that the aggregate amount of those deductions exceeds two percent of adjusted gross income.¹²⁰ Second, otherwise allowable miscellaneous itemized deductions are subject to a phase-out calculation that affects most itemized deductions.¹²¹ This phase-out calculation requires a taxpayer,

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- (2) the deduction under section 164 (relating to taxes),
 - (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
 - (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),
 - (5) the deduction under section 213 (relating to medical, dental, etc., expenses),
 - (6) any deduction allowable for impairment-related work expenses,
 - (7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),
 - (8) any deduction allowable in connection with personal property used in a short sale,
 - (9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),
 - (10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),
 - (11) the deduction under section 171 (relating to deduction for amortizable bond premium), and
 - (12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations),
 - (13) Redesignated (12).

I.R.C. § 67(b) (1994). Itemized deductions are deductions other than § 151 personal exemptions and § 62 "above-the-line" deductions. I.R.C. § 63 (1994). Under § 151, a taxpayer receives a deduction each year in the form of a personal exemption for himself, his spouse, and any qualified dependants. I.R.C. § 151(b) (1994). Miscellaneous itemized deductions may be subject to significant limitations under the Code. See I.R.C. §§ 67(a), 68(a)(1), (a)(2), (b)(1) (1994).

118. See I.R.C. § 63(d) (1994) (defining taxable income as adjusted gross income less § 67 deductions and § 151 personal exemptions).

119. See *infra* notes 120-35 and accompanying text (discussing the limitations imposed on miscellaneous itemized deductions for purposes of the regular federal income tax and the alternative minimum tax).

120. I.R.C. § 67(a). Adjusted gross income is calculated by reducing the gross income of a taxpayer by all § 62 deductions. I.R.C. § 62; see also *supra* note 116 (detailing the allowable § 62 deductions for arriving at adjusted gross income). For example, if a taxpayer had \$50,000 in wages and paid alimony of \$15,000 in a given tax year, the taxpayer's adjusted gross income would be \$35,000. See I.R.C. § 62(a)(10) (allowing an above the line deduction for qualified alimony payments).

121. See I.R.C. §§ 68(a)(1), (a)(2), (b)(1). There are currently three types of non-miscellaneous itemized deductions that are not subject to the phase-out calculation. See I.R.C. § 68(c) (1994). The exceptions relate to deductions for medical expenses, investment interest, and casualty and theft losses. *Id.*

whose adjusted gross income exceeds a specified amount, to reduce the amount of his itemized deductions by three percent of the excess.¹²² Although these limitations alone can be significant in a given taxable year, the treatment of miscellaneous itemized deductions is subject to even harsher rules for taxpayers under the Alternative Minimum Tax.¹²³

E. The Alternative Minimum Tax Trap

Even more onerous than the limitations on deductions for legal fees for regular tax purposes is the treatment of such expenses under the Alternative Minimum Tax ("AMT").¹²⁴ Congress first created the AMT in 1969 as an add-on tax, exacted in addition to the regular tax.¹²⁵ The overall objective in designing the AMT was to ensure that no taxpayer with substantial income could avoid tax liability through the use of excessive deductions or credits.¹²⁶ Congress believed that the favored tax status afforded certain types of income and expenses allowed

122. *Id.* Section 68 reduces the total of all itemized deductions by the lesser of three percent of the amount by which adjusted gross income exceeds \$100,000, or 80% of otherwise allowable itemized deductions. I.R.C. § 68(b)(2). The \$100,000 threshold is adjusted annually for inflation. *Id.* For 2001, the inflation-adjusted threshold is \$132,950. See I.R.S. Pub. 17, at 144 (2001). For example, if a taxpayer has AGI of \$350,000 and allowable itemized deductions of \$110,000, the itemized deduction phase-out would be \$65,115 calculated as follows:

$$\$350,000 \text{ (AGI)} - \$132,950 \text{ (2001 threshold)} = \$217,050$$

$$\$217,050 \times 3\% = \$65,115$$

$$\text{Compare } 80\% \times \$110,000 \text{ (otherwise allowable itemized deductions)} = \$88,000$$

Since \$65,115 is less than \$88,000, the phase-out amount is \$65,115.

123. See *infra* Part II.E (examining the applicable deduction rules under the AMT).

124. See I.R.C. §§ 55–58 (1994). Section 55 requires every taxpayer to compute the AMT each year based on the taxpayer's alternative minimum taxable income ("AMTI"). I.R.C. § 55(a). AMTI is equal to the taxpayer's taxable income as reported for regular tax purposes with various statutory adjustments. I.R.C. § 55(b)(2). The AMT is then calculated by applying two rate brackets, 26% and 28%, to the amount of the taxpayers AMTI that exceeds a fixed exemption amount. I.R.C. §§ 55(b)(1)(A)(i)(I)–(II). For 2001, the exemption amounts are \$49,000 for married taxpayers filing a joint tax return, and \$35,750 for unmarried taxpayers and surviving spouses. I.R.C. § 55(d)(1). In a given year, if a taxpayer's minimum tax exceeds his regular tax liability, the higher amount must be paid. I.R.C. § 55(a).

125. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 301(a), 83 Stat. 487 (codified at I.R.C. §§ 56–58). Since 1969, Congress restructured the AMT at various time through amendments. See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1520, 1549-54. Under current law, the AMT is not an "add-on tax," but rather an alternative tax that must be paid whenever an individual's AMT liability exceeds his regular tax liability. See I.R.C. § 55(a); see also *supra* note 124 (detailing the computation of the AMT).

126. See STAFF OF JOINT COMM. ON TAX'N, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 105 (Comm. Print 1970) (explaining the purpose of the first add-on minimum tax as providing "a minimum tax on specified tax preference income received by individuals and corporations in order to make sure that all taxpayers are required to pay significant amounts of tax on their economic income").

taxpayers to undermine the progressive rate structure and unfairly allocate the income tax burden.¹²⁷ Congress was also concerned that the effect of excessive tax avoidance by some taxpayers could lead to a breakdown of morale that would complicate tax collection.¹²⁸

The most significant aspect of the AMT with regard to the issue of contingent attorney's fees is its disallowance of miscellaneous itemized deductions.¹²⁹ Congress did not explain this limitation, but commentators suggest that the AMT restricts the deduction for contingent attorney's fees in order to accomplish the same objective as the deduction limitations present under the regular tax.¹³⁰ That is, to prevent a taxpayer from deducting expenses that are personal in nature.¹³¹

The disallowance of miscellaneous itemized deductions effectively creates a larger tax base upon which the AMT is calculated.¹³² If a taxpayer is required to include his contingent legal fees in gross income but cannot deduct them for AMT purposes, the AMT will almost certainly exceed the regular tax for the year, triggering additional tax liability.¹³³ Not only does the applicability of the AMT take many taxpayers by surprise, but the amount of additional tax imposed can be substantial.¹³⁴ The United States Tax Court examined the tax treatment of contingent attorney's fees with consistent results.¹³⁵

127. *See id.*

128. *See* S. REP. NO. 91-552, at 2040 (1969).

129. I.R.C. § 56(b)(1)(A)(i).

(b) Adjustments applicable to individuals.—In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax):

(1) Limitation on deductions.—

(A) In general.—No deduction shall be allowed—

(i) for any miscellaneous itemized deduction (as defined in section 67(b)).

Id.

130. *See* Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1092 (2000).

131. *Id.* Professors Sager and Cohen suggest that Congress' motive in restricting AMT deductions was "to prevent the deduction of 'expenses [that] have characteristics of voluntary personal consumption expenditures.'" *Id.* (quoting STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 78-79 (Comm. Print 1987)).

132. *See* I.R.C. § 55(b)(2) (1994).

133. *See id.* (explaining that because the tentative minimum tax factors in the exclusion for miscellaneous itemized deductions, the tentative minimum tax will likely exceed the regular tax for taxpayers with significant legal fees in a given tax year).

134. *See* Sheridan, *supra* note 17, at 312; Sager & Cohen, *supra* note 130, at 1078 (stating that "[i]f the ratio of attorney's fees to the entire recovery is high enough, a before-tax gain may

*F. The Tax Court's View Regarding the Taxation of
Contingent Attorney's Fees*

With one exception,¹³⁶ the Tax Court has consistently held that a taxpayer's entire recovery, including the portion used to pay his contingent attorney's fees, is fully includible in the taxpayer's gross income.¹³⁷ Although the Tax Court has reached this conclusion on

metamorphose into an after-tax loss"). Because of the exclusion of miscellaneous itemized deductions under the AMT, it is possible for the attorney's fees and tax burden to consume most or all of the recovery received by the client. Sheridan, *supra* note 17, at 312. For example, in *Alexander v. IRS*, the plaintiff received a settlement of \$350,000 in a suit for breach of contract and age discrimination which was includible in gross income. *Alexander v. IRS*, 72 F.3d 938, 940 (1st Cir. 1995). He paid legal fees of \$258,000 out of this settlement which were allowed as a miscellaneous itemized deduction. *Id.* Presuming that the AMT rate on the \$350,000 recovery was twenty-eight percent, the plaintiff paid \$98,000 in taxes on his recovery. See Sheridan, *supra* note 17, at 312. Adding the tax to the total legal fees paid, the taxpayer paid \$356,000 in order to receive a \$350,000 settlement. *Id.*

135. See *infra* Part II.F (discussing the reasoning of the Tax Court with regard to contingent attorney's fees).

136. *Davis v. Comm'r*, 76 T.C.M. (CCH) 46, *aff'd*, 210 F.3d 1346 (11th Cir. 2000) (per curiam). In *Davis*, the Tax Court ruled that it was bound to allow the exclusion of attorney fees under Fifth Circuit precedent because it was binding on the Eleventh Circuit to which *Davis* was appealable. *Id.* at 48; see also *Bonner v. City of Prichard*, 661 F.2d 1206, 1207 (11th Cir. 1981) (en banc) (adopting as binding precedent all of the decisions of the "old Fifth" Circuit handed down prior to the close of business on September 30, 1981).

The only time the Tax Court held that contingent attorney's fees could be excluded from gross income, it did so under the *Golsen* rule. See *Golsen v. Comm'r*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The *Golsen* rule requires that the Tax Court defer to the law of the United States Courts of Appeals to which a particular case is appealable. *Id.* The plaintiff in *Golsen* purchased life insurance for himself and his family using a device whereby he paid little or no after-tax cost for the premiums. *Id.* at 752. The device was based on a specially designed insurance policy that allowed borrowing of the annual increase in the cash value of the policy at four percent interest. *Id.* The net result of this scheme was that the insured's net out-of-pocket cost of the insurance would be equal to the true actuarial cost of the insurance benefits. *Id.* The success of this device required that a deduction for the interest paid on the loans would be allowed. *Id.* The Commissioner contended that the "loan" feature of the scheme lacked substance and challenged the interest deductions. *Id.* at 752-53. The court, in finding for the Commissioner on the merits, concluded that its holding was mandated by a prior case decided by the Court of Appeals for the same circuit within which *Golsen* arose. *Id.* at 756-57. The Tax Court stated:

[I]t is our best judgment that better judicial administration requires us to follow a Court of Appeals decision which is squarely in [sic] point where appeal from our decision lies to that Court of Appeals and to that court alone.

Id. at 757 (footnote omitted).

137. See, e.g., *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2126 (2000) (relying "on the well-established assignment of income doctrine" to reject the contention that taxpayers may exclude contingent attorney's fees from their gross income), *aff'd sub nom Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Petersen v. Comm'r*, 38 T.C. 137, 152 (1962) (stating that "[i]t is our conclusion that the awards, undiminished by the attorney's fees, constituted taxable income to the petitioners under the principle of *Lucas v. Earl* . . .").

many occasions, the rationale for its position was most fully presented in the recent case of *Kenseth v. Commissioner* ("*Kenseth I*").¹³⁸

In *Kenseth I*, Eldon Kenseth was terminated by his employer after twenty-one years of service.¹³⁹ As a result of his termination, Mr. Kenseth joined a class action suit against his former employer under the 1967 Federal Age Discrimination in Employment Act.¹⁴⁰ Each member of the class entered into an identical contingent fee agreement with a

138. *Kenseth I*, 114 T.C. 399 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001). *Kenseth I* was a fully reviewed decision. *Id.* at 417. A reviewed case is one in which all thirteen Tax Court judges participate in the decision. See Wood, *supra* note 115, at 1161. Normally, decisions are made by only one judge. *Id.* In *Kenseth I*, eight Tax Court judges were in the majority and five judges dissented. See *Kenseth I*, 114 T.C. at 417, 421. The dissent in *Kenseth I* focused on the inapplicability of the assignment-of-income doctrine to contingent fee agreements. *Id.* at 441 (Beghe, J., dissenting). Judge Beghe reasoned that when a taxpayer enters a contingent fee agreement, he relinquishes meaningful control over the outcome of his suit. *Id.* at 443-44 (Beghe, J., dissenting). Judge Beghe argued further that the result in *Kenseth I* was unfair to the taxpayer and that the court should act to remedy the unfairness in the absence of Congressional or Supreme Court intervention. See *id.* at 426 (Beghe, J., dissenting). The split on the Tax Court with respect to contingent attorney fees indicates the magnitude of the problem facing taxpayers and signals an urgent need for resolution by Congress or the Supreme Court. See Robert W. Wood, *Even Tax Court Itself Divided on Attorneys' Fees Issue!*, 88 TAX NOTES 573, 576 (2000).

The United States Court of Federal Claims and the Federal District Court for the Northern District of Alabama also heard cases on this issue, and acknowledged their support for the Tax Court's reasoning. See, e.g., *Foster v. United States*, 106 F. Supp. 2d 1234, 1238 (N.D. Ala. 2000) (allowing, reluctantly, exclusion of contingent attorney's fees based on binding precedent within the jurisdiction but agreeing with the Tax Court's reasoning on the issue), *aff'd in part*, 249 F.3d 1275 (11th Cir. 2001); *Baylin v. United States*, 30 Fed. Cl. 248, 259 (Fed. Cl. 1993) (requiring the inclusion of contingent attorneys fees), *aff'd*, 43 F.3d 1451 (Fed. Cir. 1995); see also *infra* note 164 (discussing the facts and holding of both *Baylin* and *Foster*).

139. *Kenseth I*, 114 T.C. at 400. Prior to his termination, Mr. Kenseth was a forty-five year old master scheduler for APV Crepaco (APV) with twenty-one years seniority. *Id.* In 1991, APV terminated Mr. Kenseth along with sixteen other employees over the age of forty. *Id.* At the same time, APV did not terminate younger employees occupying the same position with the company. *Id.* Mr. Kenseth, along with the other sixteen former employees of APV, hired the law firm of Fox & Fox, S.C. to represent them in a class action suit against APV for violation of the Federal Age Discrimination in Employment Act of 1967. *Id.* The relevant portion of the Age Discrimination in Employment Act of 1967 provides:

It shall be unlawful for an employer—

- (1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age;
- (2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's age; or
- (3) to reduce the wage rate of any employee in order to comply with this chapter.

29 U.S.C. § 623(a) (1994).

140. *Kenseth I*, 114 T.C. at 400, 403.

law firm, which included a clause outlining the fee arrangement in the event of a settlement or favorable judgment.¹⁴¹

The plaintiffs eventually resolved their dispute and executed a settlement agreement for \$2,650,000 to be apportioned among the plaintiffs and their attorneys pursuant to the contingent fee agreements.¹⁴² Mr. Kenseth's share of the gross settlement totaled \$230,000.¹⁴³ The settlement agreement divided the recovery into lost wages and personal injury damages.¹⁴⁴ Mr. Kenseth appropriately included \$32,000, the amount of his recovery attributable to lost wages, in gross income on his federal income tax return.¹⁴⁵ The remaining \$198,000 of his recovery was not reported in gross income on the basis of the settlement agreement, which designated those damages as excludable under § 104(a)(2) of the Internal Revenue Code as damages for personal injuries.¹⁴⁶

After a review of Mr. and Mrs. Kenseths' joint federal tax return, the Internal Revenue Service issued a notice of deficiency increasing the Kenseths' gross income by \$198,000.¹⁴⁷ The IRS notice allowed a \$91,800 itemized deduction for legal fees paid in connection with the

141. *Id.* at 400-02 (discussing the terms of the contingent fee contract). The contingent fee agreement provided that the attorney would "have a lien against any damages, proceeds, costs and fees recovered in the client's action for the fees and costs due the attorney under" the contract. *Id.* at 402.

142. *Id.* at 404.

143. *Id.* The exact amount retained by the taxpayer was \$229,501.37. *Id.*

144. *Id.* at 404-05.

145. *Id.* at 405. The actual amount included in gross income was \$32,476.61. *Id.* Prior to issuing Mr. Kenseth a check, APV withheld federal and state employment taxes of \$11,230.41 on the lost wages portion of the settlement. *Id.* at 404. The net amount of the check to Mr. Kenseth was \$21,246.20. *Id.*

146. *Id.* at 404-05. The exact amount the settlement agreement purported to exclude was \$197,024.76. *Id.* at 405. Prior to its amendment in 1996, § 104(a)(2) of the Internal Revenue Code exempted from gross income "the amount of any damages received on account of personal injuries" I.R.C. § 104(a)(2) (1994 & West Supp. 2001). The applicable Treasury Regulations clarified that the damages excludable under § 104(a)(2) were those received through "prosecution of a legal suit or action based on tort or tort type rights." Treas. Reg. § 1.104-1(c) (1970). Although the status of damages based on a discrimination suit was unclear at the time that Mr. Kenseth filed his 1993 tax return, Congress modified the statute in 1996 and limited the exclusion to damages for "physical injuries or physical sickness." I.R.C. § 104(a)(2). As a result of this revision, the damages recovered by Mr. Kenseth were explicitly excluded from § 104(a)(2) and thus includible in his gross income. *Kenseth I*, 114 T.C. at 406-07.

147. *Kenseth I*, 114 T.C. at 405-06. The IRS increased the Kenseths' gross income to \$229,501 calculated by adding the \$197,024 in income that was inappropriately excluded under § 104(a)(2) to the original \$32,477 reported. *Id.*

taxable damages recovered.¹⁴⁸ The effect of the IRS adjustments resulted in a net deficiency of \$55,037 in federal tax.¹⁴⁹

The Kenseths objected to the validity of the additional tax liability and filed suit in the Tax Court against the Commissioner.¹⁵⁰ They challenged the inclusion of the settlement portion paid directly to Mr. Kenseth's attorneys under the contingent fee agreement.¹⁵¹ The Tax Court agreed with the IRS, concluding that the entire recovery, including the amount paid to the attorneys, constituted gross income and that the amount paid in legal fees could be deducted subject to any applicable statutory limitations.¹⁵²

In *Kenseth I*, the Tax Court held that when a taxpayer remits a portion of a judgment or settlement to his attorney under a contingent fee arrangement, the taxpayer receives the full benefit of those funds in the form of payment for the legal services required in obtaining the award.¹⁵³ The Tax Court held that the assignment-of-income doctrine requires the taxpayer to include the full amount of the award in gross income despite the fact that he does not actually receive the portion of the award used to pay the his attorney's fees.¹⁵⁴ The Tax Court explicitly stated that its conclusion rested entirely on assignment of income principles, and not on the effect of any state law rights granted to attorneys with respect to awards obtained for their clients.¹⁵⁵

148. *Id.* at 405; see also I.R.C. § 212 (1994) (allowing a deduction for expenses incurred in the production of taxable income). The \$91,800 in legal fees was reduced by the two percent floor on miscellaneous itemized deductions and by \$4,694 for the overall limitation on itemized deductions. *Kenseth I*, 114 T.C. at 405-06.; see also I.R.C. §§ 67(a), 68(a)(1), (a)(2), (b)(1) (1994) (providing limitations on itemized deductions).

149. *Kenseth I*, 114 T.C. at 406.

150. *Id.* at 400.

151. *Id.* at 406-07.

152. *Id.* at 417; see also I.R.C. §§ 67(a), 68(a)(1), (a)(2), (b)(1); see *supra* notes 119-35 and accompanying text (discussing the limitations imposed on miscellaneous itemized deductions for purposes of the regular federal income tax and the alternative minimum tax).

153. *Kenseth I*, 114 T.C. at 413. The IRS explicitly recognized only one exception to this rule. See Rev. Rul. 80-364, 1980-2 C.B. 294. Where a taxpayer's attorney is paid out of a judgment where the attorneys' fees are actually expenses of another party, the taxpayer does not have to include in gross income the attorneys' fees paid out of the award. *Id.* at 295. This would occur, for example, where a taxpayer was a member of a union and the attorneys' fees were expenses of the union, and not the taxpayer/union member who received the award. *Id.*

154. *Kenseth I*, 114 T.C. at 413-15. The court cited the landmark case *Lucas v Earl* in support of its application of the assignment-of-income doctrine. *Id.* at 414 (citing *Lucas v. Earl*, 281 U.S. 111 (1930)); see also *supra* notes 66-79 and accompanying text (discussing *Lucas v. Earl*).

155. *Kenseth I*, 114 T.C. at 413-16. The state law rights referred to by the Tax Court were those granted by applicable state attorney lien statutes. *Id.* at 415. The Tax Court's view with regard to the relevance of state law was also endorsed in *Young v. Commission* by the Fourth Circuit. *Young v. Comm'r*, 240 F.3d 369, 378 (4th Cir. 2001). The court in *Young* explicitly

In contrast, early decisions by the Tax Court indicated that state law rights granted in attorney's lien statutes¹⁵⁶ are relevant in determining the tax treatment of contingent attorney's fees.¹⁵⁷ However, the development of case law in this area led the Tax Court to reject this proposition and base its holding solely on the assignment-of-income doctrine supported by the plain language of the Internal Revenue Code.¹⁵⁸ The court stated that it had long viewed taxable lawsuit

rejected an analysis based on state law and held that the taxation of attorney's fees under a contingent fee contract should be resolved "by proper federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action." *Id.*; see *infra* note 156 (discussing the application of state attorney lien statutes).

156. See *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (illustrating the Alabama attorney's lien statute). An attorney's lien statute is a state law concept allowing an attorney, who provides legal services on behalf of a client, to obtain a security interest in any judgment or settlement that results from the client's claim. *Id.*; see also I.R.C. § 6323(b)(8) (1994) (giving attorney's liens priority status if the legal services result in a recovery of amounts payable to the taxpayer). Section 6323(b)(8) states:

Attorneys' liens.—With respect to a judgment or other amount in settlement of a claim or of a cause of action, as against an attorney who, under local law, holds a lien upon or a contract enforceable against such judgment or amount, to the extent of his reasonable compensation for obtaining such judgment or procuring such settlement, except that this paragraph shall not apply to any judgment or amount in settlement of a claim or of a cause of action against the United States to the extent that the United States offsets such judgment or amount against any liability of the taxpayer to the United States.

I.R.C. § 6323(b)(8).

157. *Kenseth I*, 114 T.C. at 412. In *Cotnam v. Commissioner*, the seminal case setting forth the Fifth, Sixth, and Eleventh Circuits' positions, the Fifth Circuit relied in part on a then applicable Alabama attorney's lien statute that gave attorneys the same rights as their clients over recoveries obtained. See *Cotnam*, 263 F.2d 119. As a result of the Fifth Circuit's analysis in *Cotnam*, the Tax Court examined relevant state law to determine the rights granted to attorneys when it heard similar cases. See, e.g., *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2126-27 (2000) (applying Missouri law), *aff'd sub nom. Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654, 658 (1998) (applying Arizona law), *aff'd*, 268 F.3d 756 (9th Cir. 2001); *Srivastava v. Comm'r*, 76 T.C.M. (CCH) 638, 643 (1998) (applying Texas law), *aff'd in part, rev'd in part*, 220 F.3d 353 (5th Cir. 2000); *Coady v. Comm'r*, 76 T.C.M. (CCH) 257, 258-59 (1998) (applying Alaska law), *aff'd*, 213 F.3d 1187 (9th Cir. 2000); *Estate of Gadlow v. Comm'r*, 50 T.C. 975, 979-80 (1968) (applying Pennsylvania law); *Petersen v. Comm'r*, 38 T.C. 137, 151-52 (1962) (applying Nebraska and South Dakota law). Despite a review of state law, the Tax Court held in all of these cases that the taxpayers were required to include the fee portion of their recoveries in gross income, relying principally on the assignment-of-income doctrine. See *Kenseth I*, 114 T.C. at 411-12. Further, in *O'Brien v. Commissioner*, the Tax Court held that "even if the taxpayer had made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto even for a split second, it would still be gross income to him under assignment of income principles." See *id.* (quoting *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963)).

158. See, e.g., *Kenseth I*, 114 T.C. at 412 (rejecting the significance of state attorney's lien statutes); *Sinyard*, 76 T.C.M. (CCH) at 658 (holding that an attorney does not have equitable

recoveries as gross income and any associated legal fees incurred as deductions.¹⁵⁹

Expanding on its view that the right to a recovery belongs to the client alone, the Tax Court found the argument that the assistance of an attorney was necessary to pursue a claim unpersuasive.¹⁶⁰ The court refused to convert the fiduciary nature of the attorney-client relationship into a joint venture or partnership giving the attorney his own rights to the eventual recovery by the client.¹⁶¹

Although the court recognized the potential unfairness to taxpayers who are forced to include contingent legal fees in gross income but may not deduct the fees due to statutory limitations, it maintained that issues of tax policy are for Congress to decide.¹⁶² Further, the court recognized the potential danger in trying to fashion remedies for unfairness by modifying established tax law principles.¹⁶³

The Tax Court's view regarding the proper tax treatment of contingent attorney's fees is not unique.¹⁶⁴ While some courts have

rights in funds recovered on behalf of his client and that the total amount recovered by the taxpayer is gross income to him).

159. *Kenseth I*, 114 T.C. at 411 (stating that the court "has, for an extended period of time, held the view that taxable recoveries in lawsuits are gross income in their entirety to the party-client and that associated legal fees—contingent or otherwise—are to be treated as deductions").

160. *Id.* at 413 (stating that "[a]ttorney's fees, contingent or otherwise, are merely a cost of litigation in pursuing a client's personal rights").

161. *See id.* (declining to accept that the "speculative nature" of a claim was evidence of greater rights held by an attorney under a contingent fee arrangement); *see also* Deborah A. Geier & Maxine Aaronson, *Point & Counterpoint: Plaintiff's Attorney Fees and Costs*, 19 A.B.A. SEC. OF TAX'N NEWSLETTER 13, 14 (2000) (stating that just because "a relationship might be 'conceptualized' as a partnership does not mean that it should be so treated for tax purposes . . .").

162. *Kenseth I*, 114 T.C. at 407. The court stated:

[I]f the AMT computation effectively renders de minimus a taxpayer's recovery due to the nondeductibility of the attorney's fees, we should not be tempted to modify established assignment of income principles to remedy the situation. That could result in a certain class of taxpayers (those who receive reportable income from judgments) being treated differently from all other taxpayers who are subject to the AMT. These are matters within Congress' authority to decide. Congress, not the courts, is the final arbiter of how the tax burden is to be borne by taxpayers.

Id. at 415.

163. *Id.* at 407 (arguing that there is risk in the "ad hoc modification of established tax law principles or doctrines to counteract hardship in specific cases . . ."). In *Kenseth I*, the Tax Court explained its reluctance to acquiesce in approaches putting equity ahead of the plain language of the law. *Id.*

164. In addition to the Tax Court, the United States Court of Federal Claims heard cases that served as the basis for the circuit split on contingent attorney's fees. *See* Baylin v. United States, 30 Fed. Cl. 248 (Fed. Cl. 1993), *aff'd*, 43 F.3d 1451 (Fed. Cir. 1995). In *Baylin*, a partnership taxpayer hired an attorney under a contingent fee arrangement to appeal a condemnation award against the Maryland State Highway Administration. *Id.* at 250-51. The parties agreed to a

held to the contrary, the Tax Court's reasoning in *Kenseth I* clearly articulates the majority approach in the circuits.¹⁶⁵

III. DISCUSSION

The Tax Court has consistently required contingent attorney's fees incurred in obtaining a taxable recovery to be included in the taxpayer's

settlement of \$16,319,522.91 and the partnership paid \$4,843,622 of this amount to its attorney as legal fees. *Id.* at 251. The partnership reported income from the condemnation award net of the legal fees paid and the Commissioner objected. *Id.* at 252. The Court of Federal Claims used the Tax Court's reasoning to require the inclusion of contingent attorney's fees in the gross income of the partnership. *Id.* at 258. Like the Tax Court, the court in *Baylin* used the assignment-of-income doctrine to hold that although the partnership did not take actual possession of the funds it paid to its attorney, it received the benefit of those funds because they discharged the obligation of the partnership to pay its attorney. *Id.* Accordingly, the court held the partnership liable for the tax due on the entire settlement amount. *Id.* at 259. In addition, the court dismissed the argument that Alabama state law vested an ownership interest in the taxpayer's attorney with respect to the contingent fee portion of a damage recovery. *Id.* at 258. Five years after *Baylin*, the same issue came before the Federal District Court for the Northern District of Alabama in *Foster v. United States*, 106 F. Supp. 2d 1234 (N.D. Ala. 2000), *aff'd*, 249 F.3d 1275 (11th Cir. 2001). In *Foster*, the court reluctantly upheld Alabama precedent by holding that attorney's contingent fees related to a punitive damages recovery are excludable from the client's gross income. *Id.* at 1237-38 (acknowledging that *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), originally tried in the Tax Court, was binding on *Foster* due to the factual similarity of the two cases). The court, however, noted that it had "serious and legitimate questions" as to whether the exclusion of contingent attorney's fees was the proper treatment and whether it should continue to be followed by the courts. *Id.* at 1239. Ultimately, however, the Alabama district court could not distinguish *Foster* from *Cotnam* and was required to follow it as binding precedent in the Fifth Circuit. *Id.* Although generally, taxpayers litigate disputes with the IRS in the Tax Court, the decision by a taxpayer of the forum it will use to dispute a tax deficiency assessed by the IRS is dependant on several factors. See IRS, PUB. NO. 1, YOUR RIGHTS AS A TAXPAYER 2 (2000). Generally, a taxpayer may contest a proposed tax deficiency either by filing a timely petition in the Tax Court (which does not require a prior payment of the deficiency), or by paying the deficiency and, after exhausting administrative remedies, suing for a refund in either the taxpayer's local district court or in the Court of Federal Claims. *Id.*

165. See, e.g., *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2126-27 (2000) (holding that a taxpayer must include the contingent fees paid to her attorney related to a sexual harassment lawsuit against her former employer), *aff'd sub nom.* *Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Young v. Comm'r*, 113 T.C. 152, 157 (1999) (holding that the taxpayer must include the contingent attorney's fees paid in settling a property dispute incident to a divorce), *aff'd*, 240 F.3d 369, 379 (4th Cir. 2001); *Benci-Woodward v. Comm'r*, 76 T.C.M. (CCH) 787, 791 (1998) (holding that a taxpayer must include the contingent fees paid to his attorney related to tort and contract claims against his former employer), *aff'd*, 219 F.3d 941, 943-44 (9th Cir. 2000); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654, 658 (1998) (holding that a taxpayer must include the contingent fees paid to his attorneys related to a class action age discrimination claim against his former employer), *aff'd*, 268 F.3d 756 (9th Cir. 2001); *Coady v. Comm'r*, 76 T.C.M. (CCH) 257, 259 (1998) (holding that a taxpayer must include the contingent fees paid to her attorney related to a wrongful termination suit against her former employer), *aff'd*, 213 F.3d 1187, 1190 (9th Cir. 2000).

gross income.¹⁶⁶ However, a deep dichotomy exists in the United States Courts of Appeals.¹⁶⁷ The Fifth, Sixth, and Eleventh Circuits steadfastly oppose the inclusion of contingent attorney's fees,¹⁶⁸ while the Third, Fourth, Seventh, Ninth, Tenth and Federal Circuits strongly support the inclusion position of the Tax Court.¹⁶⁹

A. *The Case For Exclusion*

Out of the Fifth, Sixth, and Eleventh Circuits' cases allowing for the exclusion of contingent attorney's fees from a client's gross income, two prevailing themes surfaced.¹⁷⁰ First, the courts in these cases

166. See *supra* Part II.F (analyzing the Tax Court's view regarding contingent attorney's fees).

167. See *supra* notes 11-12 (listing those cases requiring inclusion and those permitting exclusion of contingent attorneys fees); see also *infra* Part III.A (discussing the position of the courts permitting exclusion of contingent attorney's fees from gross income); Part III.B (examining the rationale of the courts requiring inclusion of contingent attorney's fees in gross income).

168. See *Srivastava v. Comm'r*, 220 F.3d 353, 365 (5th Cir. 2000) (holding that a taxpayer could exclude the contingent fees paid to his attorney in connection with a defamation claim against a television station); *Davis v. Comm'r*, 210 F.3d 1346, 1347 (11th Cir. 2000) (per curiam) (holding that a taxpayer could exclude the contingent fees paid to her attorney for his assistance related to her claims against a mortgage company for fraud, conspiracy, and breach of contract); *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000) (holding that a taxpayer could exclude the contingent attorney's fees paid by a decedent's estate related to a lawsuit against the decedent's former employer); *Cotnam*, 263 F.2d at 126 (holding that a taxpayer could exclude the contingent fees paid to her attorney for his services related to her claim to enforce an oral contract against an intestate decedent's estate); see also *infra* Part III.A (discussing the reasoning of the courts allowing the exclusion of contingent fees from gross income).

169. See *Campbell*, 274 F.3d at 1313-14 (holding that a taxpayer must include the contingent fees paid to her attorney related to a sexual harassment lawsuit against her former employer); *Sinyard*, 268 F.3d at 759 (holding that a taxpayer must include the contingent fees paid to his attorneys related to a class action age discrimination claim against his former employer); *Kenseth II*, 259 F.3d 881, 885 (7th Cir. 2001) (holding that a taxpayer must include the contingent attorney's fees paid related to an age discrimination suit against his former employer); *Young v. Comm'r*, 240 F.3d 369, 379 (4th Cir. 2001) (holding that the taxpayer must include the contingent attorney's fees paid in settling a property dispute incident to a divorce); *Benci-Woodward*, 219 F.3d at 943-44 (holding that a taxpayer must include the contingent fees paid to his attorney related to tort and contract claims against his former employer); *Coady*, 213 F.3d at 1190 (holding that a taxpayer must include the contingent fees paid to her attorney related to a wrongful termination suit against her former employer); *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (holding that a partnership taxpayer must include the attorney's fees paid in connection with a condemnation lawsuit against the State of Maryland); *O'Brien v. Comm'r*, 319 F.2d 532, 532 (3d Cir. 1963) (holding that a taxpayer must include the contingent fees paid to his attorney related to a wrongful discharge action against his former employer); see also *infra* Part III.B (discussing the reasoning of the courts requiring inclusion of contingent fees in gross income).

170. See *infra* Part III.A.1 (discussing the Fifth Circuit's rationale based on state law in *Cotnam v. Commissioner*); *infra* Part III.A.4 (discussing the Sixth Circuit's rationale based on the relationship of the attorney and the taxpayer in *Estate of Clarks v. Commissioner*).

pointed to relevant state attorney's lien statutes to hold that clients transfer "property" to their attorneys through contingent fee agreements.¹⁷¹ Based on this property transfer, these courts concluded that an attorney possesses an equitable interest in his client's claim.¹⁷² Second, these courts cite the inherent risk involved in litigation and the necessity of counsel as evidence that a partnership exists between the client and his attorney.¹⁷³ Accordingly, the courts conclude that each partner, the attorney and the client, earns, receives, and should pay tax on their respective portions of the eventual recovery.¹⁷⁴

1. The Fifth Circuit Sets the Stage

The Fifth Circuit was the first to hold that contingent attorney's fees should be excluded from a taxpayer's gross income.¹⁷⁵ In *Cotnam v. Commissioner*, Ethel Cotnam entered into a verbal agreement with T. Shannon Hunter in 1940 under which she agreed to perform services as his attendant in the last years of his life in exchange for his promise to bequeath to her a one-fifth interest in his estate.¹⁷⁶ Although Mrs. Cotnam performed the agreed-upon services, Mr. Hunter died intestate five years later.¹⁷⁷ After the administrator refused to recognize Mrs. Cotnam's claim, she filed a successful action against the estate to enforce her contract and received a judgment in the amount of \$120,000.¹⁷⁸ Mrs. Cotnam paid her attorneys out of this judgment

171. See *Cotnam*, 263 F.2d at 125; *infra* Part III.A.1 (examining the relevance of state law to the Fifth Circuit's contingent attorney's fee analysis).

172. *Cotnam*, 263 F.2d at 125. The court in *Cotnam* held that an Alabama attorney's lien statute granted an equity interest to a client's attorney, allowing the client to exclude the attorney's fee portion of his recovery from gross income. *Id.*; see also *Davis*, 210 F.3d at 1347 (adhering to the state law rationale set forth in *Cotnam*). Both the transfer of "income" and the transfer of "property" fall under the assignment-of-income doctrine. See *supra* notes 61-102 and accompanying text (discussing the origin and development of the assignment-of-income doctrine); *infra* Part III.A.1 (discussing the Fifth Circuits' decision in *Cotnam*); *infra* Part III.A.3 (discussing the Eleventh Circuit's decision in *Davis*).

173. *Davis*, 210 F.3d at 1347 (holding that *Cotnam* controlled the analysis in *Davis*); see *infra* Part III.A.1 (discussing *Cotnam*); *Cotnam*, 263 F.2d at 126 (stating that the services provided by Mrs. Cotnam's attorneys converted her claim into a judgment so that the amount of the contingent fee was earned by her attorneys); *infra* Part III.A.3 (discussing *Davis*).

174. See *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) ("[T]he value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel.").

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

176. *Cotnam v. Comm'r*, 28 T.C. 947, 947 (1957), *aff'd*, 263 F.2d 119 (5th Cir. 1959).

177. *Cotnam*, 263 F.2d at 120. A person who dies intestate is one who has died without making a valid will. See BLACK'S LAW DICTIONARY 827 (7th ed. 1999).

178. *Cotnam*, 28 T.C. at 947. The amount actually received by Mrs. Cotnam was the judgment of \$120,000 plus interest, minus her attorney's fees of \$50,365.83. *Id.*

pursuant to a contingent fee contract.¹⁷⁹ When filing her federal income tax return, Mrs. Cotnam characterized the entire award as a non-taxable bequest,¹⁸⁰ and did not include it in her gross income.¹⁸¹ The IRS Commissioner objected and maintained that the entire award constituted gross income from services.¹⁸²

The Fifth Circuit agreed with the Commissioner that the amount of the judgment attributable to services performed was taxable income, but then held that the attorney's fee portion of the award could be excluded from Mrs. Cotnam's gross income.¹⁸³ The court based its holding on an Alabama attorney's lien statute that granted Alabama lawyers a lien on the suits, judgments, and decrees of their clients.¹⁸⁴ The court concluded that Mrs. Cotnam did not realize any economic benefit from the attorney's fee portion of her recovery.¹⁸⁵ In so holding, the court found that the Alabama statute gave Mrs. Cotnam's attorneys equal rights over her judgment.¹⁸⁶ Further, the court explained that Mrs. Cotnam could never have recovered any income without the aid of counsel and that the portion of the recovery paid directly to her attorneys was properly taxed to them alone.¹⁸⁷

179. *Id.*

180. *See id.* at 947, 951. For federal income tax purposes, gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. *See* I.R.C. § 102(a) (1994).

181. *Cotnam*, 28 T.C. at 947, 951.

182. *Id.* at 947. The Tax Court agreed with the Commissioner and held that the entire award should be taxed to Mrs. Cotnam and a corresponding deduction allowed for the attorney's fees paid. *Id.* at 953-54.

183. *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959).

184. *Id.* The relevant portion of the Alabama attorneys' lien statute provided:

'Upon suits, judgments, and decrees for money, [attorneys-at-law] 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.'

Id. at 125 n.5 (quoting the Alabama Code of 1940).

185. *Id.*

186. *Id.* Under the Alabama attorney's lien statute, a taxpayer could not receive the portion of the award due to her attorney, even if she had settled the claim herself. *Id.* at 125.

187. *Id.* at 126. The court observed that the facts of the case combined with the Alabama statute led to the result in the case. *Id.* at 125. Writing separately, Fifth Circuit Judges Rives and Brown noted their agreement with the majority's result but clarified that they rested their conclusion on the assignment-of-income doctrine and not on the nature of the Alabama statute. *Id.* at 126 (stating that "Mrs. Cotnam's tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit" (citation omitted)). They found that the speculative nature of Mrs. Cotnam's claim created a dual ownership between she and her attorneys in the recovery she eventually received from their joint efforts. *Id.* Indeed, the majority, concurring, and dissenting

2. The Fifth Circuit Takes Another Look

Over forty years after *Cotnam*, the Fifth Circuit revisited the taxation of contingent attorney's fees in *Srivastava v. Commissioner*.¹⁸⁸ Although upholding the *Cotnam* precedent, the court's analysis was noticeably different.¹⁸⁹ In *Srivastava*, Dr. Sudhir Srivastava, a Texas physician, settled a defamation suit against a television station for airing a series of reports charging him with medical ethics violations.¹⁹⁰ Dr. Srivastava recovered \$8.5 million and paid roughly \$3.5 million in legal fees from his settlement under a contingent fee arrangement with his attorneys.¹⁹¹

Dr. Srivastava did not report any income from the settlement on his 1991 federal income tax return, believing that the entire settlement was excludable as a recovery for personal injury damages.¹⁹² The Commissioner issued a notice of deficiency,¹⁹³ maintaining that a

opinions in *Cotnam* all discussed the application of assignment of income principles. *Id.* at 125, 127. The concurrence, in holding that these principles did not apply, reasoned that Mrs. Cotnam's claim was uncertain and had no fair market value. *Id.* at 125. Thus, the economic benefit related to her claim could only be realized by assigning a portion of the claim to her attorneys. *Id.* (stating that Mrs. Cotnam's claim was "worthless" without the skill of her attorneys). The dissent, acknowledging the clear application of assignment of income principles, held that the assignment of a portion of Mrs. Cotnam's claim discharged her obligation to pay her attorneys, a clear benefit to Mrs. Cotnam. *Id.* at 126-27 (Wisdom, J., dissenting). Although the court was divided and the holding has been widely criticized, the importance of *Cotnam* in more recent case law cannot be ignored. Thad Austin Davis, *Cotnam v. Commissioner and the Income Tax Treatment of Contingency-Based Attorney's Fees—The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head On*, 51 ALA. L. REV. 1683, 1700 (2000). Despite the controversy surrounding the opinion, courts have been even less receptive to arguments by taxpayers that are not based on *Cotnam*. *Id.* (discussing the skepticism of courts to sanction the reasoning beyond that used by the court in *Cotnam*). For example, the Tax Court rejected the argument that a contingency fee contract with an attorney constitutes a joint venture or partnership. *See Kenseth I*, 114 T.C. 399, 413 (2000), *aff'd*, 259 F.3d 881 (2001); *see also* Bagley v. Comm'r, 105 T.C. 396, 418-19 (1995) (rejecting the partnership argument in holding that a partnership is formed through mutual ownership interests and the sharing of profits and losses), *aff'd*, 121 F.3d 393 (8th Cir. 1997).

188. *Srivastava v. Comm'r*, 220 F.3d 353 (5th Cir. 2000).

189. *See id.* at 364-65.

190. *Srivastava v. Comm'r*, 76 T.C.M. (CCH) 638, 640 (1998), *rev'd*, 220 F.3d 353 (5th Cir. 2000). The television station aired a series of reports accusing Dr. Srivastava of performing unnecessary surgery and delivering poor quality medical care. *Id.* These reports destroyed Dr. Srivastava's practice and caused him severe financial and emotional harm. *Id.*

191. *Id.* at 641-42. The actual amount paid in fees by Srivastava to his attorneys was \$3,455,500. *Id.* at 640.

192. *Id.*; *see supra* note 146 (discussing prior law excluding personal injury damages from gross income and the subsequent amendment limiting the exclusion to awards for physical injury).

193. I.R.C. § 6212(a) (1994) (authorizing the Secretary of Treasury to issue a notice of deficiency when it is determined that there is a deficiency in respect to any tax imposed by the

portion of the settlement represented taxable punitive damages and interest income.¹⁹⁴ Dr. Srivastava pursued his claim in the Tax Court which upheld the Commissioner's determination.¹⁹⁵ The court determined that the punitive damages portion of Dr. Srivastava's settlement was gross income to him and that he was entitled to a miscellaneous itemized deduction for the related attorney's fees paid from his settlement.¹⁹⁶

On appeal, however, the Fifth Circuit reversed the Tax Court, holding that *Cotnam v. Commissioner*¹⁹⁷ was binding precedent and that Dr. Srivastava could exclude the attorney's fee portion of his settlement from his gross income.¹⁹⁸ Interestingly, the court stated that if it were ruling on a "tabula rasa,"¹⁹⁹ it would be inclined to include Dr. Srivastava's contingent fees in gross income.²⁰⁰ In support of its "tabula rasa" analysis, the court found no distinction between a contingent fee contract and a contract under which a client agrees to pay his attorney on an hourly basis.²⁰¹ It reasoned that principles of tax neutrality dictate that such a choice should not alter the tax

Code); see *supra* note 164 (indicating the ways in which a taxpayer may contest a proposed tax deficiency).

194. *Srivastava*, 76 T.C.M. (CCH) at 642. The IRS notice indicated a tax deficiency of \$1,466,348, which included penalties and interest for the tax years 1991 and 1992. *Srivastava*, 220 F.3d at 356. The 1992 deficiency was related to the elimination of a net operating loss carryover attributable to the settlement proceeds received in 1991. *Id.* at 356 n.4. The Commissioner's decision was based on a jury award to Dr. Srivastava of \$11.5 million in actual damages and \$17.5 million in punitive damages. *Srivastava*, 76 T.C.M. (CCH) at 640. Dr. Srivastava decided to settle rather than facing an appeal, however, the settlement agreement did not indicate an allocation between actual and punitive damages. *Id.*

195. *Srivastava*, 76 T.C.M. (CCH) at 642. Despite that *Srivastava* was appealable to the Fifth Circuit, the Tax Court held for inclusion of attorney's fees because it distinguished the case from *Cotnam* based on the difference in state law. *Id.* at 640; see also *supra* note 136 (discussing the *Golsen* rule); see also *infra* note 204 (highlighting the differences in Alabama and Texas law regarding attorney's liens).

196. *Srivastava*, 76 T.C.M. (CCH) at 640.

197. *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

198. *Srivastava*, 220 F.3d at 355 (citing *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959)).

199. A "tabula rasa" is defined as "a blank tablet ready for writing; a clean slate." BLACK'S LAW DICTIONARY 1465 (7th ed. 1999).

200. *Srivastava*, 220 F.3d at 357. The court acknowledged that if it were deciding the matter on a clean slate, it would apply the anticipatory assignment of income doctrine to require that Dr. Srivastava include the contingent attorney's fees paid in his gross income. *Id.* at 363. The court stated that "when a taxpayer recovers from a favorable judgment or litigation settlement, and compensates his attorney on a non-contingent basis, the full amount of the recovery may be treated as gross income." *Id.* at 357.

201. *Id.* at 362-63.

consequences of the fees.²⁰² Further, the court noted that, under an assignment of income analysis, Dr. Srivastava's contingent attorney's fees should be characterized as an anticipatory assignment of income because he benefited from the discharge of the obligation to pay his attorney using another source of taxable income.²⁰³

In light of the court's rejection of the analysis in *Cotnam*, it could have distinguished the case based on the fact that *Cotnam* turned on the existence of an Alabama statute, while *Srivastava* occurred in Texas.²⁰⁴ Instead, the Fifth Circuit adhered to the *Cotnam* precedent by determining that the assignment-of-income doctrine governs the contingent fee analysis and that the differences in attorney's rights granted by state statute do not provide an adequate basis for distinction.²⁰⁵ In refusing to distinguish *Srivastava* from *Cotnam*, the court explained that it is the taxpayer's degree of control over the income that is determinative, and not the attorney's bundle of rights granted by state law.²⁰⁶

202. *Id.* at 357 (noting that "[t]here is no apparent reason to treat *contingent* fees differently or to believe that Congress intended to subsidize contingent fee agreements in such a fashion"). Tax neutrality is often viewed in the context of the horizontal equity theory which requires that similarly situated taxpayers be treated equally under the Code and by the courts. *See* Rasmussen, *supra* note 13, at 316; *see also* Campbell, *supra* note 1, at 172 (citing BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* 3.1.4, at 3-9 to 3-10 (3d ed. 1999)) (defining horizontal equity).

203. *Srivastava*, 220 F.3d at 363-64. The court determined that the benefit of an attorney's services in exchange for a contingent fee was not to be excluded from gross income solely on the basis that the money is diverted to, and realized by, the taxpayer's assignee. *Id.* at 363.

204. *Id.* The court acknowledged that Texas law did not confer the same degree of power to an attorney, as did the Alabama attorney's lien statute applicable in *Cotnam*. *Id.* However, the court refused to base its analysis on this distinction, choosing rather to adhere to the assignment-of-income doctrine. *Id.* at 363-64. *Compare* ALA. CODE § 34-3-61(b) (1997) (stating that "attorney's-at-law shall have the same right and power over action or judgment to enforce their liens as their clients had or may have for the amount due thereon to them"), *with* *Srivastava*, 220 F.3d at 364, n.33 (citing Texas law in stating that "even when the attorney has been assigned an ownership interest in his clients cause of action, his rights remain wholly derivative from those of his client," and "the client's action is indivisible and may not be tried for only a percentage of the cause of action").

205. *Srivastava*, 220 F.3d at 364. The court concluded that it could not distinguish *Srivastava* from *Cotnam* because the differences in attorney's rights granted by state statute do not "meaningfully affect the economic reality facing the *taxpayer-plaintiff*." *Id.* Judge Dennis concurred in the opinion but dissented as to the treatment of the state statute issue. *Id.* at 367 (Dennis, J., dissenting in part). "[U]nder Texas law, unlike that of Alabama, an attorney is not granted by statute the same right and power as his client over his client's cause of action and judgment for the independent enforcement of his attorney's fee claim." *Id.* at 369 (Dennis, J., dissenting). He argued that the difference in control granted by the state laws in Alabama and Texas did play a significant role and should be a meaningful factor. *Id.* (Dennis, J., dissenting).

206. *Id.* at 364; *see also* RESEARCH INST. OF AM., ARE ATTORNEY'S FEES PAYABLE OUT OF JUDGMENT 'ASSIGNED INCOME,' *FED. TAX COORDINATOR* ch. J-8258 (2d ed. 2001) (discussing

3. The Eleventh Circuit Follows Suit

The Eleventh Circuit followed the *Cotnam* rule in *Davis v. Commissioner*.²⁰⁷ In that case, Ms. Willie Mae Barlow Davis prevailed in a suit against a mortgage company for fraud, conspiracy, and breach of contract and she ultimately received a \$6.1 million judgment, of which \$6 million represented punitive damages.²⁰⁸ Under a contingent fee contract, she paid her attorneys \$3.1 million in fees from that judgment.²⁰⁹ Ms. Davis did not report any of the award on her federal income tax return, and, as a result of an audit, the Commissioner determined that the entire award constituted gross income.²¹⁰ The Commissioner allowed a deduction for attorney's fees and assessed a tax deficiency of \$1.4 million.²¹¹

Although Ms. Davis appealed her case, the Tax Court was required to follow *Cotnam* because it was the controlling decision of the circuit

the importance of an attorney's control over the outcome of a client's lawsuit). Commentators have suggested that the court's holding in *Srivastava*, based on the forty-one year old *Cotnam* precedent, is reminiscent of the wisdom of former Supreme Court Justice Hugo Black. See Rasmussen, *supra* note 13, at 305. Justice Black wrote, "[w]hen precedent and precedent alone is all the argument that can be made to support a court-fashioned rule, it is time for the rule's creator to destroy it." *Id.*

207. *Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000) (per curiam). The Eleventh Circuit split off from the old Fifth Circuit in 1981 and continues to be bound by the *Cotnam* precedent to the same extent as is the current Fifth Circuit. See Fifth Circuit Court of Appeals Reorganization Act of 1980, Pub. L. No. 96-752, § 2, 94 Stat. 1994 (codified as amended at 28 U.S.C. § 41 (1994)). Prior to 1981, the Fifth Circuit consisted of Texas, Louisiana, Mississippi, Alabama, Georgia, and Florida. *Id.* The Fifth Circuit Court of Appeals Reorganization Act, effective October 1, 1981, moved Alabama, Georgia, and Florida to the newly created Eleventh Circuit. *Id.*

208. *Davis v. Comm'r*, 76 T.C.M. (CCH) 46, 47 (1998), *aff'd*, 210 F.3d 1346 (11th Cir. 2000) (per curiam). In *Davis*, the plaintiff applied for a home loan of \$2,000 from American Home Improvement Services of Alabama, Inc. ("American Home"). *Id.* American Home denied the plaintiff's application, but later offered to loan her the money if she would make certain improvements to her home at a cost of \$6,000. *Id.* American Home offered to add the cost of the improvements to the loan amount. *Id.* On August 2, 1988, the plaintiff contracted with American Home to make the repairs, and in exchange, American Home lent the plaintiff \$8,000. *Id.* The next day, the plaintiff decided against making the repairs and attempted to cancel the repair contract and mortgage loan. *Id.* American Home refused to cancel the contract, and the repairs were made to the plaintiff's home. *Id.* The plaintiff filed suit seeking compensatory and punitive damages for the defendant's alleged acts of fraud, conspiracy, and breach of contract. *Id.* A jury awarded the plaintiff \$6,151,000, of which \$152,000 was for compensatory damages and the remainder consisted of punitive damages. *Id.* The court upheld the punitive damages award, and American Home paid the damages to the plaintiff. *Id.* Pursuant to a contingent fee contract, the plaintiff paid her attorneys \$3,111,809 in legal fees and retained \$3,039,191 of the award. *Davis*, 210 F.3d at 1346.

209. *Davis*, 210 F.3d at 1347.

210. *Id.*

211. *Id.* The Commissioner limited the allowed deduction for legal fees and costs to \$3,069,250. *Id.*

court to which Davis appealed.²¹² Distinguishing a long line of contrary precedent,²¹³ the Tax Court held that Ms. Davis could exclude the entire attorney's fee portion of her award.²¹⁴ The Eleventh Circuit affirmed the Tax Court and held without further explanation that *Cotnam* controlled.²¹⁵ Although the Eleventh Circuit's analysis was based solely on precedent, the absence of an explanation in the court's opinion signaled its reluctance to overturn the rationale set forth in *Cotnam*.²¹⁶

212. See *supra* note 136 (discussing the *Golsen* rule). Here, because the Eleventh Circuit was bound by Fifth Circuit precedent, the Tax Court was required to adhere to the precedent set in *Cotnam*. See *supra* note 207 (discussing the reorganization of the Fifth Circuit).

213. See, e.g., *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2126-27 (2000) (holding that a taxpayer must include the contingent fees paid to her attorney related to a sexual harassment lawsuit against her former employer), *aff'd sub nom.* *Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth I*, 114 T.C. 399 (2000) (holding that a taxpayer must include in gross income the contingent attorney's fees paid related to an age discrimination suit against his former employer), *aff'd*, 259 F.3d 881, 885 (7th Cir. 2001); *Young v. Comm'r*, 113 T.C. 152, 157 (1999) (holding that the taxpayer must include in gross income the contingent attorney's fees paid in settling a property dispute incident to a divorce), *aff'd*, 240 F.3d 369, 379 (4th Cir. 2001); *Benci-Woodward v. Comm'r*, 76 T.C.M. (CCH) 787, 791 (1998) (holding that a taxpayer must include in gross income the contingent fees paid to his attorney related to tort and contract claims against his former employer), *aff'd*, 219 F.3d 941, 943-44 (9th Cir. 2000); *Sinyard v. Comm'r*, 76 T.C.M. (CCH) 654, 658 (1998) (holding that a taxpayer must include in gross income the contingent fees paid to his attorneys related to a class action age discrimination claim against his former employer), *aff'd*, 268 F.3d 756 (9th Cir. 2001); *Coady v. Comm'r*, 76 T.C.M. (CCH) 257, 259 (1998) (holding that a taxpayer must include in gross income the contingent fees paid to her attorney related to a wrongful termination suit against her former employer), *aff'd*, 213 F.3d 1187, 1190 (9th Cir. 2000).

214. *Davis v. Comm'r*, 76 T.C.M. (CCH) 46, 48 (1998).

215. *Davis*, 210 F.3d at 1347 n.4. "Because *Cotnam* is squarely on point and controlling, as the IRS acknowledges, we affirm the Tax Court on this issue." *Id.* at 1347. Most recently, the Eleventh Circuit again bowed to *Cotnam* in *Foster v. United States*. *Foster v. United States*, 249 F.3d 1275, 1280 (11th Cir. 2001). The taxpayer in that case entered into a contingent fee arrangement prior to receiving punitive damages in the amount of \$1 million, of which the taxpayer received \$500,000 and her attorneys received approximately \$500,000. *Foster v. United States*, 106 F. Supp. 2d 1234, 1235 (N.D. Ala. 2000), *aff'd*, 249 F.3d 1275 (11th Cir. 2001). In addition, interest of \$156,032.80 accrued by the time the judgment was paid. *Id.* The entire interest portion was paid to the attorneys pursuant to an appellate services agreement between the taxpayer and her attorneys. *Id.* at 1238. Reasoning that the entire amount of the award represented non-taxable damages, Ms. Foster reported no gross income from the award. *Id.* at 1236. However, the Commissioner disagreed, and the case was appealed to the federal district court. *Id.* The district court validated the government's argument and required Ms. Foster to pay income tax on the punitive damages portion of the award, as well as the interest portion and the amount paid to her attorneys under the contingent fee contract. *Id.* at 1238. The Eleventh Circuit, following *Cotnam*, affirmed the district court, and held that Ms. Foster was not required to include the contingent fee portion of her award in gross income. *Foster*, 249 F.3d at 1280 (reasoning that, through the contingent fee contract, Ms. Foster had transferred to her attorneys half of her claim).

216. *Davis*, 210 F.3d at 1347 n.4. It is unclear how the Eleventh Circuit, which includes Georgia and Florida, would treat contingent attorney's fees for income tax purposes. See *Serven*, *supra* note 18, at 377 n.33. Its decision in *Davis v. Commissioner* was based on Alabama's

4. The Sixth Circuit Takes a New Approach

In *Estate of Clarks v. United States*, the Sixth Circuit joined the Fifth and Eleventh Circuits in holding that contingent fees paid to an attorney do not constitute gross income to the client.²¹⁷ However, the Sixth Circuit's analysis provided a new perspective.²¹⁸ In this case, Arthur Clarks suffered severe injuries during his employment.²¹⁹ He successfully sued his employer and recovered approximately \$11.4 million in damages.²²⁰ Pursuant to a contingent fee arrangement, Mr. Clarks' attorney received \$3.8 million out of the award.²²¹ After his death, Mr. Clarks' estate excluded the attorney's fee portion of his recovery from gross income when filing his federal income tax return, but the Commissioner subsequently assessed a deficiency of approximately \$255,000.²²² The IRS allowed a corresponding miscellaneous itemized deduction in the amount of the attorney's fees related to the taxable portion of the award.²²³

At the outset, the Sixth Circuit recognized the conflict among the federal courts with respect to contingent attorney's fees.²²⁴ Contrary to the majority of the recent circuit decisions, the Sixth Circuit adopted the holding of *Cotnam*, but chose to focus its analysis more on the attorney-

attorney's lien statute, so the Eleventh Circuit may not be bound to its holding in cases arising in Georgia or Florida. *Davis*, 210 F.3d at 1347.

217. *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000).

218. *See id.* at 858 (following the *Cotnam* holding but analyzing the facts of the case using the assignment-of-income doctrine instead of state law).

219. *Id.* at 855. Mr. Clarks worked for K-mart and sustained closed-head injuries while he was unloading a truck at a K-Mart facility on November 13, 1994. *Estate of Clarks v. United States*, 1998 WL 839415, at *1 (E.D. Mich. 1998).

220. *Estate of Clarks*, 202 F.3d at 855. The actual amount of the estate's award was \$11,307,837.55, which included \$5,600,000 in damages and \$5,707,837.55 in accrued interest. *Id.*

221. *Id.* The actual amount retained by Mr. Clark's attorney was \$3,766,471.21. *Id.*

222. *Id.* The actual amount of tax deficiency was \$254,298. *Id.* Although the damages awarded for physical injuries were excluded from gross income under I.R.C. § 104(a)(2), the attorney's fees allocable to the interest portion of the award were taxable as gross income under I.R.C. § 61(a). *Id.* Section 104(a)(2) states:

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include . . . the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness . . .

I.R.C. § 104(a)(2) (1994); *see also supra* note 46 (citing I.R.C. § 61(a)).

223. *Estate of Clarks*, 202 F.3d at 855.

224. *Id.* at 856. The court compared *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), with *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995) to illustrate the conflict among the circuit courts regarding the tax treatment of contingent attorney's fees. *Id.*

client relationship with respect to the claim and less on state law concerns.²²⁵ The court rested its analysis on the speculative nature of Mr. Clarks' claim and reasoned that a successful outcome was largely dependent on the services of his attorney.²²⁶ Accordingly, the Sixth Circuit likened the relationship between Mr. Clarks and his attorneys to a partnership or joint venture and held that Mr. Clarks had transferred an interest in his claim through their contingent fee contract.²²⁷

The court in *Estate of Clarks* contrasted the uncertain nature of the income recovered as attorney's fees against the compensation and interest income already earned and payable in cases such as *Lucas v. Earl*²²⁸ and *Helvering v. Horst*.²²⁹ The court further determined that the assignment-of-income doctrine does not apply to transfers to an attorney of a portion of a client's award under a contingent fee contract.²³⁰ In so holding, the Sixth Circuit revised the familiar fruit-tree metaphor from *Lucas v. Earl*²³¹ and concluded that the taxpayer in *Estate of Clarks* had transferred some of the trees in his orchard and not merely the fruit from the trees.²³² Just like a transfer of a partial interest in property, the court viewed the assignment of a portion of Mr. Clark's award as income belonging to his attorney and properly taxed only to him.²³³

225. *Id.* at 857. Although certainly not the center of its analysis, the court did mention that the common law lien under Michigan law operated "more or less the same way as the Alabama lien in *Cotnam*." *Id.* at 856. Similar to the Alabama statute, Michigan common law provides that "[the [contingent fee] agreement . . . amounts to an assignment of a portion of the judgment sought to be recovered" *Dreiband v. Candler*, 131 N.W. 129, 129 (Mich. 1911).

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

227. *Id.* The court reasoned that Mr. Clarks assigned his attorney a one-third interest in the venture in order to have a chance to recover the remaining two-thirds. *Id.* The court further stated that Mr. Clark's claim without his attorney "simply amounted to an intangible, contingent expectancy." *Id.*

228. *Id.* (citing *Lucas v. Earl* and *Helvering v. Horst*); see *supra* notes 66-91 and accompanying text (discussing *Earl* and *Horst*).

229. *Id.*

230. *Estate of Clarks*, 202 F.3d at 857-58 (stating that the income transferred in *Earl* and *Horst* was "already earned, vested and relatively certain to be paid to the assignor"). The Sixth Circuit also found significant that the seminal assignment of income cases centered on gratuitous transfers to family members, which were not at issue in *Estate of Clarks*. *Id.* at 857; see also *supra* Part II.C (discussing the origin and development of the assignment-of-income doctrine).

231. *Earl*, 281 U.S. at 115.

232. *Estate of Clarks*, 202 F.3d at 858. The court stated that the taxpayer had "transferred some of the trees in his orchard, not merely the fruit from the trees" thereby rendering his attorney akin to a "tenant in common of the orchard owner." *Id.* The court further compared the attorney to a "tenant in common" of an orchard owner who "must cultivate and care for and harvest the fruit of the entire tract." *Id.*

233. *Id.*

Based on the holdings in *Cotnam*, *Srivastava*, *Davis*, and *Estate of Clarks*, it is evident that taxpayers have not been completely unsuccessful in convincing the courts that the exclusion of contingent attorney's fees is proper.²³⁴ However, the clear majority of the circuit courts have held that a taxpayer's gross income should include the entire amount of a taxable judgment or settlement, including amounts paid to an attorney under a contingent fee contract.²³⁵

B. The Case for Inclusion

An increasing majority of courts have held that contingent attorney's fees paid to an attorney are includible in the client's gross income.²³⁶ They do so based on the plain language of the Code as well as on established precedent applying the assignment-of-income doctrine.²³⁷

1. The Third Circuit's Early Adherence to Assignment of Income Principles

Shortly after the Fifth Circuit decided *Cotnam*, the Third Circuit faced the contingent attorney's fee issue in *O'Brien v. Commissioner*.²³⁸ In this case, Walter O'Brien worked for years as a deputy collector of internal revenue in Philadelphia, Pennsylvania before being discharged in 1952.²³⁹ Mr. O'Brien filed a lawsuit against his former employer for wrongful discharge and contract interference and was reinstated to his job pursuant to an order of the District Court for the District of Columbia.²⁴⁰ Mr. O'Brien then filed a claim in the United States Court of Claims to recover the salary he lost during the period between his termination from service and his reinstatement and received a recovery

234. See *supra* notes 170-233 and accompanying text (discussing the rationale used by courts to allow taxpayers to exclude contingent attorney's fees from gross income).

235. See *infra* Part III.B (discussing the rationale used by courts to require taxpayers to include contingent attorney's fees in gross income).

236. See *supra* note 11 (citing cases in which inclusion of contingent attorney's fees in gross income was required).

237. See, e.g., *Campbell v. Comm'r*, 274 F.3d 1312, 1313-14 (10th Cir. 2001) (holding that the client's discharge of an obligation to pay legal fees owed by her is a benefit to the client within the definition of gross income); *Kenseth II*, 259 F.3d 881, 884 (7th Cir. 2001) (using assignment of income principles to require the taxpayer to include contingent attorney's fees in gross income); *Young v. Comm'r*, 240 F.3d 369, 376-77 (4th Cir. 2001) (acknowledging that the reasoning of *Earl* and *Horst* require that the client be taxed on the contingent legal fees paid to his attorney).

238. *O'Brien v. Comm'r*, 319 F.2d 532 (3d Cir. 1963).

239. *O'Brien v. Comm'r*, 38 T.C. 707, 708 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

240. *Id.*

of approximately \$16,000.²⁴¹ Mr. O'Brien paid his attorney approximately \$8,200 in legal fees under a contingent fee contract.²⁴² He did not include any of his recovery in his gross income on his federal income tax return, reasoning that it was afforded special tax treatment under the Code.²⁴³ The Commissioner assessed a deficiency of approximately \$2,200 after concluding that the entire amount of Mr. O'Brien's recovery was gross income and that he was entitled to a deduction for legal expenses.²⁴⁴

Affirming the Tax Court, the Third Circuit held that the contingent attorney's fee portion of the taxpayer's recovery should be included in gross income.²⁴⁵ The court held, in dictum, that even if there had been a Pennsylvania law that gave attorneys an equitable lien in the client's recovery, it would not have served to allow the taxpayer to exclude the contingent attorney's fees from gross income.²⁴⁶ In dismissing the relevance of state law to the contingent attorney's fee issue, the Third Circuit expressly endorsed the application of the assignment-of-income doctrine to this issue.²⁴⁷

2. The Federal Circuit Analysis

The Federal Circuit addressed the proper taxation of contingent attorney's fees in *Baylin v. United States* and added depth to the

241. *Id.* The actual amount of the recovery obtained by Mr. O'Brien was \$16,173.05, which was calculated at a rate of \$4,455 per year from January 29, 1952, to December 31, 1956, less any income earned by him during that period from other employment. *Id.*

242. *Id.* at 708-09. The actual amount paid to Mr. O'Brien's attorney was \$8,243.10. *Id.* at 709.

243. *Id.* Mr. O'Brien believed that his recovery was not includable in gross income under I.R.C. § 1303, which at the time, allowed a taxpayer to spread an award of back pay among several taxable years. *Id.* at 709-10. Section 1303 was repealed effective December 31, 1986. I.R.C. § 1303 (1982) (repealed 1986).

244. *O'Brien*, 38 T.C. at 708, 710. The exact amount of the deficiency was \$2,205.33. *Id.* at 708.

245. *O'Brien v. Comm'r*, 319 F.2d 532, 532 (3d Cir. 1963) ("We find the decision of the Tax Court is correct in all respects and accordingly it will be affirmed on the excellent opinion of Judge Raum."); see *O'Brien v. Comm'r*, 38 T.C. 707 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

246. See *O'Brien v. Comm'r*, 38 T.C. at 712. The court stated that

even had the taxpayer made an irrevocable assignment of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto for even a split second, it would still be gross income to him under the familiar principles of *Lucas v. Earl* and *Helvering v. Horst*.

Id. (citations omitted).

247. See *O'Brien*, 319 F.2d at 532.

application of assignment of income principles.²⁴⁸ *Baylin* involved a dispute between a partnership taxpayer and the Maryland State Highway Administration.²⁴⁹ Maryland condemned 137 acres of the partnership's land to build a highway and paid the partnership inadequate compensation in exchange.²⁵⁰ The partnership sued the Highway Administration in the Court of Federal Claims, and with the aid of attorneys retained under a contingent fee contract, recovered triple the amount originally offered by the state.²⁵¹ The partnership argued that, because it assigned a portion of the award to its attorneys in advance, the partnership never realized the income.²⁵²

On appeal, the Federal Circuit flatly rejected the partnership's argument and refused to "elevate form over substance."²⁵³ The court, instead, characterized the contingent fee arrangement as a discharge of an obligation of the partnership that provided a clearly realized benefit appropriately taxed to the partnership.²⁵⁴

248. *Baylin v. United States*, 43 F.3d 1451, 1453-54 (Fed. Cir. 1995); see also *supra* Part II.C (discussing the origin and development of the assignment of income doctrine).

249. *Baylin*, 43 F.3d at 1452.

250. *Id.* The Maryland State Highway Commission estimated the fair market value of the partnership's property at nearly \$2.7 million. *Id.* The partnership disagreed and filed suit in state court, and a jury awarded the partnership approximately \$3.9 million plus interest and costs. *Id.* The partnership appealed the jury's condemnation award with the assistance of counsel retained on a contingent fee. *Id.* The appeals court determined that the trial court applied the wrong valuation standard to the property and remanded for a new valuation. *Id.* at 1452-53. In response, Maryland offered a settlement, and after negotiations, the parties agreed to a settlement of \$16.3 million. *Id.* at 1453.

251. *Id.* The partnership received its condemnation award and interest between 1981 and 1988 and paid legal fees on \$4 million. *Id.*

252. *Id.* at 1454. The partnership had argued first that it was entitled to deduct the legal fees including the fees allocable to the interest portion of the recovery as a business expense. *Id.* at 1453. The court used the "origin of the claim" test to reject this argument. *Id.* at 1453-54; see also *supra* note 115 (discussing the "origin of the claim" test). The court held that the partnership could not base the tax treatment of its legal fees on the relative amounts of principal and interest received. *Baylin*, 43 F.3d at 1453. The court reasoned that such an allocation would be improper because the focus of the "origin of the claim" test is not the proportional recovery of each type of income, but rather the origin and character of the claim with respect to which the fees were incurred. *Id.*

253. *Baylin*, 43 F.3d at 1454. Noting that "[v]ery little need be said about this argument, which, if accepted, would elevate form over substance and allow the partnership to escape taxation on a portion of its income through a 'skillfully devised' fee arrangement." *Id.* (quoting Justice Holmes in *Lucas v. Earl*, 281 U.S. 111, 115 (1930)).

254. *Id.* The partnership further argued that Maryland law gave attorneys a lien on the claim of their client. *Id.* at 1455. The court was not persuaded, however, and held the argument was "simply without legal basis." *Id.* The Maryland statute gave an attorney a lien on "attorney's fees and compensation specially agreed on with the attorney's client." MD. CODE ANN., BUS. OCC. & PROF. § 10-501 (1989). The court rejected the argument that this statute gave an attorney an ownership interest in his client's claim reasoning that Maryland courts had not interpreted the state lien statutes as creating such an interest. *Baylin*, 43 F.3d at 1455.

3. The Ninth Circuit

In a trio of recent cases, the Ninth Circuit addressed the taxation of contingent attorney's fees with consistent results.²⁵⁵ In the first case, *Coady v. Commissioner*, Mrs. Nona Coady filed a wrongful termination suit against her former employer after being discharged.²⁵⁶ Mrs. Coady eventually recovered nearly \$374,000 in compensatory damages.²⁵⁷ Out of that amount, Mrs. Coady paid her attorneys approximately \$221,000 in fees and costs pursuant to a contingent fee agreement.²⁵⁸ On their joint federal income tax return, the Coadys reported as income from wages the portion of the award allocable to lost wages and reported the amount allocable to future earnings and lost pension benefits as self-employment²⁵⁹ income.²⁶⁰ Against the amount reported as self-employment income, the Coadys deducted approximately \$168,000 in attorney's fees and costs.²⁶¹ After the Commissioner issued a notice of deficiency for \$49,531 in tax to the Coadys, they conceded that the damages should not have been reported as self-employment income.²⁶² Instead, they advanced the argument that, under *Cotnam*, they had not

255. See *Sinyard v. Comm'r*, 268 F.3d 756, 760 (9th Cir. 2001) (holding that a taxpayer must include the contingent fees paid to his attorneys related to a class action age discrimination claim against his former employer); *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943-44 (9th Cir. 2000) (holding that a taxpayer must include the contingent fees paid to his attorney related to tort and contract claims against his former employer); *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (holding that a taxpayer must include the contingent fees paid to her attorney related to a wrongful termination suit against her former employer).

256. *Coady*, 213 F.3d at 1187-88.

257. *Id.* at 1187. The exact amount of Mrs. Coady's judgment was \$373,307, including \$89,225 for back pay, \$76,980 for future lost earnings, and \$207,102 for lost fringe and pension benefits. *Id.*

258. *Id.* at 1188. The actual amount paid to Mrs. Coady's attorneys for fees and costs was \$221,338.82. *Id.*

259. Income from self-employment is defined as gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business. See I.R.C. § 1402(a) (1994). Thus, Mrs. Coady treated part of her award as gross income from a trade or business against which the corresponding attorney's fees could be deducted without concern for the itemized deduction or AMT limitations that would otherwise apply. See *supra* Part II.D (discussing deductions).

260. *Coady*, 213 F.3d at 1188. The amount reported as self-employment income was \$284,082 comprised of \$76,980 in future lost earnings, and \$207,102 in lost fringe benefits and pension benefits. *Id.* at 1187-88.

261. *Id.* at 1188. The actual amount of attorney's fees used to offset the self-employment income was \$168,217. *Id.* In addition, the Coadys took a miscellaneous itemized deduction of \$53,121 for the attorney's fees they allocated to the lost wages portion of Mrs. Coady's recovery. *Id.*

262. *Id.*

realized the income paid as legal fees because it was assigned to their attorneys.²⁶³

After recognizing that a split existed among the federal courts, the Ninth Circuit relied on the assignment-of-income doctrine to conclude that Mrs. Coady could not exclude from her gross income the portion of her recovery that was paid to her attorneys as a contingent fee.²⁶⁴ The Ninth Circuit relied on the Federal Circuit's reasoning in *Baylin*²⁶⁵ as well as the dissent in *Cotnam*²⁶⁶ in holding that the contingent fee contract was an anticipatory assignment of income properly taxable to Mrs. Coady.²⁶⁷ The court in *Coady* refused to distinguish a contingency attorney's fee contract from other creditor situations controlled by the assignment-of-income doctrine simply because of the speculative nature of the arrangement.²⁶⁸

Shortly after *Coady*, the Ninth Circuit addressed the issue of contingent attorney's fees again in *Benci-Woodward v. Commissioner*.²⁶⁹ The taxpayer in *Benci-Woodward* won punitive damages in a lawsuit against his employer involving several tort and contract claims, including wrongful discharge.²⁷⁰ In *Benci-Woodward*, the Ninth Circuit reinforced its decision in *Coady* and held that the portion of the punitive damages award retained by the taxpayer's attorney pursuant to a contingent fee contract constituted gross income to the taxpayer.²⁷¹ As it did in *Coady*, the Ninth Circuit based its

263. *Id.*; see also *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959) (holding that amount of contingent fee paid out of judgment to taxpayer's attorneys was not income to the taxpayer).

264. *Coady*, 213 F.3d at 1191. The court compared *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) with *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995) in order to illustrate the conflict among the circuit courts with regard to contingent attorney's fees. *Id.* at 1189-90.

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

266. See *Cotnam*, 263 F.2d at 126-27 (Wisdom, J., dissenting).

267. *Coady*, 213 F.3d at 1191 (stating that "[t]he Supreme Court has explicitly rejected the notion that taxation can be escaped by procuring payment directly to creditors or by making anticipatory arrangements to prevent earnings from 'vesting even for a second' in the person who earned it") (quoting *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930)).

268. *Id.* (noting that because "an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped . . ."). The court in *Coady* did not rely on state attorney's lien law to reach its holding. *Id.* at 1190. However, the court did note that the Alaska statute governing attorney's rights under a contingency fee contract granted less of an interest in the claim than did the Alabama law examined in *Cotnam*. See *id.* The court explained that the Alaska statute confers a "lien which attaches to property belonging to the client" and "does not confer an ownership interest upon attorneys" such that they have any power over the judgments of their clients. *Id. Contra Cotnam*, 263 F.2d at 125.

269. *Benci-Woodward v. Comm'r*, 219 F.3d 941 (9th Cir. 2000).

270. *Id.* at 942-43.

271. *Id.* at 943.

decision on assignment of income principles, but also pointed out that relevant state law did not transfer an equity interest in the cause of action of the plaintiff to his attorney.²⁷²

In the most recent case, *Sinyard v. Commissioner*, the Ninth Circuit solidified its position on the proper taxation of contingent attorney's fees.²⁷³ In *Sinyard*, Mr. Sinyard settled an age discrimination claim as a member in a class action against his former employer.²⁷⁴ The Ninth Circuit applied its reasoning from *Coady*²⁷⁵ and *Benci-Woodward*,²⁷⁶ holding that the attorney's fee portion of the settlement must be included in Mr. Sinyard's gross income.²⁷⁷ Once again applying assignment of income principles, the court rejected the taxpayer's arguments under *Cotnam* that state law granted his attorney an equitable interest in his claim.²⁷⁸

Also, Mr. Sinyard unsuccessfully argued that taxing him on the recovery of attorney's fees, which he never received, was unfair and produced inequitable treatment due to the Code's limitations on legal fee deductions.²⁷⁹ The court was sympathetic, but concluded that the power to create a remedy for such unfairness rests with Congress.²⁸⁰

272. *Id.* (stating that California law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients"); *see also* *Fifield Manor v. Finston*, 354 P.2d 1073, 1079 (Cal. 1960) (explaining that contingent fee contracts do not confer a part of a client's cause of action to the attorney, but instead give him a lien upon an eventual recovery by the client).

273. *Sinyard v. Comm'r*, 268 F.3d 756 (9th Cir. 2001).

274. *Id.* at 757.

275. *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000).

276. *Benci-Woodward*, 219 F.3d 941.

277. *Sinyard*, 268 F.3d at 759.

278. *Id.* at 760. *But see* *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959). Mr. Sinyard was a resident of Alabama when he made the contingent fee contract with his attorneys. *Sinyard*, 268 F.3d at 759. The Ninth Circuit acknowledged the Fifth Circuit's previous determination in *Cotnam* that a contingent fee contract under Alabama law transfers ownership of a portion of the claim from the client to the attorney. *Id.* at 759-60. However, the Ninth Circuit declined to follow *Cotnam* and held that Alabama law did not affect the taxation of the contingent fees paid. *Id.* at 760.

279. *Sinyard*, 268 F.3d at 759. Mr. Sinyard argued that it was unfair to tax him on income paid to his attorney. *Id.* However, the court maintained that the tax impact of the attorney's fees resulted from the application of the AMT. *Id.*

280. *See id.* The court stated:

Without [the AMT's] limitation, the attorneys' fees would be income to the Sinyards, and the income would be wiped out by deduction of the total received. It would be a wash. The anomalous result, no doubt unintended, arises when part of the deduction is blocked by the AMT. We do not think we can change the basic rules of income tax in order to correct this result.

Id.

4. The Seventh Circuit Weighs In

In a case that tipped the scales in favor of inclusion, the Seventh Circuit recently strengthened the position of the Federal Tax Court²⁸¹ in *Kenseth v. Commissioner* ("*Kenseth I*").²⁸² Affirming the Tax Court, the Seventh Circuit endorsed the application of the assignment-of-income doctrine and held that the entire age discrimination settlement recovered by Mr. Kenseth, including the attorney's fee portion, constituted gross income.²⁸³ Although the Seventh Circuit explicitly recognized the existing circuit split on the proper income tax treatment of contingent attorney's fees, the court found the reasoning of the Tax Court "clearly correct."²⁸⁴

The court in *Kenseth II* refused to distinguish a contingent fee contract from a fee arrangement by which a client's attorney is paid by the hour.²⁸⁵ In addition, the court rejected the argument that an equity interest was transferred to Mr. Kenseth's attorney based on the applicable Wisconsin attorney's lien statute.²⁸⁶ The Seventh Circuit

281. See *supra* notes 138-65 and accompanying text (examining the facts of *Kenseth I* and the reasoning of the Tax Court with respect to contingent attorney's fees).

282. *Kenseth II*, 259 F.3d 881, 883 (7th Cir. 2001) (stating "[b]ut with all due respect to those who disagree, we think the Tax Court's resolution of the issue is clearly correct").

283. *Id.* at 883-84. The court allowed the Kenseths a miscellaneous itemized deduction for the attorney's fees paid under the contingent fee arrangement. See *id.* at 884. The miscellaneous itemized deduction for attorney's fees is an I.R.C. § 67 deduction which is subject to the two-percent of adjusted gross income limitation. I.R.C. § 67(a) (1994).

284. *Kenseth II*, 259 F.3d at 883. The court stated:

Taxable income is gross income minus allowable deductions. If a taxpayer obtains income of \$100 at a cost in generating that income of \$25, he has gross income of \$100 and a deduction of \$25, yielding taxable income of \$75 . . . If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income of \$100. . . . That is Kenseth's situation under the alternative minimum tax.

Id. (citations omitted).

285. *Id.* ("We cannot see what difference it makes that the expense happened to be contingent rather than fixed."). The court compared an attorney's contingent fee arrangement to commissions earned by a salesman. *Id.* "If a firm pays a salesman on a commission basis, the sales income he generates is income to the firm and his commissions are a deductible expense, even though they were contingent on his making sales." *Id.*

286. *Id.* The Wisconsin attorney's lien statute provides that an attorney has a lien or security interest but not an ownership interest in the client's cause of action. WIS. STAT. ANN. § 757.36 (West 2001). The statute states:

Any person having or claiming a right of action, sounding in tort or for unliquidated damages on contract, may contract with any attorney to prosecute the action and give the attorney a lien upon the cause of action and upon the proceeds or damages derived in any action brought for the enforcement of the cause of action, as security for fees in the conduct of the litigation; when such agreement is made and notice thereof given to the opposite party or his or her attorney, no settlement or adjustment of the action may be valid as against the lien so created, provided the agreement for fees is fair and

held that a lien statute merely transfers a security interest in the client's eventual recovery, not an equitable interest.²⁸⁷ The court recognized that there is a risk that a contingent fee attorney will expend effort on behalf of his client only to have the client terminate the attorney-client relationship.²⁸⁸ But, the court reasoned, this situation is not meaningfully different from any other trade creditor who is "stiffed" by his debtor.²⁸⁹ Concluding that Mr. Kenseth could not effectively assign an interest in his claim to his attorney through a contingent fee contract, the court held that an assignment of a portion of his income to his attorney could not serve to shift his tax liability.²⁹⁰

Finally, the court explicitly refused to remedy the inequity facing taxpayers due to the inclusion of contingent attorney's fees in gross income, opting instead to leave that task for Congress.²⁹¹

5. The Fourth Circuit Continues the Trend

The Fourth Circuit joined the courts endorsing the inclusion of contingent attorney's fees with its decision in *Young v.*

reasonable. This section shall not be construed as changing the law in respect to champertous contracts.

Id.

287. *Kenseth II*, 259 F.3d at 883 ("But the ownership of a security interest is not ownership of the security."). The court explained the difference between a security interest and a proprietary interest through an example using interest expense. *Id.* The court stated that "[a] firm whose assets are secured by a mortgage can deduct the interest from its income, but it is not allowed to reduce its income by the amount of the interest. Interest on a secured obligation is just another expense." *Id.*

288. *Id.* at 884.

289. *Id.* The court indicated that in the situation where a client has confiscated an attorney's work, the lawyer has a claim against his client, not his client's cause of action. *Id.* The court stated that "[i]n essence, Kenseth wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent fee contract is not an assignment . . ." *Id.*

290. *Id.* The court stated:

So what Kenseth really is asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.

Id.

291. *Id.* In discussing the potentially harsh results to a taxpayer who is required to include contingent attorney's fees in gross income and may be denied a deduction for those fees, the court stated:

[I]n taxation's Garden of Eden, it would indeed be difficult to think of a reason why Kenseth should have been denied the normal privilege of deducting from his gross income 100 percent of an expense reasonably incurred for the production of taxable income . . . [but] equity in taxation [is] a political rather than a jural concept.

Id. at 884-85.

Commissioner.²⁹² In this case, the taxpayer, Mrs. Young, received a promissory note pursuant to a divorce settlement under which she was to receive \$1.5 million from her ex-husband.²⁹³ In October 1990, Mr. Young defaulted on his obligations under the divorce settlement agreement, including the note payable to Mrs. Young.²⁹⁴ Mrs. Young sued and eventually agreed to a settlement which provided that she would receive a fifty-nine acre tract of land in satisfaction of the debt.²⁹⁵ She subsequently received \$2.2 million on the sale of the land and paid \$300,606 directly to her attorneys pursuant to a contingent fee agreement.²⁹⁶ Mrs. Young did not report any gain to the IRS on the sale of the property, and accordingly, did not report any of the fees paid to attorneys.²⁹⁷

Mrs. Young argued that she never realized the portion of the income used to pay her attorneys under a contingent fee contract.²⁹⁸ The Fourth Circuit rejected this argument, resting its holding on the assignment-of-income doctrine and finding that the attorney's fee portion of Mrs. Young's recovery was gross income to her under the reasoning of *Earl*²⁹⁹ and *Horst*.³⁰⁰ In explicitly rejecting the holdings in *Cotnam*³⁰¹ and *Estate of Clarks*,³⁰² the court in *Young* reasoned that permitting the contingent attorney's fees to be excluded would allow Mrs. Young to

292. *Young v. Comm'r*, 240 F.3d 369 (4th Cir. 2001).

293. *Id.* at 372.

294. *Id.*

295. *Id.* Prior to this settlement, Mr. Young paid only \$160,000 toward satisfaction of the judgment awarded to Mrs. Young as a result of her lawsuit. *Id.* Before executing the remainder of the judgment, Mr. and Mrs. Young entered into a settlement agreement and release under which Mrs. Young was to receive the fifty-nine acre piece of land. *Id.* Mr. Young retained an option to repurchase the land for \$2.2 million prior to December 1992. *Id.* Mr. Young assigned the option to a third party, who exercised it and bought the land from Mrs. Young for \$2.2 million. *Id.*

296. *Id.*

297. *Id.* Mrs. Young sought to exclude the capital gain on the sale of the land under I.R.C. § 1041(a)(2) which provides that "[n]o gain or loss shall be recognized on a transfer of property . . . to . . . a former spouse . . . if the transfer is incident to the divorce." *Id.* (quoting I.R.C. § 1041(a)(2) (1994)). In rejecting this argument, the Tax Court held that Mrs. Young could properly exclude the transfer of the land under § 1041(a)(2), but that Mrs. Young must report the gain derived from the sale of the property to the extent that the sales price exceeded her husband's basis in the property. *Id.* at 272-73; see *Young v. Comm'r*, 113 T.C. 152, 155-56 (1999). A taxpayer's "basis" in property is generally the cost of such property with certain adjustments. See I.R.C. §§ 1011-1012, 1016 (1994).

298. *Young*, 240 F.3d at 376; see also *Young*, 113 T.C. at 157.

299. *Lucas v. Earl*, 281 U.S. 111 (1930).

300. *Young*, 240 F.3d at 377; see also *Helvering v. Horst*, 311 U.S. 112 (1940).

301. *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

302. *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000).

avoid taxation by skillfully devising the method for paying her attorney's fees.³⁰³

Like the Seventh Circuit, the Fourth Circuit refused to distinguish between a contingent attorney's fee arrangement and an arrangement under which a client pays an attorney at an hourly rate.³⁰⁴ Further, the court held that the presumption articulated in *Cotnam*, that a client's claim is worthless without the skill of an attorney, overlooked that an attorney paid by the hour adds just as much value to a claim as a contingent fee attorney.³⁰⁵ Recognizing that if Mrs. Young had paid her attorney by the hour, the entire settlement amount would constitute gross income, the Fourth Circuit held that the same treatment should apply under a contingent fee arrangement.³⁰⁶

6. The Tenth Circuit Has the Last Word

The most recent Court of Appeals decision relating to the taxation of contingent attorney's fees came in *Campbell v. Commissioner*.³⁰⁷ In *Campbell*, the Tenth Circuit held that the attorney's fee portion of a taxpayer's recovery for damages constitutes gross income.³⁰⁸ The taxpayer in *Campbell* prevailed in a Title VII sexual harassment lawsuit against her former employer.³⁰⁹ As a result, she received \$150,000, of which she paid approximately \$74,000 directly to her attorneys under a contingent fee contract.³¹⁰

303. *Young*, 240 F.3d at 377 (reasoning that the choice of a contingent fee arrangement to avoid taxation is the "precise danger the Supreme Court warned against in *Earl*"); see also *Lucas*, 281 U.S. at 115 (holding that the "tax could not be escaped by anticipatory arrangements and contracts however skillfully devised . . .").

304. *Young*, 240 F.3d at 377-78 ("We see no reason to allow her to escape taxation on a portion of the settlement proceeds simply because she arranged to compensate her attorneys directly from the proceeds through a contingent fee arrangement.").

305. *Id.* at 378. *Contra Cotnam*, 263 F.2d at 125 (Rives & Brown, JJ., concurring).

306. *Young*, 240 F.3d at 378. In addition, the court rejected an analysis of contingent attorney's fees based on state law rights granted to an attorney. *Id.* (stating that the taxation of attorney's fees under a contingent fee contract "should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action"). *Id.* The court did state that even if state law were considered, the law in North Carolina did not provide an attorney with an interest in a client's cause of action or judgment such that control of a portion of the claim would be transferred. *Id.* at 379.

307. *Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001).

308. *Id.* at 1313-14.

309. *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2123 (2000), *aff'd sub nom. Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001); see also 42 U.S.C. § 2000e-2 (1994 & Supp. V 2000) (describing unlawful employment practices under Title VII).

310. *Campbell*, 274 F.3d at 1313. The exact amount paid by Ms. Campbell to her attorneys was \$73,399.25. *Id.* Originally, Ms. Campbell reported the entire award as "other [i]ncome" and took a miscellaneous itemized deduction for the attorney's fee portion. *Id.* However, she later

The court in *Campbell* held that the entire award was taxable to Ms. Campbell.³¹¹ In doing so, the court rejected Ms. Campbell's argument that she lacked the requisite control and beneficial ownership of the funds paid to her attorneys.³¹² The court held that, regardless of the label placed on the contract between Ms. Campbell and her attorneys, the end result was that the fee portion of the recovery benefited her.³¹³ Ms. Campbell, however, advanced an alternative argument under *Cotnam*,³¹⁴ maintaining that the relevant Missouri lien statute gave her attorneys an ownership interest in her claim and the subsequent recovery.³¹⁵ Finding the reasoning in *Cotnam* unpersuasive, the court held that the effect of the Missouri law did not alter its analysis.³¹⁶

The court recognized that a universal standard applicable to contingent legal fees was needed, and proposed that such a standard should be applied without regard to state law.³¹⁷ Responding to Ms. Campbell's argument that inclusion of attorney's fees produced an unjust result, the Tenth Circuit stated that Congress, not the courts, should remedy any unfairness in the Code.³¹⁸ The Tenth Circuit, having

filed an amended return excluding the award entirely and claiming a refund for the tax paid. *Id.* The Commissioner not only denied the refund but also assessed a deficiency of \$17,402, representing an AMT liability that Ms. Campbell did not report on her original or amended tax returns. *Id.*

311. *Id.* at 1313-14.

312. *Id.*

313. *Id.* (explaining that the legal fee portion of Ms. Campbell's recovery allowed her to discharge the personal obligation owed to her attorneys).

314. *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959).

315. *Campbell*, 274 F.3d at 1314; *see also Cotnam*, 263 F.2d at 123 (discussing the Alabama attorneys' lien statute).

316. *Campbell*, 274 F.3d at 1314 (stating that it would join "the majority of the Circuits [that] have rejected this argument"). The court determined that the Missouri lien statute granting a lien interest to secure an attorney's compensation was more like those attorney lien provisions of States that have been distinguished from the Alabama statute applicable in *Cotnam*. *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2126-27 (2000), *aff'd sub nom. Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001). The Missouri attorney's lien statute states:

The compensation of an attorney or counselor for his services is governed by agreement, express or implied, which is not restrained by law. From the commencement of an action or the service of an answer containing a counterclaim, the attorney who appears for a party has a lien upon his client's cause of action or counterclaim, which attaches to a verdict, report, decision or judgment in his client's favor, and the proceeds thereof in whosoever hands they may come; and cannot be affected by any settlement between the parties before or after judgment.

MO. ANN. STAT. § 484.130 (West 1987).

317. *Campbell*, 274 F.3d at 1314. The court stated that "the 'intricacies of any attorney's bundle of rights,' or the unique provisions of a particular state's attorney lien statute" should not affect the taxation of contingent attorney's fees. *Id.*

318. *Id.* at 1314-15. Ms. Campbell was particularly upset about the effect of the AMT provision on legal fee deductions that created additional tax liability for her. *Id.* The court

the last word on the taxation of contingent attorney's fees, has widened the gap between the circuits and made more compelling the need for a consistent resolution to this issue.³¹⁹

IV. ANALYSIS

The recent judicial developments strengthening the majority view have intensified the philosophical split among the federal courts regarding the proper taxation of contingent attorney's fees.³²⁰ Consistent with the clear weight of authority, courts in every jurisdiction should require that contingent attorney's fees incurred in connection with a taxable recovery be included in gross income.³²¹ Courts should uniformly reject the inconsistent and misguided tax treatment of contingent attorney's fees by the Fifth, Sixth, and Eleventh Circuits.³²²

A. Inclusion of Contingent Attorney's Fees in Gross Income Properly Reflects Current Tax Law

The Third, Fourth, Seventh, Ninth, Tenth and Federal Circuits correctly held that a client must include the contingent attorney's fee portion of a taxable damages recovery in gross income.³²³ First, the plain language of the Code, as well as the judicially developed assignment-of-income doctrine, support the analysis of these circuits.³²⁴ These courts correctly applied the statutory definition of gross income to hold that a client receives a taxable benefit through the use of a

recognized the inequity, but maintained that the Code mandated this result, not the courts. *Id.* at 1315.

319. *See id.* at 1314.

320. *See supra* Part III.B (discussing the reasoning of the majority of courts requiring inclusion); *see also* Serven, *supra* note 79, at 83 (acknowledging the effect of the recent case law developments on the contingent attorney's fee issue).

321. *See* Serven, *supra* note 18, at 377; *see also infra* Part IV.A (arguing that the inclusion of contingent attorney's fees in gross income properly reflects current tax law).

322. *See supra* Part III.A (providing the reasoning of the Circuits permitting exclusion); *see also infra* Part IV.B (objecting to the reasoning of the circuit courts that have permitted taxpayers to exclude contingent attorney's fees from gross income).

323. *See supra* note 11 and accompanying text (identifying the circuit courts requiring inclusion of contingent attorney's fees); *see also* *Kenseth II*, 259 F.3d 881, 883 (7th Cir. 2001) (acknowledging that the inclusion of contingent attorney's fees in gross income is "clearly correct").

324. *See* I.R.C. § 61(a) (1994); *see also* *Lucas v. Earl*, 281 U.S. 111 (1930) (establishing the assignment-of-income doctrine); *infra* Part IV.A.1 (arguing that the language of the I Code supports the inclusion of contingent attorney's fees in gross income).

contingent attorney's fee contract.³²⁵ In so holding, the courts correctly recognized that such a contract falls squarely within the assignment-of-income doctrine.³²⁶ Second, the circuits favoring inclusion properly determined that the selection of a particular fee arrangement should not dictate the tax consequences of the fees.³²⁷ These courts correctly identified that there is no meaningful distinction between a contingent fee contract and a fixed fee arrangement that would support differing tax treatment.³²⁸ Ultimately, the circuits requiring inclusion properly declined to provide contingent fee clients a tax benefit by refusing to allow them to exclude their attorney's fees from gross income.³²⁹

1. The Inclusion Approach is Proper Under the Plain Language
of the Internal Revenue Code and the Judicially Developed
Assignment-of-Income Doctrine

The Third, Fourth, Seventh, Ninth, Tenth and Federal Circuits correctly applied the statutory definition of gross income and properly held that a taxpayer creates an assignment of income when he transfers the right to receive prospective income to his attorney.³³⁰ First, while

325. See *Coady v Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (holding that the statutory definition of gross income applies to contingent attorney's fees); see also *Kenseth II*, 259 F.3d at 884 (noting that all receipts, including contingent attorney's fees, are gross income unless specifically excluded).

326. See *Coady*, 213 F.3d at 1191 (holding that a taxpayer must include contingent attorney's fees in gross income because the transfer is equivalent to an assignment of income); *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (holding that the assignment of a payment to a third party is gross income under the assignment-of-income doctrine); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962) (holding that the assignment-of-income doctrine required a taxpayer to include contingent attorney's fees in gross income), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

327. See *infra* Part IV.A.2 (arguing that contingent attorney's fees should not be given preferential tax treatment over non-contingent fees).

328. See *Kenseth II*, 259 F.3d at 885 (acknowledging that the same tax treatment is warranted under both fixed and contingent fee agreements); *Srivastava v. Comm'r*, 220 F.3d 353, 357 (5th Cir. 2000) (reasoning that there is no justification for treating contingent fees differently than non-contingent fees for tax purposes); *Baylin v. United States*, 30 Fed. Cl. 248, 258 (1993) (holding that the taxpayer receives a benefit from fees paid to his attorney regardless of whether the attorney was retained on an hourly basis or on a contingency basis), *aff'd*, 43 F.3d 1451 (Fed. Cir. 1995). The court in *Baylin* stated that "[t]he contingency fee agreement merely established the amount the plaintiff was obligated to pay—it did not specify out of which funds such amounts had to be paid." *Baylin*, 30 Fed. Cl. at 258. Accordingly, the court reasoned that the fact that the taxpayer used a portion of his lawsuit recovery, rather than other available funds to pay his attorney, did not change the tax consequences of the payment. *Id.*

329. See *infra* Part IV.A.1–2 (arguing the appropriateness of a consistent tax treatment of attorney's fee arrangements).

330. *Old Colony Trust v. Comm'r*, 279 U.S. 716, 729 (1929) (stating that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed"); see also *Campbell v. Comm'r*, 274 F.3d 1312, 1313–14 (10th Cir. 2001) (holding that a taxpayer must

the definition of gross income is broad and includes benefits accrued to a taxpayer that are not specifically mentioned in the Code, exclusions from gross income are statutory and limited to those items that Congress has explicitly approved of by affirmative legislation.³³¹ An exclusion from gross income of contingent attorney's fees simply does not fit into the framework established by Congress for permitting exclusions.³³² Courts that have imprudently bypassed this framework in order to provide such an exclusion have done so in contravention of the clear intent of Congress.³³³

Second, in correctly applying the assignment-of-income doctrine in the context of contingent attorney's fees, the Third, Fourth, Seventh, Ninth, Tenth and Federal Circuits correctly recognized that the power to control the disposition of income is the same as ownership of it.³³⁴ These courts properly maintained that, while the taxpayer may not take possession of the portion of the award used to pay his attorney's fees, he does receive the full benefit of those funds because he is relieved of the

include the contingent fees paid to her attorney under assignment of income principles); *Sinyard v. Comm'r*, 268 F.3d 756, 759 (9th Cir. 2001) (using the assignment-of-income doctrine to hold that a taxpayer must include the contingent fees paid to his attorneys in his gross income); *Kenseth II*, 259 F.3d at 885 (holding that a taxpayer must include the contingent attorney's fees paid in gross income under the assignment-of-income doctrine); *Young v. Comm'r*, 240 F.3d 369, 379 (4th Cir. 2001) (holding that the taxpayer must include the contingent attorney's fees paid in settling a property dispute due to the application of assignment of income principles); *Srivastava*, 220 F.3d at 360 (holding that "a taxpayer who makes an assignment of future income streams but retains ownership and control over the source of those funds has effected an anticipatory assignment of income"); *Baylin*, 43 F.3d at 1455 (using assignment of income principles to require a partnership taxpayer to include the attorney's fees paid in gross income); *O'Brien*, 38 T.C. at 712 (holding that contingent attorney's fees are includible in gross income under the assignment-of-income doctrine).

331. See I.R.C. §§ 101–137 (1994) (providing specific exclusions from gross income); see also *supra* note 46 and accompanying (discussing the theory behind gross income and deductions); *supra* notes 146, 222 (illustrating the specific exclusion from gross income of damages obtained in connection with a physical injury).

332. See Campbell, *supra* note 1, at 183 (discussing Congress' motivation for excluding specific items from gross income). Mr. Campbell correctly points out that the structure of exclusions under the Code illustrates that only Congress has the authority to legislate exclusions from gross income and that, as yet, contingent attorney's fees are not among those exclusions. *Id.* Mr. Campbell further notes that judicially permitting the exclusion of contingent attorney's fees violates the separation of powers doctrine because it devalues Congress' taxing power. *Id.* at 200.

333. *Id.* at 183.

334. See *Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (citing *Horst* to explain the rationale underlying the assignment-of-income doctrine); see also *Helvering v. Horst*, 311 U.S. 112, 118 (1940) (discussing the rationale of the assignment-of-income doctrine); Campbell, *supra* note 1, at 196–97 (discussing the applicability of assignment-of-income principles to contingent attorney's fee contracts).

obligation to pay for the legal services incurred to obtain the award.³³⁵ That the taxpayer must include the full amount of that benefit in gross income is the proper result under the assignment-of-income doctrine.³³⁶

As the Federal Circuit best stated, a taxpayer choosing to pay his attorney directly out of the eventual recovery from his claim receives the benefit of those funds just as if he received the income personally and then turned it over to his attorney.³³⁷ The uncertainty regarding the exact amount of the recovery prior to the assignment does not mean that this amount never belonged to the client.³³⁸ It means simply that the attorney and client chose to estimate the value of the attorney's services by connecting the fee to the ultimate recovery.³³⁹

Further, as correctly stated by the Seventh Circuit, while the assignment-of-income doctrine requires taxpayers to include all of the income realized by them, the statutory deduction provisions allow taxpayers to deduct expenses incurred in producing that taxable income.³⁴⁰ In the context of attorney's fees, critics view the statutory limitations on deductions as eliminating any benefit of these expenses.³⁴¹ However, the plain language of the Code survives such a

335. See *Baylin*, 43 F.3d at 1454 (noting that a taxpayer derives a benefit when he assigns a portion of his recovery to his attorneys in satisfaction of his obligation to pay legal fees); see also Campbell, *supra* note 1, at 197; *Are Attorney's Fees Payable Out of Judgment 'Assigned Income,' supra* note 206, at ch J.4690 (acknowledging that assignment of income principles require the inclusion in gross income of the contingent legal fees paid to a taxpayer's attorney).

336. *Baylin*, 43 F.3d at 1454; see also Campbell, *supra* note 1, at 197 (arguing that the assignment-of-income doctrine mandates inclusion of attorney's fees under a contingent fee contract).

337. See *Baylin v. United States*, 30 Fed. Cl. 248, 258 (1993) (stating that the client enjoys the full benefit of the damages award by using a portion of it to compensate his attorney for his services), *aff'd*, 43 F.3d 1451 (Fed Cir. 1995). The court stated that "although the partnership did not take actual possession of the funds it paid to its attorney . . . [it] 'made such use or disposition of [its] power to receive . . . the income as to procure in its place other satisfactions which are of economic worth.'" *Baylin*, 43 F.3d at 1454 (quoting *Horst*, 311 U.S. 112).

338. *Baylin*, 43 F.3d at 1455; see also B. Douglas Smith, Jr., *Ethel Cotnam's Ghost: The Conflicting Tax Treatment of Contingent Attorney's Fees*; *Srivastava v. Commissioner*, 54 TAX. LAW. 437, 445 (2001) (arguing that the uncertainty of the amount of the attorney's fees does not prevent the application of the assignment-of-income doctrine).

339. See *Srivastava v. Comm'r*, 220 F.3d 353, 362 (5th Cir. 2000) (noting that the uncertain value of a future income stream does not mean a taxpayer cannot achieve gain from anticipatorily assigning it to another); Geier & Aaronson, *supra* note 161, at 14 (arguing that a contingent fee contract allows plaintiffs to agree to measure the worth of their attorney's services by reference to the gross recovery under the lawsuit).

340. See *Kenseth I*, 114 T.C. 399, 417 (2000) (holding that the contingent legal fees incurred are deductible expenses subject to applicable statutory limitations), *aff'd*, 259 F.3d 881 (7th Cir. 2001); see also I.R.C. §§ 67(a), 68(a)(1), (a)(2), (b)(1) (1994) (setting forth limitations on itemized deductions).

341. *Kenseth I*, 114 T.C. at 407-08.

critique.³⁴² As the Seventh Circuit properly acknowledged, expenses incurred in producing taxable income do not reduce the amount of that income.³⁴³ Instead, they create deductions that may be used to reduce any income tax due.³⁴⁴ That statutory provisions may limit the amount of the benefit of a deduction does not change the character of the income, but rather reflects the intent of Congress to tax income broadly.³⁴⁵ Indeed, it is not unusual that the realization of income from an asset is dependent on the work of a skilled agent.³⁴⁶ However, any payment made to such an agent is a deductible expense, not an exclusion from income.³⁴⁷ Ultimately, the character of contingent attorney's fees as both an item of income and as a potentially deductible expense supports the separate treatment of such fees consistent with the majority rule requiring inclusion.³⁴⁸

2. Contingent Fee Agreements Should Not Receive Preferential Tax Treatment

The circuits permitting exclusion of contingent attorney's fees fail to recognize the absence of a distinction between a client using a contingent fee contract and one retaining counsel on a fixed fee basis.³⁴⁹ A taxpayer who enters into a contingent fee arrangement recognizes that in order to obtain income from his cause of action, he must hire a competent attorney.³⁵⁰ This is equally true for a client who retains an attorney on a non-contingent fee basis.³⁵¹ As the Fifth Circuit correctly noted, the use of a contingent fee arrangement is a means of allocating

342. *Id.* at 407 (noting that despite the potential for unfairness, the Code must be followed as written); *see also* I.R.C. §§ 67(a), 68(a)(1), (a)(2), (b)(1) (providing limitations on itemized deductions).

343. *Kenseth II*, 259 F.3d 881, 883 (7th Cir. 2001).

344. *See id.* (explaining that taxable income is gross income less the deductible costs incurred in generating such income).

345. I.R.C. § 61(a) (1994) (indicating that gross income includes "all income from whatever source derived"); *see also* *Kenseth II*, 259 F.3d at 883.

346. *See* *Kenseth II*, 259 F.3d at 883.

347. *Id.*

348. *Id.* at 884-85.

349. *Id.* at 883 (noting that there is no distinction warranting different tax treatment of fixed and contingent fee arrangements).

350. *Id.* (explaining that it is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front); *Srivastava v. Comm'r*, 220 F.3d 353, 362-63; (5th Cir. 2000) (noting that the fact that a contingent fee arrangement has the added benefits of risk-shifting and realignment of incentives does not alter the economic reality that it is the same as a fixed fee arrangement).

351. *Srivastava*, 220 F.3d at 362-63.

risk and reward.³⁵² Nonetheless, in the case of a favorable judgment, a plaintiff would have to pay his attorney's fees regardless of whether he is bound to do so on a contingent or non-contingent fee basis.³⁵³ The circuits requiring inclusion of contingent attorney's fees properly recognize that the economic reality of this conclusion should be the basis for the tax consequences as well.³⁵⁴

It is illogical that a client who uses a contingent fee arrangement should receive preferential tax treatment simply because of the method used to compensate his attorney.³⁵⁵ While the arguments for exclusion may often be appealing when viewed from the standpoint of the taxpayer, these arguments cannot sensibly prevail when the outcome results in differing tax treatment of attorney's fees based on the selection of a fee arrangement.³⁵⁶ In the end, the circuits that permit the exclusion of the contingent fee portion of a client's recovery only succeed in creating an artificial distinction between these methods of payment that cannot survive a test of neutral tax principles.³⁵⁷

B. The Exclusion of Contingent Attorney's Fees from Gross Income is Misguided Under Existing Tax Law

The Fifth, Sixth, and Eleventh Circuits incorrectly permitted the exclusion of contingent attorney's fees from gross income by treating a contingent attorney's fee contract as a transfer of a property interest from the client to his attorney.³⁵⁸ In support of this analysis, the Fifth

352. *Id.*

353. *Id.* at 363.

354. See Smith, *supra* note 338, at 445 (stating in the context of attorney's fees that "[n]o matter how the paperwork is written, the satisfaction of [a] debt should be a taxable event to the taxpayer under *Old Colony Trust* . . .").

355. See *Srivastava*, 220 F.3d at 363 (noting that an attorney's method of compensation does not meaningfully affect the gain the client is able to enjoy from a favorable resolution of his claim); *Baylin v. United States*, 43 F.3d 1451, 1453 (Fed. Cir. 1995) (explaining that it would be unfair to give a client a tax windfall based only on his choice of a fee arrangement, because regardless of the arrangement, he would still enjoy the same economic benefit upon favorable resolution of his claim).

356. See *Srivastava*, 220 F.3d at 362-63 (suggesting that there would be inequity if the taxpayer could receive the benefit of initial risk-shifting and an exclusion from gross income simply by deciding to use a contingent fee arrangement).

357. *Kenseth II*, 259 F.3d 881, 885 (7th Cir. 2001); see also *Srivastava*, 220 F.3d at 357 (recognizing that principles of tax neutrality require uniform treatment of attorney's fees regardless of a client's fee arrangement); see also *supra* note 202 (discussing the horizontal equity theory as applied to contingent attorney's fees).

358. See *Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000) (*per curiam*); *Estate of Clarks v. Comm'r*, 202 F.3d 854, 857-58 (6th Cir. 2000) (permitting the taxpayer to exclude contingent attorney's fees based on a transfer of property theory); *Cotnam v. Comm'r*, 263 F.2d 119, 125-26

and Eleventh Circuits improperly looked to applicable state attorney's lien statutes to conclude that an attorney has an equitable interest in his client's claim.³⁵⁹ Although the Sixth Circuit took a different approach, it came to a similarly unsound conclusion by focusing on the speculative nature of a claim under a contingent fee contract as evidence of a partnership between the client and his attorney.³⁶⁰ In addition to the transfer of property and control arguments of the Fifth, Sixth, and Eleventh Circuits, the Sixth Circuit improperly employed equity-based arguments to permit the exclusion of contingent attorney's fees from gross income.³⁶¹

1. A Contingent Attorney's Fee Contract Does Not Shift Partial Control of a Client's Claim to His Attorney

Until recently, courts permitting exclusion have mistakenly avoided a full analysis of the assignment-of-income doctrine and have instead focused on the attorney's rights under the applicable state attorney's lien statute.³⁶² Not surprisingly, this tenuous approach has led to the inconsistent tax treatment of similarly situated taxpayers living in different states and forces the IRS to administer two conflicting sets of rules based solely on jurisdiction.³⁶³ As a result of this clearly illogical outcome, the Sixth Circuit recently applied a different analysis.³⁶⁴ Ultimately, however, the court focused on the nature of the assignment,

(5th Cir. 1959) (allowing the taxpayer to exclude contingent attorney's fees due to the transfer of a property interest to his attorney).

359. *Davis*, 210 F.3d at 1347 n.4; *Cotnam*, 263 F.2d at 125; *see also* *Serven*, *supra* note 79, at 83 (noting that the emerging analysis is moving away from the *Cotnam* attorney's lien analysis in favor of a more broad doctrinal analysis in analyzing contingent attorney's fees).

360. *Estate of Clarks*, 202 F.3d at 857-58 (reasoning that the speculative nature of a taxpayer's claim under a contingent fee created a partnership between attorney and client); *infra* Part IV.B.1 (arguing that the uncertain nature of a client's claim cannot meaningfully affect the property rights of his attorney under a contingent fee contract).

361. *Estate of Clarks*, 202 F.3d. at 857-58; *infra* Part IV.B.2 (arguing that equity cannot overcome the plain meaning of the Code).

362. *See, e.g., supra* Part III.A.1 (discussing the Fifth Circuit's approach in *Cotnam*); *Serven*, *supra* note 79, at 83 (examining the reasoning of courts permitting exclusion of contingent attorney's fees from gross income).

363. *Serven*, *supra* note 79, at 83; *see also* *Srivastava v. Comm'r*, 76 T.C.M. (CCH) 638, 644 (1998) (holding that state law determines what property rights and interest a taxpayer has, but federal law determines the tax consequences of those rights), *rev'd*, 220 F.3d 353 (5th Cir. 2000); *Campbell*, *supra* note 1, at 202 (recognizing the inequity that results from the IRS applying different rules to taxpayers based on where they reside); *Serven*, *supra* note 18, at 376 (stating that "[n]o one can seriously argue that the degree of geographic inequity now present in the treatment of contingent legal fees is anything but ludicrous").

364. *See* *Serven*, *supra* note 79, at 83 (discussing the shift by the Sixth Circuit from a state law approach to a broader analysis).

and improperly concluded that the attorney-client relationship under a contingent fee contract is comparable to a partnership or joint venture.³⁶⁵

The rationale under either theory is that if a property interest is transferred from a client to his attorney, the client cannot exercise complete control over the income attributable to the attorney's fee portion of his claim.³⁶⁶ Thus, it is argued that because the client never exercises complete control of the contingent attorney's fees, these fees do not constitute gross income to the client.³⁶⁷ This reasoning is plainly flawed because it fails to recognize that the taxpayer never loses control over the source of the income.³⁶⁸ By virtue of their attorney-client relationship, the taxpayer does not divest himself of ownership or control of the portion of the claim allocated to the attorney under a contingent fee contract.³⁶⁹ While the attorney may advise his client, the client makes the ultimate decisions with respect to his claim.³⁷⁰ The

365. *Estate of Clarks*, 202 F.3d at 858. Both the Fifth and Eleventh Circuits were not compelling in their analysis leading to the holding that taxpayers may exclude contingent attorney's fees from gross income. See *Serven*, *supra* note 18, at 374 (stating that both the Fifth and Eleventh Circuit relied exclusively on the precedent established in *Cotnam*). Based on the reasoning of those circuits, it appears that only the Sixth Circuit independently supports the exclusion of contingent attorney's fees. *Id.* Notably, Professor *Serven* points out that the Sixth Circuit has twice been reversed or overridden by the Supreme Court on its pro-taxpayer holdings in the area of taxable recoveries. *Id.* at 374-75 (citing *O'Gilvie v. United States*, 519 U.S. 79 (1996); *Burke v. United States*, 504 U.S. 229 (1992)).

366. See *Campbell*, *supra* note 1, at 198 (recognizing that control over the underlying source of income is the essence of arguments based on a property transfer theory).

367. See *Estate of Clarks*, 202 F.3d at 857-58 (permitting the taxpayer to exclude contingent attorney's fees based on a transfer of property theory); *Cotnam v. Comm'r*, 263 F.2d 119, 125-26 (5th Cir. 1959) (allowing the taxpayer to exclude contingent attorney's fees due to the transfer of a property interest to his attorney); see also *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding that the taxpayer must exercise complete control in order to include an item in gross income).

368. See *Srivastava v. Comm'r*, 220 F.3d 353, 362 (5th Cir. 2000) (acknowledging that the assignment-of-income doctrine is difficult to ignore because the taxpayer does not relinquish full control over his claim to his attorney); *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (explaining that the taxpayer never gives up ownership over the source of the income); *Foster v. United States*, 106 F. Supp. 2d 1234, 1239 (N.D. Ala. 2000) (holding that *Cotnam* did not give attention to the continuing control that a client, even after entering a contingent fee contract, has over his claim), *aff'd*, 249 F.3d 1275 (11th Cir. 2001); see also *Campbell*, *supra* note 1, at 198 (arguing that the client under a contingent fee contract retains control over his cause of action).

369. See *Srivastava*, 220 F.3d at 362.

370. See MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2001). Rule 1.2(a) states:

A lawyer shall abide by a client's decisions concerning the objectives of representation, subject to paragraphs (c), (d) and (e), and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter. In a criminal case, the lawyer shall abide by the client's decision, after consultation with the lawyer, as to a plea to be entered, whether to waive jury trial and whether the client will testify

attorney cannot decide to resolve his portion of the claim without the consent of his client.³⁷¹ Further, the attorney does not generally have recourse if the client decides to end the relationship prior to the resolution of his claim.³⁷² Without the ability to make these vital decisions, the attorney lacks meaningful control over the claim and simply provides a service to the taxpayer in the hope of receiving compensation through its successful resolution.³⁷³ Although there is no dispute that an attorney contributes expertise and may add to the value of the ultimate recovery, this contribution does not rise to the level of ownership.³⁷⁴

(stating that an attorney shall abide by his client's decisions concerning the objectives of representation including whether or not to accept an offer of settlement).

Id.

371. *Id.*; see also Grant, *supra* note 2, at 377 (discussing the lack of control an attorney has with respect to his client's claim).

372. See *Kenseth I*, 114 T.C. 399, 414 (2000) (noting the continual control a client has over his claim), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

373. See *Srivastava*, 220 F.3d at 369 (Dennis, J., dissenting) (noting that the attorney has no control over the "tree," and as such, the fees paid are income to the client); *Coady*, 213 F.3d at 1191 (noting that a client uses a portion of his award to pay for the services rendered by his attorney); see also MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (2001) (endorsing the use of contingent fee arrangements in exchange for legal services by an attorney). Rule 1.5(c) states:

A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in writing and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

MODEL RULES OF PROF'L CONDUCT R. 1.5(c).

374. See *Kenseth II*, 259 F.3d 881, 884 (7th Cir. 2001). Although the court maintained that control is not relinquished by a client who enters a contingent attorney's fee contract, the *Kenseth II* court questioned the relevance of this point, noting that owners of income-producing property frequently relinquish control over the property and are still taxed on the income. *Id.* Commentators also argue that the Sixth Circuit's improper focus on the uncertain nature of the client's claim is unfounded. See Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, 2001 TAX NOTES 126-42 (suggesting that the timing of the alleged transfer from client to attorney of a portion of the claim under an attorney's fee contract prevents the taxpayer from escaping the income tax associated with that portion). Although a plaintiff's chances of prevailing in court may be uncertain, the income eventually recovered by him is already earned at the time the contingent fee contract is signed. *Id.* Professor Koski convincingly argues that the "fruit" in contingent attorney's fee cases ripens prior to the contract between the client and the attorney. *Id.* Accordingly, the "client cannot escape taxation on the 'fruit' that has already ripened by transferring control of the tree to another, even if the ripened fruit has not yet been harvested and the assistance of an attorney is necessary to bring it to harvest." *Id.*

2. Inequity in the Tax Law is Not the Province of the Judiciary to Resolve

As an initial matter, the Sixth Circuit improperly objected to the inequity of having the client and the attorney both pay tax on the contingent fee portion of the client's recovery.³⁷⁵ The Sixth Circuit's argument against both parties paying tax on the same income is not supported by sound logic because it ignores the fact that the result is the same whenever a taxpayer hires a third party to perform services on his behalf.³⁷⁶ Although the method of payment differs, a taxpayer retaining an attorney using a fixed fee arrangement would have to compensate his attorney out of his own pocket with funds subject to tax.³⁷⁷ For example, a taxpayer who pays an attorney by the hour is taxed both on the amount he earns as wages to accumulate the funds to make the payment and on the eventual recovery from the claim.³⁷⁸ Allowing an exclusion from gross income of contingent attorney's fees would give unfair preferential treatment to clients based on the fortuitous selection of a fee arrangement.³⁷⁹ This artificial distinction does not solve problems of inequity, but rather compounds them.³⁸⁰

The Sixth Circuit also incorrectly advanced an equity-based argument the application of deduction limitations under the Code.³⁸¹ Although, in theory, a taxpayer is allowed to deduct expenses incurred in the production of income, large recoveries often trigger the application of

375. See *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000). The court explained that in contrast to the assignees in cases like *Earl* and *Horst*, who were the object of gifts and not subject to income tax themselves, there is no similar concern that income from contingent attorney's fees would escape taxation because an attorney is required to pay tax on his gross receipts from services provided. *Id.*

376. *Kenseth II*, 259 F.3d at 883 (acknowledging that payments by a taxpayer to his agent are potentially deductible expenses and not exclusions from gross income).

377. *Estate of Clarks*, 202 F.3d at 857-58 (holding that the double tax on attorneys fees, if not excluded, would be unduly burdensome). It is also noteworthy that the gratuitous nature of the transfers in *Earl* and *Horst* did not by itself determine the application of assignment of income principles. See *Srivastava*, 220 F.3d at 361 (stating that "a taxpayer who anticipatorily assigns future streams of income to obtain services in return has quite obviously procured a benefit").

378. *Srivastava*, 220 F.3d at 363. A client's eventual recovery from his claim is not taxed if it qualifies for exclusion under the Code. See I.R.C. § 104(a) (1994) (providing an exclusion for damages received in connection with a physical injury); see also *supra* note 9 (discussing the method of determining whether a recovery is taxable).

379. *Srivastava*, 220 F.3d at 363 (recognizing that the taxpayer would receive a double benefit of initial risk-shifting and an exclusion from gross income due to the "simple fortuity that he hired counsel on a contingent basis").

380. See *Kenseth II*, 259 F.3d at 885 (stating that a distinction between contingent and non-contingent fee arrangements "flunks the test of neutral principles").

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

statutory deduction limitations.³⁸² While courts on both sides of the contingent attorney's fee issue viewed this result with sympathy, the application of such deduction limitations merely reflects the operation of the statute as currently written.³⁸³ Although unfairness to taxpayers is always of concern to the courts, it is unsound for them to substitute their judgment for the plain language of the Code.³⁸⁴ Courts favoring inclusion of contingent fees properly recognize that there are many situations in which taxpayers face harsh tax consequences under the law.³⁸⁵ These courts, however, respect that their role is a limited one and does not extend to rewriting the existing tax law.³⁸⁶

V. PROPOSAL

Due to the inequity resulting from the different tax treatment of similarly situated taxpayers,³⁸⁷ and despite the pro-taxpayer approach of the circuits favoring exclusion,³⁸⁸ the Supreme Court should resolve the existing circuit split and require that taxpayers in all jurisdictions

382. See I.R.C. § 56(b)(1)(A) (1994); *supra* note 129 (providing the text of I.R.C. § 56(b)(1)(A)(i)); see also Shop Talk, Whipsaw on Lawsuit Settlements: The Courts Still Can't Agree, 93 J. TAX'N 188, 188 (2000) (arguing that the IRS position results in the nondeductibility of attorney's fees for purposes of the alternative minimum tax).

383. See, e.g., *Alexander v. Comm'r*, 72 F.3d 938, 946 (1st Cir. 1995) (stating that the application of the AMT "smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment"); *Kenseth I*, 114 T.C. 399, 407 (2000) (recognizing the potential unfairness to taxpayers resulting from the application of the AMT), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

384. See *Kenseth II*, 259 F.3d at 885 (recognizing that inequity often exists within the Code is not the function of the judiciary to resolve); see also Grant, *supra* note 2, at 381 (arguing that courts allowing the exclusion of contingent attorney's fees "base their opinion on emotion, not the law").

385. *Kenseth II*, 259 F.3d at 884 ("[I]ncomplete deductibility here is not surprising or anomalous or inappropriate."). The *Kenseth II* court also stated:

[C]onsider now the operation of a construction business. All receipts are counted as gross income, and outlays to subcontractors and materialmen are deductible, even though these subcontractors have liens on the work and even though the general contractor could say that he just "assigns" a part of the job to the sub.

Id.

386. *Id.* at 884-85 ("So rather than ask why attorneys' fees are not deductible for purposes of the alternative minimum tax, we should ask why those fees should be distinguished from other miscellaneous deductions that the tax disallows; no answer comes to mind."); see also Campbell, *supra* note 1, at 200 (arguing that courts that have permitted exclusion of contingent attorney's fees have violated the separation of powers doctrine by infringing on Congress' lawmaking role).

387. See *supra* notes 358-74 and accompanying text (discussing the impact on taxpayers and the IRS in applying different rules depending on where a taxpayer lives).

388. See *supra* notes 375-86 and accompanying text (examining the equity arguments of proponents of exclusion of contingent attorney's fees).

include contingent attorney's fees in gross income.³⁸⁹ In addition, Congress should amend the Code to allow an unrestricted deduction for contingent attorney's fees incurred in connection with a taxable recovery.³⁹⁰

A. The Supreme Court Should Require Inclusion of Contingent Attorney's Fees in Gross Income

Inclusion of contingent attorney's fees in gross income is consistent with current tax law and with Congress' intent to tax income broadly.³⁹¹ The fair imposition of the progressive income tax system depends on an accurate measure of each individual's gross income.³⁹² Excluding contingent attorney's fees from the gross income of individuals using contingent fee contracts distorts this measurement and provides a tax benefit to a select group of people based solely on the choice of an economic arrangement between client and attorney.³⁹³

As the Fifth Circuit correctly recognized, one who pays his attorney by the hour to represent him in a suit for damages is taxed on both the amount he earns as wages to accumulate the funds to pay his attorney and on the total award.³⁹⁴ Similarly, the client who assigns a portion of his claim in return for representation receives income in the amount of the full judgment.³⁹⁵ That the client does not actually receive the portion of the judgment paid directly to his attorney does not alter this result under the assignment-of-income doctrine.³⁹⁶ As long as there is a split between Federal Courts of Appeals as to the basic principles

389. See *Kenseth II*, 259 F.3d at 885; Grant, *supra* note 2, at 381 (arguing that the Supreme Court should grant certiorari and hold that contingent attorney's fees be included in gross income in the interest of uniformity); Serven, *supra* note 18, at 377 (speculating that the Supreme Court would hold that contingent attorney's fees should be included absent any contrary indication from Congress); see *infra* Part V.A (proposing that the Supreme Court require that contingent attorney's fees be included in gross income).

390. See Campbell, *supra* note 1, at 203; see also *infra* Part V.B (proposing a congressional amendment to remedy the inconsistent treatment of contingent attorney's fees).

391. See *supra* notes 45-48 and accompanying text (discussing the broad definition of gross income).

392. See Grant, *supra* note 2, at 364-65 (discussing the nature of the progressive income tax system under the Code).

393. See Campbell, *supra* note 1, at 205 (exploring the income tax policy issues related to the proper reflection of gross income).

394. *Srivastava v. Comm'r*, 220 F.3d 353, 357 (5th Cir. 2000).

395. See Smith, *supra* note 338, at 448.

396. See *id.*

underlying contingent attorney's fees, a fair resolution cannot be achieved.³⁹⁷

The clear weight of authority now supports the inclusion of contingent attorney's fees in gross income. Perhaps tellingly, the Supreme Court recently denied certiorari in two Ninth Circuit contingent attorney's fee cases.³⁹⁸ However, the most recent decisions strengthening the majority approach will make it difficult for the Supreme Court to avoid dealing with this issue any longer.³⁹⁹ If the Supreme Court does take up this issue, it is likely that it would side with the government and hold that contingent attorney's fees incurred in obtaining a taxable recovery are gross income to the taxpayer.⁴⁰⁰ This result would properly impose the same tax consequences to similarly situated taxpayers and would remove the existing distinction based on jurisdiction.⁴⁰¹ Although the harsh result to taxpayers of such a ruling is apparent, the problem lies not with the Court but with the current application of the deduction provisions of the Code.⁴⁰²

B. Congress Should Make Technical Amendments to the Internal Revenue Code

Even if the Supreme Court resolves the circuit split, Congress should amend the Internal Revenue Code to allow an unrestricted deduction for contingent attorney's fees incurred in connection with a taxable recovery.⁴⁰³ Although there are various ways that Congress could act to accomplish this result, the most effective and sensible approach would be to add qualified contingent attorney's fees to the current list of non-miscellaneous itemized deductions that are not subject to the itemized deduction phase-out.⁴⁰⁴ Qualified contingent attorney's fees are those

397. See Grant, *supra* note 2, at 381 (noting that the assignment-of-income doctrine should be interpreted by the Supreme Court as applicable to contingent attorney's fees).

398. Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001), Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); Serven, *supra* note 18, at 377.

399. See Serven, *supra* note 18, at 377 (noting that it would not be surprising if the Supreme Court agreed to resolve this issue in the upcoming term).

400. *Id.* (speculating that the Supreme Court would agree with the majority of the circuit courts and require the inclusion in gross income of contingent attorney's fees).

401. See Campbell, *supra* note 1, at 203-04 (discussing the positive results of uniform tax treatment related to contingent attorney's fees).

402. *Id.*

403. See Sager & Cohen, *supra* note 130, at 1103 (proposing a congressional amendment to allow employment discrimination plaintiffs to deduct attorney's fees without special restrictions); see also *supra* notes 117-22 (discussing the deductions limitations under § 67 and § 68).

404. The proposed technical amendments would require first that Congress add contingent attorney's fees paid in connection with a taxable recovery to the current list of non-miscellaneous

deductible under § 212 and which are incurred in connection with a taxable recovery.⁴⁰⁵

A review of the current itemized deductions chosen by Congress to retain non-miscellaneous status fails to identify any single common characteristic.⁴⁰⁶ However, many of the expenses appear to be those aimed at ensuring that income is taxed net of any expenses incurred in producing it.⁴⁰⁷ This conclusion is supported by examining Congress' intent in placing limitations on miscellaneous itemized deductions.⁴⁰⁸ In effect, there are two main purposes for limiting miscellaneous itemized deductions.⁴⁰⁹ First, the miscellaneous itemized deduction

itemized deductions under § 67(b). See I.R.C. § 67(b) (1994). Next, these same fees would be added to the list of non-miscellaneous itemized deductions not subject to the itemized deduction phase-out under § 68. See I.R.C. § 68(c) (1994); see also *supra* note 122 (discussing the itemized deduction phase-out under § 68). See generally Malcolm L. Morris, *Determining Deductions Deserves Deductibility*, 21 FLA. ST. U. L. REV. 75, 100-01 (arguing for the recharacterization of § 212(3) deductions related to tax compliance fees). Currently, § 67(b) carves out several itemized deductions that are considered non-miscellaneous and are thus not subject to the most severe statutory limitations. See I.R.C. § 67(b); see also *supra* note 117 (providing the text of § 67(b)). These deductions include medical expenses, certain types of interest, charitable contributions, state, local and foreign taxes, and certain other expenses. I.R.C. § 67(b).

Although not within the scope of this Comment, the operation of the proposed amendment suggests that it should apply similarly to fixed attorney's fees where there is an eventual taxable recovery. See *supra* notes 349-57 and accompanying text (arguing the logic of uniform tax treatment for attorney's fees).

405. See I.R.C. § 212 (1994); see also *supra* notes 114-15 and accompanying text (examining the requirements for deduction under § 212).

406. See Morris, *supra* note 404, at 89 (acknowledging that there is no clear pattern associated with the current non-miscellaneous itemized deductions).

407. *Id.* Professor Morris also speculates that other expenses were not relegated to miscellaneous itemized deduction status due to political pressure on Congress. *Id.* at 90. Courts have recognized that it is "a fundamental principle of taxation: that a person's taxable income should not include the cost of producing that income." See James Serven, *Oral Argument in Hukkanen-Campbell: Taxpayers' Last Stand?*, 93 TAX NOTES 854, 861 n.39 (2001), available at LEXSTAT 2001 TNT 214-55 (citing *Hantzis v. Comm'r*, 638 F.2d 248, 249 (1st Cir. 1981)).

408. See I.R.C. §§ 67, 68 (1994). Section 67 divides itemized deductions into two categories: miscellaneous, and non-miscellaneous. I.R.C. § 67. Miscellaneous itemized deductions are subject to significant statutory limitations. See I.R.C. §§ 67(a), 68; *supra* notes 117-35 and accompanying text (explaining the statutory deduction limitations applicable to miscellaneous itemized deductions).

Congress also indicated several reasons for the enactment of § 67. See Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1418-22 (2001) (quoting STAFF OF JOINT COMM. ON TAX'N, *supra* note 126, at 105 (1970)). Among them was to raise revenue and promote simplification in the Code. *Id.* With respect to the limitations on miscellaneous itemized deductions, Congress sought to prevent taxpayers from deducting expenses that were personal in nature. *Id.* In addition, Congress expressed a desire to remedy errors by taxpayers with regard to the deduction for unreimbursed employee business expenses. *Id.*

409. See Peroni, *supra* note 408, at 1418-22 (discussing Congress' intent in enacting § 67 and limiting miscellaneous itemized deductions).

limitations reduce the taxpayer's ability to deduct expenses which are personal in nature.⁴¹⁰ Second, the limitations curtail a taxpayer's ability to deduct recurring de minimis expenses that cannot easily be linked to the production of taxable income.⁴¹¹ Contingent attorney's fees simply do not fit into either category.⁴¹² A payment of legal fees under a contingent fee contract is typically a one-time expense of a significant amount and is easily tied to the production of taxable income.⁴¹³ In fact, because a taxpayer under a contingent fee contract is not obligated to pay legal fees if he does not ultimately recover, the arrangement itself dictates that the expenses cannot be incurred in the absence of corresponding income.⁴¹⁴ Further, in order to qualify for deduction under § 212, attorney's fees are already subject to initial scrutiny to ensure that they are not personal in nature.⁴¹⁵ For these reasons, the classification of contingent attorney's fees as miscellaneous itemized deductions is plainly incorrect.⁴¹⁶ In contrast, allowing such fees to be deductible as non-miscellaneous itemized deductions would produce a more equitable result.⁴¹⁷

There is no doubt that Congress has made an affirmative decision not to exclude certain types of lawsuit recoveries from gross income.⁴¹⁸ However, the fact that Congress has expressed its desire to tax individuals on such awards does not mean that it intended to overtax

410. *Id.*

411. *See id.*; *see also* *Serven*, *supra* note 18, at 377 (stating that § 67 and § 68 limitations are "safeguard enough that de minimis items of deduction, often representing expenditures having an element of taxable personal consumption, will not clutter up tax returns . . .").

412. *See supra* notes 111-14 and accompanying text (examining the character of the deduction for legal fees).

413. *See supra* note 113 and accompanying text (discussing the deduction for legal fees under § 212).

414. *See supra* notes 34-44 and accompanying text (examining the nature and use of the contingent attorney's fee contract).

415. *See supra* note 115 and accompanying text (discussing the use of the "origin of the claim" test for determining whether an expense is deductible under § 212).

416. *See Peroni*, *supra* note 408, at 1422-23 (illustrating the inappropriate outcome of the current deduction provisions as applied to contingent attorney's fees).

417. *Id.*

418. *See* I.R.C. § 104 (1994 & West Supp. 2001). Congress amended § 104 in 1996 after two earlier Supreme Court cases narrowed the exclusion. *See Schleier v. Comm'r*, 515 U.S. 323 (1995) (holding a taxpayer's ADEA recovery fully taxable); *Burke v. United States*, 504 U.S. 229 (1992) (holding a taxpayer's Title VII recovery fully taxable). The purpose of the amendment was to tax damage awards in employment discrimination and injury to reputation lawsuits where there was no related physical injury. *See* Fred A. Simpson, *Federal Income Tax and Personal Injury Judgments and Settlements*, available at <http://www.jw.com/articles/details.cfm?articlenum=81> (citing the Joint Explanation of Conferees on H.B. 3448, Small Business Job Protection Act of 1996). Further, Congress did not want to provide a tax-free "windfall" to a taxpayer because the purpose of punitive damages is to punish the wrongdoer. *Id.*

them.⁴¹⁹ Although the definition of gross income is broad, Congress expressed its desire to allow taxpayers to deduct expenses incurred in the production of taxable income when it enacted § 212.⁴²⁰ Allowing taxpayers to deduct contingent attorney's fees that are clearly identifiable as incurred to produce a taxable recovery strikes the appropriate balance between these interests.⁴²¹

Perhaps the most far-reaching result of the proposed technical amendments would be realized by taxpayers subject to the Alternative Minimum Tax.⁴²² Because qualified contingent attorney's fees would not be considered miscellaneous itemized deductions, they would not be disallowed under the AMT.⁴²³ This result is particularly appealing, as even courts requiring inclusion of contingent attorney's fees in gross income disapprove of the harsh and unintended consequences of the AMT provisions affecting taxpayers who hire attorneys to assist them in recovery.⁴²⁴ Moreover, removing qualified attorney's fees from the miscellaneous itemized deduction category for AMT purposes is consistent with Congress' intent in creating the AMT.⁴²⁵ As correctly recognized by the Fifth Circuit, the deduction of a one-time payment of

419. Simpson, *supra* note 418; *see also* Morris, *supra* note 404, at 88 (arguing that "[s]ection 67 is high on the list of mischief-makers in the Code"); Sager & Cohen, *supra* note 130, at 1083 (stating that "[t]he attorneys' fees—the cost of producing the income—must be fully deductible in order to arrive at a true income figure"). Professor Morris suggests that the practical application of § 67 is often inconsistent with Congress' goal of broadening the tax base while maintaining neutral revenue raising. Morris, *supra* note 404, at 89.

420. *See supra* notes 113-14 and accompanying text (discussing the enactment and operation of § 212).

421. *See* I.R.C. § 104 (allowing an exclusion from gross income for damages received as a result of physical injuries); *see also supra* notes 146, 222 (discussing the exclusion of certain damage recoveries under § 104(a)(2)).

422. *See* I.R.C. §§ 55-58 (1994); *see also supra* notes 124-35 (discussing the limitations on miscellaneous itemized deductions under the AMT).

423. *See* I.R.C. § 56(b)(1)(A)(i) (disallowing a deduction for miscellaneous itemized deductions).

424. *See* *Srivastava v. Comm'r*, 220 F.3d 353, 357 n.6 (5th Cir. 2000); Davis, *supra* note 187, at 1722 (noting that the harsh application of the AMT to contingent attorney's fees undermines the policy behind the creation of the AMT); *see also* Morris, *supra* note 404, at 90-91 (arguing the unfairness of the operation of the AMT when applied to plaintiffs under a contingent fee arrangement); Simpson, *supra* note 418 (stating that "[t]here is no reason for [miscellaneous itemized deductions] to be denied under the alternative system when they are sufficiently 'income related' to be allowed under the regular tax system").

425. *See* I.R.C. § 55(a); *see also supra* note 126 and accompanying text (discussing that Congress' main objective in establishing the AMT was to prevent high income taxpayers from avoiding tax by utilizing excessive deductions).

attorney's fees does not reach the level of sophisticated tax scheming that Congress intended to target with the AMT.⁴²⁶

VI. CONCLUSION

As a result of the inconsistency of the current state of the law with respect to contingent attorney's fees, a uniform resolution is needed. Under current tax law, including contingent attorney's fees in gross income is the proper course of action. The plain language of the Code and the assignment-of-income doctrine mandate this result. Accordingly, the Supreme Court should grant certiorari and resolve this issue once and for all.

Although current tax law mandates the inclusion of contingent attorney's fees, it is illogical that taxpayers are restricted from deducting the attorney's fees paid under a contingent fee contract. In order to remedy the inequity of deduction limitations that distort Congress' goal of fair taxation, Congress should amend the Code to allow for the unrestricted deduction of contingent attorneys fees incurred in connection with a taxable recovery.

426. See *Srivastava*, 220 F.3d at 357-65 (acknowledging the potential inequity of including contingent attorney's fees in gross income); Campbell, *supra* note 1, at 201; Davis, *supra* note 187, at 1722 (noting that the current AMT reaches beyond its purpose to areas where it was never intended to apply).