

## TAXATION OF CONTINGENT LEGAL FEES ON SETTLEMENTS OR AWARDS

*Richard E. Simpson\**

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\* Youngstown State University, B.A., Case Western Reserve University School of Law, J.D., University of Houston Law Center, L.L.M., Texas Board of Legal Specialization, Board Certified, Tax Law.

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## I. INTRODUCTION

This article will review and discuss the federal individual income taxation of contingent legal fees on settlements or awards in the context of damages received as compensation for injuries or sickness.<sup>1</sup> The discussion is limited to recoveries by individual taxpayers, because a business entity cannot suffer a personal

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1. The Internal Revenue Code of 1986, the Treasury Regulations thereunder, and the prodigy of federal tax cases that attempt to give guidance, albeit inconsistent, will be examined on the issue. I.R.C. § 104 (West 1986); Treas. Reg. § 1.104-1 (2000).

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injury within the meaning of section 104(a)(2).<sup>2</sup> The topic is increasingly relevant because, according to recent IRS examination revelations, there are a growing number of large verdicts and settlements that escape taxation.<sup>3</sup>

Furthermore, taxpayers are improperly excluding income or taking inappropriate deductions for attorney fees paid directly to their lawyers.<sup>4</sup> Payers of the judgments or awards are not reporting the results correctly to the plaintiffs and plaintiffs' attorney's tax advice has been absent or ineffective.<sup>5</sup>

The Internal Revenue Service ("IRS") fears that verdict and settlement payments are too easily falling "through the gap of unreported income."<sup>6</sup> An IRS "Audit Guide" suggests to agents to research news reports of verdicts and settlements looking for individuals to audit.<sup>7</sup> Taxpayer/plaintiffs and their attorneys need to be aware and give greater consideration to the federal income tax aspects of pursuing and receiving a judgment award or settlement.

## II. TAXATION OF PLAINTIFFS' DAMAGE SETTLEMENTS OR AWARDS

### A. Introduction

Many lawsuits are handled on a contingent fee basis, with the contingent fee typically ranging from 25% to 52.5% of the total amount received by the plaintiff.<sup>8</sup> State law usually requires that the contingent legal fee agreement be in writing, but recent case law has allowed attorney recovery of oral contingent fee agreements in quantum meruit from a successor

2. *P & X Markets, Inc. v. Comm'r*, 106 T.C. 441, 444-45 (1996), *aff'd without published opinion*, 139 F.3d 907 (9th Cir. 1998).

3. INTERNAL REVENUE SERV., MARKET SEGMENT SPECIALIZATION PROGRAM: LAWSUIT AWARDS AND SETTLEMENTS \*2, *available at* 2000 WL 33171823 (2000) [hereinafter MSSP].

4. *Id.* at \*20.

5. *See id.* at \*31 (setting forth the reliance on attorney's advice as a factor to determine whether penalties based on inaccuracies and frauds are warranted); *see also* Sylvia Hsieh, *IRS Cracking Down on Plaintiffs*, LAW. WKLY. USA, March 5, 2001, at 1, 18 (explaining that changes in the tax law have created confusion for lawyers, which renders their advice inaccurate).

6. MSSP, *supra* note 3, at \*2.

7. *Id.* at \*22; *see also* Hsieh, *supra* note 5.

8. *See Griffin v. Comm'r*, 81 T.C.M. (CCH) 972, 974 (2001) (explaining that "[d]uring September 1990, petitioner and HGTG retained attorney Vincent F. Kilborn by means of a contingent fee arrangement under which the attorney's fee was 52-1/2 percent of any recovery or zero if there was no recovery"). *See generally* W. Kent Davis, *The International View of Attorney Fees in Civil Suits: Why is the United States the "Odd Man Out" in How it Pays its Lawyers?*, 16 ARIZ. J. INT'L & COMP. L. 361, 374 (1999) (stating contingent fees in the United States range from twenty-five to forty percent).

attorney for prior legal services performed.<sup>9</sup> Attorneys will often include in the contingency fee agreement arrangements for the payment or reimbursement of expenses associated with prosecuting the plaintiff's cause of action.<sup>10</sup>

The tax problem presented, discussed, and analyzed is when an individual plaintiff who receives a settlement or award, some part of which is taxable, may be taxed on the amount of the contingent legal fee paid to the attorney. Although the plaintiff/taxpayer is entitled to deduct the legal fee as a miscellaneous itemized deduction (unless it relates to the individual's trade or business), such deduction may provide little benefit due to the 2% of adjusted gross income floor,<sup>11</sup> the phase-out of itemized deductions,<sup>12</sup> and the adjustment of the miscellaneous itemized deduction for Alternative Minimum Tax purposes.<sup>13</sup>

The IRS takes the position that the contingent legal fee is effectively paid by the plaintiff to the attorney *after* the plaintiff has received, and included in gross income, the settlement or award.<sup>14</sup> The current taxation rules will be discussed and analyzed.

The various federal courts have reached inconsistent conclusions concerning the plaintiff's tax treatment of contingent legal fees, some favoring the taxpayer's position while others favoring the government's position. This article examines the conflict among the U.S. Circuit Courts of Appeals and the United States Tax Court, as well as the underlying taxpayer and government tax theories. Some of the inconsistencies surrounding the application of various state laws concern attorney liens, equitable assignment, and general property rights. Various state law principles are examined in an effort to clarify the different results.

### B. *Inconsistent Decisions in Federal Courts*

The U.S. Supreme Court has thus far refused to weigh in on the inconsistent treatment of taxpayers in this area.<sup>15</sup> This

9. *Gagne v. Vaccaro*, 766 A.2d 416, 427 (Conn. 2001).

10. *See id.* at 424; *see also Was Justice Served?*, WALL ST. J., Oct. 4, 1995, at A14 (explaining that the contingency fee is normally one third of the amount recovered once expenses have been reimbursed to the attorney).

11. I.R.C. § 67(a) (2000).

12. § 68(a).

13. § 56(b)(1)(A)(i).

14. MSSP, *supra* note 3, at \*19–\*20 (recognizing “the anticipatory assignment principles require a taxpayer to include in gross income the entire amount of judgment/settlement proceeds”).

15. The following cases exemplify the disagreement among the circuits and that

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article will attempt to predict the likely outcome based on other recent authority from the Supreme Court on analogous tax matters.<sup>16</sup>

The situation has become more critical for taxpayers after the 1996 changes to the Internal Revenue Code,<sup>17</sup> amending I.R.C. § 104 to require physical injury or illness before allowing an award for personal damages to be nontaxable.<sup>18</sup> Because more personal damage settlements and awards are now taxable, many taxpayers find themselves paying tax on what they and their attorney received.<sup>19</sup> In reviewing the current cases, the prior law regarding taxation of damage settlements and awards is acknowledged.

The IRS has taken recent steps to diminish perceived abuses in the area of taxation of damages and awards with a new audit program, designed to prevent recipients of large damage settlements and awards from escaping taxation.<sup>20</sup> The new IRS audit guide is analyzed and some suggestions and planning ideas are discussed to minimize the effect of the new law and adverse court rulings.<sup>21</sup> This article sets forth minimum criteria for attorneys drafting agreements, thereby attempting to minimize the adverse tax effects.

### C. *Is a Contingent Attorney Fee Gross Income to the Client?*

Is a contingent attorney fee included in the gross income of the client? The federal courts have occasionally sided with taxpayers on this issue, beginning in 1959, with the 5th Circuit Court of Appeals decision in *Cotnam v. Commissioner*.<sup>22</sup> More often than not, however, the IRS has persuaded the United States Tax Court and thus taxpayers have been required to include in their gross income the entire amount of the verdict or award, with the often limited use of a miscellaneous itemized deduction for the attorney's share of the recovery.<sup>23</sup>

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certiorari has not been granted: *Cotnam v. Comm'r*, 263 F.2d 119, 121 (5th Cir. 1959) (holding that attorney's fees are not taxable income to the taxpayer); *O'Brien v. Comm'r*, 319 F.2d 532 (3d Cir. 1963) (affirming the decision of *O'Brien v. Commissioner*, 38 T.C. 707, 712 (1962), that, although deductible for tax purposes, the taxpayer's contingent attorney's fees must be included in his income).

16. See, e.g., *Drye v. United States*, 528 U.S. 49, 52 (1999) (holding that a taxpayer's interest as heir to an estate qualifies as property subject to the federal tax lien statute).

17. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(d), 110 Stat. 1755, 1838-39.

18. I.R.C. § 104(a)(2) (2000).

19. MSSP, *supra* note 3, at \*10.

20. *Id.* at \*3 (describing the purpose of the guide).

21. *Id.*

22. 263 F.2d 119 (5th Cir. 1959).

23. MSSP, *supra* note 3, at \*21.

The United States Tax Court has consistently ruled against the taxpayer on this issue, most recently with some disdain.<sup>24</sup> In fact, the Tax Court views the taxation of settlements and awards as black letter law according to the “common law” of taxation.<sup>25</sup>

### III. CURRENT TAXATION RULES

Settlement and award amounts received by individual taxpayers generally are classified into two distinct categories.<sup>26</sup> One category includes claims arising from a physical injury and the other category includes claims arising from a non-physical injury.<sup>27</sup> The damage claims from each of the two major categories will ordinarily include the following three groups:

- (1) Actual damages resulting from the physical or non-physical injury;
- (2) Emotional distress damages arising from the actual physical or non-physical injury; and
- (3) Punitive damages.<sup>28</sup>

#### A. *Taxable Damage Settlements or Awards*

##### 1. Non-physical Injuries

Damage awards included in gross income now include the following broad categories of non-physical injuries: contractual (lawsuits against insurance companies, finance companies, etc., for negligence, fraud, breach of contract), products liability, employment related, discrimination suits, and libel and defamation.<sup>29</sup>

24. Biehl v. Comm’r, 118 T.C. 467, 471 (2002) (the court stated:

This is yet another case in which a taxpayer who successfully prosecuted a wrongful termination claim against his former employer, obtaining a taxable recovery, has attempted to avoid treating as an itemized deduction from adjusted gross income the attorney’s fee paid to his attorney under their contingent fee agreement. It is clear under the jurisprudence of the Tax Court, and the Court of Appeals for the Ninth Circuit, to which this case would be appealable, that such a fee is not excluded from gross income under the “common law” of taxation.”).

25. *Id.* at 471 n.2 (citing several cases supporting the taxation of settlements and awards).

26. MSSP, *supra* note 3, at \*7–\*8.

27. MSSP, *supra* note 3, at \*7–\*8.

28. *Id.* at \*7–\*8.

29. *Id.* at \*11–\*15.

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Non-physical personal injury suits generally include claims for mental and emotional distress damages arising from the non-physical injury.<sup>30</sup> Areas that involve cases such as these include wrongful discharge, discrimination, and libel.<sup>31</sup> In the past, the IRS has challenged the taxpayer's allocation of settlement proceeds to compensatory damages for these types of distress based damages when the taxpayer's calculations did not accurately reflect the economics of the underlying claims.<sup>32</sup> The current version of the Code<sup>33</sup> clarifies that, excluding amounts recovered for emotional distress, damages received after August 20, 1996, are excludable only if they are received for physical injury or physical illness.<sup>34</sup>

Punitive damages have a long history of inconsistent treatment by the IRS and the various federal courts.<sup>35</sup> However, the 1996 amendments conclusively mandated that punitive damages are not excludable from gross income, regardless of the nature of the underlying claim.<sup>36</sup>

## 2. Accrual of Interest Income

In *Francisco v. United States*, the 3rd Circuit Court held that prejudgment interest allocable to the receipt of damages for personal injury is subject to income tax.<sup>37</sup> The IRS clearly echoes this conclusion on multiple occasions in their audit guide on this subject matter.<sup>38</sup> Interest income allocation is a factor for attorneys to consider in advising their clients about the client's responsibility to correctly report his taxable income.

### B. *Non-Taxable Damage Settlements or Awards*

#### 1. Personal Physical Injury

##### (a) Law Prior to 1996

The law prior to August 1996 was a patch quilt of litigation surrounding every aspect of the nature of the claim and the

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30. *Id.* at \*12.

31. *Id.*

32. *Id.*

33. I.R.C. § 104(a) (2000).

34. *See* MSSP, *supra* note 3, at \*12.

35. *Id.* at \*9–\*10 (setting forth various Revenue Rulings and cases).

36. *Id.* at \*10.

37. *Francisco v. United States*, 267 F.3d 303, 318 (3d Cir. 2001).

38. *See* MSSP, *supra* note 3, at \*20–\*21.

definitions of physical and non-physical injury.<sup>39</sup> Many cases focused on determining whether the claim at issue arose from a personal physical injury or something else.<sup>40</sup>

(b) Changes to the Law in 1996

Plaintiffs may exclude from gross income any damages they receive for personal physical injuries or physical sickness.<sup>41</sup> “Damages” are defined as any amount received through:

- (1) Prosecution of a lawsuit or court action based on tort or tort-type rights; or
- (2) a settlement agreement that the parties enter into as an alternative to trial litigation.<sup>42</sup>

However, the definition of damages does not include punitive damages, unless:

- (1) the punitive damages were awarded in a wrongful death case; and
- (2) the state law in effect on or before September 13, 1995, limited damages in wrongful death cases to punitive damages.<sup>43</sup>

The term “physical injury or physical sickness” includes emotional distress resulting from the occurrence giving rise to the damages.<sup>44</sup> Plaintiffs, therefore, may exclude from gross income damages awarded for emotional distress arising from physical injury.<sup>45</sup> Plaintiffs who recover damages for non-

39. *Id.* at \*3.

40. *Id.*; see also *Galligan v. Comm’r*, 66 T.C.M. (CCH) 1669 (1993) (holding that the existence of agreements containing releases of undisclosed or partial claims is not sufficient evidence that amounts paid qualify as personal injury for § 104(a)(2) exclusion); *P & X Markets, Inc. v. Comm’r*, 106 T.C. 441 (1996) (holding that corporations cannot be personally injured and are therefore not eligible for 104(a)(2) exclusions).

41. I.R.C. § 104(a)(2) (2000).

42. Treas. Reg. § 1.104-1(c) (as amended in 1970).

43. I.R.C. § 104(a)(2), (c).

44. I.R.C. § 104(a) (providing, in part, an exclusion for “the amount of any damages . . . received . . . on account of personal physical injuries or physical sickness”); see also *MSSP*, *supra* note 3, at \*8.

45. Douglas A. Kahn, *The Constitutionality of Taxing Compensatory Damages for Mental Distress When There Was No Accompanying Physical Injury*, 4 FLA. TAX REV. 128, 129 (1999).



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physical injury, however, are still permitted to exclude from gross income damage payments based on the actual “out of pocket” medical expenses that are attributable to emotional distress, provided the payments do not exceed the expense amount.<sup>46</sup>

*C. Deduction Attributable to Payment of Contingent Legal Fees*

1. Allocation of Legal Expenses to Exempt Income

Individuals, as cash basis taxpayers, may deduct attorneys’ fees in the year they are paid, assuming the attorneys’ fees otherwise qualify as a deductible expense under some other provision of the Code.<sup>47</sup> In the majority of cases, attorneys’ fees are paid pursuant to a contingent fee arrangement once damages have been recovered.<sup>48</sup> Where the ultimate recovery is excludable from gross income, either in whole or in part, the payment of contingent attorneys’ fees allocable to exempt income is not deductible.<sup>49</sup> No deduction is permitted for legal fees properly allocable to non-taxable awards or settlements.<sup>50</sup>

2. Self-Employed Individuals

Except in rare cases, such as a compensatory recovery of self-employment income, (for example, commissions that are reported on Schedule C) or a recovery of capital gain income, legal fees will be a Schedule A miscellaneous itemized deduction, subject to the 2 percent floor and Alternative Minimum Tax.<sup>51</sup> A recent Tax Court case carved out an exception to the general rule of taxability and held adversely to the IRS.<sup>52</sup> The Tax Court ruled that a self-employed individual could deduct legal fees

46. Merritt A. Gardner, *Florida Civil Practice Damages: Tax Aspects of Damage Awards*, FLA. B. § 14.8 (2000).

47. I.R.C. §§ 62(a)(1), 63(d) (2000); *see also* Ira B. Shepard & Martin J. McMahon, *Recent Developments in Federal Income Taxation: The Year 2001*, 51 FLA. TAX REV. 627, 690 (2002).

48. *See* W. Kent Davis, *The International View of Attorney Fees in Civil Suits: Why is the United States the “Odd Man Out” in How it Pays its Lawyers?*, 16 ARIZ. J. INT’L & COMP. L. 361 (1999) (noting how common contingent fee arrangements have become); Ted Scheyer, *Contingency Fee Financing of Litigation in America*, 47 DEPAUL L. REV. 371, 371 (1998) (noting that close to half of all tort cases are taken on a contingency fee basis).

49. *Church v. Comm’r*, 80 T.C. 1104, 1110–11 (1983); I.R.C. § 265(a)(1).

50. *Id.*

51. *Guill v. Comm’r*, 112 T.C. 325, 327–29 (1999). This, of course, assumes that the lawsuit proceeds have been fully included in the taxpayer’s gross income.

52. *See id.* at 331–32.

allocable to the recovery of punitive damages on Schedule C, Form 1040, Individual Income Tax Return, rather than as a miscellaneous itemized deduction on Schedule A.<sup>53</sup> As a consequence, the court held that the punitive damages recovered by the taxpayer were Schedule C income.<sup>54</sup>

### 3. Miscellaneous Itemized Deductions

The question of whether the contingent legal fee paid to an attorney is included in the gross income of an individual taxpayer/plaintiff is important since inclusion in gross income allows the deductibility of the legal fee as an itemized deduction.<sup>55</sup> If contingent legal fees are included in the plaintiff's gross income, a trade or business miscellaneous itemized deduction is permitted for the amount of the legal fee,<sup>56</sup> either as an ordinary and necessary expense of a trade or business<sup>57</sup> or as an ordinary and necessary expense for the production of income.<sup>58</sup> Determining if the deduction applies requires the use of the "origin of the claim" test.<sup>59</sup>

The inclusion in gross income of the contingent legal fee and the deduction as an itemized deduction triggers various limitations that may operate to reduce the benefit provided to the individual by deducting the contingent legal fee.

#### (a) Subject to 2% Floor

The first limitation imposed on deductibility of contingent legal fees, for regular tax purposes, is on all miscellaneous deductions.<sup>60</sup> Section 67(a) states that "the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income."<sup>61</sup>

53. *Id.* at 327, 332.

54. *Id.* at 328, 332.

55. *Alexander v. IRS*, 72 F.3d 938, 944 (1st Cir. 1995).

56. *See id.*

57. I.R.C. § 162(a) (2000); *Guill v. Comm'r*, 112 T.C. 325, 328 (1999).

58. I.R.C. § 212 (2000).

59. *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *see also* Edward J. Schnee & Nancy J. Stara, *The Origin of the Claim Test: A Search for Objectivity*, 13 AKRON TAX J. 97, 97 (1997) (discussing the origin of the claim test).

60. I.R.C. § 67 (2000).

61. § 67(a).

(b) Subject to Overall Phase-out of Itemized Deductions

The second limitation imposed on the deduction of contingent legal fees is the limitation imposed on high income taxpayers that reduces the total amount of itemized deductions allowed.<sup>62</sup> The overall limitation on itemized deduction depends on the amount of adjusted gross income and the total amount of the itemized deductions.<sup>63</sup> The overall limitation may never exceed 80% of the amount of the itemized deduction otherwise allowable for the taxable year.<sup>64</sup>

*D. Alternative Minimum Tax Impact*

The Alternative Minimum Tax ("AMT") was "enacted to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."<sup>65</sup> Although the AMT has been successful in preventing tax abuse, it has also affected unintended victims.<sup>66</sup>

The AMT has great impact on taxpayers attempting to deduct contingent legal fees paid directly to the attorney as an itemized deduction.<sup>67</sup> The AMT may also operate to reduce the valuation of any deduction of contingent legal fees by the plaintiff/taxpayer.<sup>68</sup>

It is unfortunate that the taxation to a plaintiff of contingent legal fees, combined with the application of the AMT, sometimes converts a pre-tax profit into a net after-tax loss.<sup>69</sup> The AMT is often criticized for its inequities. As the 7th Circuit noted, "in taxation's Garden of Eden, it would indeed be difficult to think of a reason why [plaintiff] 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."<sup>70</sup> Unfortunately, the AMT is not designed to reach this

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62. § 68 (2000).

63. § 68(a).

64. § 68(a)(2).

65. *Alexander v. I.R.S.*, 72 F.3d 938, 947 (1st Cir. 1995) (quoting S. REP. NO. 99-313, at 518 (1986)).

66. *Id.* at 946 (stating the AMT can result in "gross injustice").

67. *Id.*

68. I.R.C. § 56(b)(1)(A)(i)(2000).

69. *See Sinyard v. Comm'r*, 268 F.3d 756, 760 (9th Cir. 2001), *cert. denied*, 122 S. Ct. 2357 (2002).

70. *Kenseth v. Comm'r*, 259 F.3d 881, 884 (7th Cir. 2001).

more equitable result.

In the appeal opinion of *Sinyard v. Commissioner*, the Ninth Circuit Court held,

[t]he tax impact of the attorneys' fees arises from the Alternative Minimum Tax. Without its limitation, the attorneys' fees would be income to the [plaintiff], and the income would be wiped out by deduction of the total received. . . . 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.<sup>71</sup>

The courts that have spoken on the issue have generally expressed sympathy for the taxpayer, but they steadfastly believe the creation of a solution is entirely the duty of Congress, not the federal court system.<sup>72</sup>

#### E. *Illustrating Example of Individual Taxpayer Whipsaw*

An illustrating example may help to clarify the taxpayer's predicament upon winning an award or negotiating a settlement. The Tax Court Memorandum decision in *Griffin v. Commissioner* included a stipulation by both parties that the contingent legal fee paid according to the legal fee agreement was \$2,519,000.00.<sup>73</sup> The gross value of the settlement was \$4,997,895.70.<sup>74</sup> Calculating the tax using 2001 tax rates<sup>75</sup> and married filing joint status, two very different results occur hinging on whether the taxpayer recognizes income for the amount paid directly to the attorneys.<sup>76</sup> Ignoring any other income or deductions of the taxpayer in the sample calculations, gross proceeds from the settlement yields \$4,997,895.70, and a miscellaneous itemized

71. *Id.* at 759.

72. *See, e.g., Kenseth*, 259 F.3d at 885; *see also* James Serven, *Update to "The Federal Income Tax Treatment of Contingent Legal Fees in Personal Injury Cases"*, 31 COLO. LAW. 77, 77 (2002) (expressing that a solution to this issue must come from Congress, especially because of the split among the circuits).

73. *Griffin v. Comm'r*, 81 T.C.M. (CCH) 972, 978 n.4 (2001).

74. *Id.* at 975.

75. I.R.C. § 1(a)(2000); *see also* Colonel Parker, *TJGSA Practice Notes*, 2001-DEC ARMY LAW. 13, 26-27 (2000).

76. The calculations are based generally on the *Griffin* case.

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deduction for the contingent legal fees paid of \$2,519,000.00.<sup>77</sup> Because of the high income taxpayer situation, there is the loss of all personal exemption deduction amounts, a loss of miscellaneous itemized deductions due to the 2% limitation of \$99,958.00, and a phase-out of itemized deductions to the extent of \$66,475.<sup>78</sup> Therefore, taxable income under this method is \$2,724,802.00. Regular tax on taxable income is \$1,037,440.00 and the AMT is \$358,471.00, for total tax due of \$1,395,911.00.

Calculating the tax based on the scenario of excluding the contingent legal fee paid directly to the attorney from the plaintiff's gross income results in \$2,478,896.00 (\$4,997,896.00 gross proceeds, less \$2,519,000.00 paid in contingent legal fees) of gross income to the plaintiff/taxpayer.<sup>79</sup> Again, the taxpayer receives no benefit for personal exemptions, and, after a standard deduction of \$7,600.00, taxable income of \$2,471,296.00.<sup>80</sup> The taxpayer is not subject to AMT because there is no miscellaneous itemized deduction of the contingent attorney fee.<sup>81</sup> As a result, the only tax due is regular income tax in the amount of \$938,320.00. The taxpayer realizes a considerable savings in tax of more than \$400,000.00 by not having to recognize gross income on the attorney's share of the proceeds from an award or settlement involving contingent legal fee arrangements.<sup>82</sup>

The tax calculations may be summarized as a comparison of whether the plaintiff is taxed on the gross amount of the award or settlement received, versus taxation on the net amount of proceeds, after reducing the gross recovery amount for the amount of contingent legal fees paid.

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77. *Griffin*, 81 T.C.M. at 975, 978 n.4.

78. I.R.C. § 151(d)(3) (2000) (eliminating the deductions for personal exemptions on income over \$150,000 for a joint return and \$100,000 for an individual); I.R.C. § 67(a) (2000) (allowing miscellaneous deductions "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income"); *see also* Parker, *supra* note 75, at 27.

79. *Griffin*, 81 T.C.M. at 975, 978 (calculating similar computations regarding contingent legal fees).

80. *See supra* note 78 and accompanying text.

81. I.R.C. § 56(b)(1)(A)(i) (2000).

82. *See Griffin*, 81 T.C.M. at 977-78 (explaining that \$2,519,000 of the total \$4,997,895.70 disbursed in connection with petitioner's interest is not includable in gross income).

The comparison of the calculation is summarized as:

	<u>Tax on Gross Recovery</u>	<u>Tax on Net Recovery</u>
Adjusted Gross Income	\$4,997,896.00	\$2,478,896.00
Itemized or Standard Deduction	<2,273,094.00>	<7,600.00>
Exemptions	-0-	-0-
Taxable Income	2,724,802.00	2,471,296.00
Regular Tax	1,037,440.00	938,320.00
Alternative Minimum Tax	<u>358,471.00</u>	<u>-0-</u>
Total Tax Due	<u>\$1,395,911.00</u>	<u>\$938,320.00</u>

The taxpayer in our example pays an additional tax of \$457,591.00 when the attorney fee is included as gross income to the taxpayer and a miscellaneous itemized deduction is allowed for the actual payment to the attorneys. This difference in tax cannot be ignored. One can easily understand the taxpayers' struggle with the tax concepts in this area and continued legal challenges in the Circuit Courts of Appeals where plaintiffs are not permitted to exclude any contingent attorney fees from their gross income.

Though the current results are often harsh, recent changes in the law offer some relief to taxpayers. Starting in 2006, the limit on itemized deductions will be phased out.<sup>83</sup> Beginning in tax years after December 31, 2005, the limit on itemized deductions for high income taxpayers will be phased-out until it is fully repealed after 2009.<sup>84</sup>

#### IV. FEDERAL COURT DECISION ANALYSIS

##### *A. Survey of Inconsistent Conclusions in Federal Court*

Several recent cases have considered whether plaintiffs can avoid taxes by not including in their gross income contingent fees paid to their lawyers. The Fifth, Sixth and Eleventh Circuits

83. Scott E. Vincent, *Tax "Relief" Act of 2001? You Be the Judge*, 57 J. Mo. B. 195, 196 (2001) (explaining that "[f]or tax years starting in 2006 and 2007, the overall limitation on itemized deductions will be reduced by one-third").

84. Economic Growth and Tax Relief Reconciliation Act of 2001, 26 U.S.C. §§ 68(f), (g) (2000).

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have permitted exclusion of contingent legal fees from gross income, while the Fourth, Ninth and Federal Circuits, as well as the U. S. Tax Court, have rejected the various arguments supporting gross income exclusion.<sup>85</sup> Some courts have looked to attorney lien statutes in states such as Texas, Alabama and Michigan to determine whether the attorney had a property right in the contingent fee portion of the award, thereby excluding that portion from the plaintiff's taxable recovery.<sup>86</sup>

A plaintiffs' residence appears to have a significant impact on whether they may prevail in a challenge to a court decision. According to the *Golsen* rule, Tax Court decisions arising in jurisdictions with a favorable ruling of a Circuit Court of Appeals are bound by the appeal court's decision.<sup>87</sup> The rule sets forth that the Tax Court is bound by the decisions and precedent of the Circuit Court of Appeals within its jurisdiction.<sup>88</sup>

The Tax Court reluctantly agreed to the exclusion from income of an attorney's fee in a case within the taxpayer-friendly Eleventh Circuit, grudgingly applying the *Golsen* rule.<sup>89</sup> The IRS intends to continue auditing taxpayers and fighting cases in circuit courts of appeals that favor taxpayers.<sup>90</sup> The IRS is not prepared to follow the court of appeals cases in any jurisdiction allowing the exclusion of contingent legal fees from taxpayer's gross income.<sup>91</sup>

The situation is ripe for a decision from the Supreme Court, although none may be forthcoming in the immediate future. The following is a brief review of applicable cases in the various noted jurisdictions.

The Third Circuit is an unfavorable jurisdiction to the taxpayer. In the case of *Walter O'Brien v. Commissioner*, the court held that the plaintiff must pay tax on the attorney fee

85. William H. Baker, *Contingent Fee Agreements & Tax Liability: An Opportunity for Change*, 42 SANTA CLARA L. REV. 757, 761-62 (2002).

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

87. *Golsen v. Comm'r*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

88. *Id.* at 757 n.16 (applying I.R.C. § 7482(a) (2000)).

89. *Griffin v. Comm'r*, 81 T.C.M. (CCH) 972, 978 (2001) (observing "we hold for petitioner on this issue in accord with the holding of the Court of Appeals to which appeal of our decision would lie. Our longstanding practice, founded in *Golsen* . . . is to follow the holding of a Court of Appeals where the facts are squarely on point"); *Golsen*, 54 T.C. at 756-57.

90. See MSSP, *supra* note 3, at \*20 (stating "[a]n action on Decision in the *Cotnam* case [where the contingent fee was not excluded] states that the Service will not follow the court's ruling in future cases").

91. *Id.*

portion of an award.<sup>92</sup> The court found that it did not make a difference in the result where an attorney had a lien on the award, according to applicable Pennsylvania state law.<sup>93</sup> The court also reasoned that the fact the plaintiff made an irrevocable assignment of a portion of his right to any further recovery did not change their holding either.<sup>94</sup>

In a related cause of action, the Third Circuit Court of Appeals held that prejudgment interest for personal injury is subject to income tax in the case of *Francisco v. United States*.<sup>95</sup> The IRS clearly echoes this conclusion in their audit guide on this subject matter.<sup>96</sup>

The Fourth Circuit is also unfavorable to the taxpayer on this issue. In *Young v. Commissioner*, the court reviewed North Carolina common law provisions granting an attorney a “charging lien” that attaches only to the plaintiff’s judgment, and not the plaintiff’s cause of action.<sup>97</sup> The determination of the court resulted in the plaintiff including in gross income the gross amount received, including \$300,000.00 paid to her attorney as a contingent legal fee.<sup>98</sup>

The court said to exclude the amount of the contingency legal fee from income was to accept the argument that paying an attorney a contingency fee instead of a hourly rate could avoid the imposition of income tax on the amount received.<sup>99</sup> The implication was that such a result would violate tax neutrality principles.<sup>100</sup> Tax neutrality requires that the form of the income or transaction should not dictate how that item is ultimately taxed.<sup>101</sup> The court viewed the transaction as tax neutral, holding:

92. O’Brien v. Comm’r, 38 T.C. 707, 710–11 (1962), *aff’d*, 319 F.2d 532 (3d Cir. 1963).

93. *Id.* at 712.

94. *Id.* (expressing 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 . . .”).

95. 267 F.3d 303, 318 (3d Cir. 2001).

96. MSSP, *supra* note 3, at \*9 (stating “[a]ny interest associated with an award or settlement is always taxable”).

97. *Young v. Comm’r*, 240 F.3d 369, 379 (4th Cir. 2001).

98. *Id.* at 379.

99. *Id.* at 377–78 (proclaiming that the court wanted to avoid the tax design using a payment method to avoid taxation, a “danger the Supreme Court warned against”).

100. *See id.* (implying that an individual who has a contingent fee arrangement should not “receive preferential tax treatment” over an individual who has an hourly basis arrangement); *see also* F. Philip Manns, Jr., *Internal Revenue Code Section 162(F): When Does the Payment of Damages to a Government Punish the Payor?*, 13 VA. TAX REV. 271, 276–77 (1993) (discussing the “public policy disallowance of income tax deductions”).

101. *Srivastava v. Comm’r*, 220 F.3d 353, 357 (5th Cir. 2000) (applying tax



[i]f her attorneys charged an hourly rate, [the plaintiff] would certainly have to include within her gross income any income used to pay her legal fees, whether the income came from the settlement proceeds or otherwise. We see no reason to allow her to escape the 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.<sup>102</sup>

The *Young* court concluded in its opinion that federal law, not state law, decides whether an attorney has a property right or interest in the cause of action of the plaintiff.<sup>103</sup> The court reasoned, “[u]ntil judgment, or in this case settlement, the attorney has the right to recover fees for services rendered, but not to obtain a share of the income produced by the client’s claim.”<sup>104</sup>

Unfortunately, the deduction was of limited value to the taxpayer because, ultimately, *Young* had to include the \$300,606 attorney’s fee in gross income.<sup>105</sup>

Unlike the Fourth Circuit, the Fifth Circuit is favorable to the taxpayer on this issue. In the seminal case of *Cotnam v. Commissioner*, it was determined that Alabama law grants a property interest to attorneys in their client’s cause of action.<sup>106</sup> Alabama law gives attorneys similar rights and powers to those a client has to enforce a lien on proceeds of a settlement or award.<sup>107</sup> According to the facts of the case, the taxpayer entered into a contingent fee arrangement to pay her attorney forty percent of any amount recovered on a claim prosecuted on her behalf.<sup>108</sup>

The court decided the decedent’s care-giver, Mrs. Cotnam, could exclude from gross income the portion of the probate award that was paid to her attorneys after the successful prosecution of her claim.<sup>109</sup> Because Mrs. Cotnam never had a right to the

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neutrality principles to awards and settlements).

102. *Young*, 240 F.3d at 377–78.

103. *Id.* at 378.

104. *Id.* at 379.

105. *Id.* at 378; see also *Alexander v. I.R.S.*, 72 F.3d 938, 946 (1st Cir. 1995) (noting that Section 56(b)(1)(A)(i) precludes deducting legal fees when computing AMT).

106. See *Cotnam v. Comm’r*, 263 F.2d 119, 125 (5th Cir. 1959).

107. *Id.* at 125; ALA. CODE § 34-3-61(b) (Supp. 2002).

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

109. *Id.*

attorney contingent legal fee, she was taxed on the net amount received, and not “unjustly” taxed on the attorney’s portion.<sup>110</sup>

The *Cotnam* court also noted that the value of the lawsuit to the plaintiff was entirely speculative and dependent on the attorney’s services.<sup>111</sup> Apparently, the taxpayer’s claim was initially worth little and the attorney who prosecuted the claim added significant value.<sup>112</sup>

In the case of *Srivastava v. Commissioner*, Texas common law was deemed to give a lawyer a property interest in the plaintiff’s cause of action.<sup>113</sup> The court followed its own precedent, holding that a plaintiff in a defamation suit recovering a settlement of \$8,500,000.00 may exclude \$3,000,000.00 in attorney fees from income.<sup>114</sup>

The *Srivastava* court noted that it was inclined to rule that the tax treatment should be neutral between a contingent fee and an hourly fee.<sup>115</sup> The court declined to apply principles of tax neutrality in favor of deciding consistently with its decision in *Cotnam*, since the facts in the cases were indistinguishable.<sup>116</sup> The court reversed the Tax Court and held that a contingent legal fee arrangement, under Texas law, caused the fees to be excluded from the plaintiff’s taxable income.<sup>117</sup>

The Sixth Circuit is also favorable to the taxpayer on this issue. In the case of *Estate of Clarks v. United States*, the court of appeals applied Michigan lien law that was similar to Alabama’s, thereby permitting an attorney an enforceable lien against the recovery of any amounts by the plaintiff.<sup>118</sup> The estate sought to exclude from its gross income the amount of interest income accrued on a personal injury settlement.<sup>119</sup> The interest income was paid directly to the attorney, in partial settlement of the attorney’s contingent legal fee for winning the appeal from the district court.<sup>120</sup>

110. *Id.* at 126.

111. *Id.* at 125.

112. *See id.* at 125–26 (explaining the only way the taxpayer’s claim could be of use was to transfer a part interest in it to an attorney who then provided the services necessary to bring out its value).

113. *Srivastava v. Comm’r*, 220 F.3d 353, 360 (5th Cir. 2000) (utilizing the assignment of income doctrine).

114. *Id.* at 355 (following *Cotnam v. Comm’r*, 263 F.2d 119 (5th Cir. 1959)).

115. *Id.* at 357.

116. *Id.* at 357–58.

117. *Id.* at 355.

118. *Estate of Clarks v. United States*, 202 F.3d 854, 856 (6th Cir. 2000).

119. *Id.* at 855.

120. *Id.*

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The Court of Appeals for the Sixth Circuit believed that the assignment of income doctrine did not apply, because the Michigan attorney lien statute permits a special kind of lien to attach, and “[a]lthough the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer’s portion of the judgment.”<sup>121</sup>

The court of appeals acknowledged the conflict between the Fifth Circuit decision in *Cotnam*, which is favorable to taxpayers, and that of the Federal Court of Appeals in *Baylin v. Commissioner*, which is unfavorable to taxpayers, in holding that the value of a contingent fee type cause of action is “entirely speculative and dependent on the services of counsel.”<sup>122</sup> According to the court, the taxpayer could hardly have made an assignment of income to his attorney if the claim assigned under a contingent legal fee arrangement had little or no value prior to conclusion by settlement or judgment award.<sup>123</sup> The court of appeals also reasoned that the taxpayer had neither earned nor received the money, but rather it was earned by the attorney as a result of his own personal skill and judgment.<sup>124</sup> The plaintiff was permitted to exclude the attorney fee portion of the award from taxable income and was taxed only on the net amount received.<sup>125</sup>

The Seventh Circuit is unfavorable to the taxpayer on this issue. In *Kenseth v. Commissioner*, the court held that, regardless of Wisconsin attorney lien law, a plaintiff may not exclude a contingent legal fee payment from income arising from an age discrimination suit against a former employer.<sup>126</sup> The appeal was from a U.S. Tax Court opinion in which a majority of judges specifically rejected deciding the case through the application of state attorney lien law.<sup>127</sup>

The case was one of first impression for the Seventh Circuit. The court embraced the Tax Court’s position, ruling against the taxpayer’s attempt to exclude the contingent legal fee from his gross income.<sup>128</sup> The court reasoned that state law also “does not make the contingent fee lawyer a joint owner of his client’s claim in the legal sense.”<sup>129</sup> By having a lien, the lawyer has a security

121. *Id.* at 856.

122. *Id.* at 856–57.

123. *Id.* at 857.

124. *Id.* at 858.

125. *Id.*

126. *Kenseth v. Comm’r*, 259 F.3d 881 (7th Cir. 2001).

127. *Kenseth v. Comm’r*, 114 T.C. 399, 412 (2000), *aff’d*, 259 F.3d 881 (7th Cir. 2001).

128. *Kenseth*, 259 F.3d at 883.

129. *Id.* at 883.

interest.<sup>130</sup> However, according to the court, “ownership of a security interest is not ownership of the security.”<sup>131</sup> The contingent-fee arrangement is not considered an assignment and Wisconsin attorney lien law prohibits a lawyer from “acquiring ownership of his client’s claim.”<sup>132</sup>

The *Kenseth* court relied on the assignment of income doctrine to prevent the plaintiff from excluding from gross income the attorney’s contingent fee portion of his award, reasoning that the plaintiff/taxpayer retained sufficient control over the transferred income to justify holding him liable for taxes on the income.<sup>133</sup>

The Ninth Circuit is also unfavorable to the taxpayer on this issue. In *Sinyard v. Commissioner*, the court of appeals decided that a plaintiff in an age discrimination suit is taxable on attorney fees regardless of how they were paid to the attorney.<sup>134</sup> The court concluded, consistent with *Benci-Woodward v. Commissioner*,<sup>135</sup> that the plaintiff was obligated to pay the attorney, and when defendant paid the attorney directly, the plaintiff was thus enriched.<sup>136</sup> According to the court in *Sinyard*, “[i]f A owes B a debt, and C pays the debt on A’s behalf, it is elementary that C’s payment is income to A as well as to B.”<sup>137</sup> Therefore, the court held that plaintiff had constructive receipt of income paid directly to attorney by defendant.<sup>138</sup>

The *Sinyard* case also attempted to seek the benefits of Alabama lien law as the plaintiff in the *Cotnam* case did.<sup>139</sup> In *Sinyard*, the taxpayer claimed residence in Alabama during the period in which the contract with the law firm was made.<sup>140</sup> The court did not dispute the Fifth Circuit’s statement of Alabama state law, but refused to follow its result or the holding of *Cotnam*, and instead decided to affirm the Tax Court’s decision.<sup>141</sup>

Another Ninth Circuit Court of Appeals decision is *Coady v. Commissioner*.<sup>142</sup> In that case, Mrs. Coady secured a judgment

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130. *Id.*

131. *Id.*

132. *Id.* at 884.

133. *Id.*

134. *Sinyard v. Comm’r*, 268 F.3d 756, 759 (9th Cir. 2001).

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

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

137. *Sinyard*, 268 F.3d at 758.

138. *Id.* at 758–59.

139. *Id.*; see also *Cotnam v. Comm’r*, 263 F.2d 119, 125 (5th Cir. 1959).

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

141. *Id.* at 760.

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

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for lost wages and benefits arising out of her wrongful termination.<sup>143</sup> She attempted to report part of the award as self-employment income, with a deduction for attorney fees, but later agreed at trial in the Tax Court that all amounts were wages.<sup>144</sup> In *Coady*, the Court distinguished state lien law in Michigan and Alabama from the law in Alaska.<sup>145</sup>

The court recognized that Alaska state law permits an attorney's lien to attach to property belonging to the client.<sup>146</sup> Alaska law, however, does not create any superior lien or ownership interest in the plaintiff's cause of action for the attorney.<sup>147</sup> Nor does Alaska law "confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients."<sup>148</sup> The court concluded that the taxpayer retained all proprietary rights in the claim and simply used a portion of the award on receipt to discharge her personal liability to her attorney.<sup>149</sup>

The court emphasized that the assignment of income doctrine requires the inclusion of a contingent attorney fee, contrary to the taxpayer's argument that an effective assignment of income had been made.<sup>150</sup> The court concluded that the plaintiff's entire award, including the attorney's contingency fee, was includible in the plaintiff's gross income, and the attorney's fee and litigation costs were deductible as a miscellaneous itemized deduction, subject to the floor limit and phase out provisions.<sup>151</sup> The end result of this decision was that the plaintiff was required to pay an asserted tax deficiency of an additional federal income tax amount of \$49,531, plus interest, on the award paid.<sup>152</sup>

One of the Ninth Circuit's more recent decisions is *Benci-Woodward v. Commissioner*.<sup>153</sup> In *Benci*, the court reviewed California law and decided that it gives an attorney a "lien" on any recovery of plaintiff in a personal injury cause of action.<sup>154</sup>

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143. *Id.* at 1187.

144. *Id.* at 1188.

145. *Id.* at 1189–1190.

146. *Id.* at 1190 (citing ALASKA STAT. § 34.35.430 (Michie 2002)).

147. *Coady*, 213 F.3d at 1190.

148. *Id.*

149. *Id.* at 1191.

150. *Id.*; see also *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930); *Cotnam v. Comm'r*, 263 F.2d 119, 125–26 (5th Cir. 1959).

151. *Coady*, 213 F.3d. at 1188, & n.2, 1191.

152. *Id.*

153. 219 F.3d 941 (9th Cir. 2000).

154. *Id.* at 943.

However, the court said California law's "lien" is "no more than a security interest in the proceeds of the litigation."<sup>155</sup> Therefore, the entire amount received was taxable to the plaintiff because California law states that an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right or power over the judgments or decrees of their clients.<sup>156</sup> The Court apparently followed its prior decision in *Coady*, holding that in a contingent fee arrangement governed by California's attorney lien law, the entire damage award must be included in the plaintiff's income.<sup>157</sup>

The taxpayer also attempted to persuade the court that the attorney fee portion was not subject to disallowance as a result of the application of the AMT.<sup>158</sup> The *Benci-Woodward* court disagreed, citing the plain language of the statute governing the AMT and stating the application of the law was "crystal clear."<sup>159</sup> This allowed the plaintiff a miscellaneous itemized deduction for the contingent attorney fee portion of the total amount received and subjected the deduction to the whipsaw of limited deduction, phase-out of deduction and the AMT.<sup>160</sup>

Finally, in *Fredrickson v. Commissioner*, the plaintiff was entitled to only a miscellaneous itemized deduction for the attorney fee portion of an award and was required to include the entire amount of the award in gross income.<sup>161</sup> The Ninth Circuit Court of Appeals again concluded that the plaintiff received a benefit from the portion of the award that went to the attorney directly because the payment discharged the plaintiff's obligation to the attorney.<sup>162</sup>

The Tenth Circuit is unfavorable to taxpayers on this issue. In the case of *Hukkanen-Campbell v. Commissioner*, the plaintiff's attorney retained approximately \$73,000.00 paid jointly to plaintiff and her attorney in a sexual harassment suit.<sup>163</sup> Missouri law provides for an attorney non-priority lien, rather than an ownership interest in the judgment of the plaintiff.<sup>164</sup> The court held that, unlike in the Fifth Circuit case

155. *Id.* (quoting *Isrin v. Superior Court*, 403 P.2d 728, 732 (Cal. 1965)).

156. *Id.*

157. *Id.*

158. *Id.* at 943.

159. *Id.* at 944.

160. *Id.* at 943-44.

161. *Fredrickson v. Comm'r*, 166 F.3d 342 (9th Cir. 1998).

162. *Id.*

163. *Hukkanen-Campbell v. Comm'r*, 274 F.3d 1312, 1313 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002).

164. *Id.* at 1313.

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of *Srivastava, Cotnam* was not controlling under the facts of the instant case.<sup>165</sup>

The Eleventh Circuit is favorable to taxpayer on this issue. In support of the Fifth Circuit's decision, the court decided *Davis v. Commissioner*.<sup>166</sup> The court rejected the IRS' argument that the contingent legal fee should be income in the year of the judgment because the value of the contingent legal fee was unknown when the fee agreement was made.<sup>167</sup> The court allowed the IRS to tax the plaintiff only on the net amount of the damage recovery, after excluding the amount paid directly as contingent attorneys' fees.<sup>168</sup>

In the case of *Foster v. United States*, the District Court approved the dismissal, without prejudice, of the plaintiffs cause of action after amicable settlement of all claims and counter-claims in the case.<sup>169</sup> According to the Eleventh Circuit Court, this Alabama case followed the decision in *Cotnam* concerning taxation of contingent legal fees.<sup>170</sup> Under the District Court decision, the plaintiff was incorrectly taxed on post-judgment interest that the attorney retained as compensation for representation at the appellate level.<sup>171</sup> Again, it is worth noting that the IRS and courts have held that prejudgment interest for personal injury is subject to inclusion in gross income.<sup>172</sup>

The Federal Circuit is unfavorable to taxpayers on this issue. In *Baylin v. Commissioner*, the attorney had a statutory lien against the plaintiff's recovery.<sup>173</sup> The attorney received a contingency fee directly from the court in a condemnation proceeding.<sup>174</sup> The contingent attorney fees were not excludable from income of the plaintiff.<sup>175</sup> The court noted the taxpayer received the benefit of the proceeds, even though he did not take possession of the funds.<sup>176</sup>

The assignment of income doctrine requires that the plaintiff be taxed on the entire amount of the award, even if an attorney

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165. *Id.*

166. 210 F.3d 1346, 1348 (11th Cir. 2000).

167. *Id.*

168. *Id.* at 1347-48.

169. *Foster v. United States*, No. CV 99-J-1838-S, 2001 U.S. Dist. LEXIS 17640 (N.D. Ala. 2001).

170. *Foster v. United States*, 249 F.3d 1275, 1280-81 (11th Cir. 2001).

171. *Id.* at 1279.

172. *Francisco v. United States*, 267 F.3d 303, 318 (3d Cir. 2001).

173. *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

174. *Id.* at 1454.

175. *See id.* at 1455.

176. *Id.* at 1454.

lien statute applies in a contingent fee arrangement.<sup>177</sup> The court ultimately reached the opposite result as in *Cotnam*.<sup>178</sup>

The U.S. Tax Court has consistently ruled unfavorably to taxpayers, including the cases of *Sinyard v. Commissioner*,<sup>179</sup> *Kenseth v. Commissioner*,<sup>180</sup> *Hukkanen-Campbell v. Commissioner*,<sup>181</sup> *Banaitis v. Commissioner*,<sup>182</sup> *Freeman v. Commissioner*,<sup>183</sup> and *Banks v. Commissioner*.<sup>184</sup> The only discussed case favorable to taxpayers, because of the *Golsen* rule, is *Griffin v. Commissioner*.<sup>185</sup>

## B. Taxpayer's Arguments

### 1. Property Rights of Attorneys in Plaintiff's Case

The most successful argument for the taxpayer seems to be referencing a property right created under applicable state law. The Fifth Circuit in *Cotnam*, and most recently in *Srivastava*, has accepted the state attorney lien law reasoning in finding for the taxpayer.<sup>186</sup> The Sixth Circuit in *Estate of Clarks*, and the Eleventh Circuit in *Davis* have also been persuaded by the logic of state law creating undefeatable property rights in the attorney's claim for contingent legal fees.<sup>187</sup>

However, the courts have frequently held against the taxpayer. The Third Circuit, in *O'Brien* and the Federal Circuit in *Baylin* determined that state attorney lien law made no difference to the outcome of their decisions.<sup>188</sup> In *Sinyard*, the Tax Court held that a case settled out of court does not create an attorney lien exempting proceeds from tax.<sup>189</sup> In *Kenseth*, the majority specifically rejected the argument advanced by the

177. See *id.* at 1455.

178. See *id.* at 1455.

179. 76 T.C.M. (CCH) 654 (1998).

180. 114 T.C. 399, 417 (2000).

181. 79 T.C.M. (CCH) 2122 (2000).

182. 83 T.C.M. (CCH) 1053 (2002).

183. 82 T.C. M. (CCH) 643 (2001).

184. 81 T.C. M. (CCH) 1219 (2001).

185. 81 T.C. M. (CCH) 972, 973 (2001).

186. *Srivastava v. Comm'r.*, 220 F.3d 353, 363 (5th Cir. 2000); *Cotnam v. Comm'r.*, 263 F.2d 119, 125 (5th Cir. 1959).

187. *Estate of Clark v. United States*, 202 F.3d 854, 858 (6th Cir. 2000); *Davis v. Comm'r.*, 210 F.3d 1346, 1347 (11th Cir. 2000).

188. *O'Brien v. Comm'r.*, 319 F.2d 532 (3d Cir. 1963) (affirming the decision of the tax court); *O'Brien v. Comm'r.*, 38 T.C. 707, 712 (1962); *Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995).

189. *Sinyard v. Comm'r.*, 268 F.3d 756, 760 (9th Cir. 2001).



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plaintiff that the case turns on the state attorney lien law.<sup>190</sup> The Tax Court in *Hukkanen-Campbell* held that Missouri attorney lien law is non-priority and, therefore, does not create a property right in the plaintiff's claim.<sup>191</sup>

The Ninth Circuit, in *Coady*, examined the Alaska state attorney lien law, but decided it did not give attorneys a superior lien or ownership interest in the client's claim.<sup>192</sup> The Ninth Circuit reached a similar result in *Benci-Woodward* after review of a California state attorney lien law.<sup>193</sup>

### C. IRS's Arguments

#### 1. Assignment of Income Doctrine

The IRS has used several arguments successfully against a taxpayer's desire to exclude contingent legal fees from income. The IRS's position treating the portion of an award or settlement paid to an attorney as income to the plaintiff is consistent with the "fruit of the tree" theory that income is taxable to the person who earns it and cannot be assigned to another.<sup>194</sup> According to this theory, the assignment of income doctrine mandates that a taxpayer has an includable and taxable event on the assignment of part of the settlement or award through the contingent legal fee arrangement.<sup>195</sup> The assignment of income doctrine continues to be applied by the U.S. Tax Court to cause the taxpayer to be taxed on the attorney's fee portion of the settlement or award.<sup>196</sup>

#### 2. Principal of Tax Neutrality

The IRS has successfully argued contingent legal fees should not be taxed any different than legal fees paid on an hourly basis.<sup>197</sup> To make such a distinction violates tax neutrality principles, as was discussed in the section of this paper surveying

190. *Kenseth v. Comm'r*, 259 F.3d 881, 883 (7th Cir. 2001).

191. *Hukkanen-Campbell v. Comm'r*, 79 T.C.M. (CCH) 2122, 2126 (2000).

192. *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000).

193. *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943 (9th Cir. 2000).

194. *Id.*; see Sarah Dods, Note and Comment, *Kochansky v. Comm'r: The Assignment of Income Doctrine, Community Property Law, and I.R.C. § 1041*, 72 WASH. L. REV. 873, 875 (1997) (explaining the metaphor as "the 'tree' represents income-producing property or a person, and the 'fruit' represents any income the 'tree' produces. Essentially, the doctrine requires that assignment of 'fruit' is not effective for tax purposes without a corresponding transfer of the 'tree' that produces it").

195. See Dods, *supra* note 194, at 875.

196. See, e.g., *Griffin v. Comm'r*, 81 T.C.M. (CCH) 972, 977 (2001).

197. *Kenseth v. Comm'r*, 259 F.3d 881, 884 (7th Cir. 2001).

the inconsistent conclusions reached in the federal courts.<sup>198</sup> The question of the timing and deductibility of attorneys' fees paid prior to resolution of the lawsuit on a non-contingent fee basis requires additional analysis that is outside the scope of this paper.

### 3. Tax Benefit Rule Applied to Plaintiffs

The tax benefit rule as applied to the payment of contingent legal fees holds that when the defendant pays the plaintiff's legal fees, the plaintiff has thereby received a benefit of considerable value and that the plaintiff should be taxed accordingly.<sup>199</sup>

### 4. Open Transaction Doctrine Interpretation of *Cotnam*

The IRS has attacked the decision in *Cotnam* in a variety of creative ways. One of the more recent was discussed in *Griffin v. Commissioner*, in which the IRS tried a different approach to overturning *Cotnam* and thwarting the plaintiff's attempt to avoid including in taxes the attorney's contingent legal fee portion of the amount received from a lawsuit.<sup>200</sup>

198. *Supra* Part. IV.

199. MSSP, *supra* note 3, at \*6.

200. *Griffin*, 81 T.C.M. at 977-78 (stating:

Respondent, [the IRS] however, raises a different theory here than the one that was decided in *Kenseth*. Respondent's primary argument is that *Cotnam* was wrongly decided by the Court of Appeals. If this Court decides that the *Cotnam* rationale was correct, then respondent argues that under the rationale of *Cotnam*, petitioner recognized gain on the initial transfer of his interest to his attorneys.

Respondent's alternative argument may be summarized as follows: (1) *Cotnam* holds "At the time that \* \* \*[the taxpayer] entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder." *Cotnam v. Comm'r*, 263 F.2d at 125. (2) Ordinarily the above-described transfer could result in income for the year of the transfer, depending on the transferor's basis, because legal services are received in exchange for the transfer. (3) In petitioner's case, 1990 was the year of transfer and 1994 the year of the recovery, but the open transaction doctrine causes the deferral of the gain to 1994 because the amount or value of the transfer was not determinable until the lawsuit settlement.

In a recent opinion, the Court of Appeals for the Eleventh Circuit followed the *Cotnam* holding that the contingent legal fees in Alabama are not includable in a taxpayer's gross income as part of the taxpayer's lawsuit recovery. *See, Davis v. Commissioner, supra*. In that case, the Court of Appeals considered respondent's above-described alternative argument and rejected it for lack of proof that the "values of the properties exchanged" were sufficiently "unascertainable" to bring the open transaction doctrine into play. *See id.* at 1348. Likewise, the evidence in this case is insufficient to reach the question of whether

D. *The Supreme Court Must Decide*

1. Question Presented

The issue is ripe for the U.S. Supreme Court to decide whether state attorney lien law controls the determination of the gross income inclusion under federal law.

The Supreme Court has spoken in this area before. It has held in the past that “although state law creates legal interests and rights in property, federal law determines whether and to what extent those interests will be taxed.”<sup>201</sup> A recent Supreme Court pronouncement may help to predict what the Court’s likely decision will be on its consideration of the issues associated with attorney contingent legal fee inclusion in income of the plaintiff and ultimate taxation.

2. Analogy to Inheritance Disclaimer Rules

In 1999, the Supreme Court decided the case of *Drye v. United States*.<sup>202</sup> In that case, Mr. Drye, the sole heir to his mother’s estate, owed the Federal Government some \$325,000.00 on unpaid assessments.<sup>203</sup> The IRS had valid tax liens against all of Mr. Drye’s property or right to property pursuant to the Internal Revenue Code.<sup>204</sup>

Mr. Drye attempted to defeat the IRS’s lien enforcement against his inheritance by disclaiming it under Arkansas law.<sup>205</sup> Under Arkansas law, such a disclaimer creates the legal fiction that the disclaimant predeceased the decedent.<sup>206</sup> Therefore, the *Drye* court rationalized, “consequently, the disclaimant’s share of the estate passes to the person next in line to receive that share.”<sup>207</sup> The Court further stated that “[t]he disavowing heir’s creditors, Arkansas law provides, may not reach property thus disclaimed.”<sup>208</sup> The Supreme Court ruled that a state disclaimer law, which applies retroactively and treats the disclaimant as having predeceased the decedent, does not defeat a federal tax

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respondent’s alternative theory would change the result.)

201. *United States v. Irvine*, 511 U.S. 224, 238 (1994); *Comm’r v. Estate of Bosch*, 387 U.S. 456, 464–65 (1967).

202. 528 U.S. 49 (1999).

203. *Id.* at 49.

204. I.R.C. § 6321 (2000).

205. *Drye*, 528 U.S. at 53.

206. *Id.*

207. *Id.* at 52.

208. *Id.* (citing ARK. CODE ANN. § 28-2-108 (Michie 1987)).

lien that has already attached to the disclaimant's property.<sup>209</sup> In *Drye*, the Court relied on prior precedent that reference to state law is required to initially determine the property rights of the taxpayer, but a federal court must then review federal law to determine how those interests or rights created shall be taxed.<sup>210</sup>

Therefore, the likely outcome of a Supreme Court review of a case in this area does not appear to be favorable to a plaintiff seeking exclusion of the portion of the proceeds payable to the attorney.

### E. Congress May Decide

#### 1. Change the Alternative Minimum Tax

In pointing out the odd result of a deduction being blocked by the AMT, the Court of Appeals for the Ninth Circuit stated the following in *Sinyard*:

[t]he tax impact of the attorneys' fees arises from the Alternative Minimum Tax. Without its 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.<sup>211</sup>

The Tax Court's recent pronouncement in *Biehl* is similar.

We acknowledge, as have courts in prior cases, that the result we reach today "smacks of

209. See *id.* at 52.

210. See *id.* at 52, 55 n.1. The Supreme Court noted the following:  
As restated in *National Bank of Commerce*: "The question whether a state-law right constitutes 'property' or 'rights to property' is a matter of federal law." 472 U.S., at 727, 105 S.Ct. 2919. We look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as "property" or "rights to property" within the compass of the federal tax lien legislation. C.f. *Morgan v. Commissioner*, 309 U.S. 78, 80, 60 S.Ct. 424, 84 L.Ed. 1035 (1940) ("State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.")

*Drye*, 528 U.S. at 58.

211. *Sinyard v. Comm'r*, 268 F.3d 756, 759 (9th Cir. 2001).

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injustice” because petitioners are, in effect, denied the benefit of a deduction for Mr. Biehl’s attorney’s fee. . . . However, the injustice is the direct result of the plain meaning and original intent of section 62(a), with its built-in disparity in treatment of Schedule C expenses and employee expenses, and the mechanical operation of the itemized deduction provisions of section 67 and 68 and the AMT provisions. Petitioners’ efforts to circumvent the business connection requirement built into section 62(a)(2)(A) and to avoid the restrictions on the deductibility of itemized deductions must fail. We conclude in this case, as we have in prior cases, that it is the job of Congress, if it should decide in its wisdom to do so, to cure the injustice.<sup>212</sup>

## 2. Change Taxation of Settlements and Awards to Exclude Legal Fees

Congress made major changes to the taxation of compensation for injuries and sickness in 1996.<sup>213</sup> The issue of inconsistent treatment among the circuit courts of appeal was probably also known to Congress at that time. Nevertheless, Congress chose not to address the issue in the reforms that were taken.

## V. INTERNAL REVENUE SERVICE ENFORCEMENT

IRS enforcement in the area of settlements and awards has increased lately because of the growing number of large verdicts and settlements that have escaped taxation. This circumstance is due to a lack of knowledge of the current law and its changes, as well as improper reporting of income to the plaintiff and the plaintiff’s attorney.<sup>214</sup>

### A. *How the IRS Targets People*

The IRS has increased its efforts to educate their auditors about how to find plaintiffs whose audits might uncover taxable damages being excluded from their income.<sup>215</sup> The IRS audit

212. Biehl v. Comm’r, 188 T.C. 467, 488 (2002) (citations omitted).

213. Small Business Job Protection Act of 1996, Pub. L. No. 104-188 § 1605(b), 26 U.S.C. § 104(a)(2) (2000).

214. See MSSP, *supra* note 3, at \*2–\*3 (announcing that “none of the [lawsuit verdicts and settlements] were reported on Forms 1099”).

215. See MSSP, *supra* note 3, at \*22.

guide suggests that the auditors comb through newspaper articles because "large punitive damage verdicts generally make headlines."<sup>216</sup> In order to pinpoint large punitive damages cases, the audit guide also recommends sifting through the thousands of civil court cases filed every year at local courthouses or by reviewing computerized data from state agencies that track all lawsuits in order to identify large awards.<sup>217</sup> Once all the data is collected, the audit guide suggests creating a list of all civil cases decided by juries with specific dollar amounts designated as compensatory and punitive.<sup>218</sup> The list could also be further sorted by geographic area.<sup>219</sup>

Plaintiff lawyers can easily see that if they are involved in widely publicized cases and very large settlements, there is a greater likelihood that the case may be targeted for examination by the IRS, rather than a single plaintiff lawsuit, which doesn't have fanfare or any press release from the attorney.

#### B. Market Segment Specialization Program Audit Technique Guide

The IRS' examination of news coverage of large verdicts and settlements in Alabama has prompted it to provide its auditors with information and techniques for the examination of taxpayers receiving the awards and settlements.<sup>220</sup>

#### C. Allocation of Damages Between Various Claims

The IRS is looking closely at how taxpayers are allocating damages among the various claims included in their lawsuit.<sup>221</sup> The IRS determined in their study of 1994 and 1995 tax returns that the taxpayers often classified the award or settlement as compensatory, usually for personal injuries.<sup>222</sup> The taxpayers were effectively relying on the Code's only provision to directly address the exclusion from income of award or settlement proceeds.<sup>223</sup> Section 104(a)(2) is most often relied upon by taxpayers and their lawyers in an attempt to avoid taxation of lawsuit proceeds.<sup>224</sup>

216. *Id.*

217. *See id.* at \*22-\*23 (summarizing courthouse research and computerized data research).

218. *Id.* at \*23.

219. *Id.*

220. MSSP, *supra* note 3, at \*2.

221. *See id.*

222. *See id.*

223. *See id.* at \*3.

224. I.R.C. § 104(a)(2) (2000); *see* Burnet R. Maybank et al., *Taxation of Damages*

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Congress amended section 104(a)(2) in 1996, to permit the exclusion from income of damages only for personal physical injuries.<sup>225</sup> The amended Internal Revenue Code section now explicitly provides that punitive damages received in connection with a case not involving “physical injury or physical sickness” are not excludable from gross income.<sup>226</sup>

Settlement agreements will most certainly be examined more closely upon review by the IRS. Plaintiff attorneys often include allegations of punitive damages in the original complaint petition, but the settlement agreement avoids characterizing any of the payment as related to those claims.<sup>227</sup> As a result, the IRS intends to examine the allocation of damages in out-of-court settlements where the parties have the same interest of allocating as much as possible to non-taxable damages.<sup>228</sup> To effectuate this, the IRS plans to scrutinize, if available, both the pleadings in the case and the settlement agreement.<sup>229</sup>

Attorneys must be wary of including too much information in the plaintiff's settlement agreement that could be detrimental to the plaintiff/taxpayer and should draft the agreement with this in mind.

#### D. 1999 Proposed Regulations on Issuing Form 1099-MISC

The IRS' key to enforcing the proper reporting requirements for the payment of awards or settlements is the rules surrounding the use of the Form 1099.<sup>230</sup> The IRS has a current program that effectively matches information reported on Form 1099 with the taxpayer return reporting through the current tax year, sending notices to taxpayers of the discrepancies that often result.<sup>231</sup> The IRS is quick to assert a tax deficiency by automatic notice issued by the local IRS service center (or campus, as they prefer to be known today).<sup>232</sup>

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*and Settlements for Personal Injury or Sickness*, 8 S.C. LAW. 37, 37 (1997) (discussing the status of I.R.C. § 104(a)(2) prior to the 1996 amendments).

225. See MSSP, *supra* note 3, at \*3; I.R.C. § 104(a)(2) (2000).

226. I.R.C. § 104(a)(2).

227. See Brent B. Nicholas & Douglas K. Chapman, *Enforceability of Settlement Agreement Allocations Under Section 104(A)(2) of the Internal Revenue Code*, 47 BAYLOR L. REV. 97, 114–15 (1995) (suggesting implications in drafting complaints and settlement agreements).

228. MSSP, *supra* note 3, at \*28.

229. *Id.*

230. *Id.* at \*31–\*32.

231. Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595, 635–36 (1982); I.R.S. News Release IR-89–35 (Mar. 22, 1989), at 1989 WL 607113 [hereinafter I.R.S. Press Release].

232. I.R.S. Press Release, *supra* note 231.

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New regulations now make several reporting procedures mandatory in an attempt to curb abuse and errors in reporting.<sup>233</sup> The first new requirement is that defendants issuing a Form 1099 must report the entire amount of an award, including all attorney fees.<sup>234</sup> The requirement to include the gross proceeds on the plaintiff's Form 1099 applies whether or not the defendant has cut two separate checks to the plaintiff and the attorney.<sup>235</sup>

Attorneys need to inform their clients of the potential tax trap inherent in the new regulations, and involve the taxpayer's accountant early in the process. The attorney should not fail to at least inform his client of the potential tax liability and review the regulations, or get assistance from a knowledgeable tax attorney in deciding on a tax reporting strategy for the taxpayer. The IRS intends to litigate with taxpayers attempting to net-out the contingent legal fees from settlements or awards of damages.<sup>236</sup>

Attorneys recovering settlements and awards for their clients need to be aware that another change made by the new regulations concerns the proper reporting of the legal fee, if it is known or not.<sup>237</sup> The new regulations require defendants who pay settlements or awards to report that entire payment to the attorney, even where the check is also payable to the client.<sup>238</sup>

The new regulations controlling the issuance of the Form 1099 may cause the attorney to be caught up in his client's tax audit. Penalties are also imposed for issuing an incorrect Form 1099.<sup>239</sup>

It is now strongly recommended that the attorney include in the written settlement agreement provisions negotiating exactly how the proceeds will be reported on the Form 1099 issued by the defendant.<sup>240</sup> It is also doubly important for attorneys to maintain good records of what was actually received from a

233. Treas. Reg. § 1.6041-1 (as amended 2000) (governing return of information as to payments of \$600 or more).

234. Treas. Reg. § 1.6041-1(f) (as amended 2000).

235. MSSP, *supra* note 3, at \*33.

236. See, e.g., *Coady v Comm'r*, 213 F.3d 1187, 1187 (9th Cir. 2000); *Bagley v. Comm'r*, 121 F.3d 393 (8th Cir. 1997) (holding that portion of settlement allocated to punitive damages was not excludable from taxable income on account of personal injuries); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995) (holding that the amount received as a contingency fee by the attorney did not render the amount excludable from partnership's gross income).

237. Treas. Reg. § 1.6041-1(f) (2002).

238. *Id.*

239. Treas. Reg. § 1.6041-8 (2002); Treas. Reg. § 301.672-1 (2002).

240. Robert W. Wood, *Why You Need to Address Tax Issues in Settlement Agreements*, MONT. LAW., Mar. 2001, at 28, 28.



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settlement, especially where the attorney has received the gross amount of the settlement and dispersed funds to his client/taxpayer.<sup>241</sup>

### VI. ATTORNEY-CLIENT PRIVILEGE AND SETTLEMENT DISCLOSURE

The attorney-client privilege is under attack from the IRS, who attempts to learn all it can when auditing a taxpayer who has received proceeds from the settlement or award of damages in a lawsuit.<sup>242</sup> The audit guide suggests several ways that auditors may get information from attorneys in an effort to obtain the other names and amounts associated or involved in the settlement payments.<sup>243</sup>

The IRS takes the position that although the attorney-client privilege is a valid basis for not providing some requested information, fee arrangements with contingent fee clients are not covered by the privilege.<sup>244</sup> In addition, the IRS cautions its auditors that protracted litigation may result from their request for confidential information and recommends that auditors first exhaust all other avenues of investigation first, including the taxpayer, accountant, and searching available public records.<sup>245</sup>

### VII. PLANNING FOR CONTINGENT FEE AWARDS

#### *A. Allocation of Legal Fees to Various Claims*

The Tax Court has held that a portion of an award for legal fees granted to protect the taxpayer's future employment potential are deductible as trade or business expenses under the Code.<sup>246</sup> In a case where the plaintiff received an award for employment discrimination, the Tax Court ruled only the portion of attorney's fee that related to the protection of the plaintiff's reputation and future employment potential are deductible, because those expenses are to protect the plaintiff's future employment and his ability to earn a living.<sup>247</sup>

Taxpayers and their attorneys must be mindful of how the settlement or award agreement allocates the recovery of damages from the defendant. Although the court documents or the

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241. *Id.* at 35.

242. MSSP, *supra* note 3, at \*27.

243. *Id.* at \*26.

244. *Id.*

245. *Id.*

246. *Remkiewicz v. Comm'r*, 81 T.C.M. (CCH) 945, 947 (2001).

247. *Id.*

settlement agreements do not always control the determination of the outcome of the case, they can be very useful to the taxpayer in establishing the kind and nature of the transaction between the defendant and the attorney.<sup>248</sup>

### B. *Legal Reimbursement Plans*

The use of an employee reimbursement plan, either during the term of employment prior to the claim for damages, or as part of the settlement or award agreement, has been a technique used by attorneys in an attempt to avoid the impact of the client/taxpayer having to recognize the attorney's contingent fee as income.<sup>249</sup> The Tax Court, however, has rung the death knoll to structuring settlement agreements to include a legal reimbursement plan for employee disputes. One case reinforcing this conclusion is *Biehl v. Commissioner*, in which, according to a reimbursement plan, the payment of contingent legal fees of an employee was deemed to be part of a "reimbursement or other expense allowance arrangement" under the Internal Revenue Code.<sup>250</sup>

The taxpayers in *Biehl* did not report \$401,000.00 paid to their lawyers for settling a wrongful termination suit because the payment was made pursuant to just such a reimbursement plan.<sup>251</sup> The Tax Court disagreed with the taxpayer's treatment, holding that amounts paid by an employer to a former employee in settling a wrongful termination claim fail to satisfy the "business connection" requirement for an accountable plan.<sup>252</sup> As a result, the payment to the attorneys was includible in the taxpayers' gross income and should have been deducted as an itemized deduction.<sup>253</sup>

The business connection requirement, as interpreted by the court, requires a direct connection between services performed as an employee for an employer and the reimbursement of the expense.<sup>254</sup> According to the court, providing for a reimbursement

248. Wood, *supra* note 240, at 28.

249. See, e.g., *Biehl v. Comm'r*, 118 T.C. 467, 467 (2002).

250. *Id.*; I.R.C. § 62(a)(2)(A) (2000); Treas. Reg. § 1.62-2 (as amended 2000).

251. *Biehl*, 118 T.C. at 467.

252. Treas. Reg. § 1.62-2(d)(1) (as amended 2000); *Biehl*, 118 T.C. 467-68.

253. *Biehl*, 118 T.C. at 488.

254. *Id.* at 485. The court held,

The fact that the attorney's fee somehow may have been "spawned" by the performance of prior services is much too tenuous a connection. The attorney's fee incurred in the prosecution by a former employee of a wrongful termination claim is simply too far removed from the performance of an employee's regular duties to have been incurred "in

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arrangement in the negotiated settlement agreement will not satisfy the business connection requirement either.<sup>255</sup>

### C. *Forum Shopping*

Considering the tax cost associated with the transaction, as demonstrated in the illustrative example of taxing the gross proceeds amount and net proceeds amount, it may not be too far fetched to consider establishing a residence in Alabama, Texas, or one of the other states from which the appeal would emanate, before the settlement or award transaction takes place. One might also consider establishing a base for filing an individual income tax return for the year in which the proceeds are received in a favorable jurisdiction.

The examples benefiting a change of forum include the case of *Griffin v. Commissioner*, in which an Alabama resident did not have to pay tax on a legal fee paid in the amount of \$2,519,000.000.<sup>256</sup> Another use of an advantageous forum is exemplified by a Texas plaintiff in *Srivastava v. Commissioner*.<sup>257</sup> The plaintiff in *Srivastava* was permitted to exclude his attorney's fees from income.<sup>258</sup>

The current AMT rates for individuals may be 26% or 28% and, although some exclusions apply, a rough tax estimate would yield taxes due in the hundreds of thousands of dollars for the plaintiffs in *Griffin* and *Srivastava*, if they did not live in the states where their case of action arose (disregarding any state income tax calculations).<sup>259</sup> The difference in tax due is enough to consider establishing a bona-fide residence in a state where the most favorable tax treatment may be received. To date, no cases in any of the circuit courts of appeal have addressed the issue of forum shopping and from a review of the facts in various cases, there appears to have been no attempt on the part of taxpayers to change their residence in an attempt to avoid unfavorable precedent in that particular jurisdiction.

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connection with the performance by him of services as an employee" of the employer.

*Id.*

255. *Id.* at 485–86.

256. *Griffin v. Comm'r*, 81 T.C.M. (CCH) 972, 973, 978 (2001).

257. *See Srivastava v. Comm'r*, 220 F.3d 353, 369 (5th Cir. 2000).

258. *Id.* at 365–66.

259. *See Griffin*, 81 T.C.M. at 977; *Srivastava*, 220 F.3d at 365–66; I.R.C. § 55(b)(1)(A)(i)(I)–(II) (2000).

## VIII. CONCLUSION

A. *Correct Tax Policy on This Issue*

The correct tax policy on this issue is that the taxpayer should not have to pay tax on the amount of contingent legal fees paid to his or her lawyer from the receipt of a taxable settlement or award of damages. The transaction is not tax neutral. There is an essential and fundamental difference between having a contingent fee arrangement with a client and having one that pays for time and materials on a current basis. Because the attorney invests his potential receipt of a contingent legal fee in his client, and the proceeds of any recovery, the ultimate proceeds from recovery of just such an investment should be taxed uniquely. The difference between a contingent legal fee recovery and being paid by the hour does raise other issues, however, including whether an attorney and a client can participate in an ordinary joint venture or partnership. A partnership or joint venture between an attorney and client may not be feasible because an attorney cannot share a fee with anyone else, except another attorney.<sup>260</sup>

B. *How Should the Tax Policy be Implemented?*

The AMT rules should be amended to exclude a plaintiff's recovery of a judgment, award, or settlement from the calculation of alternative minimum taxable income. This may be accomplished by a change in the way that miscellaneous deductions are treated for AMT purposes.

The taxpayer could then continue to be permitted a miscellaneous itemized deduction for the amount of the contingent legal fee paid. However, this miscellaneous itemized deduction for the contingent legal portion of a damage settlement or award should not be included in the determination of alternative minimum taxable income, as is the current requirement. The AMT was not designed to apply to the one time windfall of a damage settlement or award, especially not including in the plaintiff's income the amount of contingent legal fee paid the attorney.<sup>261</sup>

A change in the AMT rules to exclude from alternative minimum taxable income the amount of the contingent legal fee portion of an award or settlement amount would leave

260. MODEL RULES OF PROF'L CONDUCT R. 5.4 (2002).

261. See *Sinyard v. Comm'r*, 268 F.3d 756, 759 (9th Cir. 2001).

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unchanged other limitations.<sup>262</sup> The plaintiff in a successful lawsuit would continue to be subject to the two percent limitation on total miscellaneous itemized deductions and also the possible limitation, depending on adjusted gross income of the taxpayer, on total itemized deductions.

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262. See generally Cornelius Cowles, *To Include or Exclude? The Circuit Court Split on Double Taxation of Contingent Fees*, 28 MAR. VT. B.J. 25 (2002) (discussing the applicability of the 2% floor on miscellaneous itemized deductions as separate from the alternative minimum tax).