Brigham Young University Journal of Public Law

Volume 15 | Issue 2 Article 8

3-1-2001

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Recommended Citation

Benjamin C. Rasmussen, *Taxation of an Attorney's Contingency Fee of a Punitive Damages Recovery: The Srivastava Approach*, 15 BYU J. Pub. L. 301 (2013).
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Taxation of an Attorney's Contingency Fee of a Punitive Damages Recovery: The *Srivastava* Approach*

I. INTRODUCTION

With its landmark tax decision in *Commissioner v. Glenshaw Glass Co.*,[1] the United States Supreme Court adopted the rule that litigants are required to include the punitive damages portion of awards in their taxable income. The Court's decision was based on the nature of the award, which the Court characterized as "undeniable accessions to wealth, clearly realized, and over which the taxpayers have *complete dominion*."[2] Based on this treatment, the Court concluded that punitive damages were clearly of the nature that Congress intended to be taxed, and reversed the Third Circuit's decision.[3] This interpretation is now codified in section 104 of the Internal Revenue Code, which exempts actual damages from certain lawsuits, but does not exempt punitive damages.[4]

In spite of the *Glenshaw Glass* decision, there is still dispute about certain aspects of the punitive damages award. Recently, a noticeable split has occurred in the federal circuit courts regarding the proper treatment of the portion of a punitive damages award retained by the litigant's attorney as a contingency fee.[5] This dispute between the circuits seems ripe for determination by the United States Supreme Court, but until the Supreme Court resolves the conflict, taxpayers and their attorneys are faced with the challenge of determining how they should calculate their taxes and approach the situation.

This Note will first consider the reasoning employed by the different circuit courts of appeal, with particular emphasis on the decision of the Fifth Circuit in *Srivastava v. Commissioner*, which held that the portion of the settlement payable to the attorney under the contingency agreement was not gross income for taxable purposes.[6] The *Srivastava* ap-

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1. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

2. *Id.* at 431 (emphasis added).

3. *Id.* at 432-33.

4. 26 U.S.C. § 104(a)(2) (1994).

5. *See, e.g.*, Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000); Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000).

6. *See Srivastava*, 220 F.3d 353.

proach will be compared to other circuits to determine the key trends in the decisions. Next, this Note will address the most sound approaches and important considerations for practitioners dealing with the issue until such time as the United States Supreme Court gives a more definitive answer to the question. Finally, this Note will examine possible solutions to this critical issue.

II. THE FIFTH CIRCUIT APPROACH: *SRIVASTAVA V. COMMISSIONER*

A. *Factual Background*

The Fifth Circuit's opportunity to address the question of taxation of the contingency fee portion of a punitive damages recovery arose out of a substantial defamation suit involving two married doctors, Sudhir Srivastava and Elizabeth S. Pascual (Petitioners).[7] Petitioners were awarded twenty-nine million dollars in a jury verdict after a Texas television station aired a series of investigative reports accusing the Petitioners of poor medical care and various criminal acts, which destroyed the Petitioners' medical practice and led to severe financial and emotional distress for the family.[8] After appeals, the parties came to a settlement with the station and its insurance carriers for $8.5 million.[9] The parties divided the portions of the award paid by the station and three insurance companies, but did not distinguish between the actual and punitive damages ordered in making the settlement allotment.[10] After the Petitioners reported no taxable income from their award, the Internal Revenue Service issued a notice of deficiency to Petitioners allocating amounts to actual damages, punitive damages, and interest in proportion to the original jury award and taxing the amounts allocated to punitive damages and interest.[11] The Internal Revenue Service's estimation left the Petitioners with $1,466,348 in additional taxes and penalties for the tax years 1991 and 1992.[12] Upon appeal to the Tax Court, Petitioners argued that the portion of the settlement paid to their attorneys under a contingency fee agreement was not includable in gross income. The Tax Court rejected their argument[13] and allocated the settlement agreement similarly to the ap-

7. *See id.* at 355.
8. *See id.*
9. *See id.*
10. *See id.* at 356.
11. *See id.*
12. *See id.*
13. While not addressed in this casenote, the Tax Court has addressed this issue in an *en banc* decision. In *Kenseth v. Commissioner*, 114 T.C. 399 (2000), the Tax Court, by an 8-5 vote, concluded that attorneys' contingency fees are taxable to the client. *See id.* at 417.

proach of the Internal Revenue Service.[14] It sustained the deficiency based upon the punitive damages award, but eliminated the penalties for Petitioners' failure to include the amounts in their reported income because of their reasonable cause for failing to do so.[15]

B. Say One Thing, Do the Opposite

1. Clean slate perspective

The *Srivastava* court began its analysis by looking at the facts of the case as if it was going to make the decision on a *tabula rasa*.[16] The court first looked for answers within the doctrine of anticipatory assignment of income.[17] The court noted that the doctrine usually centers around two extremes: where the taxpayer who controls the source of the income assigns future income to another to avoid taxation, or, in the alternative, where the taxpayer fully divests himself of control over the source by transferring or selling it to another.[18] Had this case fallen into one of those easily determined streams, the court thought that the solution would have been straight forward, but the Fifth Circuit felt that "contingent fee contracts defy easy categorization."[19] The court was of the opinion that the contingency fee arrangement involved something similar to a partnership agreement with "virtual co-ownership" and a division of property.[20] Concluding that this analysis gave no clear answer, the court looked to which party did the work to produce the money under the contingency fee agreement, whether the contingency fee agreement involved a gratuitous transfer as opposed to an arm's length transfer, as well as how the uncertainty of the ultimate value of the contingency fee agreement affected the analysis.[21] In all three cases, the court concluded that the resulting analysis was of little or no help in determining whether the portion retained by the attorney should be taxed to the client.[22]

Ultimately, the court determined that the closest analogy involved a plaintiff in a contingency fee case versus a plaintiff retaining counsel on a non-contingent fee agreement.[23] The court concluded that the use of the

14. *Srivastava*, 220 F.3d at 356-57.
15. *See id.* at 357.
16. *See id.*
17. *See id.* at 358.
18. *See id.* at 358-59.
19. *Id.* at 360.
20. *Id.*
21. *See id.* at 360-62.
22. *See id.*
23. *See id.* at 362.

contingency fee was merely a means of shifting the risk of loss, but that in the case of a judgment, both plaintiffs would have to pay their attorneys and should be taxed on their income in like manner.[24] The court hypothesized that it would not be fair to give Petitioners a tax windfall based solely on their choice of fee arrangement, because regardless of the arrangement they would still enjoy the same economic benefit upon favorable resolution of the case.[25]

2. Adherence to questioned precedent

In spite of its analysis leading to the contrary conclusion, the Fifth Circuit decided that it could not rule on the matter from a clean slate, but instead was bound to follow the *Cotnam v. Commissioner*[26] decision, which held that the amount of the contingency fee paid out of the judgment to the attorney was not income to the taxpayer because, under Alabama law, the attorney has an interest in the amount of the contingency fee.[27] The Internal Revenue Service urged the court to distinguish the case from *Cotnam* based on the different rights each state afforded to attorneys under a contingency fee arrangement. However, the Fifth Circuit declined to do so, concluding that this decision more appropriately belonged in the anticipatory assignment of income analysis, which produced no clear distinction between the two cases.[28]

In order to understand the conclusion of the Fifth Circuit, it is important to understand the precedent to which the court felt bound. *Cotnam* is the oldest standing opinion concerning the taxability of attorney's contingency fees from punitive damages. The *Cotnam* decision involved a question of Alabama law.[29] Alabama law gave attorneys what was essentially an equitable interest in their clients' recoveries.[30] The taxpayer in *Cotnam* was precluded from receiving her part of the judgment because of her attorney's equitable lien on the judgment as applied by the courts of Alabama.[31] The court concluded that because the taxpayer never would have been able to recover anything without the aid of counsel and because the attorneys earned the contingency fee in which they had a strong interest under Alabama law, the taxpayer had not realized any

24. *See id.* at 362-63.

25. *See id.* at 363.

26. 263 F.2d 119 (5th Cir. 1959). *Cotnam* was decided just four years after the landmark *Glenshaw Glass* decision originally required inclusion of punitive damages in gross income.

27. *See Srivastava*, 220 F.3d at 363.

28. *Id.* at 363-64.

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

30. *See id.*

31. *See id.*

economic benefit from that portion of the recovery and could not be taxed for it.[32] By comparison, *Srivastava* involved Texas law, which provides that "the lawyer's rights, based on the contingent fee contract, are wholly derivative from those of his client."[33]

B. Why Not Right the Perceived Wrong?

The differences in the state laws concerning attorneys' interests in contingency fees were clear, with Alabama law providing an attorney with an equal, if not superior interest, to his client's damages recovery[34] and Texas law subordinating the rights of the attorney to those of his client.[35] The distinctions would have allowed a simple mechanism to distinguish a precedent that the court's analysis clearly called into question. The Internal Revenue Service drew this conclusion,[36] and Circuit Judge James L. Dennis noted as much in his dissenting opinion.[37] Judge Dennis wrote:

> [T]he taxpayers in the present case did not by virtue of their attorney-client contract divest themselves of part of their interests in the claim, or vest a legal, independently enforceable ownership interest in that claim in their attorneys. Accordingly, the taxpayers received as income the portions of the settlement consisting of punitive damages and interest that were earmarked for the payment of their attorney's fees, and I believe that the taxpayer must pay taxes on those proceeds.[38]

The *Srivastava* court's adherence to a 41-year-old precedent, despite a logical means for the precedent to be distinguished, brings to mind the wisdom of former Supreme Court Justice Hugo Black. Justice Black wrote in another setting, "[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."[39] Even if the *Srivastava* court felt that *Cotnam* followed a logical line of reason, the court noted in its own analysis of the issue that it considered the *Cotnam* line of reasoning to be unpersuasive.[40] However, the dissent's reasoning in *Cotnam* provided

32. *See id.* at 125-26.

33. Dow Chemical Co. v. Benton, 357 S.W.2d 565, 567 (Tex. 1962).

34. ALA. CODE § 61 (1940), *cited in Cotnam*, 263 F.2d at 123 n.4.

35. *See Dow Chemical Co.*, 357 S.W.2d at 567.

36. *See Srivastava*, 220 F.3d at 363.

37. *See id.* at 367 (Dennis, J., dissenting).

38. *Id.* at 369.

39. Francis v. Southern Pac. Co., 333 U.S. 445, 471 (1948) (Black, J., dissenting).

40. The concurring opinion in *Cotnam*, which constituted the majority on this question, in addition to focusing heavily on the distinguishable Alabama law, relied in large part on the argument that without the services of the attorney, a client's claim would never bear fruit, and that as such, a client should not be taxed on the portion it did not receive. *See Cotnam*, 263 F.2d at 125-26. Of this

support for the *Srivastava* court's conclusion.[41] The court noted the wide disagreement that exists in the circuit courts on this issue.[42] The majority in *Srivastava* had plenty of reason for abandoning the old Fifth Circuit rule and ample persuasive support from other circuits going the other way. Its reliance on the antiquated *Cotnam* precedent at least raises questions.[43]

Indeed, when compared to the other circuits that have given opinions on this issue, the *Srivastava* court was the only circuit that used precedent as a crutch in making its decision conform to an outcome it questioned. As will be seen, there is legal support for either position on this critical issue. The analyses of the other circuits on both sides of the issue, many of which were available for the Fifth Circuit to consider, make the ultimate conclusion of the court less compelling and more questionable. This Note will consider the lines of reasoning employed by these courts and compare them to the *Srivastava* outcome.

III. CIRCUIT COURT APPROACHES INCLUDING THE ATTORNEY'S CONTINGENCY FEE IN GROSS INCOME

In the last five years, three circuits have ruled against taxpayers who excluded their attorneys' contingency fee from their gross income.[44] In most instances, these circuits have followed a similar line of reasoning. Additionally, the line of reasoning prevailing in these circuits is very similar to the clean slate analysis provided in *Srivastava.*

A. *The Federal Circuit*

In 1995, the Federal Circuit addressed the issue in *Baylin v. United States.*[45] *Baylin* involved a dispute between a partnership and the Mary-

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line of reasoning the *Srivastava* court wrote, "That gain – no less than the non-monetary gains recognized as income in *Earl*, *Horst*, and their progeny – is not to be excluded from gross income solely on the basis that the money is diverted to, and realized by, the taxpayer's assignee." *Srivastava*, 220 F.3d at 363.

41. Judge Wisdom dissented from the *Cotnam* decision under the theory that even though the taxpayer never actually took control of the portion of her damages that went to her attorney under the contingency fee agreement, she enjoyed the benefit of the damages award and should have been taxed on it. *See Cotnam*, 263 F.2d at 127.

42. *See Srivastava*, 220 F.3d at 358.

43. It should be noted that technically the Fifth Circuit could not have completely overruled the *Cotnam* decision in *Srivastava*. Fifth Circuit rules preclude a three-judge panel from overturning a prior decision within the circuit, absent an *en banc* review by the court. *See* Floors Unlimited, Inc. v. Fieldcrest Cannon, Inc., 55 F.3d 181, 185 (5th Cir. 1995).

44. *See* Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000); Alexander v. IRS, 72 F.3d 938 (1st Cir. 1995); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

45. 43 F.3d at 1451.

land State Highway Administration, which condemned 137 acres owned by the partnership.[46] The partnership disputed the state's valuation of its property and entered into a contingency fee agreement with its attorneys to challenge the valuation in court.[47] The partnership deducted the legal fees as a business expense incurred in the collection of income.[48] The court rejected the taxpayers' argument that the portion of the attorneys' fees derived from interest on the principal judgment in their favor was a business expense, focusing on the "origin of the claim" test from *United States v. Gilmore*,[49] and determining that the legal fees in this case were more appropriately classified as a capital expenditure.[50]

The taxpayers advanced an alternative argument that is more pertinent to this Note's analysis. They argued that because they assigned the portion going to their attorneys in advance, they had never realized the income.[51] They relied on Maryland law, which gives an attorney a lien on the eventual judgment in the case of a contingency fee agreement.[52] The Federal Circuit, however, was not persuaded by the taxpayers' arguments. It noted that the lien available in Maryland law simply gave the attorneys extra security on the debt owed them by their client.[53] This court was most persuaded by the fact that the courts have broadly defined the definition of gross income and reasoned that, unless specifically exempted, the taxpayers' accession to wealth was taxable.[54] The court noted that the taxpayers clearly enjoyed a benefit from the increased valuation brought about by their attorneys' work and did not accept that the taxpayers and their attorneys could dictate their own treatment under the law.[55] Specifically, the court noted that "[t]he temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees."[56] As evidenced by the three paragraphs of treatment the court gave the issue, the Federal Circuit didn't seem to find the issue a difficult one.[57]

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46. *See id.* at 1452.
47. *Id.*
48. *See id.* at 1453; 26 U.S.C. § 212(1) (1988).
49. 372 U.S. 39 (1963).
50. *See Baylin*, 43 F.3d at 1453-54.
51. *See id.* at 1454-55.
52. *See id.* at 1455.
53. *See id.*
54. *See id.* at 1454.
55. *See id.* at 1454-55.
56. *Id.* at 1455.
57. *See id.* at 1454-55.

B. The First Circuit

Later in 1995 the First Circuit indirectly addressed this issue in *Alexander v. Internal Revenue Service*.[58] *Alexander* involved a terminated employee who obtained a settlement from his former employer after he filed suit seeking damages for age discrimination and breach of contract.[59] The First Circuit rejected the taxpayers' arguments that his legal fees were deductible under several sections of the code.[60]

Like the taxpayers in *Baylin*, after losing other battles, the taxpayer in *Alexander* sought to exclude part of his attorneys' fees from gross income because he never had control.[61] After the settlement, the employer provided checks jointly payable to the taxpayer and his attorneys in satisfaction of the agreement.[62] The taxpayer argued that under 26 U.S.C. § 62(a)(2)(A), where the taxpayer was being classified as an employee by the court, satisfaction of his contingency fee agreement by payment to the attorneys was a deductible reimbursement arrangement.[63] Like *Baylin*, the taxpayer in *Alexander* tried to persuade the court with state law, in this case Massachusetts, which gave the attorney a lien on the payment, and which precluded the taxpayer from enjoying the benefit of that portion of the funds.[64]

The First Circuit did not address the issue in the manner that the other similarly holding circuits did. Instead, the First Circuit refused to consider the issue where there was no support in the record that a contingency fee agreement was formally entered into.[65] The court rejected the taxpayer's argument that the agreement was implied by the parties as part of the standard operating procedure for cases of the kind.[66] Although the setting in which it rejected the taxpayer's argument is distinguishable, the First Circuit demonstrated that it would not let the taxpayer use his agreement with his attorney to avoid tax liability.[67]

C. The Ninth Circuit

The Federal Circuit and the First Circuit differed from *Srivastava* in that no reference was made to *Cotnam* as support for the taxpayers' at-

58. 72 F.3d 938 (1st Cir. 1995).
59. *See id.* at 940.
60. *See id.* at 941.
61. *See id.* at 945.
62. *See id.*
63. *See id.* at 945-46.
64. *See id.* at 946.
65. *See id.*
66. *See id.*
67. *See id.*

tempts to exclude their attorneys' contingency fees from taxable income. However, the case in which the Ninth Circuit first addressed the issue, *Coady v. Commissioner*,[68] involved a direct argument by the taxpayer based on *Cotnam*, although it was not controlling precedent for that court.[69] *Coady*, like *Alexander*, was a wrongful termination suit where the taxpayer claimed a deduction for his attorneys' fees. The taxpayer relied directly on *Cotnam* and claimed that they had not realized the income because it was assigned to their attorneys.[70] Alaska law gives an attorney a lien on his client's funds, but the Alaska courts have interpreted it not to give any ownership interest to the attorney, thus differing from the Alabama statute involved in *Cotnam*.[71]

At the outset, the Ninth Circuit recognized that a split existed among the circuits on this issue.[72] However, this court found convincing the reasoning employed by the courts in *Baylin* and *Alexander*, as well as the reasoning of the dissent in *Cotnam*.[73] The court wrote 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."[74] Like the Federal Circuit, the Ninth Circuit refused to distinguish a contingency fee arrangement because of the uncertainty of the outcome and held that anticipatory assignments made to prevent earnings from vesting in the taxpayer will not be recognized for tax purposes.[75] The court further distinguished the case from *Cotnam* and *Estate of Clarks v. United States*,[76] which will be considered in the next section of this Note, based on the nature of the state law, where *Cotnam* was based on a law where attorneys have a greater interest in their portion of the judgment than their clients under a contingency fee arrangement.[77]

The Ninth Circuit addressed the issue again in a decision filed a little over a month after its *Coady* decision, *Benci-Woodward v. Commissioner*.[78] *Benci-Woodward* dealt with an issue more similar to *Srivastava* than the other courts, choosing to not exclude an attorney's contingency

68. 213 F.3d 1187 (9th Cir. 2000).
69. *See id.* at 1188.
70. *See id.*
71. *See id.* at 1190.
72. *See id.* at 1189.
73. *See id.* at 1190.
74. *Id.* at 1191.
75. *See id.* at 1191.
76. 202 F.3d 854 (6th Cir. 2000).
77. *See Coady*, 213 F.3d at 1190.
78. 219 F.3d 941 (9th Cir. 2000).

fee income from the taxpayer's gross income. *Benci-Woodward* involved the portion of attorneys' fees arising from a punitive damages award in a tort complaint filed against Target Stores for several torts and contract counts, including wrongful termination.[79] *Benci-Woodward* was based on California law, in which contingency fee contracts "do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery."[80] As such, the Ninth Circuit deferred to its *Coady* decision and distinguished the California law based on the lesser interest available to an attorney in the state.[81]

D. *Prevailing Themes in the Federal, First, and Ninth Circuits*

There are two important prevailing themes in the decisions of the courts that have required inclusion of an attorney's contingency fee portion of a settlement or award in gross income. First, these courts have generally done so under the theory that for tax purposes contingency fee agreements are nothing more than anticipatory assignments of income from the client to the attorney.[82] Courts have consistently held that such transfers of interest will not provide a means for the taxpayer to reduce his liability.[83] Second, these courts have consistently distinguished their respective cases based on state laws that do not provide the attorney with an equal interest in the contingency fee.[84] Both of these themes are similar to analyses considered, favored, and ultimately rejected by the *Srivastava* court in the name of precedent.[85] However, the Fifth Circuit, as evidenced in the next section of this note, is not the only court to take the position it did.

IV. OTHER CIRCUIT COURT APPROACHES EXCLUDING THE ATTORNEY'S CONTINGENCY FEE FROM GROSS INCOME

Aside from the Fifth Circuit, two other circuits have taken the position that the contingency fee received by the attorney is not taxable income to the client. The Eleventh and Sixth Circuits have also followed

79. *See id.* at 942-43.

80. Fifield Manor v. Finston, 354 P.2d 1073, 1079 (Cal. 1960).

81. *See Benci-Woodward*, 219 F.3d at 943.

82. *See Baylin*, 43 F.3d at 1454-55; *Coady*, 213 F.3d at 1188-91.

83. *See e.g.*, Lucas v. Earl, 281 U.S. 111 (1930).

84. *See Baylin*, 43 F.3d at 1455; *Coady*, 213 F.3d at 1190; *Benci-Woodward*, 219 F.3d at 943; *Alexander*, 72 F.3d at 946. Although the *Alexander* court did not specifically distinguish the Massachusetts law, it did reject the taxpayer's claim under the Massachusetts statute in similar fashion to the other courts discussed in this section.

85. *See Srivastava*, 220 F.3d at 362-63, 369. *But see id.* at 363-64 (declining to distinguish the case based on the differences in Texas and Alabama law).

this approach.[86] While the Eleventh Circuit approach was ultimately somewhat similar to that employed in *Srivastava*, the Sixth Circuit employed a different line of reasoning that demonstrates more fully the differences in the opinions on this side of the issue.

A. *The Eleventh Circuit*

The Internal Revenue Service has attempted to challenge the *Cotnam* rule in the Eleventh Circuit, in addition to the Fifth. The Eleventh Circuit was split off from the old Fifth Circuit in 1981 and is bound by *Cotnam* to the same extent as the present Fifth Circuit. The Internal Revenue Service brought its Eleventh Circuit challenge in *Davis v. Commissioner*.[87] This case arose out of a lawsuit against a mortgage company in which the taxpayer won over six million dollars, nearly all in punitive damages.[88] In *Davis*, the taxpayer prevailed at the Tax Court level prior to consideration by the Eleventh Circuit.

The Eleventh Circuit's consideration of the issue was the briefest of all of the circuits addressing similar questions. The court noted that this was simply an attempt by the Internal Revenue Service to get the circuit to do away with precedent that the Service did not like.[89] The Eleventh Circuit considered *Davis* to be right on point with the earlier *Cotnam* decision and affirmed the decision of the Tax Court in accordance with a precedent "squarely on point."[90] However, unlike the Fifth Circuit in *Srivastava*, the Eleventh Circuit did not openly call into question its own decision by undermining its logic with contradictory reasoning and analysis.[91]

B. *The Sixth Circuit*

The Sixth Circuit dealt with the treatment of an attorney's contingency fee in *Clarks*.[92] This case arose after K-Mart Corporation lost a personal injury case brought by Arthur Clarks in 1988.[93] K-Mart paid the damages in 1991 with interest and shortly thereafter Clarks died.[94] The

86. *See Clarks*, 202 F.3d at 854; Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000).

87. 210 F.3d 1346.

88. *See id.* at 1347.

89. *See id.* at 1347 n.4.

90. *Id.* at 1347. The court further noted that it could not overrule *Cotnam* without a hearing of the en banc court. *See supra* note 44.

91. The *Davis* court did not have the opportunity to distinguish *Cotnam* under state laws as did the *Srivastava* court. *Davis* involved Alabama law, just as *Cotnam* did. *See id.* at 1346.

92. 202 F.3d 854 (6th Cir. 2000).

93. *See id.* at 855.

94. *See id.*

issue arises in *Clarks* because Clarks' estate failed to include the contingency fee portion arising out of the interest on the judgment in Clarks' Form 1040 for 1991.[95] The estate never received the portion of the interest payable to the attorneys under the contingency fee.[96] After auditing the estate's return, the Internal Revenue Service issued a deficiency notice because the estate failed to include the attorneys' fees as gross income.[97]

After the district court granted summary judgment against the estate, the Sixth Circuit reversed.[98] The Sixth Circuit's analysis, like many of the other circuits addressing the issue, centered on *Cotnam*. After considering the *Cotnam* decision, the *Clarks* court looked to Michigan law to compare the attorney's interest in the contingency fee to the Alabama law in *Cotnam*.[99] The Sixth Circuit was persuaded by the fact that under Michigan law the contingency fee agreement assigned a portion of the judgment to the attorney, and at the same time gave him superior rights to recovery of that portion than those of his client.[100]

On this basis, the Sixth Circuit sought to distinguish itself from the Federal Circuit in *Baylin*. It said that the *Baylin* court's reliance on *Lucas v. Earl*[101] and *Helvering v. Horst*[102] did not apply to this case because the assignments in those cases centered around gifts to family members already earned by the taxpayer and vested to him.[103] The *Clarks* court reasoned that the assignment in a contingency fee case was totally different for a couple of reasons. First, it noted that under a typical assignment to avoid income, the assignee was not taxed on the income because it is taxable income to the assignor or donor under *Lucas* and *Horst*.[104] The court contrasted this to a contingency fee arrangement where the attorney will be taxed on the income, allowing for double taxation under the approach the Internal Revenue Service was advocating.[105]

Second, the Sixth Circuit focused on the nature of the assignment, reasoning that it was closer to a division of property between tenants in common or a partnership.[106] More importantly perhaps, the court focused

95. *See id.*
96. *See id.*
97. *See id.*
98. *See id.* at 856.
99. *See id.*
100. *See id.*
101. 281 U.S. 111 (1930).
102. 311 U.S. 112 (1940).
103. *See Clarks*, 202 F.3d at 857.
104. *See id.*
105. *See id.*
106. *See id.* at 857-58.

on the work involved in reaping the benefits of the personal injury judgment, noting that neither party would benefit from the money without the skills and work of the attorney.[107] The court wrote that "[t]he income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it."[108]

Thus, in *Clarks*, the Sixth Circuit articulated a position to support exclusion of an attorney's contingency fee (a derived interest on the judgments as opposed to punitive damages in this case), which was not the line of reasoning used by the other two circuits coming to similar conclusions. Where *Srivastava* and *Davis* essentially based their decision solely on the *Cotnam* precedent, *Clarks* articulated an approach based partly on the treatment of the attorney lien under Michigan law, where the court sought to avoid double taxation, as well as taxing the party who earned and received possession of the money under a partnership approach, something that the client does not do under a contingency fee agreement.

V. PRACTICAL CONSIDERATIONS: HOW SHOULD AN ATTORNEY ADVISE HIS CLIENT NOW?

Given the wide range of opinions espoused by the circuits, practitioners face several issues in determining what approaches to take with their clients. Among the concerns attorneys must consider is how best to protect their client's interests while simultaneously minimizing their tax exposure. The balance can be a tricky course that must be navigated with precision. Attention to certain details and considerations will make an attorney better able to protect his client in reporting income and dealing with other related tax issues arising from the contingency fee agreement.

The first issue of particular concern is the nature of the attorney's rights as afforded by the law of the state where the client resides. Most of the cases have given some attention to the nature of the state's statutes or case law and how an attorney's rights in his contingency fee compare to the rights of his client.[109] Where many of the circuits allowing exclusion of the attorneys' fees give deference to the rights of the attorney under state law, attorneys practicing in states with favorable laws may have a greater argument for urging their clients to exclude the attorneys' fees from income. The argument may even be a valid one in circuits who have sided with the Internal Revenue Service, since many such cases

107. *See id.* at 858.

108. *Id.*

109. *See e.g.*, *Srivastava*, 220 F.3d at 363.

were decided by distinguishing the nature of the state law from the Alabama statute involved in *Cotnam.*[110] With specific state legal rights in mind, parties can structure contingency fee agreements to provide appropriate liens to the attorney, as well as structure the method that defendants will pay out settlements and judgments.[111]

Along the same lines, attorneys need to carefully consider how certain documents can be structured to make the facts more favorable to the client. The *Srivastava* court considered the Tax Court's allotment of the settlement for purposes of determining what part of the settlement was attributable to punitive damages and interest.[112] The taxpayer was arguably hindered because the settlement agreement did not specify the party's intentions with regard to the allotment between actual and other damages.[113] The taxpayer was also limited in his ability to argue for a more favorable allotment by virtue of the wording of his request for damages in the original defamation complaint.[114] As such, practitioners would be wise to carefully word settlement agreements, as well as any other pleadings throughout the litigation process, in such a way that will benefit the client's tax interests down the road by expressing how the parties wish the settlement to be allotted between the different kinds of damages. While such attempts may not ultimately prevail in persuading the court, they are likely to give an appellant more credibility in reaching their ultimate goal.

Next, attorneys should be careful to take into consideration the consequences of section 83 of the Internal Revenue Code. Section 83 provides that when property rights are transferred by one party to another party, in connection with the performance of services, and subject to a substantial risk of forfeiture, the fair market value of these rights should be included in the transferor's taxable income when the interest loses its substantial risk of forfeiture.[115] Some recent academic analysis suggests that an attorney's contingency fee interest is a capital interest that is governed by section 83.[116] Although none of the circuits addressing the issue have considered Section 83 in their analysis, application of it may lead to

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110. *See e.g.*, *Coady*, 213 F.2d at 1190.

111. *See* Robert W. Richards, Jr. & Fred Meissner, *Feature: A New IRS Tax Audit Trigger for Attorneys: Form 1099 Misc.*, 41 ORANGE COUNTY LAWYER 8, 9 (1999).

112. *See Srivastava*, 220 F.3d at 365.

113. *See id.*

114. *See id.* In *Srivastava*, the petitioner attempted to have the allotment adjusted to reflect only actual damages based on the fact that the settlement for $8.5 million between the taxpayer and the defendants was the same as the actual damages requested in the complaint. The court took issue partly because the complaint requested "an amount *in excess* of $8,500,000.00." *Id.* at 365.

115. *See* 26 U.S.C. § 83(1)(A) (1994).

116. *See* Gregg D. Polsky, *Taxing Contingent Attorneys' Fees: Many Courts Are Getting It Wrong*, 89 TAX NOTES 917 (Nov. 13, 2000).

a different result in cases like *Clarks* where the pro-taxpayer decision was made based significantly on a partnership analysis.[117] Consideration of this section may lead to different structuring of fee agreements in anticipation of its application.

Determining the tax approach may also have consequences in how the Internal Revenue Service deals with the returns in an eventual audit and assessment of deficiency, depending on the circuit from which the considerations are derived. Attempts to get around the circuits' decisions could, theoretically, subject a taxpayer to penalties for substantial understatement of tax under section 6662 of the Internal Revenue Code unless there is sufficient authority to establish the existence of reasonable cause or a good faith belief that the taxpayer would be treated otherwise.[118] While the Internal Revenue Service may not assert these or similar penalties in all cases, the expense involved in potentially challenging the penalties, or worse paying them, can be great to a taxpayer if their arguments for exclusion of the attorneys' fees are not sufficiently based on the relevant precedents.[119]

Finally, those taxpayers who fear the consequences and costs involved in a potential court fight with the Internal Revenue Service have other options available to them under the Internal Revenue Code. The code provides that taxpayers may take deductions for business expenses, [120] ordinary and necessary expenses "for the production or collection of income,"[121] and other expenses. Depending on the circumstances and facts in the given case, attorneys' contingency fees may be deductible and would reduce the taxpayer's tax liability. While deductions may not be the most ideal end for a client,[122] where exclusion of the contingency fee from income is not an option because of the jurisdiction or otherwise, these deductions may serve to alleviate some of the financial pain experienced by the taxpayer on April 15th.

117. *See id.* at 922. *But see* Robert W. Wood, *Leave Section 83 Out of This Mess*, 89 TAX NOTES 1187 (Nov. 27, 2000) (arguing that section 83 analysis has no place in determining whether the attorney's portion of the contingency fee should be taxed to the client).

118. *See* Treas. Reg. § 1.6662-4 (2001).

119. *See* Sheldon I. Banoff & Richard M. Lipton, *Whipsaw on Lawsuit Settlements: The Courts Still Can't Agree*, 93 J. TAX'N. 12 (Sep. 2000).

120. *See* 26 U.S.C. § 162 (1994).

121. 26 U.S.C. § 212(1) (1994).

122. Under 26 U.S.C. § 67 (1994), the deductions may be subject to a floor equal to two percent of a taxpayer's adjusted gross income. They are also subject to phase-out for higher income taxpayers. *See* 26 U.S.C. § 68 (1994). Similarly, for purposes of the Alternative Minimum Tax, attorney's fees are not deductible where limited under § 67. *See* 26 U.S.C. § 56(b)(1)(A)(i) (1994).

VI. CONCLUSION

It is apparent that many questions still linger over the proper treatment of an attorney's contingency fee arising from punitive damages, interest on the judgment, and the like. The *Srivastava* decision, with analysis that seems to indicate one thing and a conclusion that says another, seems representative of the existent split among many of the circuit courts of appeals in the United States. Attorneys and their clients have a daunting challenge to look to the approach prevailing in their circuits or circumstances similar to their own. Their analysis of the issues must be carefully done to avoid the messy consequences and high costs that may result from misguided planning.

In spite of its contradictory result, the *Srivastava* court's analysis probably comes closest to providing a reasonable solution. The court wrote:

> A taxpayer who enters into the contract recognizes that, to realize and maximize the value of his claim, he must necessarily obtain the resources and expertise of counsel. But of course, the same is true of a client who retains counsel on a non-contingent fee basis. The fact that a contingent fee arrangement has the added benefits of risk-shifting and realignment of incentives does not alter the economic reality.
>
> . . . He ought not receive preferential tax treatment from the simple fortuity that he hired counsel on a contingent basis, for his attorney's method of compensation did not meaningfully affect the gain he was able to enjoy from a favorable resolution of the litigation.[123]

Under the often-debated principle of horizontal equity in tax, similarly situated taxpayers should be treated equally by the tax code and the courts. As the Fifth Circuit noted, there is no reason to reward a taxpayer for pursuing their litigation with attorneys who are willing to enter into a contingent arrangement.[124] To the contrary, this kind of approach is tantamount to punishing those who are financially able to deal with their counsel under a more traditional fee agreement. While it is arguable that those who employ attorneys on a contingency fee basis have less means than their counterparts, that loses relevance after a judgment is paid out. In either circumstance, the taxpayer has received a judgment, and where the judgment is not excludable under the Internal Revenue Code, the tax treatment should be similar. A clear congressional or judicial directive to include an attorney's contingency fee payment in the client's income

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

124. *See id.*

would be the best resolution to the conflict as a matter of fairness and equity.

Perhaps one day Congress or the Supreme Court will provide some means of establishing uniformity in this increasingly difficult area and will resolve the split amongst the circuits. There are any number of viable approaches that could be employed to resolve the issue. Until then, taxpayers will be forced to keep grappling with the Internal Revenue Service through its appellate procedures and the courts in hopes of minimizing their tax liability.

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