# *COTNAM V. COMMISSIONER* AND THE INCOME TAX TREATMENT OF CONTINGENCY-BASED ATTORNEYS' FEES—THE ALABAMA ATTORNEY'S CHARGING LIEN MEETS *LUCAS V. EARL* HEAD-ON

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## I. INTRODUCTION

In 1991, Willie Mae Barlow won a landmark consumer finance fraud case against the purchaser of her home improvement loan.[1] Four years earlier, Ms. Barlow had applied for a $2000 loan from American Home Improvement to pay her daughter's medical bills, but American Home denied her loan

1. Union Mortgage Co. v. Barlow, 595 So. 2d 1335, 1345 (Ala. 1992) (per curiam). The author acknowledges the assistance of Professor James Bryce of the University of Alabama School of Law for his assistance in identifying the issue discussed in this article.

application.[2] Eight months after turning Ms. Barlow down, American Home contacted her and offered to loan her $2000, but only if she would allow American Home to make $6000 in home improvements to her three-year-old home.[3] Ms. Barlow agreed and signed a contract with American Home for $8000 in home repairs.[4] American Home assigned the loan to Union Mortgage Company, Inc. ("Union Mortgage"), who bought the loan at a ten percent discount.[5] Union Mortgage then resold the paper to Mitsui Bank of Japan for approximately ten percent over what it had paid for the loan.[6]

As a condition of receiving the $2000, Ms. Barlow had to tell Union Mortgage that she had received $8000 in home improvements rather than $6000.[7] American Home sent a check for $2000 to a friend, who cashed it for Ms. Barlow.[8] When Ms. Barlow contacted American Home to rescind the loan, the company refused.[9] Ms. Barlow later sued Union Mortgage and American Home for $4,500,000, alleging fraud, conspiracy and breach of contract.[10] Union Mortgage counterclaimed for $6,250,000 and brought the same allegations against Ms. Barlow.[11] The jury heard testimony that a representative of Union Mortgage had called Ms. Barlow and threatened to "kick her butt out in the street"[12] and that Union Mortgage had known about the kickback arrangements that American Home

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2. *Union Mortgage*, 595 So. 2d at 1338.

3. *Id.* at 1338-39.

4. *Id.*

5. *Id.* at 1338. Union Mortgage approved 50-60% of the loans submitted by American Home, and there was no evidence that American Home sold commercial paper to anyone other than Union Mortgage or that American Home extended credit to anyone to whom Union Mortgage denied credit. *Id.*

6. *Union Mortgage*, 595 So. 2d at 1338.

7. *Id.* at 1339. The fair market value of the repairs was reported as approximately $1,500. L. Gordon Crovitz, *Rule of Law: When a Finnish Bank Hit an Alabama Jury . . .* , THE WALL ST. J. EUR., Apr. 16, 1992, at 6.

8. *Union Mortgage*, 595 So. 2d at 1339.

9. *Id.*

10. *Id.* at 1337. Her son, Willie J. Galy also joined her as a plaintiff in the suit. *Id.* For an analysis of the claims involved in the *Union Mortgage* case and the general liability of lenders in the home improvement market, see Gene A. Marsh, *Lender Liability for Consumer Fraud Practices of Retail Dealers and Home Improvement Contractors*, 45 ALA. L. REV. 1, 20 (1993).

11. *Union Mortgage*, 595 So. 2d at 1337.

12. *Id.* at 1339.

had with its customers.[13] Ms. Barlow's first victory came when a jury awarded her a total of $152,000 in compensatory damages and $6,001,000 in punitive damages.[14] The Alabama Supreme Court later upheld the lion's share of the award when it granted remittitur of only $1000 each to the compensatory and punitive damage awards.[15] The case attracted both national and international media attention to the size of the jury's punitive damage award.[16]

While observers of other Alabama cases may not have been surprised by the large punitive damages of Ms. Barlow's first victory,[17] her second victory in the United States Tax Court constituted a surprising setback for the Internal Revenue Service (the "Service").[18] Relying on the Fifth Circuit's 1959 ruling in *Cotnam v. Commissioner*,[19] the Tax Court distinguished a long line of contrary precedent and ruled that Ms. Barlow, now

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13. *Id.* at 1341.

14. *Id.* at 1342.

15. *Id.* at 1348. The court granted remittitur on the ground that the jury's judgment on the fraud claim precluded a judgment on the conspiracy claim. *Union Mortgage*, 595 So. 2d at 1344.

16. Daniel Fisher, *When Juries Get Mad*, DALLAS TIMES HERALD, Aug. 11, 1991, at D1 (quoting Montgomery attorney Jere Beasley as saying that Union Mortgage was "basically going after a market that is black, uneducated, and poor."); Crovitz, *supra* note 7, at 6 (quoting Ms. Barlow's attorney's description of the case to the jury: "So a bank from Finland owns a company in Dallas that makes a loan to Ms. Barlow and sells it to some Japs.").

17. Even the United States Tax Court has taken notice of the size of Alabama damage awards. In settlement negotiations for one Alabama case, the defendant corporation settled because it "feared a runaway jury on punitive damages in the event that the case were remanded to State court, since Alabama juries were 'known' for their large punitive damages awards." LeFleur v. Commissioner, 74 T.C.M. (CCH) 37, 43 (1997). In determining what portion of the settlement proceeds in that case were attributable to taxable punitive damages, the Tax Court allocated a large percentage of the settlement to punitive damages based on the defendant's fear of a runaway jury. *LeFleur*, 74 T.C.M. (CCH) at 43.

18. Davis v. Commissioner, 76 T.C.M. (CCH) 46 (1998). Since the Tax Court ruled that her punitive damage award was included in gross income, Mrs. Davis might disagree with this author's contention that her case constituted a victory. *Davis*, 76 T.C.M. (CCH) at 48. The Tax Court's holding that the attorneys' fees should be excluded from gross income, however, is surprising given the weight of contrary precedent. *See infra* note 79. Shortly before the publication of this article, the Eleventh Circuit affirmed the Tax Court's decision. Davis v. Commissioner, No. 98-7026 (11th Cir. Apr. 27, 2000) (per curiam). See *infra* notes 157-58 for a discussion of the Eleventh Circuit's holding.

19. 263 F.2d 119 (5th Cir. 1959) (2-1), *aff'g in part and rev'g in part*, 28 T.C. 947 (1957).

Mrs. Davis, was entitled to exclude from gross income the portion of her award retained by her attorneys for fees and expenses.[20]

The importance of the Tax Court's exclusion of contingency-based attorneys' fees in *Davis v. Commissioner* appears when viewed through the lens of another decision. The case of *Coady v. Commissioner*[21] involved a $373,307 taxable damage award for wrongful termination.[22] The taxpayer argued that the $221,338 paid to her attorneys for fees and litigation expenses should be excluded from gross income under *Cotnam*.[23] The Tax Court ruled that the Alaska attorney's lien statute was distinguishable from Alabama's and that the entire amount of the award should be included in gross income.[24] After state and federal tax withholding and attorneys' fees and expenses, the taxpayer in *Coady* received approximately $38,000.[25] The court did allow the taxpayer to deduct the fees and expenses, which would normally result in a much smaller tax liability, but the deduction was reduced substantially by several limitations.[26]

The treatment of contingency-based attorneys' fees when a plaintiff in a lawsuit receives taxable damages has plagued courts, the Service, and taxpayers since the earliest days of the federal income tax.[27] In its most rudimentary formulation, the problem essentially involves the definition of gross income and judicial rules governing the assignment of income.[28] Under normal circumstances, these tax doctrines would require the plaintiff taxpayer to include the entire amount of the taxable award, including relevant attorneys' fees and litigation expenses, in gross income and then deduct the fees and expenses under one

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20. *Davis*, 76 T.C.M. (CCH) at 48.

21. 76 T.C.M. (CCH) 257 (1998).

22. 76 T.C.M. (CCH) at 258.

23. *Id.* Her attorneys received one-third of the judgment, or $124,436, in fees and $96,903 as reimbursement for expenses. *Id.*

24. *Id.* at 259.

25. *See id.* at 258. The net amount of $38,000 was calculated by subtracting the following from the $373,307 damage award: $113,696 in federal and state tax withholding, $124,436 in contingency fees, and $96,903 in litigation costs. *See id.*

26. See *infra* notes 80-98 and accompanying text for a discussion of the limitations.

27. *See* Appeal of A. L. Voyer, 4 B.T.A. 1192, 1197 (1926) (allowing the exclusion of attorneys' fees from gross income prior to the Supreme Court's decision in *Lucas v. Earl*, 281 U.S. 111 (1930)).

28. *See infra* notes 99-123 and accompanying text.

of several methods.[29]

This simple formulation falters, however, when the Alabama attorney's charging lien is factored into the equation. Under the Alabama statute, attorneys have rights in a lawsuit equal to those of their clients in the form of an equitable charging lien[30] from the moment service occurs upon the defendant.[31] The lien is superior to all other liens except tax liens[32] and can even take priority over a defendant's right of setoff.[33] The *Cotnam* court ruled that the Alabama attorney's lien statute created a right of the attorney to receive his fee equal to that of the client and that the income was not properly allocable to her.[34]

During the last ten years, Congress and the Supreme Court have whittled away at the traditional nontaxability of damage awards.[35] These incursions, combined with tax code provisions that severely limit the deductibility of attorneys' fees, have spawned several attempts by taxpayers to invoke *Cotnam* to exclude attorneys' fees and expenses from gross income.[36] With the exception of the *Davis* case and a recent Sixth Circuit decision, these taxpayers have failed because the charging lien statutes in question did not grant attorneys rights equal to those of plaintiffs.'[37] Thus, the *Cotnam* and *Davis* decisions owe their

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29. *LeFleur*, 74 T.C.M. (CCH) at 44-45 (explaining that legal expenses and costs related to a recovery as an employee are deductible as a miscellaneous itemized deduction). For a more detailed discussion of the deductions available for contingency-based attorneys' fees, see *infra* notes 80-83 and accompanying text.

30. ALA. CODE § 34-3-61(b) (1997). See Part II.A *infra* for an explanation of the attorney's charging lien.

31. *Id.* § 34-3-61(d).

32. *Id.* § 34-3-61(b).

33. U.S. Fidelity & Guar. Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935) (interpreting the Alabama charging lien statute to give the lien priority over the defendant's right of setoff when the lien attached prior to the time setoff accrued).

34. Cotnam v. Commissioner, 263 F.2d 119, 126 (5th Cir. 1959).

35. *See infra* notes 75-79 and accompanying text.

36. For a discussion of the obstacles to deducting attorneys' fees paid pursuant to a contingency fee contract, see, for example, Syphrett v. Commissioner, 74 T.C.M. (CCH) 1267, 1269 (1997) (ruling that petitioners could not take contingency-based attorneys' fees as a miscellaneous itemized deduction because they were subject to the alternative minimum tax).

37. *See, e.g.*, Baylin v. United States, 43 F. 3d 1451 (Fed. Cir. 1995), *aff'g* 30 Fed. Cl. 248 (1993). *But see* Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000) (accepting the *Cotnam* court's reasoning in the context of Michigan attorney's lien). For a complete discussion of the cases deciding that attorneys' fees and expenses are to be included in gross income, see *infra* notes 177-89 and accompanying text.

results to the unique nature of the Alabama charging lien statute.[38]

This Note will examine the tax treatment of attorneys' fees and expenses in the context of the attorney's charging lien. Part II of the Note will explore the nature of the attorney's charging lien and the general tax principles applicable to the taxation of damage awards. Part III will discuss the *Cotnam* decision, its recent rise in importance, and the failure of the Tax Court to apply it outside of Alabama. Part IV will examine the charging lien law of other jurisdictions in an effort to determine whether *Cotnam* applies by extension outside of Alabama. Based on the analysis of charging lien law, Part V will discuss problems with the current approach, and the Conclusion will advocate changes to the treatment of attorneys' fees to equalize tax treatment in all jurisdictions.

## II. GENERAL PRINCIPLES OF APPLICABLE LAW

### *A. The Attorney's Charging Lien*

The attorney's charging lien, also known as a special lien or particular lien, gives an attorney a lien that enables him or her to obtain payment from judgments and settlements won through the attorney's labor.[39] The attorney's charging lien exists in both statutory and common law form.[40] Generally, an attorney's charging lien is on a client's cause of action, judgment or the proceeds thereof.[41] The lien attaches to the fruits of the

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38. The Tax Court has noted that the *Cotnam* decision relied heavily on the distinctive features of the Alabama statute. O'Brien v. Commissioner, 38 T.C. 707, 712 (1962). Part III, *infra*, examines the factors that courts have used to distinguish the Alabama charging lien statute from the lien law of other states.

39. RAY ANDREWS BROWN & WALTER B. RAUSHENBUSH, THE LAW OF PERSONAL PROPERTY § 13.10, at 429-30 (3d ed. 1975); 2 ROBERT L. ROSSI, ATTORNEYS' FEES § 12:13, at 246 (2d ed. 1995).

40. BROWN & RAUSHENBUSH, *supra* note 39, § 13.10, at 429. Alabama, for example, defines its attorney's charging lien by statute. ALA. CODE § 34-3-61 (1997). The Texas charging lien, however, exists at common law. McManus v. Cash & Luckel, 108 S.W. 800, 803 (Tex. 1908).

41. 2 ROSSI, *supra* note 39, § 12:13, at 246-47; James T. Flaherty, *Attorney Liens and the Code of Professional Responsibility*, 14 J. LEGAL PROF. 137, 139 (1989). Although the two terms are sometimes used interchangeably, the attorney's charging

attorney's labor and skill when realized by judgment, settlement or other exercise of the attorney's efforts.[42]

The charging lien is designed to protect attorneys from the "knavery" of their clients.[43] In keeping with this purpose, the lien gives attorneys the right to recoup their costs from funds recovered through their efforts and to prevent those funds from being paid to a client, whether after judgment or settlement, where the attorney's lien has not been satisfied.[44] The amount of the lien derives from the value of the services performed in that particular action.[45]

The tax cases examining the effect of an attorney's charging lien on whether attorneys' fees should be included in gross income only focus on a few aspects of the charging lien, and only those attributes will be reviewed here.[46] Courts have focused on when an attorney's lien attaches, the priority of the lien over other liens and a defendant's right of setoff, and the extent to which the lien gives an attorney an equitable interest in the claim. The charging lien can attach at any time from the filing of a complaint or answer containing a counterclaim,[47] to the service of process on the defendant,[48] to the entry of final judgment.[49] In some states, the lien does not exist until the funds are in the attorney's possession.[50] Commentators have noted

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lien differs from the attorney's retaining or general lien, which attaches to papers, documents and money in the attorney's possession. Flaherty, *supra* this note, at 140. Unlike the retaining lien, the charging lien does not depend on possession and usually only applies to the particular action for which the attorney rendered services. 2 ROSSI, *supra* note 39, § 12:13, at 247. For a detailed discussion of the attorney's retaining lien, see *id.* §§ 12:4-12:12, at 232-46.

42. Camp v. U.S. Fidelity & Guar. Co., 157 S.E. 209, 210 (Ga. 1931); Wylie v. Cox, 56 U.S. 415, 420 (1853) (holding that a contingency fee contract gave rise to a lien on the fund awarded). *But see* Collins v. Schneider, 192 So. 20, 22 (Miss. 1939) (holding that the attorney's common law lien was based mainly on possession of funds and partially on the merit and value of an attorney's services).

43. Goodrich v. McDonald, 19 N.E. 649, 651 (N.Y. 1889).

44. Hale v. Tyson, 79 So. 499, 500 (Ala. 1918).

45. *In re* Heinsheimer, 108 N.E. 636, 637 (N.Y. 1915) (Cardozo, J.).

46. *See infra* notes 176-89 and accompanying text for a discussion of the relevant attributes. For an in-depth examination of the attorney's charging lien, see BROWN & RAUSHENBUSH, *supra* note 39, § 10.13; 2 ROSSI, *supra* note 39, §§ 12:13-41, at 246-89; 7 AM. JUR. 2D *Attorneys at Law* §§ 342-69 (1997).

47. OKLA. STAT. tit. 5, § 6 (1995).

48. In Alabama, the lien attaches when the complaint is served on the defendant. ALA. CODE § 34-3-61(d) (1997).

49. N.Y. JUDICIARY LAW § 475 (McKinney 1983).

50. Finkelstein v. Roberts, 220 S.W. 401, 405 (Tex. Civ. App. 1920) (holding that

that without a controlling statute or a contract between the parties acting as a lien or equitable assignment, a charging lien does not attach until judgment.[51] Some courts hold that even if a lien is created early in the litigation process, it cannot be enforced until the suit is prosecuted to final judgment.[52] Other jurisdictions simply allow a lien to attach upon judgment.[53] The Alabama statute also gives the attorney rights in the claim equal to those of the client's.[54]

The charging lien often has priority over other liens and can even take priority over a defendant's right of setoff. Several states, including Alabama, give a charging lien priority over all other liens except tax liens.[55] The approaches to the priority of a charging lien over a defendant's right of setoff run the gamut of possibilities from priority of the charging lien over setoff,[56] to priority based on which right accrued first,[57] to priority of the right of setoff over the charging lien.[58] Where a charging lien is created upon filing or service of a complaint and attaches to the claim and where that lien has priority over the defendant's right of setoff and gives the attorney equitable rights in the claim equal to that of the client, courts have allowed taxpayers to exclude contingency-based attorneys' fees from gross income.[59]

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Texas does not recognize a general lien on a cause of action or judgment until it is collected and in an attorney's hands). Technically, such a lien more closely resembles the attorney's retaining lien described at note 41, *supra*.

51. BROWN & RAUSHENBUSH, *supra* note 39, § 10.13, at 430-33; 2 ROSSI, *supra* note 39, § 12:28, at 267.

52. Locke v. Barranco, 102 So. 2d 2, 4 (Ala. 1958).

53. *See, e.g.*, WASH. REV. CODE ANN. § 60.40.010 (West 1990) (granting a lien upon judgment to the extent of the value of the attorney's services).

54. ALA. CODE § 34-3-61(d) (1997). This provision was central to the *Cotnam* court's decision to exclude damages, *Cotnam*, 263 F.2d at 125-26, and has proven to be one of the key factors in subsequent decisions by the Tax Court. *See, e.g.*, Petersen v. Commissioner, 38 T.C. 137, 152 (1962) (holding that the South Dakota and Nebraska charging lien laws did not give attorneys rights equal to those of their clients). Part III of this Note, *infra*, discusses all of the factors emphasized.

55. *See, e.g.*, ALA. CODE § 36-3-61(b).

56. BROWN & RAUSHENBUSH, *supra* note 39, § 10.13, at 430-35 (noting that where the right of setoff arose from an entirely separate cause of action, certain courts view the lien as an assignment "subject to all defenses and claims to which the judgment is subject in the hands of its owner.").

57. U.S. Fidelity & Guar. Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935).

58. 2 ROSSI, *supra* note 39, § 12:21, at 259-60.

59. *See infra* notes 182-89 and accompanying text.

### *B. General Federal Income Tax Principles*

The question of whether contingency-based attorneys' fees and expenses should be included in a taxpayer's income involves the fundamental concern over what items should be included in gross income. Section 61 of the Internal Revenue Code of 1986 (the "Code") defines gross income as "all income from whatever source derived."[60] While the Code does not give specific guidance on the inclusion of damage awards, courts construe the definition of gross income broadly in accordance with Congress' intent to tax income comprehensively.[61]

In *Glenshaw Glass v. Commissioner*, the United State Supreme Court formulated a three-part test for gross income. A determination that an item should be included in gross income requires "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[62] In that case, the Court found that treble damages for antitrust violations and punitive damages for antitrust violations were both taxable.[63]

While the *Glenshaw Glass* court found that the damages in the two cases before it were indeed taxable, § 104(a)(2) excludes many tort-like damages from gross income.[64] Section 104(a)(2) supplies the explicit statutory authority that courts require in

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60. I.R.C. § 61(a) (1994). Section 61 goes on to provide a nonexclusive list of items included in income, but it does not specifically mention damage awards. *Id.* Nor are damage awards mentioned in the Code's subchapter B, part II, Items Specifically Included in Gross Income. *See* I.R.C. §§ 61(b), 71-90 (1994 & Supp. IV 1998).

61. Commissioner v. Jacobson, 336 U.S. 28, 49 (1949). The Supreme Court has also held that in enacting § 61, Congress exercised the full extent of its power to levy an income tax under the Sixteenth Amendment and that the statute should be interpreted broadly to conform to that purpose. Helvering v. Clifford, 309 U.S. 331, 334 (1940) (interpreting a prior version of § 61).

62. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (Warren, C.J.).

63. *Glenshaw Glass*, 348 U.S. at 432. Interestingly, the Court noted that the Commissioner determined that the taxable amount was the award less the deductible attorneys' fees. *Id.* at 428. No other mention of the propriety of deducting the fees was made and apparently was not at issue in the case. See *infra* note 81 and accompanying text for an explanation of the deductibility of attorneys' fees incurred in the conduct of a trade or business.

64. *See* I.R.C. § 104(a)(2) (Supp. IV 1998); Treas. Reg. § 1.104-1(c) (as amended in 1970). The regulations under § 104 have not been amended since 1970 and do not reflect the substantial changes in the statute since that time.

order to exclude from gross income an item that comes within the broad sweep of the *Glenshaw Glass* definition.[65] Even when Congress does exclude items from gross income with provisions such as § 104(a)(2), courts construe those exclusions narrowly.[66] Section 104(a)(2) excludes from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."[67] Some states, such as Alabama, only allow punitive damages in wrongful death actions,[68] and § 104 provides that punitive damages received in a wrongful death action, where only punitive damages are available, are excludable from gross income.[69] The regulations promulgated by the Service explain that the phrase "damages received (whether by suit or agreement) . . . " denotes amounts received by virtue of prosecuting a legal action "based upon tort or tort type rights" or settlement agreement as an alternative to such an action.[70] Nowhere does § 104 or the relevant regulations deal with the proper tax treatment of contingency-based attorneys' fees.[71]

The treatment of damages received for emotional distress merits specific attention. Section 104 limits the exclusion by providing that emotional distress is not a personal physical injury,[72] but it does allow taxpayers to exclude emotional dis-

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65. The Supreme Court has held that defining gross income broadly under § 61 necessitates interpreting exclusions from gross income narrowly. *Jacobson*, 336 U.S. at 49; United States v. Centennial Savings Bank, 499 U.S. 573, 583 (1991).

66. *Jacobson*, 336 U.S. at 49.

67. I.R.C. § 104(a)(2).

68. Alabama's Wrongful Death Act, ALA. CODE § 6-5-410 (1993), has been interpreted by the Alabama Supreme Court to allow only punitive damages in a wrongful death action. *Ex parte* Cincinnati Ins. Co., 689 So. 2d 47, 50 (Ala. 1997) (holding that damages for wrongful death are "imposed against the tortfeasor for the purpose of preserving human life, to punish the tortfeasor for the wrongful act, and to deter the tortfeasor and others from similar conduct in the future.") Bonner v. Williams, 370 F.2d 301, 303 (5th Cir. 1967) (noting that wrongful death damages in Alabama are punitive in nature).

69. I.R.C. § 104(c) (Supp. IV 1998). Section 104(c) provides that the parenthetical phrase "other than punitive damages" in § 104(a)(2) does not apply to punitive damages awarded in a civil wrongful death action where the relevant state law states or has been interpreted to mean that only punitive damages may be awarded in a wrongful death action. *Id.* § 104(c).

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

71. *See* I.R.C. § 104 (1994 & Supp. IV 1998).

72. I.R.C. § 104(a) (Supp. IV 1998) (flush language).

tress damages up to the amount spent on medical treatment of the emotional distress.[73] Therefore, damages received for emotional distress are included in gross income to the extent that they exceed the amount spent for medical treatment of the emotional distress.[74]

During the 1990s, Congress and the Supreme Court gradually whittled away at the types of damages excluded from gross income.[75] In 1992, the Supreme Court held that settlements for back pay under Title VII of the Civil Rights Act of 1964 were not excluded under § 104(a)(2).[76] A similar ruling in 1995 rendered damages under the Age Discrimination in Employment Act taxable.[77] In 1996, Congress joined the Supreme Court and further limited the exclusion of damages by amending § 104(a)(2) to prohibit the exclusion of punitive damages from gross income.[78] The new statute also changed the fundamental exclusionary language of § 104(a)(2) from "on account of *personal* injuries or sickness" to the current language, "on account of personal *physical* injuries or *physical* sickness."[79]

To understand why the inclusion of attorneys' fees is being hotly contested by taxpayers and the Service, it is important to understand the deductions available to successful plaintiffs. The debate about whether the portion of a taxable damage award attributable to contingency-based attorneys' fees should be excluded from gross income would be moot if all taxpayers were allowed to deduct the entirety of the fees and expenses. At the opposite end of the spectrum, the question is equally moot in cases where the damage award is excluded from gross income by § 104 because deductions are not allowed for any expense allocable to a nontaxable class of income.[80]

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73. *Id.*

74. *Id.* § 104(a)(2).

75. *See* JAVED A. KHOKHAR, TAX ASPECTS OF SETTLEMENTS AND JUDGMENTS, at A-18 (BNA Tax Management Portfolios No. 522, 2d ed. 1999).

76. United States v. Burke, 504 U.S. 229 (1992).

77. Commissioner v. Schleier, 515 U.S. 323 (1995).

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

79. *Compare* I.R.C. § 104(a)(2) (Supp. IV 1998) (emphasis added), *with* I.R.C. § 104(a)(2) (1994), *repealed by* Pub. L. No. 104-188 § 1605(a), 110 Stat. 1755, 1838 (emphasis added).

80. I.R.C. § 265(a)(1) (1994); LeFleur v. Commissioner, 74 T.C.M. (CCH) 37, 44 (1997) (noting that when none of the proceeds of the suit is excludable, § 265 does

Taxpayers who receive taxable damage awards subject to contingency-based attorneys' fees and expenses have three basic opportunities to deduct expenses. First, they can attempt to deduct the litigation expenses under § 162(a) as a trade or business expense.[81] This optimal approach allows an undiluted reduction in taxable income.[82] Many individual plaintiffs, however, do not sue in a business capacity and will not be able to meet § 162(a)'s requirements that expenses be ordinary and necessary expenses incurred in the conduct of a trade or business.[83] A second, less common approach requires taxpayers to capitalize litigation expenses under § 263.[84]

Most individual taxpayers, however, will be forced to pursue the third option and deduct the expenses as a miscellaneous itemized deduction.[85] Normally, § 262(a) denies deductions for personal, living and family expenses.[86] Contingency-based attorneys' fees that are not deductible elsewhere can often be deducted as a miscellaneous itemized deduction "for the production of income" under § 212.[87] The regulations require that such a deduction be reasonable in amount and bear proximate relation to the production of income.[88] Contingency-based attorneys' fees that are deemed employee-related expenses are also allowed as a miscellaneous itemized deduction.[89]

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not disallow any of the deductions).

81. I.R.C. § 162(a) (1994 & Supp. IV 1998).

82. Section 162 deductions are taken "above-the-line," meaning that the deductions reduce gross income on a dollar-per-dollar basis. *See id.* § 62(a)(1) (1994) (providing that trade or business deductions are subtracted from gross income in computing adjusted gross income).

83. *See id.* § 162(a) (1994 & Supp. IV 1998).

84. *Id.* § 263.

85. The term "miscellaneous itemized deductions" is not specifically defined in the Code. Section 67(b) only describes miscellaneous itemized deductions as itemized deductions other than the deductions specifically mentioned in § 67(b)(1) through (12). *Id.* § 67(b). Itemized deductions are deductions other than the § 151 personal exemptions and those identified as "above-the-line" deductions by § 62(a). *See* I.R.C. § 63(d) (1994). Miscellaneous itemized deductions are subject to severe limitations in some instances. *See infra* notes 91, 95-98, 121, 261 and accompanying text.

86. I.R.C. § 262(a) (1994).

87. *See id.* § 212.

88. Treas. Reg. § 1.212-1(d) (as amended in 1975).

89. LeFleur v. Commissioner, 74 T.C.M. (CCH) 37, 44 (1997). Although "trade or business" would seem to encompass employee expenses, the Code specifically denies above-the-line treatment to "the performance of services by the taxpayer as an employee." I.R.C. § 62(a)(1) (1994).

The miscellaneous itemized deduction treatment of litigation expenses creates several distinct problems for taxpayers who receive large taxable damage awards. Miscellaneous itemized deductions are only allowed to the extent that they exceed two percent of adjusted gross income ("AGI").[90] The Code also imposes a phaseout of itemized deductions for taxpayers with an AGI over $128,950 ($64,475 if married filing separately).[91] The final and most insurmountable obstacle posed by miscellaneous itemized deduction treatment is the alternative minimum tax ("AMT").

Congress designed the AMT to ensure that high income taxpayers who make aggressive use of deductions pay some taxes.[92] Congress believed that excessive tax avoidance could lead to a breakdown in taxpayer morale that would complicate tax collection.[93] While a detailed discussion of the AMT is be-

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90. I.R.C. § 67(a). AGI is calculated by subtracting a taxpayer's above-the-line deductions from gross income. *See id.* § 62(a) (1994 & Supp. IV 1998); *LeFleur*, 74 T.C.M. (CCH) at 44.

91. I.R.C. § 68(b) (1994) (amounts adjusted for inflation for tax year 2000). The reduction mandated by § 68 is the lesser of three percent of the excess of AGI over $128,950 ($64,475 if married filing separately) or eighty percent of the amount of deductions otherwise allowable for the taxable year. *Id.* § 68(a), (b). Naturally, the larger the award, the larger the bite that § 68's phase-out provisions will be. For an example of the effects of §§ 67 and 68 in the context of attorneys' fees deducted as an employment-related expense, see *LeFleur*, 74 T.C.M. (CCH) at 44 (noting the applicability of the § 68 phaseout and the two-percent floor to contingency-based legal fees deducted as a miscellaneous itemized deduction).

92. The Senate Finance Committee explained the purpose of the minimum tax, the predecessor of the AMT, as follows: "Increasingly in recent years, taxpayers with substantial incomes have found ways of gaining tax advantages from the provisions that were placed in the code primarily to aid limited segments of the economy." S. REP. NO. 91-552, pt. 1, at 1 (1969). When it enacted the current version of the individual AMT in 1982, Congress reemphasized that the overriding objective of the individual AMT was that "no taxpayer with substantial economic income should be able to avoid virtually all tax liability by using exclusions, deductions and credits." STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 17 (Comm. Print 1982) [hereinafter 1982 BLUEBOOK]. The AMT does stray beyond its original purpose and snares those who are not in the original target groups. The AMT's disallowance of the personal and dependency exemptions can lead to harsh results. *See* Klaasen v. Commissioner, 76 T.C.M. (CCH) 20 (1998) (rejecting the taxpayers' arguments that the AMT's denial of their twelve personal and dependency exemptions unconstitutionally penalized them for their religious beliefs against birth control).

93. In enacting the minimum tax, Congress voiced the following concerns over taxpayer morale:

The fact that present law permits a small minority of high-income individuals

yond the scope of this Note,[94] the relevant feature of the AMT in this area is the AMT's disallowance of miscellaneous itemized deductions.[95] If a taxpayer's award is large enough to trigger AMT treatment, the taxpayer will lose the benefit of deducting the attorney's fees as a miscellaneous itemized deduction.[96] In other words, a miscellaneous itemized deduction for contingency-based attorneys' fees in the context of a large taxable damage award is really a phantom deduction that the taxpayer never realizes.[97] Not surprisingly, the Service advocates that taxpayers must include the whole amount of the award, including any attorneys' fees pursuant to a contingency fee arrangement, in gross income and then deduct the fees and expenses as a miscellaneous itemized deduction.[98]

Now that the pitfalls of deducting contingency-based attorneys' fees from gross income have been examined, this Note will survey the income tax principles that govern whether the fees are included in gross income. In *Lucas v. Earl*, the Supreme

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> to escape tax on a large proportion of their income has seriously undermined the belief of taxpayers that others are paying their fair share of the tax burden. It is essential that tax reform be obtained not only as a matter of justice but also as a matter of taxpayer morale. Our individual and corporate income taxes, which are the mainstays of our tax system, depend upon self-assessment and the cooperation of taxpayers. The loss of confidence on their part in the fairness of the tax system could result in a breakdown of taxpayer morale and make it far more difficult to collect the necessary revenues.

S. REP. NO. 91-552, pt. 2, at 13 (1969). When the AMT was enacted, Congress again emphasized preserving taxpayer morale as one of the goals of the AMT. 1982 BLUEBOOK, *supra* note 92, at 17 (noting that "[t]he ability of high-income individuals to pay little or no tax undermines respect for the entire tax system. . . . ").

94. For an overview of the AMT, see 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 111.4, at 111-88 to 111-16 (2d ed. 1992).

95. I.R.C. § 56 (b)(1)(A)(i) (1994).

96. *See* Benci-Woodward v. Commissioner, 76 T.C.M. (CCH) 787, 790 (1998) (holding that contingency-based attorneys' fees, which are deductible as a miscellaneous itemized deduction, were subject to the AMT's disallowance of miscellaneous of itemized deductions).

97. *See* Syphrett v. Commissioner, 74 T.C.M. (CCH) 1267, 1269 (1997) (ruling that the application of the AMT in this case prevented the taxpayers from taking the contingency-based attorneys' fees as a miscellaneous itemized deduction).

98. In a recent private letter ruling, the Service ruled that the portion of a taxable damage award attributable to attorneys' fees must be included in gross income and that the fee might be deductible as a miscellaneous itemized deduction if the AMT did not apply. Priv. Ltr. Rul. 98-09-053 (Feb. 27, 1998) (citing Lucas v. Earl, 281 U.S. 111 (1930)). See *infra* notes 156-57 and accompanying text for more on the Service's approach and the value of private letter rulings as precedent.

Court articulated the assignment of income doctrine that governs when gross income is properly taxable to a particular taxpayer.[99] In 1901, before the birth of the federal income tax,[100] Mr. Earl entered into a contract with his wife in which they agreed to own jointly all property, including earnings, acquired during the course of their marriage.[101] He argued that his taxpayer's salary became the joint property of the taxpayer and his wife at the moment it was received.[102] While the Court characterized his arguments as "very forcible," all nine Justices held that, regardless of the arrangement between the Mr. Earl and wife, Mr. Earl was the party to the contract who earned the income, and it was he who had to take the last step in performing the contract.[103]

The Court ruled that the broad purpose of the Code was to tax salaries to those who earn them without regard for "skillfully devised" anticipatory arrangements designed to prevent salaries from accruing to those who earn them.[104] Indeed, a later Supreme Court decision described *Lucas v. Earl* as standing for the principle that income must be taxed to those who earn it.[105] Under *Lucas v. Earl*, the fruits of income must be attributed to the tree on which they grow.[106]

To meet the realization and control requirements of *Glenshaw Glass* for income, a taxpayer does not have to receive the income directly. In determining whether an employer paying income taxes to an employee generated gross income to the employee, the Supreme Court ruled that the discharge of a taxpayer's obligation by a third person equals receipt by the person owing the obligation.[107] Although income is normally taxed upon receipt and not when the right to receive payment accrues, certain tax avoidance situations may give rise to differ-

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99. Lucas v. Earl, 281 U.S. 111, 115 (1930) (Holmes, J.). The Supreme Court has described the *Lucas v. Earl* decision as the "cornerstone" of the federal income tax system. United States v. Bayse, 410 U.S. 441, 450 (1973).

100. 3 BITTKER & LOKKEN, *supra* note 94, ¶ 75.2.1, at 75-8 (2d ed. 1991).

101. *Earl*, 281 U.S. at 114.

102. *Id.*

103. *Id.*

104. *Id.* at 114-15.

105. Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949).

106. *See Earl*, 281 U.S. at 115.

107. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929) (Taft, C.J.).

ent results. In *Helvering v. Horst*,[108] a father clipped the coupons from his negotiable coupon bonds shortly before they matured and gave the coupons to his son.[109] The son then collected the payment of the coupons and reported the income for tax purposes.[110] The Service maintained that the income should be taxed to the father rather than to the son.[111]

The Supreme Court held that the realization requirement does not mean that a taxpayer, who has fully enjoyed an economic gain by virtue of a right to receive income, can avoid taxation of income merely because the income has not been received.[112] Normally, the realization requirement delays the imposition of the income tax until the enjoyment of the income, which is usually the receipt by the taxpayer.[113] The Court noted, however, that enjoyment may occur before receipt if the taxpayer "has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth" and concluded that the coupon income was properly included in the father's gross income.[114]

The broad assignment of income doctrine articulated by the Supreme Court in *Lucas v. Earl* and subsequent cases contrasts sharply with the Court's approach to income earned by one spouse in community property states. In *Poe v. Seaborn*,[115] less than a year after the *Lucas v. Earl* decision, the Court held that a husband and wife, living in a community property state, were entitled to file separate returns attributing half of the income and expenses to each spouse even though the husband had earned all of the salary.[116] The Court distinguished the com-

108. 311 U.S. 112 (1940).
109. *Horst*, 311 U.S. at 114.
110. 311 U.S. at 114.
111. *Id.*
112. *Id.* at 115-16 (stating that the realization requirement "has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor."); Helvering v. Eubank, 311 U.S. 122, 125 (1940) (holding that the rationale applied to this indistinguishable case, which was decided on the same day). Although these two cases are often cited together, this Article will only cite to the *Horst* opinion since it contains the Court's reasoning on the issue.
113. *Horst*, 311 U.S. at 116.
114. *Id.*
115. 282 U.S. 101 (1930).
116. *Seaborn*, 282 U.S. at 106. Ultimately, this case led Congress to allow mar-

munity property couple's situation from that of the couple in the *Earl* case by noting that the contract to split income in *Earl* was predicated upon the salary belonging to the husband.[117] In *Seaborn*, the relevant community property law determined that the earnings did not belong to the husband but to the community, with both spouses having vested rights in the income.[118] Since the income belonged to both spouses, the Court allowed them to file separate returns for their respective shares of the income.[119]

In an attempt to reconcile *Lucas v. Earl* and *Poe v. Seaborn*, one commentator has suggested that the Court may have been reluctant to view the community property law as a "skillfully devised" arrangement for splitting income within the meaning of *Lucas v. Earl*.[120] The tension between *Earl* and *Seaborn* is instructive in deciding whether attorneys' fees covered by the charging lien are properly taxed to just the attorney holding the lien or to both the attorney and the client, who might be able to deduct the fees paid to the attorney.[121] To determine whether the portion of a damage award covered by the attorney's charging lien is income, courts must decide whether the charging lien more closely resembles a community property-type situation or a private contractual arrangement. The *Seaborn* Court noted that *Lucas v. Earl* "was bottomed on the fact that the earnings would be the husband's property."[122] In a community property state," earnings are never the property of the husband, but that of the community."[123] Indeed, it appears that when approached with an attorney's charging lien statute that gives the attorney an interest in the claim, some courts will follow an approach resembling *Poe v. Seaborn*.

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ried couples to file joint returns in 1948. 3 BITTKER & LOKKEN, *supra* note 94, ¶ 75.2.1, at 75-11.

117. *Seaborn*, 282 U.S. at 117.

118. *Id.*

119. *Id.* at 117-18.

120. 3 BITTKER & LOKKEN, *supra* note 94, ¶ 75.2.1, at 75-11.

121. If the award is large and the fees must be deducted as a miscellaneous itemized deduction, the deduction may be substantially reduced by the phaseout or even completely denied by the AMT. *See supra* notes 85-98 and accompanying text.

122. *Seaborn*, 282 U.S. at 117.

123. *Id.*

## III. *COTNAM V. COMMISSIONER*—THE CHARGING LIEN MEETS *LUCAS V. EARL*

### *A.* Cotnam v. Commissioner

This Section will discuss the Fifth Circuit's rather unique decision in *Cotnam v. Commissioner,*[124] which excluded a contingency-based attorney's fee from gross income because the Alabama attorney's charging lien prevented the taxpayer from ever enjoying the fruits of her income within the meaning of *Lucas v. Earl.* The *Cotnam* decision's importance for today's litigants is underscored by not only the limitations placed on deductions by the AMT and the miscellaneous itemized deduction, but also by the fact that charging lien is the only available argument, outside of § 104(a)(2), for excluding an award from gross income. While *Cotnam* has not been warmly received, courts have been even less cordial to arguments that are not based on *Cotnam.* The Tax Court rejected one taxpayer's argument that a contingency fee arrangement with an attorney constitutes a partnership.[125] Courts have also refused taxpayers' equitable arguments that the application of the AMT unfairly imposes a double tax.[126]

The *Cotnam* case involved the taxability of a damage award that Ethel Cotnam had won against the estate of T. Shannon Hunter.[127] Mr. Hunter had promised Mrs. Cotnam one-fifth of his estate if she would serve as his personal attendant for the

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124. 263 F.2d 119 (5th Cir. 1959) (2-1), *aff'g in part and rev'd in part* 28 T.C. 947 (1957).

125. Bagley v. Commissioner, 105 T.C. 396, 418-19 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997) (rejecting partnership argument on the basis that a partnership is characterized by mutual proprietary interest and sharing of net profits and losses). Such an arrangement would probably violate the ABA's Model Rules of Professional Conduct Rule 1.8(j) (1983) (prohibiting an attorney from obtaining a proprietary interest in a claim except to the extent necessary acquire an attorney's lien granted by law).

126. *See* Alexander v. I.R.S., 72 F.3d 938, 947 (1st Cir. 1995) ("It is well established that equitable arguments cannot overcome the plain meaning of the statute."); Benci-Woodward v. Commissoner, 76 T.C.M. (CCH) 787, 790 (1998) (rejecting the taxpayer's argument that the AMT's application to disallow the deduction of contingency-based attorneys' fees resulted in unfair double taxation).

127. *Cotnam,* 263 F.2d at 120.

rest of his life.[128] She served as his attendant until his death, but the administrator of his estate refused to recognize her claim to the estate.[129] Eventually, the Supreme Court of Alabama validated her claim and awarded her $120,000.[130]

After determining that the award was not a nontaxable bequest and was taxable income,[131] the Fifth Circuit next turned to the issue of whether Mrs. Cotnam's contingency-based attorneys' fees should be included in her gross income.[132] A majority of the Fifth Circuit panel concluded that attorneys' fees are not included in gross income when a plaintiff contracts with an attorney on a contingency fee basis and the applicable attorney's lien statute gives that attorney the same rights as the client in the suit and the lien is superior to the defendant's right to setoff.[133] The relevant portion of the Alabama attorney's lien statute states now, as it did then, that:

> Upon actions and judgments for money, [attorneys-at-law] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said action or judgment, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys-at-law shall have the same right and power over action or judgment to enforce their liens as their clients had or may have for the amount due thereon to them.[134]

All three members of the Fifth Circuit panel cited the statute as giving attorneys the same right as clients over suits and noted that Alabama courts had given full effect to that language.[135] The court also noted that a prior Fifth Circuit decision had interpreted the statute to create a

> charge in the nature of an equitable assignment . . . [or] equitable lien' in the cause of action. An attorney 'holding such an interest has an equity in the cause of action and the recovery under it pri-

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128. *Id.*
129. *Id.*
130. Merchants Nat'l Bank of Mobile v. Cotnam, 34 So. 2d 122, 132 (Ala. 1948).
131. *Cotnam*, 263 F.2d at 125.
132. *Id.*
133. *Id.*
134. ALA. CODE § 34-3-61(b) (1997).
135. *Cotnam*, 263 F.2d at 125 (citing Western Railway Co. v. Foshee, 62 So. 500, 503 (Ala. 1913)); *see also* Denson v. Alabama Fuel & Iron Co., 73 So. 525, 528 (Ala. 1916) (holding that the attorney may prosecute the suit to final judgment even though the client and the defendant have settled the case)).

> or to that of the defendant in the judgment to exercise a right of set-off accruing to him after the attorney's interest had attached.'"[136]

The court observed that the unusual facts of the case and the Alabama's attorney's lien statute combined to exclude the attorney's fees from Mrs. Cotnam's gross income.[137]

In the *Cotnam* case, the ramifications of the *Lucas v. Earl* and *Helvering v. Horst* decisions on the inclusion of attorneys' fees and expenses in gross income were discussed by both the majority and minority decisions. The majority noted that after Mr. Hunter's death, Mrs. Cotnam's claim was uncertain and had no fair market value.[138] The only economic benefit she could receive was to assign forty percent of her claim to her attorneys to collect the remainder.[139] In short, her claim was "worthless" without the skill of her attorneys.[140]

The majority held that such an assignment did not come under the rubric of *Lucas v. Earl*.[141] Mrs. Cotnam's limited use of her claim in assigning an uncertain, contingent portion thereof did not equal the full enjoyment of an economic gain as required by the Supreme Court's decision in *Helvering v. Horst*.[142] The court acknowledged that Mrs. Cotnam had earned the entire judgment in a remote sense by serving as Hunter's attendant, but held that she had to part with a portion of her claim long before realizing any of it.[143] Therefore, the majority concluded that the fees were income to the attorneys and not to Mrs. Cotnam.[144]

The dissent in *Cotnam* also relied heavily on the *Lucas v.*

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136. *Cotnam*, 263 F.2d at 125 (quoting U.S. Fidelity & Guar. Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935)).

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

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

142. *Id.* at 126. The court reasoned that "[b]y such limited use [Mrs. Cotnam] has not 'fully enjoyed the benefit of [her] economic gain represented by [her] right to receive income' within the doctrine of *Helvering v. Horst*." *Id.* (quoting Helvering v. Horst, 311 U.S. 112, 116 (1940)).

143. *Id.* at 126.

144. *Id.* The majority concluded its opinion by paraphrasing *Lucas v. Earl*: "Mrs. Cotnam's tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit." *Cotnam*, 263 F.2d at 126.

*Earl* and *Helvering v. Horst* decisions but placed a different spin on the facts surrounding Mrs. Cotnam's assignment.[145] The dissent claimed that Mrs. Cotnam's agreement with her attorney allowed her to enjoy a taxable economic benefit—fighting her case in court.[146] The assignment also discharged her obligations to her attorneys, which the dissent viewed as a receipt of income under *Old Colony Trust v. Commissioner*.[147] While other courts have tended to agree with the dissent's interpretation of the Supreme Court's general tax principles,[148] the *Cotnam* decision still stands as precedent in the Fifth and Eleventh Circuits, and the Sixth Circuit recently adopted the *Cotnam* majority's reasoning in *Estate of Clarks v. United States*.[149]

This is not to imply that the *Cotnam* decision has been received with aplomb by the courts. Indeed, the Tax Court has only grudgingly accepted *Cotnam*, and it seems likely that the Tax Court will greet *Estate of Clarks* with equal warmth. In one of the first decisions after *Cotnam*, the Tax Court suggested that the Fifth Circuit had put too fine a point on the issue.[150] The Tax Court opined that *Lucas v. Earl* and *Helvering v. Horst* would include the amount subject to the attorney's lien even if the client were never entitled to receive the money.[151] The United States Court of Federal Claims holds a similarly dim view of *Cotnam*. In a 1993 case, the claims court was faced with a taxpayer's argument, based on *Cotnam*, that contingency-based attorneys' fees should be excluded from gross income be-

145. *Id.* at 126-27 (Wisdom, J. dissenting).

146. *Id.* at 127.

147. *Id.* See *supra* note 106 and accompanying text for a brief discussion of the *Old Colony Trust* decision. The *Cotnam* dissent's characterization of the assignment resembles the Service's recent open transaction doctrine argument. See *infra* note 157 for a brief discussion of the doctrine.

148. O'Brien v. Commissioner, 38 T.C. 707, 712 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963). The Third Circuit's per curiam decision affirmed the Tax Court without a discussion of the issues. *O'Brien*, 319 F.2d at 532.

149. Davis v. Commissioner, 76 T.C.M. (CCH) 46, 48 (1998) (discussing *Cotnam's* applicability to the Fifth and Eleventh Circuits), *aff'd* No. 98-7026 (11th Cir. Apr. 27, 2000) (per curiam); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000) (adopting the *Cotnam* court's reasoning). For a discussion of the *Clarks* case, *see infra* text accompanying notes 175, 180.

150. *O'Brien*, 38 T.C. at 712.

151. *Id.* The court did observe that the attorneys' fees would be deductible. *Id.* The implementation of the AMT since the *O'Brien* decision, however, has rendered the deductibility of the fees a moot point for many taxpayers.

cause of the attorney's charging lien.[152] In holding that the fees should be included in the taxpayer's income, the claims court rejected the *Cotnam* decision and observed that the taxpayer had misconstrued the basic nature and function of a lien.[153] The court based its reasoning on its understanding that a lien never creates an ownership interest in the attorney.[154]

The Service's approach to contingency-based attorneys' fees also rejects the *Cotnam* rule. A 1980 revenue ruling determined that the entire amount of taxable damages from which attorneys' fees were paid was income to the plaintiff.[155] In a recent private letter ruling, the Service took the position that contingency-based attorneys' fees are includable in gross income under *Lucas v. Earl* even if the damage award was subject to an attorney's charging lien.[156] The Service has also argued unsuccessfully that the assignment of a claim via an attorney's lien is

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152. Baylin v. United States, 30 Fed. Cl. 248, 258 (1993), *aff'd* 43 F.3d 1451 (Fed. Cir. 1995) Taxpayers have the option of bringing refund suits in either the Court of Federal Claims or federal district court. *See* 28 U.S.C. § 1346(a)(1) (1994) (Federal District Court); 28 U.S.C. § 1491(a)(1) (1994) (Court of Federal Claims); Flora v. United States, 362 U.S. 145, 150-51 (1960) (interpreting § 1346(a)(1) to require a taxpayer to pay the tax before filing a refund suit). The claims court's attitude toward the *Cotnam* decision suggests that taxpayers should avoid refund suits in that court even if they reside in Alabama. On the other hand, the Federal Circuit's decision affirming the claims court did not address whether *Cotnam* misinterpreted the nature of the attorney's lien, so the issue might be open on appeal. *See* Baylin v. United States, 43 F.3d at 1454-55.

153. *Baylin*, 30 Fed. Cl. at 258.

154. *Id.* Unfortunately, the Claims Court's opinion directly contradicts the charging lien law of at least two states that grants attorneys equitable interests in the claim. See *infra* Part IV for a discussion of the states granting an ownership interest in the attorney.

155. Rev. Rul. 80-364 C.B. 1980-2, 294 at 295. In one of the ruling's factual situations, the court ordered a payment of 10x dollars to the plaintiff but did not indicate whether a portion was attorneys' fees. *Id.* at 294. The plaintiff paid 1x dollars in attorneys' fees. *Id.* The Service ruled that the full amount was income to the employee. *Id.* at 295.

156. Priv. Ltr. Rul. 98-09-053 (Feb. 27, 1998) ("It is well established that taxpayers must include in income that portion of a damage award that is remitted to attorneys under a contingency fee arrangement. This position is based on the well settled principle of tax law that income is taxable to the person who earns it or otherwise creates the right to receive it and enjoys the benefit of it when paid.") (citation omitted). A taxpayer may usually rely on a letter ruling issued to the taxpayer. 1 LAURENCE F. CASEY & EDWARD J. SMITH, FEDERAL TAX PRACTICE § 1.33, at 1-47 (1997 rev.). Taxpayers, however, may not rely on letter rulings issued to other taxpayers. *Id.* Letter rulings, however, do serve as useful planning tools for divining the Service's approach to a particular issue. JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 27 (9th ed. 1996).

a sale that should be taxed under the open transaction doctrine.[157]

At first glance, the *Cotnam* decision may seem to contradict the broad definition of income intended by Congress and enforced by the courts. *Cotnam*, however, is not a wild decision from the hinterlands.[158] The dissent in *Cotnam* and other courts addressing the issue have neglected two lines of cases that support *Cotnam*. The first line of cases involves the very assignment of income cases that many courts have used to include the fees in income.

The Supreme Court's decision in *Poe v. Seaborn* endorsed the position that state property law can trump general income tax principles when examining who has the right to earned

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157. Davis v. Commissioner, No. 98-7026 (11th Cir. Apr. 27, 2000) (per curiam). The open transaction doctrine applies when a transferred property interest has no ascertainable value at the time of the transaction. *Id.* In *Davis*, the Service argued that the value of the interest in the case was unascertainable in 1989 when Ms. Barlow retained her attorneys and that her taxes on the 1989 transfer should be assessed in 1992 when she won her judgment. *Id.* Under the open transaction doctrine, the Service must prove that the assets transferred had no ascertainable value. The Eleventh Circuit refused to apply the open transaction doctrine because the Service offered no proof of the impossibility of valuing the assets in 1989. For a more detailed discussion of the open transaction doctrine, see 2 BITTKER & LOKKEN, *supra* note 94, ¶ 43.2 (2d ed. 1990).

The Service's argument presents a new challenge to successful plaintiffs who wish to exclude their attorneys' fees from gross income. The open transaction doctrine's applicability was not fully considered in the Davis decision because of the Service's failure to provide proof. Therefore, the issue remains open and may plague taxpayers in the future.

158. In its recent opinion in *Davis*, the Eleventh Circuit strengthened the value of *Cotnam* as precedent in two ways. First, the circuit implicitly refused to overrule *Cotnam* by refusing to hear the case en banc. *See Davis*, No. 98-7026, n.4 (11th Cir. Apr. 27, 2000) (per curiam). Second, the court rejected the Service's alternative open transaction doctrine argument. *See supra* note 157 for a more detailed discussion. This refusal to apply the open transaction doctrine blocks, at least temporarily, the Service's creative attempt to side-step the *Cotnam* rule in the Eleventh Circuit.

Other circuits have also enhanced *Cotnam*'s stature. The Sixth Circuit explicitly adopted the reasoning of the *Cotnam* majority in *Estate of Clarks v. Commissioner*, 202 F.3d 267 (6th Cir. 1999). Furthermore, the Fifth Circuit has extended *Cotnam* by analogy since its original decision. *See* Jones v. Hamilton, 306 F.2d 292, 301 (5th Cir. 1962) (holding that a taxpayer who had sold his interest in a corporation and then later sold his interest in an uncertain, contingent claim against the government could not be taxed on the proceeds of the suit). In *Jones*, the Fifth Circuit adhered to its reasoning in *Cotnam* in ruling that the lawsuit, when assigned, had born no fruit and that the tree (suit) seemed blighted at the time of the assignment. *Id.*

income.[159] The Alabama charging lien in *Cotnam* gives an attorney an equitable lien in a client's cause of action similar to the right to income enjoyed by the spouse in *Poe v. Seaborn*. While the *Cotnam* dissent argued that assigning the right to the attorneys generated an economic benefit, the majority pointed out that the benefit was far removed from an uncertain recovery. The plaintiff's position in *Cotnam* resembles that of the husband in *Poe*. A portion of the damages never belonged to Mrs. Cotnam—as soon as she engaged an attorney, a portion of the damages automatically belonged to the attorney under Alabama law.[160]

Furthermore, it is not clear that the rationale of the assignment of income cases should apply to contingency-based attorneys' fees. The Supreme Court decisions in *Lucas v. Earl* and *Helvering v. Horst* expressed concern with abusive assignments of income. The equitable assignment created by the Alabama charging lien is not the type of "skillfully devised" anticipatory assignment that *Lucas v. Earl* was designed to defeat.[161] The attorney's charging lien was designed to protect attorneys, not to aid plaintiffs to avoid taxation.[162] The operation of the attorney's lien law more closely resembles the state community property law involved in *Seaborn* than the contract law implicated in the assignment of income decisions. In the situation of an attorney's lien, the assignment to an attorney results from the automatic operation of a state law designed to protect the attorney's interests, instead of as the result of a cleverly devised scheme to use state contract law to shift earned income to someone in a lower tax bracket.

The second line of tax cases supporting the majority's opinion in *Cotnam* involves pre-award agreements to split lottery prizes. These cases usually involve an agreement in which the purchaser of the lottery ticket agrees to share a part of the winnings with a non-purchasing party. One of the first cases in this vein involved the tax treatment of contingency fees. In *Appeal of*

159. *See Seaborn*, 282 U.S. at 117.

160. *Compare to id.* at 117.

161. 281 U.S. 111, 115 (1930); *see* Clarks v. United States, No. 98 Civ. 60446, slip. op. at 7 (E.D. Mich. Nov. 23, 1998) (ruling that attorneys' fees were included in gross income when Michigan charging lien law was applicable).

162. *See supra* note 43 and accompanying text.

*A.L. Voyer*,[163] several friends purchased a block of lottery tickets as a group and agreed to share any winnings equally.[164] When they won the lottery, the sponsor did not pay the prize.[165] The lottery winners hired an attorney on a contingency basis to help them recover their winnings.[166] The attorney disbursed settlement proceeds to the group but retained a portion subject to his attorney's lien.[167]

The Board of Tax Appeals noted that the attorney was an agent of the taxpayer and that receipt by an agent generally amounts to receipt by the principal.[168] The Board held, however, that the amount retained by the attorney should be excluded from gross income.[169] Adopting reasoning similar to that applied by the *Cotnam* court, the Board observed that the attorney could assert his attorney's lien against the funds and that the clients would never be able to receive the amount claimed by the attorney.[170]

While the *Voyer* case was decided before *Lucas v. Earl* and might be decided differently in the absence of an Alabama-type attorney's lien, the premise of the more recent lottery cases still applies to the *Cotnam* situation. In these cases, the purchaser of a ticket usually promises to give a friend or family member a portion of any lottery winnings.[171] A recent Tax Court opinion summarized the lottery cases as expressing a preference for taxing the awards to the recipients of the proceeds as opposed to taxing the purchaser of the ticket.[172] This treatment applies even if the taxpayer's agreement to share the proceeds is void

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163. 4 B.T.A. 1192 (1926).
164. *Appeal of A.L. Voyer*, 4 B.T.A. at 1193-94.
165. *Id.* at 1194.
166. *Id.*
167. *Id.* at 1195-96
168. *Id.* at 1197.
169. *Appeal of A.L. Voyer*, 4 B.T.A. at 1197.
170. *Id.* ("It is perfectly clear that the taxpayer has not in fact received and has no right to receive the full amount paid to his counsel and that he never will receive such amount.").
171. *See, e.g.*, Droge v. Commissioner, 35 B.T.A. 829 (1937) (involving an unenforceable agreement between a husband and wife to split any winnings from their lottery tickets).
172. Estate of Winkler v. Commissioner, 73 T.C.M. (CCH) 1657, 1665 (1997); *see also* Huntington v. Commissioner, 35 B.T.A. 835, 838 (holding that a husband who split the proceeds of a sweepstakes ticket did not have to include the portion of income received by his wife in his income).

and unenforceable.[173] The lottery cases stem from equitable concerns about the possibility of double taxation of the purchaser of the ticket.[174]

The lottery cases point out how contingency fee arrangements fail the economic enjoyment aspect for taxable income. Although the awards in the lottery cases are hopefully more contingent and remote than most lawsuits, the transfers in both situations are far more remote than the actual economic enjoyment required by *Helvering v. Horst*.[175] In *Horst*, the gift of the coupon occurred shortly before the maturity date, and the benefit resulting from the coupon was a virtual certainty. Both the lottery cases and the attorney's lien cases involve uncertain, contingent rights to income that may never mature. Furthermore, the agreements in the lottery cases are often void and unenforceable, whereas the certainy of a contingency-based fee arrangement is reinforced by the attorney's charging lien as sanctioned by state law.

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173. Tavares v. Commissioner, 275 F.2d 369, 372 (1st Cir. 1960).

174. *See, e.g.*, *Droge*, 35 B.T.A. at 834 (holding in the lottery ticket situation that double taxation should be avoided unless required); *see also* United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924) (Taft, C.J.) (expressing a preference to avoid double taxation). *But see* Perthur Holding Co. v. Commissioner, 61 F.2d 785, 786 (2d Cir. 1932) (Hand, J.) (noting that "[w]hen the purpose is plain, the statute will stand; courts will not interfere because taxes are duplicated."). See *supra* note 126 and accompanying text for the judicial response to equitable and double taxation arguments in this context.

175. *See* Jones v. Hamilton, 306 F.2d 292, 301 (5th Cir. 1962) ("Experienced lawyers have long since learned that it is unwise and indeed, ultra foolish to predict the results of litigation."). In assignment of income cases, the remoteness of the transfer is not always dispositive. In *Brown v. Commissioner*, the Tax Court considered whether the portion of tips paid by a waitress to bartenders and busboys who worked with her should be included in her gross income or deducted as an itemized deduction for employee expenses. 72 T.C.M. (CCH) 59, 60-63 (1996). The court cited its established precedent in concluding that the amounts of the tips "paid out" to other employees should be excluded from gross income. *Id.* at 61, *citing* Menequzzo v. Commissioner, 43 T.C. 824, 829 (1965). The court's rationale is based on a judicially created intent on the part of the customer to "pass through" a portion of the tip to other employees who served their table. *See id.* at 62. In the server cases, the assignment to the other employees is relatively certain and imminent, yet the courts recognize the established practice and exclude the shared amount from gross income.

### *B. Post-*Cotnam *Cases*

The treatment of attorneys' fees has been litigated repeatedly since the *Cotnam* decision.[176] Rather than evaluating the decision's validity under general income tax principles,[177] subsequent courts have primarily focused on analyzing the particular attorney's lien applicable to the contingency-based attorneys' fees involved in the specific case.[178] In the vast majority of the cases not involving Alabama's charging lien, courts have distinguished the attorney's charging lien law at issue from Alabama's lien law.[179] The Tax Court's decision in *Davis*, for example, did not discuss the pros and cons of the *Cotnam* court's approach but rested instead on the *Cotnam* precedent citing the rule of *Golsen v. Commissioner*.[180] The factors used by these courts to

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176. The litigation can be divided into two distinct periods, each with decisions applying or distinguishing *Cotnam*. The first period came in the 1960s after *Cotnam* was announced in 1959. *See, e.g.*, Petersen v. Commissioner, 38 T.C. 137 (1962) (distinguishing the attorney's charging lien at issue from the Alabama statute in *Cotnam*). *But see* Jones v. Hamilton, 306 F.2d at 301 (extending *Cotnam* by analogy). The second period of activity began in the early 1990s about the time Congress and the courts started to tighten the exclusion for damages. *See, e.g.*, Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995) (distinguishing the charging lien law at issue from Alabama's). *But see In re* Hamilton, 212 B.R. 384 (M.D. Ala. 1997); Davis v. Commissioner, 76 T.C.M. (CCH) 46 (1998) (applying *Cotnam* to exclude attorneys' fees from gross income). This period reached its high point with a flurry of cases in late 1998. See *infra* note 179 and accompanying text for all of the cases (outside of Alabama) dealing with the interplay of the charging lien and inclusion in gross income.

177. *But see supra* notes 152-54 and accompanying text for a Claims Court decision that contradicts the *Cotnam* court.

178. *See, e.g., Petersen*, 38 T.C. at 152 (analyzing the charging lien law of Nebraska and South Dakota to distinguish the case from *Cotnam*).

179. *Baylin*, 43 F.3d 1451 (Fed. Cir. 1995); Lind v. United States, 335 F. Supp. 76 (S.D.N.Y. 1971); Gadlow v. Commissioner, 50 T.C. 975 (1967); *Petersen*, 38 T.C. 137; O'Brien v. Commissioner, 38 T.C. 707 (1962), *aff'd per curiam* 319 F.2d 532 (3d Cir. 1963); Sinyard v. Commissioner, 76 T.C.M. (CCH) 654 (1998); Srivastava v. Commissioner, 76 T.C.M. (CCH) 638 (1998); Benci-Woodward v. Commissioner, 76 T.C.M. (CCH) 787 (1998); Coady v. Commissioner, 76 T.C.M. (CCH) 257 (1998); Smith v. Commissioner, 36 T.C.M. (P-H) ¶ 67,206 at 1116 (1967). *But see* Estate of Clarks v. United States, 202 F.3d 267 (6th Cir. 2000).

180. *Davis*, 76 T.C.M. (CCH) at 48. The *Golsen* rule constrains the Tax Court to follow the law of the circuit to which a taxpayer's appeal lies. Golsen v. Commissioner, 54 T.C. 742, 757 (1970), *aff'd by* 445 F.2d 985 (10th Cir. 1971). One commentator, however, has noted that the *Golsen* rule is prudential and the Tax Court does not view itself as bound to follow the law of a particular circuit. David F.

distinguish non-Alabama charging lien law provide a road map to determine whether a given charging lien will allow a taxpayer to exclude contingency-based attorneys' fees from gross income.[181]

The Tax Court requires a contingency fee contract as a prerequisite to *Cotnam* treatment; otherwise, the attorney's fee is treated as an ordinary debt.[182] First, the contingency fee contract must give rise to an attorney's charging lien similar to Alabama's lien that vests in the attorney rights equal to those of a client or equitable rights or an equitable assignment.[183]

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Shores, *Rethinking Deferential Review of Tax Court Decisions*, 53 TAX LAW. 35, 37-38 n.6 (1999). In *Davis*, the Tax Court ruled that it was bound to treat *Cotnam* as binding precedent since the Eleventh Circuit adopted the case law of the former Fifth Circuit as of September 30, 1981 until it is modified or reversed by the Eleventh Circuit. *See* Bonner v. City of Prichard, Alabama, 661 F.2d 1206, 1207 (11th Cir. 1981) (en banc) (ruling in the first Eleventh Circuit decision that the Eleventh Circuit would follow the law of the "Old Fifth" Circuit).

181. Since many of the Tax Court cases cited in this Article were designated memorandum decisions by the court, it is important to note the difference between the Tax Court's "regular" opinions and its memorandum decisions. Tax Court opinions are generally "issued if there is a unique aspect of the law to be ruled on," and are binding on all of the court's judges. 1 CASEY & SMITH, *supra* note 156, § 6.12, at 6-17. Memorandum decisions generally involve cases without unique legal issues or with significant factual issues. *Id.* Another important distinction is the value of the decisions as precedent. The Tax Court does not consider its memorandum decisions to be controlling precedent. Nico v. Commissioner, 67 T.C. 647, 654 (1977). Some commentators, however, caution against disregarding cases merely because the court issues them in memorandum form. 1 CASEY & SMITH, *supra* note 156, § 6.12, at 6-17. Chief Judge Mary Ann Cohen advises: "If you're an advocate and the case is decided the way you like, you'll want to say that [the facts of your case] are indistinguishable [from those of the memorandum]. . . . Never say to a judge, 'That's only a memorandum opinion of Judge X.'" *News in Brief*, 58 TAX NOTES 400 (1993) (quoting then Judge Cohen). For a more detailed discussion of the value of memorandum decisions as precedent, see Mark F. Sommer and Anne D. Waters, *Tax Court Memorandum Decisions—What are they Worth?*, 98 TAX NOTES 138-96 (1998).

182. Gadlow v. Commissioner, 50 T.C. 975, 980 (1968).

183. The overarching theme of the cases is that the charging lien law must give rights similar to Alabama's to exclude the fees from gross income. *See O'Brien*, 38 T.C. at 712 (noting that the *Cotnam* court placed "considerable stress" on the Alabama lien law); *Smith*, 36 T.C.M. at 1119 (observing in dicta that an attorney's lien similar to Alabama's is required); *Sinyard*, 76 T.C.M. (CCH) at 658 (holding that Arizona law is not the same as Alabama law). A key factor is that the lien law must give the attorney an equitable interest in the client's claim. *Baylin*, 43 F.3d at 1455 (holding that Maryland lien law was distinguishable from Alabama's); *Lind*, 335 F. Supp. at 77; *Petersen*, 38 T.C. at 152; *Gadlow*, 50 T.C. at 980; *Coady*, 76 T.C.M. (CCH) at 259; *Srivastava*, 76 T.C.M. (CCH) at 645-46 (following the *Cotnam* decision under the *Golsen* rule, but distinguishing the Texas attorney's lien from Alabama's because it did not give attorneys property rights in the claim or rights in

Without this right, the fees are included in gross income.[184] One commentator noted that courts are looking for "a strong state law lien that gives the plaintiff's attorney a right in and to the fees, negating any constructive receipt by the plaintiff."[185]

The next two factors emphasized by courts have only been applied on a hypothetical basis. To date, no court has been needed to proceed beyond the equitable interest step of the analysis, but courts have distinguished situations from *Cotnam* based on these other factors.[186] A possible second requirement, noted in *Cotnam* and mentioned by the Tax Court, is that the attorney's lien must be capable of trumping the defendant's right of setoff.[187] Some courts also evaluate whether the lien is superior to all other liens except tax liens.[188] Essentially, courts seem to require the lien to have a relatively high priority vis-a-vis other claims.

A possible third requirement would demand that the lien attach to the claim or judgment as opposed to coming into existence only when the money is in the attorney's hands.[189] In the following Section, this Note will apply the above requirements to the charging liens of other states to determine whether any charging lien other than Alabama's has the attributes necessary to allow a taxpayer to exclude contingent attorneys' fees from gross income.

Notwithstanding the contrary precedent of the Tax Court and the Federal Circuit, the Sixth Circuit recently adopted the

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the claim equal to those of their clients); *Benci-Woodward*, 76 T.C.M. (CCH) at 791 (finding that California lien law does not give ownership or proprietary interest to an attorney). Other courts have required that the lien law give rights equal to those of the client. Estate of Clarks v. United States, No. 98 Civ. 60446, slip. op. at 5 (ruling that Michigan law does not give the same rights to an attorney as to a client), *rev'd*, 202 F.3d at 858.

184. *See, e.g.*, *Benci-Woodward*, 76 T.C.M. (CCH) at 789.

185. Robert W. Wood, *The Plight of the Plaintiff: The Tax Treatment of Legal Fees*, 98 TAX NOTES TODAY 220-101 (1998).

186. *See, e.g.*, *Coady*, 76 T.C.M. (CCH) at 259.

187. *See, e.g.*, *Cotnam*, 263 F.2d at 125; *Coady*, 76 T.C.M. (CCH) at 259 (noting that the Alaska lien subordinated the attorney's interests to the rights of the parties of the proceeding).

188. *Coady*, 76 T.C.M. (CCH) at 259 (noting that the Alabama charging lien statute rendered the charging lien superior to all other liens except tax liens);

189. *Srivastava*, 76 T.C.M. (CCH) at 643 (observing that the Texas lien was superior to the rights of the parties, but was not property and did not come into existence until the money was in the attorney's hands).

*Cotnam* court's approach in *Estate of Clarks v. United States*.[190] In *Estate of Clarks*, the $5.6 million in compensatory damages awarded to the taxpayer against K-Mart were excluded from gross income as personal injury damages.[191] The $5.7 million in interest owed by K-Mart, however, was taxable.[192] Almost two million dollars of the interest award belonged to the taxpayer's attorney pursuant to a contingency fee contract and subject to the Michigan attorney's lien, but the Service sought to include all of the interest in the taxpayer's gross income.[193] The taxpayer paid the deficiency and sued for a refund in federal district court.[194] The district court rejected the taxpayer's argument that the Michigan attorney's lien created a *Cotnam*-type assignment to the attorney.[195] The court recognized that Michigan law did operate as an assignment but held that it did not grant an equitable interest in the action to the attorney.[196]

The Sixth Circuit reversed the lower court and explicitly adopted the *Cotnam* approach.[197] Most notably, the Sixth Circuit allowed *Cotnam* treatment under somewhat relaxed requirements when compared to the Tax Court's decisions in the area. The Michigan common law attorney's lien did not explicitly give attorneys rights equal to those of their clients as the Tax Court requires. Instead, the Michigan Supreme Court has held that the charging lien "amounts to an assignment of a portion of the judgment sought to be recovered or expected as the fruit of the litigation."[198] The Sixth Circuit did not discuss explanatory language in a later Michigan decision that held that the Michigan Supreme Court "stated that an attorney's lien 'amounts to an assignment' in order to analogize its function for purposes of explanation."[199] The district court in *Estate of Clarks* used the

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190. 202 F.3d 854 (6th Cir. 2000), *rev'g*, Estate of Clarks v. United States, No. 98 Civ. 60446 (E.D. Mich. Nov. 23, 1998).

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

192. *Id.*

193. *Id.*

194. *Estate of Clarks*, No. 98 Civ. 60446, slip. op. at *2.

195. *Id.* at *8.

196. *Id.* at *5-6.

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

198. Dreibank v. Candler, 131 N.W. 129 (Mich. 1911), *quoted in Clarks*, 202 F.3d at 856.

199. Aetna Casualty & Surety Co. v. Starkey, 323 N.W.2d 325, 328 (Mich. App. 1981).

qualifying language from the later opinion to distinguish the Michigan lien from the Alabama charging lien.[200] The Sixth Circuit's willingness to disregard the language of the other Michigan decision may evince a relaxed attitude toward qualifying for *Cotnam* treatment. The Sixth Circuit reasoned that even though the client originally owns the underlying claim, the attorney's lien causes the client to lose the right to be paid from the lawyer's portion of the judgment.[201]

The Sixth Circuit's opinion appears to distinguish the attorneys' fees situation from those in *Lucas v. Earl* and *Helvering v. Horst* on three grounds. First, the court noted that the facts in both *Earl* and *Horst* involved abusive attempts to shift taxable income from a high bracket taxpayer to one in a lower bracket.[202] The Sixth Circuit, however, misconstrued the facts of the *Earl* case by characterizing it as an attempt at tax avoidance. Mr. Earl entered into the contract to share income with his wife in 1901—years before the Sixteenth Amendment authorized an individual income tax.[203] The *Earl* decision reaches a larger variety of situations than the mere abusive assignment of income.

The Sixth Circuit next emphasized that the taxpayer's claim was "entirely speculative and dependent on the services of counsel," whereas the income in *Earl* and *Horst* was "already earned, vested and relatively certain to be paid to the assignor."[204] The court then reasoned that the decisions in *Earl* and *Horst* did not create a danger of double taxation because those who ultimately received the income were not taxed on it.[205] In the case of a client being taxed on money paid to the attorney, the Service's approach would tax both the lawyer and the client on the same payment.[206] The Sixth Circuit's decision means that successful plaintiffs in the state of Michigan may now exclude attorneys' fees from gross income, and that taxpayers in Ohio, Kentucky, and Tennessee may be able to obtain the same treatment depending on their respective state's charging lien law.

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200. *Estate of Clarks*, No. 98 Civ. 60446, slip. op. at *5.
201. *See Estate of Clarks*, 202 F.3d at 856.
202. *Id.* at 857.
203. Lucas v. Earl, 281 U.S. 111, 114 (1930).
204. *Estate of Clarks*, 202 F.3d at 857.
205. *Id.*
206. *Id.*

## IV. A SURVEY OF CHARGING LIEN LAW THROUGH THE *COTNAM* LENS

### *A. The Georgia Model*

The Alabama attorney's charging lien statute does not stand alone in its language. The Alabama statute was adapted from and is virtually identical to Georgia's charging lien statute,[207] and that same Georgia statute also served as the model for the Oregon charging lien statute.[208] The common heritage of the three statutes strengthens taxpayers' arguments in Oregon and Georgia since those statutes are less susceptible to being distinguished from Alabama's by the Tax Court.

While both statutes are virtually identical to Alabama's, the Georgia statute presents a stronger case for excluding contingency-based attorneys' fees from gross income. Not only does the statute mirror the language of Alabama's statute, but Georgia was also one of the states in the pre-split Fifth Circuit. As noted in the Tax Court's *Davis* opinion, *Cotnam* applies equally to the states of the Eleventh Circuit and is binding precedent for Tax Court cases from Georgia.[209] The *Cotnam* rule appears to be relatively entrenched as precedent in the Eleventh Circuit since the Eleventh Circuit can only overturn the decision of the Old Fifth Circuit upon review en banc.[210]

The Georgia charging lien statute appears to satisfy the

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207. In *Hale v. Tyson*, the Alabama Supreme Court observed that the Alabama charging lien statute was borrowed from the Georgia charging lien statute. Hale v. Tyson, 79 So. 499, 504 (Ala. 1918) (noting that, unlike the Georgia statute, the old Alabama statute did not create a charging lien on actions to recover property).

208. William J. Ohle, Comment, *Oregon Attorneys' Liens: Their Function and Ethics*, 27 WILLAMETTE L. REV. 891, 893 n.17 (1991) (citing *In re* Grimes' Estate, 131 P.2d 448, 451 (1943)).

209. *See Davis*, 76 T.C.M. (CCH) at 48 (citing Bonner v. City of Prichard, Alabama, 661 F.2d 1206, 1207 (11th Cir. 1981) (en banc)). *But see Srivastava*, 76 T.C.M. (CCH) at 643 (following the Fifth Circuit's precedent in *Cotnam* on the taxation of contingency-based attorneys' fees, but distinguishing the Texas attorney's lien from the lien in *Cotnam* because it did not give a property interest in the claim); 1 CASEY & SMITH, *supra* note 156, § 6.06 at 6-10 (noting the types of situations in which the Tax Court has refused to pay "blind obedience" to contrary appellate authority).

210. *Bonner*, 661 F.2d at 1211.

first and second requirements for *Cotnam* treatment. First, the statute grants attorneys the "same right and power over the actions . . . to enforce their liens" as their clients.[211] This language is identical to the language of the Alabama lien that led the *Cotnam* court to hold that the lien created an equitable interest in the attorney.[212] Second, the Georgia statute states that attorneys shall have liens superior to all liens, except tax liens similar to the Alabama lien as noted in *Cotnam*.[213] On the issue of when the lien is created, the Georgia lien appears to arise when the suit is filed.[214]

In evaluating Oregon law, the *Golsen* rule plays an important role in the interpretation of the charging lien's effect on the tax treatment of attorneys' fees. Since an Oregon taxpayer would appeal to the Ninth Circuit, the Tax Court would not be constrained to follow the *Cotnam* decision.[215] The Oregon charging lien statute meets the first requirement for *Cotnam* treatment by granting attorneys rights equal to those of their clients.[216] The attorney's lien in Oregon also satisfies the second and third requirements because it is superior to all other liens but tax liens[217] and attaches at the commencement of the action.[218] Both the Oregon and Georgia charging lien statutes grant attorneys rights in their clients' claims that mirror those discussed in *Cotnam* and subsequent cases. The common history

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211. GA. CODE ANN. § 15-19-14(b) (Michie 1999). The relevant portion of the Georgia code states:

> Upon actions, judgments, and decrees for money, attorneys at law shall have a lien superior to all liens except tax liens; and no person shall be at liberty to satisfy such an action, judgment, or decree until the lien or claim of the attorney for his fees is fully satisfied. Attorneys at law shall have the same right and power over the actions, judgments, and decrees to enforce their liens as their clients had or may have for the amount due thereon to them.

*Id.*

212. *Compare* GA. CODE ANN. § 15-19-14(b) (Michie 1999), *to* ALA. CODE § 34-3-61(b) (1997).

213. GA. CODE ANN. § 15-19-14(b) (Michie 1999); *see* Cotnam v. Commissioner, 263 F.2d 119, 125 (5th Cir. 1959).

214. *See, e.g.*, Camp v. United States Fidelity & Guar. Co., 157 S.E. 209, 210 (Ga. 1931).

215. *See Golsen*, 54 T.C. at 757; *Davis*, 76 T.C.M. (CCH) at 48.

216. OR. REV. STAT. § 87.480 (1983) ("Attorneys have the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount due thereon to them.").

217. *Id.* § 87.490(1).

218. *Id.* § 87.445 (1983).

and the similar provisions of the Oregon and Georgia statutes could allow successful plaintiffs in those states to convince either the Tax Court or a federal district court to apply *Cotnam* to damages subject to contingency-based attorneys' fees outside of Alabama.

### *B. Other Charging Lien Law*

Outside of the states adopting the Georgia model, the vast majority of charging lien law fails to meet the first requirement for *Cotnam* treatment under the Tax Court's strict construction of the *Cotnam* decision. In the old Fifth Circuit, courts have only examined the attorney's charging lien in Texas, and that lien did not qualify for *Cotnam* treatment.[219] With the exception of Georgia, none of the other states in the region appear to have liens that satisfy the courts' requirements. The attorneys' charging liens in Florida and Mississippi exist at common law.[220] Neither of those liens provides attorneys with equitable rights in their clients' actions.[221] Similarly, the Louisiana statute fails to give attorneys a *Cotnam*-type right in the underlying claim.[222]

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219. *Srivastava*, 76 T.C.M. (CCH) at 643.

220. Tyson v. Moore, 613 So. 2d 817, 826 (Miss. 1992) (discussing the Mississippi common law attorney's charging lien); Lawrence B. Lambert, Note, *Murder by Numbers: Calculating Reasonable Attorney Fees Pursuant to Attorney Charging Liens*, 45 FLA. L. REV. 135, 150 (1993) (noting that the Florida charging lien is a "creature of the common law").

221. An attorney's charging lien in Mississippi is superior to a defendant's right of setoff. Halsell v. Turner, 36 So. 2d 531 (Miss. 1904). The lien does not, however, attach until judgment is handed down, and the cases do not give an attorney rights in the action equal to those of the client. *See, e.g.*, *Tyson*, 613 So. at 826. In Florida, one of the requirements for a valid charging lien is either an attempt to avoid payment to the attorney or a dispute over the amount of the fee. Sinclair, Louis, Siegel, Health, Nussbaum, & Zavertnik, P.A. v. Baucom, 428 So. 2d 1383, 1385 (Fla. 1983). The Florida charging lien apparently does not give attorneys rights equal to those of their clients since the lien only arises if there is a judgment. *See* Rosenberg v. Levin, 409 So. 2d 1016 (Fla. 1982) (holding that there is no charging lien when an attorney is discharged prior to obtaining a judgment).

222. LA. REV. STAT. ANN. § 9:5001 (West 1991). In the context of a motion to force a judge to recuse himself from a case in which his son was the plaintiff's attorney, the Louisiana Supreme Court did note that "plaintiff's counsel are as directly, and perhaps as much, interested in the judgment to be rendered in this case as the plaintiff himself. . . ." White v. McClanahan, 63 So. 61, 63 (La. 1913). The key for *Cotnam* treatment, however, is that a Louisiana's attorney must have an interest in the claim or action, not in the judgment. *See Srivastava*, 76 T.C.M. (CCH) at 63.

When applying the *Estate of Clarks* decision to determine whether attorney's liens in the Sixth Circuit allow plaintiffs to exclude attorneys' fees from gross income, the Tax Court will probably adopt the factors that it uses in applying the *Cotnam* decision. If those factors are applied to the states that have not yet been examined by the courts, the attorney's liens of Kentucky, Ohio, and Tennessee probably do not allow plaintiffs to exclude fees from gross income.

In Ohio, the attorney's charging lien exists at common law[223] while the liens of Kentucky and Tennessee are governed by statute.[224] The liens of all three states take priority over a defendant's right of setoff.[225] None of the states, however, gives attorneys an assignment or an equitable interest in their clients' actions.[226] Regarding the Ohio lien, the Sixth Circuit has already determined that the Ohio charging lien does not give an attorney a lien on the underlying cause of action.[227] Requiring the lien to attach to the action would seem to be a prerequisite for acquiring an interest or assignment in the case prior to judgment. The Tennessee statute also probably fails to qualify for *Cotnam* treatment. The Tennessee Supreme Court has explicitly stated that a prior version of the statute failed to give the same protection to an attorney as the Georgia statute does.[228] Unlike the Georgia charging lien, the Tennessee lien does not allow attorneys to control the suit in order to enforce their lien.[229]

The Kentucky lien could possibly qualify for *Cotnam* treatment because the statute gives attorneys a lien on claims in the attorney's hands even before suit is filed.[230] Under the strict

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223. Fire Protection Resources v. Johnson Fire Protection, 594 N.E.2d 146, 148 (Ohio Ct. App. 6th Dist. 1991).

224. KY. REV. STAT. ANN. § 376.460 (Michie Supp. 1998); TENN. CODE ANN. § 23-2-102 (1994).

225. Exchange Bank of Kentucky v. Wells, 860 S.W.2d 785, 787 (Ky. Ct. App. 1993); *Fire Protection Resources*, 594 N.E.2d at 148, 149; Mack v. Hugger Bros. Contr. Co., 10 Tenn. App. 402, 424 (1929) (holding that the Tennessee attorney's lien is superior to the defendant's right of setoff from a different action but not the defendant's right of recoupment).

226. *See generally* KY. REV. STAT. ANN. § 376.460; TENN. CODE ANN. § 23-2-102; *Fire Protection Resources*, 594 N.E.2d at 148.

227. *In re* Hronek, 563 F.2d 296, 299 (6th Cir. 1977). It is normal for common law liens to attach only to the judgment. BROWN, *supra* note 39, § 13.10, at 431.

228. Tompkins v. Nashville, C. & St. L. Ry., 72 S.W. 116, 117 (Tenn. 1903).

229. *Tompkins*, 72 S.W. at 117.

230. KY. REV. STAT. ANN. § 376.460; *Exchange Bank of Kentucky*, 860 S.W.2d at

approach applied by the Tax Court, the Kentucky lien might fail to qualify for *Cotnam* treatment since there is no express language in the statute or relevant decisions that gives attorneys an equitable interest in their clients' actions. Under the Sixth Circuit's relaxed requirements in *Estate of Clarks*, however, the Kentucky lien might qualify for *Cotnam* treatment if a court viewed the attorney's lien as an assignment of the client's interest.[231] The Kentucky lien could very well meet this requirement because the lien is created from the commencement of the attorney's services, which could be interpreted as an assignment.

Outside of the Fifth, Sixth and Eleventh Circuits, courts have already determined that the attorneys' liens of Maryland,[232] Pennsylvania,[233] California,[234] Nebraska, South Dakota,[235] Alaska,[236] Arizona[237] and the District of Columbia[238] do not grant attorneys an equitable interest in their clients' suits. Furthermore, the vast majority of the remaining statutory and common law charging liens do not grant attorneys an equitable interest or a right equal to that of their clients in the claim.[239] Of the remaining state charging liens, only the lien in New York merits *Cotnam* treatment.

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787 (holding that "an attorney's lien relates back to the time of the commencement of services. . . .").

231. *See* Estate of Clarks v. United States, 202 F.3d 854, 856 (6th Cir. 2000) (discussing the nature of the Michigan attorney's lien).

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

233. O'Brien v. Commissioner, 38 T.C. 707, 712 (1962); Gadlow v. Commissioner, 50 T.C. 975, 979-80 (1967).

234. Benci-Woodward v. Commissioner, 76 T.C.M. (CCH) 787, 790 (1998).

235. Petersen v. Commissioner, 38 T.C. 137, 152 (1962) (holding that neither South Dakota nor Nebraska charging lien law gives attorneys rights equal to those of their clients).

236. Coady v. Commissioner, 76 T.C.M. (CCH) 257, 259 (1998).

237. Sinyard v. Commissioner, 76 T.C.M. (CCH) 654, 658 (1998).

238. Smith v. Commissioner, 36 T.C.M. (P-H) ¶ 67,206, at 1116, 1119 (1967).

239. The charging lien statutes of most states fail to provide for an equity interest in clients' claims. *See, e.g.*, ARK. CODE ANN. § 16-22-304 (Michie 1999); COLO. REV. STAT. ANN. § 12-5-119 (1996); IDAHO CODE § 3-205 (1998); OKLA. STAT. ANN. tit. 5, § 6 (1996); WASH. REV. CODE § 60.40.010 (1990). The common law charging liens offer even less help. Most do not delineate the extent to which attorneys have an equitable interest in their clients' claims. Since it is normal for common law liens to attach only to the judgment, BROWN & RAUSHENBUSH, *supra* note 39, § 13.10, at 431, most common law liens will probably not meet the Tax Court's strict requirements.

The New York statutory charging lien satisfies the critical requirement of an equitable interest by the attorney in the action.[240] In New York, an attorney has a lien on a cause of action once the client signs a retainer agreement.[241] The New York charging lien does not simply give an attorney a claim to the client's property or proceeds—it gives the attorney a vested property right in the client's cause of action.[242] The client's interest in the claim is what remains after the attorney's share for fees, which is set by agreement, is satisfied.[243]

Not only does the New York lien satisfy the courts' equitable interest requirement, but it also meets the other factors stressed by the Tax Court and *Cotnam*. The New York statute meets the twin requirements that the attorney's lien must have priority over other liens and that must it have priority over a defendant's right of setoff. The scope of the equitable interest of an attorney in New York is great indeed, for the attorney's interest cannot "be disturbed by the client or anyone claiming through or against the client."[244] The equitable ownership interest has priority, in some situations, over tax liens that arise prior to the attorney's lien.[245] The superiority to some tax liens possibly gives a New York attorney greater rights than an Alabama attorney, whose lien is not superior to tax liens.[246] The New York lien also meets the third requirement that the lien

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240. The New York charging lien is created by statute, which provides:

> From the commencement of an action, special or other proceeding in any court or before any state, municipal or federal department, except a department of labor, or the service of an answer containing a counterclaim, the attorney who appears for a party has a lien upon his client's cause of action, claim or counterclaim, which attaches to a verdict, report, determination, decision, judgment or final order in his client's favor, and the proceeds thereof in whatever hands they may come; and the lien cannot be affected by any settlement between the parties before or after judgment, final order or determination. The court upon the petition of the client or attorney may determine and enforce the lien.

N.Y. Judiciary Law § 475 (McKinney 1983).

241. *In re* Washington Square Slum Clearance, 157 N.E.2d 587, 593 (N.Y. 1959), *cert. denied sub nom.*, United States v. Coblentz, 363 U.S. 841 (1960).

242. LMWT Realty v. Davis Agency, 649 N.E.2d 1183, 1186 (N.Y. 1995) ("[B]ecause a cause of action is a species of property, an attorney acquires a 'vested property interest' in the cause of action at the signing of the retainer agreement. . . .").

243. *LMWT Realty*, 649 N.E.2d at 1186.

244. People v. Keeffe, 405 N.E.2d 1012, 1015 (N.Y. 1980).

245. *LMWT Realty*, 649 N.E.2d at 1186-87.

246. *Compare id. to* ALA. CODE § 34-3-61(b) (1997).

must attach to the claim or judgment. The New York charging lien is created from the commencement of an action and attaches to a judgment in favor of the attorney's client.[247]

## V. ANALYSIS OF THE CURRENT APPROACH

One of the key problems with excluding attorneys' fees from gross income lies with the state of the relevant charging lien law. As one commentator has noted, charging lien law is often dated, obscure and ill-defined.[248] The dearth of authority on the inquiry of whether an attorney has an equitable interest demonstrates the primary problem with the charging lien approach—critical federal tax issues are being decided using nonexistent state law.[249] The problem lies not so much with the *Cotnam* court's reasoning as it does with resolving an issue utilizing state law that does not provide any answers. In this situation, Congress should resolve the issue through legislation.

Indeed, the American Bar Association ("ABA") has called for legislative guidance on the exclusion of attorneys' fees from gross income.[250] The ABA points out that the inability of most successful plaintiffs to take a meaningful deduction for attorneys' fees creates an incentive for them to take aggressive stances in determining what portion of the award is excludable under § 104(a)(2).[251] The ABA's argument is persuasive when one considers that successful plaintiffs, such as Mrs. Davis, have large amounts of ready cash and ample economic incentive to litigate the inclusion of attorneys' fees in gross income. Moreover, successful plaintiffs have already demonstrated that they possess the fortitude to weather the litigation process. A statuto-

247. N.Y. Jud. Law § 475 (McKinney 1983).

248. Wood, *supra* note 185, ¶ 26.

249. This lack of state court rulings is often fatal to the taxpayers claim. *See, e.g.*, Petersen v. Commissioner, 38 T.C. 137, 152 (1962) (holding that the South Dakota and Nebraska charging lien laws did not give attorneys rights equal to those of their clients).

250. Letter from Stefan F. Tucker, American Bar Association, to Honorable William V. Roth, Jr., Chairman, Senate Finance Committee (June 19, 1998), *in ABA Tax Section Requests Repeal of New Code Section on Amounts Paid to Attorneys*, 98 TAX NOTES TODAY 129-31, ¶ 24 (1998) (advocating that Congress should specify the precise type of attorneys' fees that are part of damage awards which are included in gross income).

251. *Id.*

ry approach that mitigated the Service's position could reduce costly litigation over the nature of the charging lien law in the almost forty states whose lien laws have not been considered by the courts.

Another reason for Congress to provide guidance on the exclusion of attorneys' fees arises from two measures being advocated to avoid inclusion of the fees in gross income. The first proposal would change state lien law and bar rules to provide attorneys with an equitable lien in their clients' actions.[252] It seems dangerous to amend state charging lien law solely in the uncertain hope of obtaining favorable tax treatment for successful plaintiffs. The second proposes to rewrite contingency fee contracts to give attorneys equitable assignments in their clients' actions.[253] This gambit, however, appears tantamount to acquiring a prohibited interest in a client's action.[254] Even though interests are allowed for the purposes of attorney's liens, the interests must arise from the lien law and not the contingency fee agreement.[255]

To avoid unnecessary tinkering with the state charging lien laws and traditional contingency fee contracts, Congress should exclude attorneys' fees from gross income or allow a meaningful deduction. Legislative action would have the added benefit of unifying the treatment of attorneys' fees so that successful plaintiffs living outside of the states qualifying for *Cotnam* treatment would be able to exclude fees or take a meaningful deduction. Legislation should also reduce the amount of litigation on this issue and render the tax planning process more predictable.

Other criticism has focused on the application of the AMT to eliminate the deduction for attorneys' fees. A leading authority on the taxation of damages has labeled the treatment of contingency-based attorneys' fees "one of the most egregious applications of the AMT" and has called for Congress to eliminate miscellaneous itemized deductions for attorneys' fees from items that trigger the AMT.[256] Even courts that have ruled against

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252. Burgess J.W. Raby & William L. Raby, *Deducting Legal Fees—Before-tax and After-tax*, 79 TAX NOTES 1295, 1299 (1998).

253. *Id.* at 1298, 1299.

254. *See* ABA MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.8(j) (1998).

255. *Id.* (prohibiting attorneys from obtaining a proprietary interest in a claim except to the extent necessary to acquire an attorney's lien granted by law).

256. Letter to the Editor from Robert W. Wood, *in* 98 TAX NOTES TODAY 239-80

the taxpayers on the issue have sympathized with their plight.[257]

The primary problem with the AMT's application to the deduction of contingency-based attorneys' fees stems from the policy behind the AMT. Originally, Congress designed the precursor to the AMT to expand the tax base to snare taxpayers with large amounts of economic income but with zero world-wide tax liability.[258] Congress was concerned that the level of tax avoidance was undermining taxpayer morale.[259] With the enactment of the individual AMT in 1982, Congress reiterated its original goals.[260] The AMT, however, reaches beyond its purpose to areas where it was never intended to apply.

Deducting a one-time payment of attorneys' fees does not reach the level of sophisticated tax scheming that Congress targeted with the AMT. The application to attorneys' fees goes beyond merely not fitting the AMT's purpose and actually undermining the policy behind the AMT. Congress intended the AMT to snare high-income taxpayers who made overly aggressive use of deductions to avoid paying taxes. While the AMT was designed to increase taxpayer morale, the application of the AMT to deny the miscellaneous itemized deduction of attorneys' fees

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(1998).

257. In *Alexander v. I.R.S.*, the First Circuit observed: "We recognize that, because the amounts involved trigger the AMT . . . , the outcome smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment." 72 F.3d 938, 946 (1st Cir. 1995). The court, however, rejected the taxpayers' horizontal equity complaint that the taxpayers were not being treated similarly to those similarly situated. *Alexander*, 72 F.3d at 946-47. Without further reasoning, the court found that the taxpayers had not really been denied the deduction of the legal expenses. *Id.* at 947.

258. Congress intended the minimum tax, the precursor to the AMT, to expand the tax base to cover the 154 individual taxpayers who, in 1966, showed over $200,000 of AGI but no tax liability and others who made aggressive use of deductions to avoid a large portion of their income tax burden. 4 LOKKEN & BITTKER, *supra* note 94, ¶ 111.4 at 111-88 (2d ed. 1992); *see also* 1982 BLUEBOOK, *supra* note 92, at 17 (noting Congress' concern with taxpayers avoiding virtually all tax liability). Thirty years later, the AMT had yet to accomplish the goal of its predecessor. In 1996, over nine hundred tax returns with AGI over $200,000 showed no world-wide income tax liability. 18 STATISTICS OF INCOME BULLETIN 9 (Winter 1998-99). In this sense, the AMT is underinclusive. For a discussion of general AMT reform, see Stewart S. Karlinsky, *A Report on Reforming the Alternative Minimum Tax System*, 12 AM. J. OF TAX POL'Y 139 (1995).

259. *See supra* note 93 and accompanying text.

260. *See supra* notes 92-93 and accompanying text.

paid in connection with taxable damage awards serves as an example of the AMT's rigidity and supports arguments that the tax system is unfair.[261]

## VI. CONCLUSION

Congress should allow the exclusion of contingency-based attorneys' fees generated by taxable damage awards from gross income or provide for a meaningful deduction of the attorneys' fees.[262] An exclusion from gross income could be accomplished by amending § 104 to exclude contingency-based attorneys' fees paid as a result of a taxable damage award. Such an approach would foster simplicity in the approach to attorneys' fees. Plaintiffs would no longer have to deal with the limitations placed on deducting attorneys' fees such as the two percent floor on miscellaneous itemized deductions, the AMT, and the phaseout of itemized deductions. The exclusion approach would foster uniformity in the application of the Code to attorneys' fees. No longer would taxpayers in Alabama be able to exclude attorneys' fees from gross income while those in states such as Texas and California are required to include them in income. An exclusion of the attorneys' fees from income would also eliminate the application of the AMT to this nonabusive area.

Under this approach, however, the Service and taxpayers would have to haggle over what portion of any attorneys' fees was attributable to taxable damages and what portion was attributable to nontaxable damages. Since the attorneys' fees would reduce the taxpayers' taxable income on a dollar-for-dollar basis, individual taxpayers would have an incentive to allocate as much of the fees as possible to taxable income. This allocation

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261. *See* Edwin S. Cohen, *ATPI Roundtable on the Alternative Minimum Tax*, 12 AM. J. OF TAX POL'Y 133, 136 (1995) ("The disallowance of all miscellaneous deductions can produce absurd results. For example, if an employee sues an employer to collect compensation he believes is due him, his legal fees and expenses must be claimed on his return as part of his miscellaneous itemized deductions. Disallowance of deductions for these expenses in calculating AMT liability leaves him subject to AMT liability on the gross amount of his recovery. I think such a result is patently unfair.").

262. While it is possible that Congress could specifically include attorneys' fees in gross income while keeping the current "phantom" deduction scheme, the fact that these fees are never truly realized by the plaintiffs should mitigate against such a possibility.

problem could be minimized by adopting a rebuttable presumption that allocates attorneys' fees to taxable and nontaxable damages on a pro rata basis. Unless a taxpayer could produce evidence to the contrary, the fees generated by an attorney's efforts would be attributable to taxable and nontaxable damages based on each type's relative share of the total damages.[263]

In another approach, Congress could allow a meaningful deduction for contingency-based fees by eliminating the AMT's disallowance of the deduction. Such an approach would represent a compromise because it would still subject the deduction to the two-percent floor and the phaseout of the miscellaneous itemized deduction. This AMT adjustment approach would eliminate the application of the AMT to this unintended area while still offering some relief to taxpayers. On the other hand, tinkering with the AMT creates an exception to an already obscure set of tax rules—a practice that unnecessarily complicates the Code. Nor does this approach eliminate the incentive to overallocate attorneys' fees to taxable damages.

Finally, the AMT compromise does not eliminate the main problem with the current approach to the taxability of contingency-based attorneys' fees—outdated and often ill-defined state law is being used to determine the taxability of attorneys' fees. Plaintiffs in Alabama could still use *Cotnam* to exclude attorneys' fees from gross income while those in most other states could not. In light of the problem of uniform tax treatment of attorneys' fees, Congress should amend § 104(a)(2) to allow the exclusion of attorneys' fees from all damage awards.

*Thad Austin Davis*

263. Under this presumption, a taxpayer who was awarded $60,000 in taxable damages and $40,000 in nontaxable damages would allocate 60% of any attorneys' fees to the taxable damages and 40% to nontaxable damages.