

COMMENT

Wiping the Slate Clean: An Examination on How a Court's Characterization of Contingent Attorney's Fees Implicates the Alternative Minimum Tax and Affects the Taxpayers

Darren J. Campbell^{*}

TABLE OF CONTENTS

INTRODUCTION	172
I. THE UNITED STATES TAX SYSTEM AND ITS EFFECT ON CONTINGENT ATTORNEY'S FEES	175
A. <i>How the Federal Income Tax System Works</i>	176
B. <i>Tax Policy and Statutory Exclusions from Gross Income</i>	182
1. Deductions – Expenses of Producing Income that Congress Allows the Taxpayer to Exclude from Gross Income	183
2. Structure and Function of the Alternative Minimum Tax	185

^{*} Articles Editor, U.C. Davis Law Review, Volume 35. J.D. Candidate, U.C. Davis School of Law, 2002; B.S., Biology, U.C. Irvine, 1998; B.A., Political Science, U.C. Irvine, 1998. I would like to thank Jennifer Derwin and my parents for their constant love and support and Professor Simmons for providing me with the topic and giving me advice throughout the process.

II. THE FIFTH AND NINTH CIRCUIT SPLIT OVER THE CHARACTERIZATION OF CONTINGENT ATTORNEY'S FEES	189
A. <i>The Ninth Circuit Approach: Including Contingent Attorney's Fees as Gross Income</i>	190
B. <i>The Fifth Circuit Approach: Excluding Contingent Attorney's Fees from Gross Income</i>	192
C. <i>The Ninth Circuit Approach Properly Administers Current Tax Law</i>	196
1. <i>The Ninth Circuit Approach Correctly Applies the Statutory and Judicially Developed Definitions of Gross Income</i>	196
2. <i>The Exclusion of Contingent Attorney's Fees from Gross Income is Inconsistent with the Application of the Transfer of Property Theory</i>	199
3. <i>The Fifth Circuit Violated the Separation of Powers Doctrine by Excluding Contingent Attorney's Fees from Gross Income</i>	200
D. <i>The Fifth Circuit Approach Correctly Applies the Congressional Intent Behind the Alternative Minimum Tax</i>	201
III. WIPING THE SLATE CLEAN: MAKING CONTINGENT ATTORNEY'S FEES INCLUDABLE IN GROSS INCOME AND AMENDING THE ALTERNATIVE MINIMUM TAX.....	203
CONCLUSION	205

INTRODUCTION

The traditional concept of tax equity is that persons similarly situated should pay equal amounts of tax.¹ Consider two taxpayers, John Q. Public and Jane Taxpayer, both recently settled lawsuits for \$500,000 in compensatory damages.² Based on a contingent fee agreement, their respective attorneys each received \$200,000 out of their settlements.³ Yet,

¹ See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 3.1.4, at 3-9 to 3-10 (3d ed. 1999) (defining horizontal equity); PAUL R. MCDANIEL ET AL., *FEDERAL INCOME TAXATION* 46 (4th ed. 1998) (defining horizontal equity in relation to tax policy issues); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 621 (1993).

² See Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1093-96 (2000) (describing tax consequences that result from inclusion of contingent attorney's fees in gross income). See generally *Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995) (serving as model for hypothetical).

³ This Comment pertains to all lawsuits with taxable damages using a contingent fee arrangement where the contingent fees are deductible as a miscellaneous itemized deduction. See I.R.C. § 67(b) (1994) (defining miscellaneous itemized deductions); I.R.C. § 104(a)(2) (Supp. V 1999) (excluding all compensatory damages associated with physical

due to a split of authority in the federal courts over the characterization of contingent attorney's fees, John will pay significantly more in taxes. The disproportionate tax burden occurs because the circuit in which John resides includes contingent attorney's fees in gross income.⁴ Jane pays less in tax because the circuit in which she resides excludes contingent attorney's fees from gross income.⁵

The above hypothetical demonstrates that the split of authority creates unequal tax treatment due to different characterizations of contingent attorney's fees.⁶ Some circuits hold that contingent attorney's fees are an anticipatory assignment of income, which the taxpayer must include in gross income.⁷ When John includes the fees in gross income he pays more in taxes.⁸ John's inflated income triggers application of the Alternative Minimum Tax ("AMT"), a separate income tax system designed to prevent the wealthiest taxpayers from avoiding taxation.⁹

personal injuries from taxation). According to the ABA Model Rules of Professional Conduct, this includes all lawsuits except those involving domestic relation matters, criminal defendants, or prohibited by law. See MODEL RULES OF PROF'L CONDUCT R. 1.5(c)-(d) (1983).

⁴ See *Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (holding contingent attorney's fees includable in gross income); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (including contingent fees in gross income); *Kenseth v. Comm'r*, 114 T.C. 399, 417 (2000) (including contingent attorney's fees in gross income); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd* 319 F.2d 532 (3d Cir. 1963) (holding contingent attorney's fees includable in gross income).

⁵ See *Srivastava v. Comm'r*, 220 F.3d 353, 355 (5th Cir. 2000) (holding contingent attorney's fees excludable from gross income); *Davis v. Comm'r*, 210 F.3d 1346, 1348 (11th Cir. 2000) (per curiam) (affirming Tax Court's holding that contingent attorney's fees are excludable from taxpayer's gross income); *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000) (holding contingent attorney's fees excludable from taxpayer's gross income).

⁶ Compare *Srivastava*, 220 F.3d at 355 (holding contingent attorney's fees excludable from taxpayer's gross income), and *Davis*, 210 F.3d at 1348 (holding contingent attorney's fees excludable from taxpayer's gross income), and *Estate of Clarks*, 202 F.3d at 858 (holding contingent attorney's fees excludable from gross income), with *Coady*, 213 F.3d at 1191 (holding contingent attorney's fees includable in gross income), and *Baylin*, 43 F.3d at 1454 (holding that taxpayer must include contingent fees in gross income), and *Kenseth*, 114 T.C. at 417 (holding contingent attorney's fees includable in gross income), and *O'Brien*, 38 T.C. at 712, *aff'd* 319 F.2d 532 (holding that assignment of income to attorney constitutes gross income to taxpayer).

⁷ See *Coady*, 213 F.3d at 1190-91 (holding that contingent attorney's fees fall under definition of assignment of income doctrine and are includable in taxpayer's gross income); *Baylin*, 43 F.3d at 1454; *Kenseth*, 114 T.C. at 417; *O'Brien*, 38 T.C. at 712, *aff'd* 319 F.2d 532.

⁸ See *Whipsaw on Settlement Lawsuits: New Hope?*, 92 J. TAX'N 190, 190 (Sheldon I. Banoff & Toby Lindon eds., 2000) [hereinafter *Whipsaw: New Hope?*] (arguing that effect on taxpayer in year of payment of legal fees can be profound due to application of AMT); Sager & Cohen, *supra* note 2, at 1078-79 (arguing that tax liability increases due to application of AMT).

⁹ See I.R.C. § 55(a)-(b)(3) (1994) (outlining structure of AMT for individuals); STAFF OF

Other circuits hold that contingent attorney's fees are the property of the attorney that earned them.¹⁰ The taxpayer may exclude the fees from gross income and the AMT does not apply.¹¹ The split represents a situation where jurists must choose between two statutes representing competing policy judgments.¹²

This Comment examines the different characterizations of contingent attorney's fees and argues for a congressional amendment to allow a deduction for contingent attorney's fees. Part I explains the United States tax system and discusses how the characterization of contingent attorney's fees effects gross income, deductions, and the AMT. Part II analyzes the split between the Fifth and Ninth Circuits over the characterization of contingent attorney's fees and highlights the ramifications of each approach. Part II argues the Ninth Circuit approach correctly applies existing tax law, yet does not relieve the excessive tax burden the AMT causes the taxpayer. Part III proposes that Congress amend the AMT to allow a deduction for contingent attorney's fees. Finally, Part III argues that the amendment will resolve the inequity that currently exists between two similarly situated taxpayers.

JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 433 (Comm. Print 1987) (explaining reasoning behind enactment of AMT) [hereinafter 1986 BLUEBOOK]; Treas. Reg. § 1.55-1(a)-(b) (1994) (applying specific requirements of AMT); 4 BITTKER & LOKKEN, *supra* note 1, ¶ 111.4.1, at 111-88 (explaining rationale of AMT).

¹⁰ See *Srivastava*, 220 F.3d at 357 (finding that pursuant to Texas statute contingent attorney's fees are property of attorney and holding contingent attorney's fees excludable from gross income); *Estate of Clarks*, 202 F.3d at 858 (holding contingent attorney's fees excludable from taxpayer's gross income because they are property of attorney who earned them); see also *Davis*, 210 F.3d at 1348 (holding contingent attorney's fees are property of attorney).

¹¹ See *Srivastava*, 220 F.3d at 365 (reversing Tax Court and allowing taxpayer to exclude contingent fees from gross income); *Estate of Clarks*, 202 F.3d at 857 (allowing taxpayer to exclude contingent attorney's fees from gross income); see also Sager & Cohen, *supra* note 2, at 1080-81 (arguing that reporting net recovery, settlement less attorney's fees, moots question of whether plaintiff may deduct fees).

¹² See I.R.C. § 55(a) (1994) (establishing AMT); I.R.C. § 61(a) (1994) (defining gross income broadly); *Kenseth*, 114 T.C. at 407 (explaining that controversy over characterization of contingent attorney's fees driven by difference in applying statutory definition of gross income and AMT); *Whipsaw on Lawsuit Settlements: The Courts Still Can't Agree*, 93 J. TAX'N 188, 188 (Sheldon I. Banoff & Richard M. Lipton eds., 2000)[hereinafter *Whipsaw: The Courts Still Can't Agree*].

I. THE UNITED STATES TAX SYSTEM AND ITS EFFECT ON CONTINGENT ATTORNEY'S FEES

For individual taxpayers, the United States tax system consists of the regular tax and the AMT.¹³ The regular tax assesses the taxpayer's net income, which equals gross income minus deductions.¹⁴ The AMT taxes economic income, which equals the amount the taxpayer consumes during the year plus the taxpayer's net wealth for the year.¹⁵ The regular tax and the AMT measure income in different ways, yet both utilize the same general terms to arrive at taxable income.¹⁶ The regular tax begins with gross income and subtracts different types of deductions to arrive at taxable income.¹⁷ The AMT begins with regular taxable income and adds back certain deductions allowed under the regular tax to arrive at alternative minimum taxable income ("AMTI").¹⁸ A discussion on how the federal income tax system works illustrates how the characterization of one item of income can effect an entire tax return.¹⁹

¹³ See 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.1, at 2-1 to 2-2 (providing structure of United States income tax system); see also I.R.C. § 55(a) (establishing AMT); MCDANIEL ET AL., *supra* note 1, at 1271 (explaining history and evolution of AMT).

¹⁴ See I.R.C. § 61(a) (defining gross income); I.R.C. § 67(b) (1994) (defining miscellaneous itemized deductions); I.R.C. § 162(a) (1994 & Supp. V 1999) (defining trade or business deductions); I.R.C. § 212(1) (1994) (defining cost of producing income deductions); MCDANIEL ET AL., *supra* note 1, at 55-56.

¹⁵ See DANIEL J. LATHROPE, *THE ALTERNATIVE MINIMUM TAX: COMPLIANCE AND PLANNING WITH ANALYSIS* ¶ 1.02, at 1-1 to 1-3 (1994) (explaining that Congress's stated objective is to produce "an alternative measure of income that more accurately reflects economic income than taxable income"); MCDANIEL ET AL., *supra* note 1, at 51-52 (explaining definition of economic income); HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938) (defining economic income). Under a contingent fee agreement, economic income equals the settlement amount minus the contingency fee. See Sager & Cohen, *supra* note 2, at 1077-78 (defining economic income as total settlement minus attorney's fees). This equals the amount of consumption, zero, plus the net increase in the wealth of the taxpayer, settlement amount minus the contingency fee. See *id.*

¹⁶ See LATHROPE, *supra* note 15, ¶ 1.02, at 1-1 to 1-3 (explaining congressional purpose behind AMT is to measure individual's income differently than regular tax measures individual's income); Sager & Cohen, *supra* note 2, at 1092-93.

¹⁷ See I.R.C. § 61(a) (starting point for United States tax system); I.R.C. § 63(a) (1994) (defining taxable income as gross income minus deductions); I.R.C. § 67(b) (defining miscellaneous itemized deductions); I.R.C. § 162(a) (defining trade or business deductions); I.R.C. § 212(1) (defining cost of producing income deductions).

¹⁸ See I.R.C. § 56(a)-(b) (1994 & Supp. V 1999) (defining computation of alternative minimum taxable income); Treas. Reg. § 1.56-1(a)-(b) (as amended in 2000) (explaining how to compute alternative minimum taxable income); MCDANIEL ET AL., *supra* note 1, at 1270-71.

¹⁹ See *Srivastava v. Comm'r*, 220 F.3d 353, 357 n.6 (5th Cir. 2000) (recognizing that characterization of contingent attorney's fees affects regular tax because of phaseouts and AMT because of non-deductibility of miscellaneous itemized deductions); *Alexander v. Comm'r*, 72 F.3d 938, 946 (1st Cir. 1995) (noting that characterization of contingent

A. How the Federal Income Tax System Works

The formulaic set of rules set forth by Congress to determine the amount of regular tax an individual must pay begins with gross income.²⁰ The first step of this computation asks what constitutes gross income.²¹ Next, the taxpayer deducts all ordinary and necessary expenses incurred in carrying on a trade or business to arrive at the taxpayer's adjusted gross income ("AGI").²² Then, the taxpayer deducts all itemized deductions along with all personal exemptions to arrive at taxable income.²³ For many taxpayers the final calculation results in the multiplication of taxable income by a marginal rate to arrive at the final tax.²⁴ However, for higher income taxpayers, the AMT requires a further calculation.²⁵

attorney's fees as miscellaneous itemized deductions triggers AMT); *Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000) (arguing that characterization of contingent attorney's fees affects both regular tax and AMT by reducing effectiveness of miscellaneous itemized deductions).

²⁰ See I.R.C. § 61(a) (defining gross income, which is starting point in computation of individual's regular tax); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (explaining that gross income includes any accession to wealth clearly realized over which taxpayer has complete dominion); *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929) (holding that discharge by third person of obligation of taxpayer is equivalent to receipt of income by taxpayer); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.2, at 2-2 to 2-3 (explaining computation of regular tax begins with gross income).

²¹ See I.R.C. § 61(a) (listing items that constitute gross income ending with broad catchall phrase); *Glenshaw Glass Co.*, 348 U.S. at 431 (explaining that gross income includes any economic benefit that taxpayer exercises complete control over); *Old Colony Trust Co.*, 279 U.S. at 729 (holding that gross income includes discharge by third person of obligation of taxpayer).

²² See I.R.C. § 62(a) (1994) (defining adjusted gross income); I.R.C. § 162(a) (defining ordinary and necessary business expenses); Temp. Treas. Reg. § 1.62-1T(a) (as amended in 1992) (applying statutory definition of adjusted gross income); Treas. Reg. § 1.162-1(a) (as amended in 1993) (applying statutory definition of ordinary and necessary business expenses); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.3, at 2-5 to 2-12 (providing structure of income tax regarding adjusted gross income).

²³ See I.R.C. § 63(a) (1994) (defining taxable income); I.R.C. § 151(a) (1994) (defining personal exemption); I.R.C. § 212(1)-(2) (1994) (defining production of income deductions); Treas. Reg. § 1.63-1(a) (1994) (applying statutory definition of taxable income); Treas. Reg. § 1.212-1(a) (as amended in 1975) (applying statutory definition of production of income deductions); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.4, at 2-12 (defining taxable income in relation to other tax provisions).

²⁴ See I.R.C. § 1(a)-(d) (1994) (defining rate structure for individual taxpayers); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.5, at 2-13 (applying rate structure to taxable income to arrive at final tax). See generally Stewart S. Karlinsky, *A Report on Reforming the Alternative Minimum Tax System*, 12 AM. J. TAX POL'Y 139, 139-40 (1995) (explaining complexity and administrability encountered under regular tax system).

²⁵ See I.R.C. § 55(a)-(b)(3) (1994) (defining AMT for non-corporate taxpayers); 4 BITTKER & LOKKEN, *supra* note 9, ¶ 111.4.1, at 111-89 to 111-90 (explaining when taxpayer required to calculate AMT); Karlinsky, *supra* note 24, at 139-40 (explaining requirements and

The AMT recalculates regular taxable income into AMTI and then applies a two-tiered rate structure.²⁶ First, the taxpayer adds back into the tax base many preference items that are excludable under the regular tax.²⁷ Next, the AMT requires the taxpayer to add back certain deductions, including miscellaneous itemized deductions, deducted on the regular tax to arrive at AMTI.²⁸ Finally, the taxpayer applies a two-tiered rate schedule to calculate the minimum tax.²⁹ The first tier applies a 26% tax on the first \$175,000 of AMTI, and the second tier applies a 28% tax on the remaining AMTI.³⁰ In calculating both the regular tax and the AMT the primary question is what constitutes gross income.³¹

The statutory definition of gross income appears in IRC section 61(a).³² Section 61(a) combines a descriptive list enumerating the bulk of items typically received by taxpayers with a catchall phrase including income from whatever source derived.³³ Congress intentionally left the definition broad so as to include any economic benefit or accession to wealth over which the taxpayer exercises complete dominion.³⁴ The

applicability of AMT).

²⁶ See I.R.C. § 55(b)(2)(A)-(B) (1994) (defining how taxpayer arrives at alternative minimum taxable income); 1986 BLUEBOOK, *supra* note 9, at 430-31; 4 BITTKER & LOKKEN, *supra* note 1, ¶ 111.4.1, at 111-88 to 111-90.

²⁷ See I.R.C. § 56(b) (1994) (defining which items taxpayer must add back into alternative minimum tax base to arrive at alternative minimum taxable income); 1986 BLUEBOOK, *supra* note 9, at 430-31 (listing tax preference items that taxpayer must add back into alternative minimum tax base); MCDANIEL ET AL., *supra* note 1, at 1270-71.

²⁸ See I.R.C. § 56(b)(1)(A)(i) (1994) (disallowing deduction for any miscellaneous itemized deduction as defined by I.R.C. § 67(b) for AMT purposes); 1986 BLUEBOOK, *supra* note 9, at 462 (explaining that for AMT purposes no deduction is allowed for any miscellaneous itemized deduction as defined in I.R.C. § 67(b)).

²⁹ See I.R.C. § 55(b)(1)(A)(i)(I)-(II) (1994 & Supp. V 1999) (defining non-corporate AMT rate schedule); 4 BITTKER & LOKKEN, *supra* note 1, ¶ 111.4.1, at 111-89 (explaining rate structure of AMT).

³⁰ See I.R.C. § 55(b)(1)(A)(i)(I) (defining non-corporate AMT rate on first \$175,000 of alternative minimum taxable income); I.R.C. § 55(b)(1)(A)(i)(II) (defining non-corporate AMT rate on excess of alternative minimum taxable income over \$175,000); 4 BITTKER & LOKKEN, *supra* note 1, ¶ 111.4.1, at 111-89 (explaining two-tiered rate structure for AMT).

³¹ See I.R.C. § 61(a) (1994); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929) (holding that discharge of obligation is equivalent to receipt of income that taxpayer must include as gross income); *Treas. Reg. § 1.61-1(a)* (1957) (applying statutory definition of gross income); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.2, at 2-2 (explaining definition of gross income).

³² See I.R.C. § 61(a); *see also* 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.2, at 2-2 (stating that statutory definition of gross income appears in I.R.C. § 61(a)).

³³ See I.R.C. § 61(a); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.2, at 2-3; MCDANIEL ET AL., *supra* note 1, at 63.

³⁴ See I.R.C. § 61(a) (defining gross income broadly); *James v. United States*, 366 U.S. 213, 219 (1961) (defining gross income broadly to include gains from which taxpayer derives readily realizable economic value); *Glenshaw Glass Co.*, 348 U.S. at 431; *Helvering v.*

argument over the inclusion of contingent attorney's fees in gross income turns on whether the taxpayer ever exercises complete control over the fees.³⁵

The person who exercises complete control over a particular item of income is also responsible for paying the tax on that item of income.³⁶ For example, the wage earner is responsible for the tax on her wages, the landlord on the rent received, and the sole proprietor on gross receipts.³⁷ Yet, when a taxpayer shifts income to another taxpayer the determination becomes more complicated.³⁸ An even more complicated situation occurs when a taxpayer shifts income to another taxpayer but retains control over the income producing property.³⁹ The assignment of income from one taxpayer to another does not relieve the original taxpayer of the tax liability.⁴⁰

Clifford, 309 U.S. 331, 334 (1940) (declaring that broad sweeping language of I.R.C. § 61(a) indicates purpose of Congress to use full measure of its taxing power).

³⁵ See *Glenshaw Glass Co.*, 348 U.S. at 431 (explaining that taxpayer must exercise complete dominion over item of income for item to constitute gross income). Compare *Srivastava v. Comm'r*, 220 F.3d 353, 363-64 (5th Cir. 2000) (arguing Texas attorney-lien statute diverts some measure of control over claim to attorney), and *Estate of Clarks v. United States*, 202 F.3d 854, 856 (6th Cir. 2000) (arguing that Michigan attorney-lien statute operates in same manner as Alabama lien statute and that taxpayer gives up control over portion of settlement), and *Cotnam v. Comm'r*, 263 F.2d 119, 125-26 (5th Cir. 1959) (arguing that Alabama attorney-lien statute gives attorney equitable interest in cause of action, meaning taxpayer does not include contingent attorney's fees in gross income), with *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (citing Alaska attorney-lien statute and arguing that statute does not give attorney superior lien or ownership interest in taxpayer's cause of action), and *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (citing Maryland attorney-lien statute and reasoning that argument that statute gives attorney ownership interest is unsound).

³⁶ See *MCDANIEL ET AL.*, *supra* note 1, at 1186-87 (explaining realization of income requirement determines who is responsible for tax).

³⁷ See I.R.C. § 61(a) (defining gross income as income from whatever source derived and listing fifteen typical sources of income); *MCDANIEL ET AL.*, *supra* note 1, at 1186 (describing certain situations where taxpayer must recognize gross income).

³⁸ See *Helvering v. Horst*, 311 U.S. 112, 118 (1940) (stating that power to dispose of income is equivalent of ownership of it); *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930) (holding that taxpayer cannot escape taxes by using anticipatory arrangements and skillfully devised contracts); see also Traci A. Sammeth, Note, *Beyond the Fruit Tree: A Proposal for the Revision of the Assignment of Income Doctrine*, 65 WASH. L. REV. 229, 229-30 (1990) (explaining that first question in determining whether shift of income occurred asks who is entitled to income in first place).

³⁹ See *Horst*, 311 U.S. at 116-17 (explaining that assignor realizes income because whoever owns source of income also controls disposition of income); *MCDANIEL ET AL.*, *supra* note 1, at 1186-87 (explaining how complicated assignment of income doctrine is to apply); Sammeth, *supra* note 38, at 232-33 (arguing that cases involving assignments of right to income from property follow traditional fruit-tree metaphor).

⁴⁰ See *Horst*, 311 U.S. at 116-18; *Earl*, 281 U.S. at 114-15; see also *United States v. Basye*, 410 U.S. 441, 449-50 (1973) (holding that whoever earns income is responsible for tax and

The first principle of income taxation is that whoever earns the income must pay the tax.⁴¹ Ordinarily, the obligation to pay tax accrues when the taxpayer receives the income.⁴² However, under a contingent fee arrangement the taxpayer assigns to the attorney a portion of the settlement or verdict prior to realizing the income.⁴³ Furthermore, each state has an attorney-lien statute that protects the attorney's rights.⁴⁴ In some states this statute gives the attorney a property interest in the settlement.⁴⁵ Thus, under a contingent fee arrangement the taxpayer never actually receives the income from the contingency portion of the settlement.⁴⁶ Consequently, how the court characterizes the contingent fee arrangement determines the taxation of the fees.⁴⁷

entering into contractual arrangement to divert income does not relieve taxpayer of obligation); *Helvering v. Eubank*, 311 U.S. 122, 124-25 (1940) (holding that assignment of income does not relieve taxpayer of obligation to pay tax).

⁴¹ See *Comm'r v. Culbertson*, 337 U.S. 733, 739-40 (1949) (holding that first principle of income taxation is that "income must be taxed to him who earns it"); see also *Basye*, 410 U.S. at 449 (holding that taxpayer cannot avoid taxation by diverting income to some other person or entity). But see *Sammeth*, *supra* note 38, at 229 (arguing against universal application of assignment of income doctrine).

⁴² See *Horst*, 311 U.S. at 115-16 (arguing that in ordinary case taxpayer must receive income before obligation to pay tax accrues); see also *Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (explaining that general rule is obligation to pay tax begins with realization, but that preventing income from vesting does not allow taxpayer to escape taxation).

⁴³ See *Srivastava v. Comm'r*, 220 F.3d 353, 360 (5th Cir. 2000) (reasoning that contingent fees are more like division of property than assignment of income thereby avoiding realization); *Estate of Clarks v. United States*, 202 F.3d 854, 857-58 (6th Cir. 2000) (arguing that taxpayer does not realize income because contingent fees are more like division of property than assignment of income); *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (applying Alabama attorney-lien statute that gives attorney property interest in settlement).

⁴⁴ See, e.g., GA. CODE ANN. § 15-19-14(a)-(b) (Michie 2000) (protecting attorneys' rights by giving attorney lien superior to all liens except tax liens); see also *Thad A. Davis, 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*, 51 ALA. L. REV. 1683, 1714 (2000) (explaining that all states have some type of attorney-lien statute protecting attorneys from insolvent clients).

⁴⁵ See, e.g., ALA. CODE § 34-3-6(b) (1975) (stating that attorneys have same right and power over action or judgment to enforce their liens as their clients). But see, e.g., LA. REV. STAT. ANN. § 9:5001 (West 1991) (failing to give attorney property interest in underlying claim).

⁴⁶ See *Srivastava*, 220 F.3d at 364 (arguing taxpayer gives up measure of control over contingent fee portion of settlement); *Estate of Clarks*, 202 F.3d at 858 (arguing that taxpayer never receives income from contingency portion of settlement); *Cotnam*, 263 F.2d at 125-26 (arguing that taxpayer never had right to receive contingent fee portion of settlement under Alabama attorney-lien law).

⁴⁷ Compare *Srivastava*, 220 F.3d at 363-64 (holding taxpayer gives up measure of control and assignment of income doctrine is difficult to apply), and *Davis v. Comm'r*, 210 F.3d 1346, 1347-48 (11th Cir. 2000) (per curiam) (holding that Eleventh Circuit bound by holdings of former Fifth Circuit thereby excluding contingent attorney's fees from gross income), and *Estate of Clarks*, 202 F.3d at 857-58 (concluding that assignment of income

If the court characterizes the contingent fee arrangement as an assignment of income, then the taxpayer must realize the fees as gross income.⁴⁸ The underlying reasoning is that whoever owns or controls the source of the income is responsible for the tax on the income.⁴⁹ The diversion of the settlement proceeds to the attorney procures the attorney's services, but does not shift control over the claim to the attorney.⁵⁰ Therefore, the taxpayer retains control over the claim and receives an economic benefit from the contingent attorney's fee that is subject to taxation.⁵¹ The following example illustrates why courts characterize assignments of income as a taxable event.

The analogy courts use to explain the tax consequences resulting from the assignment of income involves the fruit and the tree.⁵² The taxpayer

doctrine does not apply and taxpayer may exclude contingent attorney's fees from gross income), *with Coady*, 213 F.3d at 1191 (holding contingent attorney's fees fall within statutory definition of gross income and under judicially developed assignment of income doctrine), *and Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995) (holding that assignment of payment to third party constitutes gross income even though taxpayer never actually possessed funds), *and O'Brien v. Comm'r*, 38 T.C. 707, 711-12 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (holding that under assignment of income doctrine contingent attorney's fees are gross income).

⁴⁸ See *Coady*, 213 F.3d at 1191 (holding taxpayer must include contingent attorney's fees as gross income because transfer equivalent to assignment of income); *Baylin*, 43 F.3d at 1454 (holding that assignment of payment to third party constitutes gross income even though taxpayer never actually possessed funds); *O'Brien*, 38 T.C. 707, 711-12, *aff'd*, 319 F.2d 532 (holding that assignment of income doctrine forces taxpayer to realize contingent attorney's fees as gross income).

⁴⁹ See *Helvering v. Horst*, 311 U.S. 112, 116-17 (1940) (explaining rationale behind assignment of income doctrine); see also *Coady*, 213 F.3d at 1191 (arguing rationale behind assignment of income doctrine applies to contingent attorney's fees). *But see* *Sammeth*, *supra* note 38, at 230 (arguing against mechanical application of assignment of income doctrine).

⁵⁰ See *Horst*, 311 U.S. at 117 (arguing that taxpayer who obtains satisfaction of her desires by diverting future income streams still must pay tax); see also *Coady*, 213 F.3d at 1191 (reasoning that realization of income does not depend on possession of funds just that taxpayer benefited from economic gain). *But see* *Srivastava*, 220 F.3d at 359-61 (arguing that taxpayer shifts control over part of claim to attorney); *Estate of Clarks*, 202 F.3d at 857 (arguing that taxpayer transfers property interest to attorney to procure attorney's services).

⁵¹ See *Horst*, 311 U.S. at 116-17; *Coady*, 213 F.3d at 1190. *But see* *Estate of Clarks*, 202 F.3d at 857 (arguing that contingent fee agreement transferred property interest in claim over to attorney and taxpayer may exclude contingent attorney's fee from gross income); *but see also* *Srivastava*, 220 F.3d at 360-61 (arguing that taxpayer gave up control over portion of claim).

⁵² See *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (originating fruit-tree metaphor describing assignment of income doctrine); *Whipsaw: New Hope?*, *supra* note 8, at 191 (referring to fruit-tree metaphor as historic tax law analogy); *Sammeth*, *supra* note 38, at 233 (explaining traditional fruit-tree metaphor); see also *Ronald H. Jensen, Schneer v. Commissioner: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 628-31 (1993) (explaining development and rationale behind assignment

assigns to the attorney the fruit off of a portion of the trees in the taxpayer's orchard in exchange for services rendered.⁵³ Both parties derive an economic benefit from the fruit.⁵⁴ The taxpayer receives the economic benefit of the attorney's services. The attorney receives the fruit as payment for services rendered. Therefore, both the taxpayer and the attorney must include the fruit as gross income.⁵⁵ Yet, this is not the only way to characterize the contingent fee arrangement.⁵⁶

Under most contingent fee arrangements, the attorney receives the contingent fee before payment of the settlement to the taxpayer.⁵⁷ The taxpayer never exercises control over the portion designated under the contingent fee contract.⁵⁸ Therefore, the taxpayer does not include the contingent attorney's fee in gross income.⁵⁹ This characterization of

of income doctrine).

⁵³ See *Coady*, 213 F.3d at 1191 (explaining that *Coady* simply exchanged part of settlement for attorney's services); *Sammeth*, *supra* note 38, at 233. *But see Cotnam v. Comm'r*, 263 F.2d 119, 126 (5th Cir. 1959) (arguing that Ms. Cotnam's tree had borne no fruit and would have been barren had she not transferred part of her orchard to her attorneys).

⁵⁴ See *Horst*, 311 U.S. at 115 (explaining that both attorney and taxpayer receive economic benefit from assignment of income); *Srivastava*, 220 F.3d at 360 (noting that taxpayer and attorney economically benefit from fruit of tree). *But see Estate of Clarks*, 202 F.3d at 858 (arguing only attorney receives economic benefit from contingent attorney's fee).

⁵⁵ See *Coady*, 213 F.3d at 1191 (applying assignment of income doctrine to contingent attorney's fees); *Whipsaw: New Hope?*, *supra* note 8, at 190 (explaining affect of assignment of income doctrine on contingent attorney's fees). *But see Estate of Clarks*, 202 F.3d at 858 (holding that only attorney must include contingent fee as gross income).

⁵⁶ See *Srivastava*, 220 F.3d at 360-61 (supporting characterization of contingent attorney's fees as assignment of income or transfer of property right); *Estate of Clarks*, 202 F.3d at 857 (arguing that taxpayer transferred ownership interest in part of judgment to attorney); *Cotnam*, 263 F.2d at 125 (arguing that under Alabama law taxpayer transfers interest to attorney without ever realizing that portion as gross income).

⁵⁷ See *Srivastava*, 220 F.3d at 357 n.6 (explaining that attorney receives payment prior to payment of settlement to taxpayer).

⁵⁸ See *Srivastava*, 220 F.3d at 360-61 (arguing that taxpayer gives up measure of control over contingent attorney's fees); *Estate of Clarks*, 202 F.3d at 858 (arguing that taxpayer transferred ownership interest in part of judgment to attorney thereby never exercising control over fees); *Cotnam*, 263 F.2d at 125 (arguing that under Alabama law taxpayer transfers property interest to attorney prior to ever realizing that portion as gross income). *But see Coady*, 213 F.3d at 1191 (arguing that taxpayer does not avoid taxation of contingent attorney's fees by assigning or transferring them to attorney).

⁵⁹ See *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (explaining that items constitute gross income when the taxpayer exercises complete dominion over item of income); *Srivastava*, 220 F.3d at 355 (holding contingent attorney's fees excludable from gross income); *Estate of Clarks*, 202 F.3d at 858 (noting that taxpayers cannot exclude fees even though they have been assigned or transferred to attorney). *But see Coady*, 213 F.3d at 1191 (arguing that taxpayer must include contingent attorney's fees in gross income because taxpayer exercises control by transferring fees to attorney).

contingent attorney's fees presumes that the attorney has a property right in the settlement.⁶⁰

Using the fruit and the tree analogy, the taxpayer transfers a portion of her orchard to the attorney by agreeing to the contingent fee arrangement.⁶¹ The transfer splits the orchard into two parts, the taxpayer owns and controls one part and the attorney owns and controls the other.⁶² The taxpayer and the attorney realize as gross income only the fruit in their portion of the orchard.⁶³ This method allows the taxpayer to exclude contingent attorney's fees from gross income.⁶⁴ Yet, Congress has not authorized this type of exclusion in the Internal Revenue Code.⁶⁵

B. Tax Policy and Statutory Exclusions from Gross Income

Thus far the emphasis has been on the breadth of IRC section 61(a) and which economic benefits the taxpayer must include in gross income. The limitations placed on the scope of IRC section 61(a) are just as

⁶⁰ See *Srivastava*, 220 F.3d at 360 (arguing that claim is subject to virtual co-ownership between taxpayer and attorney); *Estate of Clarks*, 202 F.3d at 857-58 (arguing that contingent fees are more like division of property than assignment of income); *Cotnam*, 263 F.2d at 125 (arguing that under Alabama law taxpayer transfers property interest to attorney prior to ever realizing that portion as gross income).

⁶¹ See *Whipsaw: New Hope?*, *supra* note 8, at 190 (explaining how fruit-tree metaphor works under transfer of rights theory); see also *Srivastava*, 220 F.3d at 360 (explaining that neither attorney nor taxpayer retains control over trees); *Estate of Clarks*, 202 F.3d at 857-58 (arguing contingent fees are more like division of property); *Cotnam*, 263 F.2d at 125 (arguing that under Alabama law taxpayer transfers property interest to attorney).

⁶² See *Srivastava*, 220 F.3d at 360 (explaining that contingent fee agreement splits claim so that taxpayer and attorney share co-ownership); *Estate of Clarks*, 202 F.3d at 857-58 (arguing that both taxpayer and attorney own part of claim similar to partnership). *But see Coady*, 213 F.3d at 1190 (arguing that contingent fee does not alter attorney-client relationship).

⁶³ See *Estate of Clarks*, 202 F.3d at 857-58 (holding contingent attorney's fees excludable from taxpayer's gross income yet, includable in attorney's gross income); *Whipsaw: New Hope?*, *supra* note 8, at 191 (explaining how fruit-tree metaphor works under transfer of property theory); see also *Srivastava*, 220 F.3d at 365 (reversing Tax Court and excluding contingent attorney's fees from gross income of taxpayer); *Cotnam*, 263 F.2d at 126 (holding that taxpayer should not have included contingent attorney's fees in gross income).

⁶⁴ See *Srivastava*, 220 F.3d at 365 (reversing Tax Court and excluding contingent attorney's fees from taxpayer's gross income); *Estate of Clarks*, 202 F.3d at 858 (holding contingent attorney's fees excludable from taxpayer's gross income); *Cotnam*, 263 F.2d at 126 (holding that taxpayer should not have included contingent attorney's fees in gross income); *Whipsaw: New Hope?*, *supra* note 8, at 190 (explaining that under transfer of property theory taxpayer should not include contingent attorney's fees in gross income).

⁶⁵ See I.R.C. §§ 101-37 (1994 & Supp. V 1999) (authorizing exclusions from gross income for such taxable items as death benefits, gifts and inheritances, and employee fringe benefits, but not for contingent attorney's fees).

important.⁶⁶ Internal Revenue Code sections 101 through 137 specifically exclude from gross income certain items that fall within the statutory definition of gross income.⁶⁷ These exclusions illustrate two points. First, Congress has not specifically excluded contingent attorney's fees from gross income.⁶⁸ This implies that the taxpayer must include contingent attorney's fees in gross income.⁶⁹ Second, only Congress has the power to legislate exclusions from gross income.⁷⁰ The second point pervades all tax law including deductions, because nowhere in the IRC does a definition of deduction exist.⁷¹

1. Deductions - Expenses of Producing Income that Congress Allows the Taxpayer to Exclude from Gross Income

A statutory definition of what constitutes a deduction does not exist.⁷² Deductions are expenses of producing income that the taxpayer incurs during the taxable year.⁷³ Congress allows the taxpayer to exclude these expenses from gross income.⁷⁴ However, not all deductions have the same effect in reducing gross income.⁷⁵ Two broad categories of

⁶⁶ See MCDANIEL ET AL., *supra* note 1, at 64; see also 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.2.1, at 2-25 (explaining importance of statutory exclusions from gross income).

⁶⁷ See I.R.C. §§ 101-37; MCDANIEL ET AL., *supra* note 1, at 64 (noting that I.R.C. §§ 101 through 137 specifically exclude items normally included in gross income).

⁶⁸ See I.R.C. §§ 101-37 (authorizing exclusions from gross income for some items that fall under definition of gross income, but not authorizing exclusion for contingent attorney's fees).

⁶⁹ See *James v. United States*, 366 U.S. 213, 219 (1961) (noting intention of Congress to tax all gains except those specifically exempted); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940) (finding that Congress intended to exert full measure of its taxing authority through § 22 of the Revenue Act of 1934 (later codified as I.R.C. § 61(a))).

⁷⁰ See U.S. CONST. amend. XVI (bestowing on Congress power to tax incomes); *Eisner v. Macomber*, 252 U.S. 189, 206 (1920) (explaining that Constitution gives Congress power to legislate tax law); *Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000).

⁷¹ See *Davis*, *supra* note 44, at 1694 (stating that Congress has not defined what constitutes deductions, including miscellaneous itemized deductions); MCDANIEL ET AL., *supra* note 1, at 345.

⁷² See MCDANIEL ET AL., *supra* note 1, at 345 (explaining that unlike gross income no statute defines deductions); Sager & Cohen, *supra* note 2, at 1083-84; see also 1 BITTKER & LOKKEN, *supra* note 1, ¶ 20.1.1, at 20-2 to 20-5 (explaining statutory framework of deductions).

⁷³ See I.R.C. § 162(a) (1994 & Supp. V 1999) (defining ordinary and necessary deductions as expenses paid or incurred during taxable year); I.R.C. § 212(1)-(2) (1999) (defining deductions for production of income as ordinary and necessary expenses paid or incurred during taxable year); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 20.1.2, at 20-5 to 20-9.

⁷⁴ See I.R.C. § 62(a) (1999) (authorizing taxpayer to deduct from gross income all deductions attributable to carrying on trade or business).

⁷⁵ See I.R.C. § 67(a) (1999) (limiting allowance of miscellaneous itemized deductions to "the extent that the aggregate of such deductions exceeds two-percent of adjusted gross

deductions exist.⁷⁶

Internal Revenue Code section 162 allows a full deduction for ordinary and necessary expenses paid during the taxable year in carrying on a trade or business.⁷⁷ The characteristic of arising out of a trade or business distinguishes these deductions from all other deductions.⁷⁸ The tax system gives preferential treatment to these types of deductions.⁷⁹

The taxpayer deducts ordinary and necessary business expenses directly from gross income.⁸⁰ Ordinary and necessary business expenses are not subject to the same limitations as itemized deductions.⁸¹ However, the taxpayer cannot utilize these deductions unless engaged in a trade or business, which severely restricts who can claim these deductions.⁸²

The second major category of deductions is itemized deductions, which reduce a taxpayer's AGI to taxable income.⁸³ Any taxpayer can take an itemized deduction as long as the taxpayer incurred the expense during the taxable year for the production of income.⁸⁴ Under certain

income" on regular tax); *Srivastava v. Comm'r*, 220 F.3d 353, 357 (5th Cir. 2000) (stating that various limitations operate to reduce effectiveness of miscellaneous itemized deductions); *Kenseth*, 114 T.C. at 407 (recognizing limitations on miscellaneous itemized deductions on both regular tax and AMT).

⁷⁶ See I.R.C. § 63(d) (199) (defining itemized deductions as all deductions except deductions allowable in arriving at adjusted gross income and personal exemptions); I.R.C. § 162(a) (creating deduction for all ordinary and necessary expenses paid or incurred during taxable year in carrying on trade or business by taxpayer); Treas. Reg. § 1.162-1(a) (as amended in 1993) (interpreting definition of ordinary and necessary business expense).

⁷⁷ See I.R.C. § 162(a).

⁷⁸ See I.R.C. § 162(a) (requiring that expense arise out of trade or business); Treas. Reg. § 1.162-1(a) (as amended in 1993); see also 1 BITTKER & LOKKEN, *supra* note 1, ¶ 20.1.2, at 20-5 to 20-9 (explaining definition of trade or business).

⁷⁹ See I.R.C. § 62(a); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 20.1.3, at 20-9 (arguing that ordinary and necessary business expenses take precedence over specific itemized deductions).

⁸⁰ See I.R.C. § 62(a); Treas. Reg. § 1.62-2(a) (as amended in 2000) (explaining that taxpayer may deduct trade or business expenses directly from gross income).

⁸¹ See I.R.C. § 62(a); I.R.C. § 63(d) (defining itemized deductions); I.R.C. § 67(a) (1999) (limiting allowance of miscellaneous itemized deductions to "the extent that the aggregate of such deductions exceeds two-percent of adjusted gross income" on regular tax); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 20.1.3, at 20-9 (arguing that ordinary and necessary business expenses take precedence over specific itemized deductions).

⁸² See Treas. Reg. § 1.162-1(a) (as amended in 1993) (explaining that expense is deductible under I.R.C. § 162 only if directly connected with or pertaining to trade or business); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 20.1.2, at 20-5 to 20-9.

⁸³ See I.R.C. § 62(a); I.R.C. § 63(a) (1999) (defining taxable income); I.R.C. § 63(d) (defining itemized deductions).

⁸⁴ See I.R.C. § 63(d) (allowing all taxpayers to deduct itemized deductions as long as expense incurred during taxable year); I.R.C. § 212(1) (1999) (defining expenses for production of income); Treas. Reg. § 1.212-1(a) (as amended in 1975) (interpreting

circumstances contingent attorney's fees are miscellaneous itemized deductions, a subset of itemized deductions as defined by IRC section 67(b).⁸⁵ This characterization considerably limits the effectiveness of the deduction.⁸⁶ The taxpayer can only deduct the aggregate of miscellaneous itemized deductions that exceed two-percent of the taxpayer's AGI on the regular tax.⁸⁷ Also, miscellaneous itemized deductions are not deductible for the purposes of the AMT.⁸⁸

2. Structure and Function of the Alternative Minimum Tax

Structurally, the AMT is a separate and independent income tax system.⁸⁹ Congress designed the AMT to ensure that no taxpayer with substantial economic income could avoid tax liability by using exclusions, deductions, or credits.⁹⁰ The AMT is payable only to the

definition of expense for production of income).

⁸⁵ Depending on the origin of the claims test, contingent attorney's fees can be ordinary and necessary business expenses, miscellaneous itemized deductions, or non-deductible personal expenses. See *United States v. Gilmore*, 372 U.S. 39, 49 (1963) (observing that origin and character of claim tests whether expense was business or personal and controls to what extent expense is deductible); see also *Srivastava v. Comm'r*, 220 F.3d 353, 357 n.6 (5th Cir. 2000) (stating that contingent attorney's fees are potentially deductible either as ordinary and necessary business expenses or as expenses incurred for production or collection of income). This Comment treats all contingent attorney's fees as miscellaneous itemized deductions. See I.R.C. § 67(b) (1999) (defining miscellaneous itemized deductions as itemized deductions other than list of twelve exceptions); Temp. Treas. Reg. § 1.67-1T(a)(1)(i) (1988) (interpreting miscellaneous itemized deduction to include expenses for production or collection of income as defined by I.R.C. § 212 (1)-(2)).

⁸⁶ See I.R.C. § 56(b)(1)(a)(i) (1994) (disallowing for AMT purposes deduction for miscellaneous itemized deductions as defined in I.R.C. § 67(b)); I.R.C. § 67(a) (limiting allowance of miscellaneous itemized deductions to "the extent that the aggregate of such deductions exceeds two-percent of adjusted gross income" for regular tax); *Srivastava*, 220 F.3d at 357 (highlighting importance of characterization because various limitations reduce effectiveness of miscellaneous itemized deductions); *Alexander v. Comm'r*, 72 F.3d 938, 946 (1st Cir. 1995) (stating that characterization of contingent attorney's fees as miscellaneous itemized deduction limits taxpayer's ability to deduct fees on both regular tax and AMT); *Kenseth v. Comm'r*, 114 T.C. 399, 407-08 (2000) (highlighting potential unfairness that occurs due to application of AMT).

⁸⁷ See I.R.C. § 67(a); Temp. Treas. Reg. § 1.67-1T(a) (1988) (applying statutory two-percent floor).

⁸⁸ See I.R.C. § 56(b)(1)(a)(i) (disallowing miscellaneous itemized deductions as defined in I.R.C. § 67(b) on AMT); *Davis v. Comm'r*, 210 F.3d, 1346, 1347 n.3 (11th Cir. 2000) (per curiam) (stating that miscellaneous itemized deductions are not deductible for purposes of AMT); *Alexander*, 72 F.3d at 946 (noting that miscellaneous itemized deductions are not deductible on AMT); *Kenseth*, 114 T.C. at 407 (highlighting potential unfairness that occurs because miscellaneous itemized deductions are not deductible on AMT).

⁸⁹ See *MCDANIEL ET AL.*, *supra* note 1, at 1271 (explaining history and evolution of AMT). See generally 1986 BLUEBOOK, *supra* note 9, at 430-32 (explaining function of AMT for individual taxpayers).

⁹⁰ See 1986 BLUEBOOK, *supra* note 9, at 432-33 (explaining congressional intent in

extent that it exceeds the regular tax.⁹¹ The AMT becomes relevant when a taxpayer has AMTI over the statutory exemption, which ranges from \$33,750 for individuals to \$45,000 for joint returns.⁹² The changes to the AMT in the Tax Reform Act of 1986 ("TRA 1986") addressed the tax avoidance problem by eliminating certain deductions.⁹³

The AMT's distinct character means that provisions in the IRC that relate to the regular tax do not necessarily apply to the AMT.⁹⁴ In the TRA 1986, Congress eliminated miscellaneous itemized deductions, as defined in IRC section 67(b), from the AMT.⁹⁵ This affects all contingent attorney's fees characterized as miscellaneous itemized deductions under the regular tax.⁹⁶ While normally deductible under the regular tax, subject to the two-percent AGI limitation, these deductions are not deductible under the AMT.⁹⁷

enacting AMT); *see also Alexander*, 72 F.3d at 947 (recognizing congressional intent behind enactment of AMT). *But see Sager & Cohen*, *supra* note 2, at 1092-93 (arguing that overall purpose behind AMT is "to produce an alternative measure of income that more accurately reflects economic income than taxable income").

⁹¹ *See* I.R.C. § 26(a) (Supp. V 1999) (limiting amount of tax that taxpayer must pay to regular tax liability plus difference between regular tax and AMT if greater than zero); TAX REFORM ACT OF 1986, S. REP. NO. 99-313 (1986), *reprinted in* 1986 U.S.C.A.N. 4075, 4338 [hereinafter TRA 1986] (explaining that AMT is payable "to the extent in excess of regular tax liabilities"); 4 BITTKER & LOKKEN, *supra* note 1, ¶ 111.4.1, at 111-88 (explaining that taxpayer essentially pays greater of regular tax or AMT); MCDANIEL ET AL., *supra* note 1, at 1271 (explaining limitations on total extent of taxation that taxpayer is liable for in one year).

⁹² *See* I.R.C. § 55(d)(1) (1994 & Supp. V 1999) (defining statutory exemption amount for individual taxpayers); Treas. Reg. § 1.55-1(a) (1994); 4 BITTKER & LOKKEN, *supra* note 1, ¶ 111.4.1, at 111-88 (explaining when taxpayer is subject to AMT).

⁹³ *See* TRA 1986, *supra* note 91, at 4347 (explaining limited number of itemized deductions for AMT purposes); 1986 BLUEBOOK, *supra* note 9, at 462 (explaining one change to AMT is that taxpayer can no longer deduct miscellaneous itemized deductions).

⁹⁴ *See, e.g.,* I.R.C. § 56(b)(1)(A)(i) (1994) (excluding miscellaneous itemized deductions for purposes of calculating alternative minimum taxable income); *see also* MCDANIEL ET AL., *supra* note 1, at 1270-72 (noting that regular tax and AMT utilize same tax terms but employ them in different ways).

⁹⁵ *See* I.R.C. § 67(b) (1994); TRA 1986, *supra* note 93, at 4347 (eliminating miscellaneous itemized deductions for AMT purposes); 1986 BLUEBOOK, *supra* note 9, at 462 (explaining that taxpayer can no longer deduct miscellaneous itemized deductions on AMT).

⁹⁶ *See* *Srivastava v. Comm'r*, 220 F.3d 353, 357 (5th Cir. 2000) (recognizing effect that characterization of contingent attorney's fees as miscellaneous itemized deductions has on taxpayer due to AMT); *Alexander v. Comm'r*, 72 F.3d 938, 946-47 (1st Cir. 1995) (finding that contingent attorney's fees are miscellaneous itemized deductions for regular tax purposes triggering unjust effect for AMT purposes); *Whipsaw: New Hope?*, *supra* note 8, at 190 (arguing that characterization of contingent attorney's fees as miscellaneous itemized deductions creates excessive tax burden under AMT).

⁹⁷ *See* I.R.C. § 56(b)(1)(A)(i); I.R.C. § 67(a)-(b) (1994); 1986 BLUEBOOK, *supra* note 9, at 462 (explaining that taxpayer can no longer deduct miscellaneous itemized deductions on AMT).

This change in the AMT is what makes the characterization of contingent attorney's fees so important.⁹⁸ If the court characterizes the fees as property of the attorney, then the taxpayer does not include the fees in gross income.⁹⁹ A deduction for the fees on the regular tax is not necessary.¹⁰⁰ Consequently, the AMT becomes irrelevant, and the taxpayer pays no tax on the fees under the AMT.¹⁰¹

If the court characterizes the fees as an assignment of income, then the taxpayer must include the fees as gross income.¹⁰² The taxpayer will then deduct the fees as a miscellaneous itemized deduction on the regular tax.¹⁰³ If the taxpayer has AMTI over the statutory exemption amount, then the AMT applies.¹⁰⁴ Once the AMT applies, the taxpayer must add

⁹⁸ See *Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000) (arguing that controversy over characterization of contingent attorney's fees driven by substantial difference in tax burden that results when AMT applies); see also *Srivastava*, 220 F.3d at 357 (recognizing that changes in AMT relating to miscellaneous itemized deductions make characterization of contingent attorney's fees substantially important); *Alexander*, 72 F.3d at 946 (noting that characterizing contingent attorney's fees as miscellaneous itemized deductions triggers AMT and that outcome is unjust).

⁹⁹ See *Srivastava*, 220 F.3d at 364-65 (finding that contingent attorney's fees are property of attorney and reversing Tax Court's decision to include contingent attorney's fees in gross income); *Estate of Clarks v. United States*, 202 F.3d 854, 857-58 (6th Cir. 2000) (finding that contingent fee arrangement more like division of property and holding that only attorney must include contingent fee in gross income not taxpayer); *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (finding that Alabama attorney-lien statute conferred property interest on attorney and that taxpayers should not include contingent attorney's fees in gross income).

¹⁰⁰ See I.R.C. § 162(a) (1994 & Supp. V 1999) (requiring as *sine qua non* for deductibility that taxpayer become liable for expense); I.R.C. § 212 (1994) (requiring expense as *sine qua non* of deductibility).

¹⁰¹ See I.R.C. § 26(a) (Supp. V 1999) (limiting amount of tax that taxpayer must pay to regular tax liability plus difference between regular tax and AMT if greater than zero); *MCDANIEL ET AL.*, *supra* note 1, at 1271 (noting that AMT is payable "only to the extent that it exceeds the regular tax").

¹⁰² See *Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (characterizing contingent attorney's fees as assignment of income and holding them includable in gross income); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (characterizing contingent attorney's fees as assignment of income and including contingent fees in gross income); *Kenseth*, 114 T.C. at 417 (including contingent attorney's fees in gross income because they fall under assignment of income doctrine); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd* 319 F.2d 532 (3d Cir. 1963) (holding contingent attorney's fees includable in gross income because they represent assignment of income).

¹⁰³ See *Srivastava*, 220 F.3d at 357 (stating that attorney's fees are potentially deductible as miscellaneous itemized deductions depending on "origin of the claim test"); *Alexander*, 72 F.3d at 946 (reasoning that contingent attorney's fees are deductible as miscellaneous itemized deduction); *Kenseth*, 114 T.C. at 407 (arguing that controversy driven because contingent attorney's fees characterized as miscellaneous itemized deduction); see also *United States v. Gilmore*, 372 U.S. 39, 49 (1963) (arguing that origin and character of claim determines to deduct expense).

¹⁰⁴ See I.R.C. § 55(d)(1)(A)-(C) (1994 & Supp. V 1999) (defining exemption amount for

to regular taxable income all miscellaneous itemized deductions deducted under the regular tax to arrive at AMTI.¹⁰⁵ The contingent attorney's fees that were not taxable under the regular tax, except for the two-percent limitation, are completely taxable under the AMT.¹⁰⁶

The full taxation of contingent attorney's fees on the AMT is significant for two reasons.¹⁰⁷ First, contingent attorney's fees represent non-economic income to the taxpayer.¹⁰⁸ Congress designed the AMT to tax economic income, which means taxation of contingent attorney's fees on the AMT results in an excessive tax burden.¹⁰⁹ Second, a wide variety of cases use contingent attorney's fees. The ABA Model Rules of Professional Conduct approve of the use of contingency fees in all cases except those involving domestic relations or criminal defendants.¹¹⁰ This includes civil rights litigation, personal injury suits, and employment disputes.¹¹¹ Thus, the split of authority over the characterization of

AMT purposes). The exemption amount for a joint return or a surviving spouse is \$45,000, for a non-married individual the exemption is \$33,750, and for a married filing separate the exemption is \$22,500. *Id.*

¹⁰⁵ See I.R.C. 56(b)(1)(A)(i) (1994); see also TRA 1986, *supra* note 93, at 4347 (eliminating miscellaneous itemized deductions for AMT purposes); 1986 BLUEBOOK, *supra* note 9, at 462 (explaining one change to AMT is that taxpayer can no longer deduct miscellaneous itemized deductions).

¹⁰⁶ See I.R.C. 56(b)(1)(A)(i) (including miscellaneous itemized deductions in alternative minimum taxable income); I.R.C. § 67(a) (1994); *Alexander*, 72 F.3d at 946-47 (recognizing that AMT denies all miscellaneous itemized deductions defined under I.R.C. § 67(b)); *Kenseth*, 114 T.C. at 407 (stating that miscellaneous itemized deductions are deductible subject to two-percent floor on regular tax, but are non-deductible in computing AMT).

¹⁰⁷ See 1986 BLUEBOOK, *supra* note 9, at 432-33 (explaining rationale behind AMT is to tax individuals with substantial economic income); MODEL RULES OF PROF'L CONDUCT R. 1.5(c)-(d) (1983); Sager & Cohen, *supra* note 2, at 1077-78.

¹⁰⁸ See SIMONS, *supra* note 15, at 50; Sager & Cohen, *supra* note 2, at 1077-78 (defining economic income, in context of contingent attorney's fees, as total settlement minus contingent attorney's fees); see also MCDANIEL ET AL., *supra* note 1, at 51-52 (explaining definition of economic income).

¹⁰⁹ See 1986 BLUEBOOK, *supra* note 9, at 432-33 (noting purpose behind AMT is to "ensure no taxpayer with substantial economic income" can avoid tax liability); Sager & Cohen, *supra* note 2, at 1077-78 (arguing that AMT designed to tax only economic income).

¹¹⁰ See MODEL RULES OF PROF'L CONDUCT R. 1.5(c)-(d) (1983).

¹¹¹ See *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (listing different types of cases that utilize contingent attorney's fees); Sager & Cohen, *supra* note 2, at 1077-78 (noting that employment discrimination and civil rights actions are two types of cases that utilize contingent fee arrangements). Although personal injury suits utilize contingent attorney's fees, the fees are not taxable. See I.R.C. § 104(a)(2) (Supp. V 1999) (excluding amount of damages received on account of physical personal injury from gross income); STAFF OF JOINT COMM. ON TAX'N, 105TH CONG., 2D SESS., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 105TH CONGRESS 222-24 (Comm. Print 1996) (explaining that taxpayers may exclude from gross income all damages that flow from physical personal injuries); Davis, *supra* note 44, at 1692-94 (explaining that damages associated with physical personal injury suits are non-taxable including contingent attorney's fees).

contingent attorney's fees affects a large class of cases.¹¹² Where the taxpayer resides determines whether or not the split of authority adversely effects the taxation of contingent attorney's fees.¹¹³

II. THE FIFTH AND NINTH CIRCUIT SPLIT OVER THE CHARACTERIZATION OF CONTINGENT ATTORNEY'S FEES

Depending on which state the taxpayer resides, the level of taxation on contingent attorney's fees varies.¹¹⁴ If the taxpayer lives within the Ninth Circuit's jurisdiction, the taxpayer must include contingent attorney's fees as gross income.¹¹⁵ On the other hand, if the taxpayer lives within the Fifth Circuit's jurisdiction, then the taxpayer excludes contingent attorney's fees from gross income.¹¹⁶ Four other circuits have split equally between the two different theories.¹¹⁷ The competing rationales that underlie the split of authority determine the tax ramifications.¹¹⁸

¹¹² See *Srivastava*, 220 F.3d at 355 (affecting libel and slander suits); *Coady v. Comm'r*, 213 F.3d 1187, 1187 (9th Cir. 2000) (affecting wrongful termination suits); *Estate of Clarks v. United States*, 202 F.3d 854, 855 (6th Cir. 2000) (affecting wrongful death suits).

¹¹³ Compare *Srivastava*, 220 F.3d at 363-65 (holding that under Texas law contingent attorney's fees are not taxable), and *Estate of Clarks*, 202 F.3d at 857 (ruling that under Michigan law contingent attorney's fees are not taxable), and *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (finding that under Alabama law contingent attorney's fees are not taxable), with *Coady*, 213 F.3d at 1190-91 (holding that under Alaska law contingent attorney's fees are taxable as gross income), and *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (ruling that under Maryland law contingent attorney's fees are taxable as gross income), and *Kenseth v. Comm'r*, 114 T.C. 399, 413 (2000) (finding that under Wisconsin law contingent attorney's fees are taxable as gross income).

¹¹⁴ See sources cited *supra* note 113.

¹¹⁵ See *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943 (9th Cir. 2000) (holding that California taxpayer must include contingent attorney's fees in gross income); *Coady*, 213 F.3d at 1187 (holding Alaska taxpayer must include contingent attorney's fees in gross income); *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (noting that Ninth Circuit has consistently held contingent attorney's fees includable in taxpayer's gross income).

¹¹⁶ See *Srivastava*, 220 F.3d at 357-58 (holding contingent attorney's fees excludable from gross income); *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (noting that Fifth Circuit has consistently held contingent attorney's fees excludable from taxpayer's gross income).

¹¹⁷ See *Davis v. Comm'r*, 210 F.3d 1346, 1347 (11th Cir. 2000) (per curiam) (affirming Tax Court that contingent attorney's fees are excludable from gross income); *Estate of Clarks*, 202 F.3d at 857 (holding contingent attorney's fees excludable from gross income); *Baylin*, 43 F.3d at 1454-55 (including contingent fees in gross income); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (holding contingent attorney's fees includable in gross income).

¹¹⁸ Compare *Srivastava*, 220 F.3d at 363-65 (reasoning that taxpayer transfers property interest to attorney), and *Estate of Clarks*, 202 F.3d at 857 (holding taxpayer transfers property interest to attorney), with *Coady*, 213 F.3d at 1190-91 (applying statutory and judicially developed definitions of gross income), and *Baylin*, 43 F.3d at 1454-55 (applying

A. *The Ninth Circuit Approach: Including Contingent Attorney's Fees as Gross Income*

The Third, Ninth, and Federal Circuits hold that under the assignment of income doctrine the taxpayer must include contingent attorney's fees in gross income.¹¹⁹ Under the assignment of income doctrine, the taxpayer transfers a portion of the income to the attorney to procure the attorney's services.¹²⁰ The taxpayer receives the economic benefit of the contingent attorney's fees when the attorney accepts the fees as compensation for services rendered.¹²¹ The Ninth Circuit holding in *Coady v. Commissioner*¹²² exemplifies this position.

In *Coady*, the issue was whether Ms. Coady properly excluded from gross income contingent legal fees incurred in securing a judgment for wrongful termination.¹²³ In May 1990, the Alaska Housing Finance Corporation discharged Ms. Coady from her position as a Senior Loan Officer.¹²⁴ Ms. Coady retained a law firm on a 33.33% contingent fee basis and sued her former employer for wrongful termination.¹²⁵ The trial court held the employer liable, and the employer issued a check for full payment of the judgment.¹²⁶ Ms. Coady excluded from gross income the portion of the award not paid on account of past wages, including contingent attorney's fees.¹²⁷ The IRS issued a statutory notice of

assignment of income doctrine), and *Kenseth*, 114 T.C. at 413 (applying assignment of income doctrine), and *O'Brien*, 38 T.C. at 712 (applying assignment of income doctrine and concluding that contingent attorney's fees falls within judicially developed definition of gross income).

¹¹⁹ See *Coady*, 213 F.3d at 1191 (holding contingent attorney's fees includable in gross income); *Baylin*, 43 F.3d at 1454-55 (including contingent attorney's fees in gross income); *O'Brien*, 38 T.C. at 712 (affirming Tax Court and holding contingent attorney's fees in gross income).

¹²⁰ See *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (reasoning that by procuring attorney's services taxpayer enjoys economic benefit that taxpayer must include in gross income); see also *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (explaining that gross income includes any economic benefit over which taxpayer exercises complete control); *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929) (holding that discharge by third person of obligation is equivalent to receipt of income by taxpayer).

¹²¹ See *Horst*, 311 U.S. at 116-17; *Old Colony Trust Co.*, 279 U.S. at 729 (holding that taxpayer realizes gross income when taxpayer's obligation discharged by third person); see also *Coady*, 213 F.3d at 1189-91 (finding that taxpayer receives economic benefit by transferring contingent fee to attorney that taxpayer must include in gross income).

¹²² *Coady*, 213 F.3d 1187.

¹²³ *Id.* at 1187.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at 1187-88.

¹²⁷ *Id.* at 1188.

deficiency, and Ms. Coady filed suit in Tax Court.¹²⁸ The Commissioner contended that the fees were deductible as miscellaneous itemized deductions.¹²⁹ Ms. Coady argued that the fees were not reportable at all based on the Fifth Circuit's holding in *Cotnam v. Commissioner*.¹³⁰ The Tax Court upheld the Commissioner's determination and Ms. Coady appealed.¹³¹

The Ninth Circuit affirmed the Tax Court and held that the award constituted gross income.¹³² The court found that Ms. Coady simply used a portion of her award to discharge a personal liability to her attorney.¹³³ Initially, the court determined that Alaska's attorney-lien statute did not confer on Ms. Coady's attorney a property interest in the settlement.¹³⁴ According to the statute, the attorney only obtains a lien that attaches to the client's property. The court then applied the statutory and judicially developed definitions of gross income to contingent attorney's fees.¹³⁵

The court argued that the IRC defines gross income very broadly.¹³⁶ The court also noted the presumption that any accessions to wealth are gross income unless the taxpayer can prove otherwise.¹³⁷ Then, the court considered the application of the assignment of income doctrine.¹³⁸ The court cited Supreme Court precedent that explicitly rejected the notion that a taxpayer can evade taxation by assigning income to a creditor.¹³⁹ The court explained that the assignment of income doctrine prevents

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*; see *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (holding contingent attorney's fees excludable from gross income).

¹³¹ *Coady*, 213 F.3d at 1188.

¹³² *Id.* at 1191.

¹³³ *Id.*

¹³⁴ *Id.* at 1190; see ALASKA STAT. § 34.35.430 (Michie 1989) (giving attorney opportunity to place lien on property belonging to client, but not conferring any ownership interest upon attorney in client's suits, judgments, or decrees).

¹³⁵ See *Coady*, 213 F.3d at 1190-91 (applying statutory and judicially developed definitions of gross income); see also I.R.C. § 61(a) (1994) (defining gross income); *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930) (establishing judicially developed definition of gross income known as assignment of income doctrine).

¹³⁶ *Coady*, 213 F.3d at 1190; see I.R.C. § 61(a) (defining gross income broadly); *James v. United States*, 366 U.S. 213, 219 (1961) (defining gross income broadly to include gains from which taxpayer derives readily realizable economic value).

¹³⁷ *Coady*, 213 F.3d at 1190; see *Getty v. Comm'r*, 913 F.2d 1486, 1490 (9th Cir. 1990) (presuming that funds or other accessions to wealth received by taxpayer are includable as gross income unless taxpayer can demonstrate otherwise).

¹³⁸ *Coady*, 213 F.3d at 1191.

¹³⁹ *Id.* (citing *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930) (establishing assignment of income doctrine)).

taxpayers from enjoying an economic benefit, avoiding realization of the income and thereby avoiding taxation.¹⁴⁰ Finally, the court concluded that the taxpayer could not escape taxation by making an anticipatory arrangement preventing income from vesting in the person who earned it.¹⁴¹

The Ninth Circuit approach favors the government by rigorously applying the definition of gross income.¹⁴² Yet, it does so without balancing the tax burden created by the AMT.¹⁴³ A much different approach exists in three other circuits including the Fifth.

B. The Fifth Circuit Approach: Excluding Contingent Attorney's Fees from Gross Income

The Fifth, Sixth, and Eleventh Circuits hold that taxpayers may exclude contingent attorney's fees from gross income.¹⁴⁴ The courts argue that the contingent fee arrangement transfers a property interest to the attorney.¹⁴⁵ Originally, the taxpayer owned the underlying claim.¹⁴⁶ By agreeing to the contingent arrangement, the taxpayer loses the right to receive payment for the attorney's portion of the judgment.¹⁴⁷ The attorney obtains an equity interest in the cause of action, which relieves the taxpayer of responsibility for the contingent fee portion of the award.¹⁴⁸ The Fifth Circuit has consistently applied this rationale to

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² See *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (arguing that Ninth Circuit approach takes pro-government stance in applying definition of gross income to contingent attorney's fees); see also *Alexander v. Comm'r*, 72 F.3d 938, 946 (1st Cir. 1995) (recognizing that applying strict application of statutory definition of gross income creates outcome that is unjust for taxpayers).

¹⁴³ See *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (presenting recent case law showing sharp distinction between approaches and indicating excessive tax burden created by AMT).

¹⁴⁴ See *Srivastava*, 220 F.3d at 365; *Davis*, 210 F.3d at 1347; *Estate of Clarks*, 202 F.3d at 857-58.

¹⁴⁵ See *Srivastava*, 220 F.3d at 360 (reasoning that taxpayer divests part of claim to attorney); *Estate of Clarks*, 202 F.3d at 857-58 (reasoning that contingent fee agreement is more like division of property than assignment of income).

¹⁴⁶ See *Helvering v. Horst*, 311 U.S. 112, 116-17 (1940).

¹⁴⁷ See *Srivastava*, 220 F.3d at 362 (stating that contingent fee agreement contracts away taxpayer's right to part of judgment); *Estate of Clarks*, 202 F.3d at 857-58 (arguing that taxpayer loses right to contingent fee portion of settlement by agreeing to contingent fee arrangement).

¹⁴⁸ See *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) (arguing that attorney receives equity interest in taxpayer's cause of action that taxpayer does not include as gross income); see also *Estate of Clarks*, 202 F.3d at 858 (holding that contingent fee agreement transfers equity interest to attorney and taxpayer does not include fees as gross income).

contingent fee agreements beginning with *Cotnam v. Commissioner*¹⁴⁹ in 1959.

In *Cotnam*, the issue concerned whether Mrs. Cotnam could exclude from gross income the amount paid to her attorneys from the verdict.¹⁵⁰ In 1940, Mrs. Cotnam promised to attend to her friend, T. Shannon Hunter, for the rest of his life in exchange for one-fifth of his estate. After an extended legal battle, the Alabama Supreme Court upheld the validity of the contract and awarded Mrs. Cotnam \$120,000. The IRS treated the entire verdict as taxable income. The Commissioner assessed a deficiency tax of \$36,985 based on the entire \$120,000 verdict, including the contingent fee of \$50,366. The Tax Court agreed with the IRS and Mrs. Cotnam appealed.¹⁵¹

The Fifth Circuit found that the Alabama attorney-lien statute precluded Mrs. Cotnam from receiving the contingent fee portion of her verdict.¹⁵² The court explained that the statute gave the attorney an equitable interest in the client's cause of action.¹⁵³ Further, the court determined that the only income Mrs. Cotnam received consisted of the economic benefit, the verdict minus the attorney's fees.¹⁵⁴ The court then dismissed the IRS's argument that the contingent fee agreement fell under the assignment of income doctrine. The court concluded that the assignment of income doctrine did not apply because at the time of the transfer Mrs. Cotnam's tree had borne no fruit.¹⁵⁵ Therefore, the court held the fees excludable from gross income.¹⁵⁶ Using *Cotnam* as precedent a recent Fifth Circuit case, *Srivastava v. Commissioner*,¹⁵⁷ came to the same conclusion regarding the taxation of contingent attorney's fees.

In *Srivastava*, the issue was whether the portion of a settlement payable to the taxpayer's attorney pursuant to a contingent fee arrangement

¹⁴⁹ 263 F.2d 119.

¹⁵⁰ *Id.* at 121.

¹⁵¹ *Id.*

¹⁵² *Id.* at 125; see 46 ALA. CODE § 64 (1940) (defining prior Alabama attorney-lien statute).

¹⁵³ *Cotnam*, 263 F.2d at 125; see also *United States Fid. & Guar. Co. v. Levy*, 77 F.2d 972, 975 (5th Cir. 1935) (holding that Alabama statute creates equity interest in client's cause of action).

¹⁵⁴ *Cotnam*, 263 F.2d at 126; see also *Sager & Cohen*, *supra* note 2, at 1077-78 (defining economic income, in context of contingent attorney's fees, as total settlement minus attorney's fees).

¹⁵⁵ *Cotnam*, 263 F.2d at 126 (applying traditional fruit-tree metaphor).

¹⁵⁶ *Id.*

¹⁵⁷ 220 F.3d 353 (5th Cir. 2000).

constituted gross income.¹⁵⁸ Mr. Srivastava, a medical doctor licensed in the state of Texas, sued a television station for defamation and related claims. The parties settled the suit for \$8.5 million, but they did not separate the proceeds into actual damages, interest, and punitive damages. Mr. Srivastava received the settlement proceeds in 1991 but reported no gross income. The IRS issued a deficiency notice, and Mr. Srivastava challenged the deficiency in Tax Court. The Tax Court apportioned the settlement into the various categories and held that Mr. Srivastava must include the contingent attorney's fees in gross income.¹⁵⁹ Mr. Srivastava appealed.

The Fifth Circuit reversed the Tax Court and held that contingent attorney's fees governed by Texas law are excludable from gross income.¹⁶⁰ The court acknowledged that if it was writing on a clean slate it would hold contingent attorney's fees includable in gross income. The court noted that it did not believe Congress intended to subsidize contingent fee arrangements. Yet, the court felt bound by precedent to exclude contingent attorney's fees from gross income.

Initially, the court considered the tax consequences created by characterizing contingent attorney's fees as gross income.¹⁶¹ The court refused to apply the statutory definition of gross income indicating that it was too broad. Then, the court summarized the assignment of income doctrine and noted that its purpose was to prevent taxpayers from escaping taxation.¹⁶² Then, the court explained that contingent attorney's fees defy easy characterization because they represent a diversion of future income without purposely evading taxation. The court concluded that the assignment of income doctrine did not provide the complete answer because the taxpayer transferred a property interest to the attorney.¹⁶³

In applying the transfer of property theory, the court determined that when the taxpayer hired the attorney the claim split like an interest in a partnership.¹⁶⁴ Also, unlike the ordinary assignment of income situation, the attorney must work to reap the benefits of the contingent fee

¹⁵⁸ *Id.* at 355.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 358.

¹⁶¹ *Id.* at 357-58.

¹⁶² *Id.* at 358-60.

¹⁶³ *Id.* at 360.

¹⁶⁴ *Id.*; see also *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (arguing that contingency agreement similar to partnership agreement or joint venture). *But see* *Kenseth v. Comm'r*, 114 T.C. 399, 413 (2000) (arguing that attorneys can only represent clients in fiduciary capacity).

agreement.¹⁶⁵ However, the court noted that the transfer of property theory could result in taxable gains to the taxpayer, but did not elaborate. Finally, the court concluded that adherence to precedent outweighed the need to apply the assignment of income doctrine. The court argued that the principles of consistency must prevail.¹⁶⁶

Functionally, the Fifth Circuit takes a taxpayer friendly approach.¹⁶⁷ The court was given the opportunity to overturn *Cotnam*, but like the *Cotnam* court found that the assignment of income doctrine did not apply.¹⁶⁸ Although the court stated that it was simply applying precedent, the court noted that the application of the AMT drove the controversy.¹⁶⁹ Despite its taxpayer friendly attitude, the Fifth Circuit misapplied existing tax law by refusing to characterize contingent attorney's fees as an assignment of income.¹⁷⁰ Conversely, the Ninth Circuit approach correctly applies existing tax law by characterizing contingent attorney's fees as gross income, but the result adversely affects the taxpayer.¹⁷¹

¹⁶⁵ *Srivastava*, 220 F.3d at 360-65.

¹⁶⁶ *Id.* at 364 n.33.

¹⁶⁷ *See id.* at 357 (noting that question is of substantial importance due to various limitations that reduce effectiveness of deductions for taxpayer); *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (noting that Fifth Circuit has adopted pro-taxpayer approach).

¹⁶⁸ *See Srivastava*, 220 F.3d at 365 (commenting that Commissioner sought direct challenge to characterization of contingent attorney's fees as transfer of property); *see also Cotnam v. Comm'r*, 263 F.2d 119, 125-26 (5th Cir. 1959) (holding assignment of income doctrine does not apply to contingent attorney's fees).

¹⁶⁹ *See Srivastava*, 220 F.3d at 357 n.7 (noting that controversy driven by substantial difference in amount of tax incurred due to application of AMT); *see also Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000) (explaining that controversy driven by triggering of AMT due to non-deductibility of miscellaneous itemized deductions).

¹⁷⁰ *See Srivastava*, 220 F.3d at 360-61 (refusing to characterize contingent attorney's fees as assignment of income); *see also Lucas v. Earl*, 281 U.S. 111, 115 (1930) (establishing assignment of income doctrine, which prevents taxpayers from escaping taxation on economic benefit by assigning income to third party). *But see Sammeth*, *supra* note 38, at 229 (arguing against mechanical application of assignment of income doctrine).

¹⁷¹ *See Coady v. Comm'r*, 213 F.3d 1187, 1190-91 (9th Cir. 2000); *see also Whipsaw: The Court Still Can't Agree*, *supra* note 12, at 188 (noting that Ninth Circuit has adopted pro-government approach).

C. *The Ninth Circuit Approach Properly Administers Current Tax Law*

The Ninth Circuit's holding properly applies existing tax law.¹⁷² First, the Ninth Circuit approach implements the plain language of IRC section 61(a).¹⁷³ The court quoted the statutory definition of gross income and noted the presumption that all accessions to wealth are includable in gross income.¹⁷⁴ Second, the Ninth Circuit approach correctly characterizes contingent attorney's fees as an assignment of income.¹⁷⁵ Although the taxpayer never received the payment, the court recognized that contingent attorney's fees represent an economic benefit that the taxpayer must realize as gross income.¹⁷⁶ By incorporating both the statutory and judicially developed definitions of gross income, the Ninth Circuit approach correctly applies current tax law.¹⁷⁷

1. The Ninth Circuit Approach Correctly Applies the Statutory and Judicially Developed Definitions of Gross Income

The statutory definition of gross income is simple: gross income equals income from whatever source derived.¹⁷⁸ Internal Revenue Code section 61(a) directs the taxpayer to include all income whether in the form of money, services, or payments to third parties as gross income.¹⁷⁹ Courts have defined payments made to third parties on behalf of the taxpayer as an assignment of income.¹⁸⁰ The assignment of income doctrine is a

¹⁷² See I.R.C. § 61(a) (1994) (providing broad definition of gross income); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940) (arguing that broad statutory language means Congress intended to use full measure of its taxing power); *Earl*, 281 U.S. at 115 (establishing assignment of income doctrine). *But see* *Sammeth*, *supra* note 38, at 229 (arguing proper administration of tax law means not universally applying assignment of income doctrine).

¹⁷³ See *Coady*, 213 F.3d at 1190 (explaining that statutory definition of gross income applies to contingent attorney's fees); *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188 (noting that Ninth Circuit approach applies strict definition of gross income).

¹⁷⁴ See *Coady*, 213 F.3d at 1190 (quoting I.R.C. § 61(a)); *see also* *Getty v. Comm'r*, 913 F.2d 1486, 1490 (9th Cir. 1990) (presuming that funds or other accessions to wealth received by taxpayer are includable as gross income unless taxpayer can demonstrate otherwise).

¹⁷⁵ See *Coady*, 213 F.3d at 1191; *see also* *Earl*, 281 U.S. at 115 (establishing assignment of income doctrine). *But see* *Sammeth*, *supra* note 38, at 229 (arguing against application of assignment of income doctrine when taxpayer does not gratuitously transfer property interest to third party).

¹⁷⁶ See *Coady*, 213 F.3d at 1191 (recognizing that under contingent fee arrangement taxpayer does not realize income under ordinary circumstances); *see also* *Helvering v. Horst*, 311 U.S. 112, 116-17 (1940) (explaining that realization requirement does not allow taxpayer to enjoy economic benefit and escape taxation by assigning income to third party).

¹⁷⁷ See I.R.C. § 61(a); *Horst*, 311 U.S. at 115-18; *Earl*, 281 U.S. at 115.

¹⁷⁸ See I.R.C. § 61(a); 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.2, at 2-2 to 2-5.

¹⁷⁹ I.R.C. § 61(a).

¹⁸⁰ See *Earl*, 281 U.S. at 115 (establishing assignment of income doctrine); *see also* *Horst*,

judicially developed definition of gross income that is consistent with the statutory definition.¹⁸¹

The Ninth Circuit correctly identified that the contingent attorney fee arrangement falls under the assignment of income doctrine.¹⁸² The court recognized that the power to dispose of income is the equivalent of ownership of it.¹⁸³ The exercise of that power to procure the payment of income to another is an economic benefit to the taxpayer.¹⁸⁴ Although the taxpayer never physically takes control of the income, the assignment of income doctrine requires the taxpayer to include the income in gross income.¹⁸⁵ However, when a taxpayer transfers control over the source of the property to another taxpayer the assignment of income doctrine does not apply.¹⁸⁶

Other courts reason that the assignment of income doctrine does not apply because the taxpayer transfers a property interest to the attorney.¹⁸⁷ The Fifth Circuit found that pursuant to the Texas attorney-lien statute, the taxpayer transferred a property interest to the attorney.¹⁸⁸ The transfer prevents the taxpayer from ever exercising complete dominion over the contingent attorney's fees. Since the taxpayer never exercises complete dominion over the contingent attorney's fees, the fees do not constitute gross income. Therefore, the taxpayer may exclude the contingent attorney's fee from gross income.¹⁸⁹ Yet, the transfer of

311 U.S. at 115-18 (interpreting and applying assignment of income doctrine).

¹⁸¹ See *Earl*, 281 U.S. at 115; see also *Horst*, 311 U.S. at 115-18 (explaining that assignment of income doctrine coincides with statutory definition of gross income).

¹⁸² See *Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (arguing that contingent attorney's fees fall within definition of assignment of income doctrine).

¹⁸³ *Id.* (quoting *Horst* and applying assignment of income doctrine); see also *Horst*, 311 U.S. at 118 (explaining rationale behind assignment of income doctrine).

¹⁸⁴ See *Coady*, 213 F.3d at 1191 (quoting *Horst*, 311 U.S. at 118).

¹⁸⁵ See *id.* (recognizing that Congress never intended realization requirement to be taken literally); see also *Earl*, 281 U.S. at 114-15 (rejecting notion that taxpayer can escape taxation by procuring payment directly to another taxpayer to avoid realization of income).

¹⁸⁶ See *Srivastava v. Comm'r*, 220 F.3d 353, 359 (5th Cir. 2000) (explaining that assignment of income doctrine does not apply when taxpayer sells, transfers, or otherwise disposes of property).

¹⁸⁷ See *Srivastava*, 220 F.3d at 363-65; see also *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (holding contingent attorney's fees excludable from taxpayer's gross income because contingent fee arrangement creates division of property); *Cotnam v. Comm'r*, 263 F.2d 119, 125-26 (5th Cir. 1959) (holding that Alabama attorney-lien statute gives attorney equitable interest in cause of action).

¹⁸⁸ *Srivastava*, 220 F.3d at 363-64. But see *Dow Chem. Co. v. Benton*, 357 S.W.2d 565, 568 (Tex. 1962) (holding that Texas attorney-lien statute does not give attorney property interest in cause of action).

¹⁸⁹ See *Srivastava*, 220 F.3d at 365 (holding taxpayer may properly exclude contingent attorney's fees from gross income); *Estate of Clarks*, 202 F.3d at 857-58 (allowing taxpayer to exclude contingent attorney's fees from gross income based on transfer of property theory);

property theory inaccurately characterizes contingent attorney's fees because the taxpayer never loses control over the source of the income.¹⁹⁰

The characterization of contingent attorney's fees focuses on who controls the source of the income.¹⁹¹ Proponents of the transfer of property theory argue that the claim is subject to a virtual co-ownership.¹⁹² Both the attorney and the client own a portion of the claim. However, the reality is that the client never gives up control over the source of the income.¹⁹³ The attorney cannot decide to settle her portion of the case without the taxpayer's consent. The attorney simply provides a service to the taxpayer and receives compensation for that service through a contingency fee.¹⁹⁴ Therefore, the Fifth Circuit approach misapplies existing tax law by refusing to characterize contingent attorney's fees as an assignment of income.¹⁹⁵ Furthermore, the transfer of property theory leads to the inclusion of contingent attorney's fees in

Cotnam, 263 F.2d at 125-26 (allowing taxpayer to exclude contingent attorney's fees because taxpayer transferred property interest to attorney); *see also* *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (explaining that taxpayer must exercise complete control in order to include item as gross income).

¹⁹⁰ *See* *Srivastava*, 220 F.3d at 362 (explaining that assignment of income doctrine difficult to apply because taxpayer does not give up full control over claim to attorney); *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (explaining that taxpayer never relinquishes ownership over claim); *see also* *Jones v. Comm'r*, 306 F.2d 292, 302 (5th Cir. 1962) (explaining that assignment of income doctrine applies if taxpayer retains any control over income producing property).

¹⁹¹ *Compare* *Srivastava*, 220 F.3d at 361-62 (explaining that taxpayer gives up measure of control over claim), *and* *Estate of Clarks*, 202 F.3d at 857-58 (explaining that taxpayer gives up control over contingent fee portion of cause of action), *and* *Cotnam*, 263 F.2d at 125-26 (arguing that taxpayer gives control of contingent fee portion to attorney in exchange for services rendered), *with* *Coady*, 213 F.3d at 1190 (arguing that taxpayer never relinquishes control over claim), *and* *Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995) (explaining that taxpayer always retains control over claim and attorney only assists in decision-making process).

¹⁹² *See* *Srivastava*, 220 F.3d at 360 (explaining that contingent fee arrangement splits claim into virtual co-ownership); *Estate of Clarks*, 202 F.3d at 857 (arguing that contingent fee arrangement creates division of property similar to partnership); *Cotnam*, 263 F.2d at 125-26 (arguing that taxpayer and attorney share ownership interest over cause of action).

¹⁹³ *See* MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (1983) (stating that attorney shall abide by client's decisions concerning objectives of representation including whether or not to accept offer of settlement); *see also* *Coady*, 213 F.3d at 1190 (arguing that taxpayer does not relinquish ownership of claim).

¹⁹⁴ *See* *Coady*, 213 F.3d at 1191 (explaining that taxpayer used portion of award to pay attorney for services rendered); *see also* MODEL RULES OF PROF'L CONDUCT R. 1.5(c) (1983) (approving of attorney providing service in exchange for contingency fee). *But see* *Cotnam*, 263 F.2d at 125-26 (arguing that without attorney taxpayer's tree has no fruit so assignment of income doctrine cannot apply).

¹⁹⁵ *See generally* *Helvering v. Horst*, 311 U.S. 112, 116-17 (1940) (applying assignment of income doctrine); *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (establishing assignment of income doctrine).

gross income because the transfer of property is a taxable event.¹⁹⁶

2. The Exclusion of Contingent Attorney's Fees from Gross Income is Inconsistent with the Application of the Transfer of Property Theory

Contrary to its holding, the Fifth Circuit's transfer of property theory leads to the inclusion of contingent attorney's fees in gross income.¹⁹⁷ When a taxpayer sells a piece of property, the taxpayer must include in gross income the difference between the amount received and the taxpayer's basis.¹⁹⁸ If a taxpayer transfers property to another taxpayer as compensation for services rendered, then the IRS treats the transfer as a taxable event.¹⁹⁹ The taxpayer must realize as gross income the difference between the fair market value of the property and the taxpayer's basis in the property.²⁰⁰

Under the Fifth Circuit approach, the taxpayer transfers to the attorney a property interest in the settlement in exchange for the attorney's services.²⁰¹ However, the taxpayer has zero basis in the settlement.²⁰² Thus, the taxpayer must include the full amount of the contingency fee as gross income. Furthermore, the Fifth Circuit's holding, excluding contingent attorney's fees from gross income, violates the separation of powers doctrine by modifying the definition of gross income.²⁰³

¹⁹⁶ See I.R.C. § 1001(a) (1994).

¹⁹⁷ See *Srivastava*, 220 F.3d at 365 (holding contingent fees excludable from gross income on transfer of property theory). *But see* *Eisner v. Macomber*, 252 U.S. 189, 206-08 (holding taxpayer must include as gross income difference between sale price and amount invested, if greater than zero, upon sale or transfer of property); *Int'l Freighting Corp. v. Comm'r*, 135 F.2d 310, 313-14 (holding that transfer of property in exchange for services rendered is taxable event).

¹⁹⁸ I.R.C. §§ 1001(b), 1012 (1994).

¹⁹⁹ See *Int'l Freighting Corp.*, 135 F.2d at 313-14; *see also* MCDANIEL ET AL., *supra* note 1, at 217 (explaining that holding of *Int'l Freighting Corp.* requires taxpayer to include in gross income fair market value of services rendered).

²⁰⁰ See I.R.C. §§ 1001(a)-(b), 1012. The definition of fair market value is "the price a seller is willing to accept and a buyer is willing to pay on the open market." BLACK'S LAW DICTIONARY 1549 (7th ed. 1999).

²⁰¹ See *e.g.*, *Srivastava*, 220 F.3d at 363-64 (holding that taxpayer transfers property interest in settlement to attorney based on Fifth Circuit precedent).

²⁰² The taxpayer has zero basis in the settlement because the taxpayer has not invested in money or property in the claim. See I.R.C. § 1012 (defining basis in context of sale, transfer or other disposition of property); *see also* BLACK'S LAW DICTIONARY, *supra* note 200, at 145 (defining basis as value assigned to taxpayer's investment in property).

²⁰³ See *Eisner v. Macomber*, 252 U.S. 189, 206 (1920) (explaining that only Congress has power to legislate tax law); *Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000) (noting that judicial intervention into tax legislation violates separation of powers doctrine).

3. The Fifth Circuit Violated the Separation of Powers Doctrine by Excluding Contingent Attorney's Fees from Gross Income

Only Congress holds the power to legislate tax law.²⁰⁴ In nearly fifty years, Congress has not amended the definition of gross income.²⁰⁵ Congress indicated that it intends to exercise the full measure of its taxing authority by keeping the language of IRC section 61(a) broad.²⁰⁶ By holding contingent attorney's fees excludable from gross income, the Fifth Circuit violated the separation of powers doctrine by diminishing congressional taxing power.

The Fifth Circuit modified the definition of gross income by excluding contingent attorney's fees from gross income, which violates the separation of powers doctrine.²⁰⁷ Effectively, the Fifth Circuit created a new exclusion from gross income for contingent attorney's fees.²⁰⁸ This limits congressional taxing power by lowering the amount a taxpayer must include in gross income and pay tax on in a given year.²⁰⁹ Although the Fifth Circuit misapplied the tax law and violated the separation of powers doctrine, its approach correctly applied the congressional intent behind the AMT.²¹⁰

²⁰⁴ U.S. CONST. amend. XVI.

²⁰⁵ See 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.2, at 2-2 to 2-5; MCDANIEL ET AL., *supra* note 1, at 63-64.

²⁰⁶ See *James v. United States*, 366 U.S. 213, 219 (1961) (noting congressional intent to define gross income broadly); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940) (arguing that broad statutory language means Congress intended to use full measure of its taxing power).

²⁰⁷ See *Badaracco v. Comm'r*, 464 U.S. 386, 398 (1984) (reasoning that judicial intervention into province of Congress violates separation of powers doctrine); *Kenseth*, 114 T.C. at 407 (reasoning that judicial modification of definition of gross income intrudes into province of Congress).

²⁰⁸ Cf. I.R.C. §§ 101-37 (1994 & Supp. V 1999) (authorizing certain exclusions from gross income, but not for contingent attorney's fees); *United States v. Centennial Sav. Bank*, 499 U.S. 573, 583 (1991) (holding courts must broadly construe I.R.C. § 61(a) or risk creating exclusion from gross income); *Comm'r v. Jacobson*, 336 U.S. 28, 49 (1949) (holding that defining income broadly under I.R.C. § 61(a) necessitates interpreting exclusions from gross income narrowly).

²⁰⁹ See generally *Centennial Sav. Bank*, 499 U.S. at 583 (noting that narrow construction of I.R.C. § 61(a) limits congressional taxing authority); *Jacobson*, 336 U.S. at 49 (commenting that construing item as exclusion results in diminution of congressional taxing authority).

²¹⁰ See 1986 BLUEBOOK, *supra* note 9, at 433 (noting that change in AMT ensures that no taxpayer with substantial economic income can avoid taxation); LATHROPE, *supra* note 15, ¶ 1.02, at 1-2 to 1-3 (commenting that congressional purpose behind change in AMT designed to increase taxpayer morale).

D. The Fifth Circuit Approach Correctly Applies the Congressional Intent Behind the Alternative Minimum Tax

Despite misapplying existing tax law, the Fifth Circuit's holding properly applied the congressional intent behind the AMT. Originally, Congress believed that the ability of high-income taxpayers to avoid tax liability undermined the tax system.²¹¹ Congress designed the AMT to prevent tax avoidance by individuals with large amounts of economic income and numerous deductions.²¹² However, the application of the AMT to contingent attorney's fees defeats the congressional purpose by taxing individuals with high non-economic income and only one deduction.²¹³

The Fifth Circuit approach correctly identified that the purpose of the AMT was to protect against tax avoidance.²¹⁴ The court recognized that Congress never intended for the AMT to apply to a one-time payment of attorney's fees.²¹⁵ The court justified its reasoning by pointing to the unfair result caused by the triggering of the AMT.²¹⁶ While the Fifth Circuit decided to fashion its own remedy, other courts believe that only Congress has the right to amend tax policy.²¹⁷

Some courts argue that tax policy issues are squarely within the province of Congress.²¹⁸ If a statute is constitutional, then courts do not

²¹¹ See 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]; 1986 BLUEBOOK, *supra* note 9, at 433.

²¹² See sources cited *supra* note 238.

²¹³ See SIMONS, *supra* note 15, at 50; Sager & Cohen, *supra* note 2, at 1077-78 (defining economic income in context of contingent attorney's fees); Davis, *supra* note 44, at 1722-23 (arguing that Congress did not intend for AMT to apply to contingent attorney's fees).

²¹⁴ See generally 1986 BLUEBOOK, *supra* note 9, at 432 (noting congressional purpose behind change in AMT is to make sure that taxpayers with substantial economic income cannot avoid taxation); LATHROPE, *supra* note 15, ¶ 1.02, at 1-2 to 1-3 (explaining congressional objective behind AMT).

²¹⁵ See *Srivastava v. Comm'r*, 220 F.3d 353, 357 n.6 (5th Cir. 2000) (recognizing limitations on effectiveness of miscellaneous itemized deductions create excessive tax burden); Davis, *supra* note 44, at 1722-23 (arguing that Congress did not intend for AMT to apply to contingent attorney's fees).

²¹⁶ See *Srivastava*, 220 F.3d at 357-65 (recognizing potential unfairness to taxpayer due to application of AMT and excluding contingent attorney's fees from gross income); see also *Alexander v. Comm'r*, 72 F.3d 938, 946-47 (1st Cir. 1995) (recognizing that triggering of AMT results in unjust outcome).

²¹⁷ See e.g., *Badaracco v. Comm'r*, 464 U.S. 386, 398 (1984) (reasoning that courts should not intervene into province of Congress); *Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000) (noting that judicial modification of definition of gross income intrudes into province of Congress); *Warfield v. Comm'r*, 84 T.C. 179, 183 (1985) (stating that tax policy issues are province of Congress).

²¹⁸ See sources cited *supra* note 217.

have the authority to rewrite the statute solely because the court concludes the statute is unjust.²¹⁹ When statutes conflict on a policy level, and courts split over how to apply the statutes, then Congress must act to resolve the problem.²²⁰ The current split of authority embodies this situation because neither side addresses both the definition of gross income and the congressional intent behind the AMT.²²¹

Neither side in the split of authority can simultaneously incorporate both the definition of gross income and congressional intent behind the AMT in its solution.²²² The Ninth Circuit approach focuses on the statutory and judicially developed definitions of gross income.²²³ The Fifth Circuit approach emphasizes the congressional intent behind the AMT.²²⁴ This creates inequity between two similarly situated taxpayers by forcing the IRS to administer two divergent sets of rules based on where the taxpayer resides.²²⁵ This Comment proposes to eliminate that inequity by amending the AMT to integrate both the congressional intent behind the AMT and the definition of gross income.

²¹⁹ See *Kenseth*, 114 T.C. at 407.

²²⁰ *Id.*

²²¹ Compare *Srivastava*, 220 F.3d at 363-65 (rejecting statutory and judicially developed definitions of gross income and finding that taxpayer transfers property interest to attorney), and *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (holding taxpayer transfers property interest to attorney), with *Coady v. Comm'r*, 213 F.3d 1187, 1190-91 (9th Cir. 2000) (applying statutory and judicially developed definitions of gross income), and *Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995) (applying statutory definition of gross income).

²²² See *Srivastava*, 220 F.3d at 363-65 (reasoning that taxpayer transfers property interest to attorney); *Coady*, 213 F.3d at 1190-91 (applying statutory and judicially developed definitions of gross income without contemplating ramifications of AMT); *Estate of Clarks*, 202 F.3d at 857 (applying transfer of property theory); *Baylin*, 43 F.3d at 1454-55 (applying statutory definition of gross income without balancing adverse affects of AMT).

²²³ See *Coady*, 213 F.3d at 1190-91 (quoting statutory definition of gross income and explaining assignment of income doctrine rationale); see also I.R.C. § 61(a) (1994) (defining gross income); *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (establishing assignment of income doctrine as supplement to statutory definition of gross income).

²²⁴ See *Srivastava*, 220 F.3d at 357 n.7 (explaining that reduced effectiveness of miscellaneous itemized deductions adversely affects application of AMT to contingent attorney's fees); see also 1986 BLUEBOOK, *supra* note 9, at 433 (explaining congressional purpose behind AMT).

²²⁵ See 1 BITTKER & LOKKEN, *supra* note 1, ¶ 3.1.4, at 3-9 to 3-10 (defining horizontal equity); MCDANIEL ET AL., *supra* note 1, at 46 (defining horizontal equity in relation to tax policy issues).

III. WIPING THE SLATE CLEAN: MAKING CONTINGENT ATTORNEY'S FEES INCLUDABLE IN GROSS INCOME AND AMENDING THE ALTERNATIVE MINIMUM TAX

Current tax law creates a situation where jurists must choose between two statutes representing competing policy judgments.²²⁶ Internal Revenue Code section 61(a) expresses the congressional policy to tax all income from whatever source derived.²²⁷ The AMT expresses the congressional policy to tax only high-income taxpayers with large amounts of economic income.²²⁸ An amendment to the AMT would eliminate the policy conflict by creating a deduction for contingent attorney's fees on the AMT.

The amendment will apply to all cases involving contingent attorney's fees and taxable damages.²²⁹ The amendment will provide a deduction for contingent attorney's fees proportional to the compensatory damages aspect of the verdict or settlement. The amendment will modify IRC section 56(b)(1)(A)(i), which disallows a deduction for miscellaneous itemized deductions under the AMT. Internal Revenue Code section 56(b)(1)(A)(i)(I) will read:

exception for contingent attorney's fees, characterized as a miscellaneous itemized deduction per IRC section 67(b), proportional to actual compensatory damages from any settlement or award.

The amendment has two purposes. First, the amendment codifies the Ninth Circuit approach and remedies its only flaw. The amendment leaves the statutory and judicially developed definitions of gross income unaltered. Also, by removing contingent attorney's fees from the AMT's tax base, the amendment attempts to satisfy the congressional intent behind the AMT. The taxpayer must include contingent attorney's fees as gross income, but can deduct the fees as a miscellaneous itemized

²²⁶ Compare I.R.C. § 55(a) (1994) (establishing AMT designed to prevent wealthy taxpayers from avoiding taxation), with I.R.C. § 61(a) (defining gross income broadly). Both approaches are mutually exclusive, leaving it up to the Supreme Court to break the tie. *Whipsaw: The Courts Still Can't Agree*, *supra* note 12, at 188.

²²⁷ I.R.C. § 61(a); *James v. United States*, 366 U.S. 213, 219 (1961) (noting legislative intent to tax all gains except those specifically exempted); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940) (finding that Congress intended to exert full measure of its taxing authority through I.R.C. § 61(a)).

²²⁸ Otherwise, the tax system is undermined by allowing high-income taxpayers to avoid tax. See 1982 BLUEBOOK, *supra* note 211, at 17; 1986 BLUEBOOK, *supra* note 9, at 433.

²²⁹ This includes a wide variety of different types of litigation including civil rights cases, non-physical personal injury suits, and employment law cases. See MODEL RULES OF PROF'L CONDUCT R. 1.5(c)-(d) (1983).

deduction on both the regular tax and the AMT.²³⁰

Second, the amendment intends to restore tax equity by mending the split of authority. The amendment mends the split of authority by creating a uniform standard applicable to all taxpayers. Similarly situated taxpayers will be liable for the same amount of tax on both the regular tax and the AMT. However, some critics advocate a more simplistic approach due to the complexity of the AMT.²³¹

Some critics argue that Congress should exclude contingent attorney's fees from gross income instead of amending the AMT.²³² This solution has the same effect as codifying the Fifth Circuit approach. First, the solution implements the congressional intent behind the AMT.²³³ Excluding contingent attorney's fees from gross income removes non-economic income from the AMT's tax base.²³⁴ Second, the solution provides a simple method for dealing with contingent attorney's fees.²³⁵ Taxpayers would no longer have to deal with the characterization of contingent attorney's fees or the application of the AMT.²³⁶ Finally, the solution restores tax equity by resolving the split of authority, and creates a uniform standard applicable to all contingent attorney's fees.²³⁷ However, the solution ignores that contingent attorney's fees represent an economic benefit to the taxpayer, which if excluded from gross income circumvents the regular tax.²³⁸

²³⁰ See I.R.C. § 56(b)(1)(A)(i) (1994); I.R.C. § 67(b) (1994) (defining miscellaneous itemized deductions and when they are applicable).

²³¹ See *e.g.*, Davis, *supra* note 44, at 1723 (advocating amendment that would exclude contingent attorney's fees from gross income for sake of simplicity).

²³² See *Srivastava v. Comm'r*, 220 F.3d 353, 365 (5th Cir. 2000) (excluding contingent attorney's fees from gross income). See generally Davis, *supra* note 44, at 1723 (advocating exclusion of contingent attorney's fees from gross income under I.R.C. § 104(a)).

²³³ See 1986 BLUEBOOK, *supra* note 9, at 432-33 (noting that rationale behind AMT is to decrease number of taxpayers with substantial economic income that avoid tax liability). But see generally LATHROPE, *supra* note 15, ¶ 1.02, at 1-1 to 1-3 (explaining congressional purpose behind AMT is to measure income differently than regular tax); Sager & Cohen, *supra* note 2, at 1092-93 (explaining overall purpose of AMT is to produce measure of income different from regular tax).

²³⁴ See Sager & Cohen, *supra* note 2, at 1077-78 (defining economic income, in context of contingent attorney's fees, as total settlement minus contingent attorney's fees); see also MCDANIEL ET AL., *supra* note 1, at 51-52 (explaining economic income).

²³⁵ See Davis, *supra* note 44, at 1723-24 (arguing that solution would limit haggling over what portion of contingent attorney's fees was attributable to taxable damages).

²³⁶ *Id.*

²³⁷ See *id.* (arguing that Congress would bring about uniformity in application of Tax Code by excluding contingent attorney's fees from gross income); Sager & Cohen, *supra* note 2, at 1080-81 (arguing that reporting net recovery, settlement less attorney's fees, moots question of whether plaintiff may deduct fees).

²³⁸ See *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding that gross income includes any economic benefit over which taxpayer exercises complete control);

Congress designed the regular tax to assess the individual's net income.²³⁹ Removing contingent attorney's fees from gross income distorts the taxpayer's net income, and therefore under-taxes the taxpayer.²⁴⁰ The proposed amendment recognizes this loophole and prevents its exploitation by creating a deduction solely for AMT purposes.

CONCLUSION

Because contingent attorney's fees are an economic benefit to the taxpayer, the taxpayer should include the fees in gross income.²⁴¹ This is the result of the logical application of the assignment of income doctrine to contingent attorney's fees.²⁴² Since contingent attorney's fees are non-economic income to the taxpayer, application of the AMT causes an excessive tax burden.²⁴³ Congress should amend the AMT to allow a deduction for contingent attorney's fees characterized as miscellaneous itemized deductions. This would alleviate the AMT problem without modifying the definition of gross income or effecting the regular tax.

Again meet John Q. Public and Jane Taxpayer. Since we last met, Congress amended the AMT to allow a deduction for contingent attorney's fees. The tax code now treats John and Jane equally. Each pays the same amount of tax under the regular tax and pays zero dollars in tax on the contingent attorney's fees under the AMT.

MCDANIEL ET AL., *supra* note 1, at 55-56 (explaining that tax system is designed to tax net income, or gross income minus deductions).

²³⁹ See MCDANIEL ET AL., *supra* note 1, at 55-56; see also 1 BITTKER & LOKKEN, *supra* note 1, ¶ 2.1.1, at 2-1 to 2-2 (providing structure of U.S. income tax system).

²⁴⁰ See sources cited *supra* note 239.

²⁴¹ See I.R.C. § 61(a) (1994); *James v. United States*, 366 U.S. 213, 219 (1961); *Glenshaw Glass Co.*, 348 U.S. at 431.

²⁴² See *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (establishing assignment of income doctrine); *Srivastava v. Comm'r*, 220 F.3d 353, 358 (5th Cir. 2000) (admitting that logical application of assignment of income doctrine means including contingent attorney's fees in gross income).

²⁴³ See *Davis*, *supra* note 44, at 1722-23; see also *Sager & Cohen*, *supra* note 2, at 1077-78 (explaining that contingent attorney's fees are non-economic income and that Congress designed AMT to tax economic income).
