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No Taxation without Realization: Srivastava v. Commissioner, the Fifth Circuit's Answer to Tax Treatment of Attorney's Fees under a Contingency Fee Agreement.

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RECENT DEVELOPMENT

NO TAXATION WITHOUT REALIZATION: *SRIVASTAVA v. COMMISSIONER*, THE FIFTH CIRCUIT'S ANSWER TO TAX TREATMENT OF ATTORNEY'S FEES UNDER A CONTINGENCY FEE AGREEMENT

BERNARD J. GRANT, III

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I. INTRODUCTION

The Fifth Circuit Court of Appeals once stated "[t]here are no equities in tax law."[1] While the lay person may agree and think this quote states the obvious, attorneys realize the grave implications of the statement.[2] The Fifth Circuit has held that courts may not use the doctrine of equity to resolve disputed income tax issues in federal court, using the colloquial phrase "close is not good enough."[3] For example, in *Carlton v. United States*,[4] the parties negotiated an exchange of property.[5] In an effort to avoid unnecessary paperwork, Carlton received a check for his property as part of the exchange.[6] By writing the check, however, the transaction became a sale instead of an exchange.[7] As a result, Carlton incurred an additional tax burden.[8] The Fifth Circuit held that even though both parties intended to complete the transaction as an exchange, the fact that Carlton received a check destroyed one of the requirements of a legal exchange.[9] The court, therefore, was bound to a strict adherence to the tax code.[10] Consequently, the Fifth Circuit could not use the doctrine of equity because equity would defeat the purpose of a uniform tax code.[11] Although, as in *Carlton*, such harsh compliance may result in decidedly inequitable holdings, a valid reason exists for prohibiting the use of equity in tax law.

The federal government employs a progressive income tax system. As such, the system seeks to treat each taxpayer similarly.[12] The tax code

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1. United States v. Henderson Clay Prod., 324 F.2d 7, 12 (5th Cir. 1963); *see also* Gilles v. Dep't of Human Res. Dev., 521 P.2d 110, 116 n.10 (Cal. 1974) (defining "equity" as an ethical obligation, rather than a legal obligation).

2. *See* Carlton v. United States, 385 F.2d 238, 243 (5th Cir. 1967) (holding that the intent of the parties to a transaction does not control whether the transaction will be classified for tax purposes as a sale or an exchange).

3. *See id.* (holding that the actual events control over the intent of the parties).

4. 385 F.2d 238 (5th Cir. 1967).

5. *See* Carlton v. United States, 385 F.2d 238, 239 (5th Cir. 1967).

6. *Id.*

7. *See id.* at 240 n.3 (stating that when a party receives cash in a like-kind exchange, courts recognize the cash as income upon receipt).

8. *See id.* at 240.

9. *See id.* at 242 (stating that "[t]he very essence of an exchange is the transfer of property between owners, while the mark of a sale is the receipt of cash for the property").

10. *See Carlton*, 385 F.2d at 240-41 (acknowledging that the law is clear and that that court was bound to apply the law as it is written).

11. *See id.* at 241 (basing the decision on tax law, not equity); *see also* United States v. Henderson Clay Prod., 324 F.2d 7, 12 (5th Cir. 1963) (holding that "[t]here are no equities in tax law").

12. 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 825 (R.H. Campbell & A.S. Skinner, eds., Oxford Univ. Press, 1976) (stating that individuals should pay taxes based on their relative ability to pay).

achieves this result by charging high income earners at a higher percentage rate than those with lower incomes.[13] If courts used equity to resolve seemingly unfair tax burdens between two potential taxpayers, tax law would create exceptions for some but not for others.[14] These exceptions would defeat the purpose behind the uniform tax code.[15] In contrast, a progressive tax system allows distinctions based only on income.[16]

One gray area in tax law causing problems in the courts arises when one party assigns income to another. Essentially, when an individual assigns income to another person without first being taxed on the realization of that income, that person evades tax payment and, thus, defeats the uniform tax code.[17] As such, the Supreme Court established the Assignment of Income Doctrine.[18] Under this doctrine, the federal government taxes income earned by an individual before the individual assigns the income to a third party.[19] Courts justify this doctrine by noting that the taxed individual has earned and enjoyed control over the income in question; therefore, the individual must pay taxes on that income.[20]

A problem arises, however, when the taxpayer receives a settlement award from the court after entering into a contingency fee arrangement with an attorney.[21] Unfortunately, courts that have addressed this situation have come to different conclusions.[22] In *Srivastava v. Commis-*

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13. Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1906 (1987) (discussing the progressive nature of the current income tax system under the federal scheme).

14. *See* Poe v. Seaborn, 282 U.S. 101, 117-18 (1930) (noting that the Constitution requires uniformity in the tax laws of the various states).

15. *See id.* at 107 (allowing that the Federal Constitution requires uniform tax).

16. 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 825 (R.H. Campbell & A.S. Skinner, eds., Oxford Univ. Press, 1976) (arguing that people should be required to pay taxes in proportion to their abilities).

17. *See* Srivastava v. Comm'r, 220 F.3d 353, 359 (5th Cir. 2000) (discussing the Assignment of Income Doctrine as a method used by the courts to tax the "correct" taxpayer when income is earned).

18. *See* Lucas v. Earl, 281 U.S. 111, 113-14 (1930) (creating the Assignment of Income Doctrine).

19. *See Srivastava*, 220 F.3d at 359 (outlining the application of the Assignment of Income Doctrine).

20. *See id.* (providing that an individual who disposes of income once owned and controlled must bear the responsibility for paying taxes on that income). The doctrine does not apply to situations where the taxpayer "transfers, sells, or otherwise relinquishes an asset or income source to another, because the taxpayer ceases to receive any income from that asset." *Id.*

21. *See id.* at 359-60 (identifying the question before the court as an attempt to answer whether contingency fees are included in gross income for the client).

22. *See id.* at 357-58 (highlighting the various treatments of contingency fees by the circuits).

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sioner,[23] the Fifth Circuit held that where a client and attorney enter into a contingency agreement, the government may not assess an income tax on the award until after the client pays the attorney's fee.[24] As the court reasoned, the contingent fee represents a property right granted to the attorney by the client.[25] As such, the Fifth Circuit identified the contingency fee as an ownership interest vesting in the attorney before the client realizes the award as income.[26]

This Recent Development examines *Srivastava* in light of Assignment of Income Doctrine and discusses the practical impact *Srivastava* has on the Texas attorney. Part II explores the history of the Assignment of Income Doctrine. Part III analyzes the Fifth Circuit's decision in *Srivastava v. Commissioner* and argues that this decision creates a doctrine contrary to the Supreme Court's Assignment of Income Doctrine developed by *Lucas v. Earl*[27] and its progeny. Part IV addresses the impact of *Srivastava* on the Texas attorney. Finally, Part V concludes by addressing the potential viability of *Srivastava* and suggests that either Congress or the Supreme Court must act to resolve the dispute between *Srivastava* and the Assignment of Income Doctrine.

II. History of the Assignment of Income Doctrine

The Supreme Court first established the Assignment of Income Doctrine in 1930.[28] Subsequent decisions further defined the doctrine's parameters as applied to individuals in specific, problematic situations.[29] Notably, the Court has addressed such questions as whether the Assign-

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23. 220 F.3d 353 (5th Cir. 2000).

24. *See Srivastava*, 220 F.3d at 365 (holding that damage awards are correctly excluded from gross income when the client has entered into a contingency fee agreement with an attorney).

25. *See id.* at 360 (identifying the rationale for excluding the contingency fees from gross income as being grounded in property rights).

26. *See id.* at 364 n.33 (allowing that the dissenting opinion focuses on the derivative nature of the attorney's claim)

27. 281 U.S. 111 (1930).

28. Lucas v. Earl, 281 U.S. 111, 114 (1930); *see also* Nick Marsico, Note, *Chopping Down the Fruit Tree:* Caruth Corp. v. United States *Applies Assignment of Income Doctrine to Gift of Stock Between Declaration and Record Date*, 40 DePaul L. Rev. 845, 849-50 (1991) (identifying the 1930 case *Lucas v. Earl*, 281 U.S. 111 (1930) as the case establishing the assignment of income doctrine); Richard I. Zuber, *Who Pays the Tax?: The Assignment of Income Doctrine, Code § 1041, and Dividing Non-Qualified*, Colo. Law., Feb. 2000, at 59 (discussing the creation of the Assignment of Income Doctrine in 1930), 29 FEB COLAW 59.

29. *See, e.g.*, United States v. Basye, 410 U.S. 441, 451 (1973) (applying the Assignment of Income Doctrine to income earned by a partnership in an effort to determine whether deferred income should be included in the definition of income); Cotnam v. Comm'r, 263 F.2d 119, 120-21 (5th Cir. 1959) (answering the question of whether a bequest

ment of Income Doctrine applies in a community property state,[30] how to define "income,"[31] and at what point a party "realizes" income.[32] Throughout this development, the Court maintained its course of applying the tax code without variations, thus leading to the Fifth Circuit's determination that equity has no place in tax law.[33]

A. Lucas v. Earl-*Establishing the Assignment of Income Doctrine*

The landmark case of *Lucas v. Earl* represents one of the earliest instances in federal income tax law discussing the definition of income.[34] As established by the Supreme Court, the Assignment of Income Doctrine simply states that taxable income should be taxed to the person who earns the income.[35] *Lucas* involved a contract that existed prior to the passage of the Sixteenth Amendment.[36] Earl and his wife agreed in writing to share equally the proceeds of their joint efforts.[37] As a result of this contract, the Earls reported half of the salary earned by Mr. Earl with the other half earned by Mrs. Earl.[38] The Internal Revenue Service objected to this division and brought an action against the Earls.[39] The Supreme Court held that "there is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in

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made to an individual in exchange for service fits the definition of income through application of the Assignment of Income Doctrine).

30. *See* Poe v. Seaborn, 282 U.S. 101, 116-18 (1930) (applying the Assignment of Income Doctrine to determine whether income earned in a community property state could be divided between spouses).

31. *See* Old Colony Trust v. Comm'r, 279 U.S. 716, 720 (1929) (developing the Assignment of Income Doctrine in an effort to determine whether money paid by a company in an effort to reduce key employees' tax liability constitutes income to those employees).

32. *See* Helvering v. Horst, 311 U.S. 112, 116-17 (1940) (noting that a party "realizes" income upon owning and controlling the disposition of the funds).

33. *See* United States v. Henderson Clay Prod., 324 F.2d 7, 12 (5th Cir. 1963) (arguing that equity is inconstant with tax law).

34. *See* Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (stating that salaries should be taxed to those who have earned the income).

35. *See id.* at 115.

36. *See id.* at 113-14 (noting the contractual agreement between Earl and his wife). *See generally* U.S. CONST. amend. XVI (providing Congress with the power to tax an individual's income).

37. *Lucas*, 281 U.S. at 113-14 (setting forth the contractual terms that led to the dispute over how Mr. Earl's income should be taxed).

38. *See id.* at 114 (recognizing that the entire amount of income earned by Earl is taxable in its entirety).

39. *See id.* at 113-14 (acknowledging that the Internal Revenue Service objected to the income splitting contract which led to the commissioner's suit against the Earls).

the man who earned it."[40] Justice Holmes explained the Assignment of Income Doctrine by using the "tree metaphor," in which he compares an individual to a tree and the income to the fruit.[41] Justice Holmes concluded that a person cannot enter into a contract to share income for tax purposes when that income came from the sole efforts of only one of the parties.[42]

In defining the Assignment of Income Doctrine, the Court noted that it would not consider the motive of a contract.[43] Instead, courts assume an agreement serves some valid purpose, which may collaterally yield a party avoiding a potential tax burden.[44] If a party enters into an agreement by which they attempt to lessen or eliminate a potential tax burden, the court will not consider that party's motive, provided that the transaction also serves another purpose besides tax avoidance.[45] Such a rule benefits tax attorneys who advise clients how to structure transactions in order to pay the proper amount of taxes.

B. Poe v. Seaborn-*Allowing State Property Laws to Affect the Assignment of Income Doctrine*

Under a progressive tax system, economist Adam Smith felt the government should tax income based on the individual's ability to pay.[46] Accordingly, if the *Lucas* Court allowed the Earls to split their tax bill, the Earls would have enjoyed a reduction in their tax obligation, while a person without the foresight to enter into such an agreement before the passage of the Sixteenth Amendment would have to pay the tax based on one person's income.[47] As a result, *Lucas* raises the question of whether

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40. *Id.* at 114-15.

41. *See id.*; *see also* Hall v. United States, 242 F.2d 412, 413 (7th Cir. 1957) (using the "tree metaphor" to identify whether Mrs. Hall should be taxed on income after receiving the "tree" by descent from her late husband).

42. *See Lucas*, 281 U.S. at 114-15 (explaining the validity of the Revenue Act of 1918). In his opinion, Justice Holmes stated that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115.

43. *See id.* at 114 (stating "the validity of the contract is not questioned").

44. *See id.*

45. *See* Estate of Clarks *ex rel.* Brisco-Whitter, 202 F.3d 854, 857 (6th Cir. 2000) (citing *Lucas* for basis premise of the Assignment of Income Doctrine).

46. 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 825 (R.H. Campbell & A.S. Skinner, eds., Oxford Univ. Press, 1976) (arguing for taxation based on a persons ability to pay the tax).

47. *Compare* Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (providing a contractual obligation to split income requires that income to be taxed as if there was no split), *with* Poe v. Seaborn, 282 U.S. 101, 117 (1930) (recognizing the importance of state law in federal income tax litigation).

a married couple in a community property state could split the income between themselves, effectively reducing the individual tax burden.[48]

In *Poe v. Seaborn*, the United States Supreme Court answered this question by holding that married couples in community property states could split their income for tax purposes.[49] While *Poe* seems contrary to *Lucas*, the primary distinction lies in the reason for the separation of the income.[50] The Court noted in *Poe* that Washington State law created a community property situation.[51] Comparatively, in *Lucas* the Earls did not reside in a community property state but created this situation by contract.[52] *Poe* states that "the answer to the question involved in the cause must be found in the provisions of the law of the State, as to a wife's ownership of or interest in community property."[53] As a result, *Poe* creates a disparity between community and non-community property states.[54] These disparities, in turn, result in problems for a tax system based on a progressive tax because only a differentiation of income justifies any discrepancy in taxation.[55] *Poe* institutes a double standard whereby two couples earning identical incomes would pay different amounts in taxes depending on whether the couple lived in a community property state or a common law property state.[56]

As a result of this discrepancy, Congress entered the fray in 1948 by allowing married couples in non-community property states to split their income.[57] This Congressional resolution, however, perfectly illustrates why equity has no place in tax law. The *Poe* Court easily could have determined that a married couple in a non-community property state should not receive different treatment than a married couple in a commu-

48. *See Poe*, 282 U.S. at 117 (discussing the distinction between *Lucas* and *Poe*).

49. *See id.* at 118.

50. *See id.* at 117 (distinguishing *Lucas* and *Poe* based on the laws of community property).

51. *See id.*

52. *Compare Lucas*, 281 U.S. at 113-15 (dealing with contract law), *with Poe*, 282 U.S. at 117 (explaining that *Poe* dealt with community property issues rather than contract law).

53. *See Poe*, 282 U.S. at 110.

54. *See id.* at 117-18 (explaining that the lack of uniformity in state law is a state issue, not a national issue).

55. 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 825 (R.H. Campbell & A.S. Skinner, eds., Oxford Univ. Press, 1976) (proclaiming that taxes must be paid on all income derived from rent, profits, and wages).

56. *Compare Lucas*, 281 U.S. at 114-15 (declaring that contractually split income is to be taxed as if it was not split), *with Poe*, 282 U.S. at 117 (allowing income to be split between husband and wife when state law recognizes community property).

57. *See* BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 40.2 at 40-14-15 (1988) (indicating this disparity was resolved in 1948); MARK WRIGHT COCHRAN, FEDERAL INCOME TAXATION: LAW AND POLICY 2.8 (2000-2001 ed.) (indicating that this disparity was resolved by Congress in 1948).

nity property state. The Court could have reduced the couple's tax burden in the non-community property states to that of a similarly situated couple in a community property state. The Court recognized, however, that Congress must resolve inequities within the Internal Revenue Code and refused to carve out any judicially created exception to the tax code.[58]

Today, this issue has been revived with a different twist. Specifically, the code defines "gross income" as income from any source, where two married couples earn identical incomes, a married couple with one wage earner will pay less in taxes than a two-wage couple. This discrepancy is referred to as the "marriage penalty." Equity dictates that two married couples with the same income should pay the same in taxes. Unfortunately, the Internal Revenue Code does not reach this result.

C. *Defining "Income"*

Another issue regarding the Assignment of Income Doctrine addresses a determination of what constitutes income.[59] The code plainly defines "gross income" as income from any source. This definition, however, has caused courts problems for some time.[60] For example, the Supreme Court addressed the issue of defining income in 1929, one year before *Lucas v. Earl*.[61] In *Old Colony Trust Co. v. Commissioner*, the American Woolen Company voted to pay federal and state income taxes for its officers, including the president, William Wood.[62] Based on the resolution, American Woolen paid over one million dollars to the Internal Revenue Service on behalf of Mr. Wood.[63] The IRS deemed these payments additional income and sued Wood's estate over the alleged deficiency in the payment of federal taxes.[64] The Court framed the issue as whether the payment of federal income taxes constituted income to the taxpayer.[65] The Court held that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."[66] Thus, the Court de-

58. *See Poe*, 282 U.S. at 117-18 (noting that, while Congress created taxable categories, the states retained the power to define individual rights within each state).

59. *See* 26 U.S.C. § 61(a) (1994) (providing a codified definition of gross income).

60. 26 U.S.C. § 61(a) (1994) (defining gross income as "all income from whatever source"); *see* Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (discussing the definition of income as it applies to the Assignment of Income Doctrine).

61. *See* Old Colony Trust v. Comm'r, 279 U.S. 716 (1929).

62. *Old Colony Trust*, 279 U.S. at 719.

63. *Id.* at 720 (highlighting that the American Woolen Company paid $681,169.88 to the Internal Revenue Service for 1918 and $351,179.27 for 1919).

64. *Id.*

65. *Id.*

66. *Id.* at 729.

fines income with enough breadth to include the gratuitous payment of a debt or obligation by a third party.

D. *Defining "Realization" of Income*

Another definition issue courts address while analyzing the Assignment of Income Doctrine concerns determining when a party realizes income. As with defining income, the Supreme Court addressed the scope of realizing income early in the development of the Assignment of Income Doctrine.[67] Despite this early recognition, however, courts have had some trouble in applying the definition.[68]

In defining when a taxpayer realizes income, the Court focuses on who controls the taxed property. The Supreme Court initially discussed this issue in *Helvering v. Horst.*[69] In *Helvering*, the Commissioner sued Horst for a reporting deficiency that arose when Horst transferred interest coupons from bonds to his son.[70] The Commissioner argued Horst, as the donor, should be taxed on the income.[71] Horst countered that his son controlled the coupons. The Court focused on whether Horst or his son realized income in the year the interest was paid.[72] The Court stated that "income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants."[73]

The Seventh Circuit also addressed this issue in *Galt v. Commissioner.*[74] *Galt* involved a lease between Galt and a racetrack.[75] As part of the lease, Galt received a percentage of the betting receipts.[76] Thereafter, Galt distributed his percentage of the betting receipts to his children.[77] The Seventh Circuit held that because the father controlled the

67. *See* Helvering v. Horst, 311 U.S. 112 (1940).

68. *See, e.g.* Comm'r v. Fender Sales, Inc., 338 F.2d 924, 928 (9th Cir. 1964) (addressing whether a corporation's paying two employees in stock rather than cash constitutes realized income for tax purposes); Cofield v. Koehler, 207 F. Supp. 73, 74 (D. Kan. 1962) (applying *Helvering*'s definition of the realization of income to a case regarding income taxes paid on the receipt of interest on bonds).

69. 311 U.S. 112 (1940).

70. Helvering v. Horst, 311 U.S. 112, 114 (1940) (recognizing the coupons as "independent negotiable instruments").

71. *Id.*

72. *Id.*

73. *Id.* at 116-17.

74. 216 F.2d 41 (7th Cir. 1954).

75. Galt v. Comm'r, 216 F.2d 41, 43 (7th Cir. 1954).

76. *Id.*

77. *Id.*

asset from which the payments arose, the subsequent distribution of the spoils of the asset constituted income to the father and a gift to the son.[78]

III. Attorney's Fees Under the Assignment of Income Doctrine as Interpreted by the Fifth Circuit

Over the years, the Fifth Circuit has addressed the Assignment of Income Doctrine as related to attorney's fees in two significant decisions.[79] In *Cotnam v. Commissioner*, the court held that an individual is taxed on attorney's fees when those fees are part of a court ordered award[80]. In *Srivastava v. Commissioner*, the court continued to follow *Cotnam* despite changes in the tax law.[81] In so holding, however, the Fifth Circuit created a hole in the tax code that allows individuals to choose how they are taxed based on whether the attorney's fee is contingent or flat. This section discusses how the Assignment of Income Doctrine has developed within the Fifth Circuit.

A. Cotnam v. Commissioner

The Fifth Circuit first addressed the Assignment of Income Doctrine in *Cotnam v. Commissioner*, a case arising under Alabama law before the creation of the Eleventh Circuit.[82] In *Cotnam*, Ethel Cotnam agreed to serve Shannon Hunter in the last years of his life in exchange for twenty percent of Hunter's estate.[83] Accordingly, Cotnam quit her job and took care of Hunter for four and half years until his death.[84] Unfortunately for Cotnam, Hunter died intestate, and Cotnam had to sue in order to recover the money Hunter promised her.[85] The trial court awarded Cot-

78. *See id.* at 46 (citing *Lucas* and *Horst* as a basis for the courts ruling regarding income tax question).

79. *See, e.g.*, Srivastava v. Comm'r, 220 F.3d 353, 367 (5th Cir. 2000) (reversing the Tax Court holding by stating that contingency fees are excluded from tax); Cotnam v. Comm'r, 263 F.2d 119, 120 (5th Cir. 1959) (applying the Assignment of Income Doctrine to a case based on Alabama law).

80. *See Cotnam*, 263 F.2d at 121 (declaring "that the sum paid to attorneys was not taxable income to" Cotnam).

81. *See Srivastava*, 220 F.3d at 355 (stating contingent fee payments are excluded from income in the Fifth Circuit).

82. 263 F.2d 119 (5th Cir. 1959). Prior to 1981, the Fifth Circuit consisted of Texas, Louisiana, Mississippi, Alabama, Georgia, and Florida. *See* Fifth Circuit Court of Appeals Reorganization Act of 1980, Pub. L. No. 96-452, § 2, 94 Stat. 1994 (codified as amended at 28 U.S.C. § 41 (1994)). The Fifth Circuit Court of Appeals Reorganization Act moved Alabama, Georgia, and Florida to the newly-created Eleventh Circuit, effective October 1, 1981. *See id.*

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

84. *Id.*

85. *Id.* at 120-21.

nam $120,000, including over $50,000 in attorney's fees.[86] The issue on appeal asked whether the award for attorney's fees constituted taxable income to Cotnam.[87] A divided court held that the money paid by Cotnam to her attorney was not income because the attorney had an equitable lien on the money.[88] Using the "fruit of the tree" argument, Judge Wisdom dissented and stated:

> Mrs. Cotnam assigned the right to income already earned. She controlled the disposition of the entire amount and diverted part of the payment from herself to the attorneys. By virtue of the assignment Mrs. Cotnam enjoyed the economic benefit of being able to fight her case through the courts and discharged her obligation to her attorneys.[89]

In other words, Cotnam received an economic benefit from the resources she expended on her attorney; therefore, she must report this as income on her federal income taxes.[90] *Cotnam* has stoked a firestorm of controversy regarding whether contingency fees paid to attorneys for otherwise taxable jury awards constitute taxable income as well.[91]

B. Srivastava v. Commissioner

In July 2000, the Fifth Circuit once again addressed the Assignment of Income Doctrine as it pertains to attorney's fees. This time, however, the case originated in Texas.[92] The Fifth Circuit was asked to decide the tax implications for a couple who had won a defamation case against a television station in San Antonio.[93] In *Srivastava*, KENS-TV aired a series of reports linking Dr. Srivastava and his wife, Dr. Pascual, with providing poor medical care.[94] This allegation effectively destroyed Srivastava's

86. *Id.* at 121.
87. *Id.*
88. *See Cotnam*, 263 F.2d at 125 (explaining Alabama law regarding lien enforcement).
89. *Id.* at 127.
90. *See id.*
91. *See generally* Srivastava v. Comm'r, 220 F.3d 353, 358 (5th Cir. 2000) (following *Cotnam* in determining that contingency fees are excludable from income under Texas law); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (following *Cotnam* in holding that the taxpayer's claim was a contingent expectancy and, as such, entirely speculative); Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000) (distinguishing *Cotnam* because Alaskan law does not confer an attorney a superior lien or an ownership interest); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir. 1963) (upholding Tax Court's decision in *Cotnam*); Kenseth v. Comm'r, 114 T.C. 399, 429-30 (May 24, 2000) (declining to follow *Cotnam*).
92. *Srivastava*, 220 F.3d at 355.
93. *Id.*
94. *Id.*

and Pascual's medical practice, spurring the pair to sue KENS-TV for defamation.[95] The jury awarded the plaintiffs 11.5 million dollars in actual damages and 17.5 million dollars in punitive damages along with pre-judgment and post-judgment interest.[96] The station and its insurance carrier subsequently settled the claim for $8,500,000.[97]

Srivastava and Pascual received the money from the settlement in 1991 but did not report the award as income.[98] The couple reasoned that the entire settlement amount consisted of actual damages statutorily excluded from income by 26 U.S.C. § 104(a)(2).[99] Nevertheless, the Internal Revenue Service disagreed and taxed Srivastava and Pascual $1,188,920 for tax year 1991 and $33,037 for tax year 1992.[100] The Commissioner believed the settlement should be broken down proportionately in regard to the jury award.[101]

Srivastava and Pascual challenged this deficiency in Tax Court.[102] The Tax Court held that the portion of the settlement award Srivastava and Pascual paid their attorney was taxable as gross income.[103] The court also rejected the plaintiff's claim that the entire settlement award constituted actual damages.[104]

The Fifth Circuit reversed the holding of the Tax Court, and followed the precedent in *Cotnam*.[105] Significantly, *Srivastava* creates a hole in the Federal Income Tax Code by distinguishing between Texas attorneys' clients based on method of payment. The problem of this distinction lies in the result—the Fifth Circuit has judicially created an illegitimate basis for distinguishing between taxpayers.

95. *See id.*

96. *Id.*

97. *Srivastava*, 220 F.3d at 355.

98. *Id.* at 356.

99. 26 U.S.C. § 104(a)(2) (1994 & Supp. II 1997) (omitting damage awards based on injury or sickness from gross income); *see Srivastava*, 220 F.3d at 356 n.3 (explaining that 26 U.S.C. § 104(a)(2) applies to this case as that punitive damages that are not awarded based on personal injuries or sickness are excluded from taxable gross income).

100. *Srivastava*, 220 F.3d. at 356 (basing the deficiency notice on taxable portion of the settlement agreement).

101. *Id.* (pointing out the failure of the settlement agreement to separate the taxable and non-taxable income).

102. *Id.*

103. *Id.*

104. *See Srivastava*, 220 F.3d at 356 (stating that the Tax Court matched each settlement tier to their respective portion of the award to calculate the alleged tax deficiency).

105. *Id.* at 367.

1. The Fifth Circuit's *Tabula Rasa* Argument

In *Srivastava v. Commissioner*, the Fifth Circuit declined to overrule *Cotnam*.[106] Indeed, Judge Smith stated "[w]ere we ruling on a *tabula rasa*, we might be inclined to include contingent fees in gross income."[107] Accordingly, the court held that *Srivastava* was not significantly distinguishable from *Cotnam* and applicable precedent dictated this decision.[108] In so holding, however, the Fifth Circuit noted the circuit split on this issue between the Fifth and Sixth Circuits' reliance on *Cotnam* and the Third, Ninth, and Federal Circuits' inclusion of contingent fees as gross income.[109]

Judge Smith then discussed the parameters of taxable income.[110] Judge Smith stated "that any income or gain is not taxed until it is 'realized.'"[111] The judge further cited *Horst* for the proposition that an assignor who controls the source of the income and distributes the income in order to satisfy a debt or desire has realized income.[112] Applying Justice Holmes's metaphor, the person who owns the tree and distributes the fruit to others has realized income.[113] Nevertheless, the court noted that the Assignment of Income Doctrine would not apply in this instance by stating that "[w]e do not . . . decide this case on a clean slate, but must follow the contrary approach endorsed in *Cotnam*."[114]

106. *See id.* at 357-58 (using *Cotnam*, the Fifth Circuit reversed the Tax Court and decided that contingency fees are excludable from gross income).

107. *Id.* at 357.

108. *Id.* at 357-58.

109. *See Srivastava*, 220 F.3d at 357-58 (recognizing that the Sixth Circuit has adopted *Cotnam*'s reasoning while Third Circuit, Ninth Circuit, and Federal Circuits include contingency fees as gross income).

110. *Compare* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (adopting the reasoning of *Cotnam*), *with* O'Brien v. Comm'r, 319 F.2d 532, 532, 38 T.C. 707, 712 (1962) (holding that *Lucas v. Earl* dictates that attorney's fees be taxable to the clients), Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000) (noting Judge Wisdom's dissent in *Cotnam*), *and* Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995) (determining gross income to include contingent fees).

111. *Srivastava*, 220 F.3d at 358; *see* Helvering v. Horst, 311 U.S. 112, 116 (1940) (stating that income must be realized in order to be taxed).

112. *See Srivastava*, 220 F.3d at 359; *see also Helvering*, 311 U.S. at 116 (acknowledging that income is realized by an assignor who controls the source and distribution of the income and thereby diverts payment from himself to others).

113. *See* Lucas v. Earl, 281 U.S. 111, 115 (1930) (holding that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew"); *see also Helvering*, 311 U.S. at 116 (stating that one who controls the income's source also controls the distribution to others in order to receive what he wants).

114. *Srivastava*, 220 F.3d at 363.

2. Attorney's Lien

The practical effect of *Srivastava* gives an attorney a legal claim to part of the client's award. This holding should trouble many members of the Texas State Bar. In Texas, attorneys do not have a property right in their client's cause of action.[115] *Cotnam* interpreted Alabama law as creating an equitable lien for the benefit of the attorney.[116] Although the rules of ethics require attorneys to zealously advocate for their clients, allowing an attorney to become a "partner" in a client's cause of action creates ethical problems.[117] Judge Dennis dissented to the Fifth Circuit's application of *Cotnam* in *Srivastava* by distinguishing *Cotnam* and noting that "under Texas law, unlike that of Alabama, an attorney is not granted by statute the same right and power as his client over his client's cause of action and judgment for the independent enforcement of his attorney's fee claim."[118] Judge Dennis noted that the attorney-client relationship in Texas yields a principal/agent scenario where the attorney's claim remains a derivative of the client's claim.[119] The client must realize the award before distributing the contingency fee to the attorney; therefore, the contingency fee must be taxable to the client.[120]

The court in *Srivastava* nevertheless adopted the idea that a client no longer controls a portion of the tree when the attorney becomes a "partner" to the suit.[121] As such, the client need not report that portion of the taxable award as income.[122] Contrary to the court's reasoning, however, the relationship between client and attorney centers around the client's purchase of the attorney's services with the promise to pay the attorney if the client prevails in the case.[123] For example, in *Srivastava*, the defama-

115. *See* TEX. DISCIPLINARY R. PROF'L CONDUCT 1.08(h) *reprinted in* TEX. GOV'T CODE ANN., tit. 2, subtit. G app. A (Vernon 1998) (limiting an attorney's interest in a client's cause of action).

116. *See* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (allowing an attorney the right to an equitable lien in a client's cause of action under Alabama law).

117. TEX. DISCIPLINARY R. PROF'L CONDUCT 1.01 cmt. 6 (Vernon 1998) (requiring an attorney to provide clients with diligent representation); TEX. DISCIPLINARY R. PROF'L CONDUCT 1.08(h) (prohibiting an attorney from taking "a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client").

118. *Srivastava*, 220 F.3d at 369.

119. *Id.*

120. *Id.*

121. *See id.* at 360 (claiming a distinction from *Horst* because an attorney must perform in order for a client to recover).

122. *See id.* at 360-63 (discussing whether the assigning of the "fruit of the trees" to the attorney allows the client to avoid the realization of income on that portion of the income).

123. *See* Cotnam v. Comm'r, 263 F.2d 119, 125-26 (5th Cir. 1959) (realizing that without an attorney the client's chance of success is small).

tion claim against KENS-TV represents the "tree."[124] Without the claim, the client does not need an attorney. Srivastava and Pascual merely distributed a portion of the fruit of the defamation tree to the attorney in order to increase the chances of a harvest.[125] The attorney, however, does not control the defamation case.[126] While the attorney may advise the client, the client makes the ultimate decision in the case.[127] Without the ability to make a final decision, the attorney has no control over the tree and can only hope that the fruit will ripen into a collectible fee.[128]

3. Contingent Fee Versus Flat-Rate Fee

Another problem raised by *Srivastava* regards the lack of uniform treatment between contingent fees versus flat-rate fees. A client paying an attorney on a flat-rate fee arrangement receives different treatment for tax purposes when compared to a client who uses a contingent fee agreement.[129] The problem centers on the method of payment. The flat-rate client pays the attorney's fees from private funds, separate from any award derived from the cause. Thus, the flat-rate client cannot enjoy any tax savings from the fee agreement. The contingent fee client, however, pays the attorney from the fruits of the cause. The contingency fee method of payment allows the client to effectively receive the benefit of an attorney at a reduced rate because the fee paid to the attorney discounts the taxable income received by the client. Moreover, no logical reason exists for a client to continue using a flat-rate fee attorney and pay taxes on the full taxable amount of an award, while a client who chooses to pay a contingent fee can deduct the attorney's fee before computing their tax burden.[130] Indeed, as Judge Smith stated in *Srivastava* "[t]here is no apparent reason to treat contingent fees differently or to believe that Congress intended to subsidize contingent fee agreements in such a fashion."[131]

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124. *See Srivastava*, 220 F.3d at 360 (recognizing that the potential judgment is the "fruit" of the lawsuit).

125. *See id.* at 362 (stating the need for a client to hire counsel).

126. *See id.* at 368 (Dennis, J., dissenting in part) (suggesting the lack of a legal interest in a cause by Texas attorneys).

127. Texas Employers Ins. Ass'n v. Wermske, 162 Tex. 540, 545-46, 349 S.W.2d 90, 93-94 (1961) (stating that the attorney/client relationship is one of principal and agent).

128. *See Srivastava*, 220 F.3d at 369 (Dennis, J., dissenting in part) (explaining that a Texas attorney has no control over the "tree" and, as such, the fees paid are income to the client).

129. *See id.* at 362-63 (stating that a contingent fee client should be treated similarly to a flat-fee client).

130. *See id.* (stating that both contingent fee and flat fee clients engage attorneys for the same purpose).

131. *Id.* at 357.

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Judge Smith's majority opinion nevertheless stated that the court must follow the precedent laid out in *Cotnam* because *Cotnam* and *Srivastava* are "substantially indistinguishable."[132] As noted, Judge Dennis dissented from the court on this issue, reasoning that the difference in Texas law and Alabama law distinguished the two cases.[133] In response to this argument, however, Judge Smith stated that the resolution of this matter did not lie within the attorney's bundle of rights.[134] Instead, Judge Smith focused on the control and dominion of the award as the key to deciding the case.[135]

The careful reader must question the *Srivastava* holding because *Cotnam* seems to turn on the attorney's right to an equitable lien.[136] In fact, without the right to an equitable lien the Assignment of Income Doctrine should not apply in *Cotnam* or *Srivastava*.[137] The court may have believed that it acted justly by allowing Srivastava and Pascual to exclude the attorney's fees from their gross income; however, the court ignored other precedent.[138] Specifically, the court ignored the fundamental principle that "[t]here are no equities in tax law."[139]

IV. Importance of *Srivastava* to the Texas Attorney

Srivastava should raise a red flag to every attorney in Texas. The decision effectively creates a financial incentive for a client to choose a contingency fee agreement over a flat fee agreement. It does not take a great leap to envision a client filing a legal malpractice claim against an attorney for failure to disclose the tax benefits of contingency fee agreements over a flat-rate fee agreement. To avoid such an unpleasant situation, the prudent attorney should draft a form that discloses the tax benefits of a contingency fee agreement over a flat-rate fee agreement. This action

132. *See id.* at 357-58 (declining to distinguish *Cotnam*, thus, using it for precedential authority).

133. *See Srivastava*, 220 F.3d at 367-68 (Dennis, J., dissenting) (arguing that Texas law is significantly different from Alabama law and, therefore, a distinction can be made between *Srivastava* and *Cotnam*).

134. *See id.* at 364 (stating that control and dominion of the asset are the key aspects in deciding this case).

135. *Id.*

136. *See* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (arguing that the Alabama statute precluded Cotnam from realizing the attorney fee as income).

137. *See id.* at 127 (Wisdom, J., dissenting) (arguing that the equitable lien is of no use since the income was already earned).

138. *See* Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (holding contracts cannot prevent taxation of the person who earned the income); Helvering v. Horst, 311 U.S. 112, 116 (1940) (stating an arrangement in anticipation of income does not keep income from being taxed to the assignor).

139. United States v. Henderson Clay Prod., 324 F.2d 7, 12 (5th Cir. 1963).

provides the client with all the possible information needed to choose the best possible payment option for their situation. Moreover, the form becomes strong evidence against any claim that the attorney failed to warn the client about possible tax advantages of contingency fee agreements.

The attorney, after accepting a client's cause, should explain the differences between contingency fee and flat fee agreements. The attorney should explain the tax benefits of a contingency fee agreement over a flat-rate fee agreement. This discussion should focus on the material contained in the form more completely explaining the contingency fee and flat-rate fee agreements and each approach's respective tax consequences. The attorney should allow the client to read the form and then ask whether the client understands the form. If the client fails to understand the form or miscomprehends the form's content, the attorney should explain the concept more completely. When the client does understand, the client should explicitly tell the attorney which type of payment the client wants. The attorney should then memorialize this selection on the form along with a complete discussion of fees associated with pursuing the cause. Finally, both the attorney and the client should sign the document. This procedure will allow for full disclosure to the client and better insulate the attorney from liability for failure to inform their client.

V. Future Viability of *Srivastava* and *Cotnam*

The circuit split concerning the tax treatment of attorney's fees flows from the fact that many courts do not believe it just to require taxpayers to pay taxes on income they do not control.[140] As discussed, successful parties receive value from the money they pay their attorney.[141] Some courts, however, believe that successful parties should not be taxed on this income.[142] As a result, two divergent paths emerge pointing towards the future viability of *Srivastava* and *Cotnam*, one legislative and the other judicial.

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140. *See e.g.*, Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (following *Cotnam* based on the idea that the Clarks's case was "entirely speculative and dependent on the services of counsel"); Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (claiming it is unjust to tax attorney's fees over which the client has no control).

141. *See* Srivastava v. Comm'r, 220 F.3d 353, 358-59 (5th Cir. 2000) (citing *Horst* and *Lucas* as the legal basis for the proposition that parties cannot use contracts to avoid realization of income).

142. *See, e.g.*, Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (arguing that there was no realization of income by Cotnam); Estate of Clarks *ex. rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (agreeing with the conclusion in *Cotnam*).

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A. *Congressional Change to the Internal Revenue Code*

Congress could implement a new federal statute to alleviate the problem created by *Srivastava*. The statute would simply remove from taxable income any part of a jury award or other settlement used to pay an attorney for services rendered in a cause. Other parts of the Internal Revenue Code provide taxpayers with the ability to deduct the costs of producing income, and Congress could justify an amendment to the tax code under the same reasoning.[143] The benefit of this statutory change will end the controversy presented in *Srivastava* by providing a bright-line rule for the courts to follow. Moreover, changing the Internal Revenue Code to exclude payments to attorneys serves justice through the proper channel. Thus, the courts would know that attorney's fees are excluded from an otherwise taxable award.

B. *Keep the Status Quo*

Although the status quo may be the last thing to consider, keeping the law as is may be the best solution. Through *Lucas v. Earl* and its progeny, the Assignment of Income Doctrine requires the attorney's fees earned in *Srivastava v. Commissioner* to be taxed as income.[144] Under an analysis through *Lucas*, Srivastava and Pascual realized the settlement award money used to pay the attorney as fruits of the cause. As such, money expended to pay their attorney should be included as income.

The government should seek a writ of certiorari on *Srivastava*. If granted, the Supreme Court may apply the Assignment of Income Doctrine as developed in the *Lucas* line, thus resolving the circuit split. The Fifth Circuit's application of the law represents a prime example of a court discarding Supreme Court precedent and choosing to adhere to its own antiquated solution. Undoubtedly, a clear Supreme Court ruling would resolve the issue and establish a bright-line rule by which courts could address future cases.

VI. CONCLUSION

Unfortunately, no easy answers exist to rectify the present situation. The Fifth Circuit has taken the law so far afield that it will require an act of Congress or a ruling by the United States Supreme Court to correct the problem. Srivastava and Pascual realized the benefit of their settle-

143. *See* 26 U.S.C.A. § 67(b) (West Supp. 2000) (providing for a deduction related to the production of income); Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorney's Fees and Costs*, 88 TAX NOTES 531, 533-34 (2000) (discussing Sections 162 and 212's relationship to income producing activity).

144. *See* Lucas v. Earl, 281 U.S. 111, 115 (1930).

ment award paid to their attorney. Those that argue to the contrary base their opinion on emotion, not the law. A great amount of sympathy exists for a recipient of a jury award or settlement based on an injury sustained at the hands of the defendant. Nevertheless, sympathy cannot cloud judgment when the law clearly demands a contrary ruling. Under the current Assignment of Income Doctrine, Srivastava and Pascual should pay taxes for the entire taxable award including the amount paid as attorney's fees.

If we neglect to address *Srivastava*, similarly situated taxpayers will receive different treatment under the law. As such, the client choosing to pay on a flat fee basis will suffer higher taxes based on the mere fact that these clients have more resources than a contingency fee client. This "Robin Hood" argument cannot justify reaching a different result between two similarly situated parties. In fact, this treatment contradicts the philosophic idea of a progressive tax system. One of the most basic principles of a progressive tax system states that each taxpayer should pay the same in taxes based on the relative ability to pay. If two people each receive a taxable award of $120,000, each party should pay the same in taxes on that amount. Under *Srivastava*, however, the contingency fee client will pay significantly less in taxes while receiving the same award.

The United States Supreme Court should grant certiorari for this case because the current application of the law by the courts runs afoul of the established Assignment of Income Doctrine. Indeed, *Srivastava* clearly violates the Assignment of Income Doctrine. One cannot argue that *Srivastava* did not realize the fee paid to the attorney as part of a contingency fee agreement. The attorney's fee is derived from the fruit of the defamation tree. This decision should be overruled in the interest of uniformity in the Internal Revenue Code. Moreover, it must be overturned because there is no equity in tax law.

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