9-1-2000

Handling Legal Fees In Settlements

Neil Harl
Iowa State University, harl@iastate.edu

Follow this and additional works at: http://lib.dr.iastate.edu/aglawdigest

Part of the Agricultural and Resource Economics Commons, Agricultural Economics Commons, Agriculture Law Commons, and the Public Economics Commons

Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol11/iss17/1

This Article is brought to you for free and open access by the Journals at Iowa State University Digital Repository. It has been accepted for inclusion in Agricultural Law Digest by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.
HANDLING LEGAL FEES IN SETTLEMENTS  
— by Neil E. Harl

A series of cases by the Tax Court¹ and Courts of Appeal² have focused attention on a highly important question: is a successful plaintiff required to report the entire judgment or settlement recovery (including the attorney’s fee) into income? Or, can the attorney’s fee be deducted from the recovery amount?

**Cotnam v. Commissioner**

In a decision more than 40 years ago, the Fifth Circuit Court of Appeals in *Cotnam v. Commissioner*³ allowed the portion of an attorney’s contingency fee paid to the attorney to be excluded from income.⁴ An exclusion from income is more advantageous than a deduction from income (which could otherwise be claimed as a miscellaneous deduction) because of the limited benefit of a deduction after application of the alternative minimum tax⁵ and because of the limitation on miscellaneous itemized deductions to 2 percent of the taxpayer’s adjusted gross income.⁶

In the *Cotnam* case,⁷ the contingency fee was viewed as belonging directly to the attorney and that part of the recovery was not considered to be income to the successful plaintiff.⁸ In that case, the plaintiff never had a right to the portion of the judgment paid to the attorneys. A state statute (Alabama) gave attorneys “…the same right and power over…suits, judgments and decrees to enforce their liens, as their clients had or may have for the amount thereon due them.”⁹ As the majority observed, the taxpayer “…could never have received the $50,365.83 [the amount representing the attorney’s fee], even if she had settled the case directly.”¹⁰

**Other courts in agreement**

Two cases have been decided this year agreeing with *Cotnam v. Commissioner*¹¹ and holding that, where plaintiffs have a contingent fee agreement, the fee belongs directly to the attorney and the plaintiff does not have to report the amount of the attorney’s fee as income.¹² In *Estate of Clarks v. United States*,¹³ the court viewed the contingency fee agreement as an assignment which, under state law (Michigan), operated as a common law lien on a portion of the judgment and resulted in ownership of that portion of the judgment being transferred to the attorney.¹⁴ Also, the court viewed the portion of the judgment attributable to the contingency fee as earned by the attorney and properly taxable to the attorney.¹⁵

In *Davis v. Commissioner*,¹⁶ the court followed *Cotnam v. Commissioner*¹⁷ inasmuch as the Eleventh Circuit was formed out of part of the old Fifth Circuit and so was following precedent within the Circuit. Factually, *Davis*¹⁸ involved a $6,151,000 recovery against a mortgage company in Alabama of which $3,111,809 was attorneys’
fees under a contingency agreement, which the court held were excluded from the plaintiff’s income.\textsuperscript{19}

\textbf{Courts not allowing exclusion}

The position of the Internal Revenue Service has been that legal fees paid to the taxpayer’s attorney and withheld from the settlement payment are includible in the taxpayer’s income. Except where bound to follow Court of Appeals’ precedent to the contrary, the Tax Court has agreed with the IRS position.\textsuperscript{21} In a 1998 Tax Court case, the court rejected the argument that the plaintiff’s attorney had a common law lien but that case has been reversed by the Fifth Circuit Court of Appeals,\textsuperscript{22} a position embraced in \textit{Estate of Clarks v. United States}.\textsuperscript{23}

The Federal Circuit Court of Appeals, in a 1995 case,\textsuperscript{24} held that the contingency fee portion of settlement from a condemnation proceeding paid directly to the attorney was income to the plaintiff and could not be excluded. The court held that a Maryland lien statute\textsuperscript{25} did not give the attorney any ownership interest in the fee; the lien statute merely placed a charge upon the fund as security for the debt which is owed to the attorney by the client.\textsuperscript{26}

In \textit{Alexander v. Internal Revenue Service},\textsuperscript{27} the First Circuit Court of Appeals held that legal fees expended in obtaining a settlement for the loss of salary and retirement benefits had to be included in gross income and were properly deductible as a miscellaneous itemized deduction.

The Ninth Circuit Court of Appeals, in a 2000 case, \textit{Coady v. Commissioner},\textsuperscript{28} held that, under Alaska law, attorneys do not have a superior lien or ownership interest in the recovery as they do in Alabama and Michigan.\textsuperscript{29} The state law lien does not confer an ownership interest upon attorneys or grant attorneys any right over judgments or decrees in favor of their clients.\textsuperscript{30} Accordingly, the full amount of the recovery was taxable to the plaintiff. Another 2000 decision by the Ninth Circuit\textsuperscript{31} and a 1999 Ninth Circuit Court of Appeals decision reached the same result.\textsuperscript{32}

In a recent Federal District Court case in Alabama, \textit{Foster v. United States},\textsuperscript{33} the court criticized harshly the 1959 decision of the Fifth Circuit Court of Appeals in \textit{Cotnam v. Commissioner}\textsuperscript{34} in stating that there are “serious and legitimate questions as to whether the holding...should continue to be followed in this or other circuits.”\textsuperscript{35}

\textbf{In conclusion...}

At present, the handling of attorneys fees is dependent upon the Circuit Court of Appeal with jurisdiction and, to a degree, upon state lien law.

\textbf{FOOTNOTES}


2. Coady v. Comm’r, 2000-1 U.S. Tax Cas. (CCH) ¶ 50,528 (9th Cir. 2000); Brewer v. Comm’r, 99-1 U.S. Tax Cas. ¶ 50,378 (9th Cir. 1999); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Davis v. Comm’r, 210 F.3d 1346 (11th Cir. 2000); Cotnam v. Comm’r, 263 F.2d 119 (5th Cir. 1959).

3. 263 F.2d 119 (5th Cir. 1959).

4. Id.

5. See I.R.C. § 55.


7. See note 3 supra.

8. Id.


11. See note 3 supra.


13. See note 12 supra.

14. Id.

15. Id.


17. 263 F.2d 119 (5th Cir. 1959).

18. See note 16 supra.

19. Id.


21. E.g., Kenseth v. Comm’r, 114 T.C. No. 26 (2000) (contingency fee includible in taxpayer’s gross income despite state lien statute (Wisconsin) providing for an attorney’s lien upon the proceeds or damages to secure compensation; Clarks and Cotnam, supra, not followed); Sinyard v. Comm’r, T.C. Memo. 1998-364 (age discrimination suit; full amount taxable to plaintiff).


23. 202 F.3d 854 (6th Cir. 2000).


27. 72 F.3d 938 (1st Cir. 1995).

28. 2000-1 U.S. Tax Cas. (CCH) ¶ 50,528 (9th Cir. 2000).

29. Id.

30. Id.

31. Benci-Woodward v. Comm’r, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,595 (9th Cir. 2000) (portion of punitive damage award retained by attorney in taxpayer’s income; under California law, attorney’s lien did not transfer ownership interest in award).

32. Brewer v. Comm’r, 99-1 U.S. Tax Cas. (CCH) ¶ 50,378 (9th Cir. 1999) (amount paid directly to attorney as legal fees not excludible from income).


34. 263 F.2d 119 (5th Cir. 1959).

35. See note 3 supra.