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Fifth Circuit Holds That Portions of Settlements Payable to Taxpayer's Attorney Pursuant to a Contingent Fee Agreement under Texas Law Do Not Constitute Gross Income to the Taxpayer - *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000)

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FIFTH CIRCUIT HOLDS THAT PORTIONS
OF SETTLEMENTS PAYABLE TO
TAXPAYER'S ATTORNEY PURSUANT TO A
CONTINGENT FEE AGREEMENT UNDER
TEXAS LAW DO NOT CONSTITUTE GROSS
INCOME TO THE TAXPAYER—
SRIVASTAVA V. COMMISSIONER,
220 F.3d 353 (5th Cir. 2000)

*Stephanie M. Smith**

IN the recent case of *Srivastava v. Commissioner*, the Fifth Circuit ruled that attorney contingency fees are not includable in a litigant taxpayer's gross income.¹ Although the court stated that it would be "inclined to include contingent fees in gross income" if it had been ruling on a "tabula rasa,"² it instead followed the decision in *Cotnam v. Commissioner*³ because it found the decision indistinguishable from the case at hand.⁴ The court ignored the fact that *Cotnam* was decided on the basis of Alabama statutes, while *Srivastava* occurs in Texas. Contrary to Alabama law, Texas law allows attorneys less control over their contingency fees.⁵ This key difference should distinguish *Cotnam* from the case at hand and allow the court instead to consider the characterization of contingency fees to determine whether they should be included in gross income.

KENS-TV aired a series of reports accusing Petitioner Srivastava, a medical doctor, of "poor quality medical care and committing acts that would have been criminal under Texas law," acts which ruined his practice and "caused substantial financial and emotional harm to him and his

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1. 220 F.3d 353, 365 (5th Cir. 2000).
2. *Id.* at 357.
3. 263 F.2d 119 (5th Cir. 1959).
4. *See Srivastava*, 220 F.3d at 364 n.33.
5. *See id.*

family."⁶ Srivastava sued the station for defamation and other related claims and won, later settling for \$8.5 million.⁷ In 1991 Srivastava received the settlement proceeds but did not report any gross income, reasoning that the entire recovery consisted of non-taxable actual damages.⁸ The Commissioner then issued a notice of deficiency for the portions of the settlement representing interest and punitive damages⁹, which are includable in taxable income. Srivastava then challenged the notice in Tax Court.¹⁰

Since the settlement award was not separated into categories of non-taxable actual damages and taxable interest and punitive damages, the Tax Court applied proportions derived from the original jury verdict.¹¹ The Tax Court then reduced the deficiencies and penalties according to its calculations. It also waived penalties corresponding to punitive damages, ruling that Srivastava had reasonable cause not to report that portion.¹²

Further, the Commissioner did not allow Srivastava to exclude the contingency fees owed to his attorneys from his gross income.¹³ Srivastava challenged this ruling in Tax Court, citing *Cotnam v. Commissioner*, which supported the notion that contingent fees were excludable from gross income.¹⁴

The Tax Court ruled that the contingent fees were includable in gross income.¹⁵ Although its decision was appealable to the Fifth Circuit, the court determined that the case at hand involved an interpretation of Texas law, rather than Alabama law as in *Cotnam*.¹⁶ It further distinguished *Cotnam* because Texas, unlike Alabama, uses common law to regulate attorney's liens, and under Texas common law a lien is not a conveyance of ownership interest.¹⁷ Srivastava appealed, claiming that the portion of the settlement owed to his attorney as a contingent fee is not gross income.¹⁸ After examining the relationship to *Cotnam*, the

6. *Id.* at 355.

7. *Id.*

8. *Id.* at 356.

9. See *Srivastava v. Comm'r*, 76 T.C.M. (CCH) 638, 640 (1998).

10. See *Srivastava*, 220 F.3d at 353.

11. *Id.* at 356. The original jury verdict awarded \$11.5 million in actual damages and \$17.5 million in punitive damages and interest. *Id.* at 355. Due to the insolvency of two insurers, the station and Srivastava reached a settlement of \$8.5 million discharged by Continental Casualty (\$2.1 million), KENS-TV (\$3.4 million), and Columbia Casualty and Hudson Insurance (\$3 million). When matched to the jury verdict, Continental Casualty and most of KENS-TV's portion was considered not taxable as actual damages; the rest was considered punitive damages and interest. *Id.* at 356-57.

12. *Id.* at 357.

13. See *Srivastava*, 76 T.C.M. (CCH) at 640.

14. *Id.* at 642.

15. *Id.* at 645.

16. *Id.* at 643. Because the case deals with a different interpretation of law, the court is not bound by the rule that the law of the circuit in which a case is appealable must control. See *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

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

18. *Srivastava*, 220 F.3d at 357.

Fifth Circuit reversed the portion of the Tax Court's judgment ordering the amount of the contingent fee included in Srivastava's gross income.¹⁹

Writing for the Fifth Circuit, Judge Smith²⁰ first stated that *Cotnam* is "substantially indistinguishable from this case,"²¹ yet then examined the case as if it were an original matter. It explained that since the IRS is of "little help," it must turn to "judicially-developed tax law principles," in this case the anticipatory assignment of income doctrine.²² Anticipatory assignments of income may not be used to avoid taxation where the taxpayer retains control of the asset or income source and merely commits future income streams.²³ Thus, for a *tabula rasa* analysis, the primary question of characterization remained for the court to determine.²⁴

The Fifth Circuit noted that Srivastava's attorney's contingent fee should actually be characterized as an anticipatory assignment of income.²⁵ The court stated that with an anticipatory assignment of income, "what is taxed is not exclusively the receipt of funds, but rather any enjoyment of gain."²⁶ It further determined that the benefit of an attorney's services in exchange for a contingent fee "is not to be excluded from gross income solely on the basis that the money is diverted to, and realized by, the taxpayer's assignee."²⁷ However, the court finally discounted this analysis and concluded that *Cotnam* must control because the differences between attorneys' rights in Texas and Alabama do not "meaningfully affect the economic reality facing the taxpayer-plaintiff."²⁸

Judge Dennis concurred with the balance of the opinion for the reasons stated in the majority opinion²⁹ but also dissented in part.³⁰ He argued that Alabama law gives attorneys the same rights as their clients regarding enforcement of liens.³¹ In contrast, Texas law does not grant the same rights to an attorney by statute; rather, attorney and client rights are "necessarily dependent upon and inseparably interwoven with the

19. *Id.* at 367.

20. Judges Smith, Politz, and Dennis heard the appeal. Judge Politz joined Judge Smith's opinion. Judge Dennis concurred in the balance of the opinion, but dissented in the reversal of the Tax Court on the issue of the taxation of contingent fees. *See id.*

21. *Id.* at 357-58. If the case is indistinguishable, precedent from the Fifth Circuit must control under the *Golsen* rule. *See Golsen v. Comm'r*, 54 T.C. 742, (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). *See also Contingent Attorney Fees from Settlement Excluded from Gross Income*, 27 TAX PRAC. 182 (August 7, 2000).

22. *Srivastava*, 220 F.3d at 358.

23. *Id.* at 359; *see also Helvering v. Horst*, 311 U.S. 112, 119-20 (1940); *Lucas v. Earl*, 281 U.S. 111, 113-15 (1930).

24. *Srivastava*, 220 F.3d at 359.

25. *Id.* at 369. The Court explained that although the attorney could receive an assignment of part of the contingency fee agreement, the attorney was, in fact, litigating his own interest simultaneously with his client's. *Id.* (citing *Dow Chem. Co. v. Benton*, 357 S.W.2d 565, 567-68 (Tex. 1962)).

26. *Id.* at 359.

27. *Id.* at 363.

28. *Id.* at 364.

29. *Id.* at 367 (Dennis, J., concurring).

30. *Srivastava*, 220 F.3d at 367 (Dennis, J., dissenting).

31. *Id.* at 368 (citing 46 ALA. CODE § 64 (1940)).

other.”³²

The majority failed to give proper credence to the argument that this case is distinguishable from *Cotnam*. As Judge Dennis noted in his dissent, Texas does not completely protect the interest of attorneys regarding contingency fees; further, the Texas Supreme Court has ruled that “an attorney may not prosecute a cause of action on his own behalf to secure a contingent fee.”³³ This approach contrasts with the Alabama statute, under which *Cotnam* was decided.³⁴ The Third, Ninth, and Federal Circuits have already distinguished *Cotnam* and included contingent fees in gross income.³⁵ Each of these circuits distinguished *Cotnam* for a similar difference between the laws of the respective controlling state law and Alabama.³⁶

Because the court declined to distinguish *Cotnam*, it refused to answer the question of whether the control divested from the taxpayer to his attorney is sufficient to trigger the anticipatory assignment of income doctrine.³⁷ The court itself completed an entire analysis of this question in the majority opinion. It correctly concluded that a taxpayer who anticipatorily assigns future income in exchange for services has received a benefit.³⁸

Additionally, the court correctly stated that the risk-shifting quality of a contingency fee illustrates another aspect of the non-monetary benefit conferred on the litigant.³⁹ Furthermore, the uncertainty as to the amount of the contingent fee involved in a case does not prevent application of the anticipatory assignment of income doctrine.⁴⁰

The majority also remarked on tax neutrality, noting that “[t]here is no apparent reason to treat *contingent* fees differently or to believe that Congress intended to subsidize contingent fee agreements.”⁴¹ Nevertheless, this result occurs when contingent fees are excluded from gross income. The court noted that Srivastava would have had to compensate his attorney out of his own pocket if there had been a contingent fee arrange-

32. *Id.*

33. *Id.* (citing *Dow Chem. Co. v. Benton*, 357 S.W.2d 565, 567-68 (Tex. 1962)).

34. *Id.* at 364 n.33. The Alabama statute states that “attorneys-at-law shall have the same right and power over action or judgment to enforce their liens as their clients had or may have for the amount due thereon to them.” *Id.* (quoting ALA. CODE § 34-3-61(b) (1975)).

35. See *Coady v. Comm’r*, 213 F.3d 1187, 1190 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995); *O’Brien v. Comm’r*, 38 T.C. 707, 712 (1962), *aff’d*, 319 F.2d 532 (3d Cir. 1963). The Tax Court also disagrees with the Fifth Circuit’s decision in *Srivastava*. See *Srivastava*, 220 F.3d at 358 n.13; *Kenseth v. Comm’r*, 114 T.C. 2399, 408-09, 412 (2000); AMELIA D. LEGUTKI ET AL., MERTENS § 24A:42.13 (Nov. 2000);.

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

37. See *id.* at 364-65.

38. *Id.* at 360-63.

39. *Id.* at 362; see also *Old Colony Trust Co. v. Comm’r*, 279 U.S. 716, 729 (1929) (holding that “[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed”).

40. *Id.* at 361.

41. *Id.* at 357.

ment.⁴² The exclusion of the contingent fee essentially gives unfair preferential tax treatment to litigants who choose to pay with a contingent fee rather than out of their own pockets. In effect, the taxpayer receives a double benefit of initial risk-shifting and an exclusion from gross income simply from the “simple fortuity that he hired counsel on a contingent basis.”⁴³ This benefit is in addition to the fact that the attorney never really has full control of the contingent fee.⁴⁴

Thus, the analysis of the majority followed more from unwillingness to distinguish *Cotnam* than from a logical and practical analysis of the inclusion of contingency fees in a litigant taxpayer’s gross income. The majority itself admitted that if it were to analyze *Srivastava* as an original case, it would include the contingency fees in gross income.⁴⁵ Because of the circuit split, the issues involved in this case are ripe for Supreme Court review.⁴⁶ This case is also key because if the contingent fees are included in gross income, the taxpayer may deduct the fees, but only to the extent that they exceed two percent of gross income.⁴⁷ The court should have treated the contingency fee as part of the entire settlement, payable to the attorney after the fee had been taxed as gross income to the litigant taxpayer.

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

43. *Id.*

44. *Id.* at 369.

45. *Id.* at 363. See also Deborah A. Geier, *Letters to the Editor: Attorney’s Fees Debate Continues*, 88 TAX NOTES 827 (Aug. 7, 2000).

46. *Whipsaw on Lawsuit Settlements: The Courts Still Can’t Agree*, 93 J. TAX’N 188 (Sept. 2000); see also TIMOTHY R. KOSKI, *Contingent Fee Paid to Attorney Can Be Income to Client*, 65 PRAC. TAX STRATEGIES 166, 169 (Sept. 2000).

47. *Srivastava*, 220 F.3d at 357 n.7 (quoting 26 U.S.C. § 67(a) (1994)). In addition, the contingent fees are not deductible for purposes of the alternative minimum tax. I.R.C. § 56(b)(1)(A)(i).

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