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ILIR MUJALOVIC

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ILIR MUJALOVIC*

I. INTRODUCTION

Imagine that you are sixty years old and enter into an employment contract with your employer. The contract requires you to perform the duties of the Executive Vice President of the company until you reach the age of seventy. Four years later, when you are sixty-four years old, your employer suddenly terminates your employment. You now have no job, no income, and most importantly, none of the retirement benefits that were promised to you. Your economic security has been shattered.

Angered by your early termination, you decide to sue your employer for wrongful discharge. When confronted, your employer believes that you have a plausible case and offers an immediate payment of $250,000 for breach of the employment contract. In addition, the settlement agreement with your employer entitles you to receive payments totaling $70,000 per year continuing for the duration of your life. News of the settlement gives you great relief. You feel that your rights have been vindicated and your economic security has been restored.

Shortly after the settlement, you receive a $245,000 invoice from your attorney for the legal work performed. The contingent fee agreement entitled the attorney to the full and immediate payment of the legal fees without regard to your award collection schedule. As a result, after subtracting the $245,000 fee from the $250,000 breach of contract award, your current year cash award shrinks to only $5,000.

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The time comes to file your income tax return for the year. In arriving at your adjusted gross income[1], you include the $250,000 award in your gross income, and you claim an "above the line"[2] deduction for the $245,000 legal fees paid. Although you believe this income tax treatment of the award and the legal fees paid is in accordance with the Internal Revenue Code ("IRC"), the Commissioner of the Internal Revenue Service ("Commissioner") disagrees. Upon audit, the Commissioner states that the amount paid for the legal fees can only be deducted as a miscellaneous itemized deduction[3] (a "below the line" deduction). As such, although the fee expense deduction reduces your "regular" taxable income almost dollar for dollar, it is completely disallowed in determining your alternative minimum tax ("AMT") liability.[4]

The AMT, you learn, is an alternative method for calculating income tax liability for certain taxpayers whose adjusted gross income exceeds a specific threshold amount, currently $175,000.[5] Including the $250,000 award in your gross income increases your adjusted gross income beyond the threshold amount and, therefore, you are subject to the AMT. Although you have no regular tax liability, your AMT liability is $57,000. You will probably have to borrow this money to pay your taxes. Because of the AMT, the $250,000 cash award leaves you with a net current year liability of $52,000. While this result may seem odd and unfair, it is not a hy-

1. Adjusted gross income is defined in Section 62 of the Internal Revenue Code as gross income minus specific deductions listed in that Section. Usually, only business expenses are deductible to arrive at adjusted gross income. Deductions for personal and dependency exemptions, as well as standard or itemized deductions are subtracted from adjusted gross income to arrive at taxable income. Expenses that are deductible to arrive at adjusted gross income are known as "above the line" deductions; deductions that are subtracted from adjusted gross income to arrive at taxable income are known as "below the line" deductions. *See* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 21-25 (4th ed. 2001).

2. *See supra* note 1 for definition of "above the line" and "below the line" deductions.

3. *See* I.R.C. § 67(b) (2000); *see also* text accompanying notes 53-57 for a fuller discussion of the miscellaneous itemized deductions.

4. *See* I.R.C. § 56(b)(1)(A)(i) (2000). Miscellaneous itemized deductions are disallowed in computing taxpayer's AMT liability; *see also* text accompanying notes 71-72 (discussing reasons Congress enacted the AMT).

5. *See* I.R.C. § 55(b)(1)(A)(i)(I, II) (2000). In the case of a married individual filing a separate return the current threshold amount is $87,500. *See* I.R.C. § 55(b)(1)(A)(iii).

pothetical problem. The situation outlined here is based on the facts of *Alexander v. Commissioner.*[6]

The extreme result in *Alexander*, brought on also by the timing issue—the bulk of the award is to be received in the future but the legal fees are paid in the first year—nonetheless illustrates a common problem that plaintiffs face regarding the income tax treatment of the attorney fee expenses in contingent fee lawsuits. Because the majority of the courts have held that cases like *Alexander* were correctly decided, plaintiffs who recovered damages have tried to avoid the harsh results of the AMT by claiming that portion of the recovery that is paid to or retained by their attorney is excludable from gross income. When accepted, this argument eliminates the problem of treating attorney fee expenses as miscellaneous itemized deductions that leads to their non-deductibility for AMT purposes. Some courts, although a minority, have supported this result.

This Note argues that although the application of the AMT, as in *Alexander*, leads to highly inequitable results, the current state of the law requires that the entire amount of taxable damages – including the portion paid to or retained by the attorney as a contingent fee – must be included in plaintiff's gross income. To claim otherwise violates the basic principle of taxation that income should be taxed to the one who earned it. However, in view of the unfairness the AMT application creates and because the AMT "problem" extends beyond contingent fee cases (i.e., plaintiffs that hire hourly fee attorneys face the same result) a prompt legislative action is required to resolve the issue.

Part II of this Note reviews the concept of gross income as it developed from the inception of the modern IRC. This part further considers the doctrine of assignment of income to determine whether the amount claimed as attorney fees in contingent fee lawsuits should be included in a plaintiff's gross income. The purpose of this doctrine is to prevent deflection of income from taxpayers in higher tax brackets to taxpayers in lower tax brackets. This section also discusses various deductions from gross income to explain the

6. 72 F.3d 938 (1st Cir. 1995). In *Alexander*, the plaintiff also received $100,000 for the age discrimination claim. However, at that time the payment was excludable from gross income.

proper income tax treatment of contingent legal fees paid by winning plaintiffs. It is important to classify the deductions because all categories of deductions are not treated the same under the IRC. Certain deductions, as noted above, are disallowed in calculating the AMT, which leads to results like those seen in *Alexander*.

Part III focuses on the specific issue of this Note whether the amount of the recovery paid as attorney's contingent fees, when damages are taxable, should be included or excluded from a plaintiff's gross income. This part also reviews the positions the circuit courts and the tax court have taken regarding the issue.

Part IV examines the strengths and weaknesses of the various approaches taken by the circuit courts and provides a proposed legislative solution for resolving the existing split among the circuit courts.

Finally, Part V summarizes the previous discussion and reemphasizes the inequitable results reached by the AMT application.

II. Overview of the General Principles of Gross Income

A. *The Concept of Gross Income*

Section 61 of the IRC defines gross income as "all income from whatever source derived."[7] Courts have generally construed this section very broadly in accordance with Congress' intent to tax income comprehensively.[8] As early as 1920, in *Eisner v. Macomber*, the United States Supreme Court wrestled with the definition of income.[9] In *Macomber*, the Court stated: "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets."[10]

This definition was clarified and expanded in 1955 in the case of *Commissioner v. Glenshaw Glass*, where the Court held that treble damages in an antitrust case should be included in gross income of

7. *See* I.R.C. § 61(a) (2000). This section also provides a nonexclusive list of items that are specifically included in income. Attorney's fees in a contingent fee lawsuit are not on this list.

8. *See* Thad Austin Davis, In memoriam: Frank M. Johnson, Jr.: *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, 1691 (2000).

9. Eisner v. Macomber, 252 U.S. 189 (1920).

10. *Id.* at 207.

the plaintiff.[11] The Court stated that "the definition in *Macomber* was not meant to provide a touchstone to all future gross income questions."[12] It further explained that "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature."[13] The Court liberally construed this broad definition, recognizing the intent of Congress to tax all gains except those specifically exempted.[14] More importantly, the Court developed a three-prong test for determining gross income. The Court stated that taxpayers have gross income in cases where they have "[1] undeniable accessions to wealth, [2] clearly realized, and [3] over which taxpayers have complete dominion."[15] The receipt of the punitive portion of damages in *Glenshaw Glass* satisfied all three prongs of this test, and in the absence of a specific exemption in the IRC, the Court held that punitive damages should be included in the recipient's gross income.[16] The *Glenshaw Glass* rule to determine whether certain payments should be included or excluded from gross income, has survived the test of time and still provides a guide that courts use to decide what constitutes gross income.[17]

B. *Principles of Assignment of Income*

In examining tax liability courts cannot focus only on what constitutes gross income. They must also determine who the taxpayer should be and to whom the gross income belongs.[18] According to the doctrine of assignment of income, income should be taxed to the one who earned it. This doctrine prevents deflection of income from a taxpayer in a higher tax-bracket to a taxpayer in a

11. Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955).
12. *Id.* at 431.
13. *Glenshaw Glass,* 348 U.S. at 429,430.
14. *Id.* at 429,430. The Court further rejected the respondents' narrow characterization of income in *Macomber* as "the gain derived from capital, from labor, or from both combined."
15. *Id.* at 431.
16. *Id.* at 432.
17. *See* Commissioner v. Schleier, 515 U.S. 323, 328 (1995) (finding that taxpayer's settlement award for back pay and liquidated damages under the Age Discrimination in Employment Act of 1967 was includable in gross income); Commissioner v. Kowalski, 434 U.S. 77, 83 (1977) (finding that cash meal allowances given to the taxpayer from his employer were includible in gross income and not subject to exclusion under § 119 of the IRC).
18. *See* GRAETZ, *supra* note 1, at 87.

lower tax-bracket. It is best understood by comparing the tax treatment of income received from different sources, such as income received for services performed and income received from property.

1. Income Received For Services Performed

In *Lucas v. Earl,* Justice Holmes developed a touchstone for the assignment of income doctrine.[19] The issue in the case was whether Earl, an attorney, should be taxed on the entire amount of the fees collected for services he performed, or whether half of the fees should be taxed to his wife because of their joint tenancy agreement.[20] Earl and his wife signed a contract to jointly own all property they acquired during marriage, including all earnings in the form of salaries and fees.[21] The Court rejected Earl's argument that the joint tenancy agreement made half of the fees earned by him his wife's income for tax purposes.[22] It stated that "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 the man who earned it."[23] Consequently, even though the contract was valid as a matter of state property and contract law, for income tax purposes, it was ineffective in transferring the income from Earl, who earned it, to his wife.[24]

In *Armantrout v. Commissioner*, the Tax Court followed the reasoning of *Lucas*.[25] The employer in *Armantrout* funded an "Educo" trust for children of certain key employees to pay for their college expenses.[26] According to the court, payments made to the trust for the benefit of the employees' children had a "substantial compensatory flavor" with regard to the parents-employees.[27] For this reason, the Tax Court applied the *Lucas*' doctrine of assignment of income concluding that "the anticipatory arrangements designed to deflect

19. Lucas v. Earl, 281 U.S. 111 (1930).
20. *Id.* at 113.
21. *Id.* at 113-114.
22. *Id.* at 113.
23. *See Lucas*, 281 U.S. at 114-115.
24. *Id.* at 114.
25. *See* Armantrout v. Commissioner, 67 T.C. 996, *aff'd.*, 570 F.2d 210 (7th Cir. 1978).
26. *See Armantrout,* 67 T.C. at 998.
27. *Id.* at 1007.

income away from the proper taxpayer will not be given effect to avoid tax liability."[28] The real substance of the transaction was to allow the transfer of a portion of the employees' earnings to their children as a qualified tax-free scholarship.[29] But for the parents' performing services, no trust for the children would have been established and no scholarships would have been paid; therefore, the income belonged to the parents.

2. Income Received From Property

As *Lucas* and *Armantrout* hold, income paid as compensation for services is generally taxed to the one who performed the services.[30] On the other hand, income derived from property is generally taxed to the one who owned the property at the time the income was received. Once the owner of property parts with his ownership interest in the income-producing property, the income produced by the property is generally taxed to the transferee of the property.

In *Blair v. Commissioner*,[31] Blair, a beneficiary of a testamentary trust, permanently assigned a portion of his income interest in the trust to his children.[32] As a result of the assignment, the trustee distributed the income directly to the children.[33] The Commissioner ruled that the transaction was an invalid assignment of income, and therefore the income should be taxed to the father.[34] The Court of Appeals for the Seventh Circuit agreed with the Commissioner and held that the income was taxable to the father upon the ground that "his interest was not attached to the corpus of the estate and that the income was not subject to disposition until he received it."[35] Accordingly, the court concluded that the "income was [the father's] and his assignment [to the children] was merely a direction to pay over to others what was due to himself."[36]

28. *Armantrout*, 67 T.C. at 1005.
29. *See Armantrout*, 67 T.C. at 1005.
30. *See Lucas*, 281 U.S. at 114; *see also Armantrout*, 67 T.C. at 1003.
31. 300 U.S. 5 (1937).
32. *Id.* at 7.
33. *Id.*
34. *Id.*
35. *Id.* at 8; *see also* Commissioner v. Blair, 83 F.2d 655, 662 (7th Cir. 1936).
36. *See Blair*, 300 U.S. at 12.

The Supreme Court reversed the judgment of the Seventh Circuit[37] and held that "the conveyancer was not seeking to limit the assignment so as to make it anything less than a complete transfer of the specified interest."[38] The trust agreement entitled the transferee, the father, during his life, to the net income of the property held in trust.[39] The father thus became the owner of "an equitable interest in the corpus of the property,"[40] and was entitled to enforce the trust.[41] The interest was "present property alienable like any other, in the absence of a valid restraint upon alienation."[42] The Court held that the assignments were valid, and the father could thus transfer a part of the interest as well as the whole.[43] Consequently, a gift of the property interest shifted the income from the property from the father to the children.

Helvering v. Horst involved a similar issue.[44] In *Horst*, the respondent, a father, owned a number of negotiable bonds from which he removed the interest coupons and delivered them to his son as a gift, who collected the interest at maturity.[45] The Court of Appeals for the Second Circuit held for the father and stated that "[w]hen the [father] detached the coupons and handed them over to his son as a gift, the son acquired full [. . .] dominion. The [father] could not interfere in any way with the donee's control and right to receive the money when the coupons matured."[46] As a result, the income belonged to the son.[47]

The Supreme Court reversed *Horst*, relying on the reasoning set forth in *Blair*.[48] The Court distinguished the facts of this case from *Blair*, by focusing on the fact that in *Blair* the father gave a portion of his entire income-producing property to his children, whereas in *Horst*, the donor, the father, retained control of the in-

37. *Blair*, 300 U.S. at 14.
38. *Id.* at 13.
39. *Id.*
40. *Id.*
41. *See Blair*, 300 U.S. at 13.
42. *Id.*
43. *Id.*
44. Helvering v. Horst, 311 U.S. 112 (1940).
45. *Id.* at 114.
46. *See* Helvering v. Horst, 107 F.2d 906, 907 (2d Cir. 1939).
47. *Id.*
48. *Id.* at 119.

come-producing bond, and he merely parted with the right to receive some of the interest payment.[49] The Court noted that "where the donor retains control of the property the income is taxable to him although he paid it to the donee."[50] The Court explained that the "dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit when paid."[51] Therefore, the Court held that the income was taxable to the respondent, the father, because he merely parted with the interest coupons and never relinquished control over the source of income to his son.[52]

C. *Section 162 and Section 212 Deductions and the Origin of the Claim Doctrine*

In addition to determining what constitutes gross income and to whom the income belongs, federal tax law defines the deductions that are allowed in determining taxable income. Although the Supreme Court and Congress have defined gross income broadly to include "all income from whatever source derived,"[53] the same has not been true for deductions. Only those expenses specified in the IRC are deductible in determining taxable income.

There are generally two instances where plaintiffs may deduct the amount of their attorney's contingent fees from their gross income.[54] First, Section 162 (a) of the IRC provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[55] For a self-employed individual or a sole proprietor, carrying on a trade or business, expenses falling within Section 162 (a) are deductible from gross income to arrive at individual taxpayer's adjusted gross income.[56] Attorney's fees paid

49. *Horst*, 311 U.S. at 119.

50. *See Horst*, 311 U.S. at 119.

51. *See Horst*, 311 U.S. at 119.

52. Congress has changed the outcome in *Horst*, but *Horst* is still cited for its doctrine; *see also* I.R.C. § 1286 (2000).

53. *See* text accompanying notes 7-17 for a fuller discussion of gross income.

54. It is worth noting that attorney's fees are deductible only if the damages are taxable. If a client is awarded damages that are excludible from gross income then no portion of the attorney's fees are deductible.

55. *See* I.R.C. § 162(a) (2000).

56. *See id.* at § 62(a)(1) (2000).

by such a taxpayer to further his or her trade or business may be deductible under Section 162. However, Section 62 (a)(1) makes it clear that if the "trade or business" of the taxpayer consists of the performance of services by the taxpayer as an "employee," then Section 162 deductions are not allowed to reduce taxpayer's gross income to arrive at his or her adjusted gross income.[57] Instead, they are treated as miscellaneous itemized deductions and are subject to many statutory restrictions. But most significantly, Section 162 deductions for miscellaneous expenses are disallowed completely in determining the AMT liability.[58] Thus, when the Tax Court in *Alexander* held that attorney contingent fees paid by the plaintiff to recover damages for breach of the employment contract were an "unreimbursed employee business expense,"[59] Alexander was compelled to treat those expenses as miscellaneous itemized deductions,[60] and was exposed to the AMT on the entire amount of this expense. As a result, the entire deduction for the legal fees paid was disallowed.

The second opportunity for plaintiffs-taxpayers to deduct attorney's contingent fees arises from Section 212 of the IRC.[61] According to this Section, an individual shall be allowed to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income."[62] This Section permits taxpayers to deduct "ordinary and necessary" expenses incurred in income-producing activities that do not qualify as a

57. *See* I.R.C. § 62(a)(1) (2000). Moreover, it is well established that an individual may be engaged in the trade or business of rendering services as an employee.

58. *See id.* at §§ 67(b), 56 (b)(1)(A)(i).

59. The IRC distinguishes between "reimbursed" and "unreimbursed" employee expenses. Unreimbursed employee expenses are incurred by an employee in the course of his employment for which the employer provides no reimbursment. They are deductible from gross income as miscellaneous itemized deductions and completely disallowed for AMT purposes. Reimbursed expenses consist of expenses paid or incurred by the taxpayer-employee in the course of the employment, "under a reimbursment or other expense allowance arrangement with his employer." Reimbursed employee expenses are fully deductible under both the regular income tax and the AMT. *See id.* at § 62(a)(1)-(2).

60. Section 67(b) of the IRC defines miscellaneous itemized deductions as deductions that are not specifically listed in Section 67(b). Because unreimbursed employee expenses are not included in Section 67(b) they are treated as miscellaneous itemized deductions.

61. *See id.* at § 212(1).

62. *Id.*

trade or business.[63] When a taxpayer incurs expenses in generating gross income in an activity that does not qualify as a trade or business, usually an investment activity, the expenses are generally deductible as miscellaneous itemized deductions.[64] For example, legal fees incurred to collect accrued rents on a property held for investment purposes are deductible under Section 212. However, Section 212 expenses—similar to Section 162 expenses—are not deductible in determining taxpayer's AMT liability because they are classified as miscellaneous itemized deductions.[65]

Even if a court finds that the legal fees were incurred in "carrying on any trade or business," or "in the production or collection of income," as Sections 162 or 212 require, the deductions for legal fees may still be disallowed based on the "origin of the claim" doctrine. This doctrine is used to distinguish nondeductible personal expenses from deductible profit-seeking expenses. In *United States v. Gilmore*,[66] the United States Supreme Court explained the origin of the claim doctrine stating that deductibility of expenses from gross income "turns wholly upon the nature of the activities to

63. *See* GRAETZ, *supra* note 1, at 216.

64. Section 212 deductions are not on the list provided in section 67(b) and, therefore, they are treated as miscellaneous itemized deductions, subject to all the statutory limitations. There is an exception, however, for deductions with regard to rents and royalties; they are not treated as miscellaneous itemized deductions and are deductible from gross income under Section 62(a)(4). *See* GRAETZ, *supra* note 1, at 216; *see also* I.R.C. § 62(a)(4) (2000).

65. In addition to the above limitations, there is an important caveat that applies to Section 212 deductions. They are subject to three special rules. First, as previously noted, legal fees paid when deductible under Section 212 are treated as miscellaneous itemized deductions. The IRC allows miscellaneous itemized deductions only to the extent that they exceed two percent of the taxpayer's adjusted gross income. Consequently, it is almost always certain that a taxpayer will not be able to deduct one hundred percent of the legal fees paid, unless his or her adjusted gross income is zero or negative. In addition, if the legal fees paid are less than two percent of a taxpayer's adjusted gross income then the deduction is completely disallowed. Second, according to Section 68(a) of the IRC, miscellaneous itemized deductions are subject to a limitation when a taxpayer's adjusted gross income exceeds a specific threshold amount, which is adjusted every year for inflation. Finally, as stated previously, Section 56 of the IRC requires that attorney's fees, when deducted as miscellaneous itemized deductions subject to the two percent limitation for "regular" tax purposes, must be added back to gross income when computing the taxpayer's AMT liability. Therefore, deductions for attorney fees paid are allowed for "regular" tax purposes, but are disallowed when calculating taxpayer's AMT liability.

66. 372 U.S. 39 (1963).

which they relate."[67] If a taxpayer recovers an award that is personal in nature, such as an award relating to defamation of character or emotional distress, then the legal fees incurred in the process of recovery are not deductible. If a plaintiff, however, incurred legal fees in the recovery of an award relating to a profit-seeking activity, such as in collection of back pay or lost wages, then the legal fees would be deductible from gross income. In *Gilmore*, the taxpayer deducted the amount of legal fees incurred to defend against his wife's claim in a divorce proceeding where she claimed that certain assets belonged to her under the California community property law.[68] The Court reversed the lower court and held that the legal fees paid were not deductible business expenses because "[the] aspects of the wife's claims stemmed entirely from the marital relationship, and not, under any tenable view of things, from income-producing activity."[69] The Court emphasized that "the characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities."[70]

D. *Principles of Alternative Minimum Tax*

According to a 1987 report from the Staff of the Joint Committee on Taxation:

> [T]he [alternative] minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. . . . The ability of high-income taxpayers to pay little or no tax undermines respect for the entire system and, thus, for the incentive provisions themselves.[71]

By enacting the AMT, Congress attempted to broaden the general tax base because the AMT is applicable to all taxpayers regardless of their ability to eliminate regular tax liability.[72] This alternative mea-

67. *Gilmore*, 372 U.S. at 46.

68. *Id.* at 40.

69. *Id.* at 51.

70. *See id.* at 48 (emphasis in original).

71. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 429 (Comm. Print 1987).

72. *See* GRAETZ, *supra* note 1, at 853.

sure of income is designed to capture the real economics of taxpayer's income, especially in circumstances where taxpayers through various statutory deductions and exclusions are able to reduce their regular tax liability below their equitable share. When taxpayer's AMT liability is greater than the regular tax liability the taxpayer must pay the greater amount.

Although the AMT's overriding purpose to achieve fairness is laudable, it leads to inequitable and no doubt unintended results in cases such as *Alexander*. When a plaintiff receives a taxable award in an employment related case that brings his or her adjusted gross income above the AMT threshold, contingent legal fees that he or she paid reduce the real economic income. However, because of the AMT, the deduction for the legal fees paid is completely disallowed. For such plaintiffs, the combination of nondeductible legal fees paid plus taxes on the entire damages award, including the attorney's portion of the recovery, can reduce most of the award, or as in *Alexander* the taxpayer could end up with an after-tax loss. As a result, the plaintiff's economic position is overstated because the entire recovery of damages is included in gross income and the deduction for legal fees paid is disallowed for AMT purposes. The inequitable results of the AMT effectively turn the income tax into a gross receipts tax for the plaintiff.

III. THE CIRCUIT COURT SPLIT AND THE SPECIFIC CASES

Taxpayers-plaintiffs have attempted to avoid the inequitable results of the AMT in situations like *Alexander*, by arguing that the amount of their attorney's contingent fees should be excluded from their gross income because it belongs to their attorney. They strive to escape the application of AMT by treating the amount of legal fees paid as an exclusion from gross income, rather than a miscellaneous itemized deduction.[73]

The federal circuit courts are split as to whether plaintiffs in contingent fee lawsuits must include the attorney's share of taxable

73. Stated differently, plaintiffs attempt to characterize the deduction for legal fees paid as "above the line," rather than "below the line." "Above the line" deductions are not treated as miscellaneous itemized deductions, which are not deductible in determining the AMT liability. *See also* Kenseth v. Commissioner, 259 F.3d 881, 883 (7th Cir. 2001) (stating that plaintiffs attempt to treat the amount paid for legal fees in contingent lawsuits as a "reduction" and not a "deduction" from gross income).

damages in their gross income.[74] The majority of the circuits include the attorney's portion of the award in the plaintiff's gross income.[75] The most frequent rationale provided for this holding is that the attorney's contingent fee is a deduction from, and not a reduction of, gross income.[76] Therefore, the plaintiff must include the total award in his gross income and may be able to take a miscellaneous itemized deduction for the amount of the legal fees paid.

A vocal minority takes the opposite view and excludes the attorney's contingent fees from the plaintiff's gross income on the ground that that portion of the award belongs to the attorney from the outset of the litigation.[77] Under this view, the attorney becomes a part owner of the claim, with an equitable lien in the amount of damages received by the client-plaintiff.[78] As a part owner, the income represented by the contingent fee belongs to the attorney and not the client.

A. *The Majority of Circuits Include the Amount of Contingent Fees in the Client's Gross Income*

1. The Seventh Circuit Approach

In 2001, the Court of Appeals for the Seventh Circuit dealt with the tax treatment of attorney contingent fees in the case of *Kenseth v. Commissioner*.[79] Kenseth brought an age discrimination suit against his former employer.[80] After negotiations, the parties settled the case for approximately $230,000 of which Kenseth actually received only 60% or $106,000. The other 40%, or $92,000, was remitted directly to his attorneys pursuant to a contingent fee contract.[81] Of the entire settlement amount, approximately $32,500 was paid to Kenseth for lost wages and back pay.[82]

74. *See Kenseth*, at 883.
75. *Kenseth*, 259 F.3d at 883; *compare Cotnam supra* note 142; *Srivastava supra* note 158; *Clarks supra* note 173; *Davis supra* note 193;
76. *Id.*
77. *See* Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959).
78. *Id.*
79. 259 F.3d 881.
80. *Id.* at 882.
81. *Id.*
82. Kenseth v. C.I.R., 114 T.C. 399, 404 (2000).

In reporting his income for the year, Kenseth only included the amount of the back pay, excluding the amount of the attorney's contingent fees paid.[83] Kenseth did not claim a deduction for the attorney's fees paid.[84] The Commissioner issued a deficiency, and increased his gross income by the amount of the attorney's fees that he had omitted.[85] Thrown into the AMT by the resulting increase in his adjusted gross income, Kenseth's tax liability increased by approximately $17,000.[86] Kenseth challenged the deficiency, and the case proceeded in the United States Tax Court.[87]

The Tax Court ruled for the Commissioner, and held that Kenseth must include the entire amount of taxable damages in his gross income.[88] The court also stated that the amount Kenseth paid to the attorney is deductible from gross income under Section 162 for purposes of regular tax liability although not for AMT purposes.[89] Dissatisfied with the outcome, Kenseth appealed to the Seventh Circuit. Judge Posner, writing for the majority of the court, agreed with the reasoning of the Tax Court and affirmed its decision.[90] Judge Posner's analysis began by stating that the circuits are split over whether the amount paid as a contingent fee to attorneys when damages are taxable is part of a client's-plaintiff's gross income.[91] In discussing the issue, he found it puzzling that some circuits, such as the Fifth, Sixth and Eleventh, treat attorney fees in hourly fee contracts and contingent fee contracts differently.[92] He rejected Kenseth's argument that contingent fee attorneys receive a proprietary interest in the client's cause of action. He stated that although the Wisconsin law gives contingent fee attorneys a lien or a security interest in the client's claim, the ownership of a security interest or a lien on the claim is not ownership of such security.[93]

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83. *Kenseth*, 114 T.C. at 405.

84. *Id.*

85. *Id.*

86. *Id.*

87. *See Kenseth*, 114 T.C. at 399.

88. *Id.* at 417.

89. *Id.*

90. *See Kenseth*, 259 F.3d at 883. Judge Posner's reputation and expertise in law and economics grants additional weight to the *Kenseth* decision.

91. *Id.*

92. *Id.*

93. *Id.*

Furthermore, he explained it would be a violation of lawyer's ethical standards to acquire "a proprietary interest in the cause of action or subject matter litigation the lawyer is conducting for the client."[94] Therefore, according to Wisconsin law, an attorney can only obtain a lien or enter into a contingent fee contract, and neither option gives lawyers a proprietary interest in a client's cause of action.[95]

The court also rejected Kenseth's argument that he relinquished control over his income-producing asset – i.e., the age discrimination claim.[96] The court again compared the contingent fee contract with an hourly fee contract and stated that Kenseth no more relinquished control of his claim to his contingent fee lawyer than he would have relinquished control to an hourly fee lawyer.[97] Kenseth had control over his claim because Kenseth could fire the contingent fee lawyer at any time just as he could fire an hourly fee lawyer.[98]

Kenseth also raised the argument that the AMT creates grave inequities because it denied him the opportunity to deduct the amount of the expenses "reasonably incurred for the production of income."[99] In response, the court strongly stated that "it is not a feasible judicial undertaking to achieve global equity in taxation,"[100] especially in this case where means of eliminating one inequity would create another one, that is, create an "artificial a[nd] purely tax-motivated, incentive to substitute contingent [fee attorneys] for hourly fee [attorneys]."[101] The court affirmed the ruling of the Tax Court and held that the entire amount of the attorney's contingent fee must be included in Kenseth's gross income.[102]

94. *Kenseth*, 259 F.3d at 883.

95. *Id.* at 883, 884.

96. *See Kenseth*, 259 F.3d at 884.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.* at 885.

101. See *Kenseth*, 259 F.3d at 884. The inequity would be greater because plaintiffs that hire hourly fee attorneys would still face the harsh results of the AMT, and similarly situated plaintiffs-taxpayers would not be treated equally.

102. *Id.* at 883.

2. The Federal Circuit Approach

In the 1995 case of *Baylin v. United States*, Baylin, a tax matter partner for a partnership, filed suit on behalf of the partnership against the state of Maryland for land condemnation.[103] After the jury increased the original condemnation award by only $1.2 million, the partnership entered into a contingent fee agreement with its attorney to appeal the jury's verdict.[104] Following further negotiations, the parties settled for approximately $16.3 million.[105] Attorney's fees amounted to approximately $4 million.[106] One of the issues on appeal was whether the partnership should include in its gross income the amount of the attorney's contingent fees paid.[107]

The court relied on substance over form and stated that the partnership clearly received the benefit of the funds because the funds served to discharge the obligation of the partnership to pay the attorney.[108] The court also noted: "[the fact] that the partnership assigned a portion of its condemnation recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership."[109] The fact that the fee was not fixed, and the state paid a portion of the settlement amount directly to the attorney "cannot dictate the income tax treatment of those fees."[110] Therefore, the court concluded that attorney's fees should be included in the partnership's gross income.

3. The First and the Fourth Circuit Approaches

In 2001, the Court of Appeals for the Fourth Circuit considered the issue in *Young v. Commissioner*.[111] The taxpayer's liability to her attorneys, in the amount of approximately $300,000, was discharged when her spouse transferred land to the taxpayer in pursu-

103. Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.* at 1454.
108. *See Baylin*, 43 F.3d at 1454.
109. *Id.* at 1455.
110. *Id.*
111. 240 F.3d 369 (4th Cir. 2001).

ance of a settlement agreement.[112] The taxpayer sold the land and used a part of the amount realized to pay her attorneys who helped her collect the settlement amount. The Tax Court found that the amount of sales proceeds used to discharge her obligation for legal fees paid to her attorneys should have been included in her gross income.[113]

The Fourth Circuit agreed with the Tax Court.[114] The court cited *Lucas*, and stated: "to allow Mrs. Young to escape income taxation from discharge of her legal obligation would be equivalent to permitting her to avoid taxation by 'skillfully devising' the method of paying her attorneys' fees."[115] The court rejected the reasoning of *Cotnam v. Commissioner*,[116] and noted that a contingent fee agreement does not give attorneys an interest in a client's cause of action.[117] The common law of North Carolina gives attorneys a charging lien in the judgment but the lien does not attach to the client's cause of action.[118] As a result, "an attorney's right to [the] contingent fee matures at the same time the judgment is rendered or settlement achieved-i.e., when the client's income is earned."[119]

The Court of Appeals for the First Circuit considered the issue in *Alexander*.[120] The court held that the entire settlement award from a wrongful termination claim should be included in the client's gross income because the payments received were a substitute for lost wages and the benefits the taxpayer would have received under the employment contract.[121] The taxpayer in this case included the entire damages award in his gross income; thus, the court did not reach the issue of whether, in a contingent fee lawsuit, the amount attributable to attorney's fees should be excluded from gross income.[122] However, the court did find that legal fees in

112. *Young*, 240 F.3d at 372.
113. *Young*, 240 F.3d at 376.
114. *Id.* at 379.
115. *Id.* at 376.
116. 263 F.2d 119. *See supra* notes 142-172 for a full discussion of the *Cotnam* decision.
117. *Young*, 240 F.3d at 379.
118. *Id.*
119. *Id.*
120. *See supra* note 6.
121. *See Alexander*, 72 F.3d at 944.
122. *Id.* at 940.

this case should be treated as miscellaneous itemized deductions and, as such, subject to the rules of the AMT.[123]

4. The Ninth Circuit Approach

In 2000, the issue in *Coady v. Commissioner*[124] was whether the petitioner was entitled to exclude $168,000 from her gross income for contingent legal fees incurred in securing a judgment for lost wages against her employer. The Court of Appeals for the Ninth Circuit answered the question in the negative.[125] It first noted that the *Cotnam* decision had been subject to great disagreement between the circuit courts.[126] After examining various circuit court decisions, the court was persuaded by *Baylin*, *Alexander*, and Judge Wisdom's dissent in *Cotnam*.[127] Moreover, the court distinguished *Cotnam* because under Alaska law, attorneys do not have a superior lien or ownership interest in the cause of action as they do in Alabama and Michigan.[128] According to the Alaska statute, an attorney's lien attaches to property belonging to the client and it does not confer ownership interest.[129]

The court also looked at the origin of the claim doctrine to determine whether the amount of the attorney's fees should be included in the taxpayer's gross income.[130] It concluded that since the award was clearly in lieu of wages and compensation, there was no statutory or other basis for excluding the award from the taxpayer's gross income.[131]

In 2000, the Ninth Circuit addressed the issue again in *Benci-Woodward v. Commissioner*.[132] The court awarded petitioners, employees of Target Stores, punitive damages against a division of Target Stores for defamation.[133] The court, relying on *Coady*, rejected the petitioners argument that the amount of the attorneys' contin-

123. *Alexander*, 72 F.3d at 946.
124. 213 F.3d 1187 (9th Cir. 2000).
125. *Id.* at 1187.
126. *Id.* at 1189.
127. *Id.* at 1190.
128. *Id.*
129. *See Coady*, 213 F.3d at 1190.
130. *Id.*
131. *Id.*
132. 219 F.3d 941 (9th Cir. 2000).
133. *Id.* at 942.

gent fees incurred in the prosecution of the claim should be excluded from their gross income.[134] Since the case arose under California law, the court examined the California attorney lien statute.[135] The court held that the California lien statute did not operate to transfer ownership of a client's cause of action to the attorney.[136] It emphasized that the lien statute merely gave attorneys a lien upon a client's recovery. Thus, there was no basis for claiming that clients did not own the entire award in a contingent fee lawsuit.[137]

The Ninth Circuit recently reaffirmed *Coady* and *Benci-Woodward* in *Sinyard v. Commissioner*, over a strong dissent by Judge McKeown.[138] Judge McKeown was particularly concerned with harsh inequities that may result from the disallowance of the deduction for legal fees in determining the AMT.[139] Judge McKeown strongly stated that "the 'victorious' plaintiff would have been better off [. . .] [if] she had never filed her ultimately victorious suit."[140] However, the court declined to follow the *Cotnam* decision and held that, "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."[141]

B. *Circuits that Exclude Attorney's Contingent Fees from Client's Gross Income*

1. The Fifth Circuit Approach

The Court of Appeals for the Fifth Circuit first ruled on this issue in 1959 in *Cotnam v. Commissioner.*[142] In *Cotnam*, Mrs. Cotnam brought a claim for breach of contract against the administrator of

134. *Woodward*, 219 F.3d at 943.
135. *Benci-Woodward*, 219 F.3d at 943.
136. *Id.*
137. *Id. Benci-Woodward* decision is particularly important because it is one of the most recent cases regarding the tax treatment of contingent attorney fees to which the United States Supreme Court has denied *certiorari*. By allowing the decision to stand, one could imply that the Court agrees with the result.
138. Sinyard v. Commissioner, 268 F.3d 756 (9th Cir. 2001).
139. *Id.* at 762.
140. *Id* at 763. (McKeown, J., dissenting).
141. *See id* at 758. (citing Old Colony Trust Co. v. Commissioner, 279 U.S. 716,726 (1929)).
142. 263 F.2d 119.

the Estate of T. Shannon.[143] The Supreme Court of Alabama upheld the validity of the contract under which, the testator, Shannon Hunter, promised Mrs. Cotnam one-fifth of his estate in consideration for Mrs. Cotnam's services to him as an "attendant or friend for the rest of his life."[144] Mrs. Cotnam was awarded $120,000 for breach of contract and her attorney's contingent fees amounted to approximately $50,000.[145]

The issue in this case was whether or not the amount paid to the attorney from the judgment in favor of Mrs. Cotnam should be excluded from her gross income on the theory that the income belonged to her attorney.[146] The court answered the question affirmatively.[147] The court relied on the Alabama attorney's lien statute, which stated:

> Upon suits, judgments, and decrees for money, [attorneys at law] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.[148]

The court stated that this case did not involve assignment of income within the doctrine of assignment of income developed in *Lucas*.[149] Mrs. Cotnam's claim had no fair market value at the beginning of the lawsuit, and it was doubtful as to whether it ever had any value.[150] Therefore, the court stated "she assigned to her attorneys forty percent of the claim in order that she might collect the remaining sixty percent."[151] The court distinguished *Horst* by stating that the only economic benefit to the plaintiff-taxpayer was an

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143. *Cotnam*, 263 F.2d at 120.
144. *Cotnam*, 263 F.3d at 120.
145. *Id.*
146. *Id.* at 121.
147. *Id.*
148. Ala. Code § 64 (2000).
149. *See Cotnam*, 263 F.2d at 125.
150. *Id.*
151. *Id.*

aid to the collection of a part of an otherwise worthless claim.[152] Unlike *Horst*, the taxpayer had not "fully enjoyed the benefit of his [her] economic gain represented by his [her] right to receive income."[153] Therefore, the court observed that realistically the attorneys' contingent fees were not income to Mrs. Cotnam.[154] The court also rejected the argument that payment to the attorneys was a satisfaction of her legal obligation by a third party.[155] It noted that Mrs. Cotnam never obligated herself to pay the attorneys.[156] The fee was contingent upon the success of the litigation.[157]

Some forty-one years later, the court in *Srivastava v. Commissioner* followed *Cotnam.*[158] In this case, the petitioners, two medical doctors, sued a Texas television station for airing false and defamatory reports about the quality of the work they performed.[159] The jury awarded $29 million in damages to the doctors.[160] After the defendants appealed, the parties reached a settlement of $8.5 million.[161] The Commissioner challenged the doctors' claim that the amount paid as attorney's contingent fees should be excluded from their gross income.[162] The Commissioner issued a deficiency notice to the doctors in the amount of approximately $1.4 million.[163]

The Fifth Circuit, relying on *Cotnam*, ruled for the doctors.[164] The court acknowledged that attorney's fees in contingent fee lawsuits should not be treated differently than attorney's fees in noncontingent fee lawsuits.[165] Moreover, the court emphasized that the doctors "ought not receive preferential tax treatment from the simple fortuity that he [they] hired counsel on a contingent [fee]

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152. *Cotnam*, 263 F.2d at 125.
153. *Id* at 126.
154. *Cotnam*, 263 F.2d at 126.
155. *Id.*
156. *Id.*
157. *Id.*
158. Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000).
159. *Id.* at 355.
160. *Id.*
161. *Id.*
162. *Id.* at 356.
163. *Id.*
164. *Srivastava*, 220 F.3d at 357.
165. *Id.* It is worth noting that had the doctors chosen an hourly fee agreement in lieu of a contingent fee agreement then clearly the entire amount of the award would have been included in their gross income.

basis."[166] It stated that the "form of attorney's compensation should not affect the gain petitioners enjoy from a favorable resolution of the litigation."[167]

The court, however, refused to distinguish *Cotnam* from the case before it.[168] It rejected the Commissioner's distinction that Texas law gives contingent fee attorneys a lesser degree of power to enforce their rights than does Alabama.[169] The court stated that whether the amount of the attorney's contingent fees should be included in a client's gross income should not depend "on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state."[170] The court saw the Commissioner's attempt to distinguish *Cotnam* as a pretext to directly challenge the *Cotnam* reasoning, which the court was bound by.[171] The court refused to overrule *Cotnam.*[172]

2. The Sixth Circuit Approach

In 2000, the Court of Appeals for the Sixth Circuit confronted the issue of the tax treatment of attorney's contingent fees in *Estate of Clarks v. United States.*[173] In *Clarks*, the decedent, prior to his death, was awarded $5.6 million against K-Mart for personal injuries suffered while unloading his truck.[174] K-Mart paid the decedent $5.6 million to satisfy the judgment and approximately $5.7 million in interest.[175] Attorneys' contingent fees amounted to approximately $3.8 million of the total award of nearly $11.3 million, which also included approximately $1.9 of the interest award.[176]

The sole issue on appeal was whether the $1.9 million interest portion paid to the attorneys should be included in the decedent's gross income.[177] The amount of damages received on account of

166. *Srivastava*, 220 F.3d at 363.
167. *Id.*
168. *Srivastava*, 220 F.3d at 357.
169. *Id.* at 363.
170. *Id.* at 364.
171. *Srivastava*, 220 F.3d at 365.
172. *Id.*
173. 202 F.3d 854 (6th Cir. 2000).
174. *Id.* at 855.
175. *Id.*
176. *Id.*
177. *Id.*

personal physical injuries was not an issue because it was specifically excluded from gross income by the IRC.[178] The court held that the interest portion paid to the attorneys should not be included in the client's gross income.[179] The court relied heavily on *Cotnam* and treated the $3.8 million as income of the attorneys only, noting that the attorneys' common law lien in this case was similar to the attorney's lien in the Alabama *Cotnam* case.[180] The court was satisfied that "[a]lthough the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment."[181] The court reinforced its holding by citing to the old Michigan Supreme Court decision *Dreiband v. Candler*,[182] which stated that, "the [contingent fee] amounts to an assignment [to the attorney] of a portion of the judgment sought to be recovered."[183]

The court distinguished *Lucas* and *Horst* on three grounds. First, the court stated that the taxpayer's purpose of shifting tax liability was not present in this case, unlike *Lucas* and *Horst* where the court found that the transfer of income was motivated by lowering the transferor's tax liability.[184] Second, in *Lucas* and *Horst* the income was already earned prior to the assignment of income.[185] In contrast, in *Clarks*, "there was no res, no fund, no proceeds, no vested interest, [prior to the assignment] only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury."[186] Finally, in *Lucas* and *Horst*, the transfers were treated as gifts and the donees were not taxed on the value of the property transfer.[187] In *Clarks*, however, the attorney did not escape taxation.[188] He was taxed fully on his portion of the award.[189] The transaction in this case was more like a division

178. *See* I.R.C. § 104(a)(2) (2000).
179. *See Clarks*, 202 F.3d at 856.
180. *Id.*
181. *Id.* at 857.
182. 166 Mich. 49,131 (1911).
183. *See Clarks*, 202 F.3d at 856.
184. *Id.* at 857.
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Clarks*, 202 F.3d at 857.

of property than an assignment of income.[190] The court treated the attorney and the client as if they were tenants in common with respect to the claim.[191] It concluded that "[t]he income should be charged to the one who earned it and received it, not . . .. to one who neither received it nor earned it."[192]

3. The Eleventh Circuit Approach

The issue in *Davis v. Commissioner*[193] was whether the portion of the judgment paid directly to the client's attorney in a contingent fee lawsuit should be included in the client's gross income. After winning a lawsuit against her mortgage company, the respondent, Mrs. Davis, was awarded $6 million in punitive damages and approximately $151,000 in compensatory damages.[194] Initially, Mrs. Davis did not report any amount of the award on her 1992 tax return.[195] However, upon audit, the Commissioner determined that the entire punitive award should have been included in her gross income for that year.[196] Upon petition by Mrs. Davis, the Tax Court held that although punitive damages were correctly included in Mrs. Davis' income, the amount paid to her attorneys, under the contingent fee agreement, was not taxable under *Cotnam.*[197] In its very brief decision, the Court of Appeals for the Eleventh Circuit affirmed the Tax Court's decision and found that the panel was bound by *Cotnam,*[198] which could only be overruled by an *en banc* court.[199]

In 2001, the Eleventh Circuit reaffirmed *Davis* in the case of *Foster v. United States.*[200] In *Foster,* the court held that post-judgment interest was excludable from plaintiff's gross income because it be-

190. *Clarks,* 202 F.3d at 857.

191. *Clarks,* 202 F.3d at 858.

192. *Id.*

193. 210 F.3d 1346 (11th Cir. 2000).

194. *Id.* at 1347.

195. *Id.*

196. *Id.*

197. *Id.*

198. In 1981, the Eleventh Circuit was split off from the Fifth Circuit and decisions from Fifth Circuit are binding precedent on the Eleventh Circuit.

199. *See Davis,* 210 F.3d at 1347.

200. 249 F.3d 1275 (11th Cir. 2001).

longed to her attorneys as payment for costs of appeal.[201] The court found that Alabama law, which stated that attorneys "have a lien superior to all liens but tax lien," governed Foster's case and the fee arrangements.[202] Therefore, as in *Cotnam*, the post-judgment interest belonged to the attorney and not the client.

IV. THE UNFAIRNESS CREATED BY THE MAJORITY VIEW AND THE MINORITY' S CRY FOR CHANGE

In view of the substantial disagreement between the circuit courts, it is necessary for Congress to enact a legislative solution.[203] This part of the note analyzes and evaluates the reasoning and arguments behind the majority and the minority view. Finding that a balanced approach is needed, and that current approaches do not adequately resolve the problem, this part proposes a legislative solution, which incorporates various concerns expressed by the taxpayers, the Commissioner and the courts.

The majority view is correct in including the amount of taxable damage awards and settlements allocated to the attorney's contingent fees in the client's gross income.[204] As previously explained, Section 61 of the IRC defines gross income as "all income from whatever source derived."[205] Unless there is a specific exemption in the IRC, all income earned or otherwise received by a taxpayer must be included in the gross income. If a taxpayer incurs expenses in generating income, he or she may be able to deduct the expenses from gross income to arrive at his or her taxable income.[206] A simple example[207] illustrates the point: A taxpayer who

201. *Foster*, 249 F.3d at 1279.

202. *Id.* at 1279.

203. Although the United States Supreme Court could adopt the minority view and eliminate the unfairness for plaintiffs who choose contingent fee agreements, this is not advisable. Adopting the minority view would create even greater inequities because plaintiffs that hire hourly fee attorneys would still face the same unfairness. Only Congress is in the position to resolve the issue by treating similarly situated plaintiffs equally.

204. *See supra* note 75.

205. *See supra* notes 7-17 and accompanying text for a detailed discussion of gross income.

206. *See supra* notes 53-70 and accompanying text for a detailed discussion of various deductions from gross income.

207. This example is largely based on Judge Posner's example in *Kenseth*. *See Kenseth*, 259 F.3d at 883.

receives $90 contingent fee award in a contract dispute and pays the attorney $30 for legal work performed, has gross income of $90 and a potential deduction of $30. The taxpayer's gross income should not be limited to the $60 he retains. He had control over the entire accession to wealth of $90 because he could direct its distribution when realized.

The minority view, stretching the income concepts beyond their limits to reach equitable results, would hold that a taxpayer in the above example has only $60 of gross income.[208] The anomaly of such a holding is clearly evident by the minority's acknowledgment that, but for the contingent fee arrangement, the client would have had gross income of $90 and a $30 expense.[209] Unfortunately, this line of authority leads to equitable results only when the fee arrangement is a contingent fee. Clearly, clients who choose to pay their attorneys on an hourly basis and others who choose contingent fee agreements should not be treated differently under the IRC. Nonetheless, the minority's frustration with the AMT application, and its attempt to eliminate unfairness is understandable. In cases, such as *Alexander*, where plaintiffs must include the entire award in their gross income and yet the real economic costs incurred to produce the income are ignored, such as when calculating the AMT liability, their victorious judgment may turn into an after tax loss. Although an unintended outcome, it is a disturbing reality. In response to this fundamental unfairness, some courts have struggled to develop arguments, at times uncomfortable ones, to support the exclusion of the portion of the award that goes to the contingent fee attorney from the client's gross income.

The following are some of the arguments presented by the majority and the minority courts. Although the author believes that the majority's view represents the correct result within the *present* IRC, the author carefully evaluates and scrutinizes the majority's and minority's arguments, hoping to persuade future courts, in

208. *See* text accompanying notes 142-202 for a full discussion of circuit court cases excluding the amount of attorney's fees in contingent fee lawsuits from client's gross income.

209. *See, e.g.*, Kenseth's admission in *Kenseth* stating that if he had hired an hourly fee attorney, the fee would have been an expense, that is, a deduction and not a reduction from gross income.

cases like *Alexander*, to exclude[210] part of attorney's contingent fees from client's gross income until a better legislative solution is enacted. Even though, "it is not a feasible judicial undertaking to achieve global equity in taxation,"[211] the minority courts, by excluding the amount of attorney's contingent fees from client's gross income, have at least attempted to signal that a change in the IRC is needed.

1. Proprietary Interest Argument

One of the more persuasive arguments that have been made in favor of excluding attorney's contingent fees from the client's gross income is the view that attorneys receive a proprietary interest in the clients' cause of action when they enter into a contingent fee arrangement.[212] The *Cotnam* decision, in developing its proprietary interest approach, relied on the Alabama attorney lien statute.[213] The court stated that "Mrs. Cotnam's claim at the beginning of the suit had no fair market value, and that it was doubtful if indeed it had any value."[214] The court concluded that Mrs. Cotnam's attorney created the value of her claim by his work in presenting evidence and articulating arguments.

The analogy could be made to a partnership or a joint venture arrangement. If Mrs. Cotnam decided to enter into a 60-40 partnership with someone to exploit her patent for a technology, she surely would not be taxed on 100% of the profits if her partner created great value in the patent by his hard work and talent. Subchapter K of the partnership taxation would require that the income produced with the partnership is allocated to Mrs. Cotnam and her partner in accordance with their partnership agreement. If she only held a 60% interest in the partnership, only 60% of the income would be allocated to her. This outcome finds further support in the Supreme Court's statement in *Horst* that "the dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise *create the right to receive it* and enjoy the benefit

210. *See* this Note's Proposed Legislative Solution for a full discussion of which part of the attorney's contingent fees should be excluded form client's gross income.

211. *See Benci-Woodward*, 219 F.3d at 944.

212. *See Cotnam*, 263 F.2d at 125.

213. *Id.*

214. *Id.*

when paid."[215] Why should Mrs. Cotnam be taxed on 100% of her damages if she assigned to her attorney 40% of her claim so that she could collect her 60%? One possible answer is that Mrs. Cotnam and her attorney are not partners in the prosecution of her claim. The claim belongs to Mrs. Cotnam and her attorney is merely her agent who helps her establish the value of her claim. However, if Mrs. Cotnam decided from the outset to part with some control of her claim it is difficult to argue that her attorney was merely her agent. By controlling Mrs. Cotnam's claim, her attorney loses the attributes of an agent and becomes more of a joint owner or a tenant in common with her.

2. Owner-Salesman vs. Client-Attorney Argument

Judge Posner in *Kenseth* correctly stated that when a firm pays a salesman a commission for making a sale, the sales income he generates must be included in the firm's gross income and the salesman's commission becomes a deductible business expense for the employer.[216] Similarly, a plaintiff who recovers taxable damages in a contingent fee lawsuit must include the entire amount of the award in his gross income, and may deduct the legal fees retained by the attorney as a business expense where appropriate.[217]

While the analogy is strong, the cases can be distinguished. Attorneys and salesmen cannot be treated the same in the above scenario. First, unlike a salesman who presents a finished product to buyers, an attorney actually develops a product by making arguments and presenting evidence. Second, in prosecuting contingent lawsuits, attorneys take greater risks than salespersons do in selling products. At the outset of contingent lawsuits, attorneys do not know to a certainty what the value of their client's claim is. They must weigh several factors before even deciding whether to pursue the claim. They must consider the likelihood that the contingency will occur, the potential size of the recovery, the amount of work required, the amount of the lawyer's percentage and when, if at all, the contingency is likely to occur.[218] Attorneys in contingent fee

215. *See Horst*, 311 U.S. at 119 (emphasis added).
216. *See Kenseth*, 259 F.3d at 883.
217. *Id.*
218. *See* STEPHEN GILLERS, REGULATION OF LAWYERS: PROBLEMS OF LAW AND ETHICS 149 (5th ed. 1998).

agreements take great risks hoping they will get paid. Thus, they want an interest in the cause of action. The legislatures and courts have granted such an interest by creating attorney lien statutes.[219]

Third, and perhaps more important, public policy requires that attorneys be treated differently than salespersons. By serving individual clients, attorneys do not merely vindicate private interests, they are also engaged in the administration of justice and serve the public interests. On the contrary, salespersons, although promoting social good in their employment, are not directly involved in the administration of justice. Public policy encourages indigent clients to seek redress in the courts of law, and consistent with that goal is the exclusion of attorney's contingent fees from client's gross income. Including the amount of attorney's contingent fees in client's gross income puts a substantial obstacle in the way of indigent clients seeking redress in the courts of law. Plaintiffs might decide not to pursue causes of action in light of the heavy tax burdens they face.

3. Attorney-Client Partnership vs. Professional Responsibility Statutes

Some courts have relied on professional responsibility statutes to find that attorneys and clients are not engaged in a joint venture or a partnership when they sign contingent fee agreements, because such statutes prohibit lawyers from acquiring a proprietary interest in the client's cause of action and also prohibit them from sharing fees with non-lawyers.[220] Albeit the general rule is that a lawyer may not share fees with non-lawyers, and the lawyer is prohibited from acquiring a proprietary interest in the client's cause of action, most statutes provide an exception for contingent fee agreements. Specifically, Rule 1.8 of the Model Rules of Professional Conduct provides an exception to acquiring a proprietary interest in the cause of action or subject matter of the litigation in the form of contingent fees.[221] Accordingly, an attorney may acquire a pro-

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219. *See e.g.*, Alabama lien statute in *Cotnam*, 263 F.2d at 125.

220. *See Kenseth*, 259 F.3d at 883.

221. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8 (j) which states: "A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

1) acquire a lien granted by law to secure the lawyer's fee or expenses; and

prietary interest in the client's cause of action and may enforce such an interest by getting a lien on the amount of the judgment. Therefore, an attorney can own a part of the cause of action and not violate the professional standards.

4. General Contractor & Subcontractor vs. Attorney-Client

In *Kenseth*, Judge Posner developed another analogy by looking at general contractors and subcontractors. Posner argued that as a general contractor must include the entire amount of construction costs paid by the owner in his gross income, and is allowed a deduction for the amounts he pays to the subcontractors, so should a client include the entire amount of taxable damages received in his gross income and be allowed a deduction for the attorney's contingent fees paid.[222] According to Judge Posner, there should be no difference in tax treatment of attorney's contingent fees and subcontractor bills.

Judge Posner's analysis, similar to the salesperson analysis above, ignores the risk involved in contingent fee agreements. Subcontractors do not sign contingent fee agreements with general contractors. The only risk subcontractors take is the usual business risk all entrepreneurs take: the risk of miscalculating their costs or the risk of not getting paid because the general contractor may become insolvent and other similar risks. These are minimal risks compared to the risk that attorneys take with a contingent fee arrangement. Moreover, once a subcontractor has completed the work, he has an enforceable claim to be paid. Mechanics lien laws might allow subcontractors to make a claim against the property owner if the general contractor does not pay. On the other hand, attorneys have no guaranty of getting paid for their services at all. Like other entrepreneurs, attorneys calculate the risk of entering into a contingent fee agreement; however, they also do something more. Like partners in a partnership, attorneys invest their services for a return of some fixed percentage of potential profits in the future. Unlike hourly fee attorneys, they assume the risk of not getting paid just as partners assume the risk of losing the benefit of their efforts if the partnership fails to have a net profit.

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2) contract with a client for a reasonable contingent fee in a civil case.

222. *See Kenseth*, 259 F.3d at 884.

5. Control Argument

By acquiring a proprietary interest in a client's cause of action, contingent fee attorneys also acquire control over that part of their client's claim. When Mrs. Cotnam allocated 40% of her claim to her attorney, she also relinquished control to her attorney of 40% of her income-producing property, that is, her breach of contract claim. As the Court in the *Glenshaw Glass* held, control is one of the key components of gross income.[223] Mrs. Cotnam could not collect her 60% portion of the settlement until her attorney collected his 40% fee first.

Some argue that promises to pay the attorney a percentage of the recovery is different from giving up control of the claim because you could use other sources to pay the amount owed. However, that argument ignores the fact if the contingent fee agreement prohibits a client from settling his claim without the attorney's consent, the client has in effect given up control of his claim.[224] If a contingent fee attorney can veto a settlement the client desires to enter into, then the attorney has control over the client's claim.

In *Kenseth*, Judge Posner also stated that Kenseth never relinquished control of the claim because he could fire his contingent fee lawyer at any time, as he could fire his hourly fee lawyer.[225] This argument misinterprets the meaning of control. Surely he could fire both attorneys, but so could partners in a partnership vote to expel any particular partner or dissolve the partnership. That, however, does not mean that the particular partner never had control or a proprietary interest in the partnership. Even though Kenseth could fire his contingent fee attorney at any time and for any reason, his attorney does not lose control over a potential judgment in

223. *See Glenshaw Glass*, 348 U.S. at 431.

224. Even in agreements where attorneys cannot settle claims without their clients' consent, attorneys may still obtain control over a part of the client's claim. A partner in a partnership also cannot sell a partnership interest without obtaining either majority or unanimous consent from the rest of the partners. However, that doesn't mean that that particular partner never had control over the income-producing property or that he or she is "assigning" income to people who didn't earn it.

225. *See Kenseth*, 259 F.3d at 884.

the case. If Kenseth recovers, his attorney will collect the reasonable fee he earned in representing Kenseth.[226]

6. Landlord-Tenant vs. Attorney-Client Argument

The final analogy that Judge Posner draws in *Kenseth* between clients in contingent fee lawsuits and owners of rental property can also be distinguished. He argues that owners of rental property frequently relinquish physical control of the income-producing property to their tenants, but they still must include the entire proceeds from renting their property in their gross income.[227] However, the *Kenseth* opinion fails to recognize that there is a difference between relinquishing *total* control of the income-producing property and letting the tenants *use* the property. Landlords must include the entire rental proceeds in their gross income *not* because they give up *control* of their property, but because they keep most of the rights to alienate the property or use it as a security interest, and only allow the tenants to *use* their property. At most, they temporarily relinquish control over the physical *use* of the income-producing property, but they still posses the inalienable right to dispose of the property.

To the contrary, clients in contingent fee lawsuits—in cases where they lose the right to settle without attorney's consent— *give up* a percentage of their income-producing property, as well as control over that property, in expectation of an award the moment they sign a contingent fee agreement. Clients, unlike landlords, do not only relinquish control over the *use* of their income-producing property, they actually *give up* a part of their property, which equals to the attorney's contingent fee percentage. Therefore, the landlord-tenant analogy cannot be used to support the inclusion of attorney's contingent fees in client's gross income.

7. Discharge of Liability by a Third Party

Some courts have held that discharge of a client's-plaintiff's obligation to pay legal fees by a third party (the defendant) is equivalent to the receipt of the proceeds by the plaintiff, and there-

226. Of course, if Kenseth fired his attorney for cause, then the attorney might forfeit the entire fee depending on the contract and the law of the jurisdiction.
227. *Kenseth*, 259 F.3d at 884.

fore includible in the plaintiff's gross income.[228] Ordering a third party to extinguish a person's debt should not absolve that person from paying the income tax on the amount of the obligation extinguished because it amounts to an indirect payment to that person.[229] But, a contingent fee lawsuit is different. At the outset of a lawsuit, the client has no liability to the attorney and will owe nothing unless the client receives an award.[230] The client has no personal obligation until he recovers damages.[231] As the court in *Raymond v. Commissioner* stated "[b]ecause the client has not incurred a personal obligation, it scarcely seems logical to conclude, as have the panels in the Ninth, Tenth and Federal Circuits that payments under contingent arrangements serve to discharge clients' personal obligations to their attorneys, and therefore under the rule of *Old Colony Trust,* should be taxed to the clients."[232]

The inclusion of contingent attorney fees in client's gross income should not depend on whether or not the client recovers damages. The client has done nothing to gain "control" over the attorney's portion of the award. If the liability to the attorney existed before the judge or jury reached its decision, then the client would have to include the discharge of his or her debt in gross income. But here, because of the specific nature of the contingent fee agreements, where client's liability to the attorney does not arise until the client recovers damages, it cannot be said that the client ordered the third party to discharge the debt. Whether or not the client is liable for legal fees depends merely on the judge's or the jury's decision to award monetary damages to the client, and conse-

228. *See Sinyard,* 268 F.3d at 756.

229. Of course, if the IRC provided an exclusion, for example Section 102, then the discharge of the liability by a third party will not be considered gross income to the person whose liability has been extinguished.

230. In some contingent fee agreements the client may be responsible for litigation expenses even if the client does not recover.

231. *See* Raymond v. Commissioner, 2002 U.S. Dist. LEXIS 25426, at 17 (D.Vt. Dec. 17, 2002).

232. *Id.* at 18 citing *Old Colony Trust Co.,* 279 U.S. 716, 729 (discharge by third person of taxpayer's obligation is equivalent to receipt by taxpayer); *Campbell,* 274 F.3d at 1313-14 (recovery permitted taxpayer to discharge personal obligation owed to attorneys); *Coady,* 213 F.3d at 1191 (taxpayer could not avoid tax by diverting portion of recovery to her creditor contingent fee counsel); *Baylin,* 43 F.3d at 1454 (funds served to discharge obligation of partnership to its attorney).

quently, the client has no control within the meaning of the *Glenshaw Glass* principle of control.

8. Fairness, Deterrence and Non-Compliance Arguments

Decisions such as *Coady, Kenseth, Alexander, Baylin, Young* and *Davis* will deter clients from hiring attorneys on contingent fee basis and may encourage clients not to comply with the IRC. The enforcement of our tax laws and extraction of tax revenue will become more difficult. The integrity of our entire tax system is undermined when the tax system appears unreasonable and unfair. By including attorney's portion of the award in the client's gross income, the client is taxed on the monetary amount that never becomes economic income. It cannot be said that the client enjoyed the portion he never received, because that portion belonged to the attorney from the outset of the lawsuit. As a result, the appearance of unfair taxation may encourage noncompliance with the IRC.

In addition, the United States, unlike other countries, has made a public policy decision to allow contingent fee agreements. These types of agreements allow clients to seek redress in the courts of law even if they cannot afford paying hourly fees. Including the entire amount allocated to the attorney's contingent fees in the clients' gross income will force clients to abandon justifiable causes of action in light of the heavy tax burden they face. Moreover, when the cause is proper, Congress has usually lowered tax burdens as an incentive to engage in certain activities—for example, investment tax credits and education credits. Congress should also consider excluding attorney's contingent fees from plaintiff's gross income (as described in this Note's Proposed Legislative Solution below) in order to encourage vindication of public and private grievances by avoiding the inequitable results reached by the AMT application.

Proposed Legislative Solution

In light of the clear disagreement among the circuit courts, Congress should step in to resolve the problem. One solution may be to completely eliminate restrictions on deductibility of legal fees paid in determining taxpayer's AMT liability. The nondeductibility of legal fees for AMT purposes creates "phantom" income because taxpayer's real economic position is effectively overstated. Taxpayers—both those that hire hourly fee attorneys as well as those that sign contingent fee agreements—are "effectively robbed of any benefit of the [l]egal [f]ees"[233] paid, in determining their AMT liability. The real economic benefit to a taxpayer who received a $90,000 award and paid $30,000 in legal fees is only $60,000 and not $90,000. By disallowing deductions for the legal fees paid, the AMT undermines fairness—the very goal it was intended to achieve. The income tax is turned into a gross receipts tax for the plaintiff.

Another possible solution is to include in the client's gross income the amount of attorney's contingent fees that represents the attorney's total billable hours spent on the case, determined based on the attorney's hourly rate or fair market value of the time spent. Or, stated differently, this approach would exclude from plaintiff's gross income the amount of the award retained by the contingent fee attorney to the extent it exceeds the fair market value of the attorney's services based on his or her usual hourly rates. This proposal would balance the concerns the circuits have expressed. In addition, it would preserve horizontal equity. Horizontal equity requires that taxpayers in similar positions be treated equally if the tax system is to be perceived as fair and balanced. Therefore, taxpayers who decide to pay their attorneys an hourly fee and taxpayers who signed contingent fee agreements should be treated equally, because they are both plaintiffs who merely chose different schemes for compensating their attorneys.

Taxpayers who decide to pay their attorneys an hourly fee must include in their gross income the entire amount of damages recovered, and may be able to deduct the legal fees paid as miscellaneous itemized deductions. Therefore, to be fair, and preserve horizontal equity, taxpayers who choose contingent fee agreements should also include in their gross income at least the amount of legal fees that they would have paid had they signed an hourly fee agreement. They could also, if applicable, deduct that portion of the fees as miscellaneous itemized deductions. However, the difference between the total contingent fee and the fee that would have been charged had the client signed an hourly fee agreement should

233. *See Alexander*, 72 F.3d at 946.

not be included in the client's gross income because the difference represents the attorney's proprietary interest in the cause of action. This solution will force hourly fee clients and contingent fee clients to include in their gross income an equal amount of legal fees paid. More importantly, in situations where two clients, one that signed an hourly fee agreement and the other that signed a contingent fee agreement, receive the same award and pay the same amount of legal fees—assuming everything else is equal—they will pay the same amount of tax on the net proceeds they retain.

Attorneys would not be affected by this change since they would still have to include the entire fee received in their gross income. This proposed solution would benefit clients, especially in cases where the contingent fee collected by the attorneys would be much larger than had the client signed an hourly fee agreement. This certainly makes sense in light of the policy reasons that support contingent fee agreements.

Consider for example, the case of *In re Metro Mobile CTS, Inc. Shareholders Litig.*,[234] where shareholders-plaintiffs were awarded around $50 million in a shareholder class action suit.[235] The Vice Chancellor awarded the lawyer 16.7% of the settlement, or $8.5 million.[236] The attorney spent approximately 2,125 hours settling the case, which when compared with the contingent fee, amounted to around $4,000 per hour.[237] Can we candidly claim that the entire fee should be included in the clients' gross income? Is it possible to treat hourly fee agreements and contingent fee agreements entirely the same? Most of the plaintiffs-taxpayers would never be able to afford such a gigantic hourly fee. What is the economic reality of this transaction? Would the Commissioner likely find the $4,000 hourly rate as a reasonable "ordinary and necessary" expense within the meaning of Section 212? If this had been a "plain" hourly fee contract, where the terms of the contract called for a $4,000 hourly fee, it is quite possible that the Commissioner would have disallowed the deduction as "unreasonable." It is also possible that the attorney charging such an enormous hourly fee would be sanc-

234. 1993 Del. Ch. LEXIS 448, Del. Ch., Cons. C.A. No. 12300, Berger, V.C. (Aug. 18, 1993).

235. *Id.*

236. *Id.*

237. *Id.*

tioned under the Model Rules of Professional Conduct, which prohibit charging of "unreasonably high fees."[238] As we consider these questions and their possible answers, it becomes evident that, after all, it is not feasible to treat hourly fee clients and contingent fee clients entirely the same. This Proposed Legislative Solution captures the economic reality of the transaction and accounts for the fact that the contingent fee attorney is both: (1) the plaintiff's *partner* in the prosecution of the claim; and (2) the plaintiff's *agent* who helps him establish the value of his claim. As the plaintiff's *agent* he is compensated for the total time spent on the case based on his hourly rate, and as the plaintiff's *partner* the attorney shares in the award beyond the hourly fee earned.

Attorneys in contingent fee cases are compensated at a much higher rate because of the risks they take. Their role is more similar to an investor, or a partner, and not merely an agent or an employee of the client. As such, they acquire a partial interest in their clients' cause of action. On the other hand, hourly fee attorneys do not acquire an interest in the cause of action because the risk of losing the investment is entirely on the client. Hourly fee attorneys expect to be paid regardless of the outcome. Consequently, in contingent fee lawsuits the amount of legal fees that are above the amount that an hourly attorney would have charged under the circumstances belongs to the attorney as his proprietary interest. After all, that is his reward for taking the case.

V. CONCLUSION

As we have seen throughout this Note, the current state of the law leads to unfair results. However, although unfair, the majority of the courts are correct in their application of the *present* IRC. Section 61 of the IRC, *Glenshaw Glass* and *Lucas'* doctrine of assignment of income all lead to the same conclusion: attorney's contingent fees must be included in the winning plaintiff's gross income. The minority's view, excluding contingent legal fees from plaintiff's gross income stretches the IRC to great limits in its quest to reach the equitable result. But, it has long been established that

238. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.5(a).

"equitable arguments cannot overcome the plain meaning of the statute."[239]

A legislative solution is needed to correct the problem. Until then, taxpayers should continue to argue for exclusion of attorney's contingent fees from their gross income. Arguments in support of the minority view, as outlined in section IV of this Note, are at times uncomfortable to make, but are forced upon the taxpayers by the unforeseen and inequitable results of the AMT application. The situation cries out for a prompt resolution, and Congress should certainly make a policy decision to either allow a full deduction for the legal fees paid, or exclude from client's gross income the portion of contingent attorney fees that are above what an hourly rate attorney would have charged under the same or similar circumstances.

Our tax system should not discourage people from seeking redress in the courts of law by imposing heavy tax burdens on clients who cannot afford to pay their attorneys an hourly fee. Situations like *Alexander* can produce astonishing results. A victorious plaintiff, after paying all expenses and taxes, may end up with an after-tax loss. Moreover, penalizing clients as in *Alexander*, is not the way our tax system was envisioned to operate. While it is true that Section 61 of the IRC states gross income means "all income from whatever source derived,"[240] Justice Harlan also teaches us that "[i]t is not the words of the law but the internal sense of it that makes the law. The letter of the law is the body; the sense and reason of the law is the soul."[241] The AMT should not be allowed to create phantom income when economic income does not exist. Congress needs to act quickly to restore faith and fairness in the IRC.

239. *See Alexander*, 72 F.3d at 946.

240. I.R.C. § 61 (2000).

241. US v. Stanley, 109 U.S 3 (1883) (Harlan, J., dissenting).