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Young v. Commissioner, 240 F.3d 369 (4th Cir. 2001) - The Assignment of Income Doctrine and Section 1041 as Applied to Attorneys' Contingent Fees in Transfers Incident to Divorce: A One-Two Punch to Stun the Recognition of Gain

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CASENOTE

Young v. Commissioner, 240 F.3d 369 (4th Cir. 2001).
The Assignment of Income Doctrine and Section 1041 As Applied to Attorneys' Contingent Fees in Transfers Incident to Divorce: A One-Two Punch to Stun the Recognition of Gain

I. Introduction

Currently there is a divide between the circuits as to whether to treat attorneys' contingent fees as gross income to the client under the assignment of income doctrine.[1] Recently, in *Young v. Commissioner*,[2] the Fourth Circuit decided that the assignment of income doctrine does apply to attorneys' contingent fees and that clients must include in gross income amounts paid to their attorneys as contingent fees. Specifically, in *Young* the Fourth Circuit decided to apply the assignment of income doctrine to attorneys' fees in cases where the remainder of the amount paid as a result of the legal services could be deferred, if not eventually excluded, from gross income. This Note will discuss this last issue, and how if the Fourth Circuit continues to apply assignment of income to attorneys' fees in divorce cases but allows a taxpayer to defer other amounts as being transfers "incident to divorce",[3] a taxpayer could develop an argument for at least deferring attorneys' fees from gross income, if not totally excluding them, without running into assignment of income doctrine problems.

Louise Young and John Young married in 1969 and divorced in 1988. In 1989 they entered into an agreement to resolve their property claims and all other claims arising out of the marital relationship.[4] Under the terms of the agreement, Mr. Young delivered to Mrs. Young a promissory note for $1.5 million, secured by a deed of trust on 71 acres of property Mr. Young received as part of the agreement.[5] In 1990, after Mr. Young defaulted on his obligations under the 1989 agreement, Mrs. Young brought a collection action against him in

1. See Thad Austin Davis, *In Memoriam: Frank M. Johnson, Jr.: Cotnam v. Commissioner and the Income Tax Treatment of Contingency-based Attorney's Fees—The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head-on*, 51 Ala. L. Rev. 1683 (2000).
2. 240 F.3d 369 (4th Cir. 2001).
3. *See* 26 U.S.C. §1041 (2001).
4. *Id.* at 372 (4th Cir. 2001).
5. *Id.*

State court in North Carolina.[6] The court entered judgment in favor of Mrs. Young, awarding her principal, interest, and reasonable attorneys' fees.[7] Mr. Young failed to fully satisfy the judgment, and Mrs. Young took steps to execute the judgment.[8]

In 1992, before execution of the judgment, Mr. and Mrs. Young entered into a Settlement Agreement and Release.[9] The terms of this 1992 agreement provide that Mr. Young transfer to Mrs. Young 59 acres of land in return for full settlement of his obligation, approximately 42 acres of which was part of the 71 acres used as collateral for the promissory note in 1989.[10] Under the 1992 agreement, Mr. Young had an option to repurchase the land for $2.2 million before December 1992.[11] Mr. Young assigned this option to a third party who bought the land from Mrs. Young for $2.2 million.[12]

Mrs. Young did not report as income any of the $2.2 million on her federal income tax returns for 1992 or 1993, of which $300,606 was paid in attorneys' fees.[13] Also, Mr. Young did not report any gain from his transfer of the property, although his basis was only $130,794 and the property had a fair market value of $2.2 million, as evidenced by its sale to a third party for $2.2 million.[14]

The Commissioner asserted deficiencies against both Mr. Young and Mrs. Young.[15] The cases were consolidated in Tax Court, and the Tax Court ruled that the capital gain from the sale of the property to the third party was taxable to Mrs. Young, because the 1992 agreement was a transfer "incident to divorce" under 26 U.S.C. §1041.[16] Therefore, Mrs. Young took Mr. Young's adjusted basis in the land ($130,794), and thus had a capital gain upon its sale for $2.2 million.[17] Mrs. Young appealed the decision, as did her second husband, to whom she was married in 1992 and who therefore owed the money with Mrs. Young.[18]

This Note examines whether attorneys' fees paid directly to an attorney as a result of payment that is part of a transfer of property "incident" to divorce should be included in the gross income of the

6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.* at 373.

client. To fully address this issue, this Note will first examine the assignment of income doctrine as courts have applied it to attorneys' fees, and then to 26 U.S.C. §1041, which excludes gain or loss from transfers to a former spouse when the transfer is incident to divorce.[19] Though the court in *Young* applied both of these laws, Mrs. Young, the client, missed out on the significant benefit of choosing *when* to pay her taxes, or perhaps being able to avoid the tax liability altogether.

II. Background

a. *The Assignment of Income Doctrine and Attorneys' Fees*

The most notable case concerning the assignment of income doctrine is *Lucas v. Earl*.[20] In this case, a husband and wife entered into a contract to equally divide all income received by either spouse throughout the marriage.[21] Although the Supreme Court held the contract was valid under California law,[22] it nevertheless concluded that a "reasonable construction of the taxing act left no doubt that the statute could tax salaries to those who earned them, and provided that the tax could not be escaped by anticipatory arrangements and contracts."[23] The Court further stated that the agreement, no matter "however skilfully[sic] devised" could "prevent the salary when paid from vesting even for a second in the man who earned it."[24] The Court ended the decision by stating, "[t]hat seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."[25]

The Court has followed the "fruit and tree" analogy and the assignment of income doctrine numerous times since.[26]

The assignment of income doctrine has been examined with respect to attorneys' fees, and most Circuits have decided that the assignment of income doctrine does apply to attorneys' fees, and that they are therefore part of the client's gross income. However, the Fifth Circuit

19. 26 U.S.C §1041(a)(2) (2001).
20. Lucas v. Earl, 281 U.S. 111 (1930).
21. *Id.* at 113.
22. *Id.* at 114.
23. *Id.* at 114-5.
24. *Id.* at 115.
25. *Id.*
26. *See, e.g.*, Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Eubank, 311 U.S. 122 (1940).

created an exception to the assignment of income doctrine in *Cotnam v. Commissioner.*[27]

In *Cotnam*, Mrs. Cotnam sued the estate of a man with whom she had contracted to receive one-fifth of his estate upon the man's death in return for serving as his attendant and friend.[28] Mrs. Cotnam prevailed, and the court held that the 40% of the judgment used to pay Mrs. Cotnam's attorneys was not to be included in Mrs. Cotnam's gross income.[29] A majority of the court in *Cotnam* concluded that because Alabama law provided "the same right and power over said suits, judgments, and decrees . . . as their clients had,"[30] Mrs. Cotnam was not required to include the amount paid to her attorneys in her gross income. Mrs. Cotnam "could never have collected anything or have enjoyed any economic benefit unless she had employed attorneys, and to do so, she had to part with forty per cent of her claim long before the realization of any income from it."[31]

The Fifth Circuit followed the decision *Cotnam* in *Srivastava v. Commissioner,*[32] where the portion of the judgment of a defamation case, which was paid to the attorneys in the case, was excluded from the clients gross income.[33] The court acknowledges the Circuit split on the issue of attorneys' fees as gross income under the assignment of income doctrine, but nevertheless states that *Cotnam* was "substantially indistinguishable" from *Srivastava*, and therefore the exclusion was necessary.[34]

While the Eleventh Circuit has followed *Cotnam* as precedent due to the split of the Fifth Circuit,[35] only the Sixth Circuit has followed *Cotnam* on its own in *Estate of Clarks v. United States.*[36] In *Estate of Clarks*, the decedent's estate sought a refund for taxes paid on interest which accrued against a personal injury judgment for decedent, where the interest was paid by the judgment debtor directly to the attorney as part of a contingent fee agreement.[37] The court found that because "Michigan law operates in more or less the same way as the Alabama lien in *Cotnam*," the attorneys' fees received by the decedent were not required to be included in his gross income.[38]

27. Cotnam v. Commissioner, 263 F2d. 119 (5th Cir. 1959).
28. *Id.* at 120.
29. *Id.* at 125.
30. *Id.*
31. *Id.* at 126.
32. Srivatstava v. Commissioner, 220 F.3d 353 (5th Cir. 2000).
33. *Id.* at 357.
34. *Id.* at 357-8.
35. *See* Davis v. Commissioner, 210 F.3d 1346, 1347 (11th Cir. 2000).
36. Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000).
37. *Id.* at 855.
38. *Id.* at 856.

Taxpayers in other circuits must incur the full weight of the assignment of income doctrine when it comes to attorneys' fees. In the Ninth Circuit case of *Coady v. Commissioner*,[39] Mrs. Coady won a wrongful termination suit, recovered a judgment for back pay and benefits, then paid her attorneys' fees and litigation costs from this amount.[40] The *Coady* court distinguishes *Cotnam* on the facts, and then explains its decision in detail which would lead one to believe it would not follow *Cotnam* even if the facts were exactly the same.[41]

In *Kenseth v. Commissioner*,[42] the Seventh Circuit also refused to exclude attorneys' fees from gross income. The court in *Kenseth* not only concluded that Mr. Kenseth had to include his attorneys' fees in his gross income, but took the opportunity to rebuke the circuits which continue to uphold *Cotnam*.[43]

b. *Transfers Incident to Divorce Under 26 U.S.C. §1041*

The second major portion of the law that should be considered when looking at *Young*[44] is 26 U.S.C. §1041(a)(2), which states "[n]o gain or loss shall be recognized on a transfer of property from an individual to . . . a former spouse, but only if the transfer is incident to the divorce."[45] This statute was enacted in 1984 in reaction to *United States v. Davis*,[46] in which the Supreme Court ruled that a divorce transfer in return for a release of inchoate marital claims was a taxable event to the transferor, thus triggering gain or loss. Several problems arose from this treatment, such as the transferor spouse not having any cash with which to pay the tax generated, the amount of basis the transferee spouse took, and widespread unreport of the "*Davis*" income.[47] By passing 26 U.S.C. §1041, Congress allowed such problems to be avoided by making the *Davis*-type transfers a non-tax event.

One significant benefit was created with the enactment of 26 U.S.C. §1041 as well: it allows the transferee spouse to control *when* he or she wishes to incur the tax on the property, by making a decision as to when to sell the property (or to partake in some other recognition

39. Cody v. C.I.R., 213 F.3d 1187 (9th Cir. 2000).
40. *Id.* at 1188.
41. *See id.* at 1190-1.
42. Kenseth v. Commissioner, 259 F.3d 881 (7th Cir. 2001).
43. For instance, statements such as, "Indeed the cases that reject the Tax Court's position seem based on little more than sympathy for taxpayers," "It is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front," and finally, "Enough." *Id.* at 885.
44. Young v. Commissioner, 240 F.3d 369 (2001).
45. 26 U.S.C. §1041(a)(2) (2000).
46. United States v. Davis, 370 U.S. 65 (1962).
47. For a critique of the I.R.S. position on Section 1041 and the assignment of income doctrine, see Walter H. Nunnelly, *The Assignment of Income Doctrine as Applied to Section 1041 Divorce Transfers: How the Service Got It Wrong*, 68 ORE. L. REV. 615 (1989).

event with respect to the property). It is this benefit that disappears in *Young*.

III. Background

In *Young*, the Fourth Circuit had to decide to treat the 1992 settlement agreement reached by the Youngs as a transfer "incident to divorce" under 26 U.S.C. §1041.[48] The majority looked to the Treasury Regulations to determine whether a transfer was incident to divorce.[49] The Treasury Regulations state that a transfer can be "incident" to divorce if it is "made within six years of divorce" if also "pursuant to a divorce or separation instrument, as defined in § 71(b)(2)."[50] Using this test, the majority concluded that the 1992 agreement was made within 6 years of the 1988 divorce and was a proper instrument under §71(b)(2), and so was "incident to divorce" and fell under 26 U.S.C. §1041. The effect of this was that Mrs. Young had to include $2.2 million for the sale of the land in her gross income.[51]

Even though the sale of the land produced gross income to Mrs. Young, she argued that the money paid to her attorneys should be excluded from gross income, and asked the court to adopt the decision in *Cotnam*.[52] The court unanimously agreed not to do so, and held that the assignment of income doctrine compelled Mrs. Young to include in her gross income the amount paid to her attorneys.[53] In doing so, the court explicitly rejected *Cotnam*, but stated that even if it followed the reasoning of *Cotnam*, North Carolina law is different from Alabama law in regard to attorneys' right to fees, and Mrs. Young would still have to include her attorneys' fees in gross income.[54]

IV. Analysis

In *Young*, the taxpayer, Mrs. Young, is involved in a transaction, which falls under 26 U.S.C. §1041,[55] or so the majority would have one believe, but if this transaction were truly under 26 U.S.C. §1041, Mrs. Young would have the opportunity to realize the benefit described in the paragraph above; that is, to recognize the gain when she chose to recognize it. Because she had hired attorneys to assist her, she had to immediately report the amount paid to her attorneys for fees and ex-

48. Young v. Commissioner, 240 F.3d 369, 373 (4th Cir. 2001).
49. *Id.*
50. *Id.* (quoting Temp. Treas. Reg. § 1.1041-1T(b) (2000)).
51. *Id.* at 376.
52. *Id.*
53. *Id.*
54. *Id.* at 379.
55. *Id.* at 376.

penses.[56] She could not defer the gain included in the attorneys' fees, and therefore 26 U.S.C. §1041 was not given full effect in *Young*.

Consider two contrasting scenarios to illustrate the point. In the first scenario, Taxpayer A represents herself in obtaining an agreement under the same circumstances as the 1992 agreement in *Young*, and therefore has to pay no attorneys' fees. Under the ruling in *Young*, the transfer is still under 26 U.S.C. §1041 and therefore is a non-recognition event. Since this would be the case, Taxpayer A's ex-spouse would recognize no gain or loss upon the transfer, and never again have to worry about gain or loss from the property. Taxpayer A would still have to recognize gain or loss, but this gain or loss would only be recognized at some point in the future; a point that Taxpayer A could choose. Indeed Taxpayer A could choose never to recognize the gain by giving the property away during her lifetime, giving the donee her basis.[57] Taxpayer A could even utilize the ultimate tax strategy: death. Her testamentary gift would allow the beneficiary to take a step-up basis in the property, not Taxpayer A's previously unrecognized gain from the 26 U.S.C. §1041 transfer.[58]

Now consider a second scenario. In this scenario, Taxpayer B must enlist the help of attorneys in obtaining an agreement under the same circumstances as the 1992 agreement in *Young*. The attorneys will do so only in return for a fee.[59] The fee will be due once the services are rendered, and in the case of a contingent fee will be determined and also *due* at the time of settlement. If Taxpayer B settles for $2.2 million in real property, as was the case in *Young*,[60] but then chooses not to sell the land, the contingency fees of the attorneys are still immediately due. Thus, whatever percentage of the settlement is paid to the attorneys represents that same percentage of gain in the land but it is not eligible for deferral, as it would be if Taxpayer B had been represented *pro se*.[61]

Suppose now that Taxpayer B, who was represented by attorneys and paid attorneys' fees out of the settlement, wishes to defer the gain that was represented in the land. Looking back at the two scenarios we see that she could not. Here is where the assignment of income

56. *Id.* at 379.

57. *See* 26 U.S.C. §102 (2001).

58. *See* 26 U.S.C. §1015 (2001).

59. The author understands there may be extremely rare cases where an attorney will take a $2.2 million case *pro bono*, but nevertheless is playing the odds for this illustration.

60. Since Mr. Young retained an option to repurchase the land for $2.2 million and then the land was actually sold for this amount, it must be assumed this is the Fair Market Value of the land, and therefore the value of the 1992 agreement.

61. The author realizes that in *Young*, Mrs. Young immediately sold the land and therefore would have recognized her gain even if she had been represented *pro se*.

doctrine does not square with the application of 26 U.S.C. §1041 in *Young*.

The Fourth Circuit court uses the assignment of income doctrine to force Mrs. Young to include in her gross income the amount paid directly to her attorneys.[62] But what if our Taxpayer B decides to use some tax cunning, and claim that the attorneys' fees paid were not truly a portion of the settlement proceeds, but merely paid out of Taxpayer B's pocket in an amount equal to the proceeds. Taxpayer B could then claim the *entire* amount of the settlement fell under 26 U.S.C. §1041, and therefore is unrecognizable as gain until the sale of the property or some other recognition event. Generally, trying to make this distinction would be futile; a taxpayer would have to recognize income from whatever source derived.[63] But when a non-recognition statute such as 26 U.S.C. §1041 is in place, it is in the taxpayer's interest to make an argument like this. Under the now famous "fruit-tree" analysis in *Lucas v. Earl*,[64] Taxpayer B would have kept both the trees and the fruit from the divorce settlement, but paid her attorneys with fruit from trees in a completely different orchard.[65]

Taxpayer B may have some artillery for this argument supplied, perhaps accidentally, by the majority in *Young*. The majority states, "[t]he client still controls the claim (or property)" and "[t]he attorney simply provides a service and receives compensation."[66] The majority further states, "to allow her to escape taxation on a portion of the settlement proceeds simply because she arranged to compensate her attorneys directly from the proceeds through a contingent fee arrangement."[67] The "directly from the proceeds" language would allow our Taxpayer B, if able to win a well-crafted argument that her attorneys' fees were paid out of other funds ("fruit"), to avoid the assignment of income doctrine as it was applied in *Young*, and to keep from recognizing the gain until such time as Taxpayer B chose to partake in a recognition event. It was even stated in *Young* that

> The policy animating § 1041 is clear. Congress has chosen to "treat a husband and wife [and former husband and wife acting incident to divorce] as one economic unit, and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers until the property is conveyed to a third party outside the economic unit."[68]

62. Young v. Commissioner, 240 F.3d 369, 379 (4th Cir. 2001).
63. 26 U.S.C. §61 (2001).
64. *Supra*, p.2.
65. For a discussion on this topic, see Lauren E. Sheridan, Note: *Trees In The Orchard Or Fruit From The Trees: The Case For Excluding Attorneys' Contingent Fees From Client's Gross Income*, 36 GA. L. REV. 283 (2001).
66. Young at 378.
67. *Id.* at 377-8.
68. *Id.* at 375. (quoting Blatt v. Commissioner, 102 T.C. 77, 80 (1994)).

The Internal Revenue Service, however, is not so quick to allow a taxpayer to circumvent the assignment of income doctrine, no matter how legitimate the means may be. Revenue Ruling 87-112 is just such an example.[69] It states "deferred, accrued interest on U.S. savings bonds is includible in the transferor's gross income in the taxable year in which the transferor transfers the bonds to the transferor's spouse or former spouse in a transfer described in section 1041(a) of the Code."[70] This seems contrary to the entire purpose of 26 U.S.C. §1041 as discussed earlier.[71] However it is clearly the Internal Revenue Service position that 26 U.S.C. §1041 "does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer."[72]

If this harsh treatment of certain types of transfers that would normally not be recognized under 26 U.S.C. §1041 was in fact an instance where the Internal Revenue Service "got it wrong,"[73] then did the Fourth Circuit also get it wrong by creating a rule by which income that, without attorneys' fees being deducted, would have been deferred? If one applies consistently the assignment of income doctrine and 26 U.S.C. §1041 as it is used in *Young*, it is only logical to allow Taxpayer B to prevail on an argument for deferring the attorneys' fees portion from gross income, even if she is not allowed to exclude them altogether. Unfortunately, logic sometimes not only takes a back seat, but can be locked in the trunk, as the tax machine speeds down the highway.

V. Conclusion

Admittedly, this new approach to looking at the assignment of income doctrine in cases where the transfer is also deemed "incident" to divorce will be of little benefit to Mrs. Young. Her sale of the land to a third party via Mr. Young's option to repurchase[74] caused the immediate trigger of any gain she wished to defer. However, now that taxpayers know they will receive treatment under 26 U.S.C. §1041 when agreements are reached like those entered into by Mrs. Young, they should be able to defer any gain included in the attorneys' fees paid by their spouse until the realization of the rest of the gain — which, in the case of a gift or devise, would be never. To apply both the assign-

69. Rev. Rul. 87-112, 1987-2 C.B. 207.
70. *Id.*
71. *Supra* at 4.
72. Rev. Rul. 87-112, 1987-2 C.B. 207.
73. *See* note 44, *supra.*
74. Young, 240 F.3d at 372.

ment of income doctrine and 26 U.S.C. §1041 in the way the majority did in *Young* can produce no other logical result.

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