DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, KANSAS CITY, MISSOURI
SB/SE:5

FROM: Heather C. Maloy
Associate Chief Counsel
(Income Tax & Accounting)

SUBJECT: [redacted]

This Chief Counsel Advice responds to your memorandum dated May 2, 2002. In accordance with § 6110(k)(3) of the Internal Revenue Code, it should not be cited as precedent.

LEGEND

B = [redacted]
Year 1 =
$X =
$Y =
$Z =
State =
Statute =

ISSUES

1. Must B include in gross income the portion of a punitive damages award that is deemed rendered to the State pursuant to Statute?

2. May B deduct the attorneys' fees and costs allocable to the recovery of the portion of the punitive damages that is deemed rendered to the State?

CONCLUSIONS

1. B is not required to include in gross income the portion of the punitive damages award that is deemed rendered to the State.

2. B may deduct the attorneys' fees and costs allocable to the recovery of the portion of the punitive damage award that is deemed rendered to the State.

FACTS

After her husband died in a helicopter crash, B filed a wrongful death action against the manufacturers of the helicopter. Co-plaintiffs included her children and her husband's parents.[1] The defendants appealed a jury verdict, and B and the other plaintiffs accepted a remittitur of $X in compensatory damages and $Y in punitive damages. Pre- and post-judgment interest accrued on the award as remitted. The award, including interest thereon, was satisfied in Year 1. The contingent fee agreement provided that the attorneys' fees would be satisfied from the award of punitive damages.[2]

In Year 1, Statute[3] provided:

> 2. Fifty percent of any final judgment awarding punitive damages after the deduction of attorney's fees and expenses shall be deemed rendered in favor of the

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[1] Because no material differences exist between the facts in her case and those of the co-plaintiffs, we address only B's situation.

[2] This provision is not binding on the Internal Revenue Service for purposes of allocating the attorneys' fees and costs incurred between the taxable and nontaxable portions of the recovery.

[3] In Year 2, the State amended Statute to provide that parties receiving a circuit court final judgment for purposes of appeal for punitive damages are required to notify the State of such award, except in certain healthcare cases. Pursuant to this amendment, the State explicitly has a lien interest in any final judgment awarding punitive damages. The amended Statute provides in part, "The [State] shall have a lien for deposit into the tort victims' compensation fund to the extent of fifty percent of the punitive damage final judgment which shall attach in any such case after deducting attorney's fees and expenses." The State can now intervene in an action to enforce its lien rights as provided under Statute, and the State cannot satisfy its lien until the attorney's fees and expenses are paid.

> [State]. The circuit clerks shall notify the attorney general of any final judgment awarding punitive damages rendered in their circuits. With respect to such fifty percent, the attorney general shall collect upon such judgment, and may execute or make settlements with respect thereto as he deems appropriate for deposit into the fund.
>
> 3. The [State] shall have no interest in or right to intervene at any stage of any judicial proceeding under this section.

After finding that the attorneys' fees and litigation expenses claimed were reasonable, the trial court determined that, pursuant to Statute, the State was entitled to $Z from B's award of punitive damages.

LAW AND ANALYSIS

1. Inclusion in gross income.

Except as otherwise provided in the Internal Revenue Code, a taxpayer must include in gross income under § 61 all income from whatever source derived. The Supreme Court of the United States has long recognized that the definition of gross income sweeps broadly and reflects Congress' intent to exert the full measure of its taxing power and to bring within the definition of income "any accession to wealth." Commissioner v. Schleier, 515 U.S. 323, 327 (1995); United States v. Burke, 504 U.S. 229, 233 (1992).

In numerous cases, courts have struggled to determine whether a taxpayer benefitted from an accession to wealth, thereby creating an item of income. For example, courts have employed the "anticipatory assignment of income" doctrine to determine which taxpayer should be taxed upon income or gain derived from a transaction. See Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Eubank, 311 U.S. 122 (1940). Describing this foundational rule as the "first principle of taxation," Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949), the Court has concluded that income is taxable to the party who earns it and that liability may not be avoided by anticipatory assignment of that income. Lucas v. Earl, 281 U.S. at 114-15. In resolving these cases, the Court has also employed the principle that it is the command the taxpayer has over the income that is the concern of the tax laws. Harrison v. Schaffner, 312 U.S. 579, 581 (1941). Under this principle, the taxpayer will remain liable for the tax if, at the time of realization, the taxpayer retains control over the disposition of the gain or income, although the gain or income is transferred to a third party prior to receipt. We believe the circumstances of this case warrant application of this principle.

On the death of her husband, B prosecuted a wrongful death claim to its conclusion. Under these circumstances, generally, B would be considered the owner of the remitted jury verdict. By operation of law, however, one-half of the net punitive damages was deemed the property of the State. At the time the proceeds were realized, B had no command over the disposition of the portion of the proceeds deemed rendered to the State. Consequently, we conclude that B is not required to include that portion of the proceeds in her gross income.

In a line of cases, the IRS has argued that statutes creating lien rights in judgments and settlements in favor of attorneys do not transfer any portion of the client's claim to the attorney, and accordingly, that the entire litigation proceeds are includible in the gross income of the client. See, e.g., Srivastava v. Commissioner, T.C. M. 1998-362, rev'd, 220 F.3d 353 (5th Cir. 2000); Kenseth V. Commissioner, 114 T.C. 399 (2000), aff'd, 259 F.3d 881 (7th Cir. 2001); Hukkanen-Campbell v. Commissioner, T.C. M. 2000-180, aff'd, 274 F.3d 1312 (10th Cir. 2001), cert. denied, 70 U.S.L.W. 3694 (U.S. May, 13, 2002). We do not believe the position taken in this memorandum is inconsistent with our litigating position in the contingent attorney fee area. The distinguishing characteristic of the relationship between the State and B in this case, and the attorney and client in a contingent fee arrangement, is that the former is created by operation of law while the latter is created by a voluntary act, i.e., the execution of a contract. As indicated above, B had no control over the disposition of the portion deemed rendered to the State. In the contingent attorney fee area, however, a taxpayer disposes of the contingent fee in order to acquire legal services in bringing a claim to fruition.

2. Deduction for expenses.

Under § 212(a), an individual is entitled to a deduction for ordinary and necessary expenses paid or incurred for the production or collection of income. This deduction, however, is limited under § 265(a)(1) if the recovery for which the expenses are incurred or paid is exempt from tax. Under § 1.265-1(c) of the Income Tax Regulations, if an expense or amount otherwise allowable as a deduction is allocable to both taxable and exempt income, a reasonable proportion thereof shall be allocated to each. Accordingly, an individual taxpayer may not deduct, for example, any expenses incurred or paid to recover income excludable under § 104(a)(2). Stocks v. Commissioner, 98 T.C. 1, 18 (1992); Metzger v. Commissioner, 88 T.C. 834, 860 (1987); Church v. Commissioner, 80 T.C. 1104, 1111 (1983). Clearly, then, B may not deduct any expenses properly allocable to the recovery of the compensatory damages component of the settlement because they are excludable from gross income under § 104(a)(2).

Nevertheless, we do not think § 265 applies to deny B a deduction for the portion of the attorney's fees allocable to the State's share of the punitive damages. Section 265(a)(1) provides that no deduction shall be allowed for "[a]ny amount otherwise

allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from taxes imposed by this subtitle ...." The Tax Court has held that "the legislative purpose behind § 265 is to prevent taxpayers from reaping a double tax benefit by using deductions attributable to tax-exempt income to offset taxable income." Induni v. Commissioner, 98 T.C. 618, 621 (1992), aff'd, 990 F.2d 53 (2d Cir. 1993).

Allowing B to deduct attorney's fees allocable to the State's share of the punitive damages does not result in a double benefit. The portion of the punitive damages on which no tax is paid is not income to B. B pays no tax on it because she does not receive it. Therefore, if she does not receive the income, the fact that she is not taxed on income that is not hers is not a benefit for purposes of § 265.

The plain language of the statute (quoted above) supports this interpretation. The statute is concerned with deductions allocable to exempt income of a type that can be received or accrued. Here, the income is neither received nor accrued by B. Instead, it goes to the State. Under these circumstances, § 265 should not apply.

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Please call if you have any further questions.