



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

OFFICE OF
CHIEF COUNSEL

Jul 19, 2005

Number: **INFO 2005-0127**
Release Date: 9/30/05
UIL: 61.30-00; 6404.01-00; 6404.06-00

CONEX-133672-05
CC:ITA:B04:KAAqui

The Honorable Richard H. Baker
5555 Hilton Avenue, Suite 100
Baton Rouge, LA 70808

Attention: Michael R. Eby

Dear Congressman Baker:

I apologize for the delay in responding to your letters dated May 5, and June 7, 2005, on behalf of your constituent, _____ asked about the IRS policy on *Cotnam v. Commissioner*, 263 F.2d 119 (1959), which held that a taxpayer who executed a contingent fee agreement with an attorney in Alabama was not required to include the fee in her gross income.

In January 2005, the Supreme Court of the United States resolved a conflict among the circuit courts, holding that a taxpayer could not exclude a contingent fee from gross income, thereby overruling *Cotnam*. *Commissioner v. Banks*, 125 S.Ct. 826 (2005). Subsequently, the IRS determined that _____ was required to include in his gross income the contingent fee he paid to his attorney, assessed the additional tax liability, and computed statutory interest on that liability. _____ seeks relief from the additional tax and interest.

Apparently, in response to your first inquiry, an IRS employee stated that your constituent should not have followed the opinion of the Fifth Circuit where he resides, because the IRS never changed its position that a taxpayer must include contingent fees in income. I hope the following information will explain the IRS' actions.

The IRS has consistently taken the position that a taxpayer must include in gross income the entire amount of a taxable settlement or judgment, including any contingent fee paid to his attorney. The Courts of Appeals for the Second, Third, Fourth, Seventh, Tenth, and Federal Circuits, and a panel of the Ninth Circuit agreed that a taxpayer could not exclude the contingent fee from gross income. However, the Fifth, Sixth, and Eleventh Circuits, and a different panel of the Ninth Circuit had held that the law did not require taxpayers to include the contingent fee in gross income.

In *Banks*, the Supreme Court agreed with our position that, under the anticipatory assignment of income doctrine, a taxpayer must include in income the fee paid to his attorney under a contingent fee arrangement. As noted above, the Supreme Court decision resolved a conflict among the circuits on this issue, thereby overruling *Cotnam*.

When the Supreme Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be applied to all open tax years. *Harper v. Virginia Dep't of Taxation*, 509 U.S. 86, 97 (1993). Thus, the Supreme Court's opinion in *Banks* applies to the contingent fee that your constituent paid, even though he paid it before the Supreme Court rendered its opinion. To permit him to exclude the contingent fee from his gross income would undercut the very purpose of seeking Supreme Court review, *i.e.*, to establish a national rule, concerning contingent fee payments.

Until the Supreme Court renders an opinion on an issue, taxpayers may rely on the opinion of the circuits to which their cases are appealable. This reliance, however, does not shield taxpayers from liability for additional tax and statutory interest if the Supreme Court subsequently disagrees with the decision of that circuit and the tax year is still open. The IRS generally will not assess a penalty for negligence, however, if at the time a taxpayer filed his income tax return, the law of the taxpayer's circuit was inconsistent with the Supreme Court opinion ultimately deciding the law on this issue. Thus, the IRS did not assert any penalties against your constituent for failing to include the contingent fee in his gross income.

Claiming financial hardship, your constituent seeks abatement of the additional tax and interest. The tax involved in this case is the income tax. Section 6601 of the Internal Revenue Code imposes statutory interest on any underpayment of tax. The IRS may, in its discretion, abate the unpaid portion of any assessment of tax, interest, and penalties where the assessment is excessive in amount, was assessed after the expiration of the period of limitations, or was erroneously or illegally assessed. Section 6404(a). However, a taxpayer can not file a claim for the abatement of any income tax liability, such as that in dispute here. Section 6404(b).

Alternatively, the IRS can abate interest when the accumulated interest is the result of unreasonable errors and delays by the IRS in performing a ministerial or managerial act. Section 6404(e). However, none of these criteria is present in this case.

I hope this information is helpful. If you have any questions, please call me at _____, or _____, Identification Number _____, at _____.

Sincerely,

Michael J. Montemurro
Acting Branch Chief
Office of Associate Chief Counsel
(Income Tax and Accounting)