Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

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Refer Reply To:
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Date:
October 4, 2001

LEGEND:

A =
B =
C =
D =
E =

Activity =

Facility =

Specific Facility =

Plaintiff =

Insurer =

Court =

date 1 =
date 2 =
date 3 =
date 4 =
date 5 =
date 6 =
date 7 =

p =
q =
r =
s =
t =
u =
v =

w =

x =
y =

20XX =

Dear

This is in reply to your request for rulings that you are required to include in your gross income a total settlement award of $q paid as a result of your lawsuit against Insured, notwithstanding that a portion of the award, $r, was paid to your attorneys in accordance with a Contingent Fee Agreement and that another portion, $s, was paid to Plaintiff in accordance with a Settlement Agreement, leaving the remainder of the award, $t, to you. You also request that we rule that you are entitled to deduct the payments to your attorneys and Plaintiff as ordinary and necessary trade or business expenses under § 162 of the Internal Revenue Code. Finally, you ask that we rule that the amounts paid to your attorney and Plaintiff are not subject to the alternative minimum tax imposed by § 56.

FACTS

You are an organizational consultant (A), who conducts business activities as B, a sole proprietorship. B's consulting services include work redesign and re-engineering, team building, training, and management coaching. B also conducts leadership development workshops such as C. The C workshops place the employees of large companies into physically challenging situations that involves some risk, in order to help them develop the leadership skills needed for a fast-paced world. The C workshops are centered upon Activity and are held at Facilities across the country.[1]

On date 1, you conducted a C workshop for the employees of D, an unrelated corporation, at Specific Facility. One of D's employees, Plaintiff, suffered serious physical injuries while attempting to engage in Activity during the program. At the time of the accident, you were an additional insured on a general commercial liability insurance policy issued to Specific Facility by Insurer. On date 2, Plaintiff (and his wife) sued both you and Specific Facility in Court. The Insurer provided both you and Specific Facility a defense, but failed to provide you with independent counsel. After Specific Facility was dismissed from the lawsuit on date 3, Insurer also withdrew from your defense. You retained defense counsel, but after incurring attorneys' fees and costs you were unable to continue funding your defense.

The Settlement Agreement

[1] A has never been treated or considered to be an employee of any contracting party and operates B wholly independent of each Facility's operations.

Consequently, as permitted by the law of State E you entered into a Settlement Agreement Stay and Covenant Not to Execute (the "Settlement Agreement") with Plaintiff, before a judgment was entered.[2] Under the terms of the Settlement Agreement, Plaintiff agreed to provide you with a covenant to stay execution of any judgment obtained against you. You agreed to allow the action to proceed to trial in the form of an uncontested prove up of liability and damages, to be determined by the trial court. You also agreed to prosecute your claims of breach of contract and bad faith against Insurer. Section 6 of the Settlement Agreement provides, in part, that:

> [The Plaintiff] shall have a lien against any recovery obtained by ... [A] in the [action against the Insurer], such that ... [A] shall receive 10% and [the Plaintiff] shall receive 90% of any and all "Net Proceeds" obtained in the [action] as a result of any settlement or final judgment. "Net Proceeds" is defined as any amounts of money recovered (including general, special and punitive damages) after deducting any and all amounts owed by ... [A] for any federal, state or local taxes on any and all amounts recovered, [attorneys fees, costs, and any judgments on any cross-claims in the action].

The Settlement Agreement also provides, in Section 7, that upon entry of a settlement or a final judgement, "...the covenant to stay execution [shall] automatically be transformed into a final and complete covenant not to execute... ."

Thus, under the Settlement Agreement your payment to Plaintiff from any recovery from Insurer would be in full satisfaction of Plaintiff's judgement against you. On date 4, the Court entered judgment for Plaintiff and against you in the amount of $p.[3]

The Contingent Fee Agreement

Pursuant to the terms of the Settlement Agreement, you retained counsel (the "Attorneys") to prosecute the action against Insurer. Both you and Plaintiff entered into an agreement with Attorneys (the "Contingent Fee Agreement") under which the Attorneys agreed to represent both you and Plaintiff for a contingent fee of 30 percent of any recovery after payment of costs. However, in supplemental information dated July 27, 2001, you state that you were the sole party to the lawsuit against Insurer,

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[2] Under state law, if an insurer wrongfully denies coverage or refuses to provide a defense, the insured (A) is entitled to negotiate the best possible settlement with a third party claimant (Plaintiff), including an uncontested trial accompanied by a covenant not to execute.

[3] The total judgment against you consisted of the following: $u for damages to Plaintiff; $v for damages to Plaintiff's wife (loss of consortium); costs of $w; and prejudgment interest of $x. The costs and prejudgment interest were awarded on date 5.

since plaintiff had no claim against Insurer.[4] The Contingent Fee Agreement provides, in part, that:

> Clients [A and Plaintiff] hereby grant Attorneys a lien on any and all claims or causes of action encompassed by this agreement. Attorneys' lien will be for reimbursement of all costs advanced on behalf of Clients and the reasonable value of the services rendered by Attorneys as set forth herein. The lien will attach to any recovery made by Clients whether by settlement, judgment, arbitration award, or otherwise.

On date 5, Attorneys filed a lawsuit against Insurer in Court, claiming that Insurer had breached its duty to defend you against Plaintiff. On date 6, the Court held that Insurer was liable for the entire judgment ($p) that was previously entered (on date 4) in favor of Plaintiff and against you.

The General Release

Subsequently, both you and Plaintiff entered into a Settlement Agreement and General Release (the "General Release") with Insurer. Under the General Release, the lawsuit against Insurer was dismissed. The Insurer agreed to pay $q (the "Insurance Proceeds") to Attorneys for disbursement to Plaintiff and you. On date 7, the Insurance Proceeds were disbursed as follows:

Payment to Plaintiff:	$s [5]
Payment to Attorneys:	$r
Remainder to A:	$t
Total payments:	$q

LAW AND ANALYSIS

Gross Income

Section 61 (a) provides that gross income means all income from whatever source derived, except as otherwise provided by law. The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have

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[4] Plaintiff was included in the Contingency Fee Agreement in order to approve your selection of Attorneys and the terms of the Contingency Fee Agreement, including Attorneys' fees, and to avoid any potential conflict of interest between Plaintiff and you arising out of your lawsuit against Insurer.

[5] Although the total recovery from Insurer, $q, exceeded the amount of Plaintiff's judgement of $p against you, the payment to Plaintiff of $s under the General Release is substantially less than $p.

complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955);1955-1 C.B. 207; Alexander v. Internal Revenue Service, 72 F.3d 938, 942 (1st Cir. 1995) (the nature of amounts received in settlement of litigation is determined by nature and basis of action settled). Here, Plaintiff was injured in the course of A's conduct of her trade or business. In conducting her business, A was a named insured on Specific Facility's insurance policy and sought to enforce her rights under that policy. A's recovery from Insurer falls within the broad definition of gross income.

Nor is there any exception to § 61 that would exclude the Insurance Proceeds from A's gross income; amounts received from an insurance company based on a breach of its duty to defend constitute gross income to the taxpayer. See generally United States v. Benson, 67 F.3d 641 (7th Cir. 1995), modified, 74 F.3d 152 (7th Cir. 1996) (discussing the inapplicability of § 104(a)(2) to exclude such payments). Accordingly, the $q Insurance Proceeds paid by Insurer under the General Release is includible in your gross income in the year 20XX (i.e., your taxable year within which date 7 falls).

Attorneys Fees

You ask that we rule that the *portion* of the Insurance Proceeds (plus statutory interest) that was used to pay your Attorneys' fees ($r) pursuant to the Contingent Fee Agreement is includible in your gross income.

We have already concluded that the Insurance Proceeds are included in your gross income. Generally, when settlement proceeds are included in gross income, taxpayers must include in income the portion that is paid to their attorneys pursuant to contingency fee arrangements. Alexander v. Internal Revenue Service, 72 F.3d 938 (1st Cir. 1995); Estate of Gadlow v. Commissioner, 50 T.C. 975 (1968); Peterson v. Commissioner, 38 T.C. 137 (1962); Goady v. Commissioner, 231 F.3d 1187 (9th Cir. 2000); Kenseth v. Commissioner, 114 T.C. 399 (2000); Sinyard v. Commissioner, T.C.M. 1998-364; Fredrickson v. Commissioner, T.C.M. 1997-125.

In Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000), the court found that under California law an attorney's lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over their suits, judgments, or decrees of their clients. Thus, the court held that taxpayers were required to include in their income the portion of a punitive damages recovery that was retained by their attorney as an attorney's fee under a contingency fee agreement.

In Baylin v. United States, 43 F.3d 145 (Fed. Cir. 1995), the court required a partnership to include in income that portion of a settlement that was paid directly to its attorneys under a contingent fee agreement. In so holding, the court stated that the partnership received the benefits of those funds in that the funds served to discharge the obligation of the partnership owing to the attorney for his efforts to increase the settlement amount.

The Contingent Fee Agreement that you entered into with Plaintiff and Attorneys did not transfer any interest in the judgment or the cause of action to Attorneys. Under the law of State E, a contingent fee arrangement merely creates a lien upon the proceeds of a client's award; the lien attached to the *fruits* of the judgment. Thus, your situation is similar to that presented in Benci-Woodward. Finally, as in Baylin, the $r retained by Attorneys under the Contingent Fee Agreement discharged your obligation to Attorneys for their efforts to obtain the judgment against Insured.[6] Accordingly, the portion of the Insurance Proceeds ($r) that was retained by Attorneys as attorneys' fees is includible in your gross income in the year 20XX.

Settlement Agreement with Plaintiff

You ask that we rule that the *portion* of the Insurance Proceeds ($s) that you paid to Plaintiff in accordance with the terms of the Settlement Agreement is includible in your gross income.

Under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from it, if the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is practically certain to occur (i.e., whether the right basically had become a fixed right), even if the taxpayer transfers the right *before* receiving the income. Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999); Jones v. United States, 531 F.2d 1343, 1346 (6th Cir. 1976); Kinsey v. Commissioner, 447 F.2d 1058), 1063 (2d Cir. 1973); Hudspeth v. United States, 471 F.2d 275, 280(8th Cir. 1972); Est. of Applestein v. Commissioner, 80 T.C. 331, 345 (l983); Lucas v. Earl, 281 U.S. 111, 114-115(l930).

It was solely your lawsuit against Insurer that created the right to receive the Insurance Proceeds. Under the Settlement Agreement, Plaintiff's lien (like that of Attorneys' lien under the Contingent Fee Agreement) attached only to the *fruits* of the judgment against Insured. Accordingly, the portion of the Insurance Proceeds ($s) that was retained by Plaintiff following the General Release is includible in your income in the year 20XX.

Deductible Business Expenses

You ask that we rule that your payment to Plaintiff ($s) in accordance with the Settlement Agreement, and your payment to Attorneys ($r) in accordance with the

[6] This view is also consistent with the principle that when the liability of a taxpayer is paid by a third party, the taxpayer has an accession to wealth in the amount of the liability that has been paid. Old Colony Trust v. Commissioner, 279 U.S. 716 (1929). Under the terms of the General Release, your personal liability for the Attorneys' fees was paid by Insurer.

Contingency Fee Agreement, are deductible by B as trade or business expenses under § 162.

Section 162(a) of the Code provides, in part, that there 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.

In Old Town Corporation v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5, the Tax Court analyzed whether payments made by a corporation to settle a claim asserted against one of its employee/directors constituted an ordinary and necessary business expense, or whether a portion of that payment constituted a voluntary payment by the corporation on behalf of its employee/director. The court recognized that, to be "ordinary", the expenses need only be an accepted means of defense against a lawsuit affecting the safety of the business. However, to be considered "necessary", the taxpayer must illustrate that it may be liable for those expenses and that it had sufficient business motive for paying those expenses. Specifically, the court indicated that the taxpayer must show that: (1) it was not entirely confident that the claims against it would not succeed; (2) the payments in question were made for the purpose of avoiding the claims against it; and (3) a reasonable person would have determined that settlement of such claim was necessary.

Generally, amounts paid in settlement of lawsuits are currently deductible if the acts that gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See, e.g., Federation Bank & Trust Co. v. Commissioner, 27 T.C. 960 (1957) (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in liquidation of assets); Rev. Rul. 80-211, 1980-2 C.B. 57 (allowing a corporation to deduct amounts paid as punitive damages that arose from a civil lawsuit against the corporation for breach of contract and fraud in connection with the ordinary conduct of its business activities); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting taxpayer to deduct payments to settle lawsuit and obtain a release from claims under a franchise agreement).

Similarly, amounts paid for legal expenses in connection with litigation are allowed as a business expense where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, e.g., Kornhauser v. United States, 276 U.S. 145 (1928) (holding that taxpayer may currently deduct attorney fees paid in defense of a suit against him by former law partner); Ditmars v. Commissioner, 302 F.2d 481 (2nd Cir. 1962) (holding that taxpayer may currently deduct business related settlement and attorney fees paid in defense of a suit claiming taxpayer improperly charged brokerage commissions).

The portion of the Insurance Proceeds that you paid to Plaintiff ($s) in accordance with the terms of the Settlement Agreement, and the portion that you paid to Attorneys ($r) in accordance with the Contingency Fee Agreement are ordinary and necessary business expenses under the standard articulated by the Tax Court in Old Town. The expenses were ordinary because such payments are an accepted means of defending

B from liabilities that arose directly from B's conduct of the C workshops. The expenses are necessary because you made them to avoid claims or liability that might have resulted from Plaintiff's lawsuit against you. Finally, your decision to settle Plaintiff's lawsuit was reasonable in view of the fact that Insurer wrongfully withdrew from your defense against Plaintiff.

Accordingly, the amount of the Insurance Proceeds that you paid Plaintiff ($s) under the Settlement Agreement, and that you paid Attorneys ($r) under the Contingency Fee Agreement are deductible by B as trade or business expenses under § 162 in the year 20XX.

Alternative Minimum Tax

You ask that we rule that your payments of $s to Plaintiff and $r to Attorneys are not subject to the alternative minimum tax imposed by § 56(b).

Section 56(b)(1)(A)(i) provides that in determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), no deduction shall be allowed for any miscellaneous itemized deduction (as defined in § 67(b)).

In general, legal expenses are considered miscellaneous itemized deductions if they are determined to be itemized deductions that are not specifically enumerated in § 67(b). Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000) (legal fees incurred as an expense of employment); Alexander v. Commissioner, 72 F.3d 938 (1st Cir. 1995) (legal fees incurred in action against former employer for breach of contract). However, your legal fees at issue are not itemized deductions but ordinary and necessary business expenses deductible under § 162. Accordingly, your legal expenses are not subject to the alternative minimum tax disallowance rules imposed by § 56(b) in the year 20XX.

HOLDINGS

We conclude as follows:

(1) You are required to include in your gross income in year 20XX the total Insurance Proceeds of $q paid by Insured in order to settle your lawsuit and pursuant to the terms of the General Release.

(2) You may not exclude $r from your gross income in year 20XX , which was the portion of the Insurance Proceeds (plus statutory interest) that you used to pay your Attorneys' fees pursuant to the terms of the Contingent Fee Agreement.

(3) You may not exclude $s from your gross income in year 20XX, which was the portion of the Insurance Proceeds that you used to pay Plaintiff pursuant to the terms of the Settlement Agreement.

(4) Your Attorneys' fees in the amount of $r is deductible by B in year 20XX as a trade or business expense under § 162.

(5) Your payment to Plaintiff in the amount of $s is deductible by B in year 20XX as a trade or business expense under § 162.

(6) Your payments of $s to Plaintiff and $r to Attorneys are not subject to the alternative minimum tax imposed by § 56(b).

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Associate Chief Counsel
(Income Tax & Accounting)
By: George B. Baker
Assistant to Chief, Branch 5

cc: