Cotnam v. Commissioner, 28 T.C. 947 (1957)

Damages received for breach of contract, even when based on a promise to bequeath property, are taxable income and not an excludable inheritance.

Summary

The petitioner, Ethel Cotnam, sued the estate of a deceased man, Hunter, for breach of contract. Cotnam claimed Hunter had agreed to bequeath her one-fifth of his estate in exchange for her services as a companion. The court found that the amount Cotnam received from the estate as a result of a judgment in her favor was taxable income. The court distinguished this from a bequest, devise, or inheritance, all of which are excluded from gross income under the Internal Revenue Code. The court also ruled that attorney's fees incurred to obtain the judgment were not deductible and could not be allocated across the period in which the services were rendered. Finally, the court determined that the Commissioner was not estopped from assessing a tax deficiency, despite a prior administrative decision regarding the estate tax liability.

Facts

In 1940, Ethel Cotnam entered an oral agreement with Thomas Hunter, in which she agreed to quit her job and provide services to Hunter, in exchange for a bequest equivalent to one-fifth of his estate. Hunter died intestate in 1945, failing to provide for the promised bequest. Cotnam sued the estate and secured a judgment for $120,000, representing one-fifth of the estate's value. She hired attorneys on a contingency basis. The attorneys received $50,365.83 in fees, and Cotnam received the balance. The IRS determined that the $120,000 was taxable income to Cotnam. Cotnam argued that the payment was equivalent to a bequest and was therefore excluded from taxable income. The IRS also disallowed Cotnam's deduction of her attorney's fees as an expense.

Procedural History

Cotnam filed a claim against Hunter's estate in probate court, which was denied. She appealed to the Circuit Court, where she won a judgment. The Alabama Supreme Court affirmed the judgment. The administrator paid the judgment, including interest, in 1948. The IRS subsequently determined a tax deficiency against Cotnam for 1948, which Cotnam challenged in the U.S. Tax Court.

Issue(s)

1. Whether the $120,000 Cotnam received from the estate was taxable income.
2. Whether the attorney's fees could be allocated over the period the services were rendered.
3. Whether the IRS was estopped from assessing the tax deficiency due to its prior handling of the estate's tax matter.

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Holding

1. Yes, the $120,000 was taxable income.
2. No, the attorney's fees were not deductible under section 107.
3. No, the IRS was not estopped from assessing the deficiency.

Court's Reasoning

The court determined that the $120,000 was income derived from a breach of contract, not a bequest. The court stated, "[T]he judgment she obtained was not a declaratory judgment, but was a personal judgment. The action she brought as well as the claim she prosecuted was based on a breach of contract…" Cotnam's recovery was based on a contract claim, not a will or inheritance, thus it was not excludable from gross income under the Internal Revenue Code. The court cited *Lucas v. Earl*, asserting that the entire recovery was includible in her gross income, even the portion paid to attorneys. Furthermore, the Court held that the attorney's fees were not allocable over the period of the services, finding no authority for it under the applicable statute.

Practical Implications

This case clarifies that funds received from a breach of contract are taxable income, even when the underlying agreement relates to a potential inheritance or legacy. Attorneys and tax professionals must advise clients on the tax implications of settlements or judgments related to breach of contract claims. This case highlights the importance of distinguishing between a claim for damages and the receipt of a gift, bequest, devise, or inheritance. The ruling regarding attorney's fees reinforces that legal expenses are usually deductible in the year they were paid, and allocation is not permissible under normal circumstances. The case further suggests that, absent strict requirements, the IRS is not usually estopped by a prior determination unless the conditions are met. Note also that the outcome of this case can be distinguished in cases in which a will contest is settled by the beneficiaries.

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