It's a Property Issue: The Proper Treatment of Contingent Fees Under the Federal Tax Code

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INTRODUCTION

The Federal Income Tax system has always generated a fair amount of animosity among its targets. Because of the system's statutory nature, disgruntled taxpayers seeking judicial remedies based on principles of fairness and equity rarely succeed. Nevertheless, individuals continue to appeal on every imaginable basis for a deduction or exclusion from their gross income, usually by characterizing a particular source of income as one given special treatment in the Internal Revenue Code (the Code).

This Note examines one of the most recent characterizations that has formed a split among the United States Circuit Courts of Appeals. When an attorney and client enter into a contingent fee contract, the client agrees to give the attorney a certain portion of his or her future settlement or award. The circuit split concerns whether the client must report such contingent fees as gross income. The argument against their inclusion in the client's gross income is that contingent fees represent the attorney's property interest in the suit, which the client transferred to the attorney through the contingent fee contract. On the other hand, if contingent fees are merely an alternative method of payment to the attorney, they are deemed to constitute gross income to the client.

The first Court of Appeals case to deal with this issue was *Cotnam v. Commissioner*,[1] decided in 1959. In *Cotnam*, the Fifth Circuit determined that under Alabama law an attorney's interest in his contingent fee is a property interest in the suit itself rather than an

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1. 263 F.2d 119 (5th Cir. 1959).

alternative method of payment.[2] The fee was therefore an assignment of future income by the client.[3] Accordingly, the court ruled that the portion of the client's award given to the attorneys was not taxable to her.[4] Little else was decided on this issue until 1995, when the Federal Circuit dismissed the characterization relied upon in *Cotnam* and concluded that a contingent fee contract does not warrant special treatment under the Code.[5] Since that decision, eight other circuits have decided similar cases, with some siding for the exclusion and others against it.[6]

Part I of this Note discusses the tax treatment of settlements and awards under the Code, including deductions allowed for settlements and awards, and the attorney's fees paid in reaching them. This section will also consider the role of the alternative minimum tax for individuals in this tax treatment. Part II outlines the leading cases concerning the characterization problem. Part III analyzes the theories laid out in the leading cases and attempts to reconcile them within the structure of the current tax code. Part IV includes some proposals as to the correct theory and suggests action that the courts, as well as Congress, can take to resolve this dispute while maintaining the integrity of the Code.

I. Applicable Tax Law

The proper characterization of contingent attorney's fees is one facet of the more general issue of what income or items of income should be included in a taxpayer's gross income. Section 61(a) of the Code[7] states that "gross income" means "all income from whatever

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2. *Id.* at 125 (Rives and Brown, JJ., concurring).
3. *Id.*
4. *Id.*
5. Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995).
6. Hukkanen-Campbell v. Commissioner, 274 F.3d 1312 (10th Cir. 2001); Kenseth v. Commissioner, 259 F.3d 881 (7th Cir. 2001); Foster v. United States, 249 F.3d 1275 (11th Cir. 2001); Young v. Commissioner, 240 F.3d 369 (4th Cir. 2001); Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000); Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000); Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000); Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Alexander v. I.R.S., 72 F.3d 938 (1st Cir. 1995); Baylin v. Commissioner, 43 F.3d 1451 (Fed. Cir. 1995).
7. 26 U.S.C. § 61 (1994).

source derived."[8] The Code lists several items that are specifically included or excluded from gross income,[9] but does not explicitly deal with contingent attorney's fees.[10] Absent a specific exclusion in the Code, courts have generally construed section 61(a) broadly to give full effect to Congress' authority to tax income.[11] The Supreme Court first exhibited this propensity in *Glenshaw Glass Co. v. Commissioner*,[12] where the court ruled that two-thirds of treble and punitive damages should be included in gross income unless specifically excluded by the Code.[13] The Court determined that absent a clear Congressional intent to exclude such damages, they are comprehended by the general term, "income."[14]

While *Glenshaw Glass* clearly ruled on the taxability of treble and punitive damages, the Code provides for the exclusion of certain other types of income from gross income.[15] Of these exclusions, only one addresses income derived from damages, providing that income stemming from several categories of tort-like damages in section 104(a)(2) are excludable from gross income.[16] This section provides the statutory authority for the exclusion of damages received as compensation for "physical injuries" or "physical sickness."[17] While this provides some protection from taxation to the taxpayer receiving damages, courts tend to interpret these exclusions narrowly.[18]

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8. *Id.* § 61(a).
9. *See id.* § 61(b).
10. *See id.* § 61(a).
11. *See, e.g.*, Helvering v. Clifford, 309 U.S. 331, 334 (1940).
12. 348 U.S. 426 (1955).
13. *Id.* at 432-33.
14. *Id.* at 431. The Court also noted that "[h]ere we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients." *Id.*
15. *See* I.R.C. §§ 101-39 (1994). Examples of excludable income include interest payments; proceeds from life insurance contracts; money from gifts, inheritance, bequests, or devises; money received as compensation for physical injuries or sickness; and income from discharge of indebtedness. *Id.*
16. *Id.* § 104(a)(2).
17. The Code provides that gross income does not include "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." *Id.*
18. The Court determined that in order to define gross income as broadly as possible, one must interpret exclusions from gross income as narrowly as possible. United States v.

Exclusions are not the end of the story, however. Taxpayers have another tool at their disposal when computing tax liability: deductions. The Code provides two basic ways that a taxpayer can deduct monies paid for attorney's fees and expenses. First, under section 162(a), the taxpayer may be able to deduct attorney's fees and expenses as a trade or business expense.[19] However, this deduction rarely applies to average individual taxpayers because they only occasionally sue in a business capacity.[20] Further, even with the ability to utilize such deductions, the taxpayer would still have to deal with alternative minimum tax treatment as outlined below.[21]

A second more common approach for the individual taxpayer is to treat attorney's fees and expenses as expenses incurred for the production of income,[22] which qualify for a miscellaneous itemized deduction under section 212.[23] However, the use of a miscellaneous itemized deduction for litigation expenses causes several problems.

Centennial Savings Bank, 499 U.S. 573, 583 (1991). Further, the Code's exclusion in section § 104(a)(2) itself explicitly excludes punitive damages from its sweep. The addition of "physical" as a qualifier to personal injuries and sickness further limits this exclusion. I.R.C. § 104(a)(2) (1994). This makes damages recovered for emotional distress taxable to the extent that they exceed the amount spent on medical treatment. However, none of the Code's exclusion sections deal with contingent attorney's fees.

Other examples of the Supreme Court's limiting of the breadth of the Code's exclusions include Commissioner v. Schleier, 515 U.S. 323 (1995) (ruling that damages received under the Age Discrimination in Employment Act are taxable) and United States v. Burke, 504 U.S. 229 (1992) (ruling that settlements for back pay under Title VII of the Civil Rights Act of 1964 are not excluded).

19. Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered." I.R.C. § 162(a)(1) (1994).

20. The average individual taxpayer normally cannot meet the requirement that the expense is incurred "in carrying out any trade or business." *Id.*

21. *See infra* notes 27-35 and accompanying text.

22. Section 212 allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year- (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax." I.R.C. § 212 (1994). This Note focuses its attention upon the treatment of settlements and awards that would normally be subject to this deduction but for its exclusion under the AMT.

23. *See id.* § 67(b) (1994). The Code classifies "miscellaneous itemized deductions" as those other than listed in section 67(b). Section 63(d) defines "itemized deductions" as those "deductions allowable under this chapter other than- (1) the deductions allowable in arriving at adjusted gross income; and (2) the deduction for personal exemptions provided by section 151." *Id.* § 63(d) (1994).

First, the Code only allows miscellaneous itemized deductions to the extent that they exceed two percent of the taxpayer's adjusted gross income (AGI).[24] Second, the Code imposes a staged reduction[25] of itemized deductions for a taxpayer whose income exceeds $100,000.[26] Finally, the most formidable obstacle in utilizing a miscellaneous itemized deduction is the alternative minimum tax (AMT).[27]

Congress enacted the AMT in 1969 to ensure that high-income individuals do not avoid significant tax liability due to advantageous application of allowable deductions.[28] The AMT consists of a separate system for calculating income tax liability.[29] Under the AMT, taxpayers must first calculate their tax liability under the regular tax system and then determine whether their income requires further consideration under the AMT.[30] If it does, the AMT expressly

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24. *Id.* § 67(a) (1994). Adjusted gross income is calculated by subtracting deductions from one's gross income. *See id.* § 62(a).

25. *Id.* § 68(a) (1994). This provision provides:

> [I]n the case of an individual whose adjusted gross income exceeds the applicable amount, the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of- (1) 3 percent of the excess of adjusted gross income over the applicable amount, or (2) 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year.

Id.

26. *Id.* § 68(b) (1994). Subsection (1) of this section defines the "applicable amount" in § 68(a) as $100,000. This is then modified by subsection (2)(B), which provides that the applicable amount be adjusted by the cost-of-living adjustment for the applicable year. *Id.* § 68 (1994).

27. *Id.* § 55 (1994).

28. U.S. GEN. ACCOUNTING OFFICE, ALTERNATIVE MINIMUM TAX: AN OVERVIEW OF ITS RATIONALE AND IMPACT ON INDIVIDUAL TAXPAYERS, No. GAO/CGD-00-180, at 3 (2000). The testimony heard by Congress when developing the AMT included that of the Secretary of the Treasury, who reported that 155 individuals, each with an AGI above $200,000 (about $1.1 million in fiscal year 2000 dollars) as defined under the regular tax system, paid no federal income tax in 1967. JOINT ECONOMIC COMM., 107TH CONG., THE ALTERNATIVE MINIMUM TAX FOR INDIVIDUALS: A GROWING BURDEN (Comm. Print 2001) (citing *Hearings on the 1969 Economic Report of the President Before the Joint Econ. Comm.*, 91st Cong. 10 (1969) (statement of Secretary of the Treasury Joseph Barr)). In addition, a report for Congress' Joint Economic Committee stated that the purpose of enacting the AMT was "to reduce certain deductions used frequently by high-income taxpayers and infrequently by other taxpayers. Hence the AMT has provisions concerning deductions for drilling oil wells, farm tax shelters, interest from tax-exempt 'private activity bonds,' and other things unfamiliar to the average taxpayer." *Id.*

29. U.S. GEN. ACCOUNTING OFFICE, *supra* note 28, at 4.

30. *Id.*

forbids the deduction of those expenditures classified as "miscellaneous itemized deductions."[31] Therefore, if a taxpayer's award is large enough to be subject to the AMT, as is often the case when punitive damages are recovered, the taxpayer loses the benefit of the miscellaneous itemized deduction when calculating tax liability.[32] Thus, for taxpayers with large awards and large attorney's fees, the miscellaneous itemized deduction does not apply.

The Internal Revenue Service (IRS) generally requires taxpayers to characterize their entire award, including all parts allocated to their attorneys via a contingent fee arrangement, as gross income, and then deduct the fees and expenses as miscellaneous itemized deductions.[33] Often this would subject the entire amount of the award to the AMT.[34] Thus, the current tax structure, when coupled with the compensation arrangements found in contingent fee contracts, generally creates an enormous tax burden upon the remainder of any settlement or award granted to the client.[35]

II. THE CASELAW

A. Cotnam v. Commissioner

In *Cotnam v. Commissioner*,[36] the Fifth Circuit grappled with the issue of whether the fees paid to the client's attorneys by way of a contingent fee contract should be considered gross income.[37] The

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31. I.R.C. § 56(b)(1)(A)(i) (1994).
32. Benci-Woodward v. C.I.S., 219 F.3d 941 (9th Cir. 2000).
33. *See, e.g.*, Priv. Ltr. Rul. 98-09-053 (Dec. 2, 1997).
34. The result of this would be to require the taxpayer to subject his award to either a 26% or 28% tax. *See* I.R.C. § 55(b)(1)(A)(i) (1994).
35. As an illustration, take an individual who receives an award of $500,000 for back pay and who has a contingent fee contract with an attorney that awards the attorney forty percent of the final award. In this situation, the client only receives $300,000 after compensating his attorney. Further, the individual must pay either approximately $200,000 in federal income tax (if one assumes standard tax treatment) or approximately $150,000 (assuming treatment under the AMT at 28%). This leaves the client with only $150,000 to $100,000. When coupled with additional fees (court costs, etc.), as well as state income tax, the client is left with only a small portion of his or her original award.
36. 263 F.2d 119 (5th Cir. 1959).
37. *Cotnam* also involved a question of the taxability of a devise as payment for services rendered. *Id.* at 121.

then Fifth Circuit[38] characterized contingent fees in two ways. First, because the court concluded that the client could never have received the portion of the award assigned to the attorneys,[39] under Alabama law,[40] "attorneys have the same rights as their clients" to that portion of the proceeds of the client's action that are assigned to the attorneys via a contingent fee contract.[41]

Second, the court noted that the client's claim had no value without the benefit of her attorneys.[42] Thus, when she entered into a contract assigning forty percent of her case to her attorneys, it was not an assignment of income as governed by *Lucas v. Earl*,[43] but

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38. *See generally* 28 U.S.C. § 41; Bonner v. City of Prichard, 661 F.2d 1206, 1207 (11th Cir. 1981). In 1981, the former Fifth Circuit was divided into two separate circuits, the Fifth, consisting of Texas, Mississippi and Louisiana, and the Eleventh, consisting of Florida, Georgia and Alabama. Both the Fifth and Eleventh Circuits consider Fifth Circuit decisions issued prior to the 1981 division as precedent.

39. The court stated, "[u]nder Alabama law, therefore, Mrs. Cotnam could never have received the $50,365.83, even if she had settled the case directly with the Bank." *Id.*

40. The court states:

> Upon suits, judgments, and decrees for money, [attorneys] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.

263 F.2d at 125 n.5 (quoting ALA. CODE § 64(2) (1940)).

41. *Id.* at 125.

42. "[Mrs. Cotnam's] claim had no fair market value, and it was doubtful and uncertain as to whether it had any value . . . [it] was worthless without the aid of skillful attorneys." *Id.*

43. 281 U.S. 111 (1930). *Earl* provides the main basis for the assignment of income doctrine. In this case, Mr. Earl and his wife entered into a contractual arrangement by which

> any property either of us now has or may hereafter acquire . . . in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, . . . and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.

Id. at 113-14. In effect, this arrangement assigns half of Mr. Earl's income to his wife. Therefore, if filing separately, the Earls would be able to avoid taxation at a higher rate. The Court dismissed this view of the contract and stated:

> There is no doubt the statute [the Revenue Act of 1921 42 Stat. 227, 233, 213(a)] could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken

rather an assignment of valueless property to the attorneys.[44] The client therefore did not realize her attorneys' portion of the award.[45]

After the *Cotnam* decision in 1959, little was decided by the other circuits regarding taxation of the contingent fees until 1995. Since then, the Federal,[46] First,[47] Fourth,[48] Fifth,[49] Sixth,[50] Seventh,[51] Ninth,[52] Tenth,[53] and Eleventh[54] Circuits have each handed down

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> according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Id. at 114-15.

44. Under this treatment, the client transfers a portion of his claim to the attorney when they sign the contingent fee contract. Because the claim has no real value at this time, the client passes a valueless portion to his attorney. Both the attorney and client take their portion with no basis.

45. The court stated, "Mrs. Cotnam's tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit." *Id.* at 126.

46. Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

47. The First Circuit touched upon this problem in Alexander v. I.R.S., 72 F.3d 938 (1st Cir. 1995). *Alexander* involved the tax treatment of the taxpayer's settlement with his former employer regarding an age discrimination suit. *Id.* at 940. While the court did not enter into a full *Cotnam*-type discussion, it rejected a state law argument that could allow the taxpayer to avoid tax liability. *Id.* at 946. While not specifically on point, the court did seem to indicate that it would frown on a *Cotnam*-type decision. *Id.*

48. Young v. Commissioner, 240 F.3d 369 (4th Cir. 2001).

49. Srivastava v. Commissioner, 220 F.3d 353 (5th Cir. 2000).

50. Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000).

51. Kenseth v. Commissioner, 259 F.3d 881 (7th Cir. 2001).

52. The Ninth Circuit has issued two rulings dealing with whether an attorney's contingent fee should be included within the clients' income. In Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000), the Ninth Circuit put forth its first opinion dealing with the question at hand. In *Coady*, the taxpayers urged the court to exclude from their gross income that portion of the settlement from Ms. Coady's wrongful termination suit that was assigned to their attorney via a contingent fee contract. *Id.* at 1188. The court noted the split between the circuits in the treatment of such cases. *Id.* at 1189. The court then agreed with the *Baylin* line of decisions, distinguishing *Cotnam* and *Clarks* on the basis that under Alaska law, "attorneys do not have a superior lien or ownership interest in the cause of action as they do in Alabama and Michigan." *Id.* at 1190. The Alaska law governing attorney's liens provides:

> (a) An attorney has a lien for compensation, whether specially agreed upon or implied, as provided in this section . . . (4) fourth, upon a judgment to the extent of the costs included in the judgment or, if there is a special agreement, to the extent of the compensation specially agreed on, from the giving of notice of the lien to the party against whom the judgment is given and filing the original with the clerk where the judgment is entered and docketed.
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> (b) This lien is, however, subordinate to the rights existing between the parties to the action or proceeding.

decisions on the issue.

Id. (citing ALASKA STAT. § 34.35.430). According to the court, this statute provides attorneys with a lien that "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* The court concluded that the different type of lien found in *Cotnam* and *Clarks* made those cases distinguishable. *Id.* The *Coady* court was therefore unable to exclude the attorney's fees from gross income. *Id.* at 1191.

Shortly after deciding *Coady*, the Ninth Circuit considered Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000). In *Benci-Woodward*, a case arising out of California, the Court again sided with the *Baylin* line of decisions, using reasoning similar to that in *Coady*. Again, the court looked to the nature of the attorney's lien in California. It determined that:

> [I]n whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a security interest in the proceeds of the litigation . . . . While there is occasional language in cases in the effect that the attorney also becomes the equitable owner of a share of the client's cause of action, we stated more accurately in Fifield Manor v. Finston (1960) 54 Cal.2d 632, 641, 7 Cal.Rptr. 377, 383, 354 P.2d 1073, 1079, 78 A.L.R.2d 813, that contingent fee contracts "do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery.

Id. at 943 (citing Isrin v. Superior Court, 403 P.2d 728, 732-33 (1965)). Without an attorney's lien similar to either that in *Cotnam* or *Clarks*, the court again refused to exclude the attorney's fees from the Benci-Woodward's gross income. *Id.* at 943. Further, the court took a very negative view of this practice, noting:

> [T]he conclusion emerges that in litigation an attorney conducts for a client he acquires no more than a professional interest. To hold that a contingent fee contract or any "assignment" or "lien" created thereby gives the attorney the beneficial rights of a real party in interest, with the concomitant personal responsibility of financing the litigation, would be to demean his profession and distort the purpose of the various acceptable methods of securing his fee.

Id.

53. Hukkanen-Campbell v. Commissioner, 274 F.3d 1312 (10th Cir. 2001).

54. The Eleventh Circuit has decided two cases in a manner similar to *Cotnam*, the most recent being Foster v. United States, 249 F.3d 1275 (11th Cir. 2001). However, the Eleventh Circuit's primary decision regarding this issue came in Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000). In *Davis*, the Eleventh Circuit held consistently with its own precedent from the former Fifth Circuit, established in *Cotnam*. *Id.* at 1347. Further, the court refused to apply the I.R.S.'s characterization, which would value the "property" given to the attorney at its value upon the case's resolution, rather than its value at the time of transfer. *Id.* at 1348.

B. Baylin v. United States

In *Baylin v. United States*,[55] the Federal Circuit cast the first stone in opposition to the Fifth Circuit's decision in *Cotnam*. While the issue arose as a secondary point in the case,[56] the court struck down the exclusion of an attorney's contingent fee from the taxpayer's income.[57] Notably, the court found no reason to override section 61(a) of the Code, which proclaims, "gross income means all income from whatever source derived."[58] The court also rejected the taxpayers' argument that they could not have fully realized the income because they never received the money.[59] Finally, the court noted that allowing a contingent fee exclusion would allow the taxpayer to "escape taxation . . . through a 'skillfully devised' fee

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55. 43 F.3d 1451 (Fed. Cir. 1995).

56. The case primarily involved the deductibility of certain legal fees incurred by a partnership as capital expenditures. *Id.* at 1451. The question at hand only arose as an alternative argument to avoid taxation on the portion of attorney's fees and expenses paid by contingent fee agreement. *Id.* at 1454.

57. *Id*. at 1454.

58. *Id.* (citing I.R.C. § 61(a) (1994)). The court also noted that the Supreme Court, in James v. United States, 366 U.S. 213, 219 (1961), "has given a liberal construction to the broad phraseology of the 'gross income' definition statutes in recognition of the intention of Congress to tax all gains except those specifically exempted." *Id.*

59. The court states:

> Here, although the partnership did not take actual possession of the funds it paid to its attorney, opting instead to pay him directly out of its eventual recovery, it is evident that the partnership received the benefit of those funds in that the funds served to discharge the obligation of the partnership owing to the attorney as a result of the attorney's efforts to increase the settlement amount. The fee arrangement signifies the value that the parties placed on the attorney's services. In other words, the partnership "made such use or disposition of [its] power to receive . . . the income as to procure in its place other satisfactions which are of economic worth." That the partnership assigned a portion of its condemnation recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership; it means simply that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery and by having the state pay the attorney his fees directly from the recovery. The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees.

Id. at 1453-54 (citing Helvering v. Horst, 311 U.S. 112, 116 (1940)).

arrangement."[60] According to the court, this was exactly the type of situation that the Supreme Court ruled against in *Lucas v. Earl*.[61]

C. Estate of Clarks v. United States

In *Estate of Clarks v. United States*,[62] the Sixth Circuit followed the Fifth Circuit's rationale[63] while developing several alternative lines of reasoning to justify the exclusion of the attorney's portion of a client's award.[64]

First, the court noted that Michigan common law accords attorneys rights under contingent fee contracts[65] that are similar to the Alabama statutory rights discussed in *Cotnam*.[66] Second, the court pointed to the Federal Circuit's finding in *Baylin*, which held that the taxpayer received the benefit of his income.[67] However, the Sixth

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60. "Very little need be said about this argument, which, if accepted, would elevate form over substance and allow the partnership to escape taxation on a portion of its income through a 'skillfully devised' fee arrangement." *Id.* at 1454 (quoting Lucas v. Earl, 281 U.S. 111, 115).

61. *Id.* at 1454.

62. 202 F.3d 854 (6th Cir. 2000).

63. The court construed the questions as "a conflict in the Circuits on the issue of whether the interest portion of an attorney's contingency fee should be included in the client's income under Code § 61(a), even though the lawyer received and paid taxes on all of the money and the client received none of the money." *Id.* at 856.

64. The court ultimately concluded that the portion awarded to one's attorneys via a contingent fee contract should be excluded from the client's gross income. *Id.* at 858.

65. The court relied on the following description of the common law lien:

> [T]he lien, as thus established, is not strictly like any other lien known to the law, because it may exist although the attorney has not and cannot, in any proper senses [sic], have possession of the judgment recovered. It is a peculiar lien . . . for the protection of attorneys against the knavery of their clients, by disabling clients from receiving the fruits of recoveries without paying for the valuable services by which the recoveries were obtained.

Id. at 856 (quoting RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY § 116, at 559 (2d ed. 1955)).

66. *See supra* notes 40-39 and accompanying text. The court noted that a previous district court case in Michigan had adopted the view that "the [contingent fee] agreement amounts to an assignment of a portion of the judgment sought to be recovered." 202 F.3d at 856 (citing Dreiband v. Candler, 131 N.W. 129, 129 (1911)). The court further noted that "[a]lthough the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment." *Id.* Therefore, the reasoning in *Cotnam* concerning the attorney's lien, *supra* note 39, applied in this case. 202 F.3d at 857.

67. "*Baylin* mentioned the Supreme Court's liberal interpretation of 'gross income' and then found that although the plaintiff never had actual possession of the funds paid to the lawyer, plaintiff received the benefit of those funds in that they discharged an obligation of the

Circuit refused to follow this reasoning,[68] instead observing that the taxpayer's claim was valueless before the taxpayer sought the aid of an attorney and, therefore, could not be categorized as income already realized.[69]

The court also observed that the *Baylin* decision relied on two Supreme Court cases, *Lucas v. Earl*[70] and *Helvering v. Horst*.[71] The Sixth Circuit distinguished these cases on the basis that they both dealt with a taxpayer who "earned and created the right to receive and enjoy the benefit of the income before any assignment."[72] The court

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plaintiff owed to the lawyer as a result of his work." *Id.* at 856-57 (citing *Baylin*, 43 F.3d at 1454).

68. The court views the *Baylin* court's analysis of *Lucas* and *Horst* as essentially incorrect. *Id.* at 857. In the court's view, the controlling factor in both cases was that "each taxpayer earned and created the right to receive and enjoy the benefit of the income before any assignment." *Id.*

69. The court stated:

> In the instant case, as in *Cotnam*, the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy. The only economic benefit Clarks could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder.

Id. at 857.

70. 281 U.S. 111 (1930). *See supra* note 43.

71. 311 U.S. 112 (1940). In *Horst*, the taxpayer owned several negotiable bonds. He detached the interest coupons from these bonds shortly before their due date and gave them to his son, who subsequently turned them in for their cash value. 311 U.S. at 112. The Court grappled with the issue of whether the income derived from the interest coupons was taxable to the taxpayer or, alternatively, to his son. In its analysis, the Court noted that underlying the reasoning in most cases where the taxpayer has been held to have gross income even though he never personally received the income:

> Is the thought that income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.

Id. at 116-17. The Court also determined that "the power to dispose of income is the equivalent of ownership of it." *Id.* at 118. Additionally, the Court noted that the "dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefits of it when paid." *Id.* at 119.

72. In *Clarks*, the client had no predetermined interest in the case before he assigned away a portion of it. Thus, the case lacks the main evil that *Lucas* and *Horst* sought to avoid, namely the shifting of tax liability to avoid taxation. 202 F.3d 854, 857. As the court noted:

then determined that the transaction in *Baylin* was more like a division of property than an assignment of income.[73]

D. Srivastava v. Commissioner

In *Srivastava v. Commissioner*,[74] the Fifth Circuit again weighed in on the contingent fee issue. While the decision followed the circuit's precedent in *Cotnam*, the court also critically examined the argument for excluding contingent fees.[75]

The court noted that every court considering the issue had characterized contingent fees in one of two ways. The first characterization, an anticipatory assignment of income,[76] provides

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> In *Lucas* and *Horst*, the income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor. It was a gift of accrued income to a family member. The assignor's purpose was to split income with a family member and avoid the donor's higher rate under the progressive income tax . . . Here there was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury. Clarks, as an assignor, had no predetermined interest in any res before entering a contingency fee arrangement with his attorney, unlike the taxpayer plaintiffs in *Lucas* and *Horst*. There was no purpose to shift tax liability among members of a family.

Id.

73. The court states:

> Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it. The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant.

202 F.3d 854, 858.

74. 220 F.3d 353 (5th Cir. 2000).

75. In this somewhat unusual case, the court seems to indicate that it would decide contrary to *Cotnam* if not for the constraints of precedent. For further analysis of this unusual approach see Benjamin C. Rasmussen, Note, *Taxation of an Attorney's Contingency Fee of a Punitive Damages Recovery: The Srivastava Approach*. 15 BYU J. PUB. L. 301 (2000).

76. 220 F.3d at 358-59. The court also states:

> In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer . . . who has fully enjoyed the benefit of the economic gain represented by

that if a taxpayer voluntarily assigns future income to another, it is still considered income realized to the taxpayer.[77] The second characterization follows the idea that when one transfers, sells, or otherwise relinquishes an asset or income source to another, the anticipatory assignment doctrine does not apply.[78] Under the second characterization, the contingent fee contract is more like the division of a property interest than an assignment of income.[79]

The court then observed the difficulty of fitting the contingent fee contract into one of these two categories.[80] The court stated that the anticipatory assignment of income doctrine rests on the idea that as long as taxpayers maintain control of their own property, they should be liable for the income received therefrom.[81] However, in a contingent fee situation, the client is neither the sole owner of his claim nor completely divested of it.[82] The court also contrasted the

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> his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule [of realization], founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of property. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions that are of economic worth . . . .
>
> [Under the anticipatory assignment of income doctrine,] income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.

Id. at 358-59 (citing Helvering v. Horst, 311 U.S. 112, 115-17).

77. *Id.*

78. "On the other hand, the doctrine does not apply to a taxpayer who transfers, sells, or otherwise relinquishes an asset or income source to another, because the taxpayer ceases to receive any income from that asset." *Id.* at 359.

79. *Id.*

80. Specifically, the court states, "contingent fee contracts defy easy categorization, standing as they do somewhere in between the two poles—on one hand, an obvious scheme to evade taxation through diversion of future income streams to another, and on the other hand, full and complete divestment of an income source." *Id.* at 360.

81. *Id.* The court approvingly cites *Helvering*: "We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee." *Id.* (quoting Helvering v. Horst, 311 U.S. 112, 119 n.20 (1940)).

82. *Id.*

gratuitous transfers in *Horst* and *Lucas* with an arms length business transaction such as a contingent fee contract.[83]

Nevertheless, the court pointed out that while the outcome when entering into a contingent fee contract is uncertain,[84] such uncertainty had not precluded the application of the anticipatory assignment of income doctrine to other arrangements.[85] Further, the court found an inherent inconsistency in excluding attorney's fees via a contingent fee contract from a client's gross income while including attorney's fees via a standard fee contract.[86]

After its detailed analysis, the court determined that if it were approaching the case as a *tabula rasa*, it would probably find the contingent fee includible in the taxpayers' gross income.[87] The court declined to overrule *Cotnam*,[88] however, and refused to distinguish the earlier case based on its reliance on Alabama law.[89] Instead, the court determined that assignment of income analysis looks to the taxpayer's degree of control over the asset, regardless of what state law applies.[90]

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83. *Id.* at 361.
84. *Id.* at 361-62.
85. The court notes:

> But just because a future income stream . . . is of uncertain value does not mean a taxpayer cannot achieve gain from anticipatorily assigning it to another. The taxpayer in Earl, after all, was taxed on the portion of his future salary anticipatorily assigned to his spouse; that there was some degree of inherent uncertainty in his future income stream went without comment and did not preclude application of the doctrine.

Id. at 362.

86. *Id.*
87. "Thus, were we to decide this case as an original matter, we might apply the anticipatory assignment doctrine to hold that contingent fees are gross income to the client." *Id.* at 363.
88. "We do not, however, decide this case on a clean slate, but must follow the contrary approach endorsed in *Cotnam*." *Id.*
89. *See supra* note 40. The *Cotnam* court rested its decision, in part, on an Alabama law giving attorneys a superior lien upon their interest stemming from a contingent fee contract.
90. The court noted:

> These distinctions, however, should not affect the analysis required by the anticipatory assignment of income doctrine, which looks to the taxpayer's degree of control and dominion over the asset . . . . But we find no assistance from the fact that Alabama may offer its contingent fee attorneys, by way of example, greater power to pursue relief directly against the *opposing party*. Whatever are the attorney's rights against the *defendant* under Texas law as opposed to Alabama law, the discrepancy does not meaningfully affect the economic reality facing the *taxpayer-plaintiff*.

E. Young v. Commissioner

The Fourth Circuit, in *Young v. Commissioner*,[91] identified what, in its view, were three important problems with the reasoning in the *Cotnam* line of decisions. First, the court rejected the division of property rationale, pointing out that the client still had ultimate control over all decision-making aspects of the case.[92] Second, the court rejected the rationale that the taxpayer's claim would be "worthless without the aid of skillful attorneys."[93] Lastly, it pointed out the inherent unfairness in allowing tax avoidance by a simple contractual arrangement.[94] The choice between a contingency arrangement and hourly fees has little bearing on a client's enjoyment of a favorable outcome to the litigation.[95] The court therefore refused to see why the Code should treat contingent fees differently.[96]

F. Foster v. United States

In *Foster v. United States*,[97] the Eleventh Circuit both upheld a contingent fee exclusion based largely on the *Cotnam* decision[98] and

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Id. at 363-64.

91. 240 F.3d 369 (4th Cir. 2001).

92. "The client still controls the claim (or property) and ultimately decides to forego, pursue, or settle that claim. The attorney simply provides a service and receives compensation for that service, whether by an hourly rate or through a contingent fee." *Id.* at 378.

93. *Id.* at 377 (quoting *Cotnam*, 263 F.2d at 125).

94. The court noted that this would "permit a client to avoid taxation by 'skillfully devis[ing]' the method for paying her attorneys' fees, the precise danger the Supreme Court warned against in *Earl*." *Id.*

95. As support for this view the court cites *Srivastava:*

> Indeed the Fifth Circuit itself, although following *Cotnam* on stare decisis, has recently recognized that a client with a contingent fee arrangement: "[O]ught not receive preferential tax treatment from the simple fortuity that he hired counsel on a contingent basis, for his attorney's method of compensation did not meaningfully affect the gain he was able to enjoy from a favorable resolution of the litigation."

Id. at 378 (citing *Srivastava*, 220 F.3d at 363) (alteration in original).

96. "We see no reason to let her 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." *Id.* at 377-78.

97. 249 F.3d 1275 (11th Cir. 2001).

98. The court based its decision on *Cotnam* in that, due to the right of Alabama's attorneys, she "did not have the authority to access the money she had assigned to her attorneys before the appeal, she did not 'fully enjoy . . . the benefit of the economic gain represented by

extended *Cotnam*'s exclusion to cover contingent fee contracts executed after the original decision but before appeal.[99] The court reasoned that even after a district court ruling, a taxpayer's interest is still contingent on the results of the appellate process.[100]

G. Kenseth v. Commissioner

In *Kenseth v. Commissioner*,[101] the Seventh Circuit took issue with the *Cotnam* line of cases. The court noted that while several states have laws similar to those cited by the court in *Cotnam*,[102] such laws do not give the attorney an ownership interest in the actual claim. In fact, under Wisconsin law,[103] attorneys are barred from obtaining an ownership interest in their client's claim.[104] Instead of adopting the division of property theory, the Seventh Circuit classified the contingent fee attorney's interest as a security interest.[105] The court then distinguished contingent fee contracts from proprietary interests by noting that the former do not give the attorney control over the claim.[106] The court ended its analysis by determining that the contingent fee contract is merely an assignment

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[her] right to receive income,' as did the father in *Horst* who gave the gift to his son." *Id.* at 1279 (citing Helvering v. Horst, 311 U.S. 112, 116 (1940)) (alteration in original).

99. "Foster argues that the 50% of her post-judgment interest that was paid to her attorneys as the result of the pre-appeal agreement should be controlled by *Cotnam*, even though the agreement was signed after the jury had returned a verdict in her favor. We agree." *Id.* at 1280.

100. "Before the appeals process, there was no guarantee that Foster would ultimately receive the amount awarded by the jury. In fact, during the appeals process, the final judgment number was altered various times, and the ultimate number we address today is lower than the jury verdict." *Id.*

101. 259 F.3d 881 (7th Cir. 2001).

102. *Id.* at 883.

103. *Id.* "Wisconsin now . . . prohibits lawyers from acquiring 'a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client.'. . . The rule allows the lawyer to acquire a lien and to make a contingent-fee contract, but neither a lien or a contractual right is 'proprietary.'" *Id.* at 883-84 (citing Wisconsin State Rules of Professional Conduct, Supreme Court Rule 20:1.8(j)) (citation omitted).

104. "[T]he plaintiff concedes, as again he must, that Wisconsin law does not make the contingent-fee lawyer a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable." 259 F.3d at 883.

105. "The lawyer has a lien, that is, a security interest. But the ownership of a security interest is not ownership of the security." *Id.*

106. *Id.* at 884.

of a portion of the taxpayer's income.[107] The court therefore determined that the contingent fee should be included in the client's gross income.

III. ANALYSIS

As previously noted, the contingent fee issue divides the Circuit Courts of Appeals into two groups. The first group generally holds that it is proper to exclude an attorney's contingent fee from his client's gross income based on the theory that the contingent fee is not income transferred to the attorney, but rather the attorney's assumption of a portion of the client's claim. The second group holds that a contingent fee merely represents an alternative form of payment and that, under *Old Colony Trust v. Commissioner*,[108] the money received by the attorney is payment for services rendered.[109] Therefore, the entire portion of the client's award or settlement is included in his gross income less any deductions or exclusions allowed under the Code.

A. It's a Property Issue—The Cotnam Reasoning

The courts that argue for the exclusion of contingent fees from gross income generally do so under two entirely separate lines of reasoning. The first line of reasoning asserts that the host state's statutes, or the common law regarding attorney's liens, creates a special relationship that is substantively different from other creditor's liens. This lien, they argue, effectively creates a right of joint ownership between attorney and client upon entering into a

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107. The court notes:

> In essence, Kenseth wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent-fee contract is not an assignment . . . and in Wisconsin, the lawyer is prohibited from acquiring ownership of his client's claim. So what Kenseth is really asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.

Id.

108. 279 U.S. 716 (1929).

109. *Id.* at 729.

contingent fee contract.

In *Cotnam*, the court cited one of its previous decisions, where it had likened a state attorney's lien law to creating "a charge 'in the nature of an equitable assignment . . . (or) equitable lien' in the cause of action."[110] Under this analogy, the court ruled that the attorney's lien operates as an assignment of a percentage of the client's claim to his attorney. Thus, the *Cotnam* court relied primarily upon a unique characterization of Alabama's attorney's lien law in order to characterize a contingent fee contract as a property contract.[111]

After *Cotnam*, the Sixth Circuit handed down a similar decision based on Michigan law in *Estate of Clarks*.[112] The *Clarks* court followed *Cotnam* by resting its decision, in part, on the theory that the state's common law lien was of a special character that allowed it to be more like an assignment of property.[113] Thus, upon its examination of Michigan's common law attorney's lien, the Sixth Circuit determined that the lien "operates in more or less the same way as the Alabama lien in *Cotnam*."[114]

This view that the attorney's lien law transfers a portion of the client's property right in his claim to his attorneys leads one to the obvious question of whether the attorney truly has a property-like right to the claim. Clearly, the answer is no. One of the chief characteristics of property ownership is the concept of control. A contingent fee contract, however, gives the attorney no more control over the disposition of the client's claim than any other creditor. The attorney can shape and direct the course of the claim, but only within the bounds of authority given to him by the client. In other words, the

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110. Cotnam v. Commissioner, 263 F.2d 119, 125 (5th Cir. 1959) (citing United States Fidelity & Guaranty Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935)).

111. For an argument in favor of this analysis, see Thad Austin Davis, *Cotnam v. Commissioner and the Income Tax Treatment of Contingency-Based Attorneys' Fees—The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head-On*, 51 ALA. L. REV. 1683 (2000).

112. 202 F.3d 854 (6th Cir. 2000).

113. In support of this theory, the court cites Ray Andrews Brown's book, *The Law of Personal Property*, stating that the common law attorney's lien is "a peculiar lien, to be enforced by peculiar methods." 202 F.3d at 856 (quoting RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY § 116 (2d ed. 1955) (citations omitted). Somewhat paradoxically, the same passage admits that the lien "may exist although the attorney has not and cannot, in any proper senses, have possession of the judgment recovered." *Id.*

114. *Id.*

client maintains final control over the disposition of his claim. Only the client has the authority to bring or relinquish the claim. This remains true even if the client assigns a very high percentage of the final judgment to his attorney. Under a contingent fee contract, the attorney does not actually receive a portion of the claim itself. Instead, the attorney receives a charge against the client's future recovery in compensation for the attorney's services in prosecuting the client's claim.

The other line of reasoning that courts employ to exclude contingent attorney's fees is to distinguish the contingent fee from an anticipatory assignment of income. Courts assert that a contingent fee is more like a division of property between an attorney and client. In *Estate of Clarks*, the Sixth Circuit reasoned that, given the speculative nature of a client's claim, a contingent fee contract is essentially a joint venture between attorney and client from which they benefit according to the portions of the claim allotted to each by the contract.[115] The court, attempting to distinguish the tree and fruit analogy put forth in *Horst*,[116] likened a contingent fee contract to the client "transferr[ing] some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract."[117]

In *Srivastava*, the Fifth Circuit, while not completely comfortable with all of the implications of the tree and fruit rationale, noted that "when a client hires an attorney to prosecute a claim on his behalf, control over that claim—the income source or 'tree'—is neither fully

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115. The court states:

> Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds. Just as in *Cotnam*, the assignment Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney.

Id. at 857.

116. In *Horst*, the court likened the taxpayer's property to a tree bearing fruit. The right to receive income from the property is the fruit. Accordingly, it is the ownership of the tree that determines the proper taxpayer. Helvering v. Horst, 311 U.S. 112, 120 (1940).

117. 202 F.3d at 858.

divested to the attorney nor fully retained by the taxpayer-client."[118] Therefore, the Fifth Circuit ruled that, given the prior controlling precedent set forth in *Cotnam*, the exclusion was permissible because the attorney's contingent fee amounts to the realization of his portion of the claim. This "joint venture" analysis has provided the only influential, strictly analytical policy base[119] for excluding an attorney's contingent fee from the client's income.

Because this line of reasoning is strikingly similar to the attorney's lien reasoning, it falls prey to the same types of problems. The Sixth Circuit reasoned that an attorney's income under a contingent fee contract depends on his own skill and effort as well as the underlying claim provided by his client.[120] In *Horst*, the Supreme Court stated that the "dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid."[121] The Supreme Court's statement demonstrates that both the attorney and the client qualify for taxation under the Sixth Circuit's definition of a contingent fee contract. Under the reasoning set forth in *Estate of Clarks*, the client is responsible for creating the right to receive income, and the attorney is, in effect, the party credited with having "earned" this right. The rationale for this treatment is that while the client ultimately controls the underlying claim, that claim is essentially worthless without the efforts of the attorney. Therefore, both the client and attorney should be credited for having earned and created the right to receive income.

While initially appealing, this characterization of the right to

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118. Srivastava v. Commissioner, 220 F.3d 353, 360 (5th Cir. 2000).

119. Recently, an alternative characterization has been suggested, that of the relation between the sharecropper and landowner. *See* Kenseth v. Commissioner, 114 T.C. 399, 421-58 (2000) (Beghe, J., dissenting). This characterization eliminates the issue of who owns the client's claim (in a sharecropping situation, the landowner maintains ownership of the land) and seems to offer a more equitable solution (under the Code, the sharecropper's share of income from the crop is treated as income and the landowner's portion is treated as rental income on the property). However, this analogy is flawed. In a sharecropping situation, the sharecropper actually owns the crop as well as his own labor. Conversely, the attorney in a contingent fee arrangement has no property interest in the "crop" (the action started on the claim). The attorney merely has an interest in the labor that he or she has provided up until to the point in question.

120. *Estate of Clarks*, 202 F.3d at 858.

121. 311 U.S. 112, 119 (1940).

receive income may be so expansive that its adoption could alter the entire tax code. There is no doubt that a client's claim has no exact discernable value. Further, one cannot doubt that an attorney's efforts in prosecuting his client's claim can help to shape and grow the value of that claim. Yet it is questionable whether this situation is unique to the contingent fee contract. It seems that this aspect of the attorney-client relationship exists in many everyday business relationships.[122] Individuals often enlist the aid of knowledgeable experts in order to increase the value of the property they own. Usually, these experts are compensated at a flat rate. However, if the experts receive a percentage of the profit derived from the property, the tax code treats that profit as having been earned by the property owner. Further, a client's claim can have a more definite value than many speculative

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122. For example, imagine that an individual owns an estate for five years in a piece of property that contains a supermarket. The individual soon realizes that the property is situated near an affluent residential area that has the need for an organic foods store. However, the owner is unacquainted with the organic foods business and does not know how to begin the enterprise. He therefore locates a business manager who specializes in setting up organic foods stores. While the manager would accept a flat rate for his services, the owner has inadequate funds. The owner further realizes that the manager is a man of exceptional skill and may require a very large fee for his services. Accordingly, the owner offers the manager forty percent of all profits from the store during the five years he owns it if the manager agrees to set up the store. The owner, however, retains the right to override any decisions the manager makes. Further, the manager must consult with and obtain the permission of the owner before making any major decisions. However, the owner, realizing that the manager's business judgment is probably better than his own, gives the manager complete day-to-day control of the store. The owner also retains the right to terminate the business at any time, for any reason, provided that he compensates the manager for the work already completed.

Five years pass and the store has grossed over $5 million. Under the reasoning set forth in *Clarks*, one could easily conclude that the owner's property was of indiscernible value. While there was a good chance that the store would profit, it could not have done so without the manager's expert advice and planning. It seems quite a stretch, however, to say that the $2 million income received by the manager as compensation for his services was not first received by the owner. Certainly, the owner received the benefit of the manager's efforts. If the owner had agreed to pay the manager a flat fee of $2 million, the entire $5 million earned by the store would be treated as earned income to the owner. Further, while the owner gave up much in the way of everyday control to the manager, the client surrendered much control to the attorney. Thus, the owner still retained ultimate control over the store, just as a client retains ultimate control over his claim. The only difference between the owner-manager and client-attorney scenarios is that the value of the client's claim may be somewhat more speculative than the value of the owner's store. This is because the store and the land on which it sits constitute real property. This need not be the case, however, as in some situations a client's claim may have a discernible value even given the uncertainty of the legal system. Therefore, it is important to ask what unique qualities exist that warrant unique treatment of contingent fees, if any exist at all.

business ventures. In many such instances, an attorney's actions in prosecuting a client's claim is more like "cashing in" the claim than laboring to create income.

B. It is a Property Issue . . . The Client's Property

A majority of the Circuit Courts of Appeals have ruled that the entire portion of a client's settlement or award should be included in his gross income.[123] For most of the circuits, this decision comes with very little analysis. Generally, the courts first address the fact that the majority of courts that have decided to exclude contingent fees from a client's gross income have done so on the theory that the local attorney's lien law gives the attorney something approximating an actual property interest in the claim. Then, noting that the governing jurisdiction has no such lien,[124] the courts proceed to a characterization analysis. Any such analysis begins with the definition of gross income set out by Congress in the Code, noting that one's gross income includes all income except for those items explicitly excluded by the Code.

With this presumption, the courts make several notable conclusions. First, because most attorneys are ethically precluded from obtaining an ownership interest in their client's claim, whatever interest an attorney has is not one that conveys even partial ownership over the claim.[125] Further, even if the attorneys have a very strong lien, still, a lien, by definition, is merely the right to receive payment of a debt, not a property interest in the claim

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123. There is currently an eight to three split among the circuits.

124. While the courts note that the states of their respective jurisdictions have liens, they determine that these are not of the quality to transfer ownership of the claim to the attorney. *See, e.g.*, Benci-Woodward v. Commissioner, 219 F.3d 941, 943, stating:

> [T]he conclusion emerges that in litigation an attorney conducts for a client he acquires no more than a professional interest. To hold that a contingent fee contract or any "assignment" or "lien" created thereby gives the attorney the beneficial rights of a real party in interest, with the concomitant personal responsibility of financing the litigation, would be to demean his profession and distort the purpose of the various acceptable methods of securing his fee.

Id. (quoting Isrin v. Superior Court, 403 P.2d 728, 733 (Cal. 1965)). *See also Kenseth*, 259 F.3d at 883; *Young*, 240 F.3d at 379.

125. MODEL RULES OF PROF'L CONDUCT R. 1.8(i) (2002).

itself.[126] Second, the exclusion of the contingent fee from a client's gross income would lead to disparate treatment of attorney's fees based on the client's choice of hourly or contingent fee payment. Third, the client receives the benefit of the attorney's efforts via the contingent fee contract. Finally, the courts generally have rejected any argument that the Code places an undue burden on parties that choose to prosecute their claims by entering into contingent fees. The Code discriminates among taxpayers based on artificial statutory definitions that the courts have no authority to override.[127]

Accordingly, the majority of these courts hold that despite the supposed burden imposed on taxpayers, an award or settlement on a client's claim is still income to the client. The mere fact that the client has contracted away a portion of his settlement or award to his attorney as payment does not change the fact that the contingent fee amounts to an assignment of future income as payment to the attorney for services rendered on the client's behalf.

While the courts ruling that contingent fees should be included in the client's gross income are correct in determining that the client-attorney relationship under a contingent fee contract is not closely analogous to a joint venture or joint ownership in the claim, neither does it conform with normal assignment of income doctrine standards. Attempting to fit the contingent fee under the assignment of income doctrine creates several difficulties. First, unlike many early cases decided under this doctrine, the motivation behind the contingent fee contract is not tax avoidance. Second, while the doctrine has been applied in the past to future income assigned to another by the property owner when that income is speculative in

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126. *Black's Law Dictionary* defines an attorney's lien as, "the right of an attorney to hold or retain a client's money or property (a retaining lien) or to encumber money payable to the client and possessed by the court (a charging lien) until the attorney's fees have been paid." BLACK'S LAW DICTIONARY 933 (7th Ed. 1999).

127. *See Kenseth*, stating that the courts should avoid judicially eliminating inequities in the tax code:

> Especially when the means suggested for eliminating one inequity (that which Kenseth argues is created by the alternative minimum income tax) consists of creating another inequity (differential treatment for purposes of that tax of fixed and contingent legal fees). And if it were a feasible judicial undertaking, it still would not be a proper one, equity in taxation being a political rather than a jural concept.

259 F.3d 881, 885.

nature, the contingent fee provides a situation where the future income is not only speculative but alterable through the efforts of the assignee. The question remains, however, whether these differences necessarily negate a traditional assignment of income analysis.

Courts that exclude an attorney's contingent fee from his client's gross income correctly note that an underlying theme of *Horst* and *Earl* is the attempt to ensure that income is taxed to the individual for whom the income is intended, and that one cannot escape proper taxation by assigning future streams of income to others. Were this the basis for the decisions in the above two cases the exclusionary courts would have a strong case. But the Supreme Court did not rely on the taxpayer's attempt to circumvent proper taxation as the reason for applying the assignment of income doctrine in either case. If it had, the "tree and fruit" analogy outlined in *Earl*[128] would not be an exception to the rule, for when a taxpayer assigns away income producing property to another, he or she may do so with the motivation to escape taxation. However, the income from that transferred property will not be charged to the taxpayer, even though his motivation was tax avoidance. The reason for this is that the obligations put in place by the Code stem not from the ownership of a stream of income but from ownership of the property that creates the right to receive that income. Section 61(a) of the Code provides that "gross income means all income from *whatever source derived*."[129] Therefore, if one owns a piece of income-producing property, the income derived from that property is included in the gross income of the property owner. Similarly, if one is paid for services rendered, then this compensation is taxable to the renderer as *de facto* owner of his ability to perform labor.

Once the derivation-based theory laid out in *Horst* and *Earl* is understood, the other objections to applying the assignment of income doctrine to contingent fees are considerably lessened. A contingent fee contract is unlike a situation where one individual detaches interest coupons from a bond and gives them to another in order to avoid taxation on that interest. One obvious difference is that the interest coupons have a readily discernible value. Characterizing

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128. 281 U.S. 111, 115 (1930).
129. I.R.C. § 61(a) (1994) (emphasis added).

them as income to the bond owner thus assures that the owner does not escape proper tax treatment under our progressive rate schedule by assigning away streams of income and obtaining a lower tax bracket. However, income that is realized from a speculative, contingent right is still derived from that right, and that right is owned and controlled by the client. It is therefore the ownership of the right that is dispositive and not the fact that the income is easily discernible.

IV. PROPOSAL

The only treatment of contingent fees that maintains the present principles of the Code is their inclusion in the client's gross income. Excluding contingent fees would carve out an artificial judicial exception to statutory requirements, which are clearly delineated in the Code, and are interpreted by the Supreme Court in a line of cases spanning more than seventy years. While the inclusion of contingent fees in gross income may seem unfair to some, remedying the situation is a job for Congress, not the judiciary. There are several avenues Congress could take to eliminate this inequity, but the easiest method would be to allow deductions for the production of income under the AMT.[130] Not only would this method remedy the problem while respecting the structure of the Code, but it would establish parallel treatment of contingent fees under both the AMT and the traditional tax structure.[131] Further, it would conform with the AMT's purpose of ensuring that high-income individuals do not escape tax liability by the advantageous use of allowable deductions.

There are reasons why Congress may wish to sanction the exclusion of contingent fees from gross income. Chief among them is

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130. Other possible solutions include amending the Code to make all attorney's fees deductible, making contingent attorney's fees deductible, excluding all attorney's fees or just contingent attorney's fees from gross income, and eliminating the AMT altogether. However, all of these suggestions would act contrary to previous congressional actions to limit such deductions for being too broad.

131. Note that under the current standard tax code, section 162 deductions are allowed to the amount that they exceed two percent of the taxpayer's gross income. I.R.C. § 67(a) (1994). By allowing attorney's fees used for the production of income to be deducted under the AMT, the fees would receive similar treatment under both systems, thus maintaining the AMT's general purpose of ensuring proper tax treatment of high income individuals.

that the contingent fee contract is the only avenue for many lower-income individuals to obtain legal counsel. If the availability of legal counsel to low-income individuals truly depends on a different characterization of the contingent fee, Congress is warranted in taking action.

CONCLUSION

The treatment of attorney's fees under the Code has created a large burden on clients who enter into contingent fee contracts with their attorneys to initiate prosecution of their claims. Under current tax law, this burden amounts, in some instances, to a client being left with a very small portion of his award after paying attorney's fees and taxes. This inequity has caused a rash of litigation attempting to exclude contingent fees altogether from a client's gross income by characterizing the fee as the attorney's property interest in the client's claim. This characterization does not follow the standards developed by the judiciary in interpreting the Code. In reality, the client owns the entire claim; it is the client's property. While an attorney may have significant control over the prosecution of the claim, the claim is still the property of the client. The contingent fee contract simply provides a device by which the client pays for the attorney's labor with a portion of the client's future recovery. The client receives the benefit of the attorney's services and, therefore, the income represented by those services. To rule otherwise would be to create an artificial judicial exception to the statutory rules set forth by Congress in the Code.