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CONTINGENT FEE AGREEMENTS & TAX LIABILITY: AN OPPORTUNITY FOR CHANGE

William H. Baker*

I. INTRODUCTION

Over the years, the provisions of the tax law have been of extreme interest to most people. Politicians talk about the tax law, particularly during their campaigns for office, and Congress is constantly tinkering with the Internal Revenue Code, periodically making significant changes to it. The changes are made for many reasons. In some instances, changes are made to affect the nation’s economy. An increase in taxes tends to limit inflation, while a decrease in taxes tends to stimulate an economy with recessionary tendencies. Changes in the law can be made to benefit particular sectors of the business world, resulting in benefits that will accrue to society at large. An example is legislation that grants tax benefits to industries that install pollution control equipment: not only do those industries benefit from a reduction in tax, but the larger society benefits from reduced air pollution.1 There also is tax legislation designed to address the question of fairness and equal treatment of taxpayers,2 or tax legisla-

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1. In 1969, Congress enacted I.R.C. § 169, which provides an election to amortize “certified pollution control facilities” over five years. I.R.C. § 169(a), (b) (West 2001). The purpose of this legislation was to provide a financial incentive to private industry by way of a rapid write-off for facilities whose function is to abate or control air or water pollution. See S. REP. NO. 91-552 (1969).

2. For example, I.R.C. § 1041, enacted by the Tax Reform Act of 1984, provides that no gain or loss will result on the transfer of property between spouses or former spouses (if the transfer is incident to a divorce), even though the property may be subject to different state property laws. See I.R.C. § 1041. Prior to § 1041, the spouse making the transfer could recognize gain when property was transferred in connection with a divorce because the relinquishment of marital rights by the transferee spouse was held to constitute a consideration received
tion that is directed at simplifying the complex tax system. Congress and the President recently took a step in the right direction when they put new legislation on the books that addresses many of these problems.\(^3\)

The need for tax simplification can arise in unusual situations. This article will discuss the issue of identifying the proper taxpayer with respect to the fee earned in contingency fee cases. If the fee is treated as belonging to the attorney immediately upon resolution of the case, the client will not have to treat the amount of the fee as part of his or her gross income. On the other hand, if the amount of the recovery represented by the fee is treated as belonging to the client when the suit is resolved, the client, after treating that amount as gross income, will be able to claim only a miscellaneous itemized deduction, assuming that the matter in litigation is a personal as opposed to a business matter. The miscellaneous itemized deduction will not be as beneficial as having the fee be treated as income of the attorney only. The circuits are split on the issue of whether the attorney or the client should be treated as initially receiving the amount of the fee. This article will analyze this issue and the need for tax simplification that it raises.

The need for tax simplification as indicated by the contingency fee agreement issue discussed in this article is only a...
part of the broader need for simplification. The issue of simplifying the tax code has long been a subject of discussion. Many government bodies, associations, politicians and important individuals in industry and the academic world have spoken out in favor of tax simplification. On April 26, 2001, Richard M. Lipton, on behalf of the American Bar Association ("ABA") Section of Taxation,\(^4\) made a statement before the Committee on Finance of the United States Senate in which he made specific recommendations relating to tax simplification.\(^5\) In his statement, Mr. Lipton noted that the ABA and the Section of Taxation have long been strong advocates of tax simplification, and in 1976 and 1985, the ABA passed proposals of the Section of Taxation urging tax simplification.\(^6\) The statement illustrates how the Internal Revenue Code ("Code") and Regulations have become more complex in recent years, as Congress and different administrations have sought to address various tax-related issues and raise revenue without actually raising tax rates.\(^7\) Mr. Lipton makes numerous recommendations, several of which might be noted.\(^8\) The Joint Committee on Taxation recently released the 1,300-page report, representing a year and a half of study.\(^9\) The

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4. The Section of Taxation is composed of 20,000 tax lawyers, which makes it the largest and broadest based professional organization of tax lawyers in the country.


6. See id. at 40. Some of Mr. Lipton's recommendations, as Chair of the Section of Taxation of the ABA, are set forth infra note 8.

7. Mr. Lipton states, "In recent years, the Code has become more and more complex as Congress and various administrations have sought to address difficult issues, target various tax incentives and raise revenue without explicit rate increases." Fresh Solutions, supra note 5.

8. Included among Mr. Lipton's recommendations are the repeal of the individual and corporate versions of the alternative minimum tax, I.R.C. §§ 55-59 (West 2001); repeal of the itemized deduction phase-out or Pease limitation, I.R.C. § 68; repeal of PEP, I.R.C. § 151(d)(3); simplifying the capital gains provisions; and clarifying the distinction between capitalizing and deducting costs. See id. at 41-47. The individual alternative minimum tax was enacted in 1969 "to address concerns that people with significant economic income were paying little or no Federal taxes because of investments in tax shelters." Id. at 41. As previously noted, supra note 3, beginning in 2006, the Pease limitation and PEP are being repealed by the Economic Growth & Tax Relief Reconciliation Act of 2001, although the sunset provision makes the repeals inapplicable to years after 2010.

9. 1-3 STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., STUDY ON
study focused on tax simplification and suggested revamping the Code. The study details the causes of the complexity of the Code and makes a number of recommendations, including the elimination of the alternative minimum tax and the two-percent floor on miscellaneous itemized deductions.\(^\text{10}\)

Others have spoken out on this problem. On May 25, 1999, Harry L. Gutman, a partner in Klywerd, Peat, Marwick, Goerdeler ("KPMG"),\(^\text{11}\) of Washington, D.C., testified as to his own views on tax complexity and simplification before the Subcommittee on Oversight of the House Committee on Ways and Means.\(^\text{12}\) In his testimony, Mr. Gutman described the sources of much of the complexity in the tax law.\(^\text{13}\) He pointed out how complexity in the law often comes about when Congress, for political reasons, "disguises the substance of its legislative changes."\(^\text{14}\) He stated, "The personal exemption and itemized deduction phase-outs—commonly known as 'PEP and Pease'—are prime examples. Rather than providing explicitly for a marginal rate increase when these provisions were added in 1990, Congress hid the real nature of

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10. When Congress enacted the alternative minimum tax as part of the Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 83 Stat. 487, 580, the purpose of the tax was to insure a reasonable amount of fairness between the tax liabilities of high income taxpayers and lower income taxpayers. The tax was directed at high income taxpayers who could benefit from certain tax incentives and preferences that could reduce or eliminate their regular income tax liability. These benefits were not available to lower income taxpayers.

11. KPMG is one of the Big 5 accounting firms.


13. Id. at 73.

14. Id.
these provisions as rate increases by calling them 'phase-outs.' It is interesting to note that in his statement, Mr. Gutman also recommended the repeal of the alternative minimum tax.

Through the years, many people have expressed similar views. In 1985, former President Gerald R. Ford stated, "I strongly favor the concept and objectives of President Reagan's tax simplification program. . . . The goal of fairness and simplicity is very, very important . . . . I hope that we end up with a simpler and more equitable federal tax system." There clearly have been many pleas for greater fairness and simplicity in the tax laws, and the discussion that follows relates to these concepts in a particular setting.

II. RECENT CASES DEMONSTRATE NEED FOR TAX SIMPLIFICATION

A number of recent decisions have demonstrated how certain provisions of the tax law can bring about unfair and inequitable treatment of taxpayers. These cases involve the question of identifying the proper taxpayer in situations where a client and an attorney have entered into a contingency fee agreement.

The circuits are split on the question of whether a contingency fee agreement will result in the portion of the recovery representing legal fees being treated as income to the client. The Fifth, Sixth and Eleventh Circuits have held that the fee portion of the recovery is not income to the client (taxpayer).

The Third, Fourth, Seventh, Ninth and Federal Circuits have

15. Id.
16. Id. at 74-75.
18. See Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Estate of Clarks v. United States, 2000 FED App. 0020P (6th Cir.), 202 F.3d 854; Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000); Foster v. United States, 249 F.3d 1275 (11th Cir. 2001); Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); O'Brien v. Comm'r, 38 T.C. 707 (1962), aff'd 319 F.2d 532 (3d Cir. 1963); Kenseth v. Comm'r, 114 T.C. 399 (2000), aff'd 259 F.3d 881 (7th Cir. 2001).
19. See Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959); Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Estate of Clarks v. United States, 2000 FED App. 98-2437 (6th Cir.), 202 F.3d 854; Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000); Foster v. United States, 249 F.3d 1275 (11th Cir. 2001).
ruled that the attorney’s fee is treated as income to the client (taxpayer). In any event, the fee will be taxable as income to the attorney who earns the fee and ultimately receives it.

One of these recent cases involves a taxpayer who retained an attorney on a contingent fee basis to bring suit against a radio station and its parent company for defamation. The jury ruled in favor of the plaintiff-taxpayer (client) and the parties worked out a settlement, which was paid to the plaintiff in 1991. The taxpayer, however, did not report any income from the settlement. The Commissioner determined that the part of the settlement representing interest and punitive damages was taxable income and asserted a deficiency on that basis. The taxpayer contested the deficiency and filed suit, claiming that the amount payable to the attorney because of the contingency fee agreement was not includable in his gross income. The Tax Court rejected the taxpayer’s position, holding that the entire amount of the settlement, including the portion owed as attorneys’ fees, was in fact income to the taxpayer and thus upheld the Commissioner’s ruling on the tax deficiency. Accordingly, the case squarely raised the question of identifying the proper taxpayer.

Did the income earned by the attorney under the contingent fee agreement constitute income belonging to him from the instant it was available under the settlement? Or should it be viewed as having first been paid to the plaintiff, who then paid the fee to the attorney? It does not make a difference to the attorney because the fee will be income to him in any event. But it does make a difference to the plaintiff (client). If the amount of the fee is treated as part of his gross income in the first instance, he will be entitled to a deduction for the fee paid to the attorney under the contingency fee agreement. The deduction in most instances, however, will be a miscellaneous itemized deduction, which will only be deductible to the extent that it exceeds two percent of the tax-

20. See O’Brien v. Comm’r, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm’r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm’r, 259 F.3d 881 (7th Cir. 2001); Coady v. Comm’r, 213 F.3d 1187 (9th Cir. 2000); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).
22. See id. at 356.
23. See id.; see also I.R.C. § 104(a) (West 2001).
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payers adjusted gross income. Presently, there is also an overall limitation on itemized deductions, but the limitation, as previously indicated, is being repealed for years after 2009.

It also is detrimental to the taxpayer to include the attorney's fee as part of the taxpayer's gross income in cases of this kind because miscellaneous itemized deductions are not allowed to individuals for the purpose of computing the alternative minimum tax. A taxpayer would be able to avoid these obstacles if the fees were treated as belonging to the attorney in the first instance and never having become part of the gross income of the taxpayer (client). In cases like Srivastava v. Commissioner, the limitations on the deduction would never go into effect. In fact, Srivastava held that the income in the amount of the legal fee was solely the attorney's income and not that of the client.

III. THE ASSIGNMENT OF INCOME DOCTRINE

At the heart of these cases is the question of whether a contingency fee agreement amounts to an anticipatory assignment of income from the client to the attorney. Ordinarily, income is taxable to the one who receives it or has a legal right to receive it. But one who has a right to receive income cannot simply designate an alternate recipient and thereby make that person liable for the tax on the income. The Supreme Court established the assignment of income doctrine in the landmark case of Lucas v. Earl. The Internal Revenue Code does not contain a provision relating to the assignment of income.

26. See I.R.C. § 68. Adjusted gross income is defined as meaning gross income minus business deductions and a number of other specifically enumerated deductions. See I.R.C. § 62.
27. Total repeal will take place for years after 2009, but the repeal will be effected on a gradual basis beginning in 2006. See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 103, 115 Stat. 38, 44 (codified at I.R.C. § 68(f)-(g)).
30. See Srivastava, 220 F.3d at 365.
32. See id.
33. 281 U.S. 111 (1930).
Lucas v. Earl involved an attempt to assign income earned by an attorney as salary and legal fees. In 1901, an attorney and his wife entered into an agreement providing in substance that any property that either of them owned or would acquire in the future, including future earnings, would belong to both parties as joint tenants. The husband earned the salary and fees in question in 1920 and 1921, and the husband took the position that this income properly was attributable one-half to himself and one-half to his wife pursuant to the agreement between them. If, at the instant that the salaries and fees were received, one-half belonged to each party, the position of the husband would have been correct. The Supreme Court concluded, however, that salaries were taxable to the person who earned them, and held that tax liability cannot 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." The Court used the metaphor of fruit growing on a tree and indicated that the fruits (income) cannot be attributed to a "different tree from that on which they grew." In the case of income earned through personal services, once a taxpayer has earned the income, it is not possible to assign it to another to avoid tax liability with respect to the income, while making the assignee responsible for reporting and paying the tax. In Lucas, the attempted assignment was made years before the taxpayer earned the income in question, yet it still was not effective in making the taxpayer's wife liable as a taxpayer on one-half of it. The reason for that result was that in his attempt to make his wife the taxpayer as to one-half of his income, the taxpayer, who had earned the income, had exercised control over the enjoyment of the income by the act of disposing of it.

34. See id. at 113.
35. See id. at 113-14.
36. See id. at 114.
37. Id. at 115.
38. Id.
39. See id. at 114-15.
40. See id. at 113-14.
41. The definition of income is "all income from whatever source derived." I.R.C. § 61 (West 2001). Section 61 elaborates on that definition by listing fifteen examples to demonstrate various types of economic gain that can constitute income. See id. But Helvering v. Horst teaches that there must be a realization of income as the taxable event. See Helvering v. Horst, 311 U.S. 112, 115
A. Applicability of the Assignment of Income Doctrine

This doctrine applies in two situations. The first relates to income earned through personal services. As discussed above, a taxpayer cannot assign income that he plans to earn or has already earned through personal services to another person, thereby making the assignee the taxpayer with respect to that income and avoiding paying tax on it himself. Even though the taxpayer may never actually receive the income, the taxpayer has controlled the beneficial enjoyment of the income by directing payment to the assignee. The second situation relates to income produced by property owned by the taxpayer. In the case of property, one can make another the taxpayer as to income produced by the property if a transfer of ownership is made of all or the portion of the property producing the income. To put it in terms of the analogy that is customarily used, if part of the "tree" is transferred, the income subsequently produced by that part of the tree will belong to and be taxable to the transferee.

(1940). It is not, however, necessary for the taxpayer to actually receive cash or property for there to be a "realization." Id. Realization takes place "when the last step is taken by which he obtains the fruition of the economic gain which has already occurred to him." Id. The opinion goes on to point out, "[t]he power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it." Id. at 118.

42. Lucas is the original case establishing the concept that income earned by a particular person is taxable to that person. See Lucas, 281 U.S. at 114. That clearly is the rule, except in community property states where income earned by either spouse belongs one-half to the other spouse. See Poe v. Seaborn, 282 U.S. 101 (1930). However, a different rule may apply in community property states where the spouses live apart. See I.R.C. §§ 66(a), 879(a).

43. See Lucas, 281 U.S. at 111; Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000).

44. In the Horst case the Supreme Court noted, 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.

Horst, 311 U.S. at 116-17.

45. See id. at 113; Salvatore v. Comm'r, 29 T.C.M. (CCH) 89 (1970).

46. See Comm'r v. O'Donnell, 90 F.2d 907 (9th Cir. 1937), rev'd on other grounds, 303 U.S. 370 (1938); Blair v. United States, 300 U.S. 5 (1937).

47. See Lucas, 281 U.S. at 115; see also Horst, 311 U.S. at 120 (using the
One of the leading cases involving income-producing property is *Helvering v. Horst.* In *Horst,* the taxpayer, who owned bonds with interest coupons attached, transferred the interest coupons to his son and claimed that the income was taxable to the son when the son redeemed the coupons. In order to make the interest income taxable to the son, however, an interest in the bonds themselves would have had to be transferred. The Supreme Court held that the income was still taxable to the father because he owned the tree on which the fruit was produced, and he could not simply transfer the fruit and make the transferee the taxpayer as to that amount of the income. The assignment of income concept set forth in *Horst* has been followed in many subsequent cases. It should be noted that in *Horst,* nothing further remained to be done in the way of personal services to produce the interest income on the bonds. Even though no further action was required, it was a certainty that the interest income would be paid. It is understandable that under those circumstances, the father's attempt merely to assign the income, produced solely from property that he continued to own, was ineffective.

**B. Exceptions to the Assignment of Income Doctrine**

There may be unusual cases where a taxpayer can avoid being treated as the taxpayer if the "assignment" took place before the income was earned and the taxpayer did not control its disposition. Along these lines, the case of *Commis-
sioner v. Giannini is instructive but somewhat unique. In Giannini, the taxpayer had worked for a corporation for the first half of the year and had been compensated for his services. At that point, he instructed the company that he would not accept any further compensation for the year and suggested that the corporation “do something worthwhile” with the remainder of his salary. The corporation donated the money to a university. The court held that Giannini was not taxable on the income for his services for the second half of the year. The court noted that the taxpayer had not beneficially received the income because he neither received the income nor controlled its disposition. Accordingly, in that case, there was never an attempt to assign income to which the taxpayer had a right. His notice to the company of his intention not to receive any income for the second half of the year had the effect of preventing him from ever having a right to receive the income. He could not assign income that he never had a right to receive and over which he had no control. His permitting the employer to dispose of the funds according to its wishes established his complete rejection of any control over its disposition.

In the same year as the Lucas v. Earl decision, the Supreme Court decided another case, which did allow for income to be divided between taxpayers on the basis of state law provisions. Poe v. Seaborn involved the community property law of the State of Washington. Under the Washington statute, income of either spouse was treated as instantly be-

56. 129 F.2d 638 (9th Cir. 1942).
57. See id. at 639.
58. Id.
59. See id.
60. See id. at 641.
61. See id.
62. See id.
63. See id. at 640.
64. As shown by Horst and explained in Giannini, if a taxpayer does not actually receive income to which he has a right, he will still be taxable on it if he controls its disposition by directing the benefit of it to another. See Horst, 311 U.S. at 115; Giannini, 129 F.2d at 641. But where one receives no cash or property and gives up the right to receive it or to control its disposition by naming someone else to benefit from it prior to its becoming effective, Giannini holds that no income results to the taxpayer. See Giannini, 129 F.2d at 641.
66. See id. at 110-11 (explaining that a spouse's ownership interest is dictated by the statutes of the State and the decisions interpreting them).
longing to each from the moment it was earned. Therefore, spouses were able to spread their income equally and have it taxed at lower rates overall than if the one spouse who earned the income was taxed on all of it. That case provided a significant advantage to couples living in community property states. In 1948, joint income tax returns came into the law and permitted married couples to be taxed at a tax rate similar to that applicable to couples in community property states.

The assignment of income doctrine also has been held not to apply where the claim or rights of the taxpayer were uncertain and there existed doubt as to collectibility. A transfer by a taxpayer of his rights in a claim that is doubtful, uncertain and contingent becomes taxable to the assignee when collection of the claim occurs, but not to the taxpayer. Where a claim is being litigated, if the taxpayer makes a transfer of the claim before the appeals have been exhausted, the income

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67. See id. at 111.
68. See id. at 118. Because of the graduated rate structure, splitting income between two spouses was more beneficial than having all the income taxed to one spouse at a higher graduated rate. For example, if a couple had $100,000 of taxable income, and if all of it were taxable to the husband at a top marginal rate of forty percent, the total tax paid would be $40,000. But if the income were treated as belonging one-half to each spouse, and the highest marginal rate were eighteen percent on $50,000 for an individual, the total tax which would be paid by both spouses would be $36,000, or $4,000 less than if all of the income were attributable to the husband alone.
71. See Jones v. Comm'r, 306 F.2d 292 (5th Cir. 1962). In Jones, the taxpayer was a subcontractor on a construction project for the U.S. Government. Jones sustained a loss of over $350,000 in 1943 and 1944. See id. In 1944 and 1945, he sold and leased his equipment and paid part of a large debt owed to the surety on his bond. See id. In 1944, the prime contractor submitted a claim to the Government for $1,235,833.65 additional compensation due on the job. See id. at 294. Part of this claim related to services performed by Jones. Jones was not able to recover directly from the Government but was relegated to recovery through the prime contractor. See id. In 1952, Jones ended his business as an individual, and in 1953, he assigned all of his right, title or interest in the claim against the Government to a corporation, Drilling, which agreed to pay Jones $10,000 and all of Jones's income tax liability for 1948, 1949 and 1950, plus expenses incurred in the defense of such liability. See id. The claim against the Government was denied, and suit was filed by the prime contractor in the U.S. Court of Claims. See id. In 1953, the prime contractor won a substantial part of its claim, and the part of the recovery belonging to Jones was paid to him and immediately endorsed over to Drilling. The court concluded that the proceeds of the judgment attributable to Jones were not taxable to him but were taxable to Drilling, by virtue of the assignment. See id. at 301.
ultimately paid to the transferee is not taxable to the taxpayer.\textsuperscript{72} These cases generally involve situations where the claim was uncertain and contingent at the time the assignment was made, and the assignment was not a gift but made for a business purpose.\textsuperscript{73} Where the assignment was made as a gift, after all appeals had been exhausted in the pending litigation over the claim, the amount of the claim was deemed to be sufficiently certain so that income did result to the taxpayer-assignor.\textsuperscript{74}

Although these cases did not involve contingency fee agreements, they did focus on the interests that the assignors had at the time the assignments were made, which is an important factor in contingency fee cases.\textsuperscript{75} It should be noted, however, that the question of taxability in a contingency fee agreement case involves different considerations from those involved in the ordinary assignment case. An assignment that is made prior to the conclusion of litigation at a time when the claim is uncertain can result in gross income to the assignee only. But if there is a contingent fee agreement in the same matter, it is possible, based on the facts of the particular case, that at the conclusion of the litigation, the assignor (client) will be treated as receiving gross income with respect to the amount of the recovery representing the attorney's fee.

Another type of assignment of income that has received considerable attention from the general public involves lottery ticket winnings.\textsuperscript{76} Generally, if part of the ticket is assigned to someone before the ticket has become a winner, the

\begin{itemize}
\item \textsuperscript{72} Cold Metal Process Co. v. Comm'r, 247 F.2d 864 (6th Cir. 1957); Priv. Ltr. Rul. 200107019 (Feb. 16, 2001).
\item \textsuperscript{73} See Jones v. Comm'r, 306 F.2d 292 (5th Cir. 1962), and cases cited therein.
\item \textsuperscript{74} See Doyle v. Comm'r, 147 F.2d 769 (4th Cir. 1945).
\item \textsuperscript{75} Foster v. United States, a recent case which involved a contingency fee agreement, held that no income resulted to the assignor-client, even though the agreement was entered into after a jury verdict and while an appeal was pending. Foster v. United States, 249 F.3d 1275, 1277 (11th Cir. 2001). Foster was based on Alabama law and followed Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959), and Estate of Clarks v. United States, 2000 FED App. 0020P (6th Cir.), 202 F.3d 854. See Foster, 249 F.3d at 1277.
\item \textsuperscript{76} To help resolve the question of who pays the tax on lottery winnings, the Service has issued Form 5754, which is prepared by the winner but lists other parties who are entitled to share in the winnings. See Sharing the Winnings, THE BOSTON GLOBE, Apr. 2, 1995, at 80.
\end{itemize}
assignment will be effective to transfer part of the winnings to the assignee. Assuming that the person who purchased the ticket makes a valid gift or transfer of it to someone else, that person will become taxable only on his share of the winnings. This would be a means of shifting income to another taxpayer. But once the ticket has been identified as a winner, it is then too late to assign away any part of it. The ticket will then be treated as a property interest of the original owner, and the income will be attributed to him much the same as the interest income in Helvering v. Horst was treated as belonging to the bondholder.

But note the case of Kochansky v. Commissioner, in which an attorney filed a lawsuit for a client under a contingency fee arrangement. Before the suit was settled, the attorney and his wife divorced. The divorce agreement provided that the taxpayer and his wife would split the contingent fee that would be paid in connection with the lawsuit. A portion of the fee was paid to each individual, and each paid tax on the part that he or she received. The Government determined that the entire fee was the tax liability of the attorney, and the court agreed because the attorney alone had earned the income in question. That was purely a case of an attempt to assign income earned through personal services, and despite the fact that the amount to be earned was uncertain and contingent at the time of the divorce

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77. A woman who won the sweepstakes was successful in shifting the tax liability on part of the winnings. The Tax Court held that she had intended to make a gift to her husband and two children of part of her sweepstakes ticket at the time she bought it, using a nom de plume. See Chelius v. Comm'r, 17 T.C.M. (CCH) 121 (1958).
78. In Chelius, the Tax Court held that a valid gift had been made even though the transfer of a part interest in the sweepstakes ticket to the assignees was not put in writing until after the lottery took place and the ticket was drawn. See Chelius v. Comm'r, 17 T.C.M. (CCH) 121 (1958). See also Droge v. Comm'r, 35 B.T.A. 829 (1937); Huntington v. Comm'r, 35 B.T.A. 835 (1937).
79. In Braunstein v. Commissioner, the Tax Court held that where a sweepstakes ticket was assigned after the drawing but before the race, the assignor was taxable on the amount guaranteed by the designation of a horse in the drawing. Braunstein v. Comm'r, 21 T.C.M. (CCH) 1132 (1962). The assignment of the amount subsequently won in the race was held to be valid—the winnings were income to the assignees in the percentage assigned. See id.
81. See Kochansky v. Comm'r, 92 F.3d 957, 958 (9th Cir. 1996).
82. See id.
83. See id.
84. See id. at 959.
agreement, the attorney produced the income and was in control of his own services. The fact that the fee was contingent on the outcome of the litigation was not significant because the fee was attributable to the personal services rendered by the attorney. The case was one step removed from addressing the issue of the tax liability of a client with respect to the contingency fee earned by the attorney; it only involved the attempted assignment of income clearly attributable to the attorney.

Additionally, there are business contexts in which the assignment of income doctrine will not be applicable. If an assignment is made to another in return for a valuable consideration in a valid business transaction, the doctrine has been held not to apply. An example is *Estate of Stranahan v. Commissioner.* In *Stranahan,* the taxpayer transferred to another the right to receive a future dividend payment from a corporation, and at the time of the transfer, the taxpayer received a cash payment from the transferee in consideration for the transfer. Although the assignment of income doctrine did not apply in that case, it can be distinguished from the contingency fee agreement cases where the client does not receive actual cash or other property at the time of the agreement. In *Stranahan,* the purpose of the arrangement was not to avoid taxation on the dividend income, but to reduce the tax liability of the taxpayer by permitting him to offset the payment received for the future dividend against an interest deduction. Because that case involved valuable consideration, the *Stranahan* court distinguished the case from cases like *Horst,* which involved gratuitous transfers. *Stranahan* shows that the purpose of the arrangement is important, and the purpose in that case was not to shift income to a lower bracket taxpayer, but to provide the taxpayer with some income in the year of the agreement that could offset a

85. See id.
86. In the cases on which this article is based, the issue focuses on the rights to the income produced under a contingency fee arrangement between a client and an attorney. In *Kochansky,* the focus was not on that relationship but on the taxability as between an attorney and his former spouse (not the client with whom he had a contingent fee agreement). See id. at 957.
87. 472 F.2d 867 (6th Cir. 1973).
88. See id. at 868.
89. See id. at 869.
90. See id. at 870.
In order to gain a clear perspective of the nature of contingency fee agreements, how they developed and what they were intended to accomplish, this article will next examine the history of such agreements.

IV. THE ORIGINS OF CONTINGENCY FEE AGREEMENTS

Contingency fee agreements were not always looked upon with favor. In the Middle Ages in England, if a stranger offered to prosecute a legal claim held by another for compensation, he could be subject to criminal penalties and the common law doctrine of champerty. The doctrine of champerty involves the situation where a stranger enters into a bargain with a party to a lawsuit, whereby the stranger offers to prosecute the case at his own risk and expense in return for receiving a portion of any amount recovered. In the eighteenth and nineteenth centuries, high courts in England followed the tradition of holding champertous contingency fee agreements to be unlawful.

Contingency fee agreements, however, “may have been common in late colonial America.” As early as 1813, Justice Hugh Henry Brackenridge of Pennsylvania claimed that the practice of entering into contingency fee agreements was customary, even though the most prominent members of the bar still took the position that such agreements were unlawful. In fact, “most of the earliest reported antebellum American decisions on the subject held contingency fee arrangements to be champertous and void.” Between 1824 and 1840, several states approved of these agreements, and by 1875, a number

91. See id.
92. See Peter Karsten, Enabling the Poor to Have Their Day in Court: The Sanctioning of Contingency Fee Contracts, A History to 1940, 47 DePaul L. Rev. 231 (1998).
94. See Karsten, supra note 92, at 233.
95. Id. at 234.
96. See id.
97. Id. at 234-35.
98. By case law, New York approved of these agreements in 1824, Louisiana in 1834 and Tennessee in 1836. See id. at 239 n.64. The next decade found the courts of Arkansas, California, Georgia, Illinois, Iowa, Texas, Virginia and Wisconsin following the same road. See id. at 239 n.65. In 1852, the Pennsylvania Supreme Court approved of these agreements. See id. at 239. After the Civil War, Connecticut, Michigan, Missouri, New Jersey and Utah approved of these
of additional states held contingency fee agreements to be enforceable. At an early point, some states by statute permitted the use of these agreements. The Virginia legislature followed that procedure in 1839, and New York enacted a statute approving of these agreements in 1848. Many states did not enact statutes but accomplished the same result through their supreme courts. Such agreements achieved acceptance because people believed that an attorney would prosecute a case with more energy when motivated by the knowledge that he would share in the winnings. But it is more likely that these agreements became accepted because they enabled indigent plaintiffs to assert their rights in court. The popularity of these agreements can be attributed to the fact that they provide a means of financing the costs of prosecuting a claim while shifting the risk of not recovering the costs from the client to the attorney.

V. INTERESTS CREATED BY A CONTINGENCY FEE AGREEMENT

As discussed above, there is a split among the circuits as to the tax implications of contingency fee agreements. At the heart of the controversy is the type of interests created by these agreements. Prior to entering into the agreement, does the client have something that can be transferred to the attorney? At that point, the client has a cause of action against the party who will become the defendant. The cause of action is an incorporeal or intangible right. It is a chose in action, which constitutes personal property. Accordingly, because a cause of action is a form of property, it is capable of being transferred from one party to another.

agreements through their case law. See id. at 239 n.66.
99. See id. at 239.
100. See id. at 240 n.74 & n.77 (citing 1839-1840 Va. Acts ch. 50 and 1848 N.Y. Laws ch. 379, respectively).
101. See id. at 239-40.
102. See id. at 241.
104. See id.
105. See discussion supra Part II.
A. The Estate Tax Definition of Property

It is interesting to consider the effect of contingency fee agreements in an estate tax context to see if cases in that area will help to resolve the income tax question. For federal estate tax purposes, the contingent nature of claims does not prevent them from being included in the gross estate of the deceased. The term "property" as used in the federal estate tax statute "embraces all choses in action, including claims for compensation for services performed."

In Estate of Aldrich, a case involving an attorney acting under a contingency fee agreement, the Tax Court declared that the fees were to be included in his estate, despite the fact that the attorney had not received the fees during his lifetime, and that there was no specific value attributable to them at the time of his death. The Tax Court in Aldrich held that the right of an attorney to fees under a contingency fee agreement was includable in his estate even though he died prior to the disposition of the case. In addition, the Aldrich court indicated that the speculative nature of the claim did not affect the inclusion of the fees in his estate, but only affected the value of the claim. Although cases of this kind confirm the fact that contingent claims are property, they do not answer the question of whether the amount of the fee should be included in the client's gross income. The contingent fee would be includable in the estate of the deceased attorney whether the fee were treated as payable directly out of the recovery to the attorney, or payable out of the recovery after it had first been paid to the client.

Looking at the question of property rights for estate tax purposes from the client's point of view, the contingent claim is includable in the client's estate if the client dies before the recovery results. The case of Estate of Houston v. Commissioner is instructive on this point. In that case, the decedent's estate included the value of claims for damages arising

110. See Estate of Aldrich, 46 T.C.M. (CCH) at 1295.
111. See id.; see also Estate of Curry, 74 T.C. at 540.
113. 44 T.C.M. (CCH) 284 (1982).
out of the wrongful death of her deceased husband. The court there stated,

[The] Estate Tax Reg[ulations] provide that the gross es-
state shall include the date of death value of all property,
whether real or personal, tangible or intangible, benefi-
cially owned by the decedent. This includes the date of
death values of all existing claims and choses in action of
the decedent that pass to her estate notwithstanding that
they may be contingent and or uncertain as to amount. 114

The court indicated that under case law in Michigan, a right
of action constitutes a property right. 115 Regarding the con-
tingent nature of the claim of the deceased widow, the court
stated, “The fact that the decedent’s interest in the wrongful
death action was contingent upon future recovery by John’s
estate, and the court’s distribution of some or all thereof to
her, does not preclude inclusion of it in her gross estate or re-
quire that the value be set at zero.” 116 The deceased’s right of
action accrued on the date of her husband’s death and contin-
ued to her own death and thereafter. 117 The case, however,
did not involve a contingency fee agreement, which leaves
unanswered the question of whether the client should include
the amount of the recovery representing the fee in his or her
gross income.

A case that did involve a contingency fee agreement and
a deceased client’s estate, however, is Estate of Lennon v.
Commissioner. 118 In that case, the decedent had become ill
while working on a cruise ship of a shipping company. She
became comatose, and her guardian entered into a contingent
fee agreement with a law firm for the filing of a claim and
lawsuit. On April 8, 1985, a jury awarded Ms. Lennon
$7,750,000. The findings of fact indicated that “[a]fter the at-
torneys’ contingent fees and costs were paid, decedent would
have been entitled to $3,706,131 of the $7,750,000 total
judgment.” 119 The defendant filed an appeal. Ms. Lennon

114. Id. at 286 (discussing I.R.C. §§ 2031, 2033 (1954)).
115. See id.
116. Id. at 287.
117. Houston involved section 600.2922 of the Michigan Compiled Laws of
1972, a wrongful death statute that provided that the amounts recovered are to
be distributed in accordance with specific provisions in the statute. See Estate
of Houston, 44 T.C.M. (CCH) at 288.
119. Id.
died on August 18, 1985, while the appeal was pending.\textsuperscript{120}

The estate settled the case for $5,250,000 and the appeal was dismissed. The facts indicate that after the law firm was paid its fee (fifty percent of $5,250,000), and after other costs were paid, the estate received a "new payment" under the settlement of $2,456,131.\textsuperscript{121} The estate tax return included the sum of $1,312,500 as decedent's interest in the judgment, after reduction for attorneys' fees had been effected. Subsequently, the Tax Court concluded that the date of death fair market value of the decedent's interest in the judgment was $1,750,000, after reduction for attorneys' fees and costs.

It appears that the attorneys' fees were not included in the gross estate under sections 2031 and 2033 of the Code. Even if the fees had been included in the gross estate, the estate would have been entitled to a deduction for the fees under section 2053 of the Code.

Accordingly, the Lennon case seems to have reached the proper result. But the case still does not answer the question for income tax purposes of whether the fee first should be attributed to the client and then treated as passing to the attorney. In any event, although the estate tax treatment can be helpful in our analysis of the nature of the rights created under a contingency fee agreement, the estate tax treatment should not be determinative of this issue because the income tax and the estate tax are not in \textit{pari materia}.\textsuperscript{122}

\section*{B. Significance of the Contingency Fee Agreement Terms}

One important factor in these cases is the contingency fee agreement itself. If the terms of the agreement indicate that the attorney is to be the client's employee, clearly the assignment of income doctrine would apply to tax the client on the recovery in the amount of the fee paid to the attorney.\textsuperscript{123} On the other hand, if the contract shows that the attorney will be in the position of a partner or joint venturer, the fee amount should not be taxable to the client.\textsuperscript{124} The Service has referred to the importance of the wording of the contingency fee agreement.
agreement, as well as the applicable state law, in resolving this issue.\textsuperscript{125} Case law has also recognized the importance of the wording of the fee contract.\textsuperscript{126} In determining whether the client is taxable on the fees, one court recently stated that it should make no difference if the fees are paid directly by the client to the attorney or paid under a contingent fee agreement out of the recovery.\textsuperscript{127} But in many instances, the way things are actually done is of considerable importance in tax matters. For example, in \textit{Dean v. Commissioner}, the taxpayer and his wife owned all of the stock of a corporation.\textsuperscript{128} They lived in a house that the wife owned prior to their marriage.\textsuperscript{129} Their corporation was indebted to a bank for a substantial sum, and the bank required that the residence be transferred to the corporation to use as collateral for the loan.\textsuperscript{130} The couple continued to live in the house just as before.\textsuperscript{131} The Government argued that the fair rental value of the property should be included in the couple's gross income because the title transfer to the corporation al-

\textsuperscript{125} See Priv. Ltr. Rul. 200107019 (Feb. 16, 2001). The letter ruling used the language,

\begin{quote}
The Contingency Fee Agreement that you entered into with your attorney on date \textit{2}, did not transfer any interest in the judgment or the cause of action to your attorney. Instead, you used the proceeds of that portion of the judgment you had not previously transferred to the Trust to pay your attorney. Both the Contingent Fee Agreement itself and the law of [state identity concealed] support this conclusion.
\end{quote}

\textsuperscript{126} See Bagley v. Comm'r, 105 T.C. 396 (1995), aff'd, 121 F.3d 393 (8th Cir. 1997). The \textit{Bagley} case involved a plaintiff who received compensatory and punitive damages pursuant to a claim for tortious interference with future employment and an additional sum in settlement of claims for tortious interference with future employment, libel and invasion of privacy. The plaintiff asserted that the contingent legal fees paid to his attorney should be treated as a reduction of the amount that he received pursuant to the judgment or settlement of the litigation. Addressing this issue, the Tax Court stated,

Based on the record, we find that there is nothing to indicate that the parties intended the contingency fee arrangement to be a joint venture or partnership. Mr. Rawlings testified that he regarded the agreement between himself and petitioner as nothing more than an arrangement for the payment for his services.

\textsuperscript{127} See Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001).
\textsuperscript{128} See Dean v. Comm'r, 187 F.2d 1019, 1019 (3rd Cir. 1951).
\textsuperscript{129} See id.
\textsuperscript{130} See id. at 1020.
\textsuperscript{131} See id.
lowed the couple to live rent-free in property owned by the corporation. The court agreed with the Government. Even though nothing had changed insofar as how they were using their residence, the transfer of title to the corporation resulted in income to them from the continued use of the property.

If an individual about to engage in business forms a corporation, no one would doubt that the corporation would be able to deduct all of its expenses from gross income instead of being subject to the itemized deduction treatment applicable to individual taxpayers. Even though the individual would run the business in exactly the same way that he would an individual proprietorship, the tax results will be different.

Similarly, there is a significant difference between fees paid under a contingency fee agreement and fees paid to an attorney on the usual hourly charge basis. A contingency fee agreement is not a subterfuge; it is a completely different arrangement for paying legal fees. It enables a client to retain the services of an attorney to prosecute a case, which would not be possible if the client had to pay an attorney on an hourly basis. In a contingency fee agreement, the attorney assumes risks which are not present in the usual hourly fee arrangement. In the hope of achieving substantial financial gain at the end of the matter, the attorney risks committing his time and effort to what might turn out to be a losing cause. It therefore is difficult to simply disregard the unique factual situation in a contingency fee arrangement.

A recent decision indicated that a broad concept of business purpose should be applied in determining if a transaction has economic substance. In the typical case, a client

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132. See id.
133. See id. at 1019.
134. See id.
136. See also Lockard v. Commissioner, which points out the significance of the manner in which transactions are conducted. Lockard v. Comm'r, 166 F.2d 409 (1st Cir. 1948). In that case, a woman set up a trust for the benefit of her husband and made a transfer to it. She maintained that she should be treated as the owner of the income until distribution was made to the trust. The court stated, “But the fact is that she did not receive the income and then give it away by successive assignments. Upon creating the trust she made a single transfer whereby her husband then and there acquired an irrevocable right to the income for a period of years.” Id. at 412.
137. See United Parcel Serv. of America, Inc. v. Comm'r, 254 F.3d 1014 (11th
who cannot afford an attorney enters into a contingency fee agreement with an attorney to prosecute litigation which the client hopes will produce financial gain. The attorney, under such an agreement, acquires an interest that is greater than what he would have acquired under an hourly-charge fee arrangement. Accordingly, it seems logical to contend that a contingent fee agreement has economic substance, and therefore is covered by a broad concept of business purpose. Many clients would not be able to pursue lawsuits if there were no such agreements. For them, there is economic substance to these arrangements, which enables them to recover funds that often are necessary to sustain a reasonable livelihood.

Because a contingent fee agreement creates different interests from those created by the normal fee agreement, the change in form can bring about different tax consequences. The terms of the agreement and the provisions of state law which define the nature of the fee arrangement, bear on the question of the control the client has retained over the fee—an important factor in considering the application of the assignment of income doctrine.

C. Importance of the Control Factor

Although the Srivastava court took the position that the
client’s control was the key to whether the assignment of income doctrine applied, it expressed difficulty in defining “control.” The court explained that in order to resolve the control issue, other factors had to be examined. Because income is taxable to the person who earned it, a factor weighing in favor of attributing the fee solely to the attorney is the fact that his services produced the income. In Lucas v. Earl, the fees in question were taxable solely to the person who earned them. In a contingency fee arrangement, it is the services of the attorney that produces the recovery, and in Horst, the interest income was taxable solely to the person who owned the property which produced the interest income. In a contingency fee agreement, the client is unable to realize anything on his claim until the attorney’s services are obtained.

In the case of personal services, control exists on the part of the person providing the services. In a case like Horst, which involves income-producing property, control exist on the part of the person owning the property which produces the income. Of course, that is the problem in contingency fee contract cases. Who owned the tree that produced the income? According to Cotnam v. Commissioner, it was the attorney who had an interest in the client’s cause of action and whose services produced the income in question.

But although the court in Srivastava ruled in favor of the client, the language it used accorded with Lucas in noting that “[t]here is nothing about arm’s-length transactions that need preclude anticipatory assignments in that context, however. To the contrary, a taxpayer who anticipatorily assigns future streams of income to obtain services in return has quite obviously procured a benefit.” An assignment of income can result even though it was made at arm’s length and not as a gratuity. This point made by the court in

139. See id.
140. See id. at 361.
142. See Srivastava, 220 F.3d at 361.
144. See Cotnam v. Comm’r, 263 F.2d 119, 126 (5th Cir. 1959).
145. See id. at 126. For discussion of Cotnam, see infra Part VII.A.
146. Srivastava v. Comm’r, 220 F.3d 353, 361 (5th Cir. 2000).
147. See United States v. Basye, 410 U.S. 441 (1973). In the Basye case, a
Srivastava appears to be a valid one. Nothing in the assignment of income cases limits that doctrine to situations where gifts are made to family members, even though, as indicated above, it does seem that the assignment of income doctrine was created to prevent any tax advantage from resulting in gratuitous transfers to family members. The primary reason that the doctrine did not apply in Cotnam is because of the interest in the claim given to the attorneys by the Alabama Statute and the belief that the claim was worthless at the time it was assigned by the client.\textsuperscript{148} That the assignment was not a gratuitous transfer to a relative was not treated as significant.

In states where state law does not give the attorney an interest comparable to that received by the attorneys in Cotnam under Alabama law, the assignment of income doctrine could apply if the client retained significant control over the property or right to income forming the basis of his cause of action.\textsuperscript{149} The Tax Court for a long period of time has held that recoveries produced in connection with lawsuits are includable in their entirety in the gross income of the plaintiff, who then is allowed a deduction for legal fees paid to the attorney.\textsuperscript{150}

\textit{medical partnership agreed to supply medical services to members of a health foundation. Part of the foundation's compensation to the partnership consisted of payments into a retirement trust for the benefit of the physicians of the partnership. The Service asserted a deficiency against each partner of the partnership for his distributive share of the amount paid by the foundation into the retirement trust. The court stated, “The partnership earned the income and, as a result of arm's-length bargaining with Kaiser, was responsible for its diversion into the trust fund.” Id. at 451 (footnote omitted). The court added,}

\textit{Nor do we believe that the guiding principle of Lucas v. Earl may be so easily circumvented. Kaiser's motives for making payment are irrelevant to the determination whether those amounts may fairly be viewed as compensation for services rendered. Neither does Kaiser's apparent insistence upon payment to the trust deprive the agreed contributions of their character as compensation.}

\textit{Id. at 451-52 (footnote omitted).}

148. See Cotnam, 263 F.2d at 125.


150. See Benci-Woodward v. Comm'r, 76 T.C.M. (CCH) 787 (1998); Srivastava v. Comm'r, 76 T.C.M. (CCH) 638 (1998); Coady v. Comm'r, 76 T.C.M. (CCH) 257 (1998); O'Brien v. Comm'r, 38 T.C. 707 (1962); Kenseth v. Comm'r, 114 T.C. 399 (2000). In Kenseth, the Tax Court, in ruling in favor of the Commissioner, followed the O'Brien case, espoused the assignment of income doctrine and declined to base its decision on the effect of states' lien statutes. See Kenseth, 114 T.C. at 411-12; see also I.R.C. § 212 (West 2001).}
VI. ATTORNEYS LIENS

An important aspect of resolving the income tax issue raised by contingent fee agreements is whether the attorney acquires an ownership interest in the eventual proceeds produced by his efforts, or only a lien against the proceeds. The subject of liens might be examined in more detail.

Under the common law, and by statute in some states, an attorney has a lien against a judgment or decree entered on his or her client's behalf. But under the common law, the attorney would not have a lien on the cause of action itself. Some states have enacted statutes to remedy this situation and have given attorneys a lien on the cause of action prior to judgment. A lien is "[a] legal right or interest that a creditor has in another's property, lasting until a debt or duty that it secures is satisfied. Typically, the creditor does not take possession of the property on which the lien has been obtained." The lien resembles an assignment because it confers on the attorney a priority right over later assignments made by the client of an interest in the claim and over the later claims of creditors against the client.

There are two types of liens that an attorney can acquire. One is the general or retaining lien, which gives the attorney the right to retain papers and property of the client until the fee is paid. The second type of lien, the one with which we are concerned, is the special or charging lien. That lien protects the attorney's interest in funds due the cli-
ent pursuant to a settlement or judgment.\(^{159}\) The enforcement method of these liens differs among the various states. Because these liens are not based on possession but require the attorney to have the court exercise its equitable power over funds in its control, courts often refer to these liens as creating an equitable interest in funds over which they have control.\(^{160}\) Accordingly, some courts use the term "equitable assignment" in referring to these liens.\(^{161}\) Actual assignments, as opposed to equitable assignments, have been held to be against public policy if they relate to personal injury claims or to claims transferred to an attorney for the purpose of instituting legal proceedings.\(^{162}\) In some states, ethical rules relating to attorneys do not allow them to have a direct interest in their client's suit.\(^{163}\) The concept of a lien rather than an ownership interest in the client's cause of action seems appropriate where the contract between client and attorney gives the client significant independent rights, such as the right to settle the litigation without the attorney's consent and the right to terminate the attorney's services before the matter is concluded.\(^{164}\)

There are cases in various jurisdictions, however, that distinguish between assignment of a personal injury claim and the assignment of the proceeds of a personal injury recovery. The latter are held to be enforceable by these cases.\(^{165}\) In states that do not offer this protection to attorneys by way of statute, attorneys have sought to protect themselves by claiming that part of the cause of action belongs to them under the doctrine of equitable assignment.\(^{166}\) Under this doc-

\(^{159}\) See Hoover-Reynolds v. Superior Court, 58 Cal. Rptr. 2d 173 (Ct. App. 1996); Cohen v. Goldberger, 141 N.E. 656 (Ohio 1923).

\(^{160}\) See MACKINNON, supra note 155, at 72.

\(^{161}\) See id.; Missouri Pac. R.R. Co., v. Austin, 292 F.2d 415 (5th Cir. 1961).

\(^{162}\) For a detailed discussion of assignments and liens, see MACKINNON, supra note 155, at 70-73.

\(^{163}\) See Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001). See also infra note 257 relating to ethical rules in Wisconsin.

\(^{164}\) See MACKINNON, supra note 155, at 74-80.


\(^{166}\) See J.G.B., supra note 151 at 1508. Under the common law, all assignments of choses in action were invalid and unenforceable in courts of law. In order to overcome this barrier, the English Court of Chancery in its administration of equitable principles developed the doctrine of equitable assignment. See id.
trine, when the assignment is made, the assignee acquires a present equitable right, which becomes an equitable property right over the proceeds of the contingency when those proceeds come into existence.\(^\text{167}\)

The general rule seems to be that a contingency fee agreement does not give rise to an equitable assignment of the cause of action or of the proceeds of a settlement, if the contract containing the fee agreement does not so provide.\(^\text{168}\) The same rule would apply even if the contract did provide for an equitable assignment, if the cause of action, by its nature, is non-assignable.\(^\text{169}\)

In light of the above, the relationship between client and attorney, as expressed in the wording of the contingency fee agreement can be very important in determining whether an equitable assignment has taken place.

There are cases, however, which do not agree with the above-stated general proposition.\(^\text{170}\) These cases hold that under a contingency fee agreement, an attorney will have an interest in the cause of action or in the proceeds that result from the action.\(^\text{171}\)

It, therefore, seems that the key question in any given case will be whether a contingency fee agreement constitutes an assignment of part of the client’s cause of action, or whether it merely provides a lien to the attorney that attaches to the recovery that his efforts produce. Because an outright assignment of a claim to the attorney would be against public policy unless permitted by state law,\(^\text{172}\) courts referring to an attorney having a right in the recovery equal to that of the client typically use the term “equitable assignment” in describing the nature of the arrangement.\(^\text{173}\) That distinction is very important because if the agreement in effect is treated as an outright assignment, the client can be

167. *See id.* at 1508-09.
168. *See id.* at 1509.
169. *See id.*
171. For a detailed discussion of those cases holding that equitable assignments do occur under contingency fee agreements and those cases holding that they do not, *see J.G.B.*, *supra* note 151.
172. *See MACKINNON*, *supra* note 155, at 72-73.
173. *See, e.g.*, Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959).
treated as having made a transfer of property to the attorney so that the fee subsequently earned by the lawyer with respect to that property will belong solely to the attorney.\textsuperscript{174} The client will have no interest in that income because he will no longer have an interest in the property giving rise to the income.

On the other hand, if the attorney has only a lien against the recovery, the recovery will be viewed as having passed first to the client, then paid to the attorney for his fee.\textsuperscript{175} There are situations, however, where a statutory provision gives the attorney a lien on any amount recovered, which has been interpreted as giving the attorney an interest in the recovery to the extent of his fee.\textsuperscript{176} Even though the statute is worded in terms of a “lien”, which would be only a claim against the property in question, the effect is the same as if there were an assignment of the property to the attorney. These cases reached that result even though the contract did not specifically provide for an assignment. In the absence of a statute, the terms of the contingent fee agreement can provide for an equitable assignment of a portion of the cause of action in the amount of the fee.\textsuperscript{177} However, as indicated above, ethical problems can arise under state disciplinary rules if an attorney is given an actual property interest in the client’s cause of action.\textsuperscript{178}

VII. THE ROLE OF STATE LAW

The cases that have been decided on this issue indicate how important state law is in determining the interests that the client and the attorney might have in the fee. The role that state and federal law play in resolving federal tax ques-

\textsuperscript{174} The distinction between the assignment of income and the assignment of an asset which produces income was recognized in the recent case of \textit{Kenseth v. Commissioner}, 259 F.3d 881 (7th Cir. 2001).

\textsuperscript{175} See \textit{Young v. Comm’r}, 240 F.3d 369, 378 & n.7 (4th Cir. 2001).

\textsuperscript{176} It has been held that a charging lien of an attorney is not merely an enforceable right against the property recovered, but is an equitable ownership interest in the cause of action. See \textit{LMWT Realty Corp. v. Davis Agency}, 649 N.E.2d 1183 (N.Y. 1995).

\textsuperscript{177} See \textit{Camp v. Park}, 295 S.W.2d 613 (Ark. 1956); \textit{Costigan v. Stewart}, 91 P. 83 (Kan. 1907); \textit{Svea Assurance Co. v. Packham}, 48 A. 359 (Md. 1901).

\textsuperscript{178} See, e.g., \textit{TEX. DISCIPLINARY RULES PROF'L CONDUCT} 1.08(h) (1989) (providing that an attorney cannot be given a proprietary interest in a client’s cause of action or subject matter of litigation). \textit{See also Kenseth}, 259 F.3d at 881.
tions was determined in the case of Lyeth v. Hoey. In that case, a woman died in Massachusetts, leaving as her heirs four children and two grandchildren. Her will left small legacies to her heirs, but the large residuary estate was left to a trust. The heirs objected to the will when it was offered for probate on the grounds that there had been a lack of testamentary capacity and undue influence. When the probate court granted a motion for the framing of issues for jury trial, all parties in interest entered into a compromise agreement. The distribution received by the petitioner, one of the grandchildren of the deceased, was treated as income by the government. The petitioner argued that the amount received should be exempt from tax because the applicable federal statute exempted from income property received by gift, bequest, devise, or inheritance.

The question, therefore, became whether an amount received under an agreement settling a will contest brought by an heir should be treated as "acquired by inheritance." The court of appeals held that the law of the jurisdiction under which the taxpayer received the property should determine whether the property was received by inheritance. But the Supreme Court reversed, holding that the exclusion of inheritances from income granted by the federal statute was a federal question. The Court ruled that the petitioner's status as an heir was properly determined by Massachusetts law. Accordingly, state law determined what rights parties have in property, but once those rights were determined, federal law determined how they would be taxed. The Lyeth Court concluded that the petitioner received the distribution as an in-

179. 305 U.S. 188 (1938).
180. See id. at 189.
181. See id.
182. See id.
183. See id.
184. See id. at 190-91.
185. The relevant statute in the case was section 22(b)(3) of the Revenue Act of 1932. Section 102(a) of the current Internal Revenue Code exempts the same items from income. See I.R.C. § 102(a) (1994).
186. See Lyeth, 305 U.S. at 189.
187. See id. at 193.
188. See id.
189. See id.
190. See id.
What the petitioner received from the estate, he received in his capacity as an heir, and the compromise agreement was merely the means utilized to arrive at the proper amount of the distribution.

Almost thirty years later, in *Commissioner v. Estate of Bosch,* the Supreme Court had occasion to clarify the question of what constitutes state law that is binding on the federal government and the federal courts. According to *Bosch,* only where state law is determined by the highest court of the state in question is it controlling for federal tax purposes. If the highest court of the state has not ruled on the question, then federal authorities should apply what they believe to be the state law after giving consideration to decisions by other courts of the state.

The question of the validity of assignments made in connection with a contingent fee agreement is a question of state law. In *Blair v. Commissioner,* the Supreme Court held that where the income beneficiary of a trust assigned his interest in the trust to others, the validity of the assignments was controlled by state law (Illinois). The question of whether the assignor was still taxable on the income from the trust was held to be a federal question. Whether state or federal law applies in any particular factual situation is not always a simple matter to resolve.

### A. State Law in Cotnam v. Commissioner

The importance of state law on this issue can be seen in the much-discussed case of *Cotnam v. Commissioner.* In *Cotnam,* a man promised to leave a woman one-fifth of his estate if she would care for him for the rest of his life. She faithfully performed her part of the agreement. When the
man died intestate, the woman brought suit against the administrator of his estate and successfully recovered the sum of $120,000 under her contract with the deceased. The sum of $50,365.83 was paid to her attorneys out of the judgment rendered in her favor. One of the primary issues in the case was whether the woman should be treated as having received that part of the judgment as income prior to paying it over to her attorneys as a fee. The court, in ruling for Mrs. Cotnam, based its decision primarily on the Alabama statute which provided that attorneys had the same right and power as their clients over suits, judgments, and decrees to enforce their liens. The court cited with approval the Fifth Circuit case of United States Fidelity & Guaranty Co. v. Levy, which held that the Alabama statute creates an equitable assignment or equitable lien in the cause of action. Accord-

203. See id. at 121.
204. See id.
205. See id.
206. See id. at 125. Title 46 of the 1940 Code of Alabama, as quoted in Cotnam, provided:
§ 64. Lien of attorneys at law.
2. Upon suits, judgments, and decrees for money, they 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.

Cotnam, 263 F.2d at 125 n.5.
207. See id. (citing U.S. Fid. & Guar. Co. v. Levy, 77 F.2d 972 (5th Cir. 1935)).
208. It seems that only New York has an attorney charging lien statute that protects attorneys to the same degree as the charging lien statute in Alabama. See Thad Austin Davis, Cotnam v. Commissioner and the Income Tax Treatment of Contingency-Based Attorney Fees-The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head-On, 51 ALA. L. REV. 1683, 1718 (2000). The New York statute provides as follows:

From the commencement of an action, special or other proceeding in any court or before any state, municipal or federal department, except a department of labor, or the service of an answer containing a counterclaim, the attorney who appears for a party has a lien upon his client's cause of action, claim or counter-claim, which attaches to a verdict, report, determination, decision, judgment or final order in his client's favor, and the proceeds thereof in whatever hands they may come; and the lien cannot be affected by any settlement between the parties before or after judgment, final order or determination. The court upon the petition of the client or attorney may determine and enforce the lien.

N.Y. JUDICIARY LAW § 475 (McKinney 1983).
ingly, the court in *Cotnam* held that the attorneys had an eq-
uitv in Mrs. Cotnam's cause of action.

Two of the judges, Rives and Brown, expressed the view
that Mrs. Cotnam's claim had no fair market value, and that
it was doubtful and uncertain if it had any value at all.\(^\text{209}\)
They contended that her claim was worthless when she en-
tered into the contingent fee agreement, that she had not re-
alized any income from it, and that the only use she could
make of it was to transfer part of it to the attorneys with the
hope that they would be able to effect a recovery on her
claim.\(^\text{210}\) Therefore, she could not assign anything of value to
her attorneys, nor was there anything of value over which she
could exercise control so as to benefit her attorneys.\(^\text{211}\) It was
the work of the attorneys that produced the recovery out of
which their fee was paid.

The Government argued that Mrs. Cotnam was legally
obligated to pay the fees. Payment of fees out of the judg-
ment, based on her services performed under a contract with
the deceased, was the equivalent of Mrs. Cotnam's receipt of
the sum representing the attorneys' fees.\(^\text{212}\) In other words,
she had already earned the right to receive the funds, and by
permitting part of the recovery to be paid to her attorneys as
fees, she exercised control over the beneficial enjoyment of the
funds. In his dissenting opinion, Judge Wisdom used the
same reasoning contending that prior to the agreement with
her attorney, Mrs. Cotnam had completed her services under
the contract with the deceased, and even though she had not
received the income, she had earned it.\(^\text{213}\) She controlled the
disposition of the entire amount and directed that part of it be
paid to her attorneys.\(^\text{214}\) Despite these arguments, the court
held that Mrs. Cotnam was never personally obligated to pay
the fees.\(^\text{215}\) The fees could only be paid out of the judgment if
her attorneys were successful in litigating her claim.\(^\text{216}\)

Judge Wisdom's reasoning sounds logical because Mrs.
Cotnam had already performed services under her contract

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209. *See Cotnam*, 263 F.2d at 125.
210. *See id.*
211. *See id.* at 125-26.
212. *See id.* at 126; *see also* Helvering v. Horst, 311 U.S. 112 (1940).
214. *See id.* at 127; *see also* Horst, 311 U.S. at 112.
216. *See id.*
with the deceased at the time the contingent fee agreement with her attorneys was executed. But because the amount of her claim was uncertain, doubtful and contingent, the majority opinion appropriately determined that Mrs. Cotnam had not received the benefit of any economic gain within the doctrine set forth in *Horst.* But even if the claim were treated as sufficiently definite to support an assignment of income argument, that argument would run up against the Alabama statute, which gave the attorneys and Mrs. Cotnam equal rights in the suit and judgment. As indicated above, *Cotnam* was primarily based on the rights conferred on the attorneys by the Alabama statute.

The focus of *Cotnam,* however, appears to be correct because state law determines the interests that the parties have in property, and federal law then determines how these interests are taxed. It therefore is necessary first to apply the Alabama statute and next consider the question of taxation under federal law. Put another way, we can bypass the question regarding the certainty of Mrs. Cotnam's claim because the Alabama statute provides that attorneys have the same rights as their client in the amount of their fees. At the instant that the recovery takes place, the amount of the fee is treated as property of the attorney.

**B. Srivastava v. Commissioner Reluctantly Follows Cotnam**

Another Fifth Circuit decision that reached the same result as *Cotnam* is the previously referred to case of *Srivastava v. Commissioner.* The facts in that case were similar to those in *Cotnam,* except that Texas law, rather than Alabama law, was involved, and the claim in *Srivastava* was based on alleged defamation rather than personal services rendered under a contractual agreement. In Texas, an attorney's lien is based on common law, not on a statute as in Alabama.

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217. See id. at 126; see also *Horst,* 311 U.S. at 112. As will be discussed later in the article, this position would seem to be even more compelling in a tort action based on an alleged defamation or similar tort, where the damages were not subject to computation under the terms of a contract.

218. See *supra* note 206.


220. See *Cotnam,* 263 F.2d at 125.

221. 220 F.3d 353 (5th Cir. 2000).

The lien gives the attorney the right to be satisfied out of the
property, but the lien applies only to the funds once they are collected. In his dissenting opinion, Judge Dennis pointed out that "under Texas law, unlike that of Alabama, an attorney is not granted by statute the same right and power as his client over the client's cause of action and judgment for the independent enforcement of his attorney's fee claim." Judge Dennis indicated that in Texas, the attorney's rights remain derivative from the client's, even where the attorney has received an ownership interest in the cause of action by assignment from the client. The relationship is one of principal and agent. Based on the differences in the Alabama and Texas attorney's lien laws, the Government asked the court to distinguish the case from Cotnam.

The court in Srivastava, nevertheless, reluctantly ruled in favor of the taxpayer because it felt obligated to follow the prior Fifth Circuit case law that was "substantially indistinguishable." The court did not consider the difference between the Alabama and Texas lien law, and indicated that whatever rights were given to the attorney under state lien law to proceed against the defendant should not determine the question of taxability as between the attorney and the client.

225. Srivastava, 220 F.3d at 369 (Dennis, J., dissenting); see Grant, supra note 224, at 376.
226. Srivastava, 220 F.3d at 369 (Dennis, J., dissenting); see Grant, supra note 224, at 376.
227. See Srivastava, 220 F.3d at 369 (Dennis, J., dissenting).
228. See id. at 363.
229. See id. at 357.
230. A recent Tax Court case refers to the fact that the court, on many occasions, has decided these types of cases by distinguishing the lien statutes of other states from the Alabama statute involved in Cotnam. See Kenseth v. Comm'r, 114 T.C. 399, 410, 412 (2000). But it declined to decide that case based on the effect of the lien statutes. See id. at 412. Rejecting that approach, the Srivastava court quoted with approval the Tax Court decision in O'Brien v. Commissioner, where the court stated, [W]e think it doubtful that the Internal Revenue Code was intended to turn upon such refinements. For, even if the taxpayer had made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto even
Disposing of the state lien law analysis does not solve this problem. There is still the question of whether the taxpayer's cause of action had value and whether the taxpayer had control over the value—the ground on which Judges Rives and Brown relied in *Cotnam*. That raises the question of whether the client's claim was worthless or of uncertain value, in which case the assignment of income doctrine would not apply.

The *Srivastava* court believed the applicability of the doctrine depended on the client's degree of dominion and control over the asset. Although ruling in favor of the client, the court favored the view that the assignment of income doctrine really should apply. It did, however, acknowledge that the assignment of income doctrine is not applicable where an assignment is made of an entire claim of uncertain value. But it indicated that if it were deciding the case on a "tabula rasa," it might be inclined to include contingent fees in the gross income of the client. The court reasoned that the same result should follow whether the attorney is compensated under a non-contingent arrangement or under a contingent fee agreement. Under a non-contingent arrangement, a client would be treated as receiving the entire amount of the recovery and then using part of it to compensate his attorney. The court observed that there was no reason to give different treatment to fees paid under contingent fee ar-

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for a split second, it would still be gross income to him under the familiar principles of [*Earl and Horst*].

*Srivastava*, 220 F.3d at 364 n.34 (quoting O'Brien v. Comm'r, 38 T.C. 707, 712 (1962), aff'd, 319 F.2d 532 (3d Cir. 1963)) (alteration in original).

231. See *Cotnam* v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959).

232. See *Srivastava*, 220 F.3d at 363-64.

233. The court indicated its inclination toward the doctrine when it stated the following:

Similarly, *Cotnam* is indistinguishable from the instant cases, and thus however the anticipatory assignment of income doctrine applies in one case, principles of consistency dictate that the doctrine applies similarly in the other. Rightly or wrongly, this court in *Cotnam* decided not to apply the anticipatory assignment of income doctrine to contingent fee agreement. What the Commissioner and the dissent urge, in effect, is that we use whatever means necessary to avoid *Cotnam*. The Tax Court has already rejected that approach, and we do so as well.

See id. at 364 n.33.

234. See id. at 359 (citing Jones v. Comm'r, 306 F.2d 292 (5th Cir. 1962)).

235. *Srivastava*, 220 F.3d at 357.

236. See id.
arrangements.\textsuperscript{237}

As pointed out in \textit{Srivastava}, cases involving contingency fee agreements are difficult because they do not involve a straight assignment of income where the assignor retains the property producing the income or a clear divestiture of the property producing the income.\textsuperscript{238} The court in \textit{Srivastava} characterized the claim as being subject to a "sort of virtual co-ownership—like an interest in a partnership agreement or joint venture."\textsuperscript{239} The court believed that "attorney retainer agreements accompanied by contingent fee provisions assign more than just the fruit—and yet divest clients of something less than the entire tree."\textsuperscript{240}

The importance of state law in analyzing these arrangements was shown again in \textit{Estate of Clarks v. United States}.\textsuperscript{241} In that case, which was based on Michigan law, the attorney's lien arose by way of common law rather than by statute.\textsuperscript{242} The Sixth Circuit found that there was no significant difference between a common law lien and the lien created by statute in \textit{Cotnam}. The court explained that a common law attorney's lien was

"a peculiar lien, to be enforced by peculiar methods. It was a device invented by the courts 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. . . . If the fund recovered was in possession or under the control of the court, it would not allow the client to obtain it until he had paid his attorney, and in administering the fund it would see that the attorney was protected . . . ."

Although 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.\textsuperscript{243}

\begin{footnotes}
\item[237] \textit{Id.}
\item[238] \textit{See id. at 360.}
\item[240] \textit{Id.}
\item[242] \textit{See Clarks}, 202 F.3d at 856.
\item[243] \textit{Id.} (quoting \textit{RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY} (2d ed. 1955), quoting \textit{Goodrich v. McDonald}, 19 N.E. 649 (N.Y. 1889)).
\end{footnotes}
The court pointed out the similarity with *Cotnam* in that the client's claim was speculative and required the services of counsel.\(^\text{244}\) The court described the arrangement as resembling a partnership agreement or joint venture, and referred to the client's assignment as creating a lien on part of the judgment, which *transferred ownership* of that part of the judgment to the attorney.\(^\text{245}\) Furthermore, the court described the transaction as being more like a division of property, rather than an assignment, and referred to the client as transferring some of the trees that he owned to the attorney who then had to use his efforts to produce the fruit.\(^\text{246}\) The court concluded that the income belonged to the party who earned and received it.\(^\text{247}\)

It appears that the Service has recognized the significance of state law relating to attorneys' liens in contingency fee arrangements. In a private letter ruling, the Service distinguished the factual situation in *Cotnam* on the ground that the state law involved in the ruling gave the attorney only a lien, whereas in *Cotnam*, the Alabama statute gave the attorney an equitable assignment or equitable lien in the cause of action.\(^\text{248}\)

The Eleventh Circuit joined the Fifth and Sixth Circuits in holding that income does not result to the client in contingency fee agreement cases. In *Davis v. Commissioner*, the Government conceded that the court was bound by the *Cotnam* decision in the former Fifth Circuit, but, nevertheless, sought to have the court overrule *Cotnam*.\(^\text{249}\) In the alternative, the Government contended that Mrs. Davis had made a disposition of property when she entered into the contingency fee agreement.\(^\text{250}\) It argued that the value of her cause of action and the value of the attorney's services were not ascertainable in the year the parties entered into the agreement. The Government attempted to assert the open transaction doctrine to ascribe the timing of their ascertainability.\(^\text{251}\) The

\(^{244}\) See id.

\(^{245}\) See id. at 857.

\(^{246}\) See id. at 857-58.

\(^{247}\) See id. at 858.

\(^{248}\) Priv. Ltr. Rul. 200107019 (Nov. 16, 2000).

\(^{249}\) See *Davis v. Comm'r*, 210 F.3d 1346, 1347 n.4 (11th Cir. 2000).

\(^{250}\) See id. at 1347.

\(^{251}\) See id. at 1348. The Government attempted to assert the open transaction doctrine on which *Burnet v. Logan*, 283 U.S. 404 (1931), was based, so that
Government argued that under the open transaction doctrine, receipt of income by the client was delayed until the judgment was handed down and the value of the cause of action and the attorney’s fees became determinable. The Davis court rejected that position, responding that the open transaction doctrine was only available where the value of at least one side of the transaction was determinable, and the Government was unable to establish the value of one side or the other.

Another position that supports the view that attorneys’ fees should be included in the gross income of the client is that under the ethical rules applicable to the bar in a particular state, an attorney cannot acquire a proprietary interest in his client’s lawsuit. The Seventh Circuit in Kenseth referred to the Wisconsin State Rule of Professional Conduct, Supreme Court Rule 20:1.8(j), which provides that although a lawyer in Wisconsin can acquire a lien or enter into a contingent fee contract, “neither a lien nor a contractual right is ‘proprietary.’” One Tax Court judge, however, pointed out that the disciplinary rules are not promulgated to “affect the substantive legal rights of lawyers and are not designed to be a basis for civil liability.” It seems doubtful that the Wisconsin rule was intended to prevent lawyers from acquiring a proprietary interest in contingent fee matters. The comment accompanying this rule refers to the general rule that lawyers are prohibited from acquiring a proprietary interest in litigation, but goes on to point out that there are “specific exceptions,” such as in the case of reasonable contingent

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the taxable event could be delayed until Ms. Davis won her judgment in 1992 and the value of the cause of action and the attorney’s fees became determinable. See Davis, 210 F.3d at 1348.

252. See Davis, 210 F.3d at 1348.

253. See id.

254. See Kenseth v. Comm’r, 114 T.C. 399, 414 (2000), aff’d, 259 F.3d 881 (7th Cir. 2001).

255. Kenseth, 259 F.3d at 883-84.

256. Kenseth, 114 T.C. at 436 (Beghe, J., dissenting).

257. The Wisconsin court rule provides:

A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien granted by law to secure the lawyer’s fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

fees.\textsuperscript{258} One should note that the Fifth Circuit in \textit{Srivastava} ruled in favor of the client despite a Texas disciplinary rule, which is similar to the one in Wisconsin.\textsuperscript{259}

\section*{VIII. Authority For Inclusion in Client's Gross Income}

Despite the decisions by the Fifth, Sixth and Eleventh Circuits on this issue,\textsuperscript{260} five circuits have ruled the other way and held that gross income in the amount of the fee does result to the client where an action is successfully prosecuted under a contingency fee agreement.\textsuperscript{261}

In the Federal Circuit case of \textit{Baylin v. United States},\textsuperscript{262} a partnership received a condemnation award when 137 acres of its land were condemned by the State Roads Commission.\textsuperscript{263} The partnership appealed the award and entered into a contingency fee agreement with its attorney, under which the attorney would receive a percentage of any recovery above the original award.\textsuperscript{264} Eventually the matter settled and the attorney was paid his fee directly out of the condemnation award.\textsuperscript{265} The partnership claimed that the attorney's fee was not part of its gross income because the fee was paid directly to the attorney. It also relied on a Maryland statute that

\begin{itemize}
  \item\textsuperscript{258} The comment provides as follows:
  Acquisition of Interest in Litigation
  Paragraph (j) states the traditional general rule that lawyers are prohibited from acquiring a proprietary interest in litigation. This general rule, which has its basis in common law champerty and maintenance, is subject to specific exceptions developed in decisional law and continued in these rules, such as the exception for reasonable contingent fees set forth in Rule 1.5 and the exception for certain advances of the costs of litigation set forth in paragraph (e).
  \textit{Wis. Sup. Ct. R. 20:1.8} (Comment) (emphasis added). Rule 20:1.5(c) provides that a contingent fee agreement shall be in writing and indicate whether other expenses should be deducted before or after the contingent fee is calculated. \textit{See Wis. Sup. Ct. R. 20:1.5(c)}. The Rule provides in part, "Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and if there is a recovery, showing the remittance to the client and the method of its determination." \textit{Id.} (emphasis added).

  \item\textsuperscript{259} \textit{See infra} note 315.

  \item\textsuperscript{260} \textit{See infra} Part I.

  \item\textsuperscript{261} \textit{See O'Brien v. Comm'r, 38 T.C. 707 (1962), aff'd, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 114 T.C. 399 (2000), aff'd, 259 F.3d 881 (7th Cir. 2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

  \item\textsuperscript{262} 43 F.3d 1451 (Fed. Cir. 1995).

  \item\textsuperscript{263} \textit{See id. at 1452.}

  \item\textsuperscript{264} \textit{See id.}

  \item\textsuperscript{265} \textit{See id. at 1453.}
\end{itemize}
gave an attorney a lien on “attorney’s fees and compensations specially agreed on with the attorney’s client.”

On the basis of the holding in *Lucas*, the court rejected the argument that the attorney’s fee was not part of the partnership income because it was paid directly to the attorney. The partnership received the benefits of these funds, which were used to satisfy its obligation to the attorney. In addition, the fact that the partnership made the assignment of the recovery before its exact amount was determined did not convince the court that the partnership never had a right to it. The court stated that the uncertainty of the legal fees at the time of the assignment could not control the tax results: “the temporary 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.”

The court, furthermore, held that the Maryland statute did not confer an ownership interest, but merely created a lien that was a charge on the fund for the debt owed to the attorney.

*Baylin*, however, can be distinguished from the cases in the Fifth, Sixth and Eleventh Circuits. The cases in those circuits were either based on state law or the control factor.

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266. *Id.* at 1455.
268. *Baylin*, 43 F.3d at 1455.
269. *See* *Baylin*, 43 F.3d at 1454. The Maryland statute involved in the *Baylin* case provided:

§ 10-501. Attorney’s lien
(a) In general—subject to subsection (b) of this section, an attorney at law has a lien on:

(1) an action or proceeding of a client of the attorney at law from the time the action or proceeding beings; and
(2) a judgment or reward that a client receives as a result of legal services that the attorney at law performs.

(b) Limited to fee agreement. —A lien under this section attaches only if, an to the extent that, under a specific agreement between an attorney at law and a client, the client owes the attorney at law a fee or other compensation for legal services that produced the judgement or award.

(c) Subordination of lien. —A lien under this section is subordinate only to:

(1) a prior lien for wages due to an employee of the client for work related to the judgement or award; or
(2) a lien for taxes that the client owes the state.

(d) Execution. —An attorney may retain property subject to a lien under this section and bring an action for execution under the lien only in accordance with rules that the Court of Appeals adopts.

which favored the client's position.\textsuperscript{270} In addition, in \textit{Baylin}, the partnership (client) had already received a jury award in the condemnation proceeding in the amount of $3,899,000, plus interest and costs, when it decided to appeal and enter into a contingency fee agreement with its attorney.\textsuperscript{271} Under the contingency fee agreement, the partnership agreed to pay the attorney a percentage of any amount received above the previous award.\textsuperscript{272} Although the exact amount due under the award had not yet been finally determined,\textsuperscript{273} it seemed clear that the claim of the partnership did have a definite value.\textsuperscript{274} Because no ownership interest in the partnership's claim was transferred to the attorney, the total amount of the recovery belonged to the partnership. When it permitted the attorney to receive his fee directly out of the recovery, the partnership received the benefit of satisfying its obligation for legal fees in that manner.\textsuperscript{275} The Maryland statute could not support the plaintiff's position because it provided only a lien to the attorney rather than an ownership interest. Additionally, the claim was sufficiently definite and in the control of the plaintiff.\textsuperscript{276} Under these facts, it was foreseeable that the court would apply the assignment of income doctrine to rule against the plaintiff.

\textit{Coady v. Commissioner} also holds that the assignment of income doctrine is applicable in a contingency fee contract case.\textsuperscript{277} That case involved a woman who had brought suit against the Alaska Housing Finance Corporation alleging that she had been wrongfully discharged from her position.\textsuperscript{278} She retained a law firm on a contingency fee basis.\textsuperscript{279} The court found in her favor; she received the full payment of the

\begin{footnotes}
\footnote{270. \textit{See supra} notes 221-25. For example, attorneys in Texas do not acquire an ownership interest in the client's cause of action; they acquire a lien, which gives them a right to be satisfied out of the property or funds once they are collected. \textit{See Srivastava v. Comm'r}, 220 F.3d 353, 353 (5th Cir. 2000).}
\footnote{271. \textit{See Baylin}, 43 F.3d at 1452.}
\footnote{272. \textit{See id.}}
\footnote{273. Eventually, the amount due to the partnership under the award was settled for $16,319,522.91, and the court entered a judgment to that effect. \textit{See id.} at 1453.}
\footnote{274. \textit{See id.}}
\footnote{275. \textit{See id.} at 1454.}
\footnote{276. \textit{See id.} at 1455.}
\footnote{277. \textit{Coady v. Comm'r}, 213 F.3d 1187 (9th Cir. 2000).}
\footnote{278. \textit{See id.} at 1187.}
\footnote{279. \textit{See id.}}
\end{footnotes}
judgment, and subsequently paid her attorneys their fee. The Service found a deficiency in Mrs. Coady and her husband's failure to include this amount as part of their gross income. The Tax Court ruled against the Coadys. On appeal, the Ninth Circuit had to interpret Alaska law and concluded that the statute did not transfer an ownership interest in the client's cause of action to the attorneys. Acknowledging the significance of state law in cases of that kind, the court stated, "This case is unlike Cotnam and Clarks because 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." The court cited Lucas and Horst in concluding that Coady received the benefit of her economic gain (judgment), and therefore could not avoid being taxed on it simply by deflecting income to another party (attorney). It did not matter that Coady (taxpayer) did not actually receive the judgment (income) if she received its benefit by transferring it to someone else. Coady counter-argued that at the time of the contingency fee agreement, there was real doubt as to the amount recoverable under her claim. But the court rejected

280. See id. at 1187-88.
281. Section 34.35.430 of the Alaska Statutes provided as follows:
   (a) An attorney has a lien for compensation, whether specially agreed
       upon or implied, as provided in this section
       (1) first, upon the papers of the client that have come into the pos-
           session of the attorney in the course of the professional employ-
           ment;
       (2) second, upon money in the possession of the attorney belonging
           to the client;
       (3) third, upon money in the possession of the adverse party in an
           action or proceeding in which the attorney is employed, from the
           giving of notice of Lien to that party;
       (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.
   (b) This lien is, however, subordinate to the rights existing between the
       parties to the action or proceeding.
ALASKA STAT. § 34.35.430 (Michie 2001).
282. See Coady, 213 F.3d at 1190.
283. Id. at 1187 (distinguishing Cotnam v. Comm'r, 263 F.2d 119 (5th Cir.
       1959), and Estate of Clarks v. United States, 2000 FED App. 0020P (6th Cir.),
       202 F.3d 854) (emphasis added).
284. See id. at 1191.
285. See id.
this argument, replying, "we have previously held that the fact that such an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped by making anticipatory arrangements to prevent earnings from vesting in the person who earned it."286

The Coady court rejected the Coady's argument that because the assignment involved a contingent amount, the assignment of income doctrine should not apply.287 In doing so, the court relied on its prior decision in Kochansky v. Commissioner, but Kochansky is not directly on point.288 In Cotnam, Judges Rives and Brown emphasized that Mrs. Cotnam's claim had no fair market value, and that it was doubtful and uncertain as to whether it had any value at all.289 The claim was worthless without her retaining capable attorneys to convert the claim into something of value. Dis-senting Judge Wisdom also emphasized the nature of the claim in contending that at the time of the assignment, all of the services of the client had been rendered and all of the income earned.290 In other words, Judges Rives, Brown and Wisdom all based their opinions on the value that they attributed to the client's claim. In contrast, the court in Coady did not attribute any significance to the value of the claim, holding that the uncertainty of the contingent amount did not prevent the assignment of income doctrine from applying.

The Ninth Circuit in Benci-Woodward v. Commissioner291 followed Coady. In Benci-Woodward, plaintiffs were employees of Target Stores. Their suit arose out of an employer investigation and alleged false imprisonment, defamation, intentional infliction of emotional distress, wrongful discharge in violation of public policy, breach of an implied-in-fact employment contract, breach of the implied covenant of good faith and fair dealing, constructive discharge, and intentional misrepresentations.292 The petitioners entered into a contingency fee arrangement, which gave their attorney a lien on any recovery in the case. The agreement contained the fol-

286. Id.; see also Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940).
287. See Coady, 213 F.3d at 1191.
288. See infra note 312 and accompanying text.
289. See Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959).
290. See id.
291. 219 F.3d 941 (9th Cir. 2000).
292. See id. at 942.
lowing provisions:

Client agrees to pay Attorney for services a sum equal to forty percent (40%) of any amounts received or recovered in this matter on behalf of Client. Attorney may retain his share out of the amount finally collected by settlement or judgement, herein termed "recovery", in full for the services and any advanced cost. Attorney is given first lien and assignment on any recovery however procured to the extent of this contract and such amounts may be retained there from. Attorney is given a further lien and assignment on any sums recovered herein for fees incurred for all legal work performed for Client whatsoever and such amounts shall be in addition to the contingent fee and cost provided for in this agreement.\textsuperscript{293}

The plaintiffs won the jury trial.\textsuperscript{294} They agreed that the part of their award representing punitive damages should be included in their gross income, but they contended that the part of the punitive damages retained by their attorney as fees and cost should be excluded from gross income.\textsuperscript{295}

In light of the unusual nature of the tort claims raised by the plaintiff-employees, it seems that there was room to argue that the assignment of income doctrine was not applicable. The terms of the contract, however, were a factor weighing against the taxpayer. Furthermore, the California cases on which the Ninth Circuit relied in \textit{Benci-Woodward} clearly indicate that, in California, a contingent fee contract does not give the attorney any rights in the client's cause of action, but gives him a lien only on the property recovered.\textsuperscript{296}

\textsuperscript{293} Benci-Woodward v. Comm'r, 76 T.C.M. (CCH) 787 (1998).
\textsuperscript{294} See \textit{id.} at 943.
\textsuperscript{295} See \textit{id.}
\textsuperscript{296} The court in \textit{Benci-Woodward} indicated,

\textit{Under California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients. The California Supreme Court explained that in 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 \textit{Fifield Manor v. Finston} 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."}

\textit{Benci-Woodward}, 219 F.3d at 943 (citations omitted).
The Fourth Circuit in *Young v. Commissioner*\(^ {297}\) ruled that the client was taxable on fees that were paid to her attorneys out of the sale proceeds of property under a contingency fee agreement. Mrs. Young contended that her former husband owed the legal fees to her attorneys in connection with the settlement of a divorce proceeding, under which Mrs. Young was awarded reasonable attorney's fees in addition to a principal sum and interest.\(^ {298}\) The court referred to both *Cotnam* and *Clarks* but disagreed with the holdings in those cases, concluding that the uncertainty of the contingent fee does not require its exclusion from the income of the assignor.\(^ {299}\)

The court also stated that there is "no relevant distinction between the state common law discussed in *Clarks* and *Baylin*, yet those courts reached opposite conclusions."\(^ {300}\) *Young*, however, failed to attribute appropriate significance to a Maryland statute that clearly provided only a lien to attorneys.\(^ {301}\) In contrast, *Clarks* was based on the common law of Michigan, which the Sixth Circuit determined gave the attorney an ownership interest in the fee in a manner similar to that provided by the Alabama statute in *Cotnam*.\(^ {302}\)

*Young*, however, indicated that under the Michigan law involved in *Clarks*, the attorney really only received a lien on a judgment rather than an ownership interest, as was the case in *Cotnam*. As support, the *Young* court cited *Aetna Casualty & Surety Co. v. Starkey*, a Michigan case holding that an attorney's lien in the state is only a lien on the judg-

\(^{297}\) 240 F.3d 369 (4th Cir. 2001).

\(^{298}\) See id. at 376.

\(^{299}\) See id. at 378. The court in *Young* indicated that although *Cotnam* and *Clarks* resolved the tax issue on the basis of the attorney's claim under state law, "whether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action." Id. The court in *Young* also noted that to follow *Cotnam* and *Clarks*, "would permit a client to avoid taxation by 'skillfully devising' the method for paying her attorneys' fees . . . ." Id. at 377.

\(^{300}\) Id. at 378.

\(^{301}\) See Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995).

\(^{302}\) See Estate of Clarks v. United States, 2000 FED App. 0020P (6th Cir.), 202 F.3d 854, 856. For discussions of *Cotnam*, *Clarks*, and *Baylin*, see supra Part VII.A, supra text accompanying notes 241-50, and supra text accompanying notes 262-79, respectively.
The Clarks court relied on Drieband v. Candler, a Michigan Supreme Court case decided in 1911, to hold that an attorney’s lien in Michigan provides an ownership interest.\textsuperscript{304} According to Commissioner v. Estate of Bosch, the federal courts and authorities are bound by the law of a state as determined by its highest court in determining a person’s interests in property.\textsuperscript{305} The 1982 Aetna case was a decision of an intermediate court; the Clarks court, therefore, justifiably referred to the Michigan law as determined by its highest court. Despite this, the two conflicting Michigan decisions do place the current state of the Michigan law on attorneys’ liens somewhat in doubt and tend to weaken the Clarks decision.

The Young court went on to state that it did not agree with Cotnam and Clarks in their reliance on state law because this matter involves a federal tax issue.\textsuperscript{306} The decision appears to be incorrect on that point. As indicated above, Lyeth v. Hoey and Commissioner v. Estate of Bosch point out that federal tax law yields to state law with respect to determining the interests that people have in property.\textsuperscript{307} Young also indicated that even if state law were determinative, under the North Carolina common law relevant to the case, an attorney’s lien attaches only to the judgment and not to the cause of action.\textsuperscript{308} The court’s strongly worded opinion concludes that a contingent fee agreement does not give the attorney an interest in the client’s cause of action, and the fact that the assignment “involves a contingent or undetermined amount does not exempt it from taxation to the assignor.”\textsuperscript{309}

At the time that the wife and attorney entered into the contingency fee agreement in Young, the amount of any recovery the wife would eventually receive in a divorce proceeding was speculative and uncertain. Although the court stated

\textsuperscript{303} See Young, 240 F.3d at 379 n.7; Aetna Cas. & Sur. Co. v. Starkey, 323 N.W.2d 325, 328 (Mich. Ct. App. 1982).
\textsuperscript{304} See Estate of Clarks, 202 F.3d at 856 (citing Drieband v. Candler, 131 N.W. 129 (Mich. 1911)).
\textsuperscript{305} Comm'r v. Estate of Bosch, 387 U.S. 456 (1967).
\textsuperscript{306} See Young, 240 F.3d at 378.
\textsuperscript{307} See Lyeth v. Hoey, 305 U.S. 188, 193 (1938); Estate of Bosch, 387 U.S. at 465; see also supra text accompanying notes 179-92 (discussing Lyeth); see generally discussion supra Part III.
\textsuperscript{308} See Young, 240 F.3d at 379. Accordingly, under North Carolina law, the attorney does not have a property interest in the claim itself, but only in the income resulting from the prosecution of the claim.
\textsuperscript{309} Id. at 378.
that this did not prevent the amount of the fee from being taxable to the assignor-wife, there is authority, as discussed above, which has not applied the assignment of income doctrine where the claim was uncertain. In addition, Young cited Coady as authority on this point, which in turn cited Kochansky with approval, a case that did not involve a contingent fee agreement in the context of the client-attorney relationship, although it did involve the assignment of a claim that was uncertain and speculative.

At the time of this writing, the most recent decision on this issue is the Seventh Circuit case of Kenseth v. Commissioner, in which the contingency fee agreement was based on an age discrimination claim. The Tax Court ruled that the entire recovery was part of the client's gross income. On appeal, the Seventh Circuit interpreted Wisconsin law to give a security interest to an attorney in a contingency fee agreement, but not make the attorney a joint owner of the claim itself. The court also noted that the Wisconsin Supreme Court Rule of Professional Conduct prohibits lawyers in the state from acquiring a proprietary interest in a client's cause of action. As previously indicated, the position of the court in that regard may not be correct. The court's reliance on Wisconsin law in Kenseth thereby emphasized the importance of state law and distinguished the case from Cotnam and Clarks, where state law provided the attorneys with an independent interest in the amount recovered in litigation.

IX. THE RIPPLE EFFECT

If, in a given case, the assignment of income doctrine is held to apply, the client will be required to report the entire recovery as part of his gross income, and a deduction will be allowed for the amount of the recovery distributed to the attorney as a fee under the contingency fee agreement. On

311. See Young, 240 F.3d at 378 (citing Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000)).
312. See Kochansky v. Comm'r, 92 F.3d 957, 959 (9th Cir. 1996). For a discussion of Kochansky, see supra text accompanying notes 81-86.
313. 259 F.3d 881 (7th Cir. 2001).
314. See Kenseth, 259 F.3d at 883 (explaining Wis. Stat. § 757.36).
315. See id. (explaining Wis. Sup. Ct. R. 20:1.8(j)).
316. See I.R.C. §§ 67(a), 212 (West 2001); see also discussion supra Part III.
the surface, that sounds like appropriate treatment for the client, but in reality it can be a major detriment. Of course, if the client is in a position to deduct the legal fees as a business expense, the fees will be subtracted directly from gross income and will offset his prior inclusion of the amount of the fees in gross income on a dollar-for-dollar basis. In that case, there would be no difference between initially including the entire amount of the recovery in the client's gross income but allowing the client to deduct the legal fee, and taxing the client only on the portion he received after the attorney's fee is paid.

In most instances, it is doubtful that clients would be in a position to deduct the legal fee as a business expense. They will, however, most likely be able to deduct these expenses as a miscellaneous itemized deduction, which means that it will be subject to the two percent floor and the Overall Limitation on Itemized Deductions. Accordingly, taxpayers will either receive only a limited deduction or may not qualify at all to receive a deduction. Recent tax legislation repealed the Overall Limitation on Itemized Deductions provisions beginning with the year 2006 and continuing through 2009; after 2009, these limitations will no longer apply. The two percent floor provisions, however, will continue in effect.

The other problem relates to the alternative minimum tax (“AMT”). In computing that tax, no deduction is allowed

Under I.R.C. § 162, business deductions result in a dollar-for-dollar offset against gross income, whereas under § 212, deductions for expenses incurred in the production of income are reduced by the two percent floor on miscellaneous itemized deductions (§ 67) and the overall limitation on itemized deductions (§ 68).

318. The deduction would be under I.R.C. § 212.
320. Id. § 68.
321. Taxpayers who cannot deduct legal fees under § 212, however, might be able to capitalize them under § 263.
323. “When it enacted the current version of the individual AMT in 1982, Congress reemphasized that the overriding objective of the individual AMT was that 'no taxpayer with substantial economic income should be able to avoid virtually all tax liability by using exclusions, deductions, and credits.'” Davis, supra note 208, at 1695 n.92 (quoting STAFF OF JOINT COMMITTEE ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 17 (Comm. Print 1982)).
for miscellaneous itemized deductions.\textsuperscript{324} Accordingly, a taxpayer subject to the AMT will not benefit at all from a deduction for the legal fees, which was the result for the taxpayer in \textit{Benci-Woodward}.\textsuperscript{325} In that case, the court rejected the taxpayers' argument that the alternative minimum tax resulted in inequities, stating that "such considerations . . . are more appropriately left for congressional resolution."\textsuperscript{326} The harshness of the AMT was discussed in \textit{Alexander v. Internal Revenue Service}.\textsuperscript{327} The court noted, "We recognize that, because the amounts involved trigger the AMT . . . the outcome smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment," but, nevertheless, rejected the taxpayer's argument that the loss of a miscellaneous itemized deduction for the legal fees resulted in inequality of treatment as compared to similarly situated taxpayers.\textsuperscript{328} In \textit{Kenseth}, the Tax Court also noted the limitations, which affect miscellaneous itemized deductions, and the fact that such deductions are not available at all for AMT purposes. In certain cases, attorneys' fees and this tax burden, therefore, could erode the entire recovery of damages awarded to the taxpayer in litigation.\textsuperscript{329}

\section*{X. Conclusion}

There is a clear conflict among the circuits on the issue of the proper tax treatment of contingency fee arrangements. The Fifth, Sixth and Eleventh Circuits have ruled that where the parties have entered into a contingency fee agreement, the part of the recovery representing the attorney's fee is not income to the client.\textsuperscript{330} The Third, Fourth, Seventh, Ninth and Federal Circuits have ruled that this amount is indeed income to the client.\textsuperscript{331} The cases finding for the taxpayer-client relied on state laws providing for attorneys liens, which give the attorney a right equal to that of the client in the recovery. Alternatively, they refused to apply the assignment of

\textsuperscript{324} See I.R.C. § 56(b).
\textsuperscript{325} See \textit{Benci-Woodward v. Comm'r}, 219 F.3d 941 (9th Cir. 2000).
\textsuperscript{326} \textit{Id. at 943}.
\textsuperscript{327} 72 F.3d 938 (1st Cir. 1995).
\textsuperscript{328} \textit{Id. at 946}.
\textsuperscript{330} See cases cited \textit{supra} note 19.
\textsuperscript{331} See cases cited \textit{supra} note 20.
income doctrine because the client's cause of action was worthless, uncertain or indefinite at the time the client and attorney executed the contingency fee agreement. Those cases found that the services of the attorney were necessary to bring value to the claim. The cases that have ruled in favor of the Government have invoked the assignment of income doctrine and found that the client owned the entire cause of action and thereby realized income by using the property to retain an attorney who would apply his services in the hope of producing income. Some of these cases also noted the importance of applicable state law in determining the nature of the interests created by a contingency fee agreement.

This is a close question, one that gives rise to logical arguments on both sides. In attempting to resolve this difficult issue, we might note some overall characteristics of two of the most important cases relating to assignments of income.

The Supreme Court first articulated the assignment of income doctrine in *Lucas v. Earl*, which held that once the taxpayer "earned" the fee as a result of personal services, the fee was properly taxable to that individual. *Lucas*, however, did not involve an assignment of a part of a cause of action, which is a form of property, nor did it involve a contingent fee agreement. There was an agreement, however, between the two parties to share future income and the court held that the entire amount was includable in the husband's gross income. It can be argued, therefore, that if the income in *Lucas* was attributed solely to the party who earned it, it is logical to conclude that the income resulting from the personal efforts of an attorney under a contingency fee arrangement should be included in the gross income of only the attorney.

The contingency fee cases also differ from *Horst*, which involved an attempt to assign only the income produced by property still owned by the assignor. In that case, nothing further remained to be done in order for the income to be received. It therefore was attributable to the assignor who owned the property that produced the income. On the other

332. *See* discussion supra Part VII.
333. *See* discussion supra Part VIII.
334. *See* discussion supra Part VIII.
hand, in contingency fee cases, no income would be received were it not for the personal efforts of the attorney.

Income produced through the services of an attorney can be earned in one of two ways: the attorney can earn the income as the agent or employee of the client, or he can earn it as a joint venturer. A cause of action is a property right capable of being assigned to another, and under the law of several states, the attorney can acquire an interest in the recovery which is equal to that of the client.\(^{336}\)

The assignment can be governed by state law, as in Cotnaml and Clarks,\(^{337}\) or by the fact that the client has a claim that is contingent and of no present value but requires the services of an attorney to convert it into something of value.\(^{338}\) In the absence of state law giving the attorney a right equal to that of the client, or in the absence of provisions in the contingency fee agreement creating the same right in the attorney, the entire recovery initially should be attributable to the client. Also, if the facts indicate that an employment relationship is intended, the entire recovery should be treated as income to the client, since the attorney would be operating as an agent of the client.

But where state law or the terms of the contingency fee agreement make it clear that the attorney, in effect, has an interest in the claim equal to the client's, that part of the recovery representing his fee should be included in his gross income only and not in the gross income of the client.\(^{339}\)

The same result should follow where the facts show that the client's claim was originally of no value and the services of an attorney were required to create a valuable recovery.\(^{340}\) If, on the other hand, the facts indicate that the client's cause of action had a definable value and the client entered into an employment relationship with the attorney for the purpose of recovering it, the entire recovery initially should be attributable to the client in the absence of a state statute giving the attorney the equivalent of an ownership interest in part of the cause of action.

Accordingly, one cannot paint with too broad a brush in

\(^{336}\) See supra notes 200-52.

\(^{337}\) See discussion supra Part VII.A.

\(^{338}\) See supra text accompanying notes 96-104.

\(^{339}\) See supra text accompanying notes 93, 241.

\(^{340}\) See supra text accompanying notes 96-104.
these cases. The provisions of state law, as well as the facts and circumstances of each case, must be examined closely to determine the true nature of the arrangement between the client and the attorney and the proper tax effects thereof.

XI. RECOMMENDATIONS

The unfair result that follows in those jurisdictions ruling that the income representing the attorneys' fee is taxable to the client should be corrected by Congress. In the typical assignment of income case, such as <i>Lucas</i> and <i>Horst</i>, the income in question is taxed only once, to the assignor. But in the case of contingency fee agreements, the income in question often is included in the gross income of the client as well as the attorney (as previously indicated, however, the client will ordinarily receive a deduction, which may not be fully beneficial). Congress should enact legislation specifically providing for income to result to the attorney only. Under the usual contingent fee arrangement, the attorney is the taxpayer who produces the income and is the one who should be taxed. If the fee never is treated as income to the client, the problems associated with the miscellaneous itemized deduction for legal fees and the AMT would never be reached.

Although the primary issue with which we have been concerned relates to the question of whether the assignment of income doctrine applies to contingency fee agreements, this issue has shed light on the unfair workings of the miscellaneous itemized deduction as well as the AMT. By repealing the Overall Limitation on Itemized Deduction after 2009, Congress has removed part of the cloud that has been concealing what is really an increase in tax rates. The conflict in the circuits described in this article presents a clear opportunity to correct some parts of our tax law that have produced unfairness as well as complexity.

Through the years, politicians and others have stressed the need for "simplicity" in criticizing our tax code. As critics have pointed out, many provisions involve complex calculations that have the indirect effect of raising tax rates. The

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various forms that are required for filing an individual tax return and the worksheets to make calculations add to the complexity. Some have suggested drastic changes. In 2001, Senator Richard Shelby of Alabama introduced S. 1040, the “Freedom and Fairness Restoration Act of 2001,” which was directed at repealing the Internal Revenue Code and replacing it with a flat tax rate for all taxpayers. 343

Much could be done to make the present tax law easier to understand. One measure that would simplify the Code would be to abolish the two-tier system of deductions for individuals—deductions taken from gross income above the line and deductions taken from adjusted gross income, below the line. 344 Individuals should be allowed to treat their deductions as if they were corporations. All deductions should be taken directly from gross income. Present itemized deductions, such as medical expenses and charitable contributions, would receive the same treatment as business deductions. The total amount of those deductions, however, could be limited so that there would be no loss of tax revenue. It is believed that this system would provide a much simpler structure with which to work, and the average taxpayer would find it more understandable.

The Section on Taxation of the ABA and the Joint Committee on Taxation’s proposal to abolish the alternative minimum tax seems appropriate. 345 The universal discontent with the AMT and the unfair results that it can bring about have been pointed out by many critics. 346 A more straightfor-


344. See supra notes 318-22 and accompanying text.

345. For tax years 2001-2004, the exemption amount for the alternative minimum tax has been increased by $4,000 for joint returns and $2,000 for individuals. See Economic Growth and Tax Relief Reconciliation Act § 701(a), 115 Stat. at 148 (amending I.R.C. § 55(d)(1)). That is only a token adjustment when viewed in light of recommendation of the Section on Taxation of the A.B.A. See Fresh Solutions, supra note 5.

346. See, e.g., American Institute of Certified Public Accountants et al., Joint Tax Simplification Recommendations of the AICPA, American Bar Association
ward means could easily be found to ensure that no revenue is lost as a result of the repeal of the AMT. The revenue could be protected by an application of special rates to preferential types of income and special treatment for other preference items. If the alternative minimum tax remains in effect, which seems likely, a deduction from gross income could be allowed for all legal fees in computing the tax. The conflict in circuits over the taxation of contingency fee agreements presents an excellent opportunity for Congress to resolve that question and simultaneously restructure parts of the Code so as to make the application of the tax laws more fair and less complex.

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