

WON THE LEGAL BATTLE, BUT AT WHAT TAX COST TO YOUR CLIENT:
TAX CONSEQUENCES OF CONTINGENCY FEE ARRANGEMENTS
LEADING UP TO AND AFTER *COMMISSIONER V. BANKS*

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I. INTRODUCTION

Imagine a protracted legal battle to vindicate your injured or wronged client, only to discover that your client must pay an arduous amount, if not all, of the recovery to the federal government as an income tax. Impossible you say? Just ask Cynthia Spina, the Illinois police officer awarded \$300,000 in damages for sexual discrimination and harassment. Her case came to national attention because the amount she owed the federal government for income tax as the result of the lawsuit was \$399,000.¹ In

¹ Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, § 1, at 18, available at <http://www.nytimes.com/2002/08/11/national/11AWAR.html>; see

addition to her \$300,000 for compensatory damages, she was awarded \$850,000 for attorney's fees and \$100,000 for litigation costs.² She was required to include all \$1,250,000 in gross income and she was not allowed to deduct the \$950,000 in costs.³ As a result, she paid income tax on the entire \$1,250,000.⁴

The Illinois police officer is not alone in experiencing this harsh tax result, which can hardly be characterized as fair and equitable. The United States Courts of Appeals for the Second, Fourth, Seventh, Ninth, Tenth and Federal circuits, endorsed similar results by requiring that the entire amount of a recovery for damages be included in the taxpayer gross taxable income.⁵ However, claimants in the United States Courts of Appeals for the Fifth, Sixth, and Eleventh circuits and claimants in some states within the Ninth Circuit were required to pay income tax only on the amount of the recovery actually received by the taxpayer (i.e., the total amount of the recovery minus the amount paid to the lawyer under the contingency fee arrangement).⁶ With this split in the circuits, the United States Supreme Court granted writ of certiorari in two cases decided in 2003, *Banaitis v. Commissioner*⁷ and *Banks v. Commissioner*,⁸ and consolidated them. On January 24, 2005, the Supreme Court overruled both the Ninth and Sixth circuits and held "that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."⁹ The Court remanded the cases to the lower courts for further consideration. Arguably, the Court left the door open for lower courts to consider various "novel" arguments presented through amici briefs that might yet allow claimants an offset against gross income for the attorneys' fees.¹⁰

also Outrageous Injustice: Congress Must Fix a Legal Tax Quirk that Grossly Penalizes Winners of Civil Rights Cases, NEWSDAY, Aug. 17, 2002, at A16.

² Liptak, *supra* note 1, at 18.

³ *Id.*

⁴ *Id.*

⁵ See *infra* Part III.A.2.

⁶ See *infra* Part III.A.1.

⁷ 340 F.3d 1074 (9th Cir. 2003), *rev'd*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

⁸ 345 F.3d 373 (6th Cir. 2003), *rev'd*, 2005 U.S. LEXIS 1370.

⁹ *Banks*, 2005 U.S. LEXIS 1370, at *8; see *infra* Part IV.

¹⁰ *Banks*, 2005 U.S. LEXIS 1370, at *21-22.

Fortunately, for claimants in some civil rights cases, such as the Illinois police officer above, Congress has already provided relief and certainty. New provision § 62(a)(19) of the Internal Revenue Code allows, at least for certain plaintiffs, a deduction directly from gross income for the attorney's contingency fee share of the damages.¹¹ This deduction means no more potentially large and unfair income tax bills and no more uncertainty or disparate treatment across the states.

For awards received for certain civil rights claims after October 2004, plaintiffs and claimants will be allowed a "deduction for attorney's fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination" and certain other claims.¹² The taxpayer will be allowed to deduct the litigation costs directly from the damage award that the taxpayer is required to include in his or her gross income.¹³ Prospectively, taxpayers, such as the Illinois police officer and the petitioners in the two cases before the Supreme Court, who sue employers on the basis of discrimination will be guaranteed to pay income tax only on the net amount, or, in other words, the taxable award minus attorney's fees and costs.

Because the amendment applies only to certain types of cases, appropriate tax treatment of all other types of awards is still unsettled. Section 62(a)(19) does not cover attorney's fees paid in the pursuit and collection of punitive awards, awards for libel, slander, or other awards in cases not involving a physical injury or a claim of discrimination. The tax treatment of the percentage of those awards claimants must pay to their lawyers pursuant to a contingency fee agreement will continue to be in controversy. Although the two cases before the Supreme Court involve the type of awards prospectively governed by the new code provision, the ruling of the Supreme Court is an important step in the struggle to reach the appropriate tax treatment of cases not covered by the amendment.

Consider another example: Hospital has knowledge that Doctor Dan, a surgeon, is an alcoholic whose performance is adversely affected on a regular basis. The hospital takes no action to limit or revoke his privileges.

¹¹ Sections 62(a)(19) and 62(e) were added by section 703(a) and (b) of the American Jobs Creation Act of 2004, which became effective on October 22, 2004. Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546-48 (2004) (to be codified at 26 U.S.C. § 62(a)(19)). It encompasses fees and costs paid after October 22, 2004 with respect to any judgment or settlement occurring after the effective date. See *infra* Part VI.A. for a full discussion.

¹² H.R. CONF. REP. NO. 108-755, at 484 (2004).

¹³ See *supra* note 11.

Doctor Dan's medical negligence results in the paralysis of a young woman, Paulette Patient, who went in for a routine appendectomy. The woman has a very successful business as a wedding and party planner, which she will have to give up because of her limited mobility. She also has three children under six years of age. The jury awards the plaintiff \$300,000 for compensatory damages and two million for punitive damages. The \$300,000 is excluded from income and the portion of the \$300,000 paid to the lawyers is non-deductible.¹⁴ The punitive damages are taxable income.¹⁵ Without further clarification by the courts or action by Congress, the Internal Revenue Service will argue that claimants must pay income tax on the portion of the award paid to their attorney's fees.

This Article begins with a discussion of the general federal income tax provisions and doctrines that form the basis of the theories discussed in various case opinions and briefs. Part III describes the various theories available to the courts for determining the issue. *Commissioner v. Banks* is discussed in Part IV.¹⁶ Public policy and other considerations are discussed in Part V before arriving at various options for solving the inequities and uncertainty in Part VI & VII.

II. FEDERAL INCOME PRINCIPLES APPLICABLE TO THE CONTINGENCY FEE DEBATE

A. *Basic Accounting Principles Require Offsetting Costs Against Income*

Fundamental accounting principles, taught to all beginning accounting students, mandate an appropriate matching of costs to the income produced by such costs, so that an accurate and true accounting of the activity for the period of time in question will occur.¹⁷ These tenets are the foundation of accurate reporting of financial activities. To ignore costs associated with the production of income or to overstate such costs is considered not only inappropriate, but, in some situations, fraudulent. However, in the world of

¹⁴Expenses incurred in connection with the production of tax exempt income are nondeductible. I.R.C. § 265(a)(1) (2000).

¹⁵See *id.* § 104(a)(2).

¹⁶Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

¹⁷Note, *Tax Treatment of Prepublication Expenses of Authors and Publishers*, 82 MICH. L. REV. 537, 538 (1983).

federal income taxation, such concern for the accuracy of one's net income is often irrelevant.

B. Influence of Political Process on Federal Income Tax Laws

All citizens should understand that the primary purpose of federal income tax law is to establish a mathematical formula for determining a taxpayer's "fair share" of the financial burden we as citizens must bear in order to fund the operation of the federal government. Justice Oliver Wendell Holmes wrote, "[t]axes are what we pay for civilized society."¹⁸ The dollars collected from us through the federal income tax system are the largest source of revenue for the federal government.¹⁹ Regular debate occurs as to what is a taxpayer's fair share. The discussion includes such issues as which incomes and gains are taxable and which ones escape taxation, which costs and losses are deductible and when they can be deducted, as well as what tax rates apply to net incomes. The promulgated answers are heavily influenced during the legislative process by the concern, or at least the perception, that all segments of society contribute equitably to supporting the operations of the federal government and to subsidizing its programs, including ones that provide to those in need.

The federal income tax system also has a secondary function that is perhaps less obvious to the tax novice, is completely political and is regularly debated. Through the definitions that establish the types of gains and incomes that must be included in a taxpayer's gross income, and the allowances for the costs and losses that can be deducted from that gross income, the government seeks to influence our spending and our investments. Through tax laws, Congress creates incentives for citizens to privately spend money on, or invest in, activities deemed beneficial to society and, therefore, in need of our private support.²⁰ Programs and activities that citizens and businesses support voluntarily do not need as

¹⁸*Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

¹⁹<http://www.treasury.gov/education/fact-sheets/taxes/economics.shtml>. Additionally, tax legislation should address concerns for economic efficiency to limit the "distortion that taxes create in the market for goods and services," and administrative simplicity to encourage voluntary compliance. MICHAEL A. LIVINGSTON, *TAXATION LAW, PLANNING, AND POLICY* 823–24 (2003); see also PHILLIP D. OLIVER, *TAX POLICY READINGS AND MATERIALS* 1–2 (Clark et al. eds., 2d ed. 2004).

²⁰OLIVER, *supra* note 19, at 677 (citing STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX REFORM* 6 (1973)).

much, or any, support from the government.²¹ The federal income tax system also discourages various types of spending and provides punitive monetary measures for activities not favored in society.²² Moreover, the tax laws influences the economy by affecting a multitude of routine and major life choices, such as the type of housing people live in, the manner in which they save for retirement, the structure of a new business, and the arrangement of debt.²³ However, some of the special rules in the Internal Revenue Code cannot be explained or justified by the noble goal of influencing our behavior for the betterment of our society. Sometimes the explanation for a provision is the clout of a political party or the persuasiveness of special interest lobbies.

C. Application of Income Tax Principles to Contingency Fee Awards

How does this general philosophy of tax law play into the discussion of an appropriate tax treatment for contingency fee payments? Applying general accounting principles, no other conclusion can be drawn than that the amount a taxpayer pays to his or her lawyer to assist in the prosecution and collection of a claim is a cost associated with the collection of damages and should offset income. To the extent damages are subject to taxation, clients should be allowed to offset all legitimate costs incurred in the

²¹ Charitable organizations receive significant, even crucial, financial support from private donation which is encouraged through the charitable contribution deduction allowed to all taxpayers. See I.R.C. § 170 (2000). Investment incentives are created through favorable tax treatment of activities such as producing electricity from renewable resources, building low income housing and hiring previous long-term welfare recipients. See *id.* §§ 45, 42, 51A. These are just a few examples of tax rewards offered to encourage private expenditures that will in some way benefit the whole of society.

²² For example, taxpayers can no longer quickly write off the cost of a new Mercedes (a “luxury car”) driven as a business car. See *id.* § 280F(a). Tax shelters of the 1970s and 1980s, especially those involving investments made in real estate, were greatly curtailed by provisions in the Tax Reform Act of 1986 that lengthened the depreciation write off period for real estate and introduced the passive activity loss limitation rules. See generally STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (Comm. Print 1987). Fines and penalties are not deductible. See I.R.C. § 162(f). Neither are illegal bribes and kickbacks. *Id.* § 162(c).

²³ For example, recently the Treasury Department argued that President Bush’s 2003 tax proposals were “designed to invigorate the economic recovery, create jobs, and enhance long-term economic growth.” OLIVER, *supra* note 19, at 19 (citing U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2004 REVENUE PROPOSALS 1 (2003)).

production or collection of the income. Such has not been the case, depending on the type and location of the claim in dispute.

Considering the litigious nature of our society, one might wonder why this issue was not addressed and decided years ago. Contingency fee arrangements are hardly a new phenomenon. Why is it only within the last few years that there has been much attention to this tax issue? The answer lies in the realization that the Internal Revenue Code does not afford all deductions and offsets equal treatment and that those rules have changed over the years. “[A]n income tax deduction is a matter of legislative grace,” and the grace of Congress flows with the political tides.²⁴

The real question in contingency fee cases is not whether clients can take a tax deduction or offset for the amount paid to their lawyers, but rather what type of a deduction or offset will it be. Courts, and even the Internal Revenue Service (IRS), agree that the amounts paid to lawyers for services rendered in recovering an award are entitled to at least some type of deduction or offset. However, it does not always follow that the story ends as it should—with the client paying federal income tax only on the net proceeds received. As is often the case, the devil is in the details. The amount of the tax liability depends on the characterization of the allowed offset or deduction.

According to most courts and commentators on the issue,²⁵ the relevant distinction for contingency fee arrangements lies in the difference between (1) an expense related to the production of trade or business income,²⁶ and (2) an expense related to the production of income that is not trade or business income.²⁷ The Internal Revenue Code allows taxpayers an

²⁴ *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943). The Sixteenth Amendment gives Congress the power to tax all income “from whatever source derived.” U.S. CONST. amend. XVI. The Internal Revenue Code imposes tax on taxable income which is gross taxable income less allowed deductions. I.R.C. §§ 1, 63. The definition of gross income has always been interpreted broadly. “The definition extends broadly to all economic gains not otherwise exempted.” *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *14 (Jan. 24, 2005) (citing *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429–30 (1955); *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949)). However, deductions are limited to only those specifically authorized by Congress. See LIVINGSTON, *supra* note 19, at 823–24; SAMUEL A. DONALDSON, *FEDERAL INCOME TAXATION OF INDIVIDUALS: CASES, PROBLEMS AND MATERIALS* 28 (2005).

²⁵ Other theories have been advanced and are discussed *infra* Parts III.B–F.

²⁶ I.R.C. § 162.

²⁷ *Id.* § 212.

“above-the-line” deduction only for those expenses listed in § 62.²⁸ Ordinary and necessary expenses paid or incurred in carrying on a trade or business (business expenses) are allowed as an above-the-line deduction directly from gross income.²⁹ Section 62 lists a number of other expenses that are allowed as a deduction directly from gross income, including the most recent addition to the list—legal fees paid in certain civil rights cases.³⁰

On the other hand, ordinary expenses paid or incurred in the production, management or collection of other income (non-business expenses) are not allowed as a deduction from gross income.³¹ Instead, they are relegated to second-class citizenship as itemized deductions, and an even worse fate as lowly miscellaneous itemized deductions subject to several limits and reductions.³² Non-business expenses that are miscellaneous itemized deductions are subject to the “two-percent floor” rule which means non-business expenses can only be deducted to the extent they exceed two-percent of the individual taxpayer’s adjusted gross income.³³ In other words, non-business expenses are reduced by an amount equal to two-percent of adjusted gross income.

One more adverse consequence for miscellaneous itemized deductions plays an important role in the outcome of contingency fee tax cases. Miscellaneous itemized deductions, such as attorney’s fees, that are non-business expenses, are not deductible at all for purposes of the alternative minimum tax.³⁴ The alternative minimum tax is primarily responsible for the egregious results in these cases.

²⁸ Above-the-line refers to a deduction taken directly from gross income to arrive at the amount of a taxpayer’s adjusted gross income. A deduction referred to as below-the-line means one allowed by the Internal Revenue Code as a deduction from adjusted gross income to calculate a taxpayer’s taxable income.

²⁹ I.R.C. §§ 162, 62(a)(1). Rental expenses also can be deducted above-the-line, whether the rental activity is considered a business, investment or other non-business activity. *Id.* § 62(a)(4).

³⁰ *Id.* § 62.

³¹ Such expenses are allowed as a deduction under § 212; however, because those expenses are not listed in § 62, they cannot be deducted from gross income. *Id.* §§ 62, 212.

³² Not allowing the deduction above-the-line directly from gross income causes the individual’s adjusted gross income to be higher which will have an adverse consequence (in the form of reductions) on the taxpayer’s itemized deductions. *Id.* §§ 67, 68.

³³ *Id.* § 67. For example, a taxpayer with an adjusted gross income of \$100,000 can only deduct miscellaneous itemized deductions to the extent they exceed \$2,000. *Id.*

³⁴ *Id.* § 56(b)(1)(A).

Consequently, business expenses are favored with a dollar for dollar offset to the income produced by such expenses. Non-business expenses are ultimately limited or non-deductible. Thus, the characterization of the activity can make all the difference in the world of federal income taxation.

To illustrate, let us return to the example above with Doctor Dan and Paulette Patient. Assume that Paulette's lawyer represents her in accordance with a contingency fee agreement whereby the lawyer is entitled to forty percent of whatever she recovers from Doctor Dan and Hospital. When Paulette receives the jury award of \$2,300,000, the \$300,000 for compensatory damages will be divided between Paulette and her lawyer. Because the compensatory damages resulted from a physical injury or illness, Paulette will be allowed to exclude the entire amount from her gross income and, therefore, she will not be entitled to any type of offset for the \$120,000 paid to the lawyer.³⁵ The lawyer, however, will recognize his fee as gross income and pay income tax on that amount.³⁶ Until *Commissioner v. Banks*,³⁷ the tax treatment to Paulette for the \$1,200,000 punitive award paid to Paulette and the \$800,000 paid to her lawyer depended on which state Paulette lives in. Applying the rulings of the Second, Fourth, Seventh, Ninth, Tenth and Federal Courts of Appeal, the answer would be that Paulette will report \$2,000,000 of gross income, and the \$800,000 paid to lawyer will be a miscellaneous itemized deduction.³⁸ Assuming Paulette receives the payment in 2005 and she has no other income for the year, her federal income tax bill will be slightly over \$555,000.³⁹

To some observers, the result appears unjust for a claimant to incur such a large income tax bill considering the unfortunate circumstances. To others, paying tax on a windfall such as punitive damages is an appropriate sharing in the cost of living in a free society. Regardless, the inequity of the result is apparent when compared to another example involving business litigation. Randal Restaurateur establishes a corporation, RandCorp, Inc., with the sole purpose of opening and operating a new restaurant. The restaurant is successful until Big Chain Super Restaurant engages in deceptive trade practices and libel. Randal is forced to close his restaurant.

³⁵ See *id.* §§ 104(a)(2), 265(a)(1); Treas. Reg. § 1.265-1(c) (1960).

³⁶ Regardless of the outcome for Paulette, the lawyer will include the fee as gross income and pay income tax on that amount.

³⁷ Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

³⁸ See *infra* Part III.A.2.

³⁹ Assumptions made in calculating tax liability: (1) Paulette is single; (2) her three kids qualify as her dependents; and (3) she has no other income and no other deductions.

RanCorp, Inc. enters into a forty percent contingency fee agreement with his lawyer to represent him in a suit against Big Chain Super Restaurant and RandCorp, Inc. is awarded \$300,000 for lost profits and \$2,000,000 in punitive damages. The entire \$2,300,000 is gross income to RanCorp, Inc. and RandCorp, Inc. is allowed a direct, dollar-for-dollar deduction for the \$920,000 paid to its lawyers.⁴⁰ Assuming RandCorp, Inc. has no other income or expenses, its tax liability would be \$457,450.⁴¹ RandCorp, Inc. would pay almost \$100,000 less in federal income taxes even though its gross income was \$300,000 higher than Paulette's gross income.⁴²

As demonstrated, under the current tax system, as interpreted by most courts and commentators, attorney's fees paid by a business receive much more favorable tax treatment than do attorney's fees paid by individuals.⁴³ Attorney's fees paid by individuals in recovering a taxable award do not enjoy the same direct offsetting of taxable income.⁴⁴ According to the Internal Revenue Service, such amounts are only deductible as miscellaneous itemized deductions.⁴⁵ As such, they are subject to a reduction equal to two percent of the individual's adjusted gross income⁴⁶ and subject to a complete disallowance when calculating the alternative minimum tax.⁴⁷

⁴⁰ See I.R.C. § 162(a).

⁴¹ See generally *id.* § 11(b).

⁴² Compensatory damages (lost profits) are taxable to the corporation. *Id.* § 61. Compensatory damages to an individual for a physical personal injury are excluded from gross income. *Id.* § 104.

⁴³ This result applies whether the legal fee arrangement was based on an hourly or contingency basis, unless the legal fees are associated with the acquisition or disposition of an asset. In the case of the purchase of a new asset, the legal fees associated with the transaction are considered costs of acquisition and are included in the cost basis of the acquired asset. Upon disposition of an asset, related legal fees are treated as a cost of closing the transaction and they ultimately decrease the realized gain. See *id.* § 1016.

⁴⁴ There is an exception for legal fees in civil rights litigation in light of the new § 62(a)(19).

⁴⁵ The IRS maintains that such attorney's fees are treated as miscellaneous itemized deductions and are targeted for enforcement attention. *Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at *5, Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005) (Nos. 03-892, 03-907) [hereinafter *Trial Lawyers Brief*].

⁴⁶ I.R.C. § 67. Furthermore, § 68 provides for an additional reduction of itemized deductions when adjusted gross income exceeds \$142,700 in 2004, which it surely would in our example. This reduction is scheduled to phase out beginning in 2006.

⁴⁷ *Id.* § 56(b)(1)(A)(i). In calculating the alternative minimum tax, all miscellaneous itemized deductions must be added back to the taxpayer's base. Even though the marginal tax rate that

While the new § 62(a)(19) settles the issue for certain civil rights cases, the inequity and uncertainty continues for all other types of cases. No clear answer is readily apparent except that the Supreme Court held that “as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.”⁴⁸ Arguably, the question of the appropriate treatment of a deduction or offset for the attorneys’ fees remains unsettled.

D. Supreme Court Doctrine of Anticipatory Assignment of Income Prior to Commissioner v. Banks

In contingency fee cases prior to *Commissioner v. Banks*,⁴⁹ the overwhelming majority were argued and decided based on the assignment-of-income principles developed by several earlier Supreme Court cases. The *Banks* decision was decided on the basis of the anticipatory-assignment-of-income doctrine.

The anticipatory-assignment-of-income doctrine answers the question, whose income is it? Once an item of income or gain is determined to be subject to taxation, the next question is which taxpayer must recognize, report, and pay tax on, the income or gain. In contingency fee cases, the primary focus of the circuit court opinions was on determining whether the lawyers alone or the clients and the lawyers must include the contingency fee amounts in gross income.

Classic assignment-of-income analysis differentiates between two types of income: (1) earned income and (2) income produced by property. Earned income is income resulting from the personal efforts of someone, such as salary, fees or commissions. Income from property refers to the type of income produced by property that generally will accrue to the owner of the property even without the personal efforts of the owner. Examples of income from property include interest that accrues on a certificate of deposit, dividends declared on the stock of a publicly traded corporation, and rent due from a lessee of real property. Three earlier Supreme Court cases address situations involving the anticipatory assignment of income in

applies to the alternative minimum taxable income is lower than the rates that apply to the regular taxable income, the complete disallowance of a large miscellaneous itemized deduction for alternative minimum tax purposes will generally trigger the alternative minimum tax and result in a higher total tax liability.

⁴⁸ *Banks*, 2005 U.S. LEXIS 1370, at *8.

⁴⁹ *Id.*

three different scenarios. Together they develop the various components of the assignment-of-income doctrine. In the next part, this Article discusses all three cases to set the background for the theories and arguments presented by parties to the courts in contingency fee cases.

I. Earned Income Is Taxed to the Person Whose Personal Efforts Produced It

In *Lucas v. Earl*, the Supreme Court addressed an income-shifting scheme whereby the taxpayer who earned the income tried to shift part of the income to a different taxpayer who was not in any way responsible for the production of the salary.⁵⁰ The taxpayer entered into a contract with his wife whereby he assigned to her one-half of his future salary.⁵¹ If the assignment had been successful for income tax purposes, the taxpayer would have reduced his tax liability by diverting half of his salary to his wife, who was in a lower tax bracket.⁵² At trial, the taxpayer argued that because he never actually received the income, it was not gross income to him.⁵³ In ruling that all of the taxpayer's salary was income to him, even though he was contractually obligated to direct one-half of the income to his wife, the Court reasoned that he was the one whose personal labor earned him the right to receive and enjoy the benefits of the income and, therefore, he could not escape taxation by merely assigning away the right to collect the money by a gratuitous transfer of the income to a family member.⁵⁴ The Court emphasized the need to prevent the avoidance of income tax through "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."⁵⁵

⁵⁰ 281 U.S. 111, 114–15 (1930).

⁵¹ *Id.* at 113–14.

⁵² Courts and commentators sometimes attribute tax-avoidance motives to Mr. Lucas and, thus, characterizing the case as a tax-avoidance case. However, the income shifting agreement he entered into with his wife was signed twelve years prior to the passage of the Sixteenth Amendment to the Constitution authorizing an income tax. Patricia A. Cain, *The Story of Earl: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*, in *TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME CASES* 284 (Paul L. Caron ed., 2003).

⁵³ See *Lucas*, 281 U.S. at 114–15.

⁵⁴ *Id.*

⁵⁵ *Id.* at 115. The Court affirmed this principle in *Commissioner v. Banks*. Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *14 (Jan. 24, 2005) (citing *Lucas*, 281 U.S. at 115).

Merely assigning the income to someone else (e.g., the taxpayer's wife in *Lucas*) does not relieve the taxpayer of his income tax burden. The taxpayer who earned the income must recognize the entire amount of the income, regardless of who collects it. When money is received by someone other than the taxpayer (e.g., the wife), the tax consequences depend on the reason or the explanation for how or why the money is transferred from the taxpayer to the ultimate recipient. In *Lucas*, the gratuitous transfer was a gift from husband to wife with no tax consequences.⁵⁶

In *Lucas*, the famous "fruit and tree" metaphor was born. The Court refused to allow a taxpayer to attribute fruit (income) "to a different tree from that on which they grew."⁵⁷ The fruit and tree analogy appears quite commonly in cases discussing assignment-of-income concepts.

The *Lucas* assignment-of-earned-income doctrine is not as readily relevant as the principles of assignment-of-income from property established by *Helvering v. Horst*, discussed *infra* Part II.D.2. To the extent it applies in contingency fee cases, the issue is whether the taxable portion of the damages is income that has first been earned by the client and then used to pay the lawyer.⁵⁸

2. Income Produced by Property Is Taxed to the Owner of the Property

In *Helvering v. Horst*, the assigned income was the periodic interest payment on negotiable bonds.⁵⁹ The taxpayer owned negotiable bonds with detachable interest coupons.⁶⁰ Shortly before the maturity date on an interest coupon, he removed the coupon and gave it to his son to redeem.⁶¹ It appears the intent of the taxpayer was to shift income tax liability on interest income through a gratuitous transfer to a family member, his son, who was subject to a lower income tax rate. The taxpayer, who retained

⁵⁶ Gifts are excluded from the donee's gross income. I.R.C. § 102 (2000).

⁵⁷ *Lucas*, 281 U.S. at 115. Several exceptions and distinctions should be noted. Income earned by an agent is not taxed to the agent but is taxed to the principal for whom the agent works. Rev. Rul. 74-581, 1974-2 C.B. 25. Income that is rejected or refused prior to the performance of the work is not taxable to the one who performed the work on such a gratuitous basis. *Commissioner v. Giannini*, 129 F.2d 638, 640 (9th Cir. 1942); Rev. Rul. 66-167, 1966-1 C.B. 20.

⁵⁸ See *infra* Part II.D.3 for a related discussion of *Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929).

⁵⁹ 311 U.S. 112, 114 (1940).

⁶⁰ *Id.*

⁶¹ *Id.*

ownership of the source of the income production, the bond, argued that the interest income was not his because his son collected it.⁶² The Court stated that “the sole question [was] whether the gift . . . of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.”⁶³

Before determining that the gifted interest income remained taxable income to the donor, the Court recognized that a coupon bond has two independent and separable property rights: (1) the rights associated with the principal, and (2) the right to receive periodic interest payments.⁶⁴ As the owner of the bond, taxpayer was entitled to collect the interest payments or to direct the interest payments as he desired.⁶⁵ As long as he controls the disposition of the income and has the power to divert it to someone else “as the means of procuring the satisfaction of his wants,” the income is still “realized” by the taxpayer.⁶⁶ “The power to dispose of income is the equivalent of ownership of it.”⁶⁷ Taxpayer enjoyed the benefit of the income by virtue of the fact that he owned the bonds and could direct payment of the interest income to a person of his choosing. The interest coupons were found to be income to taxpayer and he was not allowed to escape taxation by giving away his right to income in advance of payment.⁶⁸

The Court emphasized, by reference to its opinion in *Blair v. Commissioner*,⁶⁹ that a distinction must be made between a gift of income and a gift of income-producing property.⁷⁰ A gift of the property that will produce income entitles the new owner to determine, or control, the disposition of the income and, therefore, the new owner shall be taxed on the income when collected, in whatever manner.⁷¹

The Supreme Court continued its comparison of the production of income to a fruit tree. The Legislature’s intent was that “the fruit . . . not . . . be attributed to a different tree from that on which it

⁶² See *id.* at 116–17.

⁶³ *Id.* at 114.

⁶⁴ *Id.* at 115.

⁶⁵ *Id.*

⁶⁶ *Id.* at 117.

⁶⁷ *Id.* at 118.

⁶⁸ *Id.* at 117–20.

⁶⁹ 300 U.S. 5 (1937).

⁷⁰ *Horst*, 311 U.S. at 118–19.

⁷¹ *Id.*

grew.”⁷² Since the taxpayer owned and retained the bond (tree), he must include in his income the interest (fruit). He cannot escape taxation on the income merely by picking the fruit from the tree and giving it to someone else to sell for money. Having the right, as the owner of the bond, to detach the interest coupon and give it to whomever he chooses for collection, or to otherwise enjoy the benefits of its disposition in whatever manner is pleasing to him, is equivalent to collecting the interest income himself and then using the proceeds to procure the same ultimate use. “The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid.”⁷³ Applying *Horst* principles to contingency fee cases, the question is whether a contingency fee contract transfers to the attorney a part of the tree (claim to damages), or whether the client retains full ownership of the tree and simply assigns to the lawyer some of fruit (income) to be collected.⁷⁴

3. Assignment of Service Income or Income Produced by Property in Satisfaction of a Debt Owed to a Third Party

The Supreme Court’s holding in *Old Colony Trust v. Commissioner* is inextricably intertwined with the assignment-of-income concepts above.⁷⁵ *Old Colony Trust* agreed not only to pay its president a salary, but also to pay the federal income tax liability resulting from his salary.⁷⁶ The Supreme Court concluded that the amount of the tax liability was also gross income to the president by saying:

The payment of the tax by the employers was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor. The form of the payment is expressly declared to make no difference It is therefore immaterial that the taxes

⁷² *Id.* at 120 (citing *Lucas v. Earl*, 281 U.S. 111, 115 (1930)).

⁷³ *Id.* at 119. The Supreme Court reaffirmed this principle in *Commissioner v. Banks*. Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *14–15 (Jan. 24, 2005). “In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question.” *Id.* at *15.

⁷⁴ In *Banks*, the Supreme Court held that in the two contingency fee cases before it, the clients retained the tree and assigned away some of the fruit. *Id.* at *17. “[A]s in *Horst*, the taxpayer retained control over the income-generating asset, diverted some of the income produced to another party, and realized a benefit by doing so.” *Id.* at *18.

⁷⁵ 279 U.S. 716 (1929).

⁷⁶ *Id.* at 719–20.

were directly paid over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.⁷⁷

In *Old Colony*, the Government was not in any way involved in the production of the income. The president's efforts were solely responsible for the earning or production of the income. On that basis, *Old Colony* is easily distinguishable from contingency fee arrangements. In every contingency fee arrangement, the lawyer directly participates in, if not is solely responsible for, the production of the income. Therefore, although the *Old Colony* doctrine is commonly cited in contingency fee cases, it is only tangentially relevant in situations where the recipient of some or all of the proceeds was involved in the production of the income.

4. Summary of the Relationship of Fruit and Tree to Income and Earners and Property

To summarize the fruit and tree analogy, if the laborer (tree) or an agent of the laborer (branch of the tree) performs the work that produces the income (fruit), the laborer is taxed on the income even if someone else is allowed to collect the income (fruit). For income-producing assets, the one who owns or controls the property (tree) that produces the income (fruit), is the one taxed on the income, no matter who collects it. Transferring ownership of the property (tree) after income is already earned or accrued but not collected (fruit is ripened but not harvested and sold) is ineffective to shift the tax on the income.⁷⁸ The owner satisfying a debt obligation by transferring income (fruit) to the obligee still results in taxable income to the owner, with tax consequences related to the payment of the debt determined by the transaction that resulted in the debt owed by the owner. If the owner transfers ownership of, or an ownership interest in, the property (tree) prior to earning or accruing income (ripened fruit), then the transferee is the new owner of the property (tree), or an interest therein, and will pay tax on the income (fruit) produced in the future.

⁷⁷ *Id.* at 729 (citation omitted).

⁷⁸ Although not cited in contingency fee cases, it is cited here to complete the holdings related to the assignment of income. See Rev. Rul. 75-11, 1975-1 C.B. 27.

III. PRIOR TO *COMMISSIONER V. BANKS*, CIRCUITS SPLIT OVER THE APPLICABLE DOCTRINE FOR TAXATION OF CONTINGENCY FEE AGREEMENTS

A plethora of theories have been presented to the courts to facilitate their reaching the correct economic and political decision. The most prevalent theory addressed in all of the cases is the anticipatory assignment-of-income theory based upon the *Lucas* and *Horst* cases discussed *supra* Part II.D.1 and 2. Other theories have been espoused in various cases and articles, while additional theories were proposed through amicus curiae briefs filed in the *Banaitis* and *Banks* cases.

The predominate outcome among circuit cases prior to *Commissioner v. Banks* was a finding consistent with the *Banks* holding that contingency fees must be included in the gross income of the plaintiff and that the limitation on the deductibility of contingency fees should be addressed by Congress.⁷⁹ The various theories will be discussed in rough chronological order as they have appeared in Federal Courts of Appeal cases. The assignment-of-income doctrine is most frequently addressed and is, therefore, discussed first.⁸⁰

A. *Assignment-of-Income Doctrine Applied in the Majority of Contingency Fee Cases*

The assignment-of-income doctrine involves different approaches depending on whether the income is earned income or income from property.⁸¹ In cases applying the assignment-of-income doctrine to contingency fee arrangements, the issue is whether the agreement transfers to an attorney a proprietary interest in the claim, or whether the plaintiff retains all ownership and control and merely has agreed to pay the attorney from his or her income at the point of collection. *Infra* in subsection 1, the cases held that the contingency fee agreement transferred a share of the claim to the attorney and, therefore, the damages are split between the plaintiff and the lawyer. In that case, the plaintiff and lawyer are each taxed only on what each receives. *Infra* in subsection 2, cases are discussed that determine contingency fee agreements to be merely an anticipatory assignment of income to be collected and not a transfer of partial

⁷⁹ 2005 U.S. LEXIS 1370.

⁸⁰ Organizing the discussion of the theories in such a manner will necessarily mean addressing some cases in multiple sections.

⁸¹ See *supra* Part II.D.

ownership. The damages received by the plaintiff are included in the plaintiff's income and the plaintiff is allowed some type of deduction. The deductibility of the expense depends on the nature of the legal claims and whether the plaintiff is an entity or individual. If the plaintiff is an individual and the lawsuit was not related to a business, the legal fees are a miscellaneous itemized deduction that is reduced for regular income tax purposes and completely disallowed for alternative minimum tax purposes.

1. State-Law-Specific Approach Recognizes that a Client Transfers a Property Interest to the Attorney

a. Fifth Circuit: State Law in Alabama Creates Equitable Assignment Through Contingency Fee Agreement.

Cotnam v. Commissioner, in 1959, was the first federal appeals court to address the tax consequences of a contingency fee arrangement.⁸² The Fifth Circuit looked to state law to determine the rights of the attorney to the fee and determined that, under Alabama law, the attorney received an equitable assignment in the claim via the contingency fee agreement.⁸³ In doing so, the court applied the assignment-of-income-from-property doctrine.⁸⁴ Through the contingency fee agreement, the taxpayer "assigned to her attorneys forty per cent [sic] of the claim in order that she might collect the remaining sixty per cent [sic]."⁸⁵ The taxpayer's "claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder."⁸⁶

The taxpayer was not required to include in her gross income the portion of the damages paid to her attorneys pursuant to the contingency fee agreement.⁸⁷ "At the time that she entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately

⁸² 263 F.2d 119 (5th Cir. 1959).

⁸³ *Id.* at 125. See *Srivastava v. Commissioner*, 220 F.3d 353, 358–59 (5th Cir. 2000), overruled by *Banks*, 2005 U.S. LEXIS 1370, for a different approach taken by the Fifth Circuit.

⁸⁴ *Cotnam*, 263 F.2d at 126.

⁸⁵ *Id.* at 125.

⁸⁶ *Id.*

⁸⁷ *Id.*

enjoying the remainder.”⁸⁸ In applying the fruit and tree analogy, the court pointed out that “[Taxpayer’s] tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit.”⁸⁹

b. Eleventh Circuit Bound to Follow Fifth Circuit’s Cotnam: Alabama Law Transfers Interest in Lawsuit

The Eleventh Circuit issued two opinions following the holding in *Cotnam* and applied the law of the Fifth Circuit.⁹⁰ In *Davis v. Commissioner*, the court, without much analysis, stated that “*Cotnam* is squarely on point and controlling.”⁹¹ The court further stated that the IRS’s primary argument was “that *Cotnam* was wrongly decided and should be overruled.”⁹² The court was not inclined to do so.⁹³

One year later in *Foster v. United States*, the Eleventh Circuit again followed *Cotnam*.⁹⁴ Before her trial, in which the taxpayer alleged fraud against a life insurance company,⁹⁵ she entered into a contingency fee agreement whereby she guaranteed her lawyers fifty percent of all monies awarded.⁹⁶ She won a jury verdict in Alabama state court, the same state as the Fifth Circuit’s *Cotnam* case.⁹⁷ Prior to the appeals she entered into a

⁸⁸ *Id.*

⁸⁹ *Id.* at 126 (citation omitted).

⁹⁰ In *Bonner v. City of Prichard*, the Eleventh Circuit “adopted as binding precedent all of the decisions of the former Fifth Circuit handed down prior to the close of business on September 30, 1981.” 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc); see also *Davis v. Commissioner*, 210 F.3d 1346, 1347 n.2 (11th Cir. 2000) (per curiam).

⁹¹ 210 F.3d at 1347. The taxpayer filed a lawsuit against a mortgage company in Alabama alleging acts of fraud, conspiracy, and breach of contract. *Davis v. Commissioner*, 76 T.C.M. (CCH) 46, 47 (1998). Taxpayer was awarded \$151,000 for compensatory damages and \$6 million for punitive damages. *Davis*, 210 F.3d at 1347. Pursuant to a contingency fee agreement, her attorneys retained \$3,111,809 and she received \$3,039,191. *Id.*

⁹² *Davis*, 210 F.3d at 1347 n.4.

⁹³ *Foster v. United States*, 249 F.3d 1275, 1280–81 (11th Cir. 2001), overruled by *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

⁹⁴ *Id.* at 1281.

⁹⁵ *Foster v. United States*, 106 F. Supp. 2d 1234, 1235 (N.D. Ala. 2000), *aff’d in part, rev’d in part*, 249 F.3d 1275 (11th Cir. 2001), overruled by *Banks*, 2005 U.S. LEXIS 1370. *Foster* filed the lawsuit charging a life insurance company with “fraud in selling her a Medicare supplement insurance policy that was essentially worthless because she did not have Medicare coverage.” *Id.*

⁹⁶ *Foster*, 249 F.3d at 1276.

⁹⁷ *Foster*, 106 F. Supp. 2d at 1235. “After a jury trial and an appeal, the Alabama Supreme

new agreement with her lawyers whereby she offered her lawyers one-hundred percent of the post-judgment interest. The court ruled that the fifty percent of the punitive damages and one-hundred percent of the post-judgment interest paid directly to the lawyers pursuant to the contingency fee agreement was not gross income to the taxpayer.⁹⁸ The court stated that *Cotnam* was controlling and, under Alabama law, the interest in the litigation held by the lawyers through the contingency fee agreement was sufficient to exclude it from the taxpayer's income.⁹⁹ In the interim between the *Davis* and *Foster* cases, the Sixth Circuit addressed the contingency fee tax question in *Estate of Clarks ex rel Brisco-Whitter v. United States*, discussed *infra* in subsection 1.C.¹⁰⁰ In *Foster*, the Eleventh Circuit cited and agreed with the Sixth Circuit's characterization of a contingency fee as "more like a division of property than an assignment of income," and the court held that the lawyer's share of the damages should be taxed to the one who earned it—the lawyer.¹⁰¹

c. Sixth Circuit: Michigan Law Operates Similarly to Cotnam's Alabama Law and Client not Taxed on Attorney's Fee

In *Estate of Clarks ex rel Brisco-Whitter v. United States*, the Sixth Circuit also used the state-law-specific analysis.¹⁰² The taxpayer, his wife

Court upheld an award to her of \$50,000 in compensatory damages and of \$1 million in punitive damages." *Id.* at 1235. "This award, plus \$156,032.80 in post-judgment interest, was paid in 1994 through a single check issued by Life of Georgia jointly to Foster and her attorneys. Consistent with their fee arrangement, the attorneys then paid Foster \$525,000, which was 50% of the amount of the judgment." *Id.*

⁹⁸ *Foster*, 249 F.3d at 1277–81.

⁹⁹ *Id.* at 1279–80.

¹⁰⁰ 202 F.3d 854 (6th Cir. 2000), *overruled by* *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

¹⁰¹ 249 F.3d at 1280 (quoting *Clarks*, 202 F.3d at 857–58).

¹⁰² 202 F.3d at 856.

In June 1988, a jury awarded Arthur Clarks \$5,600,000 in personal injury damages against K-Mart for head injuries sustained while unloading his truck. In 1991, K-Mart paid \$11,307,875.55 in total satisfaction of the judgment, \$5,600,000 for the award and \$5,707,875.55 in interest. From that amount, the judgment debtor paid Clarks' lawyer under a one-third, contingent fee contract \$1,865,156.54 based on the original award and \$1,901,314.67 based on the interest for a total fee of \$3,766,471.21.

Id. at 855.

and children sued K-Mart for head injuries sustained while unloading his truck.¹⁰³ One-third of the awards were paid to taxpayer's lawyers pursuant to a contingency fee contract.¹⁰⁴ The court held that the attorney's portion of the award was not income to the taxpayer.¹⁰⁵

The Sixth Circuit recognized the split in the circuits and then noted that Michigan law, the law governing the contingency fee arrangement in question, was similar to the Alabama law described in *Cotnam*.¹⁰⁶ Under Michigan law, "the [contingent fee] agreement amounts to an assignment of a portion of the judgment sought to be recovered."¹⁰⁷ Therefore, "the client as assignor . . . transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer [became] a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract."¹⁰⁸ Contingency fee arrangements are comparable to "the transfer of a one-third interest in real estate that is thereafter leased to a tenant."¹⁰⁹ In distinguishing the contingency fee arrangement from the gratuitous transfer of income in the *Lucas* and *Horst* cases, the court continued, "Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation."¹¹⁰ The Sixth Circuit reasoned that "[a]lthough the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment."¹¹¹

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *See id.* at 858.

¹⁰⁶ *Id.* at 856.

¹⁰⁷ *Id.* (citing *Dreiband v. Candler*, 131 N.W. 129, 129 (Mich. 1911)).

¹⁰⁸ *Id.* at 858.

¹⁰⁹ *Id.* (citing *Wodehouse v. Commissioner*, 177 F.2d 881, 884 (2d Cir. 1949), *aff'd in part, rev'd in part*, 178 F.2d 987 (4th Cir. 1949); Surrey, "Assignments of Income and Related Devices, Choice of the Taxable Person," 33 COLUM. L. REV. 791 (1933)).

¹¹⁰ *Id.*

¹¹¹ *Id.* at 856.

2. State-Law-Specific Does Not Allow for Effective Transfer of Property Interest to the Lawyer

a. *Ninth Circuit's Coady and Benci-Woodward: Alaska and California State Laws Do Not Allow for Effective Transfer of Property Interest to Lawyer*

In 2000, the Ninth Circuit applied the state-law-specific analysis to two cases, *Coady v. Commissioner*¹¹² and *Benci-Woodward v. Commissioner*.¹¹³ In *Coady*, the Ninth Circuit concluded that Alaska law “does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients.”¹¹⁴ The contingency fee in *Coady* was required to be included in the client’s gross income as an anticipatory assignment of income to the attorney resulting from a property interest owned by the client, the claimant.¹¹⁵ The same result is found in *Benci-Woodward*, after a holding by the Ninth Circuit that California law has the same effect as Alaska law (i.e., no property interest is created in the hands of the attorney and the contingency fee agreement is a mere assignment of income to attorneys).¹¹⁶

In *Coady*, a wrongful termination lawsuit, the Ninth Circuit rejected taxpayer’s argument that at the time of the execution of the contingency fee agreement she assigned to her lawyer an “uncertain, doubtful, and contingent” interest in the claim and, therefore, the assignment was distinguishable from the *Lucas* and *Helvering* line of cases.¹¹⁷ Instead, the court held that, unlike in the *Cotnam* and *Clarks* cases, the state law of Alaska does not give the lawyer “a superior lien or ownership interest in the cause of action.”¹¹⁸ Consequently, “[Taxpayer’s] recovery for back pay and

¹¹²213 F.3d 1187 (9th Cir. 2000).

¹¹³219 F.3d 941 (9th Cir. 2000).

¹¹⁴213 F.3d at 1190 (citing *Hagens, Brown & Gibbs v. First Nat'l Bank of Anchorage*, 783 P.2d 1164, 1168 (Alaska 1989)).

¹¹⁵See *id.* at 1190–91.

¹¹⁶See 219 F.3d at 943.

¹¹⁷213 F.3d at 1191. The taxpayer filed a wrongful termination lawsuit against her former employer. *Id.* After a bench trial, she received a check for \$259,610.89 from the former employer in full satisfaction of a \$373,307 jury award for back pay, future lost earnings and lost fringe and pension benefits. *Id.* Taxpayer paid the law firm representing her \$221,338.32 for attorney’s fees and litigation costs pursuant to a contingency fee agreement. *Id.* at 1188.

¹¹⁸*Id.* at 1190.

benefits was income to her on which she cannot avoid taxation by diversion to creditors, including counsel for a contingency fee."¹¹⁹

In *Benci-Woodward*, the taxpayers filed a lawsuit against their former employer citing a number of allegations including false imprisonment, defamation, and wrongful discharge.¹²⁰ After a favorable verdict for compensatory and punitive damages, a portion of the damages was transferred to the lawyers pursuant to a contingency fee agreement.¹²¹ While the court stated that its holding in *Benci-Woodward* was compelled by its analysis in *Coady*, the focus of the *Benci-Woodward* opinion was on the assignment of property principles.¹²² The Ninth Circuit cited a California Supreme Court opinion holding "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.'"¹²³ In light of California law, the Ninth Circuit held that the entire amount of damages, including the portion paid to the attorneys, was taxable to the taxpayers.¹²⁴ Taxpayers cannot escape taxation "by making anticipatory arrangements to prevent earnings from vesting in the person who earned it."¹²⁵

b. Banaitis: Ninth Circuit Finds Oregon Law Vests Lawyers with Property Rights and Transfers Ownership

In 2003, the Ninth Circuit, in *Banaitis v. Commissioner*,¹²⁶ handed down its third opinion addressing the tax consequences of contingency fee agreements.¹²⁷ The court's application of the state-law-specific analysis explains an outcome in *Banaitis* that is contrary to the two other cases from that circuit, *Coady* and *Benci-Woodward*, discussed *supra* in subsection 2.a.

In *Banaitis*, the taxpayer sued his employer for wrongful discharge and was awarded in excess of \$6 million.¹²⁸ During the course of the appeals,

¹¹⁹ *Id.* at 1191.

¹²⁰ 219 F.3d 941, 942 (9th Cir. 2000).

¹²¹ *Id.* at 942–43.

¹²² *Id.* at 942.

¹²³ *Id.* at 943 (citing *Fifield Manor v. Finston*, 354 P.2d 1073, 1079 (Cal. 1960)).

¹²⁴ *Id.*

¹²⁵ *Id.* at 943–44 n.2 (citing *Coady v. Commissioner*, 213 F.3d 1187, 1191 (9th Cir. 2000)).

¹²⁶ 340 F.3d 1074 (9th Cir. 2003), *rev'd*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

¹²⁷ *Coady v. Commissioner* and *Benci-Woodward v. Commissioner* discussed above, had contrary outcomes based upon the application of state law. 213 F.3d at 1187; 219 F.3d at 941.

¹²⁸ 340 F.3d at 1077.

the parties settled the lawsuit and the defendants agreed to pay \$8,728,559 in damages.¹²⁹ The money was disbursed in two separate amounts.¹³⁰ A check in the amount of \$3,864,012 was delivered to the attorneys pursuant to the terms of a contingency fee agreement.¹³¹ The rest of the proceeds, \$4,864,547, were remitted to the taxpayer.¹³²

Before determining the federal income tax consequences of the attorney's fee portion of the award, the court looked at state law to define the attorney's rights in the action.¹³³ Using this state-law-specific analysis,¹³⁴ the Ninth Circuit concluded that "Oregon law vests attorneys with property interests . . ."¹³⁵ In applying the assignment-of-income principles, an assignment of a property right (i.e., ownership interest in the lawsuit outcome) through a contingency fee agreement is not an anticipatory assignment of money due, but rather a transfer of the ownership and entitlement to a portion of the award. Therefore, in Oregon, the client and the attorney are co-owners of the award and each will recognize as gross income only his or her share of the proceeds.¹³⁶

c. Federal, Second, Fourth, Seventh and Tenth Circuits Agree that Contingency Fee Agreements Do Not Transfer Ownership in Maryland, Vermont, North Carolina, Wisconsin and Missouri

In addressing alternative arguments presented by taxpayers, several other circuits have held that the state law governing the contingency fee arrangements at issue did not allow the clients to transfer property interests

¹²⁹ *Id.* at 1078.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.* Taxpayer did not report any of the settlement proceeds on his 1995 federal income tax return. *Id.* Upon audit, the IRS determined that the entire amount was required to be included in his gross income and that taxpayer was entitled to a miscellaneous itemized deduction for the amount paid to the lawyers, but that for alternative minimum tax purposes, the attorney's fee was not deductible. *Id.* The Tax Court agreed with the Commissioner. *Id.* at 1079. As to the attorney's fee, the Ninth Circuit held that "[t]he Tax Court erred in holding that the attorneys fees paid to [taxpayer's attorneys] should be included in [taxpayer's] gross income total." *Id.* at 1078-79, 1081.

¹³³ *Id.* at 1081 (citing *United States v. Mitchell*, 403 U.S. 190, 197 (1971)).

¹³⁴ This state-law-specific analysis explains two other cases with contrary results. See *supra* subsection 2.a for a discussion of *Coady v. Commissioner* and *Benci-Woodward v. Commissioner*.

¹³⁵ *Banaitis*, 340 F.3d at 1083.

¹³⁶ See *id.*

in a lawsuit to the lawyers. The Federal Circuit held that Maryland's attorney lien statute did not give the attorney an ownership interest in *Baylin v. United States*.¹³⁷ In *Young v. Commissioner*, the Fourth Circuit stated that even if the court adopted the *Cotnam* view that state law was determinative, "North Carolina law is easily distinguishable from the Alabama statute on which *Cotnam* relied."¹³⁸ According to the Seventh Circuit, "Wisconsin law does not make the contingent-fee lawyer a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable."¹³⁹ Missouri's lien statute also "does not create a proprietary interest in the recovery on the attorney's behalf," according to the Tenth Circuit in *Campbell v. Commissioner*.¹⁴⁰ Finally, in *Raymond v. United States*, the Second Circuit determined that a close reading of a Vermont Supreme Court opinion indicates that under the law of that state, the attorney's lien affords "something less than a proprietary interest" to the lawyer in a wrongful termination suit.¹⁴¹

3. Taxpayer Required to Include Entire Amount of Recovery in Gross Income Based on General Assignment-of-Income Doctrine Without Specific State Law Implication

As discussed above, the Fifth, Sixth, Ninth and Eleventh Circuits relied primarily on the application of the assignment-of-income doctrine using a state-law-specific analysis.¹⁴² The Federal and Fourth Circuits relied on a more general application of the *Lucas* and *Horst* assignment-of-income doctrine, with no deference given to the specific state law governing the contingency fee contract. Additionally, the Fifth and Sixth Circuits, in later cases, appear to retreat from their state-law-specific analysis in favor of a more federalist application of the assignment-of-income doctrine.

¹³⁷ 43 F.3d 1451, 1455 (Fed. Cir. 1995).

¹³⁸ 240 F.3d 369, 379 (4th Cir. 2001).

¹³⁹ *Kenseth v. Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001).

¹⁴⁰ 274 F.3d 1312, 1314 (10th Cir. 2001).

¹⁴¹ 355 F.3d 107, 114 (2d Cir. 2004).

¹⁴² The Eleventh Circuit was bound by the precedent set by the old Fifth Circuit in *Cotnam*. Without precedent it is doubtful that the Eleventh Circuit would have reached the same result.

a. *Federal Circuit: Contingency Fee Arrangement is an Anticipatory Assignment of Income in Line with Earl and Horst*

As an alternate argument in *Baylin v. United States*, the taxpayer contended that the contingency fee agreement was an effective assignment of a portion of the condemnation recovery and, therefore, the portion of the recovery paid to the lawyer should not be included in taxpayer's gross income.¹⁴³ The Federal Circuit held that the contingency fee agreement did not transfer an ownership interest in the claim and neither did state law.¹⁴⁴ In rejecting the taxpayer's argument that the portion of the award paid directly to the lawyer was never part of the taxpayer's gross income, the court declared, "[v]ery little need be said about this argument, which, if accepted, would elevate form over substance and allow the partnership to escape taxation on a portion of its income through a 'skillfully devised' fee arrangement."¹⁴⁵ The contingency fee agreement was an anticipatory assignment of the taxpayer's income and, in accordance with *Horst*,¹⁴⁶ the taxpayer was required to include the entire amount of the condemnation recovery in gross income.¹⁴⁷

b. *Fourth Circuit Agrees with Federal Circuit and Finds an Anticipatory Assignment of Income*

In *Young v. Commissioner*, the Fourth Circuit joined the Federal Circuit in applying the *Horst* assignment-of-income doctrine to require the taxpayer to include in gross income the legal fees paid pursuant to a contingency fee agreement.¹⁴⁸ The taxpayer entered into a contingency fee agreement to

¹⁴³ 43 F.3d 1451, 1454 (Fed. Cir. 1995). *Baylin* is a partner in a partnership that filed a condemnation valuation suit related to land condemned by the state. *Id.* at 1452. The land had been valued at \$2,699,775 by the state. *Id.* The jury awarded the partnership \$3,899,000 plus interest and costs. *Id.* Upon appeal, the partnership entered into a contingency fee arrangement whereby it agreed to pay its attorney a percentage of any amount recovered above the previous award. *Id.* "The appeals court determined that the trial court used the wrong standard for valuation." *Id.* at 1453. After negotiations, the parties agreed to a settlement of \$16,319,522.91 and the lawyer received \$4,048,424 of the settlement. *Id.*

¹⁴⁴ See *id.* at 1455.

¹⁴⁵ *Id.* at 1454.

¹⁴⁶ *Baylin* also relies on *Lucas*. See *id.*

¹⁴⁷ *Id.* at 1454–55.

¹⁴⁸ 240 F.3d 369, 376–77 (4th Cir. 2001). Once again the Fourth Circuit referred to *Lucas* for its holding that the assignment of salary prior to earning it is an anticipatory assignment of income

obtain assistance with the collection of her share of marital property pursuant to a divorce decree.¹⁴⁹ From the \$2.2 million sale of property received from the settlement, \$300,606 was paid directly to the lawyers pursuant to a contingency fee agreement.¹⁵⁰ Once the court determined that the taxpayer, and not her former husband, would have to recognize the gain on the sale of the property to a third party, the court concluded that the \$300,606 in attorney's fees could not be excluded from the amount realized by taxpayer for the property.¹⁵¹

The court disagreed with the holdings in *Cotnam* and *Clarks* "that a contingent fee arrangement gives an attorney a portion of a client's cause of action, or 'property.' The client still controls the claim The attorney simply provides a service and receives compensation for that service, whether by an hourly rate or through a contingent fee."¹⁵² The court expressed its opinion that the tax consequences for contingency fee cases should not differ from situations in which the attorney is paid by the

that is ineffective to prevent the salary from vesting in the taxpayer who earned it. *Id.* at 376. No earned income was involved in *Young*; rather, at issue is gain from the disposition of property. *See id.* at 372-76. The anticipatory assignment-of-income doctrine in *Horst* is more applicable.

¹⁴⁹*See id.* at 372. In 1989, taxpayer and her husband entered into a settlement agreement stemming from their 1988 divorce. *Id.* The husband delivered a \$1.5 million promissory note payable in five annual installments, plus interest, secured by a deed of trust on seventy-one acres he received in the agreement. *Id.* In 1990, the husband defaulted on the note and taxpayer brought an action to collect. *Id.* The state court entered a judgment against the husband. *Id.* In 1992, taxpayer and her husband entered into a settlement agreement and release whereby the husband transferred to taxpayer title to fifty-nine acres, but he retained the right to reacquire the property for \$2.2 million. *Id.* The husband assigned the option to a third party who exercised the option and bought the property from taxpayer for \$2.2 million. *Id.* Taxpayer did not recognize any gain on the sale of the property based on the theory that the transfer of the fifty-nine acres was a taxable disposition of the property by her husband in payment of his obligation to taxpayer as a judgment creditor. *See id.* at 375. The court held that the transfer in 1992 was pursuant to a divorce and, therefore, pursuant to § 1041, taxpayer receives the property from her husband with his \$130,794 tax basis. *See id.* When taxpayer sold the property to the third party, she received \$2.2 million for the property and from that amount she paid the lawyers \$300,606 pursuant to the contingency fee agreement. *Id.* at 372.

¹⁵⁰*Id.*

¹⁵¹*Id.* at 376, 379. The author of this article disagrees with the majority with respect to the application of § 1041 to the 1992 settlement. As Judge Wilkins stated in his dissenting opinion, "[A] property transfer made between former spouses to satisfy a judgment is not made 'incident to' the parties' divorce merely because the lawsuit that produced the judgment was for default on a promissory note obtained in the parties' divorce property settlement." *Id.* at 379.

¹⁵²*Id.* at 378 (citations omitted).

hour.¹⁵³ According to the court, the entire taxable amount of the recovery should be included in the taxpayer's gross income.¹⁵⁴

The court also disagreed with *Cotnam's* and *Clarks's* reliance on state law to settle the issue.¹⁵⁵ Furthermore, the court noted that the Fifth Circuit in its more recent opinion, *Srivastava v. Commissioner*¹⁵⁶ recognized that the issue "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."¹⁵⁷

4. Taxpayer Makes an Effective Transfer of Interest Based on General Assignment-of-Income Doctrine Without Specific State Law Implication

a. Fifth Circuit Revisits Assignment-of-Income

In 2000, the Fifth Circuit had an occasion to revisit *Cotnam* and other contingency fee cases. In *Srivastava v. Commissioner*, the taxpayer, a medical doctor, sued a television station for defamation and related claims.¹⁵⁸ A jury awarded the taxpayer \$11.5 million in actual damages and \$17.5 million in punitive damages, plus interest.¹⁵⁹ The court acknowledged that "[w]ere we ruling on a *tabula rasa*, we might be inclined to include contingent fees in gross income."¹⁶⁰ The court explained its apparent desire to overturn *Cotnam* by stating, "Principles of tax neutrality, if nothing else," dictate the same result for contingency fee arrangements as non-contingency fee arrangements.¹⁶¹

In contrast to *Cotnam*, *Srivastava* applies the assignment-of-income doctrine without looking to state law to determine if a transfer of a property interest is possible and actually occurred through the contingency fee agreement.¹⁶² The differences among state laws "do[] not meaningfully

¹⁵³ See *id.* at 377–78.

¹⁵⁴ See *id.* at 379.

¹⁵⁵ *Id.* at 378.

¹⁵⁶ 220 F.3d 353 (5th Cir. 2000), *overruled by* *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

¹⁵⁷ *Young*, 240 F.3d at 378.

¹⁵⁸ 220 F.3d at 355.

¹⁵⁹ *Id.* at 355.

¹⁶⁰ *Id.* at 357.

¹⁶¹ *Id.*

¹⁶² *Id.* at 363–64.

affect the economic reality facing the taxpayer-plaintiff.”¹⁶³ The Fifth Circuit held, “[T]he answer does not depend on the intricacies of an attorney’s bundle of rights against the opposing party under the law of the governing state.”¹⁶⁴

Before holding that the contingency fee was not included in taxpayer’s gross income, the court discussed at some length the line of contingency fee cases from 1959 through 2000 in which the anticipatory assignment of income doctrine applied and determined the following:

The principle rests on the sound inference that a taxpayer who retains control over the tree, while handing out its fruits, is in fact continuing to enjoy the benefits of both. By contrast, a taxpayer who has divested all dominion and control over a tree cannot be said to enjoy gain from its subsequent fruits.¹⁶⁵

In applying the “fruit and tree” analogy to contingency fee arrangements, the court recognized that when a client hires a lawyer, “the income source or ‘tree’ is neither fully divested to the attorney nor fully retained by the taxpayer-client. Rather, the claim is subject to a sort of virtual co-ownership”¹⁶⁶ Although the court expressed some doubt about whether it would reach a similar outcome without the precedent in *Cotnam*, its reasoning and authority are consistent with a court firmly committed to finding that a contingency fee agreement is an effective transfer of an ownership interest to the lawyer.¹⁶⁷

b. Sixth Circuit’s Banks: Contingency Fee Cases Distinguishable from Classic Anticipatory Assignment-of-Income Cases and Assignment-of-Ownership Interest Found

The most recent contingency fee tax case from a federal court of appeals is *Banks v. Commissioner*, wherein the Sixth Circuit addressed the state-

¹⁶³ *Id.* at 364.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 360.

¹⁶⁶ *Id.*

¹⁶⁷ *See id.* at 363.

law-specific approach taken by the Ninth Circuit and others.¹⁶⁸ In *Banks*, the taxpayer sued his former employer claiming employment discrimination.¹⁶⁹ After the trial began, the parties settled the case for \$464,000.¹⁷⁰ Pursuant to a contingency fee agreement, the taxpayer's lawyers were paid \$150,000 from the settlement proceeds.¹⁷¹ The Tax Court agreed with the Commissioner and determined that the entire \$464,000 was required to be included in the taxpayer's gross income with no deduction of the attorney's fees for alternative minimum tax purposes.¹⁷² The Court of Appeals for the Sixth Circuit affirmed in part and reversed in part as to the contingency fee issue.¹⁷³ The court held that the portion of the settlement proceeds paid to the lawyers pursuant to the contingency fee agreement were not to be included in the taxpayer's gross income.¹⁷⁴ As a result, the court found that the taxpayer owed federal income tax only on the net proceeds received (\$314,000).

The court agreed with the Fifth Circuit's reasoning in *Srivastava*, that "the answer [as to whether to apply *Cotnam*] does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state."¹⁷⁵ The court recognized that such a state-by-state approach would not provide uniformity of result in tax

¹⁶⁸ 345 F.3d 373 (6th Cir. 2003), *rev'd*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

¹⁶⁹ *Id.* at 375.

¹⁷⁰ *Id.* at 376.

¹⁷¹ *Id.* Taxpayer did not report any of the settlement proceeds on his 1990 federal income tax return. *Id.* Upon audit, the IRS determined that the entire amount was required to be included in his gross income and that he was entitled to a miscellaneous itemized deduction for the \$150,000 paid to the lawyers; however, because such miscellaneous itemized deductions are not allowed for alternative minimum tax purposes, the \$150,000 was not deductible in calculating his alternative minimum tax liability. *Id.* at 377.

¹⁷² *Id.* at 377.

¹⁷³ *Id.* at 389. Prior to 1996, plaintiffs recovering an amount for a personal injury could argue that none of the award was taxable pursuant to § 104(a)(2) of the Internal Revenue Code. I.R.C. § 104(a)(2) (1995). The court applied the two prong test set forth in *Commissioner v. Schleier*, 515 U.S. 323, 329-30 (1995), to determine that taxpayer could not exclude from income the amount in settlement of his non-personal injury claims for back wages and attorney's fees. *Id.* at 378-82. In 1996, § 104 was amended to exclude from gross income only non-punitive awards in a personal injury case involving a physical injury or illness. I.R.C. § 104 (2000).

¹⁷⁴ *Banks*, 345 F.3d at 386.

¹⁷⁵ *Id.* at 385 (citing *Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000), *overruled by Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005)).

consequences throughout the country.¹⁷⁶ Instead, the court held that its opinions in *Clarks* and *Banks* are not dependent upon the state's characterization of the interests or rights that an attorney has under a contingency fee agreement.¹⁷⁷ "By signing the contingency fee agreement, [taxpayer] transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit."¹⁷⁸ Consequently, taxpayer does not have to recognize as his income the amount paid to his lawyer pursuant to the contingency fee agreement.

The Sixth Circuit acknowledged the split in the circuit court on the issue of whether contingency fees must be included in gross income.¹⁷⁹ The court recognized that the Commissioner consistently took the position that contingency fees are gross income to the client, based on the anticipatory assignment-of-income doctrine.¹⁸⁰ However, the court held that the contingency fee agreement in the case was distinguishable from the other assignment-of-income scenarios.¹⁸¹ In distinguishing the contingency fee arrangement in *Banks* from classic anticipatory assignment-of-income cases such as *Lucas* and *Horst*, five reasons were offered by reviewing an earlier decision, *Clarks*, in which the Sixth Circuit adopted the same approach as taken by the Fifth Circuit in *Cotnam*.¹⁸²

First, at the time the contingency fee contract was executed, the attorney's right to collect the contingency fee "was not already earned, vested, or even relatively certain to be paid to the assignor, but instead was merely 'an intangible, contingent expectancy,' dependent upon the attorney's skills to realize any value from it."¹⁸³ Unlike the taxpayer's salary in *Lucas*, which was very likely to occur in the future, collection of any amount from taxpayer's former employers in *Banks* was far from certain and probably would not have occurred without the skill of the attorneys.

¹⁷⁶ *Id.*

¹⁷⁷ *See id.* at 386.

¹⁷⁸ *Id.* (citing *Estate of Clarks ex rel Brisco-Whitter v. United States*, 202 F.3d 854, 858 (6th Cir. 2000), *overruled by Banks*, 2005 U.S. LEXIS 1370).

¹⁷⁹ *Id.* at 382.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 384–85.

¹⁸² *Id.* (discussing *Clarks*, 202 F.3d 854). The *Cotnam* court was the first to address the tax consequences of a contingency fee arrangement. 263 F.2d 119 (5th Cir. 1959).

¹⁸³ *Banks*, 345 F.3d at 384 (citing *Clarks*, 202 F.3d at 857).

Second, the contingency fee arrangement effectuated a transfer of a partial ownership interest in the claim to the attorneys.¹⁸⁴ “Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract.”¹⁸⁵ Unlike in *Horst*, the taxpayer here gave up some control over the tree (the legal claim). Further, unlike the taxpayer’s son in *Horst*, the “lawyer’s income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation.”¹⁸⁶ Later in the opinion, the Sixth Circuit readdresses this distinction using somewhat different language, introducing a partnership or joint venture analogy: “[The] taxpayer’s claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds.”¹⁸⁷

The Sixth Circuit continued with three additional grounds for distinguishing *Lucas* and *Horst*. First, the contingency fee arrangement was motivated by a business purpose, not a tax avoidance purpose as it was for the husband in *Lucas* and the father in *Horst*.¹⁸⁸ Second, the lawyer “earned his income” and was entitled to the income as a result of “his own skill and judgment.”¹⁸⁹ The wife in *Lucas* and the son in *Horst* in no way contributed to the production of the income. They simply reaped the benefits by reason of a gratuitous transfer from a family member.¹⁹⁰ Finally, the Sixth Circuit recognized that “applying the assignment of income doctrine to contingency fees would result in double taxation, whereas in [*Lucas*] and *Horst*, the assignees could exclude what they received as gifts.”¹⁹¹

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 384–85 (quoting *Clarks*, 202 F.3d at 858).

¹⁸⁶ *Id.* at 385 (quoting *Clarks*, 202 F.3d at 858).

¹⁸⁷ *Id.* at 386 (citing *Clarks*, 202 F.3d at 857–58).

¹⁸⁸ *Id.* at 385. However, the Sixth Circuit is apparently incorrect in attributing a tax avoidance motive to Mr. Lucas. The income shifting agreement he entered into with his wife was signed twelve years prior to the passage of the Sixteenth Amendment to the Constitution authorizing an income tax. Cain, *supra* note 52.

¹⁸⁹ *Banks*, 345 F.3d at 385.

¹⁹⁰ *Clarks*, 202 F.3d at 857.

¹⁹¹ *Banks*, 345 F.3d at 385.

5. Assignment of Income as a Discharge of Indebtedness to a Third Party: Ninth and Tenth Circuits

Two circuits held that contingency fee arrangements were analogous to the discharge of debt to a third party situation discussed in *Old Colony*.¹⁹² In *Sinyard v. Commissioner*, the Ninth Circuit abstractly stated the discharge-of-indebtedness-by-a-third-party theory in this manner: "If A owes B a debt, and C pays the debt on A's behalf, it is elementary that C's payment is income to A as well as to B."¹⁹³

In the original litigation, taxpayer joined two class action suits against his former employer for age discrimination and other torts.¹⁹⁴ Taxpayer entered into a one-third contingency fee contract with the class action counsel.¹⁹⁵ The law firm obtained a settlement for \$35 million and received payment of its one-third contingency fee directly from the former employer.¹⁹⁶ The court cited *Old Colony* in determining that the amount of attorney's fees was income to the taxpayer as if taxpayer had received it and then used it to pay off debts, including the debt to the law firm.¹⁹⁷ "The discharge by a third person of an obligation to him is the equivalent to receipt by the person taxed."¹⁹⁸ The court recognized that the negative tax impact of the attorney's fees on the client arises from disallowance of a deduction for the attorney's fees in calculating the alternative minimum tax and stated that it could not change basic tax law in order to correct the inequity.¹⁹⁹

The Tenth Circuit, in *Campbell v. Commissioner*, took the same approach as the *Sinyard* court in holding that the "recovery permitted [taxpayer] to discharge the personal obligation owed to her attorneys."²⁰⁰ The court stated that the issue was quite simple:

¹⁹² 279 U.S. 716 (1929).

¹⁹³ 268 F.3d 756, 758 (9th Cir. 2001).

¹⁹⁴ *Id.* at 757.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *See id.* at 758.

¹⁹⁸ *Id.* (citing *Old Colony Trust v. Commissioner*, 279 U.S. 716, 729 (1929)).

¹⁹⁹ *Id.* at 759.

²⁰⁰ 274 F.3d 1312, 1313–14 (10th Cir. 2001) (citing *Coady v. Commissioner*, 213 F.3d 1187, 1191 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995)). The taxpayer prevailed in a discrimination lawsuit against her former employer. *Id.* at 1313. A check for \$150,000 in partial payment of the judgment was issued jointly to taxpayer and her lawyers, of

[Taxpayer's] judgment is a recovery of lost income; the attorney fees she paid represent expenses incurred in generating that income. Like any other taxpayer, [she] must report the entire amount as gross income, and, but for the [alternative minimum tax] provisions, she would be allowed to deduct her attorney fees as an expense.²⁰¹

B. Circuits Compare Contingency Fee Agreements to Joint Venture or Partnership Arrangements

In more recent circuit court cases, taxpayers argued that partnership taxation rules apply to contingency fee agreements. The Circuit Courts that addressed the partnership argument did so only briefly and with no significant analysis of whether, and how, the partnership income tax provisions in Subchapter K of the Internal Revenue Code apply to contingency fee arrangements. However, if the client and his or her lawyer are found to be partners, partnership tax provisions generally allow the partners to divide the income by agreement.²⁰² Each partner only recognizes his or her share of the partnership income.²⁰³

1. Cases Compare Contingency Fee Contract to Partnership Agreement

a. Sixth Circuit: Contingency Fee Arrangement like an Interest in Partnership

The Sixth Circuit was the first circuit to compare contingency fee agreements to partnership or joint venture arrangements.²⁰⁴ Although the court applied the *Horst* assignment-of-income doctrine and held that the contingency fee agreement effectively transferred to the lawyer an interest in the property right that produced the income, the court referenced the

which she received \$76,600 and her lawyer retained \$73,400 pursuant to their contingency fee contract. *Id.*

²⁰¹ *Id.* at 1314.

²⁰² See I.R.C. §§ 702–704 (2000).

²⁰³ *Id.*

²⁰⁴ Estate of Clarks *ex rel* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000), *overruled by* Commissioner v. Banks, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005).

similarity to a partnership arrangement.²⁰⁵ The court stated that “[l]ike an interest in a partnership agreement or joint venture, [taxpayer] contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds.”²⁰⁶ The court hypothesized that the Fifth Circuit’s opinion in *Cotnam* was based upon a joint ownership or joint venture concept.²⁰⁷

b. Fifth Circuit: Contingency Fee Arrangement Similar to Partnership Interest

The Fifth Circuit revisited the issue in *Srivastava v. Commissioner*.²⁰⁸ The court agreed with *Clarks*’s characterization of an attorney’s interest through a contingency fee agreement as “[l]ike an interest in a partnership agreement or joint venture.”²⁰⁹ The contingency fee agreement “assign[ed] more than just the fruit—and yet divest[s] clients of something less than the entire tree.”²¹⁰

2. Cases Dismissing Arguments that Contingency Fee Arrangements Are like Partnerships

a. Ninth Circuit: Partnership Argument Not Properly Before the Court

The taxpayer in *Coady v. Commissioner* presented the argument that the contingency fee arrangement established a partnership or joint venture for federal income tax purposes.²¹¹ However, the taxpayer presented the argument for the first time in its brief to the Ninth Circuit, and the court refused to consider the argument because the taxpayer failed to raise it in the Tax Court.²¹²

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ 220 F.3d 353, 360 (5th Cir. 2000), *overruled by Banks*, 2005 U.S. LEXIS 1370.

²⁰⁹ *Id.* (citing *Clarks*, 202 F.3d at 857).

²¹⁰ *Id.*

²¹¹ 213 F.3d 1187, 1191 (9th Cir. 2000).

²¹² *Id.*

b. Seventh Circuit: State Law Does Not Allow Attorney and Client Partnership

In *Kenseth v. Commissioner*, the Seventh Circuit recognized the validity of the joint venture theory.²¹³ “Of course there is a sense in which contingent compensation constitutes the recipient a kind of joint venturer of the payor.”²¹⁴ However, the court dismissed this argument by determining that the law of the state by which the agreement was governed did not allow an attorney to become “a joint owner of his client’s claim in the legal sense any more than the commission salesman is a joint owner of his employer’s accounts receivable.”²¹⁵

C. Origin-of-Claim Doctrine Applied to Determine Contingency Fee Treatment Based Upon the Characterization of the Claim

1. Federal Circuit: Attorney’s Fees Allocated to the Cost of Disposition of Condemned Property

The Federal Circuit’s ruling in *Baylin v. United States* employed a very different approach from the other cases discussed in this article.²¹⁶ In *Baylin*, the taxpayer entered into a contingency fee agreement with a law firm for representation in the appeal of a jury award of \$3,899,000 plus interest and costs as the fair market value of land condemned by the state.²¹⁷ The contingency fee agreement entitled the lawyer to a percentage of any amount recovered above the jury award.²¹⁸ On appeal, the parties settled the case for \$10,625,850 in principal and \$6,358,418 in interest, with the lawyer receiving \$4,048,424 of the recovery.²¹⁹ The taxpayer allocated the attorney’s fees proportionately between the principal paid for the land and

²¹³ 259 F.3d 881, 883 (7th Cir. 2001).

²¹⁴ *Id.*

²¹⁵ *Id.* The court ruled against the taxpayer by applying the assignment-of-income principles. *Id.* at 884. Since state law would not allow the taxpayer to convey to his attorney an interest in the contract or asset, the contingency contract was an ineffective assignment of income. *Id.*

²¹⁶ 43 F.3d 1451, 1455 (Fed. Cir. 1995).

²¹⁷ *Id.* at 1452–53.

²¹⁸ *Id.* at 1452.

²¹⁹ *Id.* at 1453.

the interest payment.²²⁰ The IRS assigned all the legal fees to the condemnation proceeds.²²¹

The court applied the origin-of-the-claim doctrine established by *United States v. Gilmore*.²²² “[T]he proper focus is not the proportional recovery of each type of income, but the ‘origin and character of the claim’ with respect to which the legal fees at issue were incurred.”²²³ The origin of the claim was the condemnation sale of the land.²²⁴ “Efforts to increase the price of property are properly characterized as ‘part of the process of property disposition’” and, therefore, are capital expenditures.²²⁵ The court disagreed with the taxpayer’s argument that the attorney’s fees were paid for recovery of both principal and interest on the basis that the lawyer “spent a *de minimis* amount [of time] attempting to increase the interest portion of the award.”²²⁶ The court held that the entire amount of legal costs reduced the amount of capital gain from the disposition.²²⁷

2. First Circuit: Contingency Fee’s Miscellaneous Itemized Deduction Because Claim Was Related to Employment Income

In *Alexander v. IRS*, the First Circuit also utilized the origin-of-claim doctrine with no reference at all to the *Earl* and *Horst* assignment-of-income doctrine.²²⁸ Instead, the court considered “the well-settled rule that the classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and amounts received in compromise of a claim must be considered as

²²⁰ *Id.*

²²¹ *Id.* Because the gain on the forced sale of the land is capital gain and the interest payment is ordinary income, allocating the legal costs between the sale proceeds and the judgment interest payment resulted in less ordinary income taxed at higher rates and more capital gain taxed at lower tax rates. *Id.*

²²² *Id.* (applying *United States v. Gilmore* 372 U.S. 39, 50 (1963)). Origin of the claim test was more fully developed in *Woodward v. Commissioner*, 397 U.S. 572, 578 (1970).

²²³ *Baylin*, 43 F.3d at 1453 (citing *Woodward*, 397 U.S. at 578).

²²⁴ *Id.* at 1454.

²²⁵ *Id.* (citing *Stokely-Van Camp, Inc. v. United States*, 974 F.2d 1319, 1324 (Fed. Cir. 1992)); see e.g., *Woodward*, 397 U.S. at 575; accord *Isaac G. Johnson & Co. v. United States*, 149 F.2d 851, 852 (2d Cir. 1945). This part of the court’s analysis suggests it agrees with the transactional cost approach discussed below.

²²⁶ *Id.*

²²⁷ *Id.* at 1454–55.

²²⁸ 72 F.3d 938 (1st Cir. 1995).

having the same nature as the right compromised.”²²⁹ In other words, the test applied by the court was: “In lieu of what were the damages awarded?”²³⁰ Since the settlement reached by the parties required the former employer to pay taxpayer \$100,000 for age discrimination and \$250,000 for breach of an employment contract, the entire \$350,000 was held to be ordinary income to the taxpayer, including all legal fees.²³¹

D. Contingency Fees in Employment Cases as Reimbursed Employee Expenses

1. First Circuit: Reimbursed Employee Expense Theory Without Support in the Record

The taxpayer in *Alexander* presented to the First Circuit an alternative argument to be considered if the court determined, as it did, that the attorney’s fees were not allowed as an offset to amount realized from the claim.²³² In a lawsuit for breach of contract and discrimination filed against a former employer, the taxpayer argued that the employer’s payment of the proceeds jointly to the taxpayer and his lawyer qualified as a reimbursement arrangement under § 62(a)(2)(A).²³³ The court rejected the argument summarily stating that the position “is utterly without support in the record.”²³⁴

2. Ninth Circuit: Contingency Fee Not Incurred During the Performance of Services as an Employee

The Ninth Circuit likewise rejected the reimbursed employee expenses argument in *Biehl v. Commissioner*.²³⁵

²²⁹ *Id.* at 942 (citing *Parker v. United States*, 573 F.2d 42, 49 (9th Cir. 1978)).

²³⁰ *Id.* (citing *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944)).

²³¹ *Id.* at 940, 944.

²³² *Id.* at 945. See *infra* Part III.F for discussion of the transactional cost approach present by the taxpayer.

²³³ *Id.* at 945–46.

²³⁴ *Id.* at 946. While the basis for the rejection is not entirely clear, the court stated that the fact that issuing payment of a portion of the damages directly to the lawyers was “standard operating procedure” did not make the arrangement one of reimbursement as contemplated in § 62(a)(2)(A). See *id.* Additionally, the court noted that the settlement agreement made no reference to the attorney’s fees. See *id.*

²³⁵ 351 F.3d 982, 988 (9th Cir. 2003). The taxpayer sued his former employer alleging, *inter alia*, wrongful termination of employment. *Id.* at 984. After an unfavorable jury verdict, the

For a reimbursable employee expense to qualify for an above the line deduction, not only must it be attributable to a trade or business, but it must also have been incurred during the course of 'performance . . . of services as an employee.' Had Congress intended to open the flood-gates to all expenses incurred in connection with *employment* it could have done so.²³⁶

The court concluded that "[e]ven though, preliminarily, these fees might broadly qualify for treatment as a deduction under § 162(a), the legal fees associated with a wrongful termination lawsuit against a former employer are not 'in connection with the performance . . . of services as an employee.'"²³⁷ This issue of whether there was a reimbursement arrangement was not addressed.²³⁸

The Ninth Circuit also referred to the legislative history surrounding § 62 as a further indication that Congress did not intend to allow attorney's fees incurred to collect salary and damages from a former employer to be deductible under § 62.

The General Explanation of the Tax Reform Act of 1986 defines an employee business expense as 'a cost incurred by an employee in the course of performing his or her job.' . . . This strongly suggests that costs incurred after employment has terminated, such as wrongful termination litigation expenses, do not qualify.²³⁹

The court concluded, as have several courts, "If this result strikes some as bad policy, or unfair, the remedy is with Congress, not the courts."²⁴⁰

employer agreed to settle the claim for \$1.2 million. *Id.* The employer issued a separate check to the taxpayer's attorney for attorney's fees in the amount of \$401,000. *Id.* The taxpayer reported only the remaining \$799,000 as income. *Id.*

²³⁶ *Id.* at 986 (citing I.R.C. § 62(a)(2)(A) (2000)).

²³⁷ *Id.* at 988.

²³⁸ *Id.*

²³⁹ *Id.* at 986-87 (citing STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78 (Comm. Print 1987)).

²⁴⁰ *Id.* at 988; see also *Kenseth v. Commissioner*, 259 F.3d 881, 884-85 (7th Cir. 2001); *Campbell v. Commissioner*, 274 F.3d 1312, 1314-15 (10th Cir. 2001); *Benci-Woodward v. Commissioner*, 219 F.3d 941, 944 (9th Cir. 2000); *Alexander v. IRS*, 72 F.3d 938, 946-47 (1st Cir. 1995).

Although, general consensus exists as to the appropriate result, much dissension remains as to the appropriate process to achieve such result.

3. Amicus Brief: Contingency Fee Agreement Is an Employee Reimbursement Arrangement

According to Professor Stephen B. Cohen in an amicus brief filed in the *Banks* and *Banaitis* cases,²⁴¹ the amount of the employment litigation award paid by the former employer to the claimant's (former employee's) lawyers qualifies as an above-the-line deduction under § 62(a)(2)(A) as reimbursed employee expenses.²⁴² Reimbursed employee expenses are those which must be "paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer."²⁴³ Four requirements must be met in order to qualify for the above the line deduction: (1) a reimbursement arrangement with the employer; (2) paid or incurred by the taxpayer, in connection with the performance by him of services as an employee; (3) employee must be required to substantiate the expenses covered by the arrangement to the person providing the reimbursement; and (4) employee does not have the right to retain any excess amount.²⁴⁴

²⁴¹ Brief for Amicus Curiae, Prof. Stephen B. Cohen, Pro Se, in Support of Respondents at *6, *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005) (Nos. 03-892, 03-907). Cohen is a professor at Georgetown Law Center. See *supra* Part III.A.4.b for a discussion of *Banks* and *supra* Part III.A.2.b for a discussion of *Banaitis*.

²⁴² Treas. Reg. § 1.62-2(c)(4) (as amended in 2003). The "[a]mounts treated as paid under an accountable plan are excluded from the employee's gross income." *Id.* An "accountable plan" is an arrangement that meets the requirements of paragraphs (d), (e), and (f) of Treasury Regulation § 1.62-2. Treas. Reg. § 1.62-2(c)(2).

²⁴³ I.R.C. § 62(a)(2)(A) (2000).

²⁴⁴ *Id.* § 62(a)(2)(A), (c)(1), (c)(2).

E. Contingency Fee Arrangements as Open Transaction Subject to § 83

1. Eleventh Circuit: Contingency Fee Arrangement Not Open Transaction Because IRS Failed to Prove Value Undeterminable

As an alternative argument in *Davis v. Commissioner*, the IRS argued that the taxpayer, at the time she entered into the contingency fee agreement, effectively sold part of her cause of action in an open transaction.²⁴⁵ Under the open-transaction doctrine, the recognition of the gain on the disposition of an asset is postponed until such time as the value of either asset to the exchange can finally be determined.²⁴⁶ In the case of a contingency fee agreement, the argument is that it would be hard to ascertain the amount to be recovered through the representation, and it would be difficult to value the future services to be provided by the lawyer.²⁴⁷ According to the Eleventh Circuit, “[b]ecause the IRS provided no proof that the values of either the cause of action or the attorneys’ services were unascertainable, it has failed to establish that the open transaction doctrine should apply.”²⁴⁸

2. Amicus Brief: Uncertainty of Contingency Fee Makes It a Transaction Governed by § 83

The amicus brief filed by Professors Gregg D. Polsky and Brant J. Hellwig in the *Banks* and *Banaitis* cases, presents to the Supreme Court the application of the open-transaction doctrine through § 83.²⁴⁹ Section 83 applies when an independent contractor, such as a lawyer, receives property in payment for services rendered.²⁵⁰ If, at the time of the transfer, the property interest is subject to substantial risk of forfeiture, such as not winning the contingency-fee-based lawsuit, the independent contractor

²⁴⁵ 210 F.3d 1346, 1347 (11th Cir. 2000).

²⁴⁶ *Id.* at 1348.

²⁴⁷ *Id.* When only one of the assets in an exchange can be ascertained with certainty, it is presumed that the assets are equal in value. *Id.*

²⁴⁸ *Id.*

²⁴⁹ Brief for Amici Curiae Professor Gregg D. Polsky and Professor Brant J. Hellwig in Support of Petitioner at *8–13, *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005) (Nos. 03-892, 03-907).

²⁵⁰ I.R.C. § 83 (2000).

(lawyer) does not recognize income until the risk passes and the value of the property can be determined with certainty.²⁵¹ When the risk passes and the value can be determined, then the independent contractor must include the value of the property in gross income and the transferor of the property (client) must include the value in income as a disposition of the property.²⁵² At that time, the transferor of the property (client) is allowed an equal deduction for the value transferred to the independent contractor (lawyer).²⁵³

F. Contingency Fee, as a Transactional Cost, Is a Capital Expenditure and Offsets the Gain on Disposition of the Claim

1. First Circuit: No Offset for Settlement for Age Discrimination Claim, Only for Disposition of Capital Assets

The taxpayer in *Alexander v. IRS* argued that the settlement of his age discrimination claim was a disposition of property within the meaning of § 1001(a).²⁵⁴ Accordingly, the proceeds should be offset by fees paid to his lawyer as the costs of disposition within the meaning of § 1016, in order to

²⁵¹ *Id.* § 83(a); Treas. Reg. § 1.83-3(a) (as amended in 1986). “[A] transfer of property occurs when a person acquires a beneficial ownership interest in such property” Treas. Reg. § 1.83-3(a). Additionally, the treasury regulations provide as follows:

[W]hether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Treas. Reg. § 1.83-(3)(c).

²⁵² I.R.C. § 83(a)(1).

²⁵³ I.R.C. § 83(a)(2).

²⁵⁴ 72 F.3d 938, 941 (1st Cir. 1995). The settlement reached by the parties required the former employer to pay Alexander \$100,000 for age discrimination, and \$250,000 for breach of an employment contract. *Id.* at 940. The entire \$350,000 was held to be ordinary income to Alexander. *Id.* at 944. Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis as determined in § 1011. I.R.C. § 1001(a). Section 1011 provides that the adjusted basis shall be the original basis adjusted as provided in § 1016. I.R.C. § 1011. Section 1016 provides that proper adjustment shall be made for “expenditures, receipts, losses, or other items, properly chargeable to capital account.” I.R.C. § 1016(a)(1).

determine the taxable gain under § 1001.²⁵⁵ In rejecting the taxpayer's argument, the First Circuit stated that to allow the taxpayer to offset the attorney's fees "would be fundamentally inapposite in light of the controlling fact that the settlement proceeds are clearly in the nature of compensation" for services as an employee of his former employer.²⁵⁶

The court characterized the tax treatment of the legal fees based upon the origin of the settlement proceeds—the age discrimination claim.²⁵⁷ Because the settlement proceeds proximately resulted from his claim for payment of salary from his former employer, the legal fees should be treated as employee expenses.²⁵⁸

In rejecting taxpayer's argument that the legal fees should be considered as a type of closing cost for the disposition of an asset, the court stated that "the Code simply does not provide for the offsetting of basis in such circumstances except in limited cases involving capital assets."²⁵⁹ The First Circuit continued, "[i]nstead, the Code permits litigation expenses to be taken into account by way of a deduction."²⁶⁰ The *Alexander* opinion provides a general discussion of § 162(a), the general definition of deductible trade or business expenses.²⁶¹ The court focused on whether the litigation expenses in question were subject to the limitation in § 162(a)(1) that prohibits employees from deducting above the line expenses incurred "by a taxpayer engaged in the trade or business of the performance of services as an employee."²⁶² The opinion provides no basis for the

²⁵⁵ *Alexander*, 72 F.3d at 941–42.

²⁵⁶ *Id.* at 943.

²⁵⁷ *Id.* at 944.

²⁵⁸ *Id.* at 945. Unreimbursed employee expenses are deductible as miscellaneous itemized deductions and only to the extent that such miscellaneous itemized deductions exceed two percent of the taxpayer's adjusted gross income and they are not deductible at all in calculating the taxpayer's alternative minimum tax. *Id.* at 946.

²⁵⁹ *Id.* at 943 n.9. See *infra* Part VI.B.6 for further discussion of this inaccurate statement. The characterization as a capital asset determines the type of gain realized and the tax rate to which it is subject, not the amount of the gain that taxpayer will have to report and subject to income taxation. I.R.C. § 1221(a). The type of gain or loss realized, and consequently the tax treatment thereof, depends on several other factors including the type of asset disposed of. The resulting gain could be ordinary, short-term or long-term capital gain or even exempt from tax altogether. The important point is that the tax consequences are determined with regard to the gain or loss realized, not the gross amount realized. I.R.C. § 1001.

²⁶⁰ *Alexander*, 72 F.3d at 943 n.9.

²⁶¹ *Id.* at 944–45.

²⁶² *Id.* at 944; see I.R.C. § 62(a)(1). The court held that there should be no distinction made "between present and former employees if the expenses originated in the trade or business of

conclusion that “the Code simply does not provide for the offsetting of basis in such circumstances.”²⁶³

What really happened in *Alexander*? The taxpayer argued that the attorney’s fees should be considered a cost of the disposition of an asset—the claim against his former employer.²⁶⁴ The court summarily dismissed the argument, instead applying the origin-of-claim theory and holding that his lawsuit was filed to recover what would have been ordinary income (salary) if not for the discriminatory action.²⁶⁵

2. Seventh Circuit: No Exclusion from Income, Only Deductible Expense

In *Kenseth*, the Seventh Circuit addressed the transactional cost theory as it applied the assignment-of-income principles.²⁶⁶ The court required the taxpayer to include in his gross income the contingency fee paid directly to his attorney.²⁶⁷ In addressing the inequity of the outcome and while lambasting the Fifth Circuit’s *Cotnam* rationale, the Seventh Circuit stated that “it is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion from income.”²⁶⁸

3. Amicus Brief: Fees Are Subtracted from Proceeds at the Time of Disposition as Capital Expenditures

The amicus brief filed by the Association of Trial Lawyers filed in the *Banks* and *Banaitis* cases, presents the transactional cost argument with more clarity than the First and Seventh Circuits.²⁶⁹ Damages received

being an employee.” *Alexander*, 72 F.3d at 945. The lawsuit resulted directly from the employment. *Id.* at 945.

²⁶³ *Id.* at 943 n.9. The court’s reasoning includes a reference to § 162(a) providing a deduction for business expenses. *Id.* at 944. Section 1016 is the appropriate code provision for the treatment of costs of dispositions of an asset. I.R.C. § 1016. Such costs are allowed as an adjustment to the basis of the asset to be disposed of. *Id.* § 1016(a)(1).

²⁶⁴ *Alexander*, 72 F.3d at 941–42.

²⁶⁵ *See id.* at 942–44.

²⁶⁶ 259 F.3d 881, 883–85 (7th Cir. 2001).

²⁶⁷ *Id.* at 885.

²⁶⁸ *Id.*

²⁶⁹ Compare Trial Lawyers Brief, *Commissioner v. Banks*, Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370 (Jan. 24, 2005) (Nos. 03-892, 03-907), with *Alexander*, 72 F.3d at 941–46, and *Kenseth*, 259 F.3d at 884–85.

through a lawsuit or a settlement of a claim for personal injury constitute proceeds received from the disposition of property.²⁷⁰ An unliquidated cause of action “is ‘intangible personal property,’ which can be bought, sold, or assigned.”²⁷¹ Contingency fees should be treated as a capital expenditure, which is subtracted from the proceeds of the settlement or award.²⁷² Contingency fees should not be treated as a miscellaneous itemized deduction.

IV. *COMMISSIONER V. BANKS* APPLIES ASSIGNMENT OF INCOME DOCTRINE, REQUIRING LITIGANT TO INCLUDE ENTIRE AWARD IN GROSS INCOME

The Supreme Court granted Certiorari in two circuit cases, *Commissioner v. Banks* and *Commissioner v. Banaitis*, to resolve the conflict among the circuits discussed supra Part III.²⁷³ The Supreme Court defined the issue to be “whether the portion of a money judgment or settlement paid to a plaintiff’s attorney under a contingent-fee agreement is income to the plaintiff”²⁷⁴ The Court held that “as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.”²⁷⁵

A. *Preliminary Observations Recognize that Amendment to the Internal Revenue Code Will Change Outcome of Similar Cases Prospectively*

Before discussing the basis for its ruling, the Court made two preliminary observations: (1) No dispute existed that legal fees in the two cases could have been deducted as miscellaneous itemized deductions; however, the alternative minimum tax system does not allow the deduction of miscellaneous itemized deduction. (2) If these cases occurred after the enactment of the American Jobs Creation Act of 2004, the taxpayer would

²⁷⁰ Trial Lawyers Brief at *23–30, *Banks* (Nos. 03-892, 03-907).

²⁷¹ *Id.* at *4.

²⁷² Technically, § 263 capital expenditures are added to the basis of assets. I.R.C. §§ 263, 1011 (2000). Upon the disposition of an asset the gain realized is the amount of consideration realized minus the adjusted basis of the property. I.R.C. § 1001. The result is the same as if the capital expenditure were subtracted from the proceeds of the disposition.

²⁷³ 541 U. S. 958 (2004).

²⁷⁴ *Banks*, 2005 U.S. LEXIS 1370, at *6.

²⁷⁵ *Id.* at *8.

have been allowed a deduction for the attorney fees directly from gross income even under the alternative minimum tax system. What is the significance of these observations? The Court may have been addressing the argument, presented in the Joint Supplemental Brief for Respondents, that in light of the enactment of the American Jobs Creation Act of 2004, both cases should be dismissed on the basis that the new law will sharply limit the impact of the Court's decision.²⁷⁶ Perhaps also, the Court was

²⁷⁶ Joint Supplemental Brief for Respondents at *1, *Banks*, 2005 U.S. LEXIS 1370 (Nos. 03-892, 03-907). Both cases would be governed by the new Code § 62(a)(19). See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546-48 (2004) (to be codified at 26 U.S.C. § 62(a)(19)). After October 22, 2004, plaintiffs like Mr. Banks and Mr. Banaitis are allowed to take an above-the-line deduction for attorneys fees, which means they will only pay income tax on the taxable recovery proceeds actually received by the plaintiffs. Additionally, the taxpayers argued in the joint supplemental brief that the new provision was not a change in the law, simply a clarification:

Sen. Charles Grassley, the Chairman of the Senate Finance Committee, stated on the Floor of the Senate, shortly following passage of the Act by Congress, that the portion of the Act relevant to each of these cases was designed to clarify and not change existing law, and that judgments rendered or settlements reached prior to the effective date of the Act should be treated identically as judgments and settlements subject to the Act:

Mr. BAUCUS. As I understand it, the case law with respect to the tax treatment of attorney's fees paid by those that receive settlements or judgments in connection with a claim of unfaithful discrimination, a False Claims Act, "Qui Tam," proceeding or similar actions is unclear and that its application was questionable as interpreted by the IRS. Further it was never the intent of Congress that the attorneys' fees portions of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes. Is it the understanding of the chairman that it was the conferees' intention for Section 703 to clarify the proper interpretation of the prior law, and any settlements prior to the date of enactment should be treated in a manner consistent with such intent?

Mr. GRASSLEY. The Senator is correct. The conferees are acting to make it clear that attorneys' fees and costs in these cases are not taxable income, especially where the plaintiff, or in the case of a Qui Tam proceeding, the relator, never actually receives the portion of the award paid to the attorneys. Despite differing opinions by certain jurisdictions and the IRS, it is my opinion that this is the correct interpretation of the law prior to enactment of Section 703 as it will be going forward. In adopting this provision, Congress is codifying the fair and equitable policy that the tax treatment of settlements or awards made after or prior to the effective date of this provision should be the same. The courts and IRS should not treat attorneys' fees and other costs as taxable income.

agreeing that the real problem is the treatment of the type of deduction allowed for the attorneys fees and that while Congress has addressed the issue, it corrected the problem only prospectively and only for certain types of cases.

B. Broad Definition of Gross Income Prohibits Taxpayer from Escaping Income Taxation Through Anticipatory Assignment of Income

The Court began its analysis by affirming that the definition of gross income is to be interpreted broadly to include "all economic gain not otherwise exempted," and that a taxpayer cannot avoid recognizing income by an anticipatory assignment of income.²⁷⁷ The Court agreed with the Commissioner that contingency fee agreements should be viewed as an anticipatory assignment of income for the amount of the award to which the attorney is entitled pursuant to the agreement.²⁷⁸ The Court further states that the presence (or absence, as in these cases) of a tax avoidance motive is irrelevant.²⁷⁹ The key issue in anticipatory assignment of income cases is the level of control maintained by the transferor.²⁸⁰ If the taxpayer "exercises complete dominion over the income in question,"²⁸¹ then the taxpayer must recognize the income. Such is the case in contingency fee litigation cases.²⁸²

C. Arguments for the Exclusion from Income Dismissed

The Court discussed and dismissed two arguments presented by Mr. Banks and Mr. Banaitis as justifications to distinguish contingency fee cases from other anticipatory assignment of income cases.²⁸³ The Court

Joint Supplemental Brief for Respondents at *3-4, *Banks*, 2005 U.S. LEXIS 1370 (Nos. 03-892, 03-907). If the new § 62(a)(19) is only a clarification, why does it limit the above-the-line-deduction treatment to only the listed types of cases? The Supreme Court did not address this argument specifically nor does this article.

²⁷⁷ *Banks*, 2005 U.S. LEXIS 1370, at *14.

²⁷⁸ *Id.* at *15.

²⁷⁹ *Id.*

²⁸⁰ *Id.* (citing *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)).

²⁸¹ *Id.*

²⁸² *Id.* at *16.

²⁸³ *Id.* at *17-21.

specifically mentions, and then refuses to consider, three additional theories that were presented in amici briefs filed in the *Banks* case.²⁸⁴

1. Anticipatory Assignment of Income Applies to Speculative and Uncertain Claims Recovered or Increased through Combined Efforts

Taxpayers argued that, unlike the interest coupons assigned to the son in *Horst*,²⁸⁵ the value of a legal claim is too speculative, or worthless, at the time claimant and the lawyer entered into the contingency-fee agreement to be considered an assignment of income.²⁸⁶ The Court held that “the anticipatory assignment of income doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance.”²⁸⁷ The value of the claim at the time of the attempted assignment is not relevant—only the ownership and control of the income-producing asset. The claimant retained dominion over the asset and must recognize the income even though the then undetermined amount of income is diverted to another through an anticipatory assignment of income.²⁸⁸

2. Contingency Fee Arrangements Are Not Partnerships

The second argument rejected by the Supreme Court in *Banks* was the creation of a partnership or joint venture relationship between the claimant and the lawyer.²⁸⁹ The Court held that regardless of the terms of the contingency fee arrangement, the amount of contribution of “skill and effort” by the lawyer, or the special rights conferred by state law, the attorney-client relationship is a “quintessential principal-agent relationship.”²⁹⁰ As the agent, the attorney’s efforts to collect the recovery were made on behalf of the client, not for the sake of the attorney’s personal interest. An attorney is duty bound to represent the interest of the client, not himself. In such principal-agent relationships, the gain realized by the lawyer’s efforts is income to the client. The Court held that the portion of

²⁸⁴ *Id.* at *21–22.

²⁸⁵ See *supra* Part II.D.2.

²⁸⁶ *Banks*, 2005 U.S. LEXIS 1370, at *17–18.

²⁸⁷ *Id.* at *18.

²⁸⁸ *Id.*

²⁸⁹ *Id.* at *18–21.

²⁹⁰ *Id.* at *18–19 (citing RESTATEMENT (SECOND) OF AGENCY § 1 cmt. e (1957); MODEL RULES OF PROF’L CONDUCT R. 1.3 cmts. 1, 1.71 (2002)).

the proceeds paid to the lawyer pursuant to a contingent fee agreement cannot be excluded from the client's income.²⁹¹

3. Other Theories Not Properly Considered by Lower Courts

The Court mentions other arguments and theories suggested for its consideration in amici briefs. Since these arguments were not considered by the lower courts, the Court declined to comment or rule on the supplementary theories.²⁹² Three were specifically mentioned: (1) Contingency-fee agreements as partnership,²⁹³ (2) Transactional cost offset as a capital expenditure against the proceeds,²⁹⁴ and (3) Deductible reimbursed employee expenses.²⁹⁵

The Supreme Court rejected the argument presented in the taxpayers' brief that the attorney-client relationship created through a contingency fee agreement is a partnership or joint venture, and yet, the partnership theory is listed as a supplemental theory the Court will not consider.²⁹⁶ Why list partnership theory for consideration by the lower courts if the Supreme Court already rejected it? Perhaps, the answer is that the partnership theory has not been sufficiently considered by the lower courts. The *Banks*' Tax Court opinion does not mention the partnership theory.²⁹⁷ The Sixth Circuit in *Banks*, briefly references the partnership concept as one of the factors considered in its previous opinion *Estate of Clarks ex rel Brisco-Whitter v. United States*.²⁹⁸ In neither its *Banks* or *Estate of Clarks* opinion did the Sixth Circuit elaborate on the definition of a partnership for federal income tax purposes nor analyze contingent fee agreements in light of Subchapter K of the Internal Revenue Code.²⁹⁹ Additionally, the partnership concept

²⁹¹ *Id.* at *20. However, the Court recognized that the attorney's fees may be deductible. *Id.*

²⁹² *Id.* at *21-22.

²⁹³ See *supra* Part III.B.

²⁹⁴ See *supra* Part III.F.

²⁹⁵ See *supra* Part III.D.

²⁹⁶ *Banks*, 2005 U.S. LEXIS 1370, at *18-19.

²⁹⁷ See 81 T.C.M. (CCH) 1219 (2001). The Tax Court decided the contingency fee issue on the basis of assignment of income cases and whether or not applicable state law confers some type of ownership interest to the attorney, not on the basis of the definition of a partnership of federal income tax purposes. *Id.*

²⁹⁸ 202 F.3d 854 (6th Cir. 2000), *overruled by Banks*, 2005 U.S. LEXIS 1370.

²⁹⁹ Subchapter K sets forth the income tax provisions to be applied to entities that are to be taxed as a partnership as determined in accordance with Treasury Regulations § 301.7701-1 et seq. "Whether an organization is an entity separate from its owners for federal tax purposes is a

was not presented to, nor considered by, the Ninth Circuit. Partnership as a theory was presented by Mr. Banaitis for the first time in his brief to the Supreme Court.³⁰⁰ Such argument was not presented in his brief to the Ninth Circuit, nor was it addressed in the United States Tax Court opinion³⁰¹ or the Ninth Circuit opinion.³⁰² Still, will the lower courts consider partnership as a viable option with specific language of rejection by the Supreme Court? It's not likely.

D. Court Refused to Consider the Adverse Affect of Inclusion of Income on Statutory Fee Shifting Cases

The Court recognizes the concern that the inclusion of the attorney's fees in the claimant's income "would undermine the effectiveness of fee-shifting statutes"³⁰³ and "can lead to the perverse result that the plaintiff loses money by winning the suit."³⁰⁴ Because such was not the situation presented by the cases before the Court, it declined to address the concern.³⁰⁵

E. Court Did Not Address Argument that Fee Is Debt Owed by Client

In its Petitioner's brief in *Banks*, the IRS Commissioner argued that "[t]he relationship between the client and his attorney is simply that of debtor and creditor," and therefore, the client has income under the holding of *Old Colony Trust v. Commissioner*.³⁰⁶ The Supreme Court did not address this argument in its *Banks* opinion, presumably rejecting the argument.³⁰⁷

matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Treas. Reg. § 301.7701-1(a) (1996).

³⁰⁰ *Banks*, 2005 U.S. LEXIS 1370, at *21-22.

³⁰¹ *Banaitis v. Commissioner*, 83 T.C.M. (CCH) 1053 (2002).

³⁰² See *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *rev'd*, 2005 U.S. LEXIS 1370.

³⁰³ *Banks*, 2005 U.S. LEXIS 1370, at *23.

³⁰⁴ *Id.* See *infra* Part V.A.

³⁰⁵ *Id.* at *23-24

³⁰⁶ Brief for the Petitioner at *29-30, *Banks*, 2005 U.S. LEXIS 1370 (Nos. 03-892, 03-907).

³⁰⁷ As admonished by the Fifth Circuit in *Cotnam v. Commissioner*, the plaintiff is not obligated to pay the attorney's fees. 263 F.2d 119, 126 (5th Cir. 1959). The fee is contingent upon the success of the attorney's work. *Id.* Contingency fee arrangements are different from situations where the client is first obligated to pay someone (such as an attorney) money and then directs that a third party (such as a defendant) pay the client's money or income directly to the

F. Affect of Banks Ruling on Anticipatory Assignment of Income Doctrine

Banks did not change, nor add to, the anticipatory-assignment-of-income principles as discussed *supra* Part II.D. The Supreme Court merely determined that the nature of the attorney-client relationship was that of a principal-agent.³⁰⁸ As such, the client owns the claim, the efforts of the attorney are on behalf on the client and, therefore, the income from the claim is income to the client.³⁰⁹

1. *Lucas*' Assignment-of-Earned-Income Principle Is Inapplicable to Contingency Fee Cases

Although *Lucas*³¹⁰ is cited by the Supreme Court in *Banks*, for its assignment-of-earned-income principle, contingency fee arrangements create an entirely different scenario from that found in *Lucas*. Contingency fee arrangements are not created, and are not executed, to affect a gratuitous transfer of earned income. Unlike *Lucas*, plaintiffs have no intention of shifting income gratuitously when executing a contingency fee agreement. Contingency fee agreements are negotiated arms-length transactions. The attorney agrees to use his skill and training and work to represent his client. Through the efforts of the attorney, the plaintiff receives the award or settlement that will be appropriately split between the plaintiff and the lawyer.

Furthermore, the concept of earned income is not always relevant when considering awards received through lawsuits.³¹¹ Many of these cases

attorney on behalf of the client. In every contingency fee arrangement, the lawyer directly participates in, if not is solely responsible for, the production of the income. Without the efforts of the attorney, no award would be forthcoming, and therefore, no true debt is owed by the client.

³⁰⁸ *Banks*, 2005 U.S. LEXIS 1370, at *18-19.

³⁰⁹ *Id.* at *18-20.

³¹⁰ 281 U.S. 111 (1930).

³¹¹ Cases involving claims for back pay are the most troubling for those trying to differentiate between the assignment of earned income in *Lucas* and the assignment of a property interest in *Helvering v. Horst*. 311 U.S. 112 (1940). The Supreme Court addressed the distinction in *Helvering v. Eubank*. 311 U.S. 122 (1940). Eubank, an insurance salesman, had an employment agreement that entitled him to continue to receive after employment commissions on renewal premiums for policies he sold. *Id.* at 124. He assigned the renewal commissions to another. *Id.* Respondent's assignment could be framed in two alternatives. First, he assigned income that he had already earned at the time he sold the policy but which would not be collected until the premiums were due and paid by the policyholder. Alternatively, he assigned a property interest—his claim to the commissions by reason of his rights under the contract—which would produce

involve recoveries for amounts above the actual back pay owed to the discharged employee. For example, punitive damages are income to the recipient but are not earned by the recipient. Punitive damages are a windfall profit assessed to punish the wrongdoer. Perhaps in cases where the only amount recovered by the plaintiff was back pay, an analogy to *Lucas* is appropriate. In cases where the contingency fee paid to attorneys is based upon punitive damages, punitive awards do not compensate the plaintiff for any effort on the part of the plaintiff.

For personal injury cases and cases other than a suit for the collection of plaintiff's earned income, if not all cases, the *Earl* assignment-of-income approach to earned income is inapplicable. Receipt of damages through the legal process is more akin to a collection of income from, or a disposition of, a property interest—the legal claim. The assignment of income from property is the more appropriate principle.

2. *Banks* Applies Assignment-of-Income-from-Property Principles to Contingency Fee Cases

Prior to *Banks*, courts of appeal disagreed as to whether a plaintiff's claim is a property interest that, for federal income tax purposes, can be transferred.³¹² In *Banks*, the Supreme Court clearly holds that it is: "In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury."³¹³ Once a claim is recognized as a property interest that will generate taxable income, the assigned-income-from-property principle from *Helvering v. Horst*, are the guiding principles.³¹⁴ According to *Horst* and *Banks*, the key question is "whether the assignor retains dominion over the income-generating asset"³¹⁵ The Supreme Court brings *Earl* and *Horst* together with this explanation, "Looking to control over the income-generating asset, then,

future income in the form of commissions from renewal premiums when paid by the policyholder. Based on the reasoning in *Horst*, the majority determined the case to be a service income case on the basis that Eubank had already performed all the services that would ever be necessary to entitle him or someone to the commissions in the future. *Id.* at 125. Thus, applying this analysis to a claim for back pay, it appears that the future collection of back pay should be earned income, taxed to the one who earned it.

³¹² See *supra* Part III.A.

³¹³ 2005 U.S. LEXIS 1370, at *16.

³¹⁴ 311 U.S. at 116–17; see *supra* Part II.D.2.

³¹⁵ *Banks*, 2005 U.S. LEXIS 1370, at *16.

preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.”³¹⁶

According to the Supreme Court, the client, in contingency fee cases, retains ultimate control over the disposition of the cause of action and, therefore, retains ownership of the income-generating asset. “The control is evident when it is noted that, although the attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions.”³¹⁷ Because the client retains ultimate dominion over the claim, the entire amount of the award constitutes income to the client. This rule applies even though under state law, the lawyer may have special rights to, or an ownership in, the agreed upon contingency fee percentage of the award.³¹⁸ The fact that the amount of the recovery was entirely, or partially, the result of the attorney’s efforts is irrelevant.³¹⁹

3. Affect of *Banks* on Fruit-Tree Metaphor

Where does the fruit and tree metaphor, discussed *supra* Part II.D.4, stand after *Banks*? Perhaps the best answer is that its life may have passed. Not once does the Supreme Court in *Banks* refer to any species of fruit-bearing plantae in explaining and applying the anticipatory assignment of income doctrine. However, for some, the visualization continues to have utility.

The *Lucas* anticipatory-assignment-of-earned-income doctrine is inapplicable to contingency fee arrangements and therefore, not affected by *Banks*. *Banks* settled the issue of whether the recovery should be considered as income earned by the client and attorney jointly or whether the cause of action is an income-generating asset. Once the cause of action is determined to be property, the *Horst* anticipatory-assignment-of-income-from-property doctrine is the appropriate principle for consideration.

³¹⁶*Id.* The consequent benefits could include a larger award than the client may have received without the assistance and efforts of the lawyer.

³¹⁷*Id.* at *19.

³¹⁸*Id.* at *20–21 The Supreme Court qualifies the ruling by stating that the rule applies so long as any special rights or protections afforded by state law “do not alter the fundamental principal-agent character of the relationship.” *Id.*

³¹⁹*See id.* at *18–20.

A cause of action is the tree that produces the fruit (income/recovery). The relationship between an attorney and a client is that of a principal and agent. The contingency fee agreement does not transfer an ownership interest in the tree (claim) to the lawyer. The client continues to own the tree and the lawyer, as the agent of the client, is a part of the tree, like a branch of the tree; alternatively, consider the lawyer to be a caretaker of the tree on behalf of the owner. All of the fruit (recovery) is income to the client as the owner of the tree. Granted, the fruit is more plentiful because of the labor of the lawyer on behalf of the client, but nevertheless, the client remains the sole owner of the income-generating asset—the tree.

V. POLICY AND OTHER REASONS SUPPORTING THE CONCLUSION THAT CONTINGENCY FEE ARRANGEMENTS SHOULD NOT BE TAXED TO INJURED PARTY

The issue in contingency fee cases is not whether the amount of the attorney's fees will be taxed at all. The one constant outcome using any theory or approach described above is that the attorneys will recognize, report and pay tax on their fees, however calculated, when collected. The question is whether the client also should have to pay tax on the amount paid to the attorneys hired to assist them in prosecuting a private claim to collect their damages and other awards. The answer should be no.

Before addressing which of the theories above is the most viable, effective and efficient approach to solving the dilemma, presented for consideration are five reasons the client's should only have to pay income tax on the net proceeds received.

A. Taxing Contingency Fees to Plaintiff Has Chilling Effect on Private Enforcement of Rights

Any result that requires the client to pay higher federal income taxes will thwart the purpose of laws enacted to permit citizens to privately prosecute those who have caused them injury or harm.

The prospect that a "victorious" plaintiff may be required to pay for the privilege may lead some Americans to believe that their government has taken back the promise that was wrested from King John in 1215: "To no one will

we sell, to no one will we refuse or delay, right or justice.”
Many will simply decide that they cannot afford justice.³²⁰

Congress has recognized that private lawsuits not only allow individuals to vindicate and protect their civil rights, but also serve the broader public interest of punishing the wrongdoers and deterring unlawful action.³²¹ The Supreme Court acknowledged the benefit to the public of private enforcement through civil rights litigation.³²² “Unlike most private tort litigants, a civil rights plaintiff seeks to vindicate important civil and constitutional rights that cannot be valued solely in monetary terms.”³²³ “[T]here is now a rich body of academic literature supporting the view that the primary purpose of tort liability rules is to discourage inappropriate behavior.”³²⁴ Unfortunately, plaintiffs in tort and civil rights cases often cannot afford to pay an hourly or fixed rate to obtain the assistance of a lawyer, and their only means of obtaining counsel is through a contingency fee agreement.³²⁵

Plaintiffs should be supported and encouraged in their efforts to obtain adequate legal representation, not penalized by a higher income tax bill. Taxing plaintiffs on the portion of a settlement paid to the attorneys increases the cost of settlement and, therefore, undermines Congressional intent to promote settlement rather than litigation.³²⁶ Additionally, it undermines the goal of making victims whole.³²⁷

Eliminating adverse income tax consequences in civil rights cases was the motivation behind the new provision of the Internal Revenue Code, § 62(a)(19).³²⁸ With the passing of the American Job Creation Act of 2004, plaintiffs in some lawsuits—primarily civil rights litigation—will no longer

³²⁰ Trial Lawyers Brief at *9–10, *Banks*, 2005 U.S. LEXIS 1370 (Nos. 03-892, 03-907) (citing in part WILLIAM S. MCKECHNIE, *MAGNA CARTA, A COMMENTARY ON THE GREAT CHARTER OF KING JOHN* 395 (2d ed. 1914)).

³²¹ S. REP. NO. 94-1011, at 2–3 (1978), reprinted in 1976 U.S.C.C.A.N. 5908, 5910.

³²² *City of Riverside v. Rivera*, 477 U.S. 561, 574–76 (1986).

³²³ *Id.* at 574. See also Trial Lawyers Brief at *12–13, *Banks* (Nos. 03-892, 03-907).

³²⁴ Gary T. Schwartz, *Deterrence and Punishment in the Common Law of Punitive Damages: A Comment*, 56 S. CAL. L. REV. 133, 137 (1982).

³²⁵ Brief Amici Curiae of The Lawyers' Committee For Civil Rights Under Law et al. at *13–14, *Banks* (Nos. 03-892, 03-907).

³²⁶ *Id.* at *14–15 (citing *Burlington Indus. v. Ellerth*, 524 U.S. 742, 764 (1998)).

³²⁷ *Id.* at *15, (citing *Albermarle Paper Co. v. Moody*, 422 U.S. 405, 419, 421 (1975)).

³²⁸ See *infra* Part VI.A.

have to be concerned about a higher income tax bill upon the recovery of damages.³²⁹

B. Taxing Attorney's Fees to Client Results in Unfair Tax When Monetary Damages Are Small Compared to Court-Ordered or Statutory Fees Paid to Attorney

In some cases, the court will enter a separate order for the payment of the plaintiff's attorney's fees. Many of the cases like those addressed here involve the separate payment of attorney's fees pursuant to fee-shifting statutes. If these fees are taxed to the plaintiff, it is possible for the plaintiff to owe more in income tax than the monetary award received by the plaintiff. A case in point is that of the Chicago police officer, Cynthia Spina, who recovered \$300,000 for sex discrimination and harassment.³³⁰ In the end, plaintiff was presented with a tax bill of \$399,000 because of the \$950,000 of attorney's fees and costs she was required to include in her gross income.³³¹ Even the judge commented on the injustice of the situation where a woman finds the courage to take on her discriminatory employer only to be required to pay the government handsomely for the privilege of righting the wrong she suffered.³³²

As reported at a congressional hearing, a taxpayer in Iowa was tagged with a penalizing income tax bill for "do[ing] the honorable thing."³³³ A taxpayer sued his employer for retaliation after the taxpayer helped a coworker file a discrimination claim.³³⁴ The taxpayer received a \$15,000 punitive damage award; however, because of the settlement and the attorney's fees paid and included in his taxable income, he owed \$67,791 in income taxes.³³⁵ Senator Grassley lamented,

³²⁹ See *infra* Part VI.A.

³³⁰ Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, § 1, at 18, available at <http://www.nytimes.com/2002/08/11/national/11AWAR.html>.

³³¹ *Id.*

³³² *Id.* Officer Spina endured eight years of sexual harassment by her coworkers and superiors. *Id.* Sexual rumors were spread, pornography was left on her desk, tires were slashed, and she was repeatedly passed over for promotion. *Id.*; see also *Spina v. Forest Preserve Dist. of Cook County*, No. 98-C-1393, 2002 WL 1769994, at *3-4 (N.D. Ill. July 31, 2002).

³³³ See 146 CONG. REC. S7163 (daily ed. July 18, 2000) (statement of Sen. Grassley).

³³⁴ *Id.*

³³⁵ *Id.*

[He] helped out a co-worker, was attacked by his employer, and received damages in a court of law. People count on the legal system to protect them and when their civil rights are violated the system needs to function properly. It is disheartening to learn that, in actuality, [he] is going to be taken to the cleaners by the government tax system, and as a result, he ends up owing \$58,236 to the government for the “privilege” of having won his retaliation case.

It seems to me that there is something fundamentally wrong with the law when it hurts the people it is supposed to protect.³³⁶

The taxpayer in *Sinyard v. Commissioner* presented the argument that inclusion of attorney’s fees in the client income would have an undesirable result in cases where the plaintiff served as private attorneys general to seek reform or vindication of a wrong.³³⁷ In cases where the monetary damages are not the primary relief sought, the court recognized that “[i]t is possible that where monetary recovery is little or nonexistent in an ADEA case, the attorneys’ fee award would leave the taxpayer owing more tax than anything he received in his ADEA suit.”³³⁸ Judge McKeown in his dissent proclaimed, “This Draconian result under the Tax Code can only undermine our civil rights laws. After all, the purpose of fee-shifting provisions, like the one in the ADEA, is not only to permit plaintiffs without resources to pursue claims but to encourage meritorious civil rights litigation by defraying its cost.”³³⁹

The *Sinyard* majority refused to address the situation because taxpayer did not face such a harsh result; therefore, that scenario was not before the court.³⁴⁰ The court admonished Congress to remedy the unfairness of such a situation by either exempting ADEA damages like it had damages for a physical personal injury or reforming the alternative minimum tax system.³⁴¹

³³⁶ *Id.*

³³⁷ 268 F.3d 756, 760 (9th Cir. 2001).

³³⁸ *Id.*

³³⁹ *Id.* at 763 (McKeown, J., dissenting).

³⁴⁰ *See id.* at 760.

³⁴¹ *See id.*

The Supreme Court in *Commissioner v. Banks* also determined that it need not address the claims because there was no court-ordered fee award.³⁴² The claimant settled the case and the fee was based solely on the contingency-fee contract with his lawyer.³⁴³ The Supreme Court noted that the amendment added by the American Jobs Creation Act in 2004, “redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.”³⁴⁴

With the 2004 amendment to § 62(a), Congress has eradicated some situations, such as the civil rights cases discussed above.³⁴⁵ The effect of the amendment to § 62(a), discussed below, is to allow taxpayers an above-the-line deduction for attorney’s fees up to the amount of damages included in the taxpayer’s gross income.³⁴⁶ The above-the-line deduction has the same result as the exclusion suggested by the courts, such as *Sinyard*.

C. Taxing Contingency Fee to Individual Plaintiffs Gives Unfair Advantage to Business Plaintiffs

Business plaintiffs who recover damages from a legal claim are at a distinct advantage over individual plaintiffs. Businesses are entitled to deduct attorney’s fees directly from gross income.³⁴⁷ Businesses are not subject to the same reductions and limitations as individual plaintiffs.³⁴⁸ A business can offset attorney’s fees against any type of income the fees were

³⁴² Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *23–24 (Jan. 24, 2005).

³⁴³ *Id.*

³⁴⁴ *Id.* at *24.

³⁴⁵ Of the circuit court cases discussed above, taxpayers in the following cases would be allowed to deduct the contingency fee amounts directly from gross income pursuant the new provision § 62(a)(19): *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003), *rev’d*, 2005 U.S. LEXIS 1370; *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003), *rev’d*, 2005 U.S. LEXIS 1370; *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Sinyard*, 268 F.3d 756 (9th Cir. 2001); *Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000); *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995).

³⁴⁶ See *infra* Part VI.A.

³⁴⁷ *Welch v. Helvering*, 290 U.S. 111, 114 (1933) (stating that legal fees qualify as “ordinary and necessary” business expenses and are, therefore, deductible under I.R.C. § 162(a)).

³⁴⁸ Corporations and partnerships are allowed to deduct all losses, whereas individuals are limited to deducting only losses listed in § 165(c). I.R.C. § 165 (2000). Sections 67 and 68 impose reductions on certain deductions for individuals, but not other taxpayers. I.R.C. §§ 67, 68 (2000).

incurred to produce or collect.³⁴⁹ However, individuals have not been allowed to deduct attorney's fees paid in connection with a breach of contract lawsuit.³⁵⁰ This was not always the case.

Section 212 was enacted in 1942³⁵¹ in response to *Higgins v. Commissioner*, a Supreme Court case which disallowed expenses incurred in the production of investments income as a business deduction under § 162.³⁵² Congress reacted to the *Higgins* ruling not by expanding the coverage of § 162; rather, Congress enacted § 212 with language that mirrors that found in § 162 related to business expenses.³⁵³

At the time § 212 was adopted, investment expenses, deductible under § 212, and business expenses, deductible under § 162, had the same effect—a direct reduction of gross income. Not until 1986 and the passage of § 67 did the distinction between a § 162 “business” and a § 212 “non-business-but-income-producing” make a difference in calculating taxable income.³⁵⁴ Congress added § 67 to the Internal Revenue Code in

³⁴⁹I.R.C. § 165(a).

³⁵⁰See e.g., *Coady v. Commissioner*, 213 F.3d 1187, 1191 (9th Cir. 2000) (holding that a taxpayer must include contingent attorney's fees in gross income under the assignment-of-income doctrine); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (holding that the assignment of a portion of a lawsuit recovery to an attorney constitutes gross income for the client, even though the client never really obtained the funds).

³⁵¹Congress enacted what is now § 212(1) and (2) as part of the Revenue Act of 1942, ch. 619, § 121, 56 Stat. 798, 819 (1942).

³⁵²312 U.S. 212, 218 (1941). Taxpayer hired clerical staff and incurred other reasonable expenses in assisting him with the management of his extensive investment portfolio. *Id.* at 213. Taxpayer deducted the expenses on the basis that the expenses were akin to the type of expenses incurred by a business in the production of its income and deductible directly from the gross income of the business. *Id.* at 213–14. The Court held that taxpayer's investment activity could never rise to the level regular, continuous activity required to be classified as a business, and therefore, such expenses, although ordinary and necessary in the production of the income, could not be deducted. *Id.* at 218.

³⁵³Section 162 provides as follows: “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .” I.R.C. § 162(a) (2000). Section 212 provides as follows: “[T]here shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.” I.R.C. § 212(1).

³⁵⁴Prior to the enactment of § 67, non-business expenses allowed as itemized deductions were not subject to reduction; therefore, for those taxpayers with more itemized deductions than the standard deduction, taxable income was virtually the same, whether the expenses were deducted directly from gross income (such as § 162 business expenses) or from adjusted gross income as an itemized deduction (such as § 212 non-business expenses).

1986 to limit the deductibility of non-business expenses.³⁵⁵ The rationale was that some of the § 212 expenses “had only a very tenuous relationship to any income-producing activity and had personal-consumption benefits as well.”³⁵⁶ However, this is not the case with the type of litigation involved in contingency fee cases.

Attorney’s fees paid pursuant to a contingency fee arrangement are directly and causally connected to the plaintiff’s recovery of damages. None of the congressional concerns expressed in the legislative history to § 212 are present with respect to contingent fee arrangements employed to seek the assistance of skilled lawyers to pursue the claim for damages. An offset should be allowed directly from the income or award received by the client.

D. Taxing Contingency Fee to Plaintiff Has Unjust Result Because of the Denial of Deduction for the Alternative Minimum Tax

Several courts recognized the injustice when taxpayers are required to include the attorney’s fees in gross income and are denied a deduction for such fees under the alternative minimum tax provisions.³⁵⁷ In each of these cases, the courts recognized the plight of the taxpayer and some even expressed sympathy for the taxpayer.³⁵⁸ However, some courts suggest that the true issue is the shortcoming of the alternative minimum tax computation, and as such, the problem should be addressed congressionally, not judicially.³⁵⁹

As the Seventh Circuit stated in *Kenseth*,

As an original matter, in taxation’s Garden of Eden, it would indeed be difficult to think of a reason why [taxpayer] should have been denied the normal privilege of

³⁵⁵The conference committee cited “significant administrative and enforcement problems for the [IRS]” as the primary reason for limiting employee business and investment expenses to those that were “unusually large.” Committee Reports on P.L. 99-514 (Tax Reform Act of 1986), 2 Stand. Fed. Tax Rep. (CCH) ¶ 6060, at 18,411 (2005).

³⁵⁶Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys’ Fees and Costs*, 88 TAX NOTES 531, 533 (2000).

³⁵⁷See e.g. *Campbell v. Commissioner*, 274 F.3d 1312, 1314–15 (10th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, 884–85 (7th Cir. 2001); *Benci-Woodward v. Commissioner*, 219 F.3d 941, 944 (9th Cir. 2000); *Alexander v. IRS*, 72 F.3d 938, 946 (1st Cir. 1995).

³⁵⁸See e.g. *Kenseth*, 259 F.3d at 884–85; *Benci-Woodward*, 219 F.3d at 944; *Alexander*, 72 F.3d at 946–47.

³⁵⁹See e.g., *Campbell*, 274 F.3d at 1314–15.

deducting from his gross income 100 percent of an expense reasonably incurred for the production of taxable income. And nothing in the background of the alternative minimum tax law indicates why attorneys' fees were, along with other "miscellaneous expenses," lumped in with tax-preference items and denied the normal privilege.³⁶⁰

The Tenth Circuit in *Campbell v. Commissioner* summarily rejected the taxpayer's invitation to judicially overturn what she argued was an "anomalous and unjust result" caused by the alternative minimum tax system.³⁶¹ "The perceived inequities of the AMT are simply not at issue here. Congress, not this court, must correct any shortcomings in the AMT's application."³⁶²

The legislative history for the alternative minimum tax provisions is silent as to the basis for the complete denial of a miscellaneous itemized deduction; however, it is likely to rest on the same premise as that underlying the two-percent "floor" reduction for miscellaneous itemized deductions under the regular tax system.³⁶³ That is, concerns about the legitimacy and administration of those deductions, which often have characteristics of voluntary personal expenditures and often are difficult and inefficient to administer.³⁶⁴ "The Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity," thereby making reporting and enforcement difficult.³⁶⁵ Additionally, some of the expenses are quasi-personal in nature, sometimes reported incorrectly.³⁶⁶ Therefore, Congress believed such difficulties justified the enactment of the two-percent floor which serves to restrict the amount of miscellaneous itemized deductions allowed.³⁶⁷ Such concerns have no relevance when considering contingency fee agreements. The services rendered by the attorney have a direct, and often causal, impact on the

³⁶⁰ *Kenseth*, 259 F.3d at 884.

³⁶¹ *See* 274 F.3d at 1314-15.

³⁶² *Id.* at 1315.

³⁶³ *Geier*, *supra* note 356, at 534.

³⁶⁴ STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78-79 (Comm. Print 1987).

³⁶⁵ *Id.* at 78.

³⁶⁶ *Id.*

³⁶⁷ *See id.* at 78-79.

collection and amount of damages. The contingency fee paid is causally linked to the income produced by the efforts of the lawyer.

E. Tax Treatment of Contingency Fee Agreements Should Also Apply to Hourly Fee Arrangements

On what basis can a different income tax result be justified if the claim is the same and the only difference is that the client agrees to pay the lawyer by the hour, win or loss, or on a flat rate basis, rather than on a contingency basis? Should the method of calculating the amount to be paid out of the award or damages determine the tax bill to the client?

The Second Circuit's *Raymond v. United States* opinion expressed concern that an "exclusion of contingent fees from a client's gross income has the potential to 'create an artificial, a purely tax-motivated, incentive to substitute contingent for hourly legal fees.'"³⁶⁸ Also expressing concern about disparate treatment for contingency fee arrangements, the Seventh Circuit in *Kenseth* agrees that there should be no difference between contingent and fixed fees.³⁶⁹

Whichever approach is taken to achieve the most equitable, effective and efficient result for contingency fee arrangements, the same approach should be applied to hourly or flat fee arrangements with a lawyer. Why should the result be different if the only variable is the method of computing the amount of the award to which the lawyer is entitled?³⁷⁰ The justification is the same. The plaintiff would collect none or a smaller amount, if any, of the damages without the assistance of the lawyer. No tenuous connection exists between the lawyer's efforts and the collection on the plaintiff's claim. Again, plaintiff owns the claim and the lawyer's know-how and time combine to produce to outcome—the taxable income.

³⁶⁸ 355 F.3d 107, 117 (2004) (quoting *Kenseth v. Commissioner*, 259 F.3d 881, 884 (7th Cir. 2001)).

³⁶⁹ *Kenseth*, 259 F.3d at 883.

³⁷⁰ The only possible justification to treat the hourly fee arrangements differently from contingency fee agreements is if contingency fee arrangements are treated as partnerships. The fact that the client bears no risk of costs in a contingency fee arrangement and the fact that the client must pay the hourly fee even if he losses makes the economic risk and reward different.

VI. HOW DO WE REACH A VIABLE AND WORKABLE SOLUTION TO CREATE A FAIR, EQUITABLE AND EFFICIENT OUTCOME?

How can a just and equitable result be achieved so that individual plaintiffs do not pay income tax on the portion of taxable awards which is paid to lawyers? The result already has been accomplished for litigants in certain civil rights cases. After October 22, 2004, civil rights litigants are allowed to directly offset the attorney's fees against the portion of the award that is included in gross income.³⁷¹ For all other cases, the courts should revisit the issue of light of the Supreme Court's admonishment in *Banks* that there are theories not yet appropriately addressed by the lower courts, as discussed below. Otherwise, further congressional action or clarification will be required.

A. *New § 62(19) Allows Deduction for Attorney's Fees but Only in Certain Civil Rights Cases*

Congress recognized the split in the circuit courts on this issue and settled the issue at least as to certain types of civil rights litigation.³⁷² "There is a split of authority on whether contingent attorney's fees paid directly to attorneys out of a taxable judgment or settlement (i.e., for a nonphysical injury, such as unlawful discrimination) are excludable from the taxpayer's gross income or are includible in income but potentially deductible as an expense."³⁷³ Congress amended the Internal Revenue Code for plaintiffs in the types of civil rights litigation listed in new code § 62(a)(19).³⁷⁴ In such cases, plaintiffs will be allowed an above-the-line

³⁷¹ American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546-48 (2004) (to be codified at 26 U.S.C. § 62(a)(19)).

³⁷² American Jobs Creation Act of 2004 Conference Report, H.R. CONF. REP. NO. 108-755, at 483-84 (2004).

³⁷³ *Id.*

³⁷⁴ The new section reads as follows:

(19) Costs involving discrimination suits, etc. Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

e) Unlawful discrimination defined. For purposes of subsection (a)(19), the term "unlawful discrimination" means an act that is unlawful under any of the following:

- (1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).
- (2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).
- (3) The National Labor Relations Act (29 U.S.C. 151 et seq.).
- (4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).
- (5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).
- (6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).
- (7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).
- (8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).
- (9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).
- (10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
- (11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).
- (12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).
- (13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).
- (14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).
- (15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
- (16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
- (17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.
- (18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law—
 - (i) providing for the enforcement of civil rights, or
 - (ii) regulating any aspect of the employment relationship, including claims for wages,

deduction for attorney's fees and costs incurred in connection with any action taken.³⁷⁵ Because the deductions are above-the-line, they are not subject to the deduction denial under the alternative minimum tax provisions.

After October 22, 2004, plaintiffs in the discrimination and other civil rights cases, such as *Banks* and *Banaitis* discussed above, will pay tax only on the amount of damages actually received. For all other successful plaintiffs, the answer lies in the application of one of the theories discussed below, or perhaps it will ultimately be left to additional congressional action.

B. Which Judicial Interpretation Provides the Best Opportunity to Create a Fair, Equitable and Efficient Outcome

1. Nature of Attorney-Client Relationship Prevents Claimants from Arguing Assignment of a Property Interest

Although the Supreme Court in *Commissioner v. Banks* ruled that contingency fee agreements do not effectuate a valid transfer of an ownership interest of the claim from the client to the lawyer, the transfer or assignment of a property interest is a legitimate theory which should be considered for the sake of understanding the impact of the *Banks* decision on other assignment-of-income scenarios.³⁷⁶ The Supreme Court did not hold that it was not possible to transfer an interest in a cause of action or a claim. Instead, the Court ruled that such a transfer does not occur between a client and the attorney hired by the client, through a contingency fee agreement, to pursue the claim.³⁷⁷

The Supreme Court clearly states that a cause of action is property.³⁷⁸ As a property interest, a cause of action may be transferred or assigned to another. Consequently, if property is transferred to another, or if a partial interest in property is assigned to another, the future income produced by

compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

American Jobs Creation Act of 2004, § 703.

³⁷⁵ *Id.*

³⁷⁶ See Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *16-17 (Jan. 24, 2005).

³⁷⁷ *Id.* at *17-18.

³⁷⁸ *Id.* at *16.

the property should constitute income to the new owner of the property. If a cause of action is transferred to another, the new owner is the appropriate taxpayer to report the income when a recovery is received.

The IRS has acknowledged so by citing a line of cases that

support the proposition that, in general, a transferor who makes an effective transfer of a claim in litigation to a third person prior to the time of the expiration of appeals in the case is not required to include the proceeds of the judgment in income under the assignment of income doctrine because such claims are contingent and doubtful in nature.³⁷⁹

The IRS cites four factors indicating an effective transfer of the claim:

(1) at the time of the assignment, recovery on the claim was uncertain; (2) the recovery did not occur for more than a year after the assignment of the claim; (3) the assignment did not involve a gift or gratuity, and (4) the assignment was made for a legitimate non-tax purpose.³⁸⁰

Therefore, in situations where a taxpayer has performed services, not subject to dispute, and the taxpayer simply is pursuing that to which he or she is certainly entitled to receive, a transfer of the "claim" to a third party should not be effective to shift the income tax liability on the recovery. Such an attempt to shift the tax consequences to the one who collects the income is an anticipatory assignment of earned income. In accordance with *Lucas v. Earl*, such recovery should be taxed to the taxpayer who performed the services regardless of who collects the money.³⁸¹

The issue becomes more complicated when the claim is for past earnings that have an uncertain future as to collectability. Without future and new services rendered in an effort to collect the already earned income, there will be no forthcoming income. If you engage the assistance of someone else to assist you in the collection of the income, a new and

³⁷⁹ Priv. Ltr. Rul. 2004-27-009 ¶ 17 (July 2, 2004). Generally, private letter rulings may not be cited as precedent. I.R.C. § 6110(k)(3) (2000). However, private letter rulings can be cited to show inconsistent treatment of taxpayers similarly situated, or to show that a position argued by a taxpayer has been accepted by the Commissioner in other similar situations. See *Rowan Cos. v. United States*, 452 U.S. 247, 260-62 (1981); *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962).

³⁸⁰ Priv. Ltr. Rul. 2004-27-009 ¶ 16 (July 2, 2004).

³⁸¹ 281 U.S. 111, 114-15 (1930).

distinguishable situation arises. No longer is it the case of fruit which is ripened and simply waiting to be converted to money. The crop is in danger of never being harvested without the efforts of someone to step in to nurture and cultivate the harvest. The new services that are necessary to the realization of the income distinguish such situations from the *Lucas* and *Horst* cases.

For cases in which plaintiffs are not seeking that to which they are already entitled (back pay already earned), the argument for the recognition of a transfer of ownership becomes much stronger. With regard to claims for discrimination and other compensatory damages, even punitive damages, but for the efforts of the lawyers, no such damages, or at best lesser damages, would be all that the plaintiff could expect to recover. In order to collect any amount, or the larger amounts, additional effort and costs are necessary to produce the desired result. Enlisting the assistance of a lawyer necessarily involves sharing the outcome with the lawyer for his or her expertise and services. The claim—the property right—owned by the plaintiff can only be realized with the effort of the lawyer.

In many scenarios, a convincing argument can be made that the owner of the property has the choice to retain sole ownership and to hire someone to expend the effort to increase the income, or the owner can choose to transfer a part of the claim and share the income in exchange for the new efforts to increase the recovery. However, *Banks* makes it clear that such a transfer does not occur by reason of a contingency fee agreement between a client and lawyer.³⁸² The Supreme Court determined that the relationship between a client and a lawyer is a “quintessential principal-agent relationship,” and therefore, no such transfer of an ownership interest occurs between the client and the lawyer.³⁸³

Additional reasons exist to avoid reliance on the transferred property analysis for contingency fee agreements. In some states, the rules of professional responsibility prohibit a lawyer from taking an ownership interest in a client’s claim.³⁸⁴ Such rules are based on the appropriate public policy theory.³⁸⁵ While it is permissible to have a different rule apply for the federal income tax laws, it creates difficulties. In some states, not only is it unethical for lawyers to take a proprietary interest in their client’s

³⁸² 2005 U.S. LEXIS 1370, at *17–20.

³⁸³ See *id.* at *18–20.

³⁸⁴ E.g., Sharon Reece, *Lemonade from Lemons: The Solution to Taxation of the Contingent Fee Portion of Damage Awards*, 37 CREIGHTON L. REV. 305, 333 (2004).

³⁸⁵ *Id.* at 333–34.

claim, but it is also inappropriate for lawyers to even think in terms of receiving an ownership interest in their client's claim.³⁸⁶

2. Contingency Fee Agreements Do Not Create Joint Ventures Taxed as Partnerships

Can contingency fee agreements really be some type of partnership agreements in disguise? While the Supreme Court in *Banks* did not find so, it also listed the partnership theory as one of the "novel propositions" not examined by the lower courts. Therefore, the application of partnership concept to contingency fee agreements should be, and will be, considered herein.

Surely the lawyers and the client never intended to create a formal partnership. Perhaps, but such an intent is not necessary to create a partnership. According to the Revised Uniform Partnership Act, "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."³⁸⁷ Thus, intent to form a partnership is irrelevant.

From an economic standpoint, a partnership is an association or an economic relationship whereby the associates (partners) direct the allocation of resources and perform the services, or direct the efforts of the laborer providing the services. Through the use of resources and labor, a result—a profit or a loss—is produced. A partnership is distinguished from a mere co-ownership of property whereby the profit or loss is a consequence of external factors, such as "interrelating fluctuations of supply, demand, and price."³⁸⁸

"[A] partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships."³⁸⁹ A partnership is defined in § 7701(a)(2) to include "a syndicate, group, pool, joint venture, or other unincorporated

³⁸⁶ *Id.* at 332–33.

³⁸⁷ ROBERT W. HILLMAN ET AL., *THE REVISED UNIFORM PARTNERSHIP ACT* § 202(a) (2004 ed.). Although section 202 indicates that a business is part of the requirement for the creation of a partnership, the official comments to section 202 explain that "[a] business is a series of acts directed toward an end." *Id.* cmt. 1.

³⁸⁸ I ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG AND RIBSTEIN ON PARTNERSHIP* § 2.07(a), at 2:80 (Supp. 2003).

³⁸⁹ Rev. Proc. 2002-22, 2002-1 C.B. 733, 734; accord Treas. Reg. § 1.761-1(a) (as amended in 1997); Treas. Reg. § 301.7701-1(a) (1996); Treas. Reg. § 301.7701-2(c)(1) (2003); Treas. Reg. § 301.7701-3(a) (2003).

organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."³⁹⁰ "Section 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."³⁹¹

Joint venture is perhaps a more appropriate term when applying the partnership analogue to a contingency fee arrangement. The term joint venture generally refers to a partnership involving an isolated transaction³⁹² or "for a limited time or purpose."³⁹³ "Even a single transaction or an agreement to conduct business may be enough to support partnership."³⁹⁴ Most courts apply partnership law concepts to joint ventures with little or no modification.³⁹⁵

A joint venture can result from a "special combination of two or more persons, wherein some specific venture a profit is jointly sought without any actual partnership or corporate designation."³⁹⁶ Joint ventures are not necessarily called such, and a written document is not necessary.³⁹⁷ Rather,

it is well established that there are four basic attributes which are indicative of a joint venture: (1) A contract, express or implied, that a joint venture be formed; (2) the contribution of money, property and/or services by the venturers; (3) an agreement for joint proprietorship and control; and (4) an agreement to share profits.³⁹⁸

³⁹⁰ I.R.C. § 7701(a)(2) (2000).

³⁹¹ Rev. Proc. 2002-22, 2002-1 C.B. 733, 733-34.

³⁹² BROMBERG & RIBSTEIN, *supra* note 388, at 2:69 (Supp. 2004).

³⁹³ HILLMAN ET AL., *supra* note 387, author's cmt. at 79.

³⁹⁴ BROMBERG & RIBSTEIN, *supra* note 388, at 2:74 (Supp. 2003).

³⁹⁵ *Id.* at 2:69 (Supp. 2004); *Wheeler v. Commissioner*, 37 T.C.M. (CCH) 883, 887-91 (1978).

³⁹⁶ *Podell v. Commissioner*, 55 T.C. 429, 431 (1970) (quoting *Haley v. Commissioner*, 203 F.2d 815, 818 (5th Cir. 1953)).

³⁹⁷ *See S. & M. Plumbing Co. v. Commissioner*, 55 T.C. 702, 707 (1971).

³⁹⁸ *Id.* (citing *Hyman Podell*, 55 T.C. 429, 431 (1970); *Fishback v. United States*, 215 F. Supp. 621, 625 (D.S.D. 1963)); *see also Flanders v. United States*, 172 F. Supp. 935, 943 (N.D. Cal. 1959); *Tate v. Knox*, 131 F. Supp. 514, 517 (D. Minn. 1955); *Levine v. Pers. Inst., Inc.*, 138 N.Y.S.2d 243, 248-49 (Sup. Ct. 1954), *aff'd*, 158 N.Y.S.2d 740 (App. Div. 1956).

The IRS acknowledged, in Revenue Procedure 2002-22, that the application of partnership tax laws to a joint venture or other contractual arrangement is a matter of federal law and not local law.³⁹⁹ Two individuals may create a partnership for federal tax purposes if “the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.”⁴⁰⁰

The Supreme Court supports the principle that the appropriate tax treatment of joint ventures is governed by federal law and not state law. In three cases, the Court took a federal approach to the determination of a partnership, ignoring the application of state law.⁴⁰¹ “The statutes of Congress designed to tax income actually earned because of the capital and efforts of each individual member of a joint enterprise are not to be frustrated by state laws which for state purposes prescribe the relations of the members to each other and to outsiders.”⁴⁰²

Of the four circuit cases that addressed the joint venture concept, only the Seventh Circuit dismissed it.⁴⁰³ In *Kenseth*, the court determined that the state law did not allow attorneys to become a “joint owner of his client’s claim in the legal sense any more than the commission salesman is a joint owner of his employer’s accounts receivable.”⁴⁰⁴ The Supreme Court in *Banks* quotes the Seventh Circuit, affirming its analysis.⁴⁰⁵ The shortcoming of the Seventh Circuit’s and Supreme Court’s analysis is that it presupposes that an employer and employee or a principal and agent can have no other relationship. The Seventh Circuit’s comparison of the relationship between an employer and the person selling the employer’s goods is limited to one type of relationship, that of employer and employee. The Seventh Circuit’s analysis ignores the reality that the employer is free to enter into a different relationship with the employee. If the employer wants to share the risk and reward with a partner, such can be arranged

³⁹⁹ Rev. Proc. 2002-22, 2002-1 C.B. 733, 733–34.

⁴⁰⁰ *Id.*

⁴⁰¹ *Commissioner v. Culbertson*, 337 U.S. 733, 738–40 (1949); *Lusthaus v. Commissioner*, 327 U.S. 293, 297 (1946); *Commissioner v. Tower*, 327 U.S. 280, 288 (1946).

⁴⁰² *Tower*, 327 U.S. at 288.

⁴⁰³ *Kenseth v. Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001). “Of course there is a sense in which contingent compensation constitutes the recipient a kind of joint venturer of the payor.” *Id.*

⁴⁰⁴ *Id.*

⁴⁰⁵ Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *19–20 (Jan. 24, 2005).

prior to the commission of the work. Such can also be the case with a client and a lawyer.

The client can hire a lawyer for an hourly rate and therefore not shift any of the risk to the lawyer. Nor will the lawyer, in an hourly arrangement, share proportionately in the award. In the alternative, the client can enter into an agreement to shift some of the risk to the lawyer and, in exchange, agree to share the award proportionately. The first arrangement is the basis for determining that the entire award amount must be included in income and then a deduction allowed for the lawyers fees as an expense of creating the income. The second arrangement, the contingency fee agreement, could be considered a joint venture.

If two or more lawyers enter into an agreement to jointly represent a single client, the arrangement will likely be viewed as a joint venture and treated as a partnership.⁴⁰⁶ The lawyers expect to contribute money and services, to participate in decision making, and to share in the earnings from the contingency fee.⁴⁰⁷ Such is also the case between the claimant and the sole or primary lawyer. The injured or wronged party has the claim to contribute to the joint effort and the lawyer will provide the services. If there are any proceeds collected, the claimant and lawyer expect to share them as agreed.

The IRS ruled that an enterprise was a joint venture even though some venturers contributed capital and some performed services, one venturer bore the risk of loss and one venturer held the title to the venture property.⁴⁰⁸ Relying in part on this ruling, the Tax Court found that partnership taxation was appropriate for a property development arrangement between the owner of a piece of property, who maintained title to the property and bore the risk of cumulative losses, and another who provided the know-how.⁴⁰⁹ Such is the case with contingency fee arrangements. The plaintiff owns the claim. The lawyer provides the

⁴⁰⁶ HILLMAN ET AL., *supra* note 387, § 202(a) author's cmt. 5 (citing *In re Johnson*, 552 N.E.2d 703, PP (Ill. 1989) (attorneys jointly representing a client are "joint venturers, or 'special partners,' for the particular transaction"); *Scurto v. Siegrust*, 598 So. 2d 507, PP (La. App. 1st Cir. 1992) (agreement regarding division of contingency fee is a joint venture); *Duggins v. Guardianship of Washington*, 632 So. 2d 420, 427 (Miss. 1993) (associated attorneys are joint venturers in a single purpose partnership governed by UPA)).

⁴⁰⁷ *Id.*

⁴⁰⁸ Rev. Rul. 54-84, 1954-1 C.B. 284, 284.

⁴⁰⁹ *Wheeler v. Commissioner*, 37 T.C.M. (CCH) 883, 891 (1978).

expertise and labor and bears the risk of loss. Together they share the profits.

However, there is an important distinction between the attorney-client arrangement and two lawyers jointly representing a client or partners that make different types of contributions. In an attorney-client relationship, the client maintains control. The attorney may take certain steps on behalf of the client; however, the client maintains ultimate control over the critical decisions, more like a principal-agent relationship than partners.⁴¹⁰

In *Banks*, the Supreme Court outright rejects the notion that a contingency fee agreement is a partnership or joint venture.⁴¹¹ “The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship.”⁴¹² Although “quintessential” does not exclude other possible relationships, applying the joint venture analysis to contingency fee arrangements is inappropriate and problematic.

As with the transfer-of-property approach in applying the *Horst* assignment-of-income doctrine, ethical concerns are paramount. Lawyers and clients should not be viewed as partners. Lawyers should maintain their independence and their objectivity. Calling them “partners” even for the limited purpose of the federal income tax consequences is not appropriate as recognized in *Banks*.

Even where the attorney exercises independent judgment, without supervision by, or consultation with, the client, the attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party.⁴¹³

Additionally, if the arrangement is determined to be a partnership for federal income tax purposes, a partnership tax return would be required for each arrangement. Such a result is contrary to the goal of finding an

⁴¹⁰ *Banks*, 2005 U.S. LEXIS 1370, at *18–19 (citing RESTATEMENT (SECOND) OF AGENCY §§ 13, 39, 387 (1957)).

⁴¹¹ *Id.* at *18.

⁴¹² *Id.* at *18–19 (citing RESTATEMENT (SECOND) OF AGENCY § 1 cmt. e (1957); MODEL RULES OF PROF'L CONDUCT R 1.3 cmts 1, 1.71 (2002)).

⁴¹³ *Id.* at *19.

efficient manner for the effective administration and monitoring of such arrangements.

3. The Origin-of-Claim Doctrine Comes Closer to Producing the Right Result, but Some Problems Remain

Application of the origin-of-claim doctrine is a more equitable approach because it complies with basic accounting goals of matching costs to the income produced, at least in part, from the expense. If the attorney's fees were incurred in connection with the disposition of an asset, then the attorney's fees are a cost that reduces the gain realized on the disposition. If the attorney's fees were incurred in connection with collecting ordinary income, then the attorney's fees are an ordinary deduction.

The First Circuit's holding in *Alexander* was based upon a determination that because the damages recovered were "essentially a substitute for the salary and benefits he would have received under the employment contract, they are fully included as ordinary income . . . without regard to whether taxpayer's employment contracts constituted 'property' or 'intangible assets.'"⁴¹⁴ The court reasoned that if no wrong had been committed and taxpayer earned the compensation, it would have been ordinary income.⁴¹⁵ Therefore, the collection of the salary through litigation should not change the tax consequences and the damages should be fully taxable.⁴¹⁶ A more equitable and appropriate analogy would be that the income realized (damages received minus cost incurred to collect the damages) would be ordinary income because the salary, if earned, would have been ordinary compensation income.

Unfortunately, the origin-of-claims approach does not solve the miscellaneous itemized deduction issue. Attorney's fees paid in a lawsuit by an individual to collect ordinary income will still be viewed as an expense and the expense will continue to be a miscellaneous itemized deduction that is reduced for regular tax purposes and non-deductible for alternative minimum tax purposes.⁴¹⁷

⁴¹⁴ *Alexander v. IRS*, 72 F.3d 938, 944 (1st Cir. 1995).

⁴¹⁵ *Id.* at 943.

⁴¹⁶ *Id.* at 944.

⁴¹⁷ *Id.* at 946; see *McKay v. Commissioner*, 102 T.C. 465, 493 (1994).

4. Reimbursed Employee Expense Approach Not Applicable to Events that Occur After Employment

The First Circuit in *Alexander* did not accept the settlement agreement as a reimbursement arrangement between an employer and employee.⁴¹⁸ The Ninth Circuit likewise rejected that argument in *Biehl*.⁴¹⁹ For a reimbursable employee expense, “not only must it be attributable to a trade or business, but it must also have been incurred during the course of ‘performance . . . of services as an employee.’”⁴²⁰ “Had Congress intended to open the flood-gates to all expenses incurred in connection with *employment* it could have done so.”⁴²¹ The contingency fee agreement between the former employee and his attorney, and the common practice of issuing a check directly to the attorney to satisfy the attorney’s right to share in the proceeds, cannot be reasonably interpreted to be a reimbursement arrangement.

5. Open-Transaction Doctrine and § 83 Do Not Solve the Miscellaneous Itemized Deduction Problem

Application of § 83 to contingency fee arrangements is subject to the same debate as discussed above—does it transfer a property interest to the lawyer?⁴²² While the definition of property for purposes of § 83 is broad, and fairly clearly includes an interest in the client’s claim,⁴²³ the problem remains with the state law in jurisdictions that prohibit lawyers from

⁴¹⁸ *Alexander*, 72 F.3d at 946. In that case for breach of contract and discrimination against a former employer, the taxpayer argued that the employer’s payment of the proceeds jointly to the taxpayer and his lawyer qualified as a reimbursement arrangement under § 62(a)(2)(A). *Id.* at 945. The court rejected the argument summarily stating that the position “is utterly without support in the record.” *Id.* at 946.

⁴¹⁹ 351 F.3d 982, 988 (9th Cir. 2003).

⁴²⁰ *Id.* at 986 (quoting I.R.C. § 62(a)(2)(A) (2000)).

⁴²¹ *Id.*

⁴²² See *supra* Part II.D.

⁴²³ Treas. Reg. § 1.83-3(e) (2004). The treasury regulation provides as follows:

For purposes of section 83 and the regulations thereunder, the term “property” includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.

Id.

acquiring an ownership interest in the clients' lawsuits and the rules of professional responsibility for lawyers which do the same.⁴²⁴

Additionally, even with the application of § 83, the tax consequences to the client remain harsh. The deduction for attorney's fees referenced in § 83(h) does not allow the deduction as an above-the-line deduction, unless it otherwise qualifies as such.⁴²⁵ Therefore, the deduction for attorney's fees for most individuals, outside the civil rights lawsuits, would continue to be a miscellaneous itemized deduction that is reduced for regular income tax purposes and disallowed when calculating the alternative minimum tax.

6. Recognizing Attorney's Fees as a Cost Incurred for Disposing of an Asset Provides an Effective, Efficient Approach that Applies Equally to All Types of Cases

Perhaps the best approach for purposes of finding an efficient, effective and equitable answer is the transactional-cost approach. Viewing the attorney's fees as disposition costs incurred in realizing the income from the claim results in the taxpayer only paying tax on the economic income actually realized. Of the court of appeal cases, only the Seventh Circuit and the First Circuit address this theory and neither explain, nor apply, the concept correctly.⁴²⁶ Although the Supreme Court acknowledges the transactional-cost approach as presented in an amicus brief filed in *Commissioner v. Banks*, the Court refuses to consider it without prior examination by the lower courts.⁴²⁷

The Seventh Circuit, in *Kenseth*, agrees that clients should not have to pay tax on the portion of the fees paid to the lawyer under a contingency fee agreement.⁴²⁸ The court draws an analogy to hiring a salesman on a commission basis.⁴²⁹ "[T]he sales income he generates is income to the firm and his commissions are a deductible expense . . ."⁴³⁰ The court continues its pronouncement against clients paying tax on the lawyer's

⁴²⁴ Reece, *supra* note 384, at 333.

⁴²⁵ I.R.C. § 83(h).

⁴²⁶ *Kenseth v. Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001); *Alexander v. IRS*, 72 F.3d 938, 946 (1st Cir. 1995).

⁴²⁷ Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *21-22 (Jan. 24, 2005).

⁴²⁸ 259 F.3d at 883.

⁴²⁹ *Id.*

⁴³⁰ *Id.*

portion of the damages. "It is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion from income."⁴³¹ The court is only partially right. The payment of a commission does not allow an "exclusion" from income if the client retains sole ownership of the claim. The proceeds from the sale must be reported as amount realized by the taxpayer. However, treating attorney's fees as a "deduction" when the situation involves the disposition of the asset is generally not correct.⁴³² The commission should be treated as an offset to the amount realized upon the sale. Treas. Reg. § 1.263(a)-2(e) specifically endorses this concept of reducing amount realized by the costs of selling an asset in the context of selling securities. "Commissions paid in selling securities are an offset against the selling price, except in the case of a dealer in securities such commissions may be treated as an ordinary and necessary business expense."⁴³³ Therefore, the commission on the sale of non inventory assets is treated as a cost associated with the sale of the asset. As discussed

⁴³¹ *Id.* at 885.

⁴³² A deduction would be the appropriate treatment only with regard to costs of selling inventory incurred in the ordinary course of selling such inventory. Treas. Reg. § 1.263(a)-2(e) (as amended in 1987). The treasury regulations also addressed the issue of whether a cost associated with the ownership of a non-business, income-producing asset is a current deduction or an increase in basis of the asset (which will effect the gain or loss upon the disposition of the asset):

Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents.

Treas. Reg. § 1.212-1(k) (2004). Section 212 and its regulations address the issue of whether a taxpayer may take a current deduction for costs associated with the "production or collection of income" or the "management, conservation, or maintenance of property held for the production of income." I.R.C. § 212 (2000). The consistent approach, even in Treas. Reg. § 1.212-1(k), is that costs associated with the acquisition or disposition of a property interest is to be treated as an adjustment to basis and amounts associated with the continued ownership of property may or may not be treated as a current deduction. Nothing in Treas. Reg. § 1.212-1(k) is inconsistent with the transactional-cost approach proposed herein once the transaction in question (prosecution of a claim through litigation) is understood to be the disposition of a property interest as discussed *infra* Part VI.B.6.a.

⁴³³ Treas. Reg. § 1.263(a)-2(e) (as amended in 1987).

below, the seller is entitled to treat all such "closing costs" as a reduction of amount realized in calculating the appropriate amount of gain or loss on the disposition of the asset.⁴³⁴

In the First Circuit's decision in *Alexander*, the taxpayer argued that the settlement of his age discrimination claim was a disposition of property within the meaning of § 1001(a), and therefore, the attorney's fees should be treated as a cost of closing the transaction to dispose of the claim.⁴³⁵ In rejecting taxpayer's argument that the legal fees should be considered as a type of closing cost upon the disposition of an asset, the court states that "the Code simply does not provide for the offsetting of basis in such circumstances except in limited cases involving capital assets."⁴³⁶ This simply is not true.

The characterization of an item as a "capital asset" determines the type of gain realized and the tax rate which it is subject to, not the amount of the gain that is subject to taxation.⁴³⁷ As discussed below, the type of gain or loss realized, and consequently the tax treatment thereof, depends on several other factors including the type of asset disposed of. The resulting gain could be ordinary, short-term or long-term capital gain or even exempt from tax altogether.⁴³⁸ The critical point is that the tax consequences are based upon the gain or loss realized, not the gross amount realized.⁴³⁹

Interestingly, the *Horst* decision is based on the theory that taxable income should occur upon the realization of economic gain.⁴⁴⁰ The Court recognized that:

⁴³⁴ *Hunt v. Commissioner*, 47 B.T.A. 829, 839-40 (1942).

⁴³⁵ *Alexander v. IRS*, 72 F.3d 938, 943 (1st Cir. 1995). The settlement reached by the parties required the former employer to pay Alexander \$100,000 for age discrimination, and \$250,000 for breach of an employment contract. *Id.* at 940. The entire \$350,000 was held to be ordinary income to Alexander. *Id.* at 947. Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis as determined in § 1011. I.R.C. § 1001(a). Section 1011(a) provides that the adjusted basis shall be the original basis adjusted as provided in § 1016. I.R.C. § 1011(a). Section 1016(a)(1) provides that proper adjustment shall be made "for expenditures, receipts, losses, or other items, properly chargeable to capital account." I.R.C. § 1016(a)(1).

⁴³⁶ *Alexander*, 72 F.3d at 943 n.9.

⁴³⁷ I.R.C. § 1001.

⁴³⁸ For example, gain or loss from an individual's sale of a capital asset held more than one year is taxed at lower tax rates than the ordinary rates for the sale of inventory. I.R.C. § 1(h).

⁴³⁹ I.R.C. § 1001.

⁴⁴⁰ 311 U.S. 112, 116 (1940).

From the beginning the revenue laws have been interpreted as defining “realization” of income as the taxable event, rather than the acquisition of the right to receive it. And “realization” is not deemed to occur until the income is paid Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.⁴⁴¹

Applying general tax principles to the realization of income through the disposition of a claim results in the approach herein deemed the transactional-cost theory for contingency fee arrangements. Using general tax provisions, a taxpayer must realize as gain upon the disposition of property the net proceeds received for the claim.⁴⁴² The character of gain realized, as well as the timing of the recognition of such income, depends on the type of asset disposed of and the method of disposition.

a. Claim for Damages and Other Awards Constitutes Property

Application of the transactional-cost theory begins with the recognition that the client’s claim is a property right—an asset. In *Logan v. Zimmerman Brush Co.* the Supreme Court defined a cause of action as “a species of property.”⁴⁴³ Most recently, in *Commissioner v. Banks*, the Supreme Court referred to the litigant’s cause of action as an “income-generating asset.”⁴⁴⁴ The litigant’s cause of action is a property interest.

b. Receipt of Damages Through Settlement or Lawsuit Qualifies as a Disposition of Property

Once a claim is acknowledged as property, its sale, exchange or other disposition for money shall be recognized as the taxable event at which time the taxpayer realizes the gain or loss on the asset.⁴⁴⁵ As determined by

⁴⁴¹ *Id.* at 115 (citing *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729–30 (1929); *Corliss v. Bowers*, 281 U.S. 376, 378 (1930)).

⁴⁴² I.R.C. § 1001(c).

⁴⁴³ 455 U.S. 422, 428 (1982).

⁴⁴⁴ See Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *16 (Jan. 24, 2005).

⁴⁴⁵ I.R.C. § 1001.

Banks, the client is the owner of the claim—an asset. As such, the taxpayer is the appropriate person to pursue the conversion of the claim to money, which means disposing of the asset by collecting its value. Even the IRS Commissioner acknowledges that the settlements are dispositions of the plaintiff's claim. “[T]he settlement proceeds represent the value given in exchange for the dismissal of respondents’ claims.”⁴⁴⁶

c. Amount of Gain Equals Net Proceeds Received for Each Claim Reduced by Taxpayer's Adjusted Basis in that Claim

The general formula for determining the gain realized upon the disposition, collection or cancellation of any asset is:

$$\begin{array}{r} \text{Amount Realized} \\ - \text{adjusted basis of the asset (if any)} \\ \hline \text{Gain or loss realized}^{447} \end{array}$$

Upon the disposition of the claim through litigation or settlement, the taxpayer should be allowed to offset the amount realized with the basis of the asset which is adjusted for such items as amount of costs and expenditures associated with the acquisition and disposition of the claim.⁴⁴⁸

The situation is analogous to the owner of a block of stock, engaging the services of an agent to assist with the sale of the property. For his or her services in connection with the transaction and conversion of property to money, the agent is paid by way of a percentage of the sale proceeds at the time of the sale. The agent was hired to assist the owner to dispose of the property for a sum to be determined by the owner. In such situations, the percentage of the proceeds paid to the agent is unquestionably a capital expenditure under § 263, which reduces the gain realized at the time of the disposition of the property.⁴⁴⁹

Similarly, when a real estate agent is hired to market and sell a piece of land, the agent is expected to use his or her best efforts to negotiate and obtain as large a sum of money as possible in exchange for the property. When the real estate agent is paid a percentage of the sales price as the

⁴⁴⁶Brief for the Petitioner at *12, *Banks* (Nos. 03-892, 03-907).

⁴⁴⁷I.R.C. § 1001(a).

⁴⁴⁸*See id.* Sometimes the concept of basis is best understood by considering what the taxpayer has invested in the asset, i.e. purchase price, costs of acquisition, improvements to the asset, and cost of disposition.

⁴⁴⁹Treas. Reg. § 1.263(a)-2(e) (as amended in 1987).

commission for the agent's efforts, the landowner is allowed to offset the commission against the sales proceeds for purposes of determining the gain realized.⁴⁵⁰

“The rule is well settled that commissions and other similar charges, including attorney fees, incident to the sale of or other disposition of property ordinarily are to be treated as capital expenditures and are deductible from the selling price in determining the amount of the gain or loss on the transaction.”⁴⁵¹

In Internal Revenue Service Publication 544, the Internal Revenue Service allows a taxpayer to increase the adjusted basis of an asset for the closing costs when selling property.⁴⁵²

Why should the outcome be different when a client hires a lawyer to help him or her adjudicate and dispose of a claim for as large a sum of money as possible?

An additional issue must be addressed in the application of the transactional-costs doctrine—the allocation of the attorney's fees among multiple claims or awards. Since contingency fee arrangements require the plaintiff to pay the lawyer a percentage of each dollar of the award collected, the logical allocation method would be to allocate the fees among the claims or damages proportionately to the total recovery for the particular claim or damage.

Returning to our Paulette Patient example, she received \$300,000 compensatory damages for her injuries, which is excluded from her gross income.⁴⁵³ She also received \$2,000,000 in punitive damages which must be included in her gross income. The attorney's fees, totaling \$920,000, should be allocated \$120,000 to the nontaxable compensatory damages and \$800,000 to the taxable punitive damages. Paulette must pay tax on the \$1,200,000 net income from the disposition of her punitive damages claim.

⁴⁵⁰Black v. Commissioner, 60 T.C. 108, 110 (1973).

⁴⁵¹Victoria Paper Mills Co. v. Commissioner, 32 B.T.A. 666, 667 (1935), *aff'd per curiam*, 83 F.2d 1022 (2d Cir. 1936).

⁴⁵²INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. NO. 544, SALES AND OTHER DISPOSITIONS OF ASSETS 3 (2004), available at <http://www.irs.gov/pub/irs-pdf/p544.pdf>.

⁴⁵³See I.R.C. § 104(a)(2).

d. Character of the Gain Depends on the Origin of the Claim

Once the allocation to the appropriate amount of damages is complete and the amount of the net gain is calculated, the only remaining issue is the characterization of the resulting net income. The characterization of the resulting net gain is determined by applying the origin-of-claim doctrine. The character or type of gain will be traced to the origin of the claim. The nature of the claim or the type of property disposed of, and the method of disposition will determine the character of gain and the appropriate tax treatment thereof.⁴⁵⁴ For example, damages for a claim for back pay would be characterized as ordinary income because the wages would have been ordinary income if earned rather than collected through the pursuit of the claim. Punitive damages, such as those received by Paulette Patient, are always ordinary income. Proceeds from the condemnation of land would be capital gain if the land was held for investment purposes and if the land was sold or exchanged.⁴⁵⁵

The transactions-cost or capital-expenditure approach is based on fundamental tax principles that result in fair and equitable treatment in all types of cases and is in keeping with principal-agent characterization pronounced by the Supreme Court in *Commissioner v. Banks*.⁴⁵⁶ In contingency fee arrangements, the relevant parties should pay tax only on the amount exactly received, an amount that cannot exceed their economic gain. Such a result is, and should always be, a primary goal of the federal income tax system. The characterization of the resulting net gain will be determined by considering the type of claim that formed the basis for recovery. The characterization of gain is not affected by this transactional-cost approach. This approach works equally well for hourly based representation arrangements.⁴⁵⁷

⁴⁵⁴ See I.R.C. § 1221. Most of the cases utilizing contingency fee arrangements involve the collection of ordinary income and will not involve the recognition of capital gain income. Capital gain, as it is generally called, and its favorable low tax rate, occurs only when there is a sale or exchange of a capital asset that has been held by the taxpayer for more than one year. *Id.*

⁴⁵⁵ See I.R.C. § 1221. The definition of a capital asset encompasses more than just property held for investment. See *id.*

⁴⁵⁶ Nos. 03-892, 03-907, 2005 U.S. LEXIS 1370, at *18-21 (Jan. 24, 2005).

⁴⁵⁷ Some type of loss limitation is necessary in cases involving a fee-shift statute and cases handled on a hourly basis where the attorney's fees exceed the taxable award. Individuals should not be allowed to create a new type of loss that could be used to offset other incomes and gains not related to the claim. Sufficient safeguard are already in place in § 165 which limits losses for individuals to those incurred in the following: (1) a trade or business; (2) a transaction entered into for profit; and (3) casualty and theft losses to a limited very amount. I.R.C. § 165(c), (h).

VII. CONGRESS SHOULD ACT IF COURTS FAILS TO REMEDY IN AN EQUITABLE, EFFICIENT AND EFFECTIVE MANNER

Application of the transactional-cost approach to this issue would make the new § 62(a)(19) unnecessary. However, should the opinions from the courts applying the holding of *Commissioner v. Banks*⁴⁵⁸ fail to settle the issue favorably to the taxpayers using an approach that will apply equitably to all types of litigation, Congress should act.

Congress already took a step in the right direction with the amendment to add § 62(a)(19) to the Internal Revenue Code.⁴⁵⁹ However, the amendment was focused solely on a discreet group of plaintiffs, those involved in civil rights litigation. That group of plaintiffs is certainly deserving, and their plight can be distinguished from that of other claimants by considering public policy concerns for encouraging the private prosecution of wrongs in society. However, to deny a similar outcome to other litigants is unfair and without justification.

If necessary, § 62(a)(19) could be amended by taking out the language that limits the applicability and including broader coverage, as follows:

Any deduction allowable under this chapter for attorney's fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim for recovery for injury, damage, loss or harm suffered by the taxpayer of ~~unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)).~~ The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.⁴⁶⁰

Such an amendment would avoid allowing a taxpayer the advantage of a loss that could be deducted against other income. Yet, it would only tax the

⁴⁵⁸ 2005 U.S. LEXIS 1370, at *8.

⁴⁵⁹ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546-48 (2004) (to be codified at 26 U.S.C. § 62(a)(19)).

⁴⁶⁰ *Id.* (author's proposed insertions in bold and deletions stricken).

plaintiff on the economic portion actually received for taxable awards or damages.

VIII. CONCLUSION

Civil rights claimants no longer have to worry about paying income tax on the contingency fee portion of the award. Relief from taxation is now in place for clients with the types of claims listed in § 62(a)(19). As for other types of cases, the issue remains in question. Several approaches presented to the courts of appeal and the Supreme Court are viable choices. Ultimately, the answer should be based upon an approach that will accomplish the most equitable, effective and efficient result. The approach taken in the circuit cases should not depend on whether the recovered damages involve nontaxable awards, such as physical personal injury awards, or taxable awards, such as punitive, employment and other awards. The outcome should not differ for contingency, hourly or flat fee arrangements.

The best possible answer is recognizing that the costs of litigation, including the attorney's fees, are a direct cost of disposition of the claim. As a transactional cost, the fees should be a direct offset against the amount realized from the claim. This approach provides equity in assuring that all types of litigation and claims have similar treatment. All clients and lawyers will pay tax only the portion of the taxable award realized and received. This approach also provides an effective and efficient manner for addressing the issue with no amendments required and no additional reporting requirements for the parties.