Digital Commons @ University of Georgia School of Law

Scholarly Works

Faculty Scholarship

1-1-2002

A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees

Gregg D. Polsky
University of Georgia School of Law, gregg.polsky@uga.edu

Repository Citation

Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees* , 37 Ga. L. Rev 57 (2002),
Available at: https://digitalcommons.law.uga.edu/fac_artchop/1101

This Article is brought to you for free and open access by the Faculty Scholarship at Digital Commons @ University of Georgia School of Law. It has been accepted for inclusion in Scholarly Works by an authorized administrator of Digital Commons @ University of Georgia School of Law. Please share how you have benefited from this access
For more information, please contact tstriepe@uga.edu.

A CORRECT ANALYSIS OF THE TAX TREATMENT OF CONTINGENT ATTORNEY'S FEE ARRANGEMENTS: ENOUGH WITH THE FRUITS AND THE TREES

*Gregg D. Polsky**

TABLE OF CONTENTS

INTRODUCTION 59

I. THE PROBLEM 63
A. THE MECHANICS OF THE PROBLEM 63
B. TAX POLICY IMPLICATIONS 68
1. The Broad Perspective—What is Income? 68
2. The Narrow Perspective—What are the Purposes of the Deduction Limitations? 70
a. Limitations Under Sections 67 and 68 70
b. AMT 73

II. THE CONTINGENT FEE CASES 74
A. THE MINORITY VIEW—THE PROPERTY TRANSFER CASES 74
B. THE MAJORITY VIEW—THE ASSIGNMENT OF INCOME CASES 76

* Associate Professor of Law, University of Minnesota Law School. I wish to thank Martin J. McMahon, Jr., David M. Richardson, Ronald H. Jensen, and George Mundstock for their comments and assistance. I am especially indebted to my wife, Rina Lyubkin, for her immeasurable help. I also thank Anne Troy for excellent research assistance. Of course, any errors or omissions are my sole responsibility.

III. THE ASSIGNMENT OF INCOME DOCTRINE 78
A. THE DEVELOPMENT OF THE ASSIGNMENT OF INCOME DOCTRINE: PROTECTING THE PROGRESSIVE RATE STRUCTURE 79
B. LIMITED APPLICATION OF THE ASSIGNMENT OF INCOME DOCTRINE IN COMMERCIAL CASES 82
C. INAPPLICABILITY OF THE ASSIGNMENT OF INCOME DOCTRINE TO CONTINGENT FEE ARRANGEMENTS. 88

IV. THE CORRECT ANALYSIS OF THE CONTINGENT FEE ARRANGEMENT 92
A. THE NO IMMEDIATE TRANSFER CHARACTERIZATION 93
B. THE IMMEDIATE TRANSFER OF PROPERTY CHARACTERIZATION 95
1. *Is a Claim Property Under Section 83?* 96
2. *Is a Right to the Proceeds of a Claim Property Under Section 83?* 101
3. *Is There an Immediate Transfer Upon Execution of the Contingent Fee Agreement?* 102
a. *Is There an Immediate Transfer of a Portion of Claim?* 102
b. *Is There an Immediate Transfer of a Right to Proceeds from the Claim?* 104
4. *Application of the Operative Provisions of Section 83 to the Contingent Fee Arrangement* 108

V. THE PARTNERSHIP CHARACTERIZATION 111
A. IS THE ATTORNEY'S PARTNERSHIP INTEREST A CAPITAL INTEREST OR A PROFITS INTEREST? 113
B. APPLICATION OF SECTION 83 TO THE ATTORNEY'S RECEIPT OF THE PARTNERSHIP INTEREST 115
C. TAX CONSEQUENCES OF THE PARTNERSHIP CHARACTERIZATION. 116

VI. THE LEGISLATIVE SOLUTION 120

VII. CONCLUSION 120

Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it.[1]

INTRODUCTION

Paula settles a discrimination lawsuit against her former employer for $1,000,000. Pursuant to a contingent attorney's fee agreement, $400,000 of the settlement goes to her attorney, and Paula receives the remaining $600,000.[2] Unbeknownst to Paula, the settlement creates a troubling and controversial federal tax issue regarding the proper treatment of the $400,000 attorney's fee.[3] Eight circuit courts[4] as well as the Tax Court[5] have held that Paula must include the full $1,000,000 settlement in her gross income and then deduct the $400,000 fee (the inclusion and deduction method), while three circuit courts have held that Paula may exclude the attorney fee portion of the settlement from her gross income and

---

[1] Berkey v. Third Ave. Ry. Co., 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.).

[2] In the typical case, the attorney would also be reimbursed out of the settlement proceeds for costs advanced in prosecuting the case. For tax purposes, whether amounts paid to the attorney represent attorney's fees or reimbursement of costs is immaterial. Accordingly, this Article refers only to attorney's fees; however, the analysis is equally applicable to costs.

[3] *See* Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531, 532 (2000) (describing issue discussed in this Article as "hot topic" in tax law); James Serven, *Tenth Circuit Joins Majority View on Contingent Attorneys' Fee Issue*, 94 TAX NOTES 373, 373 (2002) (noting that issue "has bedeviled the courts over the past couple of years").

[4] Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001), *cert. denied*, 122 S. Ct. 1915 (2002); Sinyard v. Comm'r, 268 F.3d 756, 762 (9th Cir. 2001), *cert. denied*, 122 S. Ct. 2357, 2357 (2002); Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 372 (4th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187, 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972, 972 (2001); Bagley v. Comm'r, 121 F.3d 393, 304 (8th Cir. 1997); Alexander v. Comm'r, 72 F.3d 938, 946-47 (1st Cir. 1995); Baylin v. United States, 43 F.3d 1451, 1454 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532, 532 (3d Cir. 1963).

[5] Kenseth v. Comm'r, 114 T.C. 399, 412 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

include only $600,000, the amount of the settlement less attorney's fees (the exclusion method).[6] The Supreme Court thus far has evaded the issue, denying certiorari on three separate occasions.[7]

If, under the inclusion and deduction method, Paula was entitled to a full and unimpaired deduction for the $400,000 of attorney's fees, her tax consequences would be the same as under the exclusion method, because she would ultimately be taxed only on the $600,000 she actually receives. Under current law, however, because the attorney's fee deduction is classified as a miscellaneous itemized deduction, Paula's deduction under the inclusion and deduction method will be reduced under sections 67 and 68 of the Internal Revenue Code ("Code").[8] More significantly, the deduction is disallowed for purposes of computing her alternative minimum tax ("AMT") liability.[9] As a result, Paula's tax liability under the inclusion and deduction method will significantly exceed her

---

[6] Srivastava v. Comm'r, 220 F.3d 353, 355 (5th Cir. 2000); Davis v. Comm'r, 210 F.3d 1346, 1348 (11th Cir. 2000); Estate of Clarks v. United States, 202 F.3d 854, 858 (6th Cir. 2000); Cotnam v. Comm'r, 263 F.2d 119, 121 (5th Cir. 1959).

[7] *See* Sinyard v. Rossotti, 122 S. Ct. 2357, 2357 (2002) (mem.) (denying certiorari to appeal from Ninth Circuit); Hukkanen-Campbell v. Comm'r, 122 S. Ct. 1915, 1915 (2002) (mem.) (denying certiorari to appeal from Tenth Circuit); Coady v. Comm'r, 532 U.S. 972, 972 (2001) (mem.) (denying certiorari to appeal from Ninth Circuit).

[8] I.R.C. §§ 67(b), 68 (2000). Paula's deduction is a miscellaneous itemized deduction because it is classified as an *unreimbursed* employee business expense (rather than a *reimbursed* employee business expense, which would result in an above the line deduction, *i.e.*, a deduction taken into account in computing Paula's adjusted gross income under § 62(a)(2)(A)). *See* Alexander v. Comm'r, 72 F.3d 938, 944-47 (1st Cir. 1995) (holding that employee's legal fees incurred in connection with litigation arising out of employee's employment constitute unreimbursed employee business expenses subject to § 67(b)); Biehl v. Comm'r, 118 T.C. 467, 471-87 (2002) (same). *But see* Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1096-97 (2000) (arguing that deductions such as Paula's should be treated as reimbursed employee business expenses). If Paula's deduction for attorney's fees was above the line, the issue discussed in this Article would not arise. In such a case, Paula would be allowed a full and unimpaired deduction under the inclusion and deduction method, and Paula's tax consequences would be the same as under the exclusion method. I.R.C. § 62(a)(1).

The issue discussed in this Article arises only when taxable damages are recovered. Thus, it would not arise when only compensatory damages arising from a physical injury are recovered, because § 104(a)(2) would exclude the entire recovery, including the attorney fee portion. See § I.R.C. 104(a)(2) (2000). In such a case, the plaintiff would not report any gross income attributable to the recovery and would not be allowed a deduction for attorney's fees pursuant to § 265(a)(1). See § 265(a)(1); *see also* Bent v. Comm'r, 835 F.2d 67, 70 (3d Cir. 1987) (holding that legal fees incurred in connection with recovery excluded under § 104(a)(2) are nondeductible under § 265(a)(1)).

[9] I.R.C. § 56(b)(1)(A)(i) (2000).

liability under the exclusion method. In effect, under the inclusion and deduction method, Paula will pay tax on a portion of her $400,000 legal fee as well as on her net recovery of $600,000.

From a tax policy perspective, Paula should pay tax only on her net recovery of $600,000 because an individual should not pay tax on the cost of producing taxable income.[10] Thus, the exclusion method provides the right policy result while the inclusion and deduction method provides the wrong policy result.

The often heated debate among practitioners, judges, and academics is whether current law mandates the exclusion method, thereby producing the right policy result, or the inclusion and deduction method, thereby producing the wrong policy result.[11] The focus of the debate has involved the appropriate characterization of the contingent fee arrangement, and whether the arrangement implicates the assignment of income doctrine.

Proponents of the exclusion method argue that the contingent fee agreement transfers a portion (forty percent) of Paula's claim to her attorney, and that such portion of the claim constitutes property, as opposed to income, for purposes of applying the assignment of income doctrine.[12] As a result, they conclude that this transfer effectively shifts the burden of taxation with respect to the attorney fee portion of the settlement from Paula to her attorney.[13] Under this analysis, when the $400,000 fee is paid to Paula's attorney, it is attributable to property—the forty percent portion of the claim owned by the attorney—and thereby not taxable to Paula.

Conversely, proponents of the inclusion and deduction method

---

[10] Hantzis v. Comm'r, 638 F.2d 248, 249 (1st Cir. 1981).

[11] *Compare* Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001) (concluding that inclusion and deduction method is correct under current law), *and* Timothy R. Koski, *Should Clients Escape Tax on Lawsuit Proceeds Retained by Attorneys?*, 92 TAX NOTES 93, 97 (2001) (same), *with* Estate of Clarks v. United States, 202 F.3d 854, 858 (6th Cir. 2000) (concluding that exclusion method is correct under current law), *and* Richard B. Kells, *Problems with the Government's Position in Taxing Attorneys' Fees*, 93 TAX NOTES 1501, 1501-02 (2001) (same).

[12] This Article draws a distinction between "property" for purposes of the assignment of income doctrine and "property" for purposes of § 83. *See* I.R.C. § 83 (2000) (providing for tax treatment where property is transferred in connection with performance of services); *infra* notes 195-210 and accompanying text (analyzing definition of term "property" for purposes of § 83).

[13] *See Estate of Clarks*, 202 F.3d at 858 (holding that plaintiff is taxed only on net settlement received).

argue that the contingent fee agreement transfers from Paula to her attorney a right to the income from a portion of the claim, rather than a portion of the claim itself.[14] These proponents submit that, under the assignment of income doctrine, such a transfer is ineffective for tax purposes.[15] Consequently, they conclude that the entire settlement amount (including the attorney fee portion) is included in Paula's gross income.

Thus, the debate has focused on one particular issue, namely whether a contingent fee agreement transfers income from a portion of the claim, or transfers a portion of the claim itself. To state the matter another way, and to use the famous assignment of income metaphor, does the agreement transfer the fruit or the tree?[16] Remarkably, even though the issue has been brought before eleven circuit courts and the Tax Court,[17] this focus has been entirely misplaced. The assignment of income doctrine is inapplicable to contingent fee arrangements because the doctrine does not apply to arm's length commercial transactions.[18] By immediately jumping to the fruit versus tree analysis, the courts have failed to appreciate this point. Because of this fundamental error, no one has yet set forth a correct analysis of the issue.

This Article attempts to provide such an analysis, demonstrating that there are only two viable interpretations of the contingent fee arrangement: either the arrangement results in no transfer whatsoever until the attorney is actually paid, or alternatively, the arrangement results in a transfer of property—regardless of whether such property would constitute fruit or tree under the assignment of income doctrine—at the time the contingent fee agreement is executed. Further, under either interpretation, the tax consequences to Paula are the same. She must include the full amount of the settlement, including the attorney fee portion, in her gross income and may take a miscellaneous itemized deduction for

[14] *See Kenseth*, 259 F.3d at 884 (stating contingent fee contracts are not assignments and Wisconsin law prohibits attorney from "assigning ownership of his client's claim").

[15] *See id.* (noting "an assignment of income . . . by a taxpayer is ineffective to shift his tax liability").

[16] *See* Lucas v. Earl, 281 U.S. 111, 115 (1930) (using fruit and tree metaphor).

[17] *See supra* notes 4-6.

[18] *See infra* notes 157-74 and accompanying text (arguing that assignment of income doctrine does not apply to contingent fee arrangements).

the attorney fee portion. Consequently, this Article concludes that the wrong policy result is inevitable under current law, and that the only solution to the problem is a change in the law.

Part I of this Article more deeply illustrates the contingent fee problem and the mechanics of the relevant Code provisions.[19] Part I also explains why, as a matter of tax policy, contingent attorney's fees should be deductible in full without impairment.[20] Part II discusses the cases which have addressed the issue and led to the current split of authority.[21] Part III explains why the focus of these cases—whether a contingent fee arrangement results in a transfer of fruit or tree for purposes of applying the assignment of income doctrine—has been misplaced.[22] Part IV then provides a correct analysis of the contingent fee issue under current law.[23] Part IV ultimately concludes that the inclusion and deduction method is required, and therefore that the wrong policy result is inevitable under current law.[24] Part V addresses a creative argument made by some proponents of the exclusion method—that the contingent fee arrangement results in a partnership for tax purposes—and concludes that this argument fails to achieve its intended result.[25] Finally, Part VI proposes a legislative solution to fix the contingent fee problem.[26]

I. THE PROBLEM

A. THE MECHANICS OF THE PROBLEM

Assume that Paula, in the example above, regularly earns $50,000 per year in wages, has no other income, and has no deductions.[27] As a result, Paula ordinarily takes the standard

---

[19] *See infra* notes 27-49 and accompanying text.

[20] *See infra* notes 50-80 and accompanying text.

[21] *See infra* notes 81-99 and accompanying text.

[22] *See infra* notes 100-74 and accompanying text.

[23] *See infra* notes 175-255 and accompanying text.

[24] *See infra* notes 238-55 and accompanying text.

[25] *See infra* notes 256-308 and accompanying text.

[26] *See infra* note 309 and accompanying text.

[27] For purposes of the computations to follow, it is also assumed that Paula's filing status is single, that she has no dependents, and that the year of settlement is 2002.

deduction.[28]

Under the inclusion and deduction method, Paula would treat the entire $1,000,000 settlement as income, bringing her gross income to $1,050,000. The $400,000 attorney's fee qualifies as a deduction under section 162, since it constitutes an ordinary and necessary expense in carrying on Paula's trade or business of being an employee.[29] Paula, however, may take this deduction only by giving up her right to the standard deduction.[30] Moreover, since the $400,000 fee constitutes a miscellaneous itemized deduction,[31] it may be deducted only to the extent that it exceeds two percent of Paula's adjusted gross income.[32] This reduces Paula's fee deduction by $21,000.[33] In addition, section 68 requires Paula to reduce her fee deduction by three percent of the amount by which Paula's adjusted gross income exceeds a statutorily defined "applicable amount" ($137,300 in 2002).[34] This further reduces Paula's fee deduction by $27,381.[35] The amount of Paula's fee deduction

---

[28] *See* I.R.C. § 63(b) (2000) (providing that taxpayers who do not elect to itemize their deductions may take standard deduction).

[29] *See* Alexander v. Comm'r, 72 F.3d 938, 944-45 (1st Cir. 1995) (holding legal fees deductible under § 162(a) where taxpayer incurred such fees in connection with breach of contract and discrimination lawsuit against his former employer).

[30] *See* I.R.C. § 63(b) (2000) (providing that taxpayers may elect either to take standard deduction or to take their itemized deductions); § 63(d) (defining itemized deductions). Paula's legal fee is an itemized deduction because it constitutes an unreimbursed employee business expense. *See supra* note 8.

[31] *See supra* note 8.

[32] I.R.C. § 67(a)-(b) (2000).

[33] *Id.* In Paula's case, because she has no above the line deductions under § 62(a), her adjusted gross income equals her gross income, which is $1,050,000. *See* § 62(a). Accordingly, the reduction under § 67(a) equals 2% of $1,050,000. *See* § 67(a).

[34] I.R.C. § 68(a) (2000); Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.08. To be precise, § 68(a) reduces the aggregate amount of itemized deductions other than those specified in § 68(c) by the lesser of (i) 3% of the excess of the taxpayer's adjusted gross income over the applicable amount, or (ii) 80% of the taxpayer's itemized deductions other than those specified in § 68(c). I.R.C. § 68(a). In most instances, and in Paula's case, the amount of the reduction will equal 3% of the excess of adjusted gross income over the applicable amount. *See* Robert J. Peroni, *Reform in the Use of Phaseouts and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415, 1425 (2001) (stating that "[f]or most taxpayers, the lesser amount is 3% of the taxpayer's adjusted gross income").

[35] I.R.C. § 68(a) (2000). Applying the § 68(a) reduction to Paula, the amount of her itemized deductions is reduced by $27,381, which is the lesser of (i) $27,381 (3% of the excess of her adjusted gross income of $1,050,000 over the applicable amount of $137,300), or (ii) $320,000 (80% of $400,000, the amount of her itemized deductions). *Id.*

remaining after these reductions is $351,619.[36] Thus, Paula's taxable income equals $698,381,[37] and her tax liability under the regular tax system would be $245,774.[38]

Because of the AMT, however, Paula's computation of her tax liability does not end there.[39] Paula may not claim the attorney's fee as a deduction to reduce her alternative minimum taxable income.[40] As a result, her AMT liability is $34,716, bringing her total tax liability to $280,490.[41]

Alternatively, under the exclusion method, Paula's gross income would include only the $600,000 of the settlement proceeds she actually receives, and her $50,000 of wages. Since Paula has no deductions, she would take the standard deduction of $4,700, leaving her with $645,300 of taxable income.[42] Therefore, the exclusion method produces a tax liability of $225,285,[43] which is $55,206 less than under the inclusion and deduction method.

Comparing the two results, we can see that the $55,206 difference is the result of the following four components: (1) the inability

---

[36] This amount is the excess of Paula's $400,000 of attorney's fees over the sum of the reduction under § 67, which is $21,000, and the reduction under section 68, which is $27,381.

[37] *See* I.R.C. § 63(a) (2000). Under either the exclusion method or the inclusion and deduction method, Paula's personal exemption deduction will be phased out pursuant to § 151(d)(3). See § 151(d)(3). For 2002, the personal exemption deduction is completely phased out for single taxpayers with adjusted gross incomes in excess of $259,800. *Id.*; Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.11(2).

[38] *See* I.R.C. § 1(a) (2000) (providing taxation rate tables); Rev. Proc. 2001-59, 2001-52 I.R.B. 623 (providing inflation adjustments). This is the amount resulting from the application of the inflation adjusted rate table for unmarried individuals provided in Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.01 (Table 3).

[39] *See* I.R.C. § 55(a) (2000).

[40] *See* I.R.C. § 56(b)(1)(A)(i) (2000).

[41] *See* I.R.C. § 55 (2000). Paula's alternative minimum taxable income will equal $1,014,250, the amount of her gross income less her exemption amount of $35,750. *See* § 55(a), (d)(1)(B). Applying $1,014,250 to the AMT rates yields a tentative minimum tax of $280,490. *See* § 55(b)(1)(A). Paula's AMT liability equals the excess of her tentative minimum tax ($280,490) over her regular tax liability ($245,774). *See* § 55(a).

[42] *See* I.R.C. § 63(b) (2000) (defining taxable income for taxpayers who take standard deduction); § 63(2)(c) (providing standard deduction amount for single taxpayers prior to adjustment for inflation); Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.07(1) (providing inflation-adjusted standard deduction amount).

[43] *See* I.R.C. § 1(a) (2000) (providing taxation rate tables); Rev. Proc. 2001-59, 2001-52 I.R.B. 623 (providing inflation adjustments). This is the amount resulting from the application of the inflation adjusted rate table for unmarried individuals provided in Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.01 (Table 3). Under the exclusion method, Paula would not have any additional liability under the AMT. *See* I.R.C. § 55.

under the inclusion and deduction method to take advantage of the standard deduction in addition to the deduction for attorney's fees (this component is the "loss of standard deduction" effect),[44] (2) the section 67 reduction, (3) the section 68 reduction, and (4) the AMT. In Paula's case, the $55,206 difference is attributable to the four components as follows:[45]

	"Loss of Standard Deduction" Effect	Section 67 Reduction	Section 68 Reduction	AMT
Difference Attributable to Each Component	$1,814	$8,106	$10,569	$34,716

[44] It should be noted that, if Paula had sufficient itemized deductions other than the attorney's fee to cause her to itemize her deductions even in the absence of the settlement, the "loss of standard deduction" effect would be nonexistent. If Paula would have itemized even in the absence of the settlement, she would lose her standard deduction (because she itemizes) regardless of whether the inclusion and deduction method or the exclusion method applied. In addition, if Paula had sufficient miscellaneous itemized deductions other than the attorney's fee to reach the § 67 floor even in the absence of the settlement, the adverse effect of the § 67 reduction would also be removed. Lastly, if Paula had sufficient itemized deductions other than the attorney's fee to absorb the entire reduction under § 68, the adverse effect of the § 68 reduction would be removed. For example, if Paula had $30,000 of miscellaneous itemized deductions before taking into account the attorney's fee, none of her increased tax liability under the inclusion and deduction method would be attributable to the "loss of standard deduction" effect, the § 67 reduction, or the § 68 reduction. In such a case, her increased tax liability would result solely from the AMT.

[45] Due to rounding, the values in the table do not sum precisely. The methodology for allocating the difference in tax liability to the four components is detailed in this footnote. Note that because the components are interrelated, several simplifying assumptions were made. It was assumed, for purposes of determining the "loss of standard deduction" effect, the § 67 reduction, and the § 68 reduction, that the AMT was repealed. Conversely, it was assumed, for purposes of determining the effect of the AMT, that §§ 62, 67, and 68 would remain in effect. In determining the difference in tax liability attributable to a specific component, Paula's tax liability was computed four times: (1) under current law, subject to simplifying assumptions, using the inclusion and deduction method; (2) under current law, subject to simplifying assumptions, using the exclusion method; (3) assuming that the particular component was repealed, under the inclusion and deduction method; and (4) assuming that the particular component was repealed, under the exclusion method. With respect to a particular component, the "effect" equals the excess of (a), which is the excess of (1) over (2), over (b), which is the excess of (3) over (4). For purposes of computing the "loss of standard deduction" effect, the hypothetical repeal under computations (3) and (4) would result in Paula being allowed to take both the attorney's fee deduction and the standard deduction, but would not reduce Paula's adjusted gross income for purposes of computing the § 67 reduction.

As in most cases in which the contingent fee problem arises, the effect of the AMT on Paula's tax liability is most significant.[46]

The contrast in tax consequences under the two methods becomes even more dramatic as the ratio of the attorney's fees to the gross settlement amount increases.[47] This increased disparity occurs solely as a result of the AMT component. For example, if Paula paid sixty percent of the settlement—rather than forty percent—to her attorney, she would owe $132,406 of additional tax under the inclusion and deduction method versus the exclusion method.[48] The $132,406 difference is attributable to the four components as follows:[49]

	"Loss of Standard Deduction" Effect	Section 67 Reduction	Section 68 Reduction	AMT
Difference Attributable to Each Component	$1,814	$8,106	$10,569	$111,916

[46] *See* Geier, *supra* note 3, at 532 (stating that "the biggest consequence for [plaintiffs subject to the contingent fee problem] is not under the regular tax system but rather under the alternative minimum tax system"); Sager & Cohen, *supra* note 8, at 1077 (stating that "[t]he disallowance of AMT deductions [for attorney's fees] is particularly significant").

[47] In fact, Judge Beghe of the Tax Court has noted that if the ratio of attorney's fees to gross settlement amount is high enough, a pre-tax gain would be transmuted into an after-tax loss. Kenseth v. Comm'r, 114 T.C. 399, 425-26 (2000) (Beghe, J., dissenting). In other words, the inclusion and deduction method may, under certain circumstances, result in a victorious plaintiff owing more tax attributable to her recovery than the amount of her recovery net of attorney's fees. The absurdity of such a result has not escaped the attention of the popular press. *See* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, § 1, at 18 (describing case of discrimination plaintiff who, despite obtaining $1,250,000 judgment, ends up with after-tax loss of $99,000).

[48] In this example, under the inclusion and deduction method, Paula's gross income would equal $1,050,000, and the amount of her fee deduction would equal $600,000. Under § 67(a), the deductions would be reduced by $21,000 (2% of her adjusted gross income) and, under § 68, the deductions would be reduced by another $27,381 (3% of the excess of her adjusted gross income over the applicable amount of $137,300). *See* I.R.C. §§ 67(a), 68 (2000). Thus, her taxable income would equal $498,381, and her regular tax liability would equal $168,574. *See* §§ 1, 63. The AMT tax rates would be applied to an amount equal to $1,014,250, the amount of her gross income less the exemption amount of $35,750. See § 55(b)(2). As a result, her additional tax liability under the AMT would be $111,916, bringing her total tax liability to $280,490. See § 55.

Under the exclusion method, Paula's gross income would equal $450,000. Paula would take the standard deduction of $4,700; accordingly, her taxable income would equal $445,300. *See* I.R.C. § 63(b)-(c) (2000). Her tax liability would equal $148,084. *See* § 1.

[49] Due to rounding, the values in this table do not sum precisely.

B. TAX POLICY IMPLICATIONS

Under the inclusion and deduction method, Paula effectively pays tax on a portion of the settlement proceeds which are used to pay her attorney. Under this method, Paula's tax liability in the original hypothetical[50] is $55,206 greater than when the $400,000 fee is merely excluded from gross income; at Paula's 38.6% marginal rate, Paula is effectively taxed on $143,021 of the fees that she pays to her attorney.[51] The tax policy question is whether Paula should be taxed on any portion of the money that goes to her attorney.[52]

This question can be analyzed from both a broad and narrow perspective. From the broad perspective, the analysis focuses on the issue of whether any part of the settlement proceeds that are paid to the attorney should constitute income to Paula. The narrow perspective focuses on the specific deduction limitations that apply to the fees, namely the limitations under Code sections 67 and 68 and the disallowance of the deduction under the AMT. This latter perspective seeks to determine the purposes of these limitations and inquires whether these purposes are served when the limitations are applied to Paula's attorney's fees.

1. The Broad Perspective—What is Income? A fundamental principle of taxation is "that a person's taxable income should not include the cost of producing that income."[53] Under this principle, Paula should not pay tax on any portion of the $400,000 in attorney's fees, since these fees were the cost of producing Paula's $600,000 recovery. Because the inclusion and deduction method effectively requires Paula to pay tax on a portion of these attorney's

---

[50] *See supra* notes 27-28 and accompanying text.

[51] This amount equals the quotient derived by dividing (i) the $55,206 additional tax liability under the inclusion and deduction method by (ii) Paula's marginal tax rate of 38.6%. In effect, Paula would be taxed, under the inclusion and deduction method, on her $50,000 of wages, the $600,000 of settlement proceeds that she actually receives, and $143,021 of the settlement proceeds which go to her attorney. See Robert W. Wood, *Even Tax Court Itself Divided on Attorneys' Fees Issue!*, 88 TAX NOTES 573, 573 (2000) (concluding that plaintiffs will, under inclusion and deduction method, "end up paying tax on a good portion of the money the attorney received").

[52] The fact that the attorney is taxed on his fees is irrelevant to this inquiry. *See* Geier, *supra* note 3, at 545-46 (using example to show why "[t]he taxation of one party does not depend on the taxation of another absent a specific code provision specifying otherwise").

[53] Hantzis v. Comm'r, 638 F.2d 248, 249 (1st Cir. 1981).

fees, it violates this fundamental principle.

The Haig-Simons definition of income confirms this conclusion. This definition of income, the most widely accepted among tax theorists,[54] provides that income during a given time period equals the "sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question."[55] In other words, income equals consumption plus net accumulation of wealth.[56]

Paula's attorney's fees cannot count toward the "accumulation of wealth" prong of Haig-Simons since she actually experiences a decrease, rather than an increase, in wealth upon payment of the fees.[57] Furthermore, although the boundaries of the term "consumption" in the Haig-Simons definition are not entirely clear,[58] it is clear that none of the $400,000 paid to the attorney should be considered a consumption expenditure. Paula pays the amount for the sole purpose of generating the settlement; as a result, the fees are business- or investment-type expenditures rather than consumption-based expenditures.[59]

---

[54] BORIS I. BITTKER & LAWRENCE LOKKEN, 1 FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 3.1.1 (1999); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 46 (1990).

[55] HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938). For a discussion of the merits and limitations of the Haig-Simons definition of income, see BITTKER & LOKKEN, *supra* note 54, at ¶ 3.1.1.

[56] If the taxpayer experiences a net decrease in wealth during the time period, then income under Haig-Simons would equal the excess of consumption over such net decrease. SIMONS, *supra* note 55, at 50.

[57] Even though Paula experiences an increase in wealth in the amount of $1,000,000 upon settlement, when she pays her attorney, her wealth is reduced by $400,000. Thus, her net accumulation of wealth resulting from the settlement equals $600,000. Whether Paula's income under Haig-Simons equals only $600,000 or some greater amount depends on whether the attorney's fee, or any portion of it, contributes to Paula's consumption.

[58] *See generally* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Thomas D. Griffith, *Theories of Personal Deductions in the Ideal Income Tax*, 40 HASTINGS L.J. 343 (1989); Louis Kaplow, *The Income Tax as Insurance: The Casualty Loss and Medical Expense Deductions and the Exclusion of Medical Insurance Premiums*, 79 CAL. L. REV. 1485 (1991); Stanley A. Koppelman, *Personal Deductions Under an Ideal Income Tax*, 43 TAX L. REV. 679 (1988); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980).

[59] *See* Laura Sager & Stephen Cohen, *Kafka at the Tax Court: The Attorney's Fee in Employment Litigation*, 96 TAX NOTES 1503, 1507 (2002) (noting that "attorney's fee in employment litigation . . . virtually never provides personal consumption benefits").

Because the attorney fee portion of the settlement neither results in Paula's accumulation of wealth nor contributes to her consumption, none of the $400,000 in attorney's fees should be included in Paula's income. Thus, by effectively including $143,021 of the attorney's fees in Paula's income, the inclusion and deduction method results in an overstatement of income, according to the Haig-Simons definition of income.

2. The Narrow Perspective—What are the Purposes of the Deduction Limitations? Another way to analyze the tax policy question is to inquire whether the statutory purposes behind the deduction limitations that apply to Paula's attorney's fees under the inclusion and deduction method (*i.e.*, sections 67 and 68, and the AMT) are implicated when Paula pays her attorney. As explained below, applying these limitations to Paula's fee deduction does not further any of these purposes.

a. Limitations Under Sections 67 and 68. Section 67 serves as a "floor" for the deductibility of miscellaneous itemized deductions; they are deductible only to the extent they exceed, in the aggregate, two percent of the taxpayer's adjusted gross income.[60] When section 67(a) was added to the Code in 1986, the Joint Committee on Taxation explained Congress's intentions:

> The Congress concluded that the prior-law treatment of . . . [certain] deductions fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures. For taxpayers who anticipated claiming such itemized deductions, prior law effectively required extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service. These problems were exacerbated by the fact that taxpayers frequently made errors of law regarding what types of expenditures were properly allowable under prior law. . . .

[60] I.R.C. § 67 (2000).

> The use of the deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer.[61]

Based on this legislative history, Professor Deborah Geier concluded that, in enacting section 67, Congress targeted small deductions which "had only a very tenuous relationship to any income-producing activity and had personal-consumption benefits as well."[62]

Professor Geier cites a casual investor's subscription to the *Wall Street Journal* as the prototypical expenditure with which Congress was concerned.[63] The expenditure is small in amount, and although information read in the *Wall Street Journal* may help the reader increase his taxable income, the subscription does not have a clear and direct relationship to increased income production.[64] Furthermore, reading the *Wall Street Journal* likely provides some personal consumption benefits; in fact, the reader might have subscribed to the *Journal* even in the absence of any investment activity.[65]

---

[61] STAFF OF THE JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 78-79 (Comm. Print 1987).

[62] Geier, *supra* note 3, at 533. Thus, Congress enacted the section 67 floor to further the following two policy goals: (1) to more accurately compute a taxpayer's true income, and (2) to simplify the Code. JOINT COMM. ON TAX'N, *supra* note 61, at 78-79. In computing income under the Haig-Simons ideal, any expenditure which gives rise to personal consumption should be nondeductible to the extent of the value of the personal consumption. See Daniel I. Halperin, *Business Deductions for Personal Living Expenses: A Uniform Approach to An Unsolved Problem*, 122 U. PA. L. REV. 859, 878-80. Accordingly, under an ideal income tax, every quasi-personal expense would be split into two components, a deductible business component and a nondeductible personal consumption component. *Id.* Of course, this division would be impracticable. *Id.* at 880. *See also* S. SURREY ET AL., FEDERAL INCOME TAXATION, CASES & MATERIALS 496 (1972). As a result, Congress provided a bright line rule that miscellaneous itemized deductions are deductible only to the extent that they exceed the floor. JOINT COMM. ON TAX'N, *supra* note 61, at 78-79. In addition, the floor arguably creates simplification benefits since any taxpayer who will not have sufficient miscellaneous itemized deductions to reach the floor will be able to forgo the recordkeeping and computations required under pre-floor law. *See id.* For an analysis of whether § 67 actually furthers these policy goals, see Peroni, *supra* note 34, at 1425.

[63] Geier, *supra* note 3, at 533.

[64] *Id.*

[65] *Id.*

Congress's concerns in enacting section 67 are not implicated when Paula pays her attorney.[66] The amount of the fee is not small, but rather very significant in relation to Paula's overall financial circumstance. More importantly, Paula receives no discernable personal consumption benefit from paying this fee, and the fee has a clear and direct relationship to taxable income.[67]

The section 68 limitation generally reduces the amount of a taxpayer's itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount.[68] Professor Peroni has described section 68 as simply a mechanism to raise revenue by increasing "the effective tax rates of higher-income taxpayers in a nontransparent fashion."[69] Despite this revenue raising purpose, the section 68 reduction does not apply to all itemized deductions.[70] Rather, section 68 targets itemized deductions that have been "criticized as allowing deductions for amounts that really should be considered part of the taxpayer's standard of living or consumption."[71] Consequently, all of the miscellaneous itemized deductions, as well as deductions for home mortgage interest, charitable contributions, and state and local taxes, are subject to the section 68 reduction.[72] However, itemized deductions which do not contribute to the taxpayer's standard of living or consumption, such as deductions for medical expenses, investment interest, casualty or theft losses, and gambling losses, are specifically exempted from the section 68 reduction.[73] Since Paula's payment of attorney's fees does

---

[66] *Id.* at 534.

[67] *Id.*

[68] I.R.C. § 68(a) (2000).

[69] Peroni, *supra* note 34, at 1426. In other words, the purpose of § 68 was to raise revenue by imposing higher effective tax rates on wealthy taxpayers without raising the tax rates in § 1. *Id.* at 1425-26. Section 68 "effectively imposes a 1% tax on adjusted gross income above the [statutorily defined] threshold amount." *Id.* at 1425.

[70] I.R.C. § 68(a), (c) (2000). If Congress's sole consideration in enacting § 68 was to raise revenue in a nontransparent fashion, it could have subjected all itemized deductions to the § 68 reduction.

[71] Calvin H. Johnson, *Simplification: Replacement of the Section 68 Limitation on Itemized Deductions*, 78 TAX NOTES 89, 90 (1998).

[72] *See* I.R.C. § 68(a) (providing that itemized deductions are subject to reduction); § 68(c) (providing that, for purposes of § 68(a), itemized deductions do not include deductions for medical expenses, investment interest, casualty or theft losses, or gambling losses).

[73] I.R.C. § 68(c) (2000). Gambling losses are only deductible to the extent that they do not exceed the taxpayer's gambling gains in a given year. *See* § 165(d). Because gambling

not contribute to her standard of living or consumption, her deduction for these fees is not within the intended target of section 68.[74]

b. AMT. Congress enacted the AMT to ensure that taxpayers with substantial economic income do not escape taxation through excessive use of deductions and credits.[75] In computing AMT liability, all miscellaneous itemized deductions are disallowed.[76] Although legislative history does not explain the rationale behind this disallowance, Professor Geier concluded that it is likely based on Congress's "doubts about the legitimacy of the deductions."[77] In other words, the disallowance under the AMT of miscellaneous itemized deductions is based on the notion that these deductions have significant personal consumption components and only a tenuous relationship to business or investment activity.[78] Because Paula's attorney's fees have no personal consumption element and because they bear a clear and direct relationship to taxable income, the disallowance of miscellaneous itemized deductions under the AMT should not, as a matter of policy, apply to these fees.[79]

Accordingly, when viewed from either the broad or the narrow perspective, Paula's attorney's fees should be deductible in full without impairment. Therefore, the exclusion method provides the correct tax policy result, while the inclusion and deduction method does not.[80]

---

loss deductions may be used only to offset gambling gains, these losses do not contribute to the taxpayer's standard of living or consumption. *But see* Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 231-33 (1990) (arguing that, in principle, cost of gambling should be split into two components, nondeductible personal consumption component and investment component; under this approach even gambling losses not in excess of gambling gains would include personal consumption component).

[74] *See* Geier, *supra* note 3, at 534.

[75] BORIS BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 45.1, at 45-1 to 45-2 (3d ed. 2002). For an analysis of the impact of the AMT, see Robert P. Harvey & Jerry Tempalski, *The Individual AMT: Why it Matters*, 50 NAT'L TAX. J. 453, 463-71 (1997).

[76] I.R.C. § 56(b)(1)(A) (2000).

[77] Geier, *supra* note 3, at 534.

[78] *Id.* at 533-34.

[79] *Id.* at 534.

[80] *See* Peroni, *supra* note 34, at 1423 (stating that inclusion and deduction method provides "an inappropriate result from a tax policy point of view"); Sager & Cohen, *supra* note 8, at 1103 (stating that "tax policy considerations should favor permitting plaintiffs either to deduct fully or to exclude the recovery of attorney's fees"); James Serven, *Oral Argument in*

II. THE CONTINGENT FEE CASES

All of the cases that have considered the contingent fee issue have focused on the assignment of income doctrine.[81] In particular, courts have analyzed whether a plaintiff, upon execution of a contingent fee agreement, either transfers a portion of her claim to her attorney or merely a right to the proceeds from a portion of the claim.[82]

A. THE MINORITY VIEW—THE PROPERTY TRANSFER CASES

The minority view, followed by the Fifth, Sixth, and Eleventh Circuits, maintains that a contingent fee agreement transfers a portion of the claim to the attorney[83] and that such portion constitutes property (*i.e.*, tree) for purposes of the assignment of income

---

Hukkanen-Campbell: *Taxpayer's Last Stand?*, 93 TAX NOTES 854, 859 (2001) (stating that "[t]here is simply no public policy or conceptual theory by which the denial of a deduction under the AMT for . . . attorney's fees . . . can be plausibly defended"). Professors Sager and Cohen also contend that the effect of the inclusion and deduction method "undermines the national policy of encouraging the pursuit of meritorious civil rights claims." Sager & Cohen, *supra* note 8, at 1078.

[81] For an extended discussion of the contingent fee cases, see Geier, *supra* note 3, at 535-49.

[82] *See infra* notes 83-99 and accompanying text.

[83] Although the Fifth, Sixth and Eleventh Circuits all concluded that a contingent fee agreement transferred a portion of the claim to the attorney, they differed with respect to their level of reliance on state attorney lien law. The first in this line of cases, the 1959 Fifth Circuit decision in *Cotnam v. Commissioner*, 263 F.2d 119, 125 (5th Cir. 1959), relied on the Alabama attorney lien statute (which governed the taxpayer's relationship with her attorney) that gave attorneys "the same right and power over [claims] as their clients had . . . for the amount due thereon to them." The *Cotnam* court also noted that Alabama case law interpreting this statute had found the attorney lien to have priority even over the defendant's right of set-off. *Id.* at 125. The Eleventh Circuit, in *Davis v. Commissioner*, 210 F.3d 1346, 1347 (11th Cir. 2000), found *Cotnam* to be controlling precedent in another case involving Alabama law. Note that, under *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981), decisions of the Fifth Circuit—such as *Cotnam*—rendered prior to the creation of the Eleventh Circuit are binding precedent on the Eleventh Circuit. In *Estate of Clarks v. Commissioner*, 202 F.3d 854, 856 (6th Cir. 2000), the Sixth Circuit evaluated applicable Michigan attorney lien common law, as there was no attorney lien statute, and concluded that it "operate[d] in more or less the same way as the Alabama lien in *Cotnam*." However, notwithstanding its prior holding in *Cotnam*, the Fifth Circuit recently stated in *Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000), that state attorney lien law was irrelevant to its conclusion that the contingent fee agreement transferred a portion of the claim.

doctrine.[84] For example, in reaching its conclusion, the Sixth Circuit invoked the familiar tree versus fruit distinction made in assignment of income cases:

> The present transaction under scrutiny is more like a division of property than an assignment of income. 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.[85]

Because these cases (the "property transfer cases") determine that a contingent fee agreement transfers property rather than income, they conclude that the assignment of income doctrine does not require the plaintiff to include the attorney fee portion of the settlement in her gross income.[86]

This analysis has two problems, which are comprehensively discussed in Parts III and IV[87] and are summarized here. First, the issue of whether a contingent fee agreement transfers tree or fruit is irrelevant; the assignment of income doctrine does not apply under either scenario.[88] Second, the property transfer cases do not follow through on the tax analysis required by their factual determinations.[89] If, as these cases held, the contingent fee agreement results in a transfer of property for tax purposes,[90] then such transfer has tax consequences regardless of whether such property constitutes fruit or tree for purposes of the assignment of income doctrine. Had these courts followed through on their

---

[84] *Srivastava*, 220 F.3d at 359; *Davis*, 210 F.3d at 1347; *Estate of Clarks*, 202 F.3d at 856; *Cotnam*, 263 F.2d at 125-26.

[85] *Estate of Clarks*, 202 F.3d at 857-58.

[86] In other words, the property transfer cases determine that when the attorney receives his fee, the fee is attributable to property owned by the attorney; therefore, they conclude that the plaintiff is not required to include the attorney fee portion of the settlement in gross income. *See id.*, *Srivastava*, 220 F.3d at 363; *Cotnam*, 263 F.2d at 125.

[87] *See infra* notes 100-255 and accompanying text.

[88] *See infra* notes 157-74 and accompanying text.

[89] *See infra* notes 237-55 and accompanying text.

[90] *Srivastava*, 220 F.3d at 359; *Davis*, 210 F.3d at 1347; *Estate of Clarks*, 202 F.3d at 856; *Cotnam*, 263 F.2d at 125-26.

analysis, they would have found that, even under their characterization of the contingent fee arrangement, the plaintiff would still be required to include the full settlement amount in her gross income.

B. THE MAJORITY VIEW—THE ASSIGNMENT OF INCOME CASES

The majority view, followed by the Federal, First, Third, Fourth, Seventh, Eighth, Ninth, and Tenth Circuits, and the Tax Court, maintains that a contingent fee agreement does not transfer a portion of the plaintiff's claim to the attorney, but rather transfers a right to the proceeds from such portion of the claim.[91] Under this view, such a transfer constitutes a transfer of income (*i.e.*, fruit) that is disregarded for tax purposes under the assignment of income doctrine.

These cases (the "assignment of income cases") determine that the plaintiff retains ownership of the entire claim after the contingent fee agreement is executed.[92] The assignment of income cases base this determination on two factors. First, the cases cite the significant degree of control that the plaintiff retains with respect

[91] Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001), *cert. denied*, 122 S. Ct. 1915 (2002); Sinyard v. Comm'r, 268 F.3d 756, 758-59 (9th Cir. 2001) (affirming United States Tax Court), *cert. denied*, 122 S. Ct. 2357 (2002); Kenseth v. Comm'r, 259 F.3d 881, 883-84 (7th Cir. 2001) (affirming United States Tax Court); Young v. Comm'r, 240 F.3d 369, 376-77 (4th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187, 1189 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); Bagley v. Comm'r, 121 F.3d 393, 395-96 (8th Cir. 1997); Alexander v. Comm'r, 72 F.3d 938, 942-43 (1st Cir. 1995); Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532, 532 (3d Cir. 1963).

[92] Although the assignment of income cases all conclude that a contingent fee agreement does not transfer a portion of the plaintiff's claim to the attorney, they differ with respect to their level of reliance on state attorney lien law in reaching this conclusion. Some of the cases distinguish applicable state attorney lien law from the attorney lien statute analyzed in *Cotnam v. Commissioner*, 269 F.2d 119 (5th Cir. 1959). *See* Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001), *cert. denied*, 122 S. Ct. 1915 (2002) (distinguishing Missouri law); Coady v. Comm'r, 213 F.3d 1187, 1189-90 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001) (distinguishing Alaska law); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (distinguishing Pennsylvania law). Other cases have affirmatively concluded that state attorney lien law is irrelevant. Sinyard v. Comm'r, 268 F.3d 756, 760 (9th Cir. 2001), *cert. denied*, 122 S. Ct. 2357 (2002); Young v. Comm'r, 240 F.3d 369, 377-79 (4th Cir. 2001); Kenseth v. Comm'r, 114 T.C 399, 421 (2000) (Chabot, J., dissenting). Finally, some cases do not discuss state attorney lien law at all, implicitly concluding that it is irrelevant. *See* Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Bagley v. Comm'r, 121 F.3d 393 (8th Cir. 1997); Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995).

to the claim.[93] For example, the Fourth Circuit stated:

> We . . . do not accept the suggestion . . . that a contingent fee arrangement gives an attorney a portion of a client's cause of action. The client still controls the claim (or property) and ultimately decides to forego, pursue, or settle that claim.[94]

Second, some of the assignment of income cases note that applicable state law prohibits attorneys from acquiring a proprietary interest in the claims of their clients.[95]

Because these cases determine that the plaintiff retains ownership of the entire claim, they hold that a contingent fee agreement only transfers a right to the *income* from the claim. For example, the Seventh Circuit explained:

> In essence, [taxpayer] wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent-fee contract is not an assignment, and [under applicable state law] the lawyer is prohibited from acquiring ownership of his client's claim. So what [taxpayer] really is asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.[96]

---

[93] *See, e.g.*, Campbell v. Comm'r, 274 F.3d 1312, 1313-14 (10th Cir. 2001), *cert. denied*, 122 S. Ct. 1915 (2002); Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 378 (4th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); Kenseth v. Comm'r, 114 T.C. 399, 414 (2000), *aff'd* 259 F.3d 881 (7th Cir. 2001).

[94] *Young*, 240 F.3d at 378.

[95] *See, e.g.*, *Kenseth*, 259 F.3d at 883-84 (affirming United States Tax Court applying Wisconsin law); *Kenseth*, 114 T.C. at 414 ("In Wisconsin, a lawyer cannot acquire a propriety interest that would enable the attorney to continue to press a cause of action despite the client's wish to settle.").

[96] *Kenseth*, 259 F.3d at 884 (emphasis added) (citation omitted).

Based on their determination that the transfer resulting from a contingent fee agreement is ineffective under the assignment of income doctrine, these cases conclude that the plaintiff must include the full settlement amount, including the attorney fee portion, in her gross income.[97] As discussed in Part IV, the assignment of income cases reach the right doctrinal result;[98] however, their reasoning is substantially flawed.[99] These cases rely on the assignment of income doctrine, but the doctrine simply has no relevance to a contingent attorney fee arrangement.

III. THE ASSIGNMENT OF INCOME DOCTRINE

As Part II explained, the courts have focused on whether a contingent fee agreement transfers fruit or tree.[100] The property transfer cases determine that the agreement transfers tree, meaning the attorney fee portion of the claim, and consequently conclude that the plaintiff may exclude the attorney fee portion of the settlement.[101] The assignment of income cases determine that the agreement transfers fruit, meaning the right to the proceeds from the attorney fee portion of the claim, and thereby conclude that the plaintiff must include the entire settlement amount in gross income.[102] This Part demonstrates that this analysis by the courts is misguided.[103]

The assignment of income doctrine has no relevance to the contingent attorney fee cases. Subject to a single caveat that is not relevant to these cases,[104] the doctrine applies only to gratuitous transactions in which a right to income is transferred without

---

[97] *See, e.g.*, *Kenseth*, 259 F.3d at 884, *Coady*, 213 F.3d 1187, 1199, *Young*, 240 F.3d 369, 376-78.

[98] *See infra* notes 175-255 and accompanying text. However, as discussed in *supra* notes 50-80 and accompanying text, this result—that the plaintiff must include the full settlement amount in gross income and take a miscellaneous itemized deduction for the attorney fee portion—violates tax policy principles.

[99] *See infra* notes 157-74 and accompanying text.

[100] *See supra* notes 81-99 and accompanying text.

[101] *See supra* notes 83-90 and accompanying text.

[102] *See supra* notes 91-99 and accompanying text

[103] *See infra* notes 157-74 and accompanying text.

[104] *See infra* notes 139-46 and accompanying text.

consideration.[105] The doctrine does not apply to an arm's length transaction in which a right to income is transferred for value.[106] In the contingent fee cases, the purported income right (the right to the proceeds from the attorney fee portion of the claim) is assigned for value (legal services) in an arm's length transaction.[107] Because the assignment of income doctrine does not apply, the issue of whether a contingent fee agreement transfers fruit or tree is irrelevant.

A. THE DEVELOPMENT OF THE ASSIGNMENT OF INCOME DOCTRINE: PROTECTING THE PROGRESSIVE RATE STRUCTURE

The assignment of income doctrine was initially developed by courts to prevent the subversion of the progressive rate structure of the tax system through the use of artificial income-splitting between related parties.[108] The seminal Supreme Court assignment of income cases involved fact patterns in which income was assigned gratuitously. For example, in *Lucas v. Earl*, a high-earning husband assigned one half of his future earnings to his low-earning wife.[109] In *Helvering v. Horst*,[110] a father assigned rights to interest payments to his son; and in *Helvering v. Eubank*,[111] a taxpayer assigned his right to future insurance renewal commissions to a family trust. In each of these cases, the Court disregarded the gratuitous assignments for tax purposes, creating a common law doctrine now known as the assignment of income doctrine.[112]

---

[105] *See infra* notes 126-56 and accompanying text.

[106] *See id.*

[107] *See infra* notes 157-74 and accompanying text.

[108] For general discussions of the assignment of income doctrine, see Charles S. Lyon & James S. Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the* P.G. Lake *Case*, 17 TAX L. REV. 293, 296-301 (1962); Martin J. McMahon, Jr., *Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents*, 56 N.Y.U. L. REV. 60, 80-95 (1981); Ralph S. Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes*, 64 YALE L.J. 991, 993-1004 (1955); Stanley S. Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 COLUM. L. REV. 791, 831-33 (1933).

[109] 281 U.S. 111, 113-14 (1930). Mr. Earl was a corporate executive and an attorney who received an aggregate amount of salary and fees in excess of $20,000 in each of 1920 and 1921, the taxable years at issue. Earl v. Comm'r, 10 B.T.A. 723, 723-24 (1928). None of the opinions stated whether Mrs. Earl was employed.

[110] 311 U.S. 112, 114 (1940).

[111] 311 U.S. 122, 125 (1940).

[112] Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the*

Although in these early cases the Supreme Court never explicitly explained the policy behind the assignment of income doctrine, the policy has always been clear. Professor Ronald Jensen explains:

> Here is the essence of the assignment of income doctrine: the concern that the progressive tax rate schedule not be subverted by permitting income to be *artificially split among formally separate taxpayers who in fact constitute a single economic unit.* In more recent years, the courts have become more candid in acknowledging this policy as the basis for the assignment of income doctrine. For example, the Supreme Court in 1973 extolled the doctrine as "a cornerstone of our *graduated* income tax system." Today, this explanation is commonplace among both courts and commentators.[113]

Thus, the assignment of income doctrine has at its roots the substance over form principle that income-splitting arrangements are disregarded to the extent they lack true substance.[114] Even though income may be earned as a formal matter by one taxpayer, if it is earned in substance by another taxpayer, the income should be taxed to such other taxpayer.

The substance over form aspect of the doctrine is evident in the *Horst* case, in which a father assigned to his son rights to future interest payments from bonds retained by the father.[115] As a matter

---

Assignment of Income Doctrine and Personal Service Income, 1 FLA. TAX REV. 623, 628-33 (1993).

[113] *Id.* at 632 (first emphasis added) (citations omitted).

[114] It does not matter whether tax avoidance drives the artificial income-splitting arrangements. The key issue is whether the arrangements lack true substance. For example, in *Lucas v. Earl*, the most influential assignment of income case, the parties clearly had no tax avoidance purposes because the agreement to split income was made in 1901. 281 U.S. 111, 113 (1930). At that time, no federal income tax existed, because the 1894 income tax was declared unconstitutional in 1895. Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 442 (1895), *overruled on other grounds by* South Carolina v. Baker, 485 U.S. 505, 524 (1998). The Sixteenth Amendment, which corrected the constitutional infirmity, was ratified in 1913. U.S. CONST. amend. XVI. For a discussion of the history of the federal income tax, see 1 BITTKER & LOKKEN, *supra* note 54, ¶ 1.1.

[115] Helvering v. Horst, 311 U.S. 112, 114 (1940).

of form, the payor made the interest payments directly to his son.[116] However, the Supreme Court found that the substance of the transaction was inconsistent with its form.[117] The Court recast the transaction by treating the father as first receiving the interest payments and then transferring the payments to his son.[118] The Court reasoned that, because the father controlled the bonds, which were the source of the income, he was in substance the owner of the income payments.[119]

The *Horst* Court used the now-familiar fruit and tree metaphor.[120] The interest payments were the fruit borne by the tree (*i.e.*, the bonds) and were attributed to the owner of the tree regardless of any artificial arrangement by which the fruit was diverted to another taxpayer.[121] On the other hand, if the father had transferred the bonds—the tree itself—to his son, the future interest payments accruing on the bond would have been taxable only to the son.[122] Thus, related parties can effectively split income through the transfer of income-producing property but not through the transfer of mere rights to income from such property.

Consequently, the line was drawn between income-producing property (tree) and mere income (fruit). In determining whether an arrangement to split income among related parties is "artificial" or "lacks substance," courts have focused on the issue of whether income-producing property is transferred or whether the income from such property is transferred.[123] The former would be respected for tax purposes, and therefore would result in an effective income-splitting technique.[124] The latter would be disregarded under the

---

[116] *Id.* at 117.
[117] *Id.* at 117-18.
[118] *Id.* at 117.
[119] *Id.*
[120] *Id.* at 120.
[121] *Id.* at 117-18, 120.
[122] *See* BITTKER ET AL., *supra* note 75, ¶ 34.1, at 34-5 (stating that "[a] transfer of stocks, bonds, real estate, or other income-producing assets will effectively shift tax liability for subsequent investment income to the new owner"). However, accrued but unpaid interest generally would be taxable to the transferor. *See* Austin v. Comm'r, 161 F.2d 666, 668 (6th Cir. 1946) (holding that where taxpayer gratuitously transferred bond with accrued but unpaid interest, taxpayer was taxed on such interest as it was paid to transferee).
[123] *See* BITTKER ET AL., *supra* note 75, at ¶ 34.03[3], 34-22 to 34-24.
[124] *See, e.g.*, Blair v. Comm'r, 300 U.S. 5 (1937) (holding that transfer of equitable interest in trust was effective).

assignment of income doctrine, and therefore would be ineffective as an income-splitting technique.[125]

B. LIMITED APPLICATION OF THE ASSIGNMENT OF INCOME DOCTRINE IN COMMERCIAL CASES

Because courts developed the assignment of income doctrine to prevent the exploitation of the progressive rate structure through artificial arrangements in which related taxpayers split income,[126] the policy behind the doctrine is not implicated in an arm's length transaction. Arm's length parties simply do not engage in artificial arrangements designed to split income. Therefore, the assignment of income doctrine should not apply in commercial cases where independent parties transact.[127] The courts have followed this rule.[128]

---

[125] *See, e.g.*, Helvering v. Horst, 311 U.S. 112, 117-18 (1940) (holding that transfer of interest coupons detached from bonds was ineffective).

[126] *See* Jensen, *supra* note 112, at 632.

[127] *See* Michael Asimow, *Applying the Assignment of Income Principle Correctly*, 54 TAX NOTES 607, 608 (1992) ("[The] [a]ssignment of income [doctrine] is an indispensable weapon to protect progressivity and to attack tax avoidance schemes. It should not be used to overturn economically rational, nontax avoidance contractual arrangements."); Jensen, *supra* note 112, at 633.

> All [of the seminal assignment of income] cases . . . involved *gratuitous* assignments of income. What should the rule be when the right to future personal service income is assigned, or exchanged, for consideration? If, as is commonly agreed, the assignment of income doctrine is intended to preserve the integrity of the graduated tax rate schedule, the assignor should be taxed on the amount he receives for the assignment but no more, while any amount collected by the assignee over and above the amount paid for the assignment should be taxed to the assignee.

Id.; Elliott Manning, *The Service Corporation—Who is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351*, 37 U. MIAMI L. REV. 657, 668-69 (1983).

> [I]n either *Horst* or *Earl*, if the transferee had paid the transferor the discounted value of the future income at the time of the assignment, there is little doubt that each transferor would have been taxed upon receipt of the consideration, . . . [and that] the transferee would have been taxed on the amount received as salary or interest, but only to the extent that the payments received exceeded the consideration given.

Id.

[128] *See, e.g.*, Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 262-68 (1958) (finding that where taxpayer sold rights to oil and other mineral payments for fair market value, taxpayer realized income at time of sale, rather than as oil and mineral payments were received by buyer); Estate of Stranahan v. Comm'r, 472 F.2d 867, 870-71 (6th Cir. 1973) (holding that

For example, in *Estate of Stranahan v. Commissioner*,[129] a taxpayer sold to his son a right to receive future dividends, while retaining the underlying stock, in exchange for $122,820, the present value of the dividends.[130] The taxpayer was motivated by a desire to accelerate income in order to take advantage of significant deductions available to him in the year of sale.[131] The taxpayer took the position that he realized $122,820 of income upon the sale.[132] The IRS disagreed, arguing that the taxpayer realized income as the dividends were paid to his son.[133]

---

where taxpayer sold rights to future dividends for fair market value, taxpayer realized income at time of sale, rather than as dividends were received by buyer); Davis v. Comm'r, 119 T.C. No. 1, 3-7 (2002) (holding that where taxpayer sold rights to future lottery payments for fair market value, taxpayer realized income at time of sale, rather than as lottery payments were received by buyer); *see also* Rev. Rul. 83-46, 1983-1 C.B. 16 (ruling that where taxpayer was assigned overriding royalty interest in oil and gas—entitling taxpayer to specified fraction of future production—in exchange for services, taxpayer realized income at time of assignment, rather than as proceeds of interest were received); *infra* notes 219-36 and accompanying text (discussing Revenue Ruling 83-46); *cf.* Schuster v. Comm'r, 800 F.2d 672, 676-79 (7th Cir. 1986) (holding that where taxpayer gratuitously deflected salary to religious order pursuant to her vow of poverty, taxpayer was taxed on salary as it was received by religious order).

Courts occasionally have applied the assignment of income doctrine in commercial cases, however. *See, e.g.*, Johnson v. Comm'r, 698 F.2d 372, 374 (9th Cir. 1982) (applying assignment of income doctrine when taxpayer assigned rights to future salary in arm's length transaction); Schneer v. Comm'r, 97 T.C. 643, 662-63 (1991) (applying assignment of income doctrine when taxpayer assigned rights to income to unrelated partnership in arm's length transaction). These cases simply misapplied the assignment of income doctrine. *See* Asimow, *supra* note 127, at 608 (criticizing *Schneer*); Jensen, *supra* note 112, at 668-76 (criticizing *Johnson*); *id.* at 654-56, 676-80 (criticizing *Schneer*); Manning, *supra* note 127, at 662 (criticizing *Johnson*).

In addition, courts have applied the assignment of income doctrine in cases where the right to income was assigned in a transaction that, while not wholly gratuitous, was not entirely at arm's length. *See, e.g.*, Kochansky v. Comm'r, 92 F.3d 957, 958-59 (9th Cir. 1996) (holding that where attorney assigned right to portion of contingent fee to his former wife in connection with their divorce, attorney realized income when portion of fee was paid to wife); Leavell v. Comm'r, 104 T.C. 140, 148-59 (1995) (holding that where taxpayer assigned rights to future salary to his wholly owned personal services corporation, taxpayer realized income as salary was paid to corporation); *see also* Basye v. United States, 410 U.S. 441, 451-53 (1950) (holding that where partnership deflected income to trust which benefitted its partners and its employees, partnership realized income in the amount of deflected payments); *infra* notes 147-56 and accompanying text (distinguishing *Bayse* facts from contingent fee arrangements). These cases are readily distinguishable from the contingent fee cases, which involve commercial transactions between completely unrelated parties.

[129] 472 F.2d 867 (6th Cir. 1973).

[130] *Id.* at 868.

[131] *Id.* at 869.

[132] *Id.*

[133] *Id.*

The Tax Court held in favor of the IRS, citing the assignment of income doctrine:

> Borrowing the simile from *Helvering v. Horst*, the 1964 assignment [of the right to future dividends] was of the fruit of the tree and not the assignment of the tree itself. In other words, the [taxpayer] kept the "tree" and "assigned" part of the "fruit." By retaining the stock, the [taxpayer] controlled the source of the income and he directed its disposition in "assigning" or diverting it to his son.[134]

Consequently, the Tax Court concluded that the assignment was ineffective for tax purposes and held that the taxpayer realized income when the dividends were received by his son, not when the sale was consummated.[135]

The Sixth Circuit reversed, reasoning that the assignment of income doctrine did not apply to the case:

> [T]he substance of a transaction, and not the form, determines the taxable consequences of that transaction. . . . In the present transaction, however, it appears that both the form and the substance of the agreement assigned the right to receive future income. What was received by the [taxpayer] was the present value of that income the son could expect in the future. . . . Essentially, [taxpayer's] son paid consideration to receive future income. . . .
>
> We recognize the oft-stated principle that a taxpayer cannot escape taxation by legally assigning or giving away a portion of the income derived from income producing property retained by the taxpayer. . . . Here, however, the acceleration of income was not designed to avoid or escape recognition of the dividends but rather

---

[134] Estate of Stranahan v. Comm'r, 30 T.C.M. (CCH) 1078, 1083 (1971), *rev'd*, 472 F.2d 867 (6th Cir. 1973) (citations omitted).

[135] *Id.*

> to reduce taxation by fully utilizing a substantial interest deduction which was available. . . . [T]he fact that this was a transaction for good and sufficient consideration, and not merely gratuitous, distinguishes the instant case from the line of authority beginning with *Helvering v. Horst*. . . .
>
> [T]he fact that valuable consideration was an integral part of the transaction distinguishes this case from those where the simple expedient of drawing up legal papers and assigning income to others is used. The Tax Court [below] uses the celebrated metaphor of Justice Holmes regarding the "fruit" and the "tree," and concludes that there has been no effective separation of the fruit from the tree. Judge Cardozo's comment that "metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it" . . . is appropriate here, as the genesis of the metaphor lies in a gratuitous transaction, while the instant situation concerns a transaction for a valuable consideration.[136]

Thus, even though the parties were related, and in spite of the father's clear tax avoidance motive, the *Estate of Stranahan* court did not apply the assignment of income doctrine because the parties transacted at arm's length.[137] The court respected the form of the transaction, holding that the taxpayer was taxed on the sales proceeds he received in the year of sale, rather than on the dividends as they were paid to his son.[138]

There is one caveat to the general rule that the assignment of income doctrine does not apply in commercial cases: where a right to income is sold in an arm's length transaction, the doctrine has been invoked for the limited purpose of determining the character of the seller's income. For example, in *Commissioner v. P.G. Lake, Inc.*,[139] the taxpayer sold oil and other mineral payment rights to an

---

[136] *Estate of Stranahan*, 472 F.2d at 869-70 (citations omitted).
[137] *Id.* at 867.
[138] *Id.* at 871.
[139] 356 U.S. 260 (1958).

unrelated third party for a lump sum.[140] Had the taxpayer received the oil and other mineral payment rights in due course, rather than selling them for a lump sum, the taxpayer would have realized ordinary income.[141] The Court gave the sale tax effect, holding that the taxpayer realized income in the year of sale.[142] Furthermore, citing the seminal assignment of income cases, the Court held that the character of this income was ordinary since the sale proceeds served as "essentially a substitute for what would otherwise be received at a future time as ordinary income."[143]

Thus, the assignment of income doctrine has two distinct roles.[144] First, in cases where a mere right to income is assigned gratuitously while the assignor retains control of the source of the income, the doctrine causes the transferor to be taxed on the income as it is paid to the transferee.[145] Second, in cases where a mere right to income is sold in an arm's length transaction, the doctrine applies for a limited purpose, namely to tax the sales proceeds as ordinary income rather than capital gain.[146]

---

[140] *Id.* at 261-62.

[141] *Id.* at 265.

[142] *Id.* at 264. This determination by the Court supports the notion that, except for the limited purpose of determining character, the assignment of income doctrine does not apply where a right to income is sold for value. *Id.* If the assignment of income doctrine applied in full force, the Court would have determined that the taxpayer realized income as the payments were received by the buyer, rather than at the time of sale. *Cf.* Helvering v. Horst, 311 U.S. 112, 119 (1940) (holding that gratuitous donor of interest coupons realized income when interest paid to donee).

[143] Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (citations omitted).

[144] *See* Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65, 84 (1988):

> Over many decades, the courts have developed a two-branch doctrine generally referred to as assignment of income. The first branch, called donative assignment of income, establishes which of several possible taxpayers should pay tax on an item of income. The second branch, capital gains assignment of income, holds that certain assets do not qualify for the capital gains preference.

Id.; Lyon & Eustice, *supra* note 108, at 296 (noting that "[t]he [assignment of income] cases generally involve two situations—donative and commercial—and two corresponding issues—choice of taxpayer and rate of tax").

[145] *See, e.g.*, *Horst*, 311 U.S. at 117 (holding that where taxpayer gratuitously assigned right to interest payments from bond, taxpayer is taxed on interest payments as they were received by transferee).

[146] *See, e.g.*, *P.G. Lake*, 356 U.S. at 266 (holding that proceeds of sale of oil and other mineral payment rights taxable as ordinary income, not capital gain).

Some have suggested that the Supreme Court case of *Basye v. Commissioner*[147] undermines the notion that the assignment of income doctrine does not apply in commercial cases except to determine the character of income.[148] In *Basye*, a medical partnership entered into a contract with a health plan pursuant to which the partnership would perform medical services for the participants of the plan.[149] In consideration for these services, the plan would make payments to both the partnership and a retirement trust that would pay deferred compensation to the partnership's physicians.[150] The partnership had approximately 205 physician partners and approximately 41 physician-employees of the partnership.[151] The issue in *Basye* was whether the partnership realized income when the health plan made payments to the retirement trust.[152] The character of the income was not at issue.[153] The Court ruled that the partnership did realize this income when the trust was funded, citing the assignment of income doctrine.[154]

At first glance, *Basye* appears irreconcilable with the notion that the assignment of income doctrine applies in commercial cases only to determine the character of income. Upon closer analysis, however, it becomes clear that the relevant parties did not transact on an entirely arm's length basis. There was a substantial overlap between the owners of the partnership and the potential beneficiaries of the trust.[155] As a result of this overlap, the deflection of

---

[147] 410 U.S. 441 (1972).

[148] *See, e.g.*, Srivastava v. Comm'r, 220 F.3d 353, 361 (5th Cir. 2000) (citing *Basye* for proposition that "[t]here is nothing about arm's-length transactions that need preclude anticipatory assignments in that context"); Koski, *supra* note 11, at 97 (citing *Basye* for proposition that "[a]lthough gratuitous transfers may warrant special scrutiny, the assignment of income doctrine is equally applicable to arm's-length transactions").

[149] *Basye*, 410 U.S. at 442-43.

[150] *Id.* In order to receive the payments, the physicians would have to meet specified criteria. For instance, a physician would have to complete at least fifteen years of continuous service with the partnership before retirement, or ten years if the physician had attained the age of sixty-five at retirement, in order to be eligible to receive payments from the trust. *Id.* at 444.

[151] Appendix to Petition for a Writ of Certiorari at 82-83, Basye v. Comm'r, 410 U.S. 441 (1972) (No. 7-1022).

[152] *Basye*, 410 U.S. at 447.

[153] *Id.* at 457.

[154] *Id.* at 447-48.

[155] *See supra* note 151 and accompanying text.

income by the partnership to the trust could be characterized as a quasi-gratuitious assignment of income. Thus, *Basye* is easily distinguished from the contingent fee cases, where the plaintiff and the attorney—completely independent parties—engage in a wholly commercial arm's length transaction.[156]

C. INAPPLICABILITY OF THE ASSIGNMENT OF INCOME DOCTRINE TO CONTINGENT FEE ARRANGEMENTS

The courts faced with the contingent fee issue have attempted to determine whether the assignment of income doctrine applies by inquiring whether a contingent fee arrangement transfers property or income to the attorney.[157] In so doing, the courts, like the Tax Court in *Estate of Stranahan*, have leaped to the fruit-tree metaphor without first analyzing whether the doctrine has any relevance.

In rushing to the fruit-tree question, the courts have overlooked the policy behind the assignment of income doctrine—to prevent artificial income-splitting arrangements from subverting the

---

[156] Another, and perhaps better, way to reconcile *Basye* would be to conclude that as a matter of theory, the Court's analysis was erroneous, although its ultimate holding might be supportable on administrative convenience grounds. As a purely theoretical matter, the partnership realized income when the health plan made payments to the trust, not under the assignment of income doctrine, but because the partnership received the benefit of having its employees' retirement benefits funded by the health plan. *Id.* at 446-47. This benefit is taxable, and the only question concerns the value of the benefit. If the health plan received no benefit by making payments to the trust, as opposed to making them directly to the partnership, the valuation issue would be easy; it would be clear that the value of the benefit received by the partnership equaled the amount of the payments themselves. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 731 (1929) (holding that when employer paid employee's federal income taxes, employee realized income in amount of federal income tax payments). However, in *Basye*, the partnership asserted that the health plan received a benefit by funding the trust. 410 U.S. at 446. Specifically, the partnership contended that the terms of the trust created an incentive for the physician to remain affiliated with the partnership (or other partnerships that provided services for the health plan), thereby ensuring that the health plan would have "a stable and reliable group of physicians." *Id.* Assuming the accuracy of this contention, the valuation issue would be quite difficult, since any payment to the trust would have to be bifurcated between the portion that benefited the partnership and the portion that benefited the health plan. The partnership's portion would be included in the partnership's gross income. *See Old Colony Trust*, 279 U.S. at 731. Thus, the Court's conclusion—that the partnership realized income on a dollar for dollar basis as the trust was funded under the assignment of income doctrine—avoided this bifurcation and provided a highly administrable rule, even though as a matter of pure theory, the Court's reasoning was flawed. *Basye*, 410 U.S. at 457.

[157] *See supra* notes 81-98 and accompanying text.

progressive rate structure.[158] In the contingent fee cases, the attorney and the plaintiff are not engaging in any artificial arrangement to split income; rather, they are engaging in an entirely arm's length commercial transaction.[159] The plaintiff, in return for the attorney's promise to provide legal services, promises to transfer a percentage of her ultimate recovery to the attorney.[160] As in *Estate of Stranahan*, the substance of the transaction is entirely consistent with its form.[161]

Compare the contingent fee cases with a hypothetical in which a plaintiff purports to assign a claim to his son in a gratuitous transaction. This hypothetical implicates the policy concerns behind the assignment of income doctrine. If successful, the father's assignment would result in income-splitting. Whether the income-splitting is merely artificial and therefore subject to the assignment of income doctrine depends on whether the claim constitutes property or income for assignment of income purposes. Even if the claim constitutes property, there remains the issue of whether the father transfers the claim or merely a right to the income from the claim. Therefore, in order for the gratuitous assignment to be effective for tax purposes, two conditions must be satisfied. First, the claim must constitute property for purposes of the assignment of income doctrine. Second, the father must transfer the claim itself and not merely the right to the proceeds from the claim.

A recent IRS private letter ruling addressed these issues.[162] Although the conclusions of a letter ruling are not binding precedent,[163] the ruling is illustrative of the assignment of income

---

[158] *See supra* notes 108-25 and accompanying text.

[159] *See* Srivastava v. Comm'r, 220 F.3d 353, 362 (5th Cir. 2000):

> The main reason for a client to sign a contingent fee contract, presumably, is not to avoid taxation by anticipatorily assigning future streams of income to others in exchange for non-monetary benefits. More likely, he signs it to secure the services of an attorney without having to put any capital at risk, and to encourage the attorney to perform well by offering a personal stake in the claim.

Id.

[160] *Id.*

[161] *See* Estate of Stranahan v. Comm'r, 472 F.2d 867, 871 (6th Cir. 1973) (holding taxpayer realized income at time of sale of rights to future dividends).

[162] Priv. Ltr. Rul. 2001-07-019 (Nov. 16, 2000).

[163] I.R.C. § 6110(k)(3) (2000).

doctrine analysis that is required when a claim is gratuitously assigned.[164] In the ruling, the taxpayer gratuitously assigned a claim[165] for punitive damages to a charitable trust.[166] Subsequent to the assignment, an unspecified amount of punitive damages was paid to the taxpayer, who thereafter transferred the damages to the trust pursuant to the assignment.[167] The issue was whether the assignment of the taxpayer's claim was effective for tax purposes.[168] If so, the taxpayer would not be required to include the punitive damages amount in gross income.[169] Alternatively, if the assignment was ineffective under the assignment of income doctrine, the taxpayer would be required to include the punitive damages amount in gross income and would be entitled to a charitable deduction.[170]

The IRS concluded that the assignment was effective for tax purposes, determining that the claim constituted property, rather than income, for purposes of the assignment of income doctrine.[171]

---

[164] Priv. Ltr. Rul. 2001-07-019 (Nov. 16, 2000).

[165] *Id.* This is a slight simplification of the facts. Because the taxpayer had hired an attorney on a contingency basis, the taxpayer only transferred the non-attorney fee portion of the punitive damages claim to the trust. *Id.* Thus, if the contingent fee agreement provided that the attorney would receive 40% of any recovery, the taxpayer would have transferred the remaining 60% portion of the punitive damages claim to the trust. *Id.*

[166] At the time of the assignment, a judgment for punitive damages had been awarded, but the judgment was on appeal. *Id.* The fact that the claim had ripened into a judgment at the time it was assigned—as opposed to an assignment of a prejudgment claim—was not relevant to the IRS analysis. *Id.* For example, the IRS concluded that "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." *Id.* (emphasis added). The IRS distinction between a transfer of a claim prior to the expiration of appeals and a postappeal transfer is discussed *infra* in note 173.

[167] Priv. Ltr. Rul. 201-07-019 (Nov. 16, 2000).

[168] *Id.*

[169] *Id.*

[170] *Id.* However, the charitable deduction would be subject to the limitations of § 170. *See* I.R.C. § 170 (2000). Although the ruling did not specify whether the trust was a public charity or a private foundation, because the trust was established by the taxpayer, the trust was likely a private foundation. *See* § 170(b)(1)(E). As a result, under § 170(b), the charitable deduction generally would be limited to 30% of the taxpayer's adjusted gross income. *See* § 170(b)(1)(B).

[171] Priv. Ltr. Rul. 2001-07-019 (Nov. 16, 2000). In its analysis of the issue, the IRS did not place any emphasis on the nature of the claim, which arose out of an automobile accident that caused the death of the taxpayer's son. *Id.* One wonders how the IRS would have ruled had the claim in question arisen out of the taxpayer's employment. For example, assume that the claim was for lost wages resulting from the wrongful termination of the taxpayer's employment. Would the IRS have ruled that such claim constitutes "property" or "income"

With regard to the issue of whether the taxpayer transferred the claim itself or merely a right to proceeds, the IRS determined that the assignment was "an effective transfer of a claim in litigation," relying on the fact that under state law the assignment transferred the taxpayer's right, title, and interest in the claim to the charitable trust.[172] As a result, the IRS held that the taxpayer was not required to include the punitive damages amount in gross income.[173]

---

for purposes of the assignment of income doctrine? An argument could be made that all claims should be treated equally for purposes of the assignment of income doctrine regardless of the origin of the claim, since all claims are economically the same in that they all represent a right to income. Under this view, based on the IRS analysis in the ruling, the IRS would hold that even a claim for lost wages constitutes property for purposes of the assignment of income doctrine. *See id.* Alternatively, it can be argued that a right to wages, even one which is disputed, is inherently a "fruit" since it arises directly out of the taxpayer's efforts.

[172] *Id.* The IRS drew a distinction between the taxpayer's transfer to the trust and the taxpayer's purported transfer to her attorney pursuant to a contingent fee agreement. *Id.* While the IRS determined that the taxpayer's transfer to the trust was an effective transfer, the IRS concluded that the contingent fee agreement "did not transfer any interest in the . . . cause of action to [taxpayer's] attorney." *Id.* In support of its conclusion, the IRS cited the terms of the agreement, which the IRS described as a contract of employment, and applicable state attorney lien law, which provided a lien on the proceeds of the plaintiff's recovery rather than on the cause of action itself. *Id.* In addition, the IRS emphasized that at no point could the attorney "exercise dominion and control over [taxpayer's] cause of action." *Id.*

[173] *Id.* However, the IRS determined that, if the taxpayer had transferred the claim after all appeals were exhausted, the taxpayer would be required to include the punitive damages amount in gross income. *Id.* The reasoning behind this determination is not clear from the ruling. The IRS noted that, prior to the exhaustion of the appeals, the "recovery on the transferred claim . . . is doubtful or contingent," and that after appeals are concluded the recovery is "certain." *Id.* The IRS, in distinguishing between a postappeal transfer and a transfer that occurs prior to the exhaustion of appeals, apparently relied on the rule that if property is gratuitously transferred with "ripe fruit" attached, the ripe fruit is taxable to the transferor. *See id.* Alternatively, if the attached fruit is "contingent," then the fruit, if and when it is paid to the transferee, is not taxable to the transferor. For example, it has been held that where a taxpayer gratuitously transfers a bond with accrued interest, the accrued interest generally will be taxable to the transferor when the accrued but unpaid interest is paid to the transferee. Austin v. Comm'r, 161 F.2d 666, 668-69 (6th Cir. 1947). However, if at the time the bond is transferred there is substantial doubt as to whether the accrued interest will be collected, the transferee rather than the transferor will be taxed on the accrued interest if and when it is paid to the transferree. Wellhouse v. Tomlinson, 197 F. Supp. 739, 741-42 (S.D. Fla. 1961). It appears as though the IRS ruling reasons that, if a claim is transferred prior to the exhaustion of all appeals, a tree (the claim) with contingent fruit (the doubtful and uncertain recovery) is transferred; on the other hand, if a claim is transferred postappeal, a tree (the claim) with ripe fruit (the certain recovery) is transferred. Priv. Ltr. Rul. 2001-07-019 (Nov. 16, 2000). As a theoretical matter, the issue of whether contingent fruit or ripe fruit is transferred should be irrelevant since the risk of subverting the progressive rate structure exists in both cases. *See* Lyon & Eustice, *supra* note 108, at 356 (noting that "it is difficult to defend the rule . . . that the donor will escape taxability completely on any accrued but unpaid interest arrearages where there is doubt in the year

In a gratuitous assignment of a claim, this sort of analysis is appropriate because the risk of artificial income-splitting is present. However, in the contingent fee cases, this analysis is unwarranted because any transfer resulting from a contingent fee agreement is an assignment for value in an arm's length transaction where there is no risk of artificial income-splitting.[174] Consequently, in the contingent fee cases, the courts' focus on whether a contingent fee agreement transfers income or property is misplaced. In an assignment for value case, it does not matter whether the taxpayer transfers fruit or tree.

IV. THE CORRECT ANALYSIS OF THE CONTINGENT FEE ARRANGEMENT

Thus far, this Article has argued that the assignment of income doctrine has no relevance to the contingent fee cases.[175] This Part will provide the appropriate analysis of the issue, demonstrating that there are really only two mutually exclusive characterizations

---

of the gift as to the ultimate collectibility of the interest").

Another issue, which was not addressed in the ruling, is whether the taxpayer could have taken a charitable deduction for the contribution of the punitive damages claim. Since the ruling held that the taxpayer transferred property to the charitable trust, a question arises as to whether the taxpayer could take a deduction for the fair market value of such property at the time of the assignment, or whether such a deduction would be limited to the taxpayer's basis in the property, which was zero. *See* Priv. Ltr. Rul. 2001-07-019 (Nov. 16, 2000). The latter result is appropriate for two different reasons. First, § 170(e)(1)(A) provides that, with respect to charitable contributions of appreciated property, the amount of the charitable deduction is limited to the property's basis if, upon a hypothetical sale of the property for its fair market value, all of the gain would have been ordinary income or short-term capital gain. I.R.C. § 170(e)(1)(A) (2000). Had the taxpayer sold the punitive damages claim, all of the gain would constitute ordinary income. *See* Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 264-65 (1958). Accordingly, under § 170(e)(1)(A), the amount of the charitable deduction would be zero. *See* I.R.C. § 170(e)(1)(A). Second, § 170(e)(1)(B)(ii) provides that with respect to charitable contributions of appreciated property to a private foundation, the amount of the charitable deduction is limited to the property's basis. See § 170(e)(1)(B)(ii). Although the ruling does not specify whether the trust was a private foundation as opposed to a public charity, since the taxpayer established the trust, it was likely a private foundation. *See* § 170(b)(1)(E). As a result, under § 170(e)(1)(B)(ii), the amount of the charitable deduction would be zero. *See* § 170(e)(1)(B)(ii).

[174] *See supra* notes 159-60 and accompanying text. Moreover, *P.G. Lake* is not relevant to the contingent fee cases, since the character of the plaintiff's income is not in dispute. *See* Comm'r v. P.G. Lake, 356 U.S. 260, 261 (1958).

[175] *See supra* notes 157-74 and accompanying text.

of a contingent fee arrangement.[176] Either a contingent fee agreement results in a transfer of property *at the time the agreement is executed* or it does not.[177] It is important to emphasize that the term "property" as used in the preceding sentence means property for section 83 purposes, rather than property for purposes of the assignment of income doctrine. Because the assignment of income doctrine does not apply to the contingent fee cases, it does not matter whether the transferred property would constitute fruit or tree for purposes of the assignment of income doctrine.

The issue of whether a contingent fee agreement results in an immediate transfer of property is a difficult one, and the answer is not entirely clear. However, as this Part demonstrates, the issue is entirely academic because the tax consequences are the same regardless of how the issue is ultimately resolved.[178] Under either characterization, the plaintiff must include the full settlement amount in gross income.[179]

A. THE NO IMMEDIATE TRANSFER CHARACTERIZATION

One view of a contingent fee arrangement is that the execution of the fee agreement does not result in an immediate transfer of property. Under this view, the contingent fee agreement is purely executory in that the plaintiff merely promises to pay a contingent amount of money at some point in the future, with the amount of money dependent on the size of any recovery. The tax consequences of this promise are quite simple. The making of the promise, upon execution of the fee agreement, is inconsequential for federal income tax purposes since it is merely a promise to make a future payment.[180] In other words, nothing happens for tax purposes when the contingent fee agreement is executed.

---

[176] *See infra* notes 179-237 and accompanying text.

[177] *See id.*

[178] *See infra* notes 179-255 and accompanying text.

[179] *See id.*

[180] *See* Treas. Reg. § 1.83-3(e) (as amended in 1985) (providing that "unfunded and unsecured promise to pay money or property in the future" does not constitute property for purposes of § 83; accordingly, making of promise by plaintiff and receipt of promise by attorney are inconsequential for tax purposes).

When the case is ultimately settled, the plaintiff must include the full amount of the settlement in gross income[181] and take a miscellaneous itemized deduction for the attorney's fees paid.[182] Furthermore, it does not matter whether the plaintiff or the defendant writes the check to the attorney. Under the famous case of *Old Colony Trust Co. v. Commissioner*,[183] the defendant's satisfaction of the plaintiff's obligation to pay her own attorney is treated as a payment by the defendant to the plaintiff, followed by a payment from the plaintiff to her attorney.[184]

The following example demonstrates the consequences of the no immediate transfer characterization:

> In Year 1, Plaintiff enters into a contingent fee agreement that provides that Plaintiff is obligated to pay Attorney forty percent of the amount of any settlement. In Year 5, the claim is settled. Pursuant to the settlement, the Defendant writes a $1,000,000 check payable to Attorney, who writes a $600,000 check payable to Plaintiff.

Assuming that the contingent fee agreement does not result in an immediate transfer of property, the execution of the agreement in Year 1 is inconsequential for tax purposes. Plaintiff is merely agreeing to make a future contingent payment. When the claim is settled, Plaintiff must include the full $1,000,000 settlement in gross income and will receive a $600,000 miscellaneous itemized deduction.[185] The fact that Defendant wrote the check to the attorney is irrelevant under *Old Colony Trust*, because by making the payment to Attorney, Defendant discharged Plaintiff's obligation to make such a payment.[186]

---

[181] I.R.C. § 61(a) (2000).

[182] I.R.C. §§ 67(b), 162(a) (2000); *see also supra* note 8.

[183] 279 U.S. 716 (1929).

[184] *Id.* at 729-30.

[185] See I.R.C. §§ 61, 67(b) (2000); Alexander v. Comm'r, 72 F.3d 938, 944-47 (holding that employee's legal fees incurred in connection with litigation arising out of employee's employment constitute unreimbursed employee business expenses subject to § 67(b)).

[186] 279 U.S. at 729-30. The tax consequences would be the same even if Defendant wrote two checks, one for $600,000 payable to Plaintiff, and the other for $400,000 payable to

B. THE IMMEDIATE TRANSFER OF PROPERTY CHARACTERIZATION

The alternative view of the contingent fee agreement is that the execution of the agreement results in an immediate transfer of property under section 83. As explained below, section 83 would require the plaintiff to include the full amount of the settlement, including the attorney fee portion, in her gross income.[187]

Section 83 applies to all transactions in which property is transferred in connection with the performance of services.[188] Since it is clear that attorneys and clients enter into contingent fee agreements in connection with the performance of services, the key issue in determining the applicability of section 83 is whether such agreements result in a transfer of property. The regulations under section 83 define the terms "transfer" and "property."[189]

The regulations state that "a transfer . . . occurs when a person acquires a beneficial ownership interest in . . . property."[190] In determining whether a transfer occurs, the regulations provide that any risk that the transferee may subsequently forfeit the property is disregarded.[191] For example, if ABC, Inc. transfers 100 shares of its stock to an employee, a transfer occurs even if the employee is obligated to return the stock if he leaves the company prior to the expiration of a specified period of time.[192]

Attorney. *See id.*

[187] *See infra* notes 238-55 and accompanying text.

[188] I.R.C. § 83(a) (2000). If property is transferred in connection with the performance of services, § 83 applies regardless of whether the services are performed in an employee or independent contractor capacity. Treas. Reg. § 1.83-1(a)(1) (1978). For a discussion of the history and background of § 83, see 3 BITTKER & LOKKEN, *supra* note 54, ¶ 60.4.1; Ronald Hindin, *Internal Revenue Code Section 83 Restricted Stock Plans*, 59 CORNELL L. REV. 298 (1974).

[189] Treas. Reg. § 1.83-3(a) (as amended in 1985) (defining transfer); Treas. Reg. § 1.83-3(e) (as amended in 1985) (defining property).

[190] Treas. Reg. § 1.83-3(a)(1) (as amended in 1985).

[191] *Id.* In general, any restriction, other than a restriction which by its terms will never lapse, on the transferee's full enjoyment of the property is disregarded in determining whether a transfer occurs. *Id.* As discussed in Part IV.B.*4*, under the immediate transfer of property characterization, the property that the attorney receives is subject to a substantial risk of forfeiture which lapses upon final disposition of the plaintiff's case. *See infra* notes 238-43 and accompanying text. Accordingly, under Treas. Reg. § 1.83-3(a), this risk of forfeiture is disregarded in determining whether a transfer occurs under § 83 when the contingent fee agreement is executed. Treas. Reg. § 1.83-3(a)(1).

[192] *See* Treas. Reg. § 1.83-3(a)(1). Because the risk of forfeiture lapses after the specified

The section 83 regulations broadly define the term "property" to include "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."[193] Case law and IRS rulings have affirmed this broad definition of property.[194]

In determining whether section 83 applies to the contingent fee arrangement, the decisive issue is whether the fee agreement results in a transfer of property for purposes of section 83. The following two alternative property interests might be transferred immediately upon execution of the contingent fee agreement: (1) a portion of the claim might be transferred, or (2) a right to the proceeds from a portion of the claim might be transferred. In either case, the property interest that is transferred would constitute property for section 83 purposes, as discussed below.[195]

1. Is a Claim Property Under Section 83? The discussion in this subsection assumes that a contingent fee agreement results in a transfer of a portion of the claim to the attorney at the time the agreement is executed.[196] Whether section 83 applies to such a transfer depends on whether a claim is considered property under section 83. Under the broad regulatory definition of property, a claim, or a portion of a claim, is considered property unless it is classified as an unfunded and unsecured promise to pay money in the future.[197]

A claim does not appear to constitute a mere promise to pay money in the future. However, one might argue that a claim is

---

period of time, the risk is disregarded in determining whether a transfer occurs when ABC, Inc. furnishes the stock to the employee. *Id.*

[193] Treas. Reg. § 1.83-3(e) (as amended in 1985).

[194] *See, e.g.*, Theophilos v. Comm'r, 85 F.3d 440, 445 (9th Cir. 1996) (holding that binding contract to purchase stock is property for § 83 purposes); Mark IV Pictures, Inc. v. Comm'r, 969 F.2d 669, 673 (8th Cir. 1992) (holding that capital interest in partnership is property for § 83 purposes); Campbell v. Comm'r, 943 F.2d 815, 818-21 (8th Cir. 1991) (holding that profits interest in partnership is property for § 83 purposes); Montelepre Systemed, Inc. v. Comm'r, 61 T.C.M. (CCH) 1782, 1786 (1991), *aff'd*, 956 F.2d 496 (5th Cir. 1992) (holding that right of first refusal is property for § 83 purposes); Rev. Rul. 83-46, 1983-1 C.B. 16, 17 (ruling that overriding royalty interest in oil and gas is property for § 83 purposes).

[195] *See infra* notes 196-210 and accompanying text (analyzing whether these property interests constitute property for § 83 purposes).

[196] *See infra* notes 211-37 and accompanying text (considering issue of whether transfer, as that term is used in section 83, occurs upon execution of contingent fee agreement).

[197] See Treas. Reg. § 1.83-3(e), *supra* notes 193-94 and accompanying text.

sufficiently similar to a promise to pay money and that it should be treated as such. For example, a valid claim for damages in the amount of $1,000,000 is similar to a promise by the defendant to the plaintiff to pay such an amount. On its face, it appears this argument (that a claim is sufficiently analogous to a promise to pay, if it prevails) would remove a claim from the broad definition of property for section 83 purposes, since such a claim is clearly unfunded and unsecured.[198] However, an unstated premise of the regulatory definition of property is that, in order for a promise to pay to fall outside the definition of property, the service recipient must make the promise directly to the service provider.[199] In other words, the promise to pay must be a second party promise; it cannot be made by a third party.

The origin of the promise to pay exception in the section 83 regulations is the well-established principle of tax law that, for purposes of the cash method of accounting, the receipt of an account receivable, or of a debt instrument evidencing an account receivable, is not treated as a receipt of property.[200] As a result, such a receipt generally does not result in the realization of income by the cash method taxpayer. The following example is illustrative:

---

[198] *See* Childs v. Comm'r, 103 T.C. 634, 649-54 (1994) (setting forth conditions that must be satisfied in order for promise to pay to be treated as "funded" or "secured"). Because a plaintiff holding a valid claim is a general unsecured creditor of the defendant, the claim is both unsecured and unfunded. *See id.* at 651.

[199] *See* Rev. Rul. 77-420, 1977-2 C.B. 172 (ruling that where physician receives unfunded and unsecured promise to pay from health insurer as compensation for services rendered to patient, physician is taxed on fair market value of third party promise); Rev. Rul. 69-50, 1969-1 C.B. 140 (same); *see also* JOSEPH DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 748 n.3 (2d ed. 1999) (stating that third party promise is property for purposes of § 83 even if such promise is unfunded and unsecured).

[200] *See* BITTKER & LOKKEN, *supra* note 54, ¶ 60.4.2 (stating that "the exclusion of unfunded and unsecured promises [in the § 83 regulations] preserves the long-standing principle that these commitments are not taxed" when made to employees and contractors using cash method of accounting). However, the doctrines of cash equivalency and constructive receipt may override this principle in certain circumstances. *See* BITTKER ET AL., *supra* note 75, ¶ 39.02(2), at 39-17 to 39-18 (discussing cash equivalency doctrine); *id.* ¶ 39.02(3), at 39-19 to 39-26 (discussing constructive receipt doctrine). The discussion below assumes that these doctrines are not relevant. *See infra* notes 202-04 and accompanying text. For the purposes of this example, and all examples that follow, it is assumed that all taxpayers use the cash method of accounting.

> A provides services in Year 1 to B, who agrees to pay A $1,000. B later makes full payment in Year 2. A does not have income in Year 1 when he receives B's promise to pay. Rather, A realizes income in Year 2 when he is actually paid cash.[201] The result does not change even if, in Year 1, B gives A a promissory note evidencing his obligation to pay.

The purpose of this principle is to prevent the blurring of the cash method of accounting, pursuant to which a taxpayer generally realizes income upon the receipt of payment, with the accrual method of accounting, pursuant to which a taxpayer generally realizes income when it is earned regardless of the date of payment.[202]

If the receipt of an account receivable triggered taxation for cash method taxpayers, it would effectively put all taxpayers on the accrual method with respect to income items. Since the receivable is created upon the performance of services, both cash method and accrual method taxpayers would be taxed at same time—when services are performed. To prevent this blurring, the cash method of accounting essentially ignores the receipt of an account receivable or debt instrument evidencing such a receivable.[203]

---

[201] *See* Rev. Rul. 60-31, 1960-1 C.B. 174, 177-78.

[202] *See* BITTKER & LOKKEN, *supra* note 54, ¶ 105.3.2:

> The basic difference between cash and accrual accounting is that the latter requires accounts receivable and similar claims to be reported when they arise from a credit transaction. The difference would be obliterated if cash basis taxpayers were required to treat all claims against employers, clients, and customers as "property," to be valued and taken into income when the services are rendered, rather than when the claims are paid.

Id.

[203] The notion that the receipt of a second party promise to pay does not result in income is the backbone of traditional nonqualified deferred compensation arrangements. *See* Rev. Rul. 60-31, 1960-1 C.B. 174 (concluding that deferred compensation arrangement, pursuant to which employee receives unfunded and unsecured right to future cash payments, is generally taxable to cash method employee when cash is paid, not when right is earned); BITTKER & LOKKEN, *supra* note 54, ¶ 60.2.1 (noting that "[a] basic presupposition of Revenue Ruling 60-31 is that until payment the employees were only general creditors of the employer"). For example, if a service provider agrees, prior to Year 1, to defer his Year 1 wages until Year 2, the service provider will be taxed on the wages in Year 2 upon receipt of the wages, even though the right to the wages is earned in Year 1. *See* Rev. Rul. 60-31, 1960-

However, the concern over the potential blurring of the two methods of accounting is not present when a third party promise is received. In that case, the service provider does not receive a mere account receivable but rather receives a right to payment from a third party. As an example:

> Instead of giving A (the service provider) his own promise to pay, B (the service recipient) gives A an obligation of C to pay $1,000. In this case, the obligation of C is not an obligation of the recipient of services, but rather an obligation of a third party. As a result, treating C's obligation as property will not blur the lines between the cash and accrual method because C's obligation is not a mere account receivable. Therefore, A is taxed when he receives C's obligation.[204]

The purpose of the promise to pay exception to the definition of property in the section 83 regulations is to ensure consistency with the principle that the receipt by a cash method service provider of an account receivable is inconsequential for tax purposes.[205] Even

---

1 C.B. 174.

[204] *See* Rev. Rul. 77-420, 1977-2 C.B. 172 (ruling that where physician receives unfunded and unsecured promise to pay from health insurer as compensation for services rendered to patient, physician is taxed on fair market value of third party promise); Rev. Rul. 69-50, 1969-1 C.B. 140; *see also* JOSEPH DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 748 n.3 (2d ed. 1999) (stating that third party promise is property for purposes of § 83 even if such promise is unfunded and unsecured).

[205] *See* BITTKER & LOKKEN, *supra* note 54, ¶ 60.2.1;

> A jurisdictional conflict potentially exists between the general principles governing the tax status of compensation and section 83, which provides that property transferred in connection with the performance of services is taxed to the services performer as soon as it is free of substantial risk of forfeiture. The regulations under section 83 largely avoid this conflict by defining "property" to exclude "an unfunded and unsecured promise to pay money in the future."

Id.; *see also* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 5.02(1) n.20, at 5-6 (3d ed. 1997 & Supp. 2002):

> It seems clear that unfunded and unsecured rights to future payment were excluded from the section 83 definition of "property" to prevent section 83 from swallowing the cash method of accounting and thereby subjecting traditional nonqualified deferred compensation arrangements to immediate taxation. As broadly applicable as it is, section 83 was not intended to supplant the substantial body of law governing deferred

though the regulation does not explicitly require that the promise to pay be made by the service recipient rather than a third party, in order for the promise to be outside of the definition of property, it is clear that such a requirement exists.[206]

---

compensation arrangements.

Id. (citation omitted).

[206] Unfortunately, the Tax Court failed to appreciate the origin of the promise to pay exception in *Childs v. Commissioner*, 103 T.C. 634, 649-54 (1994). In that case, the plaintiff, who had previously entered into a contingent fee agreement with her attorney, settled a personal injury lawsuit with the defendant. *Id.* at 637-42. Pursuant to the settlement agreement, the defendant was obligated to make periodic payments to the plaintiff, and the plaintiff's attorney agreed to accept periodic payments from the defendant as his fee. *Id.* at 641-42. At issue was whether the attorney recognized income in the year of the settlement, when he received the defendant's promise to make periodic payments, or whether he recognized income as the payments were received. *Id.* at 647-48.

The following example provides a simplified version of the *Childs* facts and the issue involved:

> Plaintiff enters into a contingent fee agreement pursuant to which she will pay Attorney 40% of any recovery resulting from a personal injury claim. In Year 1, Plaintiff agrees to accept a structured settlement in which she will receive annual payments from Defendant of $60,000 for 10 years, with payments beginning in Year 2. In addition, Attorney will receive as his fee annual payments from Defendant of $40,000 for 10 years, with payments beginning in Year 2.

The issue in *Childs* was whether Attorney must include in his Year 1 income the fair market value of Defendant's obligation to pay him $40,000 a year for 10 years, or whether Attorney could include the payments in Years 2 through 11 as they were received. *See id.* at 636. The resolution of that issue depended on whether Defendant's obligation to pay money to Attorney in the future constituted property for § 83 purposes. *See id.* at 648-49. This in turn depended on whether Defendant's obligation constituted an unfunded and unsecured promise to pay. *See id.* at 649-51. If so, the Defendant's obligation did not constitute property, and Attorney would include the periodic payments in income as he received them in Years 2 through 11. *See id.* at 649. If not, the Defendant's obligation constituted property, and Attorney would include the fair market value of the obligation in Year 1. *See id.*

The Tax Court should have found that the obligation did constitute property because the obligation to pay was a third party promise rather than a second party promise. *See* Gordon T. Butler, *Economic Benefit: Formulating a Workable Theory of Income Recognition*, 27 SETON HALL L. REV. 70, 119-20 (1996) (arguing *Childs* is erroneous because court failed to recognize that obligation in question was third party promise). In substance, Defendant agreed to make $100,000 annual payments to Plaintiff who then transferred 40% of that obligation to Attorney. The fact that, as a formal matter, Defendant will write two checks every year (one to Plaintiff and one to Attorney) is irrelevant. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929). Thus, Attorney did not receive a promise to pay made by the recipient of his services, but rather received a promise to pay made by a third party. Because the Attorney received a third party promise, the Attorney should be taxed on the fair market value of Defendant's obligation in Year 1.

However, the *Childs* court ruled otherwise, determining that Defendant's obligation constituted an unfunded and unsecured promise to pay. *See Childs*, 103 T.C. at 651-53. As a result, the Tax Court erroneously concluded that Attorney could include the payments in

Applying this principle to the contingent fee arrangement, even if a claim is analogous to a promise to pay, it is still property for section 83 purposes. If the plaintiff transfers a portion of the claim to her attorney, she transfers to the attorney a portion of the *defendant's* promise to pay. The plaintiff is not transferring her own promise to pay, which would be excluded from the definition of property. As such, if a contingent fee agreement transfers a portion of the plaintiff's claim to the attorney, the agreement results in a transfer of property for purposes of section 83.

2. Is a Right to Proceeds from a Claim Property Under Section 83? This subsection assumes that the execution of a contingent fee agreement results in an immediate "transfer," as the term is used in section 83,[207] of a right to the proceeds from a portion of the claim to the attorney, rather than a portion of the claim itself.[208] The issue then arises whether such a right to proceeds constitutes property under section 83.

The analysis here is essentially the same as the analysis in the preceding subsection.[209] The right to proceeds does not appear to be a mere promise to pay, but the same argument can be made that a right to proceeds is similar to a promise to pay. For example, the

---

income as they were received. *See id.* at 653. The Tax Court was led astray by the IRS, which apparently never argued the issue of the second party promise versus the third party promise. Instead the IRS focused on the issue of whether Defendant's promise was "secured" or "funded," which was wholly irrelevant, since Defendant's third party promise constituted property even if it was neither secured nor funded. See Butler, *supra*, at 119-20. As a result of this confusion, the Tax Court never focused on the critical fact that Defendant's promise to pay was actually a third party promise, which always constitutes property for § 83 purposes. *See* Rev. Rul. 77-420, 1977-2 C.B. 172 (ruling that where physician receives unfunded and unsecured promise to pay from health insurer as compensation for services rendered to patient, physician is taxed on fair market value of third party promise); Rev. Rul. 69-50, 1969-1 C.B. 140 (same); *see also* DODGE ET AL., *supra* note 199 (stating that third party promise is property for purposes of § 83 even if such promise is unfunded and unsecured).

[207] *See* I.R.C. § 83 (2000); *see also infra* notes 211-37 and accompanying text (discussing issue of whether "transfer," as that term is used in § 83, occurs upon execution of contingent fee agreement).

[208] The distinction between the "no immediate transfer of property" characterization and the "immediate transfer of a right to proceeds" characterization is subtle. Under the former characterization, a contingent fee agreement is entirely executory in that the plaintiff does not perform her obligation until she pays her attorney out of the settlement proceeds. Under the latter characterization, the agreement is no longer entirely executory in that the plaintiff immediately performs her obligation by transferring to her attorney a right to the proceeds of a portion of the claim at the time the fee agreement is executed.

[209] *See supra* notes 196-206 and accompanying text.

plaintiff's transfer of a right to receive $1,000,000 of proceeds from a claim is analogous to the plaintiff's transfer of the defendant's promise to pay the $1,000,000. However, since the defendant's promise to pay is a third-party promise, rather than a second-party promise, the promise should be treated as property for section 83 purposes.[210] Thus, a right to the proceeds from a claim is property.

3. Is There an Immediate Transfer Upon Execution of the Contingent Fee Agreement? Having already concluded that a claim, or a right to proceeds, constitutes property when transferred from plaintiff to attorney, the analysis shifts to whether such a transfer, as that term is used in section 83, occurs at the time a contingent fee agreement is executed. In order for such a transfer to occur, the attorney must acquire, at the time the contingent fee agreement is executed, either an ownership interest in the attorney fee portion of the claim or the right to the proceeds from the attorney fee portion.[211]

a. Is There an Immediate Transfer of a Portion of the Claim? This subsection analyzes whether, upon execution of the contingent fee agreement, the plaintiff should be treated as transferring a portion of the claim to her attorney, which was the precise issue that was the focus of the courts in the contingent fee cases.[212] The property transfer cases determined that such a transfer occurred, while the assignment of income cases concluded otherwise.[213]

The proper resolution of this issue depends on which taxpayer, the attorney or the plaintiff, owns the attorney fee portion of the claim after a contingent fee agreement is executed. A transfer will be deemed to occur only if the attorney is considered the owner of

---

[210] *See supra* notes 199-206 and accompanying text (discussing whether claim is property under § 83 and concluding that it is if contingent fee agreement transfers portion of plaintiff's claim to attorney).

[211] Treas. Reg. § 1.83-3(a)(1) (as amended in 1985). For this purpose, any risk that the attorney might have to forfeit the claim or the right to proceeds in the future is disregarded. *Id.* As discussed *infra* notes 239-43 and accompanying text, because the attorney forfeits any right to compensation if he withdraws from the case prior to final disposition, the property interest that the attorney receives under the "immediate transfer of property" characterization is subject to a risk of forfeiture. However, in determining whether a transfer occurs under § 83(a), this risk of forfeiture is entirely disregarded. Treas. Reg. § 1.83-3(a)(1); *see also* I.R.C. § 83(a) (2000).

[212] *See supra* notes 81-99 and accompanying text.

[213] *See id.*

that property for tax purposes.[214]

The issue of ownership for tax purposes is a common one.[215] In general, the resolution depends on all of the facts and circumstances surrounding the ownership of the property, commonly referred to as "the incidents of ownership."[216] In the context of determining ownership of a claim, or a portion thereof, the relevant incidents of ownership are which taxpayer (1) has legal title of the claim, (2) controls the claim, (3) would receive the benefit of future appreciation of the claim, and (4) bears the risk of loss with respect to the claim.[217]

---

[214] See Treas. Reg. § 1.83-3(a) (providing that transfer of property occurs when taxpayer "acquires beneficial ownership intent in such property").

[215] *See generally* Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981); Hilton v. Comm'r, 74 T.C. 305 (1980); Decon Corp. v. Comm'r, 65 T.C. 829 (1976); Clinton Park Dev. Co. v. Comm'r, 11 T.C.M. (CCH) 768 (1952); Rev. Rul. 54-607, 1954-2 C.B. 177; Sager & Cohen, *supra* note 8; *see also* Richard E. Marsh, Jr., *Tax Ownership of Real Estate*, 39 TAX LAW. 563, 563 (1986) ("The threshold question in the taxation of real estate is the question of ownership.").

[216] *See Grodt & McKay Realty*, 77 T.C. at 1237 (analyzing facts and circumstances to determine whether transfer of property occurred for tax purposes).

[217] *See id.* at 1237-38 (discussing factors considered in determining whether transfer of property occurred for tax purposes). At issue in *Grodt & McKay* was the identity of the owner of cattle for tax purposes. *Id.* at 1236. In particular, the Tax Court analyzed whether a transfer of the cattle occurred for tax purposes. *Id.* at 1221. The resolution of this issue depended on whether the purported seller or buyer was the owner of the cattle for tax purposes after the transaction. *Id.* at 1237. The Tax Court listed the following factors:

> (1) Whether legal title passes; (2) how the parties treat the transaction [*i.e.*, as a sale or a loan]; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

Id. at 1237-38 (citations omitted). In the context of determining ownership of a claim, factors 2, 3, 4, and 6 are not applicable. With regard to the fifth factor, although a claim cannot be "possessed," this factor is properly viewed as a control criterion because the party who possesses the cattle controls the important decisions to be made with respect to the cattle. *Id.* at 1241. In analyzing the fifth factor, the Tax Court stated:

> Additionally, the agreements are clear that petitioners have no right to possess the cattle or *to exercise any real control or dominion over them.* Cattle Co. has complete control over the sale of animals, the sales price, retention of progeny, the incorporation of progeny into the breeding herds, the culling and replacing of herd animals, and the location, maintenance, expansion, and breeding (including artificial insemination) of the herds. Petitioners' only rights with respect to the *possession, control, or dominion* of the herds are extremely limited and, as a practical matter, valueless.

These incidents of ownership with respect to the attorney fee portion of a claim are divided between the plaintiff and the attorney. While the attorney will receive the benefit of a large award and bear the burden of a defense verdict with respect to that portion of the claim, the plaintiff retains legal title to the entire claim and controls the entire claim, making the important decisions of whether and when to settle the claim. Because the incidents of ownership are divided, the issue of who owns the attorney fee portion of the claim after the contingent fee agreement is a difficult one, with no definitive answer. As a result, it is unclear whether a contingent fee agreement should be treated as transferring a portion of the claim from the plaintiff to the attorney.[218]

b. Is There an Immediate Transfer of a Right to Proceeds from the Claim? Assuming that the plaintiff retains the attorney fee portion of the claim even after execution of a contingent fee agreement, an issue arises as to whether the execution of the agreement results in an immediate transfer to the attorney of the right to the proceeds from the attorney fee portion of the claim. In this regard, Revenue Ruling 83-46, which deals with the receipt of overriding royalty interests in oil and gas properties by service providers, is analogous.[219] Because Revenue Ruling 83-46 uses terminology unique to oil and gas law,[220] a brief and general explanation of this terminology is in order.

Id. (emphasis added).

[218] The circuit court split on the issue of whether a contingent fee agreement transfers a portion of the claim to the attorney is evidence of this lack of clarity. Three circuit courts have held that such a transfer occurs. *See supra* note 6 (listing decisions of Fifth, Sixth, and Eleventh Circuits). Eight circuit courts, and the Tax Court, have held otherwise. *See supra* notes 4-5 (listing decisions of First, Third, Fourth, Seventh, Eighth, Ninth, Tenth, and Federal Circuits, as well as Tax Court). Fortunately, the resolution of this issue is not really important. Whether the contingent fee agreement results in an immediate transfer of a portion of the claim, or an immediate transfer of a right to the proceeds from a portion of the claim, or even no immediate transfer whatsoever, the tax consequences are identical in that the plaintiff must include the full settlement amount in gross income. *See supra* notes 180-86 and accompanying text (demonstrating that under no immediate transfer of property characterization, plaintiff must include full settlement amount in gross income); *infra* notes 238-55 and accompanying text (demonstrating that under immediate transfer characterization, plaintiff must include full settlement amount in gross income).

[219] Rev. Rul. 83-46, 1983-1 C.B. 16.

[220] *Id.*

Typically, the owner of land where oil and gas might be captured will enter into an oil and gas lease with a lessee-developer who will undertake the exploration, development, and production of oil and gas.[221] The developer's interest under such a lease is referred to as a working interest.[222] The working interest entitles the developer to all of the oil and gas produced on the land during the lease term, subject to any royalty interests retained by the landowner.[223] A landowner's royalty generally entitles the landowner to a specified percentage of gross production—in other words, a percentage of the gas or oil captured by the lessee without diminution for expenses—during the lease term.[224] In addition to a landowner's royalty interest, the developer often will carve out of the working interest overriding royalty interests and transfer these interests in exchange for cash, property, or services.[225] These overriding royalty interests are economically identical to a landowner's royalty in that they entitle the owner to a specified percentage of gross production.[226]

For example, Landowner might enter into an oil and gas lease with Developer under which Developer will be entitled to enter Landowner's property for the purposes of exploring, developing, and producing oil and gas. During the term of the oil and gas lease, Landowner will be entitled to 1/8 of all of the gross production, and

---

[221] Patrick L. O'Daniel, Note, *Muddy Waters in the Pool of Capital:* ZuHone *and the Abolition of the Doctrine*, 70 TEX. L. REV. 243, 248-49 (1991).

[222] *Id.* at 249.

[223] *See* HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 281 (1957) (defining term "working interest").

[224] O'Daniel, *supra* note 221, at 248-49. In addition to receiving a landowner's royalty, the landowner might receive a lump sum payment of cash—a bonus—in consideration for executing the oil and gas lease. *Id.*; *see also* WILLIAMS & MEYERS, *supra* note 223, at 19 (defining term "bonus").

[225] *See* WILLIAMS & MEYERS, *supra* note 223, at 173-74 (defining term "overriding royalty"). In addition to overriding royalty interests, the developer may carve other interests out of the working interest, such as production payments, net profits interests, and carried interests, and then transfer in exchange for cash, property, or services. *See* J. DZIENKOWSKI & R. PERONI, NATURAL RESOURCES TAXATION: PRINCIPLES AND POLICIES 435-36, 471, 509-10 (1988) (discussing production payments, net profits interest, and carried interests). Furthermore, it is not uncommon for the owner of a working interest to enter into a "farm out agreement" in which the owner assigns the working interest, or a portion of it, to another developer. O'Daniel, *supra* note 221, at 250; *see also* WILLIAMS & MEYERS, *supra* note 223, at 93 (defining term "farm out agreement").

[226] *See* WILLIAMS & MEYERS, *supra* note 223, at 134 (defining term "landowner royalty").

Developer will be entitled to all of the remaining production. Developer then assigns an overriding royalty interest to a geologist for services rendered. This overriding royalty interest entitles the geologist to 1/16 of all of the gross production to which the developer is entitled during the lease term. Thus, the overriding royalty interest entitles the geologist to 1/16 of 7/8, or 7/128 (5.4688%), of the gross production. Therefore, if the land produces $1,000,000 worth of oil and gas during the lease term, 1/8 (or $125,000) will go to Landowner, 7/128 (or $54,688) will go to the geologist, and the remainder ($820,312) is retained by Developer.

Revenue Ruling 83-46 dealt with the tax consequences that arise when a taxpayer receives an overriding royalty interest in exchange for services.[227] In particular, Revenue Ruling 83-46 analyzed whether the receipt of an overriding royalty interest by a service provider triggered immediate taxation on the fair market value of the royalty interest, or whether the service provider would be taxed only when he actually received the oil and gas proceeds.[228] In the above context involving the geologist, the issue was whether the geologist would be taxed upon receipt of the 1/16 overriding royalty interest, or whether he would be taxed only when he received the $54,688 of proceeds.[229] The resolution of this issue depended on whether the assignment of an overriding royalty interest constituted such a "transfer of property" for purposes of section 83.[230] Without any discussion, the IRS concluded that the assignment of an overriding royalty interest constituted a transfer of property.[231] Therefore, pursuant to section 83(a), a service provider who receives an overriding royalty interest is required to include the fair market value of the interest in his gross income in the year he receives the interest.[232]

---

[227] Rev. Rul. 83-46, 1983-1 C.B. 17.

[228] *Id.*

[229] *See id.*

[230] *Id.*

[231] *Id.*

[232] *Id.*; *see also* I.R.C. § 83(a) (2000); Zuhone v. Comm'r, 883 F.2d 1317, 1323 (7th Cir. 1989). *But see* G.C.M. 22,730 (originating "pool of capital" doctrine which would allow service provider who receives overriding royalty interest to avoid tax in year of receipt); *see also* *Zuhone*, 883 F.2d at 1319-23 (discussing pool of capital doctrine and its doubtful continuing viability in light of Revenue Ruling 83-46).

The issue in Revenue Ruling 83-46 is a close call, with no clearly correct result. The IRS could very easily have determined that the assignment of an overriding royalty interest constituted a mere promise by the developer to pay a specified fraction of production to the service provider in the future. Under this analysis, the receipt of the overriding royalty interest would have no tax consequences, and the service provider would be taxed only when he received the oil and gas proceeds.[233] The IRS, however, determined otherwise, concluding that the assignment of an overriding royalty interest was a transfer of property for purposes of section 83.[234]

The assignment of an overriding royalty interest by a developer to a service provider is analogous to a contingent fee arrangement.[235] In the oil and gas context, the developer, in exchange for services, forgoes a specified percentage of the proceeds from his property while retaining ownership and control of the underlying property. In the contingent fee context, the plaintiff, in exchange for services, forgoes a specified percentage of the proceeds recovered in litigation while retaining ownership and control of the underlying property.

Therefore, Revenue Ruling 83-46 supports the conclusion that the execution of the contingent fee agreement, like the execution of an assignment of an overriding royalty interest in exchange for services, results in an immediate transfer of a right to proceeds from a portion of the plaintiff's claim which is subject to section 83.[236]

---

[233] *See* Treas. Reg. § 1.83-3(e) (as amended in 1985) (providing that unfunded and unsecured promise to pay money or property in future is not "property" for purposes of § 83). If the execution of the assignment of an overriding royalty interest is viewed as the making of a mere promise by the developer to make a future payment, then the assignment would not result in a transfer of property for purposes of § 83. *Id.* In such a case, there would be no tax consequences to either party until the payment was actually made. *Id.*

[234] *Id.*

[235] This assumes that the execution of the contingent fee agreement does not result in an immediate transfer to the attorney of a portion of the plaintiff's claim. In other words, this assumes that the plaintiff retains ownership of the claim after the contingent fee agreement is executed.

[236] *See* I.R.C. § 83 (2000); Rev. Rul. 83-46, 1983-1 C.B. 17. The issue of whether the execution of a contingent fee agreement results in an immediate transfer of a right to the proceeds from the attorney fee portion of the claim, or whether the agreement is purely executory (*i.e.*, because the plaintiff merely promises to make a payment in the future), is particularly difficult because the economic substance of both transactions is the same. The issue, however, is immaterial since the ultimate tax consequences are the same under either characterization. In either event, the plaintiff would be required to include the full settlement amount in gross income. *See supra* notes 180-86 and accompanying text

The following section of this Article demonstrates that section 83 would require the plaintiff to include the entire settlement amount—including the attorney's fee portion—in gross income, which is the same result as under the no immediate transfer characterization.[237]

4. Application of the Operative Provisions of Section 83 to the Contingent Fee Arrangement. Assuming that the execution of the contingent fee agreement results in an immediate transfer of property (either the attorney's fee portion of the claim or the right to the proceeds from such portion) section 83 applies to the transfer. Section 83 provides that, in cases where property is transferred subject to a substantial risk of forfeiture, the transfer is disregarded for tax purposes until the substantial risk of forfeiture lapses.[238]

A substantial risk of forfeiture exists when a "person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."[239] For example, assume that an employee receives shares of stock subject to the obligation that he return the shares if his employment is terminated prior to a specified date. The employee's full enjoyment of the property is conditioned on the future performance of services; as a result, a substantial risk of forfeiture exists until the stock "vests" on the specified date.[240]

Assuming that the contingent fee agreement results in an immediate transfer of property, is the property transferred subject to a substantial risk of forfeiture? The answer is yes. The general rule is that regardless of the specific language of the contingent fee agreement, an attorney forfeits any right to a fee if the attorney

(demonstrating that under no immediate transfer of property characterization, plaintiff must include entire settlement in gross income); *infra* notes 238-55 and accompanying text (demonstrating that under immediate transfer of property characterization, plaintiff must include entire settlement in gross income).

[237] *See supra* notes 179-86 and accompanying text.

[238] I.R.C. § 83(a) (2000); *see also* Treas. Reg. § 1.83-1(a) (1978) ("Until [the] property becomes substantially vested, the transferor shall be regarded as the owner of such property."). If, however, the transferee of property transferred subject to a substantial risk of forfeiture makes an election under § 83(b), the risk of forfeiture is ignored and the transfer is given immediate tax effect. Treas. Reg. § 1.83-2(a) (1978). None of the contingent fee cases indicate that the attorney made a § 83(b) election.

[239] I.R.C. § 83(c)(1) (2000).

[240] *See id.*

withdraws from the case or is discharged for cause prior to final disposition of the matter.[241] Thus, in order for the attorney to receive the full benefits of his ownership of the attorney fee portion of the claim, the attorney must provide legal services until the property "vests" upon final disposition of the case.[242] Otherwise, the attorney loses the benefit of the transferred property in that his right to the agreed-upon percentage of the claim is forfeited. As a result, the attorney's receipt of property upon execution of a contingent fee agreement is subject to a substantial risk of forfeiture until final disposition of the case.[243]

Because of this substantial risk of forfeiture, the transfer of the attorney fee portion of the claim is disregarded for tax purposes until the risk lapses.[244] This lapse occurs upon final disposition of

---

[241] F.B. MACKINNON, CONTINGENT FEES FOR LEGAL SERVICES 77-80 (1964); CHARLES W. WOLFMAN, MODERN LEGAL ETHICS 556 (1986). Even if an attorney withdraws for cause or is discharged without cause, the majority rule is that the attorney may recover only the reasonable value of his services under the doctrine of *quantum meruit*, rather than the specified percentage of the settlement. MACKINNON, *supra* at 79. Furthermore, the attorney may not recover more under *quantum meruit* than the specified percentage. *Id.* This potential *quantum meruit* recovery does not undermine the conclusion that the attorney receives his property subject to a substantial risk of forfeiture. The contingent fee arrangement is similar to a restricted stock grant where the employee must return the stock if prior to a specified period he leaves employment voluntarily or is terminated with cause, but the employee is entitled to retain the stock if during the specified period he leaves employment for cause or is terminated without cause. In such a restricted stock grant, it is clear that a substantial risk of forfeiture exists. *See, e.g.*, Alves v. Comm'r, 79 T.C. 864, 867-72 (1982) (stating stock was subject to substantial risk of forfeiture where taxpayer received stock from his employer subject to obligation that he resell stock to employer at ten cents per share if, prior to expiration of specified period, taxpayer voluntarily left employment or was terminated for cause).

[242] The same analysis applies if the plaintiff is deemed to transfer, at the time the contingent fee agreement is executed, a right to the proceeds from the attorney fee portion of the claim, as opposed to the attorney fee portion of the claim itself. The right to proceeds would "vest" upon final disposition. Therefore, a substantial risk of forfeiture exists prior to final disposition. Because the analysis in this subsection is the same regardless of whether the attorney is treated as receiving a portion of the claim or a right to the proceeds from a portion of the claim upon execution of the contingent fee agreement, the discussion assumes that the attorney receives a portion of the claim itself.

[243] *See* Gregg D. Polsky, *Taxing Contingent Attorneys' Fees: Many Courts are Getting it Wrong*, 89 TAX NOTES 917, 920 (2000).

[244] *See* I.R.C. § 83(a) (2000); Treas. Reg. § 1.83-1(a) (1978). The discussion in this section assumes that the attorney does not make a § 83(b) election. None of the contingent fee cases indicate that the attorney made such an election. Because an attorney would never gain from making a § 83(b) election, and because the election exposes the attorney to a significant amount of risk, an attorney would not ordinarily make such an election. *See* Polsky, *supra* note 243, at 920 n.32 (stating attorney should not make § 83(b) election because he receives

the case, at which time the transfer takes effect for tax purposes. At that time, the attorney must include the fair market value of the attorney fee portion of the claim in his gross income.[245]

In addition, upon final disposition of the case, since the plaintiff transfers property—the attorney fee portion of the claim—with a basis of zero in exchange for services, the plaintiff realizes income in an amount equal to the fair market value of such property determined as of the date of the final disposition[246] and receives a miscellaneous itemized deduction for this amount.[247] Furthermore, the plaintiff must include in gross income the amount of the settlement that she actually receives.[248] As the following example demonstrates, the tax consequences to all parties are the same as under the "no immediate transfer" characterization:

> In Year 1, Plaintiff and Attorney execute a contingent fee agreement pursuant to which forty percent of Plaintiff's employment discrimination claim is assigned to Attorney. In Year 2, Plaintiff settles the case for $1,000,000. The settlement proceeds are distributed pursuant to the contingent fee agreement—$400,000 to Attorney and $600,000 to Plaintiff.

If the contingent fee agreement results in an immediate transfer of forty percent of the claim, section 83(a) provides that since the forty percent portion would be forfeited if Attorney withdraws from the

---

no benefit, and because there is risk that attorney and IRS will disagree on value).

[245] *See* I.R.C. § 83(a) (2000). The character of the attorney's income would be ordinary compensation income. *See* Treas. Reg. § 1.83-1(a) (1978). When the attorney actually receives the cash from the settlement, he will have no further income since his basis in the attorney fee portion of the settlement equals the amount of the cash he receives. *See* §§ 1001, 1012.

[246] *See* Treas. Reg. § 1.83-6(d) (1978). This regulation merely restates the well-established principle that a transfer of property in exchange for services constitutes a realization event. *See, e.g.*, Int'l Freighting Corp. v. Comm'r, 135 F.2d 310, 313-14 (2d Cir. 1943); United States v. Gen. Shoe Corp., 282 F.2d 9, 12 (6th Cir. 1960); Riley v. Comm'r, 328 F.2d 428, 429 (5th Cir. 1964). The same result is obtained if, upon execution of the contingent fee agreement, the plaintiff is treated as immediately transferring a right to the proceeds from the attorney fee portion of the claim, rather than a portion of the claim itself, because the plaintiff has no basis in such right. See I.R.C. § 1012.

[247] *See* I.R.C. §§ 67(a), 162(a) (2000); Treas. Reg. § 1.83-6(a)(1) (1978).

[248] *See* I.R.C. § 61(a) (2000).

case prior to final disposition, the transfer is disregarded for tax purposes until such final disposition.[249] At that time, the transfer is given tax effect, and Plaintiff is deemed to transfer the forty percent portion, which is then worth $400,000.[250] As a result, Attorney must report $400,000 of ordinary income.[251] In addition, Plaintiff has gross income in the amount of $400,000, the amount by which the fair market value of the forty percent portion exceeds Plaintiff's basis of zero in the property.[252] Furthermore, Plaintiff receives a miscellaneous itemized deduction in the amount of $400,000.[253] Plaintiff also must include in gross income the $600,000 amount of the settlement that she actually receives.[254] Thus, Plaintiff includes a total amount of $1,000,000 in gross income, and receives a $400,000 miscellaneous itemized deduction, which is the same result as under the no immediate transfer characterization.[255]

V. THE PARTNERSHIP CHARACTERIZATION

Some proponents of the exclusion method contend that a contingent fee arrangement creates a partnership for tax purposes.[256] Under this characterization, the plaintiff contributes

---

[249] *See* I.R.C. § 83(a) (2000).

[250] *See id.*

[251] *See* I.R.C. §§ 61(a)(1), 83(a) (2000). When Attorney actually receives the $400,000 fee in cash, it will be attributable to the $400,000 attorney fee portion of the claim. Since Attorney will have a $400,000 basis in that property, Attorney recognizes no further income upon receipt of the cash. *See* §§ 1001, 1012.

[252] *See* Treas. Reg. § 1.83-6(b) (as amended in 2000). The character of this $400,000 income should be ordinary under the theory that the value received by Plaintiff (here, legal services) was received as a substitution for ordinary income. *See* Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 264-65 (1958) (holding that lump sum amount received as consideration for transfer of oil and other mineral payment rights was taxable to seller as ordinary income); Davis v. Comm'r, 119 T.C. No. 1, 7 (2002) (holding that amount received from sale of rights to lottery proceeds was taxable to seller as ordinary income).

[253] *See* I.R.C. § 162(a) (2000); Treas. Reg. § 1.83-6(a) (as amended in 2000).

[254] *See* I.R.C. § 61(a)(1) (2000).

[255] *See supra* notes 179-86 and accompanying text (demonstrating that under no immediate transfer characterization, plaintiff must include entire settlement amount in gross income).

[256] *See, e.g.*, Estate of Clarks v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (analogizing contingent fee arrangement to partnership); Robert W. Wood, *The Energizer Bunny Has Nothing on the Attorneys' Fee Debate*, 88 TAX NOTES 1059 (2000) (same).

her claim and the attorney contributes his services to the capital of the partnership, with each party receiving a partnership interest.[257] According to these proponents, this characterization would allow the plaintiff to exclude the attorney fee portion of the settlement from her gross income.[258]

In *Bagley v. Commissioner*,[259] the taxpayer, in an attempt to avoid the contingent fee problem, argued that a partnership was created when he entered into a contingent fee agreement with his attorney.[260] The Tax Court rejected this partnership characterization, concluding that the contingent fee agreement created an independent contractor relationship pursuant to which the attorney would receive contingent compensation for services rendered.[261] The Tax Court based this conclusion on its factual determination that the taxpayer and his attorney did not intend to form a partnership when they entered into the contingent fee agreement:

> Based on the record, we find that there is nothing to indicate that the parties intended the contingency fee arrangement to be a joint venture or partnership. [The attorney] testified that he regarded the agreement between himself and [plaintiff] as nothing more than an arrangement for the payment of his services.... There is . . . no testimony whatsoever that either party intended to form a partnership. [Plaintiff] did not report any profit or loss from any partnership with [the attorney], but instead claimed a miscellaneous itemized deduction for attorney's fees paid. We, therefore, find [plaintiff's partnership] argument to be without merit.[262]

This Part will demonstrate that even if a partnership had been created for tax purposes, the contingent fee problem would not be

---

[257] *See Estate of Clarks*, 202 F.3d at 857.
[258] *See id.* at 857-58.
[259] 105 T.C. 396 (1995).
[260] *Id.* at 418.
[261] *Id.* at 418-19.
[262] *Id.* at 419.

avoided.[263]

The analysis in this Part assumes that upon execution of the contingent fee agreement, a partnership between the plaintiff and attorney is created for tax purposes, with the plaintiff contributing her entire claim to the capital of the partnership, and the attorney contributing his services.[264] In exchange for these contributions, each party receives a partnership interest. When a settlement is reached, the proceeds are paid to the plaintiff-attorney partnership and then distributed to the parties in accordance with their respective partnership interests.

A. IS THE ATTORNEY'S PARTNERSHIP INTEREST A CAPITAL INTEREST OR A PROFITS INTEREST?

In analyzing the tax consequences of the partnership characterization, the first step is to determine the nature of the attorney's partnership interest. Specifically, that interest must be classified as either a capital interest or a profits interest.

A capital interest is defined as an interest which would entitle the holder to "a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership."[265] In other

---

[263] *See infra* notes 265-308 and accompanying text.

[264] Whether a partnership is in fact created for tax purposes pursuant to a contingent fee arrangement is a difficult issue. *See* MCKEE ET AL., *supra* note 205, ¶ 3.01(1), at 3-4 (noting that "[t]he most basic, and perhaps the most difficult, problem in the taxation of partnerships is the determination of whether a particular financial, business, or otherwise economic arrangement constitutes a partnership for income tax purposes"). Fortunately, because the partnership characterization results in the same tax consequences as under the "no immediate transfer" characterization and the "immediate transfer of property" characterization, the issue is immaterial. *See supra* notes 179-86, 238-55 and accompanying text. As a result, the issue is not addressed in this Article. For an in-depth discussion of the factors that are relevant to the determination of whether a partnership exists for tax purposes, see MCKEE ET AL., *supra* note 205, ¶¶ 3.02-.03, at 3-9, 3-24. Judge Beghe of the Tax Court has noted that if a partnership was deemed created for tax purposes when a contingent fee agreement was executed, it would "open the door to tax avoidance by attorneys who enter into contingent fee agreements." Kenseth v. Comm'r, 114 T.C. 399, 453-54 (2000) (Beghe, J., dissenting). In particular, Judge Beghe worried that "attorneys would contend that partnership characterization entitles them to distributive shares of the tax-free recoveries in personal injury actions and to current deductions for the advances of costs they make to their clients." *Id.* at 454.

[265] Rev. Proc. 93-27, 1993-2 C.B. 343, § 2.01.

words, a capital interest is one that would result in a distribution of cash to the interest holder upon a hypothetical liquidation immediately after receipt of the interest.[266] Alternatively, a profits interest is an interest that would entitle the holder to no cash upon such a hypothetical liquidation.[267] Thus, a profits interest, as distinguished from a capital interest, "entitles the recipient only to a share of future profits and appreciation."[268]

With respect to the plaintiff-attorney partnership, the attorney's interest constitutes a capital interest because the contingent fee agreement gives him a specified percentage of the claim as opposed to the right to a specified percentage of any post-agreement appreciation in the value of the claim. The following example demonstrates this point:

> Plaintiff and Attorney enter into a contingent fee agreement pursuant to which Attorney will receive a fee equal to forty percent of the recovery. At the time the agreement is executed, the claim has a value of $10,000. Assuming that the agreement results in a partnership for tax purposes, Plaintiff will receive a sixty percent interest in the partnership in exchange for her contribution of the claim, and Attorney will receive a forty percent interest in exchange for his services.

Attorney's interest in the partnership is a capital interest[269] because, if the claim was sold for fair market value immediately after execution of the fee agreement and thereafter the partnership was liquidated, Attorney would receive a distribution of $4,000.[270]

---

[266] *Id.*

[267] *Id.* § 2.02.

[268] MCKEE ET AL., *supra* note 205, ¶ 5.01, at 5-3.

[269] If the claim has absolutely no value at the time the contingent fee agreement is executed, Attorney's interest would be a profits interest because, upon the hypothetical liquidation, neither partner would receive any proceeds. However, this result rests on the factual premise that Plaintiff's claim has zero value at the same time Attorney agrees to provide valuable time and resources to prosecute the claim. Given such an agreement, it would appear to be very difficult to prove that Plaintiff's claim has no value whatsoever at the time the contingent fee agreement is executed.

[270] Attorney's partnership interest is subject to a substantial risk of forfeiture. As a result, an issue arises as to when the profits interest versus capital interest determination

B. APPLICATION OF SECTION 83 TO THE ATTORNEY'S RECEIPT OF THE PARTNERSHIP INTEREST

Because a capital interest constitutes property for section 83 purposes,[271] the transfer of the partnership interest to the attorney is subject to section 83. Because state law provides that an attorney relinquishes any right to compensation if he withdraws from a case prior to final disposition, the attorney's partnership interest is subject to a substantial risk of forfeiture.[272] Consequently, the attorney's receipt of the partnership interest is treated as occurring when the risk of forfeiture lapses on the date of final disposition of the case, rather than when the contingent fee agreement is executed.[273] Therefore, as the following example demonstrates, no partnership exists prior to final disposition:[274]

> In Year 1, Plaintiff and Attorney enter into a contingent fee agreement pursuant to which Attorney will receive a fee equal to forty percent of the recovery. In Year 2, the case is settled for $1,000,000, with Plaintiff receiving $600,000 and Attorney receiving $400,000.

---

should be made. *See* MCKEE ET AL., *supra* note 205, ¶ 5.03(1), at 5-30 to 5-31. There are two possibilities. *Id.* Either the hypothetical liquidation occurs at the time Attorney receives the partnership interest, which is when the contingent fee agreement is executed, or the hypothetical liquidation occurs at the time Attorney's partnership interest vests, which is upon final disposition of the case. *Id.* The foregoing example analyzes a hypothetical liquidation taking place at the time Attorney receives his partnership interest, although, in this case, Attorney's interest would be a capital interest even if the hypothetical liquidation took place at the time of vesting.

[271] *See* Mark IV Pictures, Inc. v. Comm'r, 969 F.2d 669, 673 (8th Cir. 1992). For a discussion regarding the controversial issue of whether a profits interest should constitute property for § 83 purposes, see MCKEE ET AL., *supra* note 205, ¶ 5.02, at 5-5 to 5-7.

[272] *See supra* notes 241-43 and accompanying text.

[273] *See* Treas. Reg. § 1.83-1(a)(1) (1978) (providing that when property is transferred subject to substantial risk of forfeiture, "the transferor shall be regarded as the owner of such property"). If the attorney makes a § 83(b) election, then the attorney's receipt of the partnership interest will be deemed to occur on the date he receives the interest, rather than on the date the interest vests. *See* I.R.C. § 83(b) (2000). The discussion below assumes that no § 83(b) election is made.

[274] *See* Treas. Reg. § 301.7701-3(a) (as amended in 1999) (providing that partnership needs at least two members).

Assuming that the agreement results in a partnership for tax purposes, Attorney will be deemed to receive his partnership interest in Year 2 upon settlement, which is when Attorney's interest vests. Thus, prior to vesting in Year 2, Plaintiff is the only "partner," and as a result, no partnership exists prior to vesting. Upon such vesting, a partnership is formed, with Attorney receiving a capital interest in the partnership.[275]

C. TAX CONSEQUENCES OF THE PARTNERSHIP CHARACTERIZATION

The Tax Court case of *McDougal v. Commissioner*[276] governs the tax consequences to the plaintiff and the attorney resulting from the formation of their partnership upon settlement.[277] In that case, McDougal purchased a race horse for $10,000 on January 1, 1968, which was subsequently trained by another taxpayer.[278] On October 4, 1968, McDougal and the trainer formed a partnership. McDougal received a fifty percent capital interest in the partnership in exchange for contributing the race horse, which then had a fair market value of $60,000, and the trainer received a fifty percent capital interest in exchange for the training services he provided between January 1, 1968 and October 4, 1968.[279] Thus, McDougal received his capital interest in exchange for his contribution of property, while the trainer received his capital interest in exchange for past services provided for the benefit of McDougal.[280]

The issue in the case was whether McDougal realized a gain upon the formation of the partnership.[281] The Tax Court held that McDougal did realize a gain, concluding that the form of the transaction—a nontaxable capital contribution of the horse—differed from its substance.[282] The court concluded that McDougal should be treated as first transferring an undivided half

---

[275] *See id.*
[276] 62 T.C. 720 (1974).
[277] *Id.* at 722.
[278] *Id.* at 721-22.
[279] *Id.* at 721.
[280] *Id.* at 724.
[281] *Id.* at 725.
[282] *Id.* at 725-26.

interest in the horse to the trainer in exchange for past services.[283] Immediately thereafter, McDougal and the trainer should each be treated as contributing their respective half interests in the horse to the partnership in exchange for their respective fifty percent capital interests in the partnership.[284]

As a result of the Tax Court's recasting of the transaction, McDougal realized a $25,000 gain upon the transfer of the half interest to the trainer.[285] In addition, McDougal received a $30,000 deduction for his payment of compensation to the trainer,[286] while the trainer received $30,000 in compensation income.[287]

The *McDougal* facts are analogous to the facts underlying a plaintiff-attorney partnership resulting from a contingent fee arrangement.[288] When upon final disposition of the case the partnership is formed for tax purposes, the plaintiff contributes her claim in exchange for a capital interest, while the attorney receives a capital interest in exchange for past services provided to the plaintiff.[289] Thus, the plaintiff is in the same position as McDougal, while the attorney is in the same position as the trainer.[290] Under *McDougal*, the partnership formation is recast as a transfer by plaintiff to attorney of the attorney fee portion of the claim in consideration for past services, and plaintiff and attorney are then treated as transferring their respective interests in the claim to the partnership in exchange for capital interests in the partnership.[291]

As a result of the first prong of the recast transaction—the transfer from the plaintiff to the attorney of the attorney fee portion

---

[283] *Id.* at 725.

[284] *Id.*

[285] *Id.* at 727. The fair market value of the half interest was $30,000, and McDougal had a $5,000 basis in such interest. *Id.* Gain was recognized pursuant to the principle that the transfer of property in exchange for services constitutes a realization event. *Id.* at 726; *see also* Int'l Freighting Corp. v. Comm'r, 135 F.2d 310, 313-14 (2d Cir. 1943) (providing that realization event occurs when taxpayer transfers property in exchange for services); Treas. Reg. § 1.83-6(b) (1978) (same).

[286] *McDougal*, 62 T.C. at 728; *see also* I.R.C. § 162(a)(1) (2000) (providing that reasonable compensation expense incurred in connection with trade or business is deductible).

[287] *McDougal*, 62 T.C. at 723; *see also* I.R.C. § 61(a)(1) (2000) (providing that gross income includes compensation for services).

[288] *See McDougal*, 62 T.C. at 721-24.

[289] *See id.* at 723-24.

[290] *See id.* at 721-24.

[291] *See id.* at 725-26.

of the claim—the plaintiff realizes a gain in an amount equal to the fair market value of such portion.[292] In addition, the plaintiff receives a miscellaneous itemized deduction equal to the fair market value, and the attorney realizes income in that amount.[293]

With respect to the second prong of the recast transaction—the plaintiff's and the attorney's contributions of their respective portions of the claim to the partnership—there are no immediate tax consequences. When the partnership receives the settlement amount, the plaintiff is allocated all of the remaining built-in gain in the claim.[294] The end result to the parties is the same as under the "no immediate transfer" characterization and the "immediate transfer of property" characterization. Consider the following example:

> In Year 1, Plaintiff and Attorney enter into a contingent fee agreement pursuant to which Attorney will receive a fee equal to forty percent of the recovery. In Year 2, the case is settled for $1,000,000 with Plaintiff receiving $600,000 and Attorney receiving $400,000.

Assuming that the contingent fee agreement results in a partnership for tax purposes, Plaintiff receives a sixty percent interest in the partnership in exchange for her contribution of the claim, and Attorney receives a forty percent interest in exchange for his services. Section 83 defers the formation of the partnership until Attorney's interest vests in Year 2 upon final disposition of the case.[295]

When the partnership is formed upon settlement of the case in Year 2, *McDougal* provides a two-step recast of the transaction.[296] First, the Plaintiff is treated as transferring the forty percent attorney fee portion of the claim to Attorney in consideration for

[292] *See* Int'l Freighting Corp. v. Comm'r, 135 F.2d 310, 313 (2d Cir. 1943); Treas. Reg. § 1.83-6(b) (as amended in 2000).
[293] *See* Treas. Reg. § 1.83-6(a) (as amended in 2000).
[294] *See* I.R.C. § 704(c) (2000).
[295] *See* I.R.C. § 83(a) (2000).
[296] *See* McDougal v. Comm'r, 62 T.C. 720, 724-26 (1974).

past services.[297] Second, Plaintiff and Attorney are then treated as transferring their respective interests in the claim to the partnership for capital interests.[298] As a result of the first-step transfer of the attorney fee portion, Plaintiff recognizes a gain of $400,000 and receives a miscellaneous itemized deduction in the same amount.[299] In addition, Attorney has $400,000 of income.[300] As a result of the second-step contributions to the partnership, neither party recognizes income.[301] Plaintiff takes a zero basis in her partnership interest;[302] Attorney takes a $400,000 basis in his partnership interest;[303] and the partnership takes a $400,000 basis in the claim.[304]

When the partnership receives the settlement proceeds, it realizes a $600,000 gain,[305] all of which is allocated to Plaintiff.[306] When the partnership distributes the settlement proceeds ($600,000 to Plaintiff, $400,000 to Attorney), no further income is realized by Plaintiff or Attorney because their bases in their respective partnership interests equal the amount of liquidation proceeds they each receive.[307] Plaintiff thus realizes a total amount of $1,000,000 of gross income and receives a $400,000 miscellaneous itemized deduction, which is the same result as under the no immediate transfer of property characterization and the immediate transfer of property characterization.[308]

---

[297] *See* I.R.C. § 724 (2000).

[298] *See* I.R.C. § 725 (2000).

[299] See Treas. Reg. § 1.83-6(a)-(b) (as amended in 2000).

[300] *See* I.R.C. § 61 (2000). Attorney takes a "tax cost" basis of $400,000 in his portion of the claim. *See* § 1012.

[301] See I.R.C. § 721 (2000).

[302] See I.R.C. § 722. (2000)

[303] *See id.*

[304] See I.R.C. § 723 (2000).

[305] See I.R.C. § 1001 (2000).

[306] See I.R.C. § 704(c)(1)(A) (2000). Treas. Reg. § 1.704-3(b)(1) (as amended in 2000).

[307] See I.R.C. § 705(a). Plaintiff's basis in her partnership interest equals $600,000 because her initial basis of zero was increased to $600,000 as a result of the allocation of income to her under § 704(c)(1)(a). *See* § 704(c)(1)(A).

[308] *See supra* notes 179-86 and accompanying text (demonstrating that under no immediate transfer of property characterization plaintiff must include full settlement amount in gross income); *supra* notes 238-55 and accompanying text (demonstrating that under immediate transfer of property characterization plaintiff must include full settlement amount in gross income).

VI. THE LEGISLATIVE SOLUTION

This Article thus far has demonstrated that the contingent attorney's fee problem is inevitable under current law. Under the no immediate transfer characterization, the immediate transfer of property characterization, or even the partnership characterization, the plaintiff must include the full settlement amount in gross income and take a miscellaneous itemized deduction for the attorney fee portion of the settlement.[309]

The legislative solution is overwhelmingly simple. Attorney's fees paid for the purpose of generating a taxable recovery should be deductible in full without impairment. Therefore, a simple amendment to section 62, adding these fees to the list of deductions that are taken into account in computing gross income, would suffice.

VII. CONCLUSION

Courts are divided with regard to the tax treatment of contingent attorney fee arrangements. Some courts conclude that a plaintiff must include the full settlement amount in gross income and take a miscellaneous itemized deduction for the attorney fee portion of the settlement. Because of the limitations on miscellaneous itemized deductions under section 67, section 68, and the AMT, this approach provides the wrong policy result by overstating the plaintiff's true income. Other courts conclude that a plaintiff may exclude the attorney fee portion of the settlement from gross income. This approach provides the right policy result, taxing the plaintiff only on her net recovery.

All of the courts faced with the contingent attorney fee issue have focused on the assignment of income doctrine. They have analyzed whether the contingent fee agreement transfers a portion of the claim (*i.e.*, tree) or merely a right to the income from a portion of the claim (*i.e.*, fruit). However, this focus is misplaced because the assignment of income doctrine is inapplicable to a contingent fee arrangement, where the plaintiff and the attorney are engaging in

---

[309] *See id.*; *supra* notes 265-308 and accompanying text (demonstrating that under partnership characterization, plaintiff must include full settlement amount in gross income).

an entirely arm's length commercial transaction. Due to this misplaced focus, the courts have not analyzed the contingent attorney fee issue correctly.

A contingent fee arrangement is susceptible to two characterizations. Either the execution of the contingent fee agreement results in no immediate transfer of property under section 83, or the execution results in an immediate transfer of property, regardless of whether the property constitutes fruit or tree for assignment of income doctrine purposes. Under either characterization, the wrong policy result—that the plaintiff must include the full settlement amount in gross income and take a miscellaneous itemized deduction for the attorney fee portion—is inevitable. The same unfortunate result is obtained even if the contingent fee arrangement is characterized as a partnership for tax purposes.

Consequently, the only solution to the contingent attorney fee problem is a legislative amendment. Attorney's fees paid for the purpose of generating taxable recoveries should be deductible in full without impairment. To solve the problem, section 62 must be amended to add these attorney's fees to the list of deductions taken into account in computing the taxpayer's adjusted gross income.