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EXPLAINING A CIRCUIT SPLIT: CONTINGENCY FEES MAY CONSTITUTE CLIENTS' GROSS INCOME DEPENDING ON WHETHER THE STATE LAW PERMITS THE ASSIGNMENT OF A CAUSE OF ACTION TO CREATE A PROPERTY OWNERSHIP INTEREST

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The United States Congress derives its taxing power from Article 1, Section 8, of the United States Constitution.[1] This power enables Congress to enact statutes, which together comprise the Internal Revenue Code (Code),[2] that provide detailed guidelines for the taxation of various types of income.[3] Despite a large number of Code provisions regulating various aspects of taxation, the Code occasionally fails to provide clear instructions as to how a particular transaction should be taxed.[4]

One area of controversy is whether a portion of a damage award paid to an attorney under a contingency fee agreement constitutes income to a client.[5] Because the Code does not address this issue, the judiciary has been asked to resolve disputes between the Internal Revenue Service and taxpayers.[6] Additionally, without factually analogous Supreme

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1. U.S. CONST. art. I, § 8. The Constitution provides: "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." *Id.*

2. I.R.C. §§ 1-9721 (1995).

3. *Id.*

4. Srivastava v. Comm'r, 220 F.3d 353, 358 (5th Cir. 2000) (noting that "the text of the Internal Revenue Code is of little help").

5. Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000) (finding income to the client), *cert. denied* 532 U.S. 972 (2001); Baylin v. United States, 43 F.3d 1451, 1452 (Fed. Cir. 1995) (recognizing income to the client). *But see* Estate of Clarks v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (finding no income to the client); Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (finding no income to the client).

6. Tax disputes are adjudicated by the United States Tax Court. Sections 7441 and 7442 of the United States Code grant jurisdiction to the Tax Court. Section 7441 states: "There is hereby established, under article I of the Constitution of the United States, a

Court cases at their disposal, circuit courts have resolved cases involving this controversy with conflicting opinions.[7]

This circuit split is a result of the circuits' different views on whether to consider contingency fee agreements under the doctrine of anticipatory assignment of income.[8] The circuits have also examined the nature and scope of a charging lien, which state law attaches to an attorney retained under a contingency fee agreement, i.e., whether an attorney has an equitable interest in his client's claim.[9]

In all but one circuit, these two tests have produced matching conclusions: where a court has found the doctrine of anticipatory assignment of income applicable, and therefore the assignment impermissible for tax purposes, the court has also found that an effective

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court of record to be known as the United States Tax Court." 26 U.S.C. § 7441 (1994). Section 7442 states:

> The Tax Court and its divisions shall have such jurisdiction as is conferred on them by this title, by chapters 1, 2, 3, and 4 of the Internal Revenue Code of 1939, by title II and title III of the Revenue Act of 1926 (44 Stat. 10-87), or by laws enacted subsequent to February 26, 1926.

26 U.S.C. § 7442 (1994). Both parties (the Commissioner of the Internal Revenue Service and the taxpayer) can appeal to a United States Court of Appeals, which has jurisdiction over the taxpayer. 26 U.S.C. § 7482(a)(1) (1994). The statute provides:

> The United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit) shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provides in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

Id.

7. *Compare Coady*, 213 F.3d at 1191 (determining there was income to the client), *and Baylin*, 43 F.3d at 1452 (same), *with Clarks*, 202 F.3d at 857 (determining there was no income to the client), *and Cotnam*, 263 F.2d at 126 (same).

8. Because some circuits consider the damage award fully vested in the client/assignor, which is the premise of the doctrine of anticipatory assignment, they view a portion of the damage award as capable of being assigned to the attorney/assignee. The doctrine then finds this assignment impermissible for tax purposes. *Coady*, 213 F.3d at 1191 (finding the doctrine applicable); *Baylin*, 43 F.3d at 1454-55 (same).

Some circuits, however, consider the damage award only an intangible expectancy, therefore not falling under the doctrine of anticipatory assignment which requires the income to vest fully in the assignor. *Clarks*, 202 F.3d at 857; *Cotnam*, 263 F.2d at 125-26.

9. *Clarks*, 202 F.3d at 857 (stating that a charging lien gives an attorney an equitable interest in the cause of action); *see also* O'Brien v. Comm'r, 38 T.C. 707, 711-12 (1962), *aff'd* 319 F.2d 532 (3d. Cir. 1963); *Cotnam*, 263 F.2d at 125-26. *But see Baylin*, 43 F.3d at 1454-55 (holding that a Maryland state statute that gives an attorney a lien on attorney's fees does not give the attorney an ownership interest in those fees).

charging lien of an attorney does not exist.[10] However, the possibility of divergent conclusions of these two tests indicates that a more suitable analytical methodology is necessary. Moreover, clients/taxpayers from jurisdictions without a judicial precedent on point are unable to predict whether a court will find the doctrine of assignment of income applicable, and whether a court will find a charging lien (if created by state law) effective. Such unpredictability of judicial resolutions demands a different analytical approach to the controversy.

This Comment examines the taxation of damage awards as it relates to contingency fees. Instead of analyzing the issue from the standpoint of the taxpayer (i.e., whether a damage award was income in full), this Comment takes a different approach by examining the nature of the transaction received by an attorney (i.e., whether, under a contingency fee agreement, an attorney received any property ownership rights in his client's cause of action). In Part I, this Comment provides an overview of the relationship between federal tax law imposing tax liability and state law that creates property rights. This section also presents the circuit split in detail, describing commonalities and differences in the circuits' reasoning. Drawing on Supreme Court precedent, in Part II, this Comment criticizes the circuit courts' analyses and explains their deficiencies. Part III recommends an analytical method extracted from Supreme Court case law, which has been ignored by the circuits representing the split. This section also demonstrates how this new approach can resolve the controversy effectively. Finally, this Comment urges the Supreme Court to grant certiorari in order to create judicial guidelines for federal courts.

I. TAXATION OF INCOME: THE ONGOING NEED FOR FEDERAL COURTS TO ADJUDICATE DISPUTES OVER WHAT CONSTITUTES "INCOME"

Article 1, Section 8, of the United States Constitution vests in Congress the power to "lay and collect Taxes, Duties, Imposts and Excises."[11] In 1986, Congress passed the Internal Revenue Code of 1986, which details the current framework of federal tax law.[12] The current

10. Srivastava v. Comm'r, 220 F.3d 353, 364 n.33 (5th Cir. 2000). The Fifth Circuit in *Srivastava*, following precedent ruling in favor of non-taxability, fully ignored the argument that the rights of Srivastava's attorney "remain[ed] wholly derivative from those of his client" and "the client's action is indivisible and may not be tried for only a percentage of the cause of action." *Id.* (internal citation omitted).

11. U.S. CONST. art. I, § 8.

12. I.R.C. §§ 1-9601 (1986). In 1939, the United States Congress enacted the first Internal Revenue Code that codified all revenue acts of the previous twenty-six years (since the enactment of the Income Tax Code of 1918). *See* James John Jurinski, TAX

Code taxes eligible income of every individual.[13] Taxable income is defined as "gross income minus the deductions allowed [by Chapter 1] (other than the standard deduction)."[14] Section 61(a) of the Code offers a definition of gross income as "all income from whatever source derived."[15] Despite the detailed itemization and numerous sections supplementing Section 61(a), the Tax Court, as well as circuit courts, frequently adjudicate disputes over what constitutes gross income.[16]

Prior to the application of the Code provisions, however, it is necessary to determine the taxpayers' legal interests in income or property that may be subject to federal tax.[17] As the voluminous case law indicates, taxpayers' legal interests arise under state not federal law.[18]

REFORM: A REFERENCE HANDBOOK 96, 99 (2000) (presenting a chronology of tax law). Congress later replaced it by enacting the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986 (currently in force). *Id.*

13. I.R.C. § 1(a)-(e) (1995).

14. *Id.* § 63(a).

15. *Id.* § 61(a). Sections 71 through 90 and 101 through 137 provide lists of items specifically included and excluded, respectively, in gross income. *Id.* §§ 71-90, 101-37. The Supreme Court has recognized that through section 61(a), Congress intended to bring under the definition of income any increase in wealth. *See, e.g.*, United States v. Burke, 504 U.S. 229, 233 (1992); Helvering v. Clifford, 309 U.S. 331, 334 (1940).

16. *See, e.g.*, Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 427 (1955); Helvering v. Horst, 311 U.S. 112, 114 (1940); Lucas v. Earl, 281 U.S. 111, 113 (1930). The precursor to section 61(a) was section 213(a) of the Revenue Act of 1918, and section 22(a) of the Internal Revenue Code of 1939. *See Earl*, 281 U.S. at 114 (quoting language from section 213(a), which is similar to the language in section 61(a)); *Glenshaw Glass Co.*, 348 U.S. at 432 n.9 (stating that section 61(a) is the successor of section 22(a)).

17. *See, e.g.*, Morgan v. Comm'r, 309 U.S. 78, 82 (1940) (stating that "in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property or income sought to be reached by the statute").

18. *See id.*; *see also* Note, *Property Subject to the Federal Tax Lien*, 77 HARV. L. REV. 1485, 1485-87 (1964). As the author observed:

> An initial question is whether the courts will look to state law to determine only the existence of interests which must then be classified by some federal test as property or not property subject to the [tax] lien, or whether state law will control as to both the existence and classification of rights. The interpretation of any federal statute is of course a matter of federal law, but only if the statute is interpreted as leaving classification to federal law are the courts free to accept or reject state policy by selective application of the [tax] lien. In tax liability decisions courts have generally adopted this approach, assigning to state law the limited function of determining 'independent juridical relations upon which Congress may or may not choose to fasten a tax,' and the Supreme Court appeared to take a similar position with respect to collection . . . stating . . . that the federal tax lien provision 'creates no property rights but merely attaches consequences, federally defined, to rights created under state law.'

A. State Law Determines the Nature of Property Ownership Interests and Federal Tax Law Attaches Thereupon

In *Morgan v. Commissioner*,[19] the Supreme Court, while dealing with the issue of whether state law determines the nature of a power of appointment over a trust, found that it is state not federal law that creates legal interests in property.[20] According to the Supreme Court, federal law, including federal tax law, only attaches tax consequences to state-created rights and legal interests.[21]

The same legal principle prevailed eighteen years later in *United States v. Bess*.[22] The Supreme Court, while addressing the question of whether the petitioner's deceased husband had any rights to property within the meaning of section 3670 of the Code,[23] resorted to the state law of the husband's domicile before applying the federal tax lien law.[24] After acknowledging that section "3670 creates no property rights but merely attaches consequences, federally defined, to rights created under state law,"[25] the Supreme Court examined the property rights of the petitioner's husband under New Jersey law.[26]

Applying a legal analysis consistent with that of both *Morgan* and *Bess*, the Supreme Court, in *Aquilino v. United States*,[27] examined the nature of the taxpayer's property rights under New York law before applying the federal tax lien law.[28] To justify the priority of state law over federal law in ascertaining taxpayers' property rights, the Supreme Court

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Id. at 1486. As summarized by the author, "state law is determinative only of the existence of interests, leaving their amenability to the tax lien a matter of federal policy." *Id.* at 1486-87.

19. 309 U.S. 78 (1940).

20. *Id.* at 79-80.

21. *Id.* at 80.

22. 357 U.S. 51 (1958).

23. *See* 26 U.S.C. § 6321 (1994). Section 3670 (currently section 6321) provides that "if any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." *Id.*

24. *Bess*, 357 U.S. at 55.

25. *Id.*

26. *Id.*

27. 363 U.S. 509 (1960).

28. *Id.* at 512-13. The Supreme Court emphasized that "once the tax lien has attached to the taxpayer's state-created interests, we enter the province of federal law, which we have consistently held determines the priority of competing liens asserted against the taxpayer's 'property' or 'rights to property.'" *Id.* at 513-14.

emphasized the traditionally strong role of the states in creating property rights for its citizens.[29]

In light of *Morgan*, *Bess*, and *Aquilino*, it follows that if a state law does not create a property right, federal law cannot attach tax liability thereupon (i.e. tax or tax lien in case of default).[30] By the same token, if an assignment of income or property is ineffective under the state law, the assignor will remain subject to tax liability, because, under the relevant state law, his property rights remain unchanged.[31] Because the circuit courts usually examine contingency fee agreements under the assignment of income doctrine, a more thorough study of this and other income-splitting doctrines is necessary.

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29. *Id.* at 514. The Supreme Court rejected the opposing view which suggests that federal law should govern the recognition of a taxpayer's right. *Id.* at 513 n.3. The Court opined that:

> [T]his approach is unsound because it ignores the long-established role that the States have played in creating property interests and places upon the courts the task of attempting to ascertain a taxpayer's property rights under an undefined rule of federal law. It would indeed be anomalous to say that the taxpayer's 'property and rights to property' included property in which, under the relevant state law, he had no property interest at all.

Id.; *see also* Green v. the Lessee of Henry Neal, 31 U.S. 291 (1832). There, the Supreme Court stated that:

> In a great majority of the causes brought before the federal tribunals, they are called to enforce the laws of the states. The rights of parties are determined under those laws, and it would be a strange perversion of this principle, if the judicial exposition of those laws, by the state tribunals, should be disregarded. These expositions constitute the law, and fix the rule of property. Rights are acquired under this rule, and it regulates all the transactions which come within its scope.

Id. at 297-98. One commentator pointed out the practicality of the rule that state law has a priority in defining property interest by mentioning that:

> [The rule] relieves the federal courts of the onerous task of defining basic incidents of property and yet enables them to subject to the lien the wide range of property interests commanded by the sweeping language of the statute, as well as to exclude some interest as not being within the statutory purpose.

Property Subject to Federal Tax Lien, *supra* note 18, at 1503.

30. *Property Subject to Federal Tax Lien*, *supra* note 18, at 1501.

31. *Id.* As one commentator elaborated:

> In imposing tax liability the courts have shown that they will ignore ordinary theories of property ownership when assignments have the effect of splitting income, and have held assignors taxable when there is a gratuitous assignment of income to be earned either by personal services or from property the ownership of which is retained by the assignor.

Id.

B. Income-Splitting: Ineffective to Transfer Property Rights and to Avoid Taxation

Income-splitting (or income-shifting) is used primarily in a family context.[32] Because the Code treats family members as individual taxable units, there is a strong incentive for a family member in the higher tax bracket to "shift" a portion of his income to another family member who is in a lower bracket.[33] If a court finds such an action unsuccessful for tax purposes, the income-splitting is then considered an impermissible assignment of income.[34]

1. Assignment of Income Considered Impermissible to Transfer a Property Right to Income

The assignment of income doctrine relies upon the principle that the power of disposition of property evidences the taxpayer's ability to enjoy his property, which then triggers taxability.[35] The doctrine assists in answering the question "who" should be subject to income tax after the assignment occurred.[36]

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32. WILLIAM A. KLEIN, ET AL., FEDERAL INCOME TAXATION 659 (12th ed. 2000). The author explains:

> For many purposes, families or households act as economic units, sharing income and other resources and assuming mutual obligations. Legal ownership or property and rights to income often has little or no effect on how funds are used. For income tax purposes, however, individual members of families or households, other than husband and wife, are, generally speaking, treated as separate taxpaying units and legal rights, rather than economic reality, often determine tax results. For example, if, within a household, a parent and his or her minor child both have income, two tax returns will be filed and the total income may enjoy the tax benefit of two starts at the bottom of the rate structure . . . .

Id.

33. *Id.* This arrangement will also allow a double enjoyment of the zero bracket benefit. *See id.*

34. *Id.*

35. *See* Patricia Ann Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income*, 29 TAX. L. REV. 525, 579 (1974). According to the commentator:

> The doctrine of assignment of income is quite similar to that of economic benefit, because, by way of explanation, the courts have consistently pointed out that the power to dispose of income represents the equivalent of ownership, while the exercise of a power to dispose of income represents the equivalent of taxable enjoyment.

Id.

36. *Id. See generally* Daniel S. Knight, *Income Tax Consequences of Nonqualified Deferred Compensation: A Recapitulation*, 21 TAX. LAW. 163, 178-80 (1967); Roswell Magill, *The Taxation of Unrealized Income*, 39 HARV. L. REV. 82, 91-95 (1925); V. Henry Rothschield & Theodore Ness, *IRS Confines Hicks Case and Sanctions Deferred Compensation Choices*, 19 J. TAX'N 216, 217 (1963).

In 1930, the Supreme Court formalized the doctrine in *Lucas v. Earl*.[37] In *Earl*, Earl assigned one half of his salary and other fees he earned to his wife as a gift.[38] In ruling that the gift should be classified as income taxable to Earl, the Supreme Court explicitly held that "the tax could not be escaped by anticipatory arrangements . . . however skillfully devised to prevent the salary when paid from vesting . . . in the man who earned it."[39] Therefore, those who earn income are obligated to pay taxes on that income.[40]

2. Assignment of Income from Property Falls Under the Doctrine of Assignment of Income, While the Assignment of Income-Producing Property Amounts to Permissible Conveyance of Property Rights

It is difficult to distinguish between the assignment of income from property (taxable to the assignor because he retains the property that generates the assigned income) and the assignment of property (taxable to the assignee upon satisfying all legal requirements for an effective transfer).[41] The Supreme Court addressed this problem in *Blair v. Commissioner*.[42] Blair assigned a portion of the trust income in his name to his children for the rest of his life.[43] Finding that Blair had an

37. 281 U.S. 111 (1930).

38. *Id.* at 114-15.

39. *Id.* at 115.

40. *Earl*, however, does not address the question whether the income is required to be fully vested in the assignor. *See generally* Lucas v. Earl, 281 U.S. 111 (1930). *But see* Harrison v. Schaffner, 312 U.S. 579 (1941) (expressly addressing the question of the vested income requirement). Schaffner, a life beneficiary of a testamentary trust, assigned a portion of her trust fund to her children and a son-in-law for one year only. *Id.* at 579. She did not pay taxes on the assigned portions, which was challenged by the Commissioner. *Id.* at 579-80. Both the district court and the court of appeals found for Schaffner, but the Supreme Court reversed, reasoning that this temporary transfer involved no disposition of property because the donor retained a substantial interest in it. *Id.* at 583-84. The Court held as previous courts did, stating that "one vested with the right to receive income [does] not escape the tax . . . since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid." *Id.* at 582. It follows that the doctrine of income assignment rests upon the premise that the assignor would have received the full benefit of his income had he not assigned it to the assignee. Comm'r v. First Sec. Bank of Utah, N.A., 405 U.S. 394, 403-04 (1972).

41. *See* MICHAEL D. ROSE & JOHN C. CHOMMIE, FEDERAL INCOME TAXATION (HORNBOOK SERIES) 393-94 (3d ed. 1988). To demonstrate this difficulty, the authors used two Supreme Court cases: *Blair v. Comm'r*, 300 U.S. 5 (1937), and *Harrison v. Shaffner*, 312 U.S. 579 (1941). *Id.* The authors quoted the Supreme Court's decision in *Shaffner*, where the Court noted that "'[d]rawing the line' is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind." *Id.* at 394.

42. 300 U.S. 5 (1937).

43. *Id.* at 7.

equitable right in the corpus of the trust,[44] and thus a property interest, the Supreme Court held that Blair's property right entitled him to convey a portion of his property interest to his children.[45]

The Supreme Court's decision in *Helvering v. Horst*[46] demonstrates a peculiar situation where what looks like a transfer of income-producing property is actually an assignment of income from property.[47] Horst assigned negotiable interest coupons from negotiable bonds to his son, who later collected the coupons at maturity.[48] The Supreme Court explicitly stated that "[t]he power to dispose of income is the equivalent of ownership of it."[49] It held that the interest payments were taxable to Horst because he retained the ownership rights to his property/bonds.[50]

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44. *Id.* at 13. Such equitable interest would allow Blair to "enforce the trust, to have a breach of trust enjoined and to obtain redress in case of breach." *Id.*

45. *Id.*; *cf. Schaffner*, 312 U.S. at 579 (involving a transfer of income from the trust to the children and a son-in-law of the trustee). In *Schaffner*, the Supreme Court held that the income was taxable to the trustee because, despite the transfer, she retained an interest in the trust corpus and a control of the trust. *Id.* at 584; *see also* Helvering v. Clifford, 309 U.S. 331, 332 (1940) (involving a transfer of income from the trust to the wife of the trustee while the trustee retained the ownership right to the trust). In *Clifford*, the Supreme Court found that:

> It cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner . . . .

Id. at 335.

46. 311 U.S. 112 (1940).

47. *Id.* at 118.

48. *Id.* at 114.

49. *Id.* at 118.

50. *Id.* at 117. The Supreme Court explained that:

> Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son . . . . The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named.

Id.

3. Transfer of Property Generated by Personal Services Found Permissible if Distinguished from Transfer of Income from Property

The assignment of income-producing property created by the transferor's personal services[51] has been litigated differently than an ordinary assignment of property. If the assignor transfers only his interest in income from property, but not the interest in the property itself, the assignment of income doctrine dictates the result in accordance with the *Earl* precedent.[52] Just like an impermissible assignment of income, the taxpayer cannot avoid taxation by assigning income generated by his property to another (usually a person in a lower tax bracket), because his right to income also creates a tax liability attached to that income.[53] If, however, the assignor transfers his property interest in an income-producing property, such a transaction usually escapes the reach of the assignment of income doctrine.[54] Such a result is consistent with the basic rule that, the transfer of property disposes the transferor of his right to the property, and therefore also of the obligation to pay taxes on the income the property generates.[55]

Heim v. Fitzpatrick[56] demonstrates this exception to the assignment of income doctrine. The Second Circuit held that Heim, an inventor, could not be taxed on patent royalty payments when he previously assigned his interest in the invention, patents, and royalties to his wife and children.[57]

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51. Patented inventions, which generate income in the form of royalties, are only one kind of income-producing property created by personal services. Heim v. Fitzpatrick, 262 F.2d 887, 888-89 (2d Cir. 1959).

52. *See* Helvering v. Eubank, 311 U.S. 122 (1930). Eubank, an insurance agent, assigned his renewal commission payments (which he earned prior to the termination of his employment) to his wife. *Id.* at 124. The Supreme Court held that the commissions constituted income to Eubank (in a form of deferred compensation) in the year in which he collected the commissions. *Id.* at 125.

53. *See* ROSE & CHOMMIE, *supra* note 41, at 392. The authors stated expressly that "if the taxpayer does not transfer the property but merely the right to receive the income, the assignment of income doctrine applies and the transferor remains taxable." *Id.* The authors continued that "[a]n assignor may be subject to the assignment of income doctrine by retaining control over the property's capacity to produce income. This nuance of retained control concerns an assignor's ability to determine the amount of income the property will generate for the assignee." *Id.* at 394.

54. *Id.* at 399. The authors noted, however, that "a blurry line separates the transfer of earned income from the transfer of income-producing property that the transferor has created." *Id.*

55. *Id.* at 392. The authors stated simply that this "principle permits a taxpayer to shift income from property if the income-producing property is [also] transferred." *Id.* In other words, "the donor must part with ownership of property." *Id.*

56. 262 F.2d 887 (2d Cir. 1959).

57. *Id.* at 890.

Distinguishing *Horst*, the court determined that Heim's assignments effectuated a transfer of income-producing property, not just the rights to income from property.[58]

Considering that there are many types of property which may create many different property rights, the circuit split concerning the taxation of contingency fees is understandable, especially if the Code provides no straightforward guidelines on point.

C. Are Contingent Legal Fees Paid from Damages Income and Thus Taxable as Gross Income?: Inconsistency in Circuit Court Decisions

Section 61(a) of the Code does not provide much guidance in answering the question whether a portion of damage awards paid to an attorney under contingency fee agreements should be included in the gross income of a client.[59] Moreover, the judiciary also has not provided clear guidance. In fact, circuit courts have generated decisions with varying conclusions on the issue.[60]

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58. *Id.* However, the same circuit held that if the assignor transfers only the royalty interest, but not the entire royalty-bearing property, the assignment of income doctrine applies. Strauss v. Comm'r, 168 F.2d 441, 442-43 (2d Cir. 1948). Investors hired Strauss to work on the financing of the Kodachrome process. *Id.* at 442. To compensate him for his services, the investors assigned a portion of the royalties to Strauss, who later assigned all of his rights to the royalties to his wife. *Id.* The court found the assignor's right to receive royalties to be analogous to the situation in *Eubank*. *Id.* at 443. As in *Eubank*, the assignor's rights to royalties were compensation for past services performed (deferred compensation), and as such had to be included in his gross income. *Id.* The court stated:

> The taxpayer did not receive for those services any part of the Kodachrome process itself or any right to control the disposition of that process. Rather, he obtained the enforceable promise of the owners of the process that he would be paid for his services a definite portion of the royalties they had the right to receive from the Eastman Kodak Company.

Id. at 442.

59. Taxation of punitive damages as a part of the compensation for injuries or sickness, a related issue, was previously a matter of controversy, until Congress recently resolved it. Section 104(a)(2) now explicitly exempts only "any damages *(other than punitive damages)* received . . . on account of personal physical injuries or physical sickness" from gross income. I.R.C. § 104(a)(2) (1995) (emphasis added).

60. *Compare* Estate of Clarks v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (determining there was no income to the client), *and* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (finding no income to the client), *with* Baylin v. United States, 43 F.3d 1451, 1452 (Fed. Cir. 1995) (finding income to the client), *and* Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000) (finding income to the client).

1. Circuit Cases Rule in Favor of Non-Taxability: Reliance on a Distinction Between Assignment of Vested Income and Assignment of Contingent Expectancy as Well as on Favorable State Law

In *Cotnam v. Commissioner*,[61] the Fifth Circuit was the first court to address the issue of whether contingency fees are taxable income to both attorney and client.[62] The court held that the sum paid to Cotnam's attorneys for securing the judgment did not constitute gross income to Cotnam.[63] The court relied on the Alabama Code, section 64(2), which gives attorneys an equitable lien in the cause of action of their client, thus vesting attorneys with virtually the same rights in the cause of action.[64] The Fifth Circuit reasoned that, under Alabama law, by entering into a contingency-fee agreement, Cotnam had effectively transferred a portion of her claim to her attorney.[65] In doing so, Cotnam lost all rights over that part of her claim.[66]

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61. 263 F.2d 119 (5th Cir. 1959).

62. Cotnam hired an attorney for a claim to recover a portion of her friend's estate that he promised to Cotnam for providing him with various household-related services and companionship. *Id.* at 120. After a lengthy litigation, the Alabama Supreme Court awarded Cotnam a judgment of $120,000. *Id.* at 121. From this amount, $50,365.83 was paid to her attorney under a contingency fee agreement. *Id.* The Internal Revenue Service (IRS) found Cotnam deficient in her income tax in the amount of $36,985.02 because the Commissioner treated the entire judgment as taxable income. *Id.* The Tax Court affirmed the Commissioner's determination and Cotnam appealed to the Court of Appeals for the Fifth Circuit. *Id.*

63. *Id.* at 126. Cotnam also argued that the portion of the judgment she retained after paying her attorney's fees constituted an increase in wealth acquired by bequest and therefore should be excluded from gross income. *Id.* at 121. The court, however, rejected this contention and held that the amount constituted income for services rendered and thus should be taxed. *Id.* at 125.

64. *Id.* at 125; *see also* United States Fidelity & Guar. Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935) (holding that under the Alabama statute, the attorney has an equitable assignment in the cause of action); 46 ALA. CODE § 64(2) (1940). The statute provides:

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

Id. The current statutory provision is virtually similar, merely replacing "suits, judgments, and decrees" with "actions and judgments for money." 18 ALA. CODE § 34-3-61 (1975).

65. *Cotnam*, 236 F.2d at 125.

66. *Id.* The Fifth Circuit also distinguished the case from *Earl* and *Horst*. *Id.* at 125-26. The court asserted that the doctrine of anticipatory assignment that *Earl* and *Horst* relied upon assumed that the assignor had a fully vested right to receive the benefits of income. *Id.* In *Cotnam*, however, Cotnam had nothing else but an expectancy of receiving some judgment, contingent upon the effectiveness of the legal services of her attorney. *Id.* Without the assistance of her attorneys, Cotnam would have never been able to "fully

In *Estate of Clarks v. United States*,[67] the Sixth Circuit adopted the *Cotnam* court's reasoning regarding contingency fee taxation.[68] Explicitly relying upon *Cotnam*, the Sixth Circuit held that the interest portion of the judgment[69] paid to the attorney did not constitute income to Clarks.[70] The Sixth Circuit reasoned that, by entering into a contingency fee agreement, Clarks effectively assigned a portion of his claim to his attorney, thereby establishing a partnership or joint venture between Clarks and his attorney.[71] The court analogized Michigan's

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enjoy[ ] the benefit of his (her) economic gain . . . ." *Id.* at 126 (quoting Helvering v. Horst, 311 U.S. at 112, 116 (1940)).

Judge Wisdom's dissenting opinion found Cotnam's property interest in income even stronger than those of the assignor in *Horst*. *Id.* at 126-27 (Wisdom, J., dissenting). In *Horst*, the Supreme Court found the income of negotiable interest coupons taxable to the assignor even though the assignment occurred before the coupons' maturity, and therefore, before the assignor had a chance to realize income generated by the coupons. *Id.*; *see also Horst*, 311 U.S. at 120. Because Cotnam assigned the right to a portion of her income after she had already earned it, Judge Wisdom argued that it naturally followed that Cotnam's income should also be found taxable. *Cotnam*, 236 F.2d at 126-27 (Wisdom, J., dissenting).

67. 202 F.3d 854 (6th Cir. 2000).

68. *Id.* at 857. Clarks received $11,307,875.55 in damages for personal injuries sustained during the course of employment at K-Mart. *Id.* at 855. The amount of $5,600,000 represented the damage award for personal injury and the remaining $5,707,837.55 represented the interest. *Id.* Under the contingency fee agreement, Clarks' attorney received one third from both the damage award and interest, amounting to $1,865,156.54 and $1,901,314.67, respectively. *Id.* After his death, Clarks' estate failed to include in his income $1,901,314.67 paid to Clarks' attorney from the interest portion of the judgment; thus, Clark's estate had a deficiency of $254,298. *Id.* The interest was deductible as a miscellaneous itemized deduction under section 67(a) subject to a two-percent of adjusted income floor. *Id.*; *see also* I.R.C. § 67(a) (1994). The effect of section 67(a), coupled with section 55, which regulates the alternative minimum tax, produced a tax deficiency in the amount of $254,298. *Clarks*, 202 F.3d at 855; *see also* I.R.C. § 55 (1994). The district court adjudicating the dispute granted summary judgment for the IRS and Clarks' estate appealed. *Clarks*, 202 F.3d at 855-56.

69. Because the damage award constituted a recovery for personal injury which is excludable from gross income under the Code section 104(a)(2), the issue of dispute was only the interest portion on this damage award. *Clarks*, 202 F.3d at 855 (stating that "[r]ecovery for personal injury is ordinarily not taxable under § 104(a)(2) of the Internal Revenue Code, but the interest on the award is taxable).

70. *Id.* at 857-58.

71. *Id.* The court quotes at length a section of Ray Andrews Brown's book, *The Law of Personal Property*, which describes an attorney's lien as "a peculiar lien, to be enforced by peculiar methods." *Id.* at 836. The court continued:

> If the fund recovered was in possession or under the control of the court, it would not allow the client to obtain it until he had paid his attorney, and in administering the fund it would see that the attorney was protected. If the thing recovered was in a judgment, and notice of the attorney's claim had been given, the court would not allow the judgment to be paid to the prejudice of the attorney.

attorney's lien law to Alabama's attorney's lien law, concluding that the two are virtually identical.[72]

Additionally, the court distinguished *Earl* and *Horst* on the issue of vested income versus contingent expectancy.[73] Unlike the decisions in *Earl* and *Horst*, the Sixth Circuit found that Clarks' claim amounted to only an intangible expectancy, fully dependent on the skills of his attorney.[74] As such, the Sixth Circuit concluded that Clarks' claim was purely speculative and not vested in Clarks.[75]

The Eleventh Circuit dealt with a similar issue in *Davis v. Commissioner*.[76] In its brief opinion, the court allowed Davis to exclude from her income, payments to her attorneys under a contingency fee agreement.[77] Since the Fifth Circuit decisions are binding on the Eleventh Circuit,[78] the court felt obligated to rule consistently with *Cotnam*, which the court found "squarely on point."[79]

One year after *Davis*, in *Foster v. United States*,[80] the Eleventh Circuit reinforced its reliance on the *Cotnam* precedent in a more detailed opinion.[81] The issue for review involved the taxation of punitive

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

72. *Id.*

73. *Id.* at 857.

74. *Id.*

75. *Id.*

76. 210 F.3d 1346 (11th Cir. 2000).

77. *Id.* at 1348.

78. Bonner v. City of Prichard, 661 F.2d 1206, 1209 (11th Cir. 1981); *see also Davis*, 210 F.3d at 1347 n.2.

79. *Davis*, 210 F.3d at 1347.

80. 249 F.3d 1275 (11th Cir. 2001).

81. Foster won damages in the Alabama state court in the amount of "$50,000 in compensatory damages, $1 million in punitive damages, and $156,032.80 in post-judgment interest." *Id.* at 1276. Based on the original contingency fee agreement, Foster's attorneys were entitled to fifty percent of her judgment. *Id.* To secure proper representation on appeal, however, Foster entered into another contingency fee agreement guaranteeing to her attorneys all of the post-judgment interest. *Id.* at 1277. After winning on appeal, Foster received half of the compensatory and punitive damages, while her attorneys received the other half as well as all of the post-judgment interest. *Id.* at 1277 n.3.

The IRS found a tax deficiency and later levied her annuity policy for taxes on the total damage award. *Id.* at 1277. The IRS allowed only an itemized deduction for attorneys' costs and fees. *Id.* Relying on *Earl* and *Horst*, the district court held that Foster should have included all of the punitive damages and half of the post-judgment interest in her gross income. *Id.* at 1277, 1279.

damages, post-judgment interest, and the award of litigation costs.[82] Because post-judgment interest was a result of a contingency fee agreement signed before the appeal, the Eleventh Circuit found Foster's situation clearly governed by the *Cotnam* precedent, and *Lucas* and *Horst's* doctrine of anticipatory assignment of income inapplicable.[83] Noticing that the fee arrangements in both *Foster* and *Cotman* were governed by Alabama law, the Eleventh Circuit, relying on the existence of an attorney's lien, had no difficulty in finding the post-judgment interest excludable from Foster's income.[84]

2. Dodging a Definite Ruling: Srivastava v. Commissioner Relies on Stare Decisis and Rules in Favor of Non-Taxability Despite No Attorney Lien Law

In July 2000, the Fifth Circuit revisited contingency fee taxation in *Srivastava v. Commissioner.*[85] The Tax Court found both Srivastava and his wife deficient on their taxes, which were due on the punitive damages and interest portions[86] of a settlement award.[87] The Srivastavas appealed to the Fifth Circuit, contesting the taxing of the the settlement portion paid to his attorney under a contingency fee agreement.[88] The Fifth Circuit, relying on the doctrine of *stare decisis,* followed the *Cotnam* precedent and held that the portion paid to the attorney did not constitute income to the taxpayers.[89]

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82. *Id.* at 1277. Because Foster's award of compensatory damages was for emotional distress,which is not considered a physical injury in Alabama, the Eleventh Circuit found her punitive damages not excludable under Section 104(a)(2). *Id.* at 1278.

83. *Id.* at 1279-80.

84. *Id.* at 1279. The Eleventh Circuit also held that the award of litigation costs should have been excluded from Foster's income, since the IRS erroneously denied her refund, which started the litigation, in the first place. *Id.* at 1280-81.

85. 220 F.3d 353 (5th Cir. 2000).

86. *Id.* at 356-57. Eleven and one-half million dollars of the settlement award represented actual damages which are not taxable under the Code section 104(a)(2). *Id.* The rest of the settlement award represented punitive damages and interest. *Id.*

87. *Id.* The case originated from a defamation action filed by Srivastava against a television station. *Id.* at 355. The jury awarded Srivastava $11,500,000 in actual damages, $17,500,000 in punitive damages, plus pre- and post-judgment interest. *Id.* The station filed an appeal but the parties finally settled for $8,500,000. *Id.* The Commissioner for the IRS found a tax deficiency on the portion of the settlement representing punitive damages and interest. *Id.* at 356. Recalculating the portion of the settlement on the basis of the original jury award, the Tax Court affirmed the Commissioner's finding in principle, but slightly reduced the deficiency. *Id.* at 356-57.

88. *Id.* at 357.

89. *Id.* at 357-58. The court also affirmed the Tax Court's recalculation of the portions of the settlement representing actual damages, punitive damages, and interest. *Id.* at 366.

Considering the issue to be one of "characterization,"[90] the majority recognized the hybrid nature of contingency fee agreements.[91] As the majority found, contingency fee contracts fall neither under the category of anticipatory assignment of vested income nor under the category of complete divestment of property.[92] Instead, the majority characterized contingency fee contracts as similar to partnerships or joint ventures.[93]

Despite the difference in attorney rights under Alabama and Texas law, the Fifth Circuit followed its decision in *Cotnam* and ruled that the attorney's fees were excludable from the client's gross income.[94] The

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90. *Id.* at 359.

91. *Id.* at 360.

92. *Id.*

93. *Id.* (quoting Estate of Clarks v. United States, 202 F.3d 854, 857-58 (6th Cir. 2000)). While the court did not elaborate on this assertion, under Texas law, the possibility of a partnership or joint venture relationship between a client and attorney might exist as Texas law explicitly recognizes that the assignment of a cause of action creates a property right in a attorney/assignee. TEX. PROP. CODE ANN. § 12.014(a) (Vernon 1984 & Supp. 2001). The statute provides:

> A judgment or part of a judgment of a court of record or an interest in a cause of action on which suit has been filed may be sold, regardless of whether the judgment or cause of action is assignable in law or equity, if the transfer is in writing.

Id.; *see also* McCloskey v. San Antonio Traction Co., 192 S.W. 1116, 1120 (Tex. Civ. App. 1917) (holding that "[s]ince a claimant has the right to assign all or any part of his cause of action, and all persons have the right to buy or acquire the same or any part thereof, it is not unlawful for the appellant to acquire an interest in any claim or claims").

As early as 1897, the Texas Court of Civil Appeals expressly held that the language of a contract between a client and an attorney was "a sufficient transfer to [the attorney] of one-half the cause of action." Texas & P. Ry. Co v. Vaughn, 40 S.W. 1065, 1066 (Tex. Civ. App. 1897). The court continued: "[the attorney] being the owner of one-half the cause of action, he was not bound by any settlement made by Waters with the company, and had the right to prosecute the suit for his own benefit to the extent of his interest." *Id.* at 1067.

In 1912, the Texas Supreme Court recognized the right of an attorney to adjudicate an assigned portion of his client's claim, even if a client chooses to settle instead. Seiter v. Marschall, 147 S.W. 226, 228 (Tex. 1912). Ruling for the attorneys, the Texas Supreme Court stated that:

> It should not be permitted to hold out to an assignee that he can with safety prosecute his cause of action in the trial court in the name of the assignor and owner of the remaining interest; but when the appellate court is reached, where he is not allowed to make himself a party of record and all opportunity to do so is gone, his interest in the cause of action shall be at the mercy of such assignor and part owner, though an absolute power to dispose of the case according to his own will, to maintain or dismiss the appeal at his pleasure, and thus make of the law a snare at the initial stage of the proceeding and a possible means of certain destruction of valuable rights in the end.

Id. at 228; *see also* Wichita Falls Elect. Co. v. Chancellor & Bryan, 229 S.W. 649, 650 (Tex. Civ. App. 1921) (upholding a directed verdict awarding damages to attorneys who, after the client settled, sued on their assigned portion of the cause of action).

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

court stated that the difference in state laws does not affect "the economic reality" facing the taxpayer.[95] Because the Fifth Circuit, in *Cotnam*, did not apply the doctrine of anticipatory assignment, which may have dictated a different outcome, and ruled in favor of non-taxability, the precedential value of this decision prevented the court from engaging in a different analysis or ruling differently.[96]

3. Circuit Cases Find in Favor of Taxability: Reliance on Earl, Horst, and Unfavorable State Law

Besides the Fifth, Sixth, and Eleventh Circuits, no other circuit has followed *Cotnam's* disregard for the doctrine of anticipatory assignment of income.[97] In fact, shortly after the Fifth Circuit decided *Cotnam*, the Third Circuit, in *O'Brien v. Commissioner*,[98] affirmed the decision of the

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95. *Id.* at 362.

96. *Id.* at 364 n.33. Although the court explicitly found the assignment of income doctrine that *Earl* and *Horst* relied upon inapplicable, it nevertheless compared *Srivastava* with both cases. *Id.* at 359-63. The Fifth Circuit found that, unlike in *Earl* and *Horst*, Srivastava did not assign a portion of his income that he had realized. *Id.* at 361. Srivastava neither owned nor controlled the source of his income; therefore, the court classified the contingency fee agreement as a "gratuitous transfer," which was the crux of both *Earl* and *Horst*. *Id.* The court noted, however, that the uncertainty of the claim should not mean that "a taxpayer cannot achieve gain from anticipatorily assigning it to another." *Id.* at 362.

The majority acknowledged that if *Srivastava* was a case of first impression, the outcome might have been the opposite because the court would have applied the anticipatory assignment doctrine. *Id.* at 357-58. Moreover, referring to the well-established rule that non-contingency fees are paid from the client's pocket, the majority explicitly concluded that "[t]here is no apparent reason to treat *contingent* fees differently [from the taxation of non-contingency fee portions of damages] or to believe that Congress intended to subsidize contingent fee agreements in such a fashion." *Id.* at 357.

In his dissenting opinion, Judge Dennis drew upon the substantial difference in Alabama and Texas laws regulating rights of attorneys. *Id.* at 367-68 (Dennis, J., dissenting). In Texas, clients entering into contingency fee agreements with their attorneys do not effectively transfer a portion of their claim. *Id.* at 368. Unlike Alabama, Texas attorneys do not have a lien on clients' claims and their rights are wholly dependent on the rights of the clients. *Id.* Therefore, because a contingency fee agreement can be satisfied only after the settlement or judgment is awarded to the client, Judge Dennis argued that such an award is taxable income to the client. *Id.*

97. *See, e.g.*, Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000), *cert. denied*, 121 S. Ct. 1604 (2001); Baylin v. United States, 43 F.3d 1451, 1454 (Fed. Cir. 1995); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963).

98. 38 T.C. 707 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963). The Court of Appeals for the Third Circuit, in a one-sentence opinion, affirmed the decision of the Tax Court without elaboration. O'Brien v. Comm'r, 319 F.2d 532 (3d Cir. 1963).

Tax Court to treat attorney fees, even those paid out under a contingency fee agreement, as gross income.[99]

The Tax Court admitted that it dealt with virtually the same issue in *Cotnam*.[100] As in *Cotnam*, the Tax Court first focused on the analysis of a governing state law relating to attorneys' rights.[101] Recognizing the difference between Alabama and Pennsylvania law, the court distinguished *Cotnam* from *O'Brien*.[102] By entering into a contingency agreement with clients, Pennsylvania attorneys (unlike their colleagues in Alabama) do not acquire a lien upon the client's claim.[103] Although noting that the difference in law dictates the difference in results, the Tax Court also admitted that it was unlikely that the "Internal Revenue Code was intended to turn upon such refinements."[104] The Tax Court then applied the doctrine of anticipatory assignment of income and concluded that legal fees should be included in clients' gross income.[105]

The Federal Circuit followed the same line of reasoning in *Baylin v. United States*.[106] In that case, the Federal Circuit affirmed the Court of Federal Claims' holding that the portion of the condemnation award paid to a partnership's attorney constituted income to the partnership.[107]

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99. *O'Brien*, 319 F.2d at 532. O'Brien, suing his former employee for wrongful discharge, received $16,173.05 in back wages, $8,243.10 out of which were paid to his attorney. *O'Brien*, 38 T.C. at 707. O'Brien argued that the legal fees should be subtracted from his recovery and the remaining portion should be spread back among previous years. *Id.* at 710. He relied upon section 1303 of the Code which allows back pay to be allocated to applicable years. *Id.* (citing I.R.C. § 1303 (1994)). In his first tax return, O'Brien also spread back the deduction for legal fees. *Id.* The Commissioner insisted that the legal fees must be deducted as one amount in the year of the judgment. *Id.* O'Brien disagreed, arguing that, before spreading his income back to previous years, legal fees should actually be excluded from his income. *Id.*

100. *O'Brien*, 38 T.C. at 711.

101. *Id.* at 712.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* The Court did not explain, however, how *Earl* and *Horst* applied to *O'Brien*.

106. 43 F.3d 1451 (Fed. Cir. 1995). In the same year, the First Circuit decided *Alexander v. Internal Revenue Service*, which arguably put that court in the anti-*Cotnam* group. 72 F.3d 938 (1st Cir. 1995). The *Alexander* court addressed whether legal fees paid to Alexander's attorneys under a contingency fee agreement (the formality of which was also questioned) were excludable from his gross income. *Id.* at 941. While the First Circuit did not discuss *Earl* and *Horst* or the doctrine of anticipatory assignment of income which the two cases represent, it nevertheless demonstrated that it was more inclined to prohibit taxpayers from evading taxes in contingency fee situations. *Id.* at 946.

107. *Baylin*, 43 F.3d at 1452. The state of Maryland condemned the property owned by Baylin and other partners in his firm. *Id.* The partnership challenged the condemnation award and the parties settled for $16,319,522.91. *Id.* at 1453. From that amount, $4,048,424 was paid to the partnership's attorney. *Id.* When filing its tax return,

Relying specifically on *Earl* and *Horst*, the Federal Circuit found that the partnership enjoyed the benefits of the funds paid to the attorney by being able to satisfy its obligation to pay legal fees.[108] Consequently, the Federal Circuit concluded that the assignment of these funds to the attorney, prior to them being secured, did not necessarily mean that the partnership did not own the funds at some point in time.[109]

The Ninth Circuit's decision in *Coady v. Commissioner*[110] strengthened the position of the anti-*Cotnam* group.[111] The Ninth Circuit, acknowledging the circuit split on the issue, adopted the reasoning of the Third and Federal Circuits, which found *Cotnam* and its progeny distinguishable.[112] First, the Ninth Circuit noted that, unlike Alabama or Michigan law, Alaska law, under which the case arose, does not create an

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the partnership did not include legal fees in its capital gain. *Id.* The partnership argued its case under three alternative theories: (1) legal fees should be deductible from the income under section 212(1) (as an "ordinary and necessary business expense"); (2) legal fees were paid under a contingency fee agreement, therefore constituting no income to the partnership; and (3) under Maryland statutory law, an attorney has a lien on a portion of a settlement or judgment received by his client, thus giving the attorney an ownership interest in the award. *Id.* at 1453-54. Because the scope of this Comment does not cover the topic of deductible business expenses, this Comment refrains from further discussion of the first theory.

108. *Baylin*, 43 F.3d at 1454. The court concluded that the partnership "'made such use or disposition of [its] power to receive . . . the income as to procure in its place other satisfactions which are of economic worth.'" *Id.* (quoting Helvering v. Horst, 311 U.S. 112, 116 (1940)).

109. *Id.* at 1455. The Federal Circuit also refused to adopt the partnership's interpretation of the Maryland statute relating to attorneys' liens. *Id.* The Federal Circuit held that, because the statute did not create an ownership interest in the award, legal fees paid out of the condemnation awards had to be included in gross income of the partnership. *Id.*

110. 213 F.3d 1187 (9th Cir. 2000). Coady received damages for wrongful termination (back pay, future lost earnings, and lost fringe and pension benefits) in the amount of $373,307. *Id.* at 1187. The Commissioner subsequently challenged Coady's failure to include the entire award in his income. *Id.* at 1188. The Coadys reported only $89,225 as income, the portion of award that represented back wages. *Id.* The Coadys reduced the remainder of $284,082 by $168,217 (deduction for legal fees), which resulted in a net self-employment income of $115,865. *Id.* The Commissioner contended that the entire award should have been reported as gross income and that the legal fees were deductible as a miscellaneous itemized deduction under section 67(a), subject to the two percent floor. *Id.*; *see also* I.R.C. § 67(a) (1994). On appeal, the Ninth Circuit addressed whether the legal fees and costs constituted income to the taxpayers. *Coady*, 213 F.3d at 1187-91.

111. *Coady*, 213 F.3d at 1190. The Ninth Circuit's unpublished opinion in *Brewer v. Commissioner*, 172 F.3d 875 (9th Cir. 1999), was consistent with *Coady*. Brewer refused to pay taxes on the portion of her Title VII settlement that was paid to her attorney under the contingency fee agreement. *Id.* at 875. The Ninth Circuit held that despite the legal fees being directly paid to the attorney, the fees were income to Brewer, who received benefit of the entire settlement award. *Id.*

112. *See Coady*, 213 F.3d at 1189.

equitable lien in the client's cause of action for an attorney working under the contingency fee agreement.[113] Second, the Ninth Circuit adopted the theory of "the nature of the underlying action" from *Tribune Publishing Co. v. United States*.[114] This theory assists courts in identifying whether damage awards constitute income, by asking the question: "In lieu of what were the damages awarded?"[115] In *Coady*, because the damage was in lieu of wages, which are taxed as ordinary income, the entire damage award was included in income.[116] Third, the Ninth Circuit expressly rejected the attempt to distinguish *Coady* from *Earl* and *Horst* because of the differences between the claim's uncertain nature and the vested interest in income or property.[117] The Ninth Circuit held that the anticipatory assignment of income doctrine is applicable even in cases where the assignment income is doubtful and uncertain.[118] This is because uncertain and contingent income will eventually vest in the client, who should then include it in his gross income.[119]

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113. *Id.* at 1190; *see also* ALASKA STAT. § 34.35.430(a) (Lexis Law Publishing 1998). The statute provides:

> An attorney has a lien for compensation, whether specially agreed upon or implied, as provided in this section (1) first, upon the papers of the client that have come into the possession of the attorney in the course of the professional employment; (2) second, upon money in the possession of the attorney belonging to the client; (3) third, upon money in the possession of the adverse party in an action or proceeding in which the attorney is employed, from the giving of notice of the lien to that party; (4) fourth, upon a judgment to the extent of the costs included in the judgment or, if there is a special agreement, to the extent of the compensation specially agreed on, from the giving of notice of the lien to the party against whom the judgment is given and filing the original with the clerk where the judgment is entered and docketed.

Id.

114. 836 F.2d 1176, 1177 (9th Cir. 1988).

115. *Coady*, 213 F.3d at 1190. "In determining whether receipts are taxable as ordinary income or return of capital it is immaterial whether taxpayer effected collection amicably or by resolving a dispute through compromise or litigation. It is the nature of the underlying claim that controls and not the manner of collection." *Tribune Publ'g Co.*, 836 F.2d at 1177-78 (citing Spangler v. Comm'r, 323 F.2d 913, 916 (9th Cir. 1963)). In *Spangler*, the Court held that because the plaintiff, who was defrauded to sell her stock, received a payment in lieu of her dividends, the payment was taxable as dividend income not as a return of capital. *Spangler*, 323 F.2d at 916-17.

116. *Coady*, 213 F.3d at 1190-91. The Court also observed, identical to the Federal Circuit's observation in *Baylin*, that Coady consumed the benefit of the award by using a portion of the award to discharge Coady's liability to her attorney. *Id.* at 1191; *see also Baylin*, 43 F.3d at 1454-55 (citing Helvering v. Horst, 311 U.S. 112, 116 (1940)).

117. *Coady*, 213 F.3d at 1191.

118. *Id.*

119. *Id.* The Court relied upon *Kochansky v. Comm'r*, 92 F.3d 957, 958-59 (9th Cir. 1996), which held that an anticipatory assignment of a contingency fee to an attorney's

In its latest decision, *Benci-Woodward v. Commissioner*,[120] the Ninth Circuit held that attorneys' fees are included in the client's income, which is consistent with *Coady*.[121] The court expressly relied upon *Coady* and held that although the realization of contingency fees is uncertain, it is not different from any other kind of impermissible assignment of income.[122] The court also examined the nature of an attorney lien under California law, finding it ineffective to convey any ownership interest in a cause of action.[123] The court considered an attorney lien to be only a guarantee on a portion of the client's prospective damage award and opined that finding otherwise would "demean [the attorney's] profession and distort the purpose of the various acceptable methods of securing [a] fee."[124] The court viewed the contingency fee agreement as creating only a "professional interest" in the cause of action.[125]

The Fourth Circuit is the latest circuit to join the anti-*Cotnam* group. In *Young v. Commissioner*,[126] the Fourth Circuit ruled on whether to include in Mrs. Young's income contingency fees paid to her attorneys from the proceeds of the sale of a tract of land transferred to Mrs. Young as incident to divorce and later purchased by a third party.[127] Relying on *Lucas* and *Horst*, the Fourth Circuit characterized Mrs. Young's situation as an assignment of income.[128] The court opined that "[u]nder the reasoning of [*Lucas*] and *Horst*, Mrs. Young's anticipatory assignment of a portion of her settlement proceeds to her attorneys does not foreclose

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wife constituted income to the attorney, despite its uncertain and doubtful character at the time of the assignment. *See Coady*, 213 F.3d at 1191.

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

121. *Id.* at 942. The Benci-Woodwards entered into a contingency fee agreement with their attorney to pursue a claim against their employee, Target Stores, for "false imprisonment, defamation, intentional infliction of emotional distress, wrongful discharge in violation of public policy, breach of implied-in-fact employment contract, breach of the implied covenant of good faith and fair dealing, constructive discharge, and intentional misrepresentations." *Id.* at 942. A jury awarded both compensatory and punitive damages to the Benci-Woodwards. *Id.* at 943. The clients/taxpayers contested the inclusion of the attorney's portion of the damage award in their gross income. *Id.*

122. *Id.* at 943 n.2.

123. *Id.* at 943. Without elaboration, the court admitted that "there is occasional language in cases in the effect that the attorney also becomes the equitable owner of a share of the client's cause of action . . . ." *Id.*

124. *Id.*

125. *Id.*

126. 240 F.3d 369 (4th Cir. 2001).

127. *Id.* at 372. The court first decided that Mrs. Young's ex-husband's transfer of property to her was incident to the divorce and therefore did not result in any taxable gain or loss. *Id.* at 375.

128. *Id.* at 376-77.

taxation of those proceeds, i.e., they are nonetheless includible within Mrs. Young's gross income."[129] The court refused to adopt the contingency fee exception established by *Cotnam*.[130] To distinguish *Cotnam* on additional grounds, the court compared North Carolina law regarding an attorney's charging lien with the law in Alabama.[131] Since a charging lien under North Carolina common law "attaches only to a judgment, not to a cause of action," the Fourth Circuit found another rationale to rule in favor of taxation.[132]

II. THE CIRCUIT COURTS BEG THE ISSUE: A SUPERFICIAL EXAMINATION OF THE ISSUE YIELDS DISTORTED RESULTS

As reflected by the circuit split, the taxation of contingency fee portions of damage awards is far from resolved.[133] The circuit courts struggle not only with the application of the facts from each case to a particular rule,[134] but also with choosing an appropriate analytical method to resolve this problem.[135]

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129. *Id.* at 377.

130. *Id.* at 379.

131. *Id.*

132. *Id.* (quoting Dillon v. Consolidated Delivery, Inc., 258 S.E.2d 829, 830 (N.C. 1979)).

133. *Compare* Srivastava v. Comm'r, 220 F.3d 353, 364 (5th Cir. 2000) (holding that under *Cotnam* the attorney fees are excludable from gross income of the taxpayer, despite the fact that under the Texas law attorneys do not have a lien in the client's cause of action), *with* Coady v. Comm'r, 213 F.3d 1187, 1190-91 (9th Cir. 2000) (holding that the attorney fees are not excludable from gross income of the taxpayer, partly because, under the Alaska law, attorneys do not have an effective lien in the client's cause of action).

134. *See, e.g.*, Cotnam v. Comm'r, 263 F.2d 119, 125-26 (5th Cir. 1959); Clarks v. United States, 202 F.3d 854, 857 (6th Cir. 2000). *But see* Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995); *Coady*, 213 F.3d at 1191.

Although the facts in the cases representing the split are strikingly similar, some courts distinguish *Earl* and *Horst* by arguing that the taxpayer's cause of action was purely an intangible contingency and therefore did not constitute a vested right, therefore making the assignment of income doctrine inapplicable. *See, e.g.*, *Cotnam*, 263 F.2d at 125-26; *Clarks*, 202 F.3d at 857. Some courts, however, find *Earl* and *Horst* analogous, arguing that by entering into a contingency fee agreement, a taxpayer attempted to assign his income to his attorney, which is impermissible under the doctrine of anticipatory assignment of income. *See, e.g.*, *Baylin*, 43 F.3d at 1454-55; *Coady*, 213 F.3d at 1191.

135. *See, e.g.*, *Srivastava*, 220 F.3d at 364 (ignoring the effect of the state law); *Cotnam*, 263 F.2d at 125 (relying on a state law regulating an attorney-client relationship); *Coady*, 213 F.3d at 1190 (applying the "nature of the underlying action" doctrine to dispose of the issue); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962) (relying on *Earl* and *Horst* without elaboration).

A. The Circuit Courts' Application of the Anticipatory Assignment of Income Doctrine Under Earl and Horst Is Inappropriate

When ruling on the issue, circuit courts analyze whether a damage award constitutes a vested right in income or only an intangible, contingent expectancy.[136] If a court finds that a client's claim amounts to a vested right in a damage award (taxable as ordinary income), a contingency fee portion of the damages represents an impermissible assignment of income and therefore is fully taxable to the client.[137] On the other hand, if a court determines that the client's claim amounts to an intangible expectancy, which is speculative in nature, a contingency fee paid to an attorney is not an anticipatory assignment of income and therefore is not taxable to the client.[138]

The circuit courts' analysis of the issue under *Earl* and *Horst* is deficient because the anticipatory assignment of income doctrine cannot effectively resolve the issue.[139] First, as previously discussed, the doctrine anticipates that the assignor would have received the full benefit of his income had he not assigned it to the assignee.[140] For courts to apply the doctrine in a contingency fee situation, they would have to be persuaded that had a client not assigned a portion of his claim to his attorney, he would have received the full benefit of the award.[141] This premise is impossible to satisfy because, in any litigation, there is no guarantee that a client will recover any damages or receive a settlement.[142]

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136. *See, e.g.*, *Cotnam*, 263 F.2d at 125-26; *Clarks*, 202 F.3d at 857; *Baylin*, 43 F.3d at 1454-55.

137. *See, e.g.*, *Baylin*, 43 F.3d at 1454; *O'Brien*, 38 T.C. at 712.

138. *See, e.g.*, *Cotnam*, 263 F.2d at 125; *Clarks*, 202 F.3d at 857.

139. *See* Srivastava v. Comm'r, 220 F.3d 353, 360-61 (5th Cir. 2000). The Fifth Circuit noted that because it is difficult to categorize the nature of contingency fee agreements, it makes it equally difficult to apply the Code as well as to judicially developed principles. *Id.* at 358-60. The Fifth Circuit stated also that "contingent fee contracts defy easy categorization, standing as they do somewhere in between the two poles – on the one hand, an obvious scheme to evade taxation through diversion of future income streams to another, and on the other hand, full and complete divestment of income source." *Id.* at 360.

140. *See, e.g.*, Comm'r v. First Sec. Bank of Utah, N.A., 405 U.S. 394, 403 (1972).

141. *See Srivastava*, 220 F.3d at 360. The Fifth Circuit also stated that because the doctrine of anticipatory assignment assumes that the taxpayer had a vested right in his income or property, it is inapplicable to those situations where a client assigns a portion of his *potential* income (not fully vested) to his attorney. *Id.* at 359.

142. *See, e.g.*, Jones v. Comm'r, 306 F.2d 292 (5th Cir. 1962). The Fifth Circuit observed that:

> Indeed, lawsuits are rarely certain and free of doubt. Experienced lawyers have long since learned that it is unwise and indeed, ultra foolish to predict the results of litigation . . . . When this assignment was made over five months before the

The second reason the doctrine is inapplicable is because courts have consistently applied the doctrine only to situations involving gratuitous transfers among family members.[143] However, an attorney-client relationship, involves an arm's-length transaction and not a gratuity.[144] The Sixth Circuit acknowledged this distinction by pointing out that "[t]he assignee [in *Earl* and *Horst*] performed no services in order to receive the income."[145] Such a fundamental difference in the nature of these transactions indicates that the application of the doctrine to attorney-client relationships is misplaced.[146]

B. State Laws on Attorney Liens Do Not Answer the Question Whether an Attorney Received Any Property Rights

In addition to applying the doctrine of anticipatory assignment of income, circuit courts have devoted substantial parts of their decisions to analyzing relevant state laws that regulate attorney-client relationships.[147] At least one circuit has indicated that under a contingency fee agreement, an attorney has some equitable interest in the client's cause of action.[148] This suggests that a portion of the client's claim has been transferred to the attorney.[149] Consequently, even if the case is settled

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> Court of Claims announced its decision, over nine months before the decision became final, and over fourteen months before payment was received, the "tree" appeared to be blighted and almost devoid of life. It had borne "no fruit" and to a layman . . . while hopeful and confident because he believed in the justice of his claim, certainly he could no be said to have sufficient insight reasonably to speculate what the United States Court of Claims would ultimately decide.

Id. at 301; *see also Cotnam*, 263 F.2d at 125 (Rives and Brown, JJ., concurring) (observing that a client who had a claim was "a long way from having the equivalent of cash . . . [because h]er claim had no fair market value, and it was doubtful and uncertain as to whether it had any value").

143. KLEIN, *supra* note 32, at 659 (stating that the assignment of income doctrine applies to those instances where a taxpayer shifts his income to a family member in a lower tax bracket, which results in a double enjoyment of the zero bracket benefit).

144. *Srivastava*, 220 F.3d at 361; *see also Clarks*, 202 F.3d at 858 (concluding that "[in *Clarks*] the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation").

145. *Clarks*, 202 F.3d at 857.

146. *See Jones*, 306 F.2d at 302. The Fifth Circuit found that "[n]o gratuity is involved here as has been involved in numerous other cases. So far as the record discloses, the assignment contract was an arm's length transaction." *Id.*

147. *See, e.g.*, *Cotnam*, 263 F.2d at 125; Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962).

148. *Cotnam*, 263 F.2d at 125-26.

149. *Id.* at 125. The Alabama Code of 1940, in section 64, provided: "[A]ttorneys at law shall have the same right and power over said suits, judgment and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them." 46 ALA. CODE § 64 (1940); *see also* 18 ALA. CODE § 34-3-61 (1975). The current statutory

directly with the defendant, the client loses the right to the attorney fees portion of the damages.[150] Some courts, therefore, interpret the effect of such laws to mean that, by entering into a contingency fee agreement, the client disposed of a portion of his claim and therefore can no longer generate any income for the client/taxpayer.[151]

In *Srivastava*, however, the Fifth Circuit refused to find the state law determinative,[152] and the Tax Court in *O'Brien* acknowledged that "it [is] doubtful that the Internal Revenue Code was intended to turn upon such refinements."[153] The *Srivastava* court disregarded the nonexistence of an attorney lien under Texas law because the court had already ruled in *Cotnam* that contingency fees were excluded from a client's income.[154] To preserve judicial uniformity, the Fifth Circuit disregarded the fact that unlike in Alabama, under which *Cotnam* arose, contingency fee attorneys in Texas do not have an effective lien in their clients' causes of action.[155]

Additionally, the *Srivastava* court opined that there was no reason for taxing clients retaining attorneys under a non-contingency fee agreement differently from those retaining attorneys under a contingency fee agreement.[156] According to the court, the attorney compensation method should have no significant bearing on the clients' enjoyment of damage awards.[157]

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provision merely replaces "said suits, judgments, and decrees" with "action or judgments." *Id.*

150. *Cotnam*, 263 F.2d at 125.

151. *Id.*; *see also Clarks*, 202 F.3d at 857-58.

152. Srivastava v. Comm'r, 220 F.3d 353, 364 (5th Cir. 2000) (stating that "the discrepancy [between Alabama law with an attorney lien and Texas law with no attorney lien] does not meaningfully affect the economic reality facing the taxpayer-plaintiff").

153. O'Brien v. Comm'r, 38 T.C. 707, 712 (1962).

154. *Srivastava*, 220 F.3d at 364-65.

155. *Id.* at 364.

156. *Id.* at 363.

157. *Id.* As the court stated in *Srivastava*:

> A taxpayer who enters into the contract recognizes that, to realize and maximize the value of his claim, he must necessarily obtain the resources and expertise of counsel. But of course, the same is true of a client who retains counsel on a non-contingent fee basis. The fact that a contingent fee arrangement has the added benefits of risk-shifting and realignment of incentives does not alter the economic reality. Such an arrangement diverts a portion of the litigation proceeds from the client to the attorney, thereby accruing to the client non-monetary gain from enjoying the assistance of counsel without otherwise having to pay for it. That gain – no less that the non-monetary gains recognized as income in *Earl*, *Horst*, and their progeny – is not to be excluded from gross income solely on the basis that the money is diverted to, and realized by, the taxpayer's assignee.

Id.

However, discussing the effects of attorney liens on the exclusion of attorney's fees from a client's gross income is irrelevant. In actuality, attorney liens do not convey a property interest in a client's cause of action; they merely function as a security on a judgment or settlement award.[158] A contingency fee agreement with a lien attached thereto gives an attorney a property right greater than if no lien was attached, but this property right is substantially smaller than if a client conveyed to his

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158. Joseph M. Perillo, *The Law of Lawyers' Contract Is Different*, 67 FORDHAM L. REV. 443, 469 (1998). The author describes the types of attorney liens as follows:

> Lawyers are endowed with remedial tools for the collection of fees that are not available to other professionals. In the eighteenth century, the common law courts empowered lawyers to assert retaining liens on their clients' papers and charging liens on their clients' judgments or amounts received in settlement. The retaining lien consists of the lawyer's privilege to retain, with certain exceptions, the papers, documents, and other personal property of the client which have come into the lawyer's possession in his or her professional capacity. The lien continues until the lawyer's fee and disbursements have been paid, or the client posts sufficient security [to] assure payment . . . . In addition to the continued availability of retaining liens, charging liens have survived in modern times. The charging lien is a security interest that the lawyer has in a judgment or settlement brought about by the lawyer's efforts. It secures the lawyer's rights to fees and reimbursement for disbursements. The lien also attaches to other funds the lawyer receives for the client in the lawyer's professional capacity. The general rule is that lien does not secure fees owed by the client for services unrelated to the particular judgment or settlement.

Id. at 468-69. Several jurisdictions have created charging lien by legislation. For example, the Illinois Attorney's Lien Act provides in relevant part that:

> Attorneys at law shall have a lien upon all claims, demands and causes of action . . . which may be placed in their hands by their clients for suit or collection, or upon which suit or action has been instituted, for the amount of any fee which may have been agreed upon by and between such attorneys and their clients . . . . Such lien shall attach to any verdict, judgment or order entered and to any money or property which may be recovered . . . .

770 ILL. COMP. STAT. 5/1 (1993); *see also* MINN. STAT. § 481.13 (1986) (providing for an attorney to obtain a charging lien upon a judgment); N.Y. JUD. LAW § 475 (McKinney 1983) (providing for an attorney to obtain a charging lien on his client's cause of action as well as proceeds); OKLA. STAT. ANN. tit. 5, § 6 (West 1991) (providing for an attorney to obtain a charging lien upon "any judgment in his client's favor").

For an exhaustive discussion of charging liens see RAY ANDREWS BROWN, THE LAW OF PERSONAL PROPERTY § 13.10 (3d. ed. 1975). The author emphasizes:

> The charging lien is, it must also be remembered, a lien only on the judgment secured by the attorney on behalf of his client. In absence of express agreement or statute, to the contrary, the attorney has no lien on the specific real or personal property which is the subject matter of the litigation. Neither is there a lien in behalf of the attorney on the property of his client which he has successfully protected against adverse claims by third parties, nor, at common law, unaided by a special agreement, upon the specific real or personal property which has been recovered for the client through the efforts of the attorney.

Id. at 431.

attorney a vested interest in a portion of a claim.[159] Therefore, the fact that an attorney lien attaches to a client's judgment or settlement award is inadequate to determine whether an attorney obtained any property rights in a client's cause of action.[160]

C. Failure to Determine the Property Interest Under Relevant State Law is the Main Flaw in the Circuit Courts' Approach

Surprisingly, when dealing with *Cotnam*-type cases, none of the circuit courts looked to the relevant state law to determine the nature of property rights conveyed to an attorney. The omission of such an essential step in the process of ascertaining tax consequences is contrary to the Supreme Court's precedents in *Morgan*, *Bess*, and *Aquilino*.[161] These cases held explicitly that the federal tax law applies only to those property interests that have been previously established by an applicable state law.[162] If state law does not recognize that a contingency fee agreement between a client and an attorney creates a property interest in the attorney, tax liability logically remains with the client.[163]

Following these Supreme Court cases, it is essential to determine first, in case of contingency fee agreements, whether the relevant state law under which the agreement arose recognizes that an equitable interest in a portion of a cause of action is fully assignable, thus creating a property

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159. *See, e.g.*, Galveston, Harrisburg & San Antonio R.R. v. Ginther, 72 S.W. 166, 167 (Tex. 1903). The Texas Supreme Court has identified three kinds of contingency fee agreements: (1) assignment of a "present interest in the cause of action," (2) "assignment of an interest in the fund when recovered," and (3) "a mere agreement to pay so much as a contingent fee." *Id.*; *see also* Wheeler v. Fronhoff, 270 S.W. 887, 888 (Tex. Civ. App. 1925) (stating that "unless the language evidenced . . . an intent [to pass title,] the agreement did not operate to then pass anything to appellants").

160. Brenan v. LaMotte, 441 S.W.2d 626, 627-30 (Tex. Civ. App. 1969). The court stated that:

> In contingent fee cases, a question frequently arises as to the nature of the interest that passes to the attorney and the determination of this issue is governed by showing the intention of the parties, and *this intention is determined primarily from an interpretation of the language of the instrument by which the assignment or transfer to the attorney was made.*

Id. at 630 (emphasis added).

161. *See* Aquilino v. United States, 363 U.S. 509, 512-514 (1960); United States v. Bess, 357 U.S. 51, 55 (1958); Morgan v. Commissioner, 309 U.S. 78, 80-82 (1940).

162. *Aquilino*, 363 U.S. at 513; *Bess*, 357 U.S. at 55; *Morgan*, 309 U.S. at 82.

163. *Property Subject to Federal Tax Lien*, *supra* note 18, at 1501. As one commentator explained: "In light of *Bess* and *Aquilino* it is difficult to justify attaching a lien to income in which, by state law, the taxpayer has no rights . . . ." *Id.*

interest in an attorney/assignee.[164] After courts make this initial inquiry into the rights under a relevant state law, they can determine whether a client, in fact, conveyed a portion of his claim to his attorney.[165] To identify the nature of a conveyed property interest, courts must examine the language in the contingency fee agreement.[166] The title of the contract as a "contingency fee agreement" alone does not provide a full description of the parties' property interests.[167] However, every circuit court that dealt with this issue has failed to examine the language of the agreement in detail.

It is possible that under a contingency fee agreement, a client only agrees to pay a portion of a damage award to his attorney, which under no circumstances can mean that the client intended to transfer a property interest in a portion of his claim to his attorney.[168] Such an arrangement constitutes only a mere promise to pay, not an assignment of any interest or right.[169] However, if a client assigns to his attorney an interest in a

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164. In *Srivastava*, attorneys, who submitted an amicus curiae brief in support of the petitioner Srivastava, advocated the same approach. Amicus Curiae Brief for Petitioner, at 28-29, Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000) (No. 99-60437).

165. *Id.* at 4.

166. *See id.*; *see also* Dow Chem. Co. v. Benton, 357 S.W.2d 565 (Tex. 1962). The Texas Supreme Court stated explicitly that "[w]e do not reject the rationale that a properly worded contingent fee contract may effect an assignment of part of recovery and a part of a cause of action to the attorney." *Id.* at 568; *see also* Brenan v. LaMotte, 441 S.W.2d 626 (Tex. Civ. App. 1969). The court stated that:

> In contingent fee cases, a question frequently arises as the nature of interest that passes to the attorney and the determination of this issue is governed by showing the intention of the parties, and *this intention is determined primarily from an interpretation of the language of the instrument by which the assignment or transfer to the attorney was made.*

Id. at 630 (emphasis added).

167. Galveston, Harrisburg & San Antonio Ry. Co. v. Ginther, 72 S.W. 166, 167 (Tex. 1903) (identifying three kinds of contingency fee agreements that create substantially different rights: (1) assignment of a "present interest in the cause of action," (2) "assignment of an interest in the fund when recovered," and (3) "a mere agreement to pay so much as a contingent fee").

168. *See, e.g.*, Wheeler v. Fronhoff, 270 S.W. 887 (Tex. Civ. App. 1925). The contingency fee contract in *Wheeler* stated that the attorneys "are to have one-third of any sum of money or property, or both or either, that may be recovered or paid as a compromise of said suit for their services therein." *Id.* at 888. The Texas Court of Civil Appeals, comparing the instant case with the cases where it found an effective transfer of a property interest in a cause of action, held that "[i]n each of those cases the intent to transfer an interest in the cause of action or subject matter thereof was shown by apt words. *Not so here.*" *Id.* (emphasis added).

169. *Ginther*, 72 S.W. at 167 (stating that the contingency fee contract expressed "[t]he intention to assign an interest in a cause of action of which a judgment or compromise was to be the measure . . . as *contradistinguished from a mere agreement to pay so much as a contingent fee*") (emphasis added).

settlement or judgment, an attorney holds a charging lien[170] representing a substantively stronger interest than a mere promise to pay.[171] Nevertheless, such an interest does not create a property right in a cause of action in an attorney.[172]

An interest in a cause of action arises only if the language of the contingency fee agreement contains words of conveyance.[173] A client's intent to convey a portion of his claim to his attorney must be apparent.[174] Therefore, without a detailed scrutiny of a contingency fee agreement, courts are unable to ascertain with precision whether an attorney has any property rights in a cause of action.[175] Additionally, courts should not forget to consult the Rules of Professional Conduct to determine whether an attorney in that particular jurisdiction is allowed to obtain a property interest in a client's case.

III. SCRUTINIZING THE NATURE OF PROPERTY OWNERSHIP RIGHTS UNDER AN APPLICABLE STATE LAW, THE LANGUAGE OF A CONTINGENCY FEE AGREEMENT, AS WELL AS THE APPLICABLE RULES

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170. Perillo, *supra* note 158, at 469 (stating that a "charging lien is a security interest that the lawyer has in a judgment or settlement brought about by the lawyer's efforts").

171. *Id.*; *see also* RESTATEMENT OF SECURITY § 62 cmt. j (1941) (stating that "[t]he charging lien is the privilege enjoyed by the attorney of charging lien against a judgment obtained for a client the amount of the attorney's disbursements and the value of his professional services . . . . Neither of these privileges is a possessory lien and neither is considered further in this Restatement"); RESTATEMENT (SECOND) OF AGENCY § 464(e) (1958). The *Restatement (Second) of Agency* states that:

> Unless he undertakes duties inconsistent with such a right or otherwise agrees that it is not to exist: . . . (e) an attorney of record who has obtained a judgment has an interest therein, as security for his fees in the case and for proper payments made and liabilities incurred during the course of the proceedings.

Id.

172. *Ginther*, 72 S.W. at 167 (stating that "a present interest in the cause of action" conveyed significantly more than an "assignment of an interest in the fund when recovered"). The Texas Supreme Court held that:

> The instrument does not, in terms, attempt to *assign a present interest in the cause of action*, but agrees to give and assign one-third of "whatever may be recovered" in the suit or by way of compromise. Mature consideration and examination of authorities has convinced us that the instrument operated as an *assignment of an interest in the fund when recovered.*

Id. (emphasis added).

173. Brenan v. LaMotte, 441 S.W.2d 626, 630 (Tex. Civ. App. 1969) (stating that the language of the contingency fee contract is decisive).

174. Wheeler v. Fronhoff, 270 S.W. 887, 888 (Tex. Civ. App. 1925) (stating that "unless the language evidenced . . . an intent [to pass title,] the agreement did not operate to then pass anything to appellants").

175. *Brenan*, 441 S.W.2d at 630.

OF PROFESSIONAL CONDUCT WILL ENABLE COURTS TO RESOLVE THE ISSUE

By engaging in a more thorough and detailed analysis of the issue as dictated by the Supreme Court's precedents in *Morgan*, *Bess*, and *Aquilino*, circuit courts will be able to correct their misunderstanding of the character of contingency fee agreements to ensure that potential litigation will result in an equitable resolution of a dispute. This analysis should consist of a three-prong test: (1) an analysis of state law to determine whether the law recognizes a transfer of a cause of action as legally permissible; (2) an analysis of the language of a contingency fee agreement to establish whether a transfer in fact occurred;[176] and (3) a determination of whether the Rules of Professional Conduct in that particular jurisdiction allow attorneys to obtain a proprietary interest in their clients' cause of action.[177]

A. The Role of State Laws in Determining the Assignability of Causes of Action: An Inquiry into a State Statute or Case Law

It is imperative to protect the independence of all states in their ability to create and define property rights for its citizens.[178] If a state recognizes that a client can assign a cause of action just like any other property, citizens of that state should be able to enter into a contract that effectuates such a desired result.[179] Many states provide for the

176. *See* Amicus Curiae Brief for Petitioner, at 28-29, Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000) (No. 99-60437) (noting that "if each one of the 50 states establish property rights differently, the residents of each of those separate states might have different federal income tax consequences"); *see also Brenan*, 441 S.W.2d at 630 (stating that only by examining closely the language of a contingency fee agreement, can a court determine whether the parties intended to execute a legal conveyance of a cause of action).

177. Bernard J. Grant, III, *No Taxation Without Realization:* Srivastava v. Commissioner, *the Fifth Circuit's Answer to Tax Treatment of Attorney's Fees Under a Contingency Fee Agreement*, 32 ST. MARY'S L.J. 363, 376 (2001) (warning that since, in Texas, attorneys cannot obtain a property interest in their clients' causes of action, "[the] holding [in *Srivastava*] should trouble many members of the Texas State Bar").

178. Aquilino v. United States, 363 U.S. 509, 514 (1960) (noticing the crucial role of states in creating property interests).

179. McCloskey v. San Antonio Traction Co., 192 S.W. 1116, 1120 (Tex. Civ. App. 1917) (holding that "[s]ince a claimant has the right to assign all or any part of his cause of action, and all persons have the right to buy or acquire the same or any part thereof, it is not unlawful for the appellant to acquire an interest in any claim or claims"); *see also* Bensinger v. Davidson, 147 F. Supp. 240, 245 (S.D. Cal. 1956) (recognizing that a cause of action for unjust enrichment is personal property).

assignment of a cause of action in a specific statute,[180] while other states have established it under common law.[181]

On the other hand, if a state law does not recognize a cause of action as freely assignable property, the parties cannot legally enter into a contract that would result in a conveyance of the client's cause of action to his attorney.[182] The prohibition of assignment is often expressly stated in a state statute.[183] In the absence of a statutory provision on point, the courts usually rule against assignability.[184]

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180. *See, e.g.*, N.Y. PERS. PROP. LAW § 41 (McKinney 2001) (providing that a cause of action in tort for damages to personal property is fully assignable); *see also* Porter v. Lane Constr. Corp., 212 A. D. 528 (N.Y. App. Div. 1925), *aff'd* 155 N.E. 881 (N.Y. 1926). Many other states have similar provisions. *See, e.g.*, Parnel v. Sother Ry. Co., 74 So. 437, 439-40 (Ala. 1917) (holding that the assignment of a cause of action against a railroad for damages to personal property was permissible under the state statute and that the statute was constitutional); Lamon v. Perry, 125 S.E. 907, 907-08 (Ga. 1924) (finding the assignment of a cause of action for damages to an automobile was permissible by state statute); Massachusetts v. Mkt. Warehouse Co., 146 N.E. 29, 29-30 (Mass. 1925) (basing its decision on a statute saying that "an assignee of a non-negotiable legal chose in action, assigned in writing, may maintain an action thereunder in his own name," thus finding that "[t]he right of action because of the defendant's tort, in failing properly to care for the wool and by reason of which it was damaged, was assignable").

181. Almost 150 years ago, the Iowa Supreme Court recognized that a cause of action "for a tort" is assignable, despite any particular Iowa Code provision on point. Weire v. Davenport, 11 Iowa 49, 52 (1860) (expressly stating that an inquiry into a statutory provision was not necessary "for the reason that we entertain no doubt but that such a liability may be sold or transferred").

182. For example, tort actions for personal injury are generally considered non-assignable. *See* Brown, *supra* note 158, at 433 (stating that "[i]f the cause of action is inherently unassignable in character, for example one for personal injury, the attorney cannot, even by express stipulation, acquire an interest therein, or a lien thereupon"). *See generally*, Franklin v. Franklin, 155 P.2d 637, 642 (Cal. 1945); State Road Dept. v. Bender, 2 So.2d 298, 300 (Fla. 1941); Benjamin-Ozburn Co. v. Morrow Transfer & Storage Co., 79 S.E. 753, 753 (Ga. 1913); Illinois ex rel. Rude v. La Salle County, 34 N.E.2d 865, 867 (Ill. App. Ct.), *aff'd* 39 N.E.2d 25 (Ill. 1941); Terrell v. Ready Mixed Concrete Co., 258 P.2d 275, 279 (Kan. 1953); Gen. Exch. Ins. Corp. v. Driscoll, 52 N.E.2d 970, 972 (Mass. 1944). Some jurisdictions, however, allow for the assignment of personal injury claims because under state law, these claims, like any other claim, can survive the death of the injured person. *See generally* Grand Rapids & Indiana Ry. Co. v. Cheboygan Circuit Judge, 126 N.W. 56, 56 (Mich. 1910); J. H. Leavenworth & Son v. Hunter, 116 So. 593, 596 (Miss. 1928).

183. Howe v. Mohl, 214 P.2d 298, 300 (Kan. 1950) (stating that the language of a Kansas statute disallows the assignment of a tort claim for damages to personal property because a tort claim does not arise out of contract); St. Paul Fire & Marine Ins. Co. v. Bender, 113 P.2d 1062, 1064 (Kan. 1941) (recognizing that the Kansas General Statues of 1935 specifically stated that an action "cannot be maintained on an assignment of a thing in an action not arising out of contract").

184. Chicago & Atl. R.R. Co. v. Maher, 91 Ill. 312, 315 (1878) (noting that if the Illinois statutes are silent on the assignability of a specific cause of action, it would be against the policy of the common law to allow such an assignment).

B. What Was the Intent of the Parties?: A Factual Inquiry into the Language of a Contingency Fee Agreement

Courts' legal analyses, however, should not stop at the threshold of a state statutory or common law inquiry. Even if, under an appropriate state law, a conveyance of a cause of action can create in an attorney a property ownership interest, it is equally important to scrutinize the language of a contingency fee agreement to ascertain whether the intent to convey a property interest exists.[185] Without an inquiry into the words of the contract, no court would be able to make a conclusive finding. However, if state law does not recognize such a transaction, a contingency fee contract, even with the appropriate words of conveyance, will be ineffective to create a property ownership interest in an attorney.[186]

C. Do Rules of Professional Conduct Allow an Attorney to Take a Proprietary Interest in a Client's Cause of Action?

The possibility that an attorney might own a portion of a client's claim undoubtedly raises an ethical issue. Attorneys are bound by the Rules of Professional Conduct to provide their clients with diligent representation.[187] It is questionable, however, whether an attorney who is in some form of a partnership with a client will be able to offer the client necessary legal representation, unblemished by a potential conflict of interests.[188] Therefore, as the last analytical step, courts should consult

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185. Dow Chem. Co. v. Benton, 357 S.W.2d 565, 568 (Tex. 1962). The Texas Supreme Court acknowledged that if a contingency fee agreement contains proper words of conveyance which will allow the court to ascertain the intent of the parties as to the assignment of the client's cause of action to his attorney, the court will then consider the assignment effective. *Id.* at 568; *see also* Brenan v. LaMotte, 441 S.W.2d 626, 630 (Tex. Civ. App. 1969). The court stated that:

> In contingent fee cases, a question frequently arises as to the nature of the interest that passes to the attorney and the determination of the issue is governed by showing the intention of the parties, and *this intention is determined primarily from an interpretation of the language of the instrument by which the assignment or transfer to the attorney was made.*

Id. (emphasis added); *see also* Amicus Curiae Brief for Petitioner at 4, Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000) (No. 99-60437).

186. E. Orange Lumber Co. v. Christian Feiganspan, 199 A. 778, 778 (N.J. 1938), *aff'd*, 10 A.2d 732 (N.J. 1940) (noting that since there is no New Jersey statute altering the common law rule disallowing the assignment of a cause of action for damages to personal property, the court could not recognize the assignment for which the parties contracted).

187. *See, e.g.*, TEXAS DISCIPLINARY RULE OF PROFESSIONAL CONDUCT 1.01 cmt. 6, *reprinted in* TEX. GOV'T CODE ANN., tit. 2, subtit. G app. A (Vernon 1998).

188. TEXAS DISCIPLINARY RULE OF PROFESSIONAL CONDUCT 1.08 cmt. 2, *reprinted in* TEX. GOV'T CODE ANN., tit. 2, subtit. G app. A (Vernon 1998). Because the topic of

the appropriate rules of professional conduct to determine whether allowing an attorney to obtain a property interest in a client's cause of action would constitute an ethical violation.[189]

The Fifth Circuit in *Srivastava*, for example, could have reached a different, but more accurate, conclusion in a very straighforward manner, had it simply followed the proposed three-prong test. Had the court inquired into Texas law, it would have realized that, in Texas, it is indeed possible to convey, assign, or sell any portion of a cause of action, regardless of the nature of the claim.[190] After this finding, the court should have looked at the language of the contingency fee agreement to ascertain whether the taxpayer intended to convey a portion of his claim to his attorney.[191] Because the language of the agreement states expressly that clients sold, conveyed, and assigned a forty percent interest in their cause of action, the court could have had no difficulty in finding that the clients disposed of the forty percent portion of their claim.[192]

Finally, the Fifth Circuit should have discussed the issue of whether attorneys practicing in Texas are allowed to hold a proprietary interest in a client's cause of action.[193] Had it done so, the court would have realized that, under the Texas Disciplinary Rules of Professional Conduct, Texas attorneys are in fact prohibited from owning any interest in a client's cause of action.[194] Therefore, the Fifth Circuit in *Srivastava* should have included contingency fees in the client's gross income.

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this Comment does not cover the issue of ethical consideration underlying the conveyance of a portion of a client's claim to an attorney, this Comment refrains from analyzing this problem in depth.

189. Grant, *supra* note 177, at 376.

190. TEX. PROP. CODE ANN. § 12.014 (Vernon 1984 & Supp. 1997); *see also* McCloskey v. San Antonio Traction Co., 192 S.W. 1116, 1120 (Tex. Civ. App. 1917) (holding that "[I]t is not unlawful for the appellant to acquire [by assignment] an interest in any claim or claims"); Galveston, Harrisburg & San Antonio Ry. Co. v. Ginther, 72 S.W. 166, 167 (Tex. 1903) (noticing the distinction between holding an equitable lien and a present interest in the cause of action through assignment); Gulf, Colorado & Santa Fé Ry. Co. v. Miller, 53 S.W. 709, 709 (Tex. Civ. App. 1899) (finding a cause of action for personal injuries assignable under a Texas statute).

191. The taxpayer's contract in *Srivastava* states:

> CLIENTS hereby sell, convey, and assign to BRANTON & HALL, P.C., as consideration for said services a forty-percent (40%) interest in and to any an all causes of action . . . which CLIENTS may hold or receive because of damages and injuries received by DR. SUDHIR SRIVASTAVA and DR. ELIZABETH PASCUAL as a result of the television broadcast on Channel 5 in February 1985.

Srivastava v. Comm'r, 76 T.C.M. (CCH) 638, 642 (1998).

192. *Id.*

193. Grant, *supra* note 177, at 376.

194. TEXAS DISCIPLINARY RULE OF PROFESSIONAL CONDUCT 1.08(h), *reprinted in* TEX. GOV'T CODE ANN., tit. 2, subtit. G app. A (Vernon 1998) (prohibiting an attorney

D. Analytical Methodology Will Lead to Greater Uniformity and Predictability

Although this proposed approach does not resolve the circuit split in favor of uniform results, it does establish a uniform and straightforward method consisting of only three basic steps: (1) an inquiry into state law to determine whether a conveyance is possible, (2) an inquiry into the language of a contingency fee agreement to establish that the conveyance in fact occurred, and (3) an inquiry into an attorney's proprietary interest in a client's cause of action as permitted under the Rules of Professional Conduct. Such a clear-cut method will ensure a relative predictability in court decisions, which in turn will allow parties entering into such transactions to understand fully the tax consequences of a judgment or settlement award.[195]

Because there are legal doctrines suitable to resolve the issue, it is unnecessary for the legislature to step in and enact a new Code provision directly on point. Even though a legislative directive would definitely assist in resolving the controversy in favor of uniform taxation of contingency fee payments, judicial direction from the Supreme Court should suffice, at least until the Congress decides to act.

IV. CONCLUSION

The circuit courts have been unable to follow any uniform analytical method when resolving the issue of whether to include contingency fees in a client's gross income. Consequently, this flaw has caused not only a circuit split, but also serious inconsistencies in the circuit courts' analyses of the issue. This result was avoidable. There are several Supreme Court cases that offer the circuit courts judicial guidelines. As suggested in this Comment, courts adjudicating disputes over the exclusion of attorneys' fees from a client's gross income should first determine whether an applicable state law recognizes that a cause of action is fully assignable as a property interest. A court should then review the expressed language of the contingency fee agreement to determine whether the parties intended such a result. Finally, a court should determine whether the Rules of Professional Conduct allow an attorney to take a proprietary interest in a client's case. By granting *certiorari* and following the

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from taking "a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client").

195. In those states that do not recognize that a cause of action is freely assignable, clients/taxpayers will very likely ask for greater judgments to make up for taxes paid on that portion of the award that will ultimately end up with the attorney. Interview with Stephen C. Leckar, Partner, Butera & Andrews, Washington, D.C. (Oct. 18, 2000).

proposed analytical method, the Supreme Court will assist in correcting the circuit courts' confusion regarding the character of contingency fee agreements. While this correction will not achieve uniformity in court decisions, it will establish a uniform analytical method to ensure a relative predictability of litigation outcomes. As a result, taxpayers that enter into contingency fee agreements will be able to fully appreciate the tax consequences of their transactions and, thus, will structure their agreements accordingly.