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ARTICLE

A CAPITAL GAINS ANOMALY: *COMMISSIONER V. BANKS* AND THE PROCEEDS FROM LAWSUITS

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I. INTRODUCTION

When a litigant receives an award of damages or agrees to a settlement of a lawsuit for which the litigant and the litigant's attorney have agreed to a contingency fee, a portion of those damages or the settlement is paid to the attorney. For income tax purposes, there was a question of whether the litigant should include the portion paid to her attorney as her own income.[1] The question was not merely academic. In a tax system that does not always allow the litigant to deduct attorney's fees,[2] the litigant may end up paying taxes on money that she never sees. In some cases, that tax can exceed the amount of money she gets from the lawsuit, making the litigant poorer by having pursued the suit at all.[3]

In January 2005, the Supreme Court heard two cases regarding the inclusion of contingency fees in income. The two cases, *Banks v. Commissioner*[4] and *Banaitis v. Commissioner*,[5] were joined.[6] The courts of appeals were split as to the issue of inclusion and had resolved their respective cases on numerous theories, ranging from exclusion derived from state attorney's lien statutes to includability because of the assignment-of-income doctrine.[7]

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1. Prior to *Commissioner v. Banks*, there was a circuit split over whether contingency fees should be includable in income. *Compare* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (holding that contingency fees should not be included in income), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005), *with* Kenseth v. Comm'r, 114 T.C. 399 (2000) (concluding that contingency fees are includable in income), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

2. *See* I.R.C. § 212 (2006) (allowing a deduction for expenses incurred in the production of income, such as legal fees); Burch v. United States, 698 F.2d 575, 577–78 (1983) ("The test for deductibility of legal fees under [Section] 212 is ordinarily an objective one, looking to the 'origin' or 'character' of the claim litigated rather than to the subjective 'purpose' of the taxpayer in pursuing it.").

3. For example, the taxpayer in *Alexander v. Internal Revenue Service* obtained a favorable settlement of her employment discrimination suit. 72 F.3d 938, 940 (1st Cir. 1995). However, legal fees and the high costs of her court battle left her with a net recovery of only $5,000, but a tax bill of $53,900. Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1078 & n.16 (2000).

4. Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *rev'd*, 543 U.S. 426.

5. Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *rev'd sub nom. Banks*, 543 U.S. 426.

6. *Banks*, 543 U.S. at 429.

7. *Compare* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856–57 (using Michigan common law for attorney's liens as the basis to exclude the contingency fee award from income (citing Dreiband v. Chandler, 131 N.W. 129, 129 (Mich. 1911))), *abrogated by Banks*, 543 U.S. 426, *with* Young v. Comm'r, 240 F.3d 369,

Other courts were influenced by the belief that taxpayers should be treated equally, whether they were paying fees on an hourly basis or on a contingency basis.[8]

Banks appeared to have settled the issue.[9] The Supreme Court held that "when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."[10] Although the decision resolved the question of includability, the Court did not explain when a litigant's recovery constitutes income, nor did the Court decide how expenses were to be treated. The Court did, however, create an anomaly when it stated that the income-producing asset was the "cause of action."[11] Taking its words at face value, it appears that the Court overturned the origin-of-the-claim doctrine that required the nature of the claim to determine the character of the income.[12] Instead, the Court appears to have made it possible to characterize all income from lawsuits or settlements as capital gain.

The Supreme Court was simply asked whether lawsuit recoveries were income to the client, including the portion payable

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377 (4th Cir. 2001) (holding that contingency fees were income under the assignment-of-income doctrine). Under the assignment-of-income doctrine, a taxpayer will realize income when the taxpayer assigns income to another. *See* Rauenhorst v. Comm'r, 119 T.C. 157, 163–64 (2002) (noting that the assignment-of-income doctrine "taxes income 'to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid'" (quoting Helvering v. Horst, 311 U.S. 112, 119 (1940))); *see also* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1933) (holding that, in an analogous situation to the assignment-of-income doctrine, an employer's payment of an employee's tax obligations was income to the employee).

8. *See* Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001) (rejecting the taxpayer's argument for exclusion of attorney's fees because it would "create an artificial[] a[nd] purely tax-motivated[] incentive to substitute contingent for hourly legal fees").

9. *See Banks*, 543 U.S. at 430 (holding that an attorney's contingency fee is included as the litigant's income).

10. *Id.* at 430.

11. *Id.* at 435.

12. *See id.* (stating that the income-producing asset was the cause of action, which implies that the character of the asset will be capital regardless of the underlying nature of the claim); *infra* Part III.D (discussing the Supreme Court's possible revocation of the origin-of-the-claim doctrine in *Banks*); *see also* United States v. Gilmore, 372 U.S. 39, 48 (1963) ("The principle we derive from these cases is that the characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities." (citing Lykes v. United States, 343 U.S. 118, 123 (1952); Kornhauser v. United States, 276 U.S. 145, 153 (1928))). The origin-of-the-claim doctrine was settled law well before this statement in *Banks*. *See Gilmore*, 372 U.S. at 49 (adopting the origin-of-the-claim doctrine).

to the attorney as a contingency fee.[13] The answer to that question should have been relatively straightforward. Pursuant to Internal Revenue Code Section 61, unless income is expressly excluded in another section, it is included in income.[14] The Court went further in trying to resolve all of the previous theories on which inclusion or exclusion had been grounded, and decided that the answer lay in the assignment-of-income doctrine.[15] By taking this course, the Court further clouded an already murky area of law and missed a chance to fix several decades of bad tax law, simply because the right question was not presented. The Court mentioned the Association of Trial Lawyers of America's (ATLA) amicus curiae brief but would not consider its arguments because it brought up "novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals."[16] Yet, these issues are at the heart of the question.

As in the prior cases, arguments were made to resolve a tax issue without addressing tax law.[17] Their non-tax theories were shot down by many of the courts of appeals[18] and by the Supreme Court.[19] However, many of the more important tax questions were not addressed, primarily because the right questions had not been asked. Although the Supreme Court ruled on the inclusion issue, it is unclear whether the Court inadvertently or deliberately ruled on the nature of the income. Further, the Court did not rule on the timing of the inclusion or the treatment of the attorney's fees. The issues are far from resolved.

II. HISTORY PRIOR TO *COMMISSIONER V. BANKS*

There was a split of authority among the circuit courts on the question of whether fees retained by attorneys pursuant to a contingency fee agreement were income to the client. Prior to

13. *Banks*, 543 U.S. at 429.

14. I.R.C. § 61 (2006).

15. *Banks*, 543 U.S. at 433–34.

16. *Id.* at 438.

17. *See id.* at 437 (rejecting the taxpayer's argument that the assignment-of-income doctrine was inapplicable due to statutory fee-shifting provisions).

18. Banaitis v. Comm'r, 340 F.3d 1074, 1082 (9th Cir. 2003) (applying Oregon law to exclude contingency fees from income), *rev'd sub nom. Banks*, 543 U.S. 426.

19. *See Banks*, 543 U.S. at 437 (rejecting application of state law because the assignment-of-income doctrine is applicable regardless of the effect of state law).

Banks, the Supreme Court had declined to grant certiorari despite the split.[20] The Fifth, Sixth, and Eleventh Circuits did not include contingency fees in income,[21] while the Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits did include contingency fees in income.[22] The courts were not applying the same rules to similar facts.[23] The cases did not turn on the particular factual setting. Rather, the outcome depended on whether the judgment or the claim was the property being transferred to the attorney.

A. *Pre*-Banks *Split of Authority*

1. Cases Holding Contingency Fees Were Not Income to the Client

a. Fifth Circuit

The earliest case in this controversy, *Cotnam v. Commissioner*,[24] emerged in the old Fifth Circuit in Alabama.[25] The Fifth Circuit, however, recently stated that the logical underpinnings of *Cotnam* were flawed and that stare decisis was the only thread by which *Cotnam* had hung as good law.[26] In *Cotnam*, the Fifth Circuit reversed the United States Tax Court and held that contingency fees paid directly to attorneys were not income to the client.[27] The taxpayer in *Cotnam* hired attorneys on a contingency fee basis to represent her in a claim against an

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20. *See, e.g.*, Coady v. Comm'r, 213 F.3d 1187, 1187 (9th Cir. 2000) (holding that contingency fees were not includable in income), *cert. denied*, 532 U.S. 972 (2001).

21. Foster v. United States, 249 F.3d 1275, 1281 (11th Cir. 2001), *abrogated by Banks*, 543 U.S. 426; Estate of Clarks *ex. rel* Brisco-Whitter v. United States, 202 F.3d 854, 858 (6th Cir. 2000), *abrogated by Banks*, 543 U.S. 426; Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959), *abrogated by Banks*, 543 U.S. 426.

22. Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881, 885 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001); *Coady*, 213 F.3d at 1191; Baylin v. United States, 43 F.3d 1451, 1454–55 (Fed. Cir. 1995).

23. *See Banks*, 543 U.S. at 429–30 ("Some of these Courts of Appeals discuss state law, but little of their analysis appears to turn on this factor. Other Courts of Appeals have been explicit that the fee portion of the recovery is always income to the plaintiff regardless of the nuances of state law." (citations omitted)).

24. Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959), *abrogated by Banks*, 543 U.S. 426.

25. *Id.* at 120.

26. Srivastava v. Comm'r, 220 F.3d 353, 363 (5th Cir. 2000), *abrogated by Banks*, 543 U.S. 426.

27. *Cotnam*, 263 F.2d at 121.

estate.[28] The taxpayer's claim was based on a verbal contract with the decedent whereby she agreed to attend to the decedent for the rest of his life in return for one-fifth of his estate.[29] After a lengthy court battle, the taxpayer was awarded $120,000.[30] Attorney's fees of $50,365.83, on a 40% contingency basis, were paid directly to the lawyers.[31] The remainder of the award was paid to the taxpayer, who did not claim any of the attorney's fees as income.[32] The Internal Revenue Service (IRS) assessed a deficiency of $36,985, claiming that the recovery was in the nature of payment for services—income—and that the attorney's fees were includable in income.[33]

The basis for the Fifth Circuit's decision that contingency fees paid directly to the attorneys were not income to the taxpayer was questionable. The court in *Cotnam* stated that an Alabama statute gave attorneys such an interest in the lawsuit and that they could be considered to "own" part of the lawsuit.[34] The court relied on an Alabama attorney's lien statute giving attorneys the same rights to enforce claims as their clients.[35] The statute would have prevented the taxpayer from receiving the portion of the award owed to her attorneys even if she settled the claim herself.[36] The opinion stated that given "[t]he facts in this unusual case" and the Alabama attorney's lien statute, the taxpayer did not realize income as to the attorneys' interests in 40% of her action.[37]

The *Cotnam* court added that the assignment-of-income

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28. *Id.* at 125.
29. *Id.* at 120.
30. *Id.* at 120–21.
31. *Id.* at 121, 125.
32. *Id.* at 125.
33. *Id.* at 121.
34. *Id.* at 125 (citation omitted).
35. The Alabama statute provided that:

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

Id. at 125 n.5 (citation omitted).
36. *Id.* at 125 (citation omitted).
37. *Id.*

doctrine did not apply.[38] The taxpayer's claim was worthless without the aid of attorneys.[39] "At the time that she entered into the contingent fee contract, she had realized no income from the claim . . . ."[40] As such, she simply assigned 40% of her claim to recover the remaining 60%.[41] The contingency fee "did not pass through her hands," and "she never had control" of it.[42] Unlike *Lucas v. Earl*,[43] the seminal assignment-of-income case, the taxpayer in *Cotnam* did not attempt to assign income by giving the fruit of a tree to another person.[44] According to the Fifth Circuit, the taxpayer's tree "had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit."[45] The assignment-of-income analysis did not rely at all on the Alabama statute.

Judge Wisdom's dissent in *Cotnam* stressed that the services upon which the taxpayer's claim was based had already been performed.[46] Because the taxpayer was assigning a "right to income already earned," this was a stronger case for applying the assignment-of-income doctrine than previous cases holding an assignment of income existed.[47]

In *Srivastava v. Commissioner*,[48] another Fifth Circuit decision, the taxpayer and his wife were medical doctors who sued a television station for defamation.[49] The recovery was a settlement

38. *Id.* at 126 (Rives & Brown, JJ., concurring).

39. *See id.* at 125 ("At the time that [the taxpayer] entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder.").

40. *Id.*

41. *Id.*

42. *Id.* at 126.

43. Lucas v. Earl, 281 U.S. 111 (1930).

44. *See id.* at 115 ("[W]e think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."); *Cotnam*, 263 F.2d at 126 (Rives & Brown, JJ., concurring) (holding that the percentage assigned to the attorney did not ripen until the case was won).

45. *Cotnam*, 263 F.2d at 126 (Rives & Brown, JJ., concurring).

46. *Id.* at 127 (Wisdom, J., dissenting).

47. *Id.*

48. Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).

49. *Id.* at 355.

during an appeal from the jury's award of $29 million in actual and punitive damages.[50] The taxpayers did not claim any of the settlement as income, and the IRS assessed approximately $1.5 million in taxes and penalties.[51] Again, the issue was whether contingency fees paid directly to attorneys must be included in the client's income.[52]

Srivastava exhaustively analyzed the inclusion of the attorney's fees in income, including whether the contingency fee contract was an assignment of income under *Earl*.[53] The court disregarded the argument that this was an arm's-length transaction and therefore escaped the assignment-of-income doctrine.[54] The court stated, rather, that control over a case may be shared between attorney and client, and, thus, it was not possible to tell whether a contingency fee arrangement transferred the fruit of the tree or the tree itself.[55]

The court stated that it might hold that contingency fees are gross income to the client under the assignment-of-income doctrine had it decided the matter on a clean slate, because "[p]rinciples of tax neutrality, if nothing else, dictate that result."[56] When a taxpayer recovers taxable damages and pays his lawyer on an hourly basis, the entire recovery is included in income.[57] Accordingly, the court stated that "[t]here is no apparent reason to treat [contingent] fees differently or to believe that Congress intended to subsidize contingent fee agreements in such a fashion."[58] Nevertheless, the court decided it was bound by *Cotnam* and held that the contingency fees paid directly to the attorneys were not income to the client.[59]

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50. *Id.*
51. *Id.* at 356.
52. *Id.* at 357.
53. *Id.* at 360–63.
54. *Id.* at 361.
55. *Id.* at 360.
56. *Id.* at 357.
57. *Id.*
58. *Id.*
59. *See id.* at 357–58 (holding that contingency fees are not taxable income to the client).

b. Sixth Circuit

In *Estate of Clarks ex rel. Brisco-Whitter v. United States*,[60] the plaintiff received an $11 million recovery for personal injuries from K-Mart ($5.6 million of personal injury damages and $5.7 million of postjudgment interest) and died shortly thereafter.[61] His estate filed his final income tax return but did not claim the $1.9 million of interest that was paid to his attorneys as a contingency fee.[62] The Sixth Circuit held that the interest portion of contingency fees paid directly to an attorney as a result of a personal injury claim was not income to the deceased taxpayer.[63]

As in *Cotnam*, the court relied on a state law giving an attorney a lien on a portion of a client's judgment.[64] The Michigan common law attorney's lien at issue operated "in more or less the same way as the Alabama lien in *Cotnam*."[65] While the court acknowledged a conflict of authority on the issue, it held in favor of the taxpayer.[66]

The court used a partnership or joint venture analogy to describe the situation.[67] The taxpayer assigned "a one-third interest in the venture" to his attorney to have a "chance to recover the remaining two-thirds."[68] The court explained:

> [T]he client . . . transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer had become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income[—the contingency fee—]is the result of his own personal skill and judgment.[69]

The speculative nature of the client's legal claim was also an important factor. *Estate of Clarks* held that, because the value of the lawsuit was "entirely speculative and dependent on the

60. Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854 (6th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).
61. *Id.* at 855.
62. *Id.*
63. *Id.* at 857.
64. *Id.*
65. *Id.* at 856.
66. *Id.* at 856–57.
67. *Id.* at 857.
68. *Id.*
69. *Id.* at 858.

services of counsel," it was distinguishable from *Earl*.[70] The court viewed the transaction as "more like a division of property than an assignment of income" and held that the fee was not includable in income.[71]

c. Eleventh Circuit

In *Foster v. United States*,[72] the taxpayer received a $1 million punitive damages award.[73] She had entered into a 50% contingency fee agreement with her attorneys before the trial.[74] Prior to the appeal, she renegotiated that fee to give her attorneys "all of the [postjudgment] interest" if they represented her through the appeal.[75] She did not declare the award as income, and the IRS assessed a deficiency.[76]

The Eleventh Circuit held that Alabama law controlled, which prevented her from accessing that money.[77] Therefore, she did not "enjoy[] the benefit of the economic gain."[78] The *Foster* court also stated that tying the contingency fee to the lawyer's work made the arrangement "more like a division of property than an assignment of income."[79] The court held that *Cotnam* controlled in the Eleventh Circuit (successor to the Fifth Circuit) and that the fee was not includable in income.[80]

The Eleventh Circuit also followed *Cotnam* in *Davis v. Commissioner*,[81] where the court held that contingency fees retained by attorneys from a punitive damage award were not income to the client.[82] The court held that *Cotnam* was directly

70. *Id.* at 857.

71. *Id.* at 857–58.

72. Foster v. United States, 249 F.3d 1275 (11th Cir. 2001), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).

73. *Id.* at 1276.

74. *Id.*

75. *Id.* at 1277.

76. *Id.*

77. *Id.* at 1279 (citing ALA. CODE § 34-6-61 (2000)).

78. *Id.* (alteration in original) (quoting Helvering v. Horst, 311 U.S. 112, 116 (1940)) (internal quotation marks omitted).

79. *Id.* at 1280 (quoting Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857–58 (6th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005)) (internal quotation marks omitted).

80. *Id.*

81. Davis v. Comm'r, 210 F.3d 1346 (11th Cir. 2000) (per curiam), *abrogated by Banks*, 543 U.S. 426.

82. *Id.* at 1347.

on point and controlling and gave no further analysis.[83] The IRS argued that entering into the contingency fee contract was a taxable exchange; however, that transaction was barred by the statute of limitations.[84] In an attempt to get around the statute of limitations, the IRS argued that the open-transaction doctrine, which would have put off recognition until the amounts became certain, should apply.[85] The court denied this approach, holding that "the IRS provided no proof that the values of either the cause of action or the attorneys' services were unascertainable."[86]

2. Cases Holding Contingency Fees Are Income to the Client

a. Tax Court

The United States Tax Court has consistently held that amounts retained by attorneys under contingency fee agreements are income to the client.[87] Most tax court cases simply distinguished

83. *Id.* The court noted that the IRS had argued that *Cotnam* was erroneous and should be overturned, but the court did not have to consider that issue because *Cotnam* could only be overturned during an en banc hearing. *Id.* at 1347 n.4 (citing United States v. Woodward, 938 F.2d 1255, 1258 (11th Cir. 1991)).

84. *Id.* at 1347–48.

85. *Id.* at 1348 (citing Burnet v. Logan, 283 U.S. 404, 412–13 (1962)). The open-transaction doctrine is necessary when it cannot be determined that the taxpayer has received income in excess of his cost basis, which would create taxable gain. *See Logan*, 283 U.S. at 412–13 (applying the open-transaction doctrine because the taxpayer had not received royalty distributions in excess of her basis); Inaja Land Co. v. Comm'r, 9 T.C. 727, 736 (1947) ("Apportionment with reasonable accuracy of the amount received not being possible, and this amount being less than petitioner's cost basis for the property, it can[]not be determined that petitioner has, in fact, realized gain in any amount."). Interestingly, the IRS attempted to use a doctrine that has traditionally favored taxpayers. *See Logan*, 283 U.S. at 413–14 (allowing a taxpayer to defer reporting potentially hundreds of thousands of dollars in income); *see also* LAURIE L. MALMAN ET AL., THE INDIVIDUAL TAX BASE: CASES, PROBLEMS AND POLICIES IN FEDERAL TAXATION 400 (2d ed. 2010) ("[T]he open[-]transaction treatment allowed [in *Logan*] significantly defers taxpayer gain and is an easy device for tax-evasive planning. The modern view, which attempts to avoid open[-]transaction treatment as much as possible, is reflected in the rules governing installment sales . . . and original issue discount . . . ." (citing Treas. Reg. § 15A.453-1(c) (1994); *id.* § 1.1275-4 (2004))).

86. *Davis*, 210 F.3d at 1348.

87. *See* Kenseth v. Comm'r, 114 T.C. 399, 417 (2000) ("We conclude that petitioner's award, undiminished by the amount that he paid to [his attorneys], is includable in his 1993 gross income."), *aff'd*, 259 F.3d 881 (7th Cir. 2001); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962) (holding that contingency fees were income to the taxpayer), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam). *But see* Davis v. Comm'r, 76 T.C.M. (CCH) 46, at *3 (1998) (concluding that *Cotnam* controls, and the contingency fees were therefore not income), *aff'd*, 210 F.3d 1346 (11th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).

the Alabama attorney's lien statute at issue in *Cotnam* from those of other states.[88] As far back as *O'Brien v. Commissioner*,[89] however, the tax court held that it made no difference whether the attorney had a lien under a state attorney's lien statute or the taxpayer irrevocably assigned a portion of his claim to the attorney.[90] In *O'Brien*, the plaintiff recovered an award of $16,000 for back pay due to his wrongful termination.[91] He paid his attorney 50% of the award under a contingency fee arrangement.[92] The tax court stated that the rights given by the state statute were irrelevant and that this was an assignment of income under *Earl*.[93] The Third Circuit affirmed without a separate opinion.[94] When referring to the impact of state attorney's lien statutes, the *O'Brien* court stated that "we think it doubtful that the Internal Revenue Code was intended to turn upon such refinements."[95]

Kenseth v. Commissioner[96] is one of the more recent, and by far the most comprehensive, tax court opinions (and dissents) on the subject. In *Kenseth*, the tax court reaffirmed the position

88. *See* Sinyard v. Comm'r, 76 T.C.M. (CCH) 654, at *5 (1998) ("The parties, however, have not cited any provision of Arizona statutory law, and we have found none, that pertains to the legal rights of Arizona attorneys in monetary awards recovered on behalf of their clients."), *aff'd*, 268 F.3d 756 (9th Cir. 2001); Coady v. Comm'r, 76 T.C.M. (CCH) 257, at *3 (1998) ("Although both provisions give an attorney a lien to secure his or her compensation, the Alaska provision, unlike the Alabama provision, does not give attorneys the same right and power over suits, judgments, and decrees as their clients had or may have." (citing ALASKA STAT. § 34.35.430 (1996))), *aff'd*, 213 F.3d 1187 (9th Cir. 2000); Estate of Gadlow v. Comm'r, 50 T.C. 975, 980 (1968) (arguing that *Cotnam* is inapplicable because "Pennsylvania does not have any statute similar to the Alabama statute" (citing Laplacca v. Phila. Rapid Transit Co., 108 A. 612, 613 (Pa. 1919))); Petersen v. Comm'r, 38 T.C. 137, 152 (1962) (distinguishing *Cotnam* by contrasting Nebraska and South Dakota attorney's lien statutes with the Alabama statute in *Cotnam* (citing NEB. REV. STAT. § 7-108 (1954))), *acq.*, 1963-2 C.B. 3, 1963 WL 65824 (1963). *But see Davis*, 76 T.C.M. (CCH) at *3 (concluding that *Cotnam* controls for Alabama and, therefore, the contingency fees were not income).

89. O'Brien v. Comm'r, 38 T.C. 707 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam).

90. *Id.* at 712.

91. *Id.* at 708–09.

92. *Id.* at 708.

93. *See id.* at 712 (opining that state law is likely inapplicable because "it [is] doubtful that the Internal Revenue Code was intended to turn upon such refinements" and stating that the principles of *Earl* applied (citing Lucas v. Earl, 281 U.S. 111, 115 (1930))).

94. *O'Brien*, 319 F.2d at 532.

95. *O'Brien*, 38 T.C. at 712.

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

originally taken in *O'Brien*.[97] The taxpayer in *Kenseth* joined other terminated employees in hiring a law firm to represent them in a class action claim under the Federal Age Discrimination in Employment Act of 1967.[98] When the case settled, the taxpayer's attorneys received the full amount of damages not labeled as lost wages, retained the amount due to them under the contingency fee agreement, and remitted the remainder to the taxpayer.[99]

Though the court acknowledged the burden imposed on the taxpayer because of the limits on miscellaneous itemized deductions under Section 67 and the treatment of miscellaneous itemized deductions under the alternative minimum tax (AMT), the tax court held that the entire lawsuit settlement, including the contingency fees, was income to the taxpayer under the assignment-of-income doctrine.[100] According to the majority, the

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97. *Id.* at 411–12.

98. *Id.* at 400, 403 (citing Federal Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621–633a (1994)).

99. *Id.* at 404–05.

100. *Id.* at 407, 417.

Miscellaneous itemized deductions are below-the-line deductions other than those specifically listed elsewhere in the Internal Revenue Code. *See* I.R.C. § 67(b) (2006) (defining miscellaneous itemized deductions by stating that those deductions are not the deductions that the Code lists in Section 67(b)). These deductions are only available for taxpayers who choose to itemize their deductions rather than take the standard deduction. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 198 (10th ed. 2005) ("'[M]iscellaneous deductions' . . . are of benefit only to those taxpayers who find it worthwhile to itemize their personal deductions."). These deductions are subject to several limitations that reduce their usefulness to taxpayers. For example, miscellaneous itemized deductions are subject to a 2% floor, which allows these deductions only to the extent that they exceed 2% of the taxpayer's adjusted gross income. I.R.C. § 67(a) (2006). These deductions are also subject to an overall limitation, which reduces the total allowable deduction by the lesser of: "3[%] of the excess of adjusted gross income over the applicable amount, or . . . 80[%] of the amount of the itemized deductions otherwise allowable for such taxable year." *Id.* § 68(a). When contingency fees are included in income, taxpayers are allowed a corresponding miscellaneous itemized deduction to help offset the increased income. *See Kenseth*, 114 T.C. at 407 (remarking that attorney's fees from contingency fees would be eligible for a miscellaneous itemized deduction). Thus, taxpayers will report more income from the inclusion of attorney's fees than they may offset by a corresponding deduction for attorney's fees.

The AMT also presents an obstacle to taxpayers including contingency fees in income. The AMT is a shadow tax that intends "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits . . . [because] it is inherently unfair for high-income taxpayers to pay little or no tax." STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 432–33 (Comm. Print 1987). The AMT is a parallel tax that forbids exclusions, deductions, or credits but also preserves the special rate for

problem created by the treatment of the attorney's fee deduction is an issue for Congress, not the courts.[101]

The tax court stated that all settlement proceeds were income under the all-inclusive income concept of Section 61[102] and could locate no specific exclusion from income for the portion of the settlement retained by the attorneys.[103] The court also rejected the taxpayer's argument that he had no control over his claim.[104] The tax court analyzed Wisconsin law along with the evidence in the case and concluded that ultimate control over the cause of action was not relinquished to the attorneys.[105] To use the oft-quoted metaphor, the taxpayer retained control over the "tree."

The tax court also rejected *Estate of Clarks*'s reliance upon the speculative nature of the claim and the dependency upon the assistance of the attorneys.[106] The fact that attorneys were necessary to pursue the claim was not determinative.[107] The court also disagreed with the joint venture and partnership analogy used in *Estate of Clarks*.[108] Under *Kenseth*, "[t]he entire . . . award was

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capital gains and applies a lower rate than the regular tax. I.R.C. § 55 (2006) (amended 2010). A taxpayer must calculate both the AMT and the regular tax and pay the greater amount. *Id.* § 55(a). Although the AMT is meant to apply to high-income taxpayers, "[i]n recent years, however, the [AMT] has begun to reach many taxpayers much lower down the income scale, a development that was not envisioned by Congress when [the] AMT was enacted." MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 211 (10th ed. 2005). This is because "the AMT exemptions and rate brackets have not been . . . adjusted" due to inflation. *Id.* One example of the unintended consequences of the AMT is in its application to contingency fees that are included in income. Because the AMT includes the entire amount of the contingency fees in income without a corresponding deduction, taxpayers may be susceptible to paying the AMT in lieu of the regular tax when contingency fees are included in income. *See Kenseth*, 114 T.C. at 407 ("This Court believes that it is Congress'[s] imposition of the AMT and limitations on personal itemized deductions that cause the tax burden here.").

101. *Id.* at 407–08 (citing Badaracco v. Comm'r, 464 U.S. 386, 398 (1984); Warfield v. Comm'r, 84 T.C. 179, 183 (1985)).

102. *Id.* at 413 (citing I.R.C. § 61(a) (2006)). "Section 61(a) provides that 'gross income means all income from whatever source derived,' and typically, all gains are taxed unless specifically excluded." *Id.* (quoting I.R.C. § 61(a)).

103. *Id.*

104. *Id.* at 414.

105. *See id.* at 414–15 (citing WIS. SUP. CT. R. 20:1.2(a) (2007); Goldman v. Home Mut. Ins. Co., 126 N.W.2d 1, 5 (Wis. 1964)).

106. *Id.* at 410 (citing Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005)).

107. *Id.* at 411.

108. *Id.*

'earned' by and owed to" the taxpayer.[109] The attorneys "merely provided a service and assisted [the taxpayer] in realizing the value already inherent" in his claim.[110]

The *Kenseth* decision was controversial. Five of the thirteen judges deciding the case dissented.[111] United States Tax Court Judge Renato Beghe analyzed the issue at length.[112] His dissent stressed the fact that the taxpayer lost too much control over the claim to justify including the contingency fee in income because control over the claim was assumed and exercised by the attorneys.[113] Judge Beghe distinguished this case from other assignment-of-income cases based on the relationship between the parties.[114] The early Supreme Court cases establishing the doctrine all involved intrafamily donative transfers where tax avoidance was a possibility.[115] In all of these cases, the taxpayer retained control over the subject matter of the assignment.[116] The dissent felt that the degree of control retained by clients who signed contingency fee agreements was insufficient to invoke the assignment-of-income doctrine.[117]

b. Fourth Circuit

In *Young v. Commissioner*,[118] the plaintiff was given a promissory note by her ex-husband in a divorce proceeding.[119] When he defaulted, she hired an attorney to execute on the agreement.[120] The controversy was settled when the husband transferred the property to her, which was later purchased on option for $2.2 million, $300,000 of which went to her attorney.[121] The Fourth Circuit held that there is no difference in the benefit given by an attorney who is paid on a contingency basis and an

109. *Id.* at 413.
110. *Id.*
111. *Id.* at 417 (Chabot, J., dissenting).
112. *Id.* at 421–58 (Beghe, J., dissenting).
113. *Id.* at 443–48.
114. *Id.* at 441–43.
115. *Id.* at 441.
116. *Id.* at 441–42.
117. *Id.* at 443.
118. Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001).
119. *Id.* at 372.
120. *Id.*
121. *Id.*

attorney who is paid on a non-contingency basis.[122] Furthermore, the court rejected the argument that the attorney had any property interest in the claim, but instead stated that the attorney only provided a service.[123] Finally, the court held that state law was irrelevant for determining the tax consequences of a contingency fee arrangement[124] and held that the fee was an anticipatory assignment of income taxable to the plaintiff, specifically rejecting *Cotnam*.[125]

c. Seventh Circuit

In 2001, the Seventh Circuit affirmed the tax court's holding in *Kenseth v. Commissioner*.[126] The tax court held that the contingency fees were an assignment of income and taxed Kenseth on his share of the gross judgment.[127] The Seventh Circuit, noting the split of authority on the issue, sided with the Tax Court.[128] The court stated that there is no difference between an hourly fee and a contingency fee, using the analogy of a salesman on commission.[129]

The Seventh Circuit also concluded that the attorney is not a joint owner under Wisconsin law, as Wisconsin law simply gives the attorney a security interest rather than a proprietary interest.[130] The court noted that the claim was for lost wages, which would have been taxable, and that incomplete deductions for expenses related to those wages is neither anomalous nor inappropriate.[131] The court held that Kenseth did not give up any control by structuring a contingency arrangement rather than an hourly fee because Kenseth could fire a contingency fee attorney, and that attorney, like an hourly attorney, would have a claim against the client for services rendered.[132]

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122. *Id.* at 378.
123. *Id.*
124. *Id.*
125. *Id.* at 379.
126. Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001).
127. *Id.* at 884.
128. *Id.* at 883.
129. *Id.*
130. *Id.* (citing WIS. STAT. § 757.36 (2011)).
131. *Id.* at 884.
132. *Id.*

d. Ninth Circuit

The Ninth Circuit has also held that contingency fees retained by attorneys are income to clients.[133] The court first addressed the issue in *Brewer v. Commissioner*,[134] though the issue was more thoroughly analyzed in *Coady v. Commissioner*.[135]

In *Coady*, the plaintiff was awarded $373,307 on a wrongful discharge action.[136] Her actual recovery, after withholding taxes, was $259,611, of which her attorneys took $221,338.[137] The IRS assessed a deficiency of $49,531, which left her owing $11,259 more than she recovered.[138] The Ninth Circuit distinguished the Alaska attorney's lien statute from the statutes at issue in *Cotnam* and *Estate of Clarks* on the basis that the Alaska statute did not give the attorney any superior rights or liens against a judgment.[139] The Ninth Circuit believed that the taxpayers benefited from the full amount of the judgment, so the entire amount was income.[140] The taxpayers could not escape taxation by entering into a contingency fee agreement and transferring some of the income to their attorney.[141] The fact that the amount of the judgment was uncertain at the time of the assignment of the contingency fee was irrelevant—the uncertainty of the assignment did not prevent the application of the assignment-of-income doctrine.[142]

Coady was followed in *Benci-Woodward v. Commissioner*,[143] where the plaintiffs recovered for wrongful discharge and related torts.[144] The court held that California law, like the Alaska law in *Coady*, did not give an attorney any right or power over the suit or judgment of the client.[145]

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133. Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001).

134. Brewer v. Comm'r, 172 F.3d 875 (9th Cir. 1999).

135. Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001).

136. *Id.*

137. *Id.* at 1187–88.

138. *Id.* at 1188.

139. *Id.* at 1190 (citing ALASKA STAT. ANN. § 34.35.430 (West 2000)).

140. *Id.*

141. *Id.* at 1191.

142. *Id.*

143. Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000).

144. *Id.* at 942–43.

145. *Id.* at 943 (citing Isrin v. Superior Court of L.A. Cnty., 403 P.3d 728, 732, 733 (Cal. 1965)).

e. Tenth Circuit

The Tenth Circuit held the income taxable to the client in *Campbell v. Commissioner*.[146] The Tenth Circuit concluded that the taxpayer's recovery of lost wages and attorney's fees was considered income that must be reported as gross income.[147] The court also recognized that the AMT may preclude effectively deducting attorney's fees when they are included in income.[148] The Tenth Circuit held that state attorney's lien statutes do not have any effect on this analysis.[149]

f. Federal Circuit

In *Baylin v. United States*,[150] the plaintiff was the firm's partner for tax matters, and he recovered additional amounts for a condemnation of property by the state.[151] The court held "that the partnership received the benefit of those funds," as it discharged the partnership's obligation to the attorney.[152] The court rejected the taxpayer's argument that the Maryland attorney's lien statute, like the Alabama statute, gave the attorney an ownership interest in his fees.[153] Further, the court held that the uncertainty of the amount was not relevant.[154] The Federal Circuit held that the portion of a condemnation award representing contingency fees paid directly to attorneys was income to the client.[155] Although the client never had possession of the funds, the funds benefitted the client by discharging his obligation to the attorney.[156] The court stated that accepting the argument that contingency fees were not income to the client "would elevate form over substance and allow [the client] to escape taxation on a portion of [his] income through a 'skillfully

146. Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001).
147. *Id.* at 1314.
148. *Id.*
149. *Id.*
150. Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).
151. *Id.* at 1453.
152. *Id.* at 1454. A partnership is a pass-through entity in taxation, which passes taxes directly through to the partners. I.R.C. § 701 (2006).
153. *Baylin*, 43 F.3d at 1455.
154. *Id.*
155. *Id.*
156. *Id.* at 1454.

devised' fee arrangement."[157] Regardless of whether this concern is valid in the contingency fee context, it is the same concern Justice Holmes expressed in *Earl*—taxpayers avoiding taxation by skillfully devised contracts.[158]

B. *Analysis of Pre-*Banks *Case Law*

The courts holding that the contingency fees were not includable in income decided cases on the following: (1) the attorney's lien statute in the state gave the attorney a proprietary interest in the lawsuit;[159] (2) the fees were never available to the party;[160] (3) the assignment-of-income doctrine did not apply because the client gave away part of the trees, not just their fruit, and formed a partnership with his attorney;[161] (4) the attorney's efforts were necessary for the income to "mature," therefore, there was no asset without the efforts of the attorney;[162] or (5) the recovery was too speculative to constitute income prior to the efforts of the attorney.[163]

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

158. *See Earl*, 281 U.S. at 114–15 (concluding that the Internal Revenue Code was designed to prevent taxpayers from avoiding taxation via skillfully designed contracts).

159. *See* Foster v. United States, 249 F.3d 1275, 1279 (11th Cir. 2001) (stating that controlling Alabama law gave the lawyer a proprietary interest in the claim (citing ALA. CODE § 34-6-61 (2000))), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005); Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (holding that the Alabama attorney's lien statute gave lawyers an interest in their clients' claims when engaged in a contingency fee arrangement, *abrogated by Banks*, 543 U.S. 426.

160. *See Cotnam*, 263 F.2d at 126 (Rives & Brown, JJ., concurring) (remarking that the taxpayer never had control of the proceeds of the lawsuit).

161. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (analogizing contingency fees with a partnership), *abrogated by Banks*, 543 U.S. 426; *Cotnam*, 263 F.2d at 126 (Rives & Brown, JJ., concurring) (stating that the tree "had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit").

162. *See Estate of Clarks*, 202 F.3d at 857 (remarking that the client had to assign part of his claim to the attorney to have a chance at recovery); *Cotnam*, 263 F.2d at 125 (Rives & Brown, JJ., concurring) ("At the time that [the taxpayer] entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder.").

163. *See Estate of Clarks*, 202 F.3d at 857 (distinguishing assignment-of-income cases because "the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of counsel"); *Cotnam*, 263 F.2d at 125–26 (Rives & Brown, JJ., concurring) (reasoning that any recovery the taxpayer may have received was entirely contingent on the efforts of her attorneys to whom she had assigned a percentage of the potential

The courts holding that the contingency fees were includable in income decided cases on the following grounds: (1) the tax court held the attorney's lien statutes were irrelevant;[164] (2) the fees constituted an assignment of income;[165] (3) the income was includable under Section 61, and the taxpayer was entitled to a deduction for the attorney's fees;[166] (4) the attorney merely helped to realize the value that was already inherent in the claim;[167] (5) the speculative nature of the claim was irrelevant;[168] or (6) there should be no difference in treatment between contingency or hourly attorney's fees.[169]

The holdings of the cases cited above seem to be completely contradictory at first, as the reasoning upon which they rest appears to differ from case to case. Upon closer inspection, however, some very intriguing themes begin to emerge. First, the decisions can be loosely grouped based upon the factual nature of the claim.[170] Unfortunately, this theme appears to be accidental

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recovery).

164. *See* O'Brien v. Comm'r, 38 T.C. 707, 712 (1962) (holding that state attorney's liens do not affect the includability of contingency fees), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam).

165. *See* Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001) (rejecting *Cotnam* and holding that the attorney's fees were an assignment of income); *O'Brien*, 38 T.C. at 712 (concluding that contingency fees are an assignment of income).

166. *See* Kenseth v. Comm'r, 114 T.C. 399, 413 (2000) ("Section 61(a) provides that 'gross income means all income from whatever source derived,' and typically, all gains are taxed unless specifically excluded." (quoting I.R.C. § 61(a) (2000))), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

167. *See id.* (stating that the taxpayer was already owed damages and that the attorney simply assisted the taxpayer in recovery of those damages).

168. *See* Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000) (stating that the assignment-of-income doctrine does not turn upon the speculative nature of the contingency fees), *cert. denied*, 532 U.S. 972 (2001); *Kenseth*, 114 T.C. at 413 (declining to accept the value that the Sixth Circuit placed on the claim's speculative nature).

169. *See Kenseth*, 259 F.3d at 884 (noting there was no difference in the tax treatment for the payment of hourly and contingency fee attorneys); *Young*, 240 F.3d at 378 (stating that attorneys only provide a service, regardless of the fee structure); *see also* Srivastava v. Comm'r, 220 F.3d 353, 357 (5th Cir. 2000) (opining that the court, if writing on a blank slate, would have treated contingency and hourly fees the same because "[p]rinciples of tax neutrality, if nothing else, dictate that result"), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).

170. *Compare Kenseth*, 259 F.3d at 884 (stating that the claim was for lost wages and concluding that the contingency fees were includable), *and O'Brien*, 38 T.C. at 708–09, 712 (remarking that the claim was based on wrongful termination and including the contingency fees in income), *with* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 855, 857 (6th Cir. 2000) (concluding that contingency fees from a tort claim were excludable), *abrogated by Banks*, 543 U.S. 426, *and Srivastava*, 220 F.3d at 355, 357–

and is not consistent from case to case.[171] Second, the decisions are highly correlated with whether the focus of the court was on the judgment versus the claim.

1. What Is the Claim?

The cases can be distinguished somewhat based upon the nature of the claim. Most of the cases that included fees in income have, as their basic claim, a suit related to employment issues.[172] The majority of the cases that excluded fees from income were based upon personal injuries and included punitive damages.[173]

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58 (holding that contingency fees derived from a successful tort claim were exlcudable).

171. For example, although the cases holding that contingency fees are excludable featured similar attorney's lien statutes, those cases were based upon different claims. *Compare* Cotnam v. Comm'r, 263 F.2d 119, 125–26 (5th Cir. 1959) (using the Alabama attorney's lien statute to rule in favor of a taxpayer who had brought an estate claim), *abrogated by Banks*, 543 U.S. 426, *with* Foster v. United States, 249 F.3d 1275, 1276 (11th Cir. 2001) (featuring the same Alabama statute, but the underlying action was centered on a massive punitive damages award), *abrogated by Banks*, 543 U.S. 426, *and Estate of Clarks*, 202 F.3d at 855–56 (concluding that the attorney's lien statute operated in the same manner as the *Cotnam* statute, but the underlying action was for a tort).

172. *See* Benci-Woodward v. Comm'r, 219 F.3d 941, 942–43 (9th Cir. 2000) (reviewing the taxpayer's exclusion from income contingency fees from a wrongful discharge action); *Coady*, 213 F.3d at 1187 (stating that the suit involved wrongful termination); *Kenseth*, 114 T.C. at 400, 403 (featuring plaintiffs suing under the Federal Age Discrimination in Employment Act of 1967); *O'Brien*, 38 T.C. at 708–09 (requiring the includability of contingency fees for a plaintiff receiving a recovery in an employment action). However, *Cotnam*, which excluded fees from income, was based upon a claim for a personal services contract, albeit in the context of probate of an estate. *Cotnam*, 263 F.2d at 125. *Srivastava*, which also excluded fees from income, was based upon a defamation suit in which most of the damages were from loss of future income. *Srivastava*, 220 F.3d at 355. However, the *Srivastava* court was less than enthusiastic in following *Cotnam*, and its vitality is questionable. *See id.* at 357 (opining that the court would have ruled differently absent *Cotnam* because "[p]rinciples of tax neutrality, if nothing else, dictate that result"). In addition, *Baylin*, which included fees in income, was a claim on a condemnation of property. Baylin v. United States, 43 F.3d 1451, 1453–54 (Fed. Cir. 1995). Baylin is something of an outlier. The argument in *Baylin* was that the attorney's fees could be allocated to the purchase price and interest based on the pro rata value of each element. *See id.* at 1453 ("The partnership contends that it should be allowed to deduct from interest income an amount of its attorney's fees proportionally equivalent to the amount of the settlement classified as interest."). Obviously, the partnership wanted more of the judgment to constitute a capital gain and less to constitute interest, which is taxable as ordinary income. The exclusion claim sounded almost frivolous in this context and clearly was treated so by the court. *See id.* at 1454 (rejecting the taxpayer's "unsupported" argument because there was little evidence that the attorney actually spent more than a *de minimis* amount of time attempting to increase the award's interest component).

173. *See Foster*, 249 F.3d at 1276, 1279 (featuring a taxpayer who had damages from

It is possible that the split in decisions was based upon a distinction between actions for recovery of lost, earned income and recovery for personal injuries.[174] This approach has a certain logical appeal. The test for inclusion of the judgment, as well as for the deductibility or capitalization of fees, is determined by applying the origin-of-the-claim test, which looks at the conduct providing the basis for the claim.[175] This test can be seen as effectively converting the judgment into the type of income that the claim represents. Because personal service income (e.g., wages) is always income to the earner under the assignment-of-income doctrine,[176] contingency fees in employment cases will always be an assignment of income if the doctrine is applied.

The sequence of cases in the Ninth Circuit is instructive. In *Coady*, the court stated that the uncertainty regarding the amount of the recovery does not matter because the taxpayer received some benefit from the assignment.[177] On its surface, this statement is wrong because it fails to determine whether the income was earned at the time of the assignment. In the context of *Coady*, however, the statement may be correct. The judgment in *Coady* was for back pay and benefits, which are personal service

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an injury); Davis v. Comm'r, 210 F.3d 1346, 1347 n.1 (11th Cir. 2000) (per curiam) (evaluating a taxpayer's claim for damages from an injury), *abrogated by Banks*, 543 U.S. 426; *Estate of Clarks*, 202 F.3d at 855 (stating that the taxpayer's estate recovered from personal injuries). *But see Srivastava*, 220 F.3d at 355 (describing the suit as based on a defamation claim with punitive damages); *Cotnam*, 263 F.2d at 120–21 (stating that the case arose from a breach of a contract regarding the drafting of a will and noting that the taxpayer was not awarded punitive damages).

174. This distinction is important because, under the Internal Revenue Code, recovery for personal injuries is excludable from income while recovery for lost wages is includable. *See* I.R.C. § 104(a) (2006) (allowing an exclusion of recovery for physical illness or injuries).

175. *See* Arthur H. DuGrenier, Inc. v. Comm'r, 58 T.C. 931, 937 (1972) ("In *Gilmore*, the Supreme Court, in attempting to distinguish between business and personal expenses indicated that it was not the 'primary purpose' which determined the nature of an expense, but rather the origin and character of such expense." (citing United States v. Gilmore, 372 U.S. 39, 49 (1963))); Reed v. Comm'r, 55 T.C. 32, 39 (1970) (stating that the origin-of-the-claim test resolved "the question of business versus personal litigation costs" (citing *Gilmore*, 372 U.S. at 49)); Javed A. Khokhar, Tax Aspects of Settlements and Judgments, 522-2nd Tax Mgt. (BNA), at A-31 (Mar. 7, 2005) ("[T]o determine whether legal fees are deductible under [Section] 162 (or [Section] 212) or whether such fees must be capitalized, the origin and nature of the claim test is applied.").

176. *See* Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001) (concluding that lost wages were income to the earner after applying the assignment-of-income doctrine).

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

income.[178] If the origin-of-the-claim test applies, the judgment itself is personal service income. As seen in *Earl*, personal service income is always earned by the person performing the services, no matter when the assignment was made.[179] Therefore, the Ninth Circuit correctly included the attorney's fees in income.

Whether the Sixth and Eleventh Circuits correctly excluded fees for interest and punitive damages stemming from personal injury claims under the origin-of-the-claim test is less clear. A personal injury is probably not personal service income,[180] but the question still remains whether it is earned before judgment is rendered. In essence, the origin-of-the-claim test would only be dispositive for compensation damages from employment claims.

Regardless of the limited utility of the test, it seems that the Ninth Circuit did not intend to adopt it because the Ninth Circuit cited *Coady* to hold that the uncertainty of a punitive damages award was irrelevant in *Benci-Woodward*.[181] This application is incorrect under the origin-of-the-claim test because the court did not determine whether the punitive damages were earned at the time of the assignment.[182] Further, under *O'Gilvie v. United States*,[183] punitive damages do not share the character of the underlying claim.[184]

The origin inquiry is rationally related to the character of any income received but has no relevance at all to whether the income has been earned. For example, in a wrongful discharge action, the plaintiff has not actually performed any services for the defendant. How, then, can the income be said to have been already earned? The origin-of-the-claim test does not provide a principled

178. *Id.* at 1187–88.

179. *See* Lucas v. Earl, 281 U.S. 111, 114 (1930) (rejecting an argument that personal service income should be income to the assignee).

180. *See* I.R.C. § 104(a) (2006) (excluding from income recovery from personal injuries).

181. *See* Benci-Woodward v. Comm'r, 219 F.3d 941, 943 n.2 (9th Cir. 2000) ("Petitioners' effort to distinguish contingent fees from other anticipatory assignments of income due to the uncertainty of their realization is foreclosed by *Coady*." (citing *Coady*, 213 F.3d at 1191)).

182. *See id.* at 943–44 (holding that the portion of the punitive damages given to the attorney via a contingency fee contract are includable in income without deciding whether the damages were earned).

183. O'Gilvie v. United States, 519 U.S. 79 (1996).

184. *Id.* at 81.

distinction between types of claims for assignment-of-income purposes.

2. Procedural Posture

The courts also did not distinguish between the procedural differences in the cases. For example, the tax court declined to treat class actions, which present a vastly different level of attorney control over the proceedings,[185] any differently than single plaintiff actions.[186]

3. Doctrinal Distinctions

Although the factual distinctions did not pan out, there was a very clear distinction based upon what property the court focused upon. Every court seemed to be analyzing the issue as an assignment of income, which required a transfer of a property interest.[187] When the court focused on the *judgment* as the property at issue, it invariably excluded it from income.[188] When the court focused on the *claim* as the property at issue, it invariably

185. *See* Abelson v. Strong, MDL No. 584, Civ. A. No. 08-0592-S, 1987 WL 15872, at *6 (D. Mass. July 30, 1987) ("[I]t would be patently unrealistic to deny that attorneys control class actions[.]" (citing M. Berenson Co. v. Faneuil Hall Marketplace, Inc., 100 F.R.D. 468, 470 (D. Mass. 1984))).

186. Tax court cases illustrate that contingency fees should be includable regardless of the number of plaintiffs. *See* Miller v. Comm'r, 81 T.C.M. (CCH) 1258, at *1 (2001) (class action); Kenseth v. Comm'r, 114 T.C. 399, 400 (2000) (class action), *aff'd*, 259 F.3d 881 (7th Cir. 2001); O'Brien v. Comm'r, 38 T.C. 707, 708–09 (1962) (single plaintiff), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam).

187. *See Kenseth*, 259 F.3d at 884 (holding that contingency fees were an assignment of income); Foster v. United States, 249 F.3d 1275, 1280 (11th Cir. 2001) (agreeing with the Sixth Circuit that the assignment-of-income doctrine was inapplicable (citing Estate of Clarks *ex. rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857–58 (6th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005))), *abrogated by Banks*, 543 U.S. 426; Young v. Comm'r, 240 F.3d 369, 378 (4th Cir. 2001) (rejecting the Fifth and Sixth Circuits' holdings that the assignment-of-income doctrine did not apply to contingency fees (citing *Estate of Clarks*, 202 F.3d at 857–58; Cotnam v. Comm'r, 263 F.3d 119, 125 (5th Cir. 1959), *abrogated by Banks*, 543 U.S. 426)); *Estate of Clarks*, 202 F.3d at 857–58 ("The present transaction . . . is more like a division of property than an assignment of income."); *Cotnam*, 263 F.2d at 125 (stating the taxpayer could not have received the portion she paid to her attorneys in contingency fees, which would imply that the assignment-of-income doctrine is inapplicable); *O'Brien*, 38 T.C. at 712 (stating that the assignment-of-income principles of *Earl* applied (citing Lucas v. Earl, 281 U.S. 111, 115 (1930))).

188. *See, e.g.*, Davis v. Comm'r, 210 F.3d 1346, 1348 (11th Cir. 2000) (rejecting application of the open-transaction doctrine and excluding contingency fees because the value of the claim was uncertain and not because the Commissioner was focusing on the judgment).

included it in income.[189] This difference in focus arose when the courts addressed the two prevailing issues in these cases: (1) whether the taxpayer gave up control over the property; and (2) whether the income from the property was earned.

4. Control

Control was the major issue for the courts in contingency fee cases, and it arose in every case in one form or another.[190] A class-action plaintiff should not be considered to own the income produced because the plaintiff surrenders sufficient control over the claim.[191] After a plaintiff enters a class-action suit, the plaintiff can no longer settle and avoid the attorney's fees.[192] Some state laws gave the attorney the power to prosecute the client's claim to protect his fee.[193] The plaintiff, particularly in a

189. *Cf. Kenseth*, 259 F.3d at 884 (framing the taxpayer's loss of control argument as a relinquishment of "control over his income-producing asset, namely the . . . *claim*" (emphasis added)). The *Srivastava* court excluded contingency fees even though it focused on the claim, but that court clearly would have included the fee in income had it not felt constrained to follow *Cotnam*. *See* Srivastava v. Comm'r, 220 F.3d 353, 357–58 (5th Cir. 2000) (affirming *Cotnam* even though the court would have ruled for includability had *Srivastava* been decided on a blank slate), *abrogated by Banks*, 543 U.S. 426.

190. *See Kenseth*, 259 F.3d at 883 (concluding that the attorney is not a joint owner under Wisconsin law because Wisconsin law simply gives the attorney a security interest rather than a proprietary interest (citing WIS. STAT. § 757.36 (2011))); *Foster*, 249 F.3d at 1280 (stating that the contingency fee arrangement was "more like a division of property than an assignment of income" (quoting *Estate of Clarks*, 202 F.3d at 857–58) (internal quotation marks omitted); *Young*, 240 F.3d at 378 (rejecting taxpayer's argument that the attorney had control over the claim in a contingency fee arrangement); Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000) (opining that a contingency fee arrangement does not give control over to the attorney, but rather it transfers part of the income to the attorney), *cert. denied*, 532 U.S. 972 (2001); *Estate of Clarks*, 202 F.3d at 858 ("[T]he client . . . transferred some of the trees in his orchard, not merely the fruit from the trees."); *Cotnam*, 263 F.2d at 126 (Rives & Brown, JJ., concurring) (emphasizing the taxpayer's lack of control over the portion of the claim assigned to her attorney as a reason for exclusion); *O'Brien*, 38 T.C. at 712 (stating that the rights given by state statute were irrelevant and that this was an assignment of income).

191. *See Kenseth*, 114 T.C. at 443–44 (Beghe, J., dissenting) (stating that the taxpayer "gave up substantial control over the conduct" of the claim and "total control of the portion of the recovery" when the taxpayer entered into a contingency fee arrangement in a class-action suit).

192. *See id.* at 444 (noting that the class-action plaintiff could not settle without the approval of his attorneys).

193. *See, e.g.*, Jeffries v. Third Judicial Dist. Court of Salt Lake Cnty., 63 P.2d 242, 244 (Utah 1936) (construing a Utah attorney's lien statute to allow a lawyer to prosecute a claim "solely for the purpose of protecting his lien for the amount of his fee in the case"

class action, has very little, if any, power over the strategic or tactical decisions in the litigation.[194] The individual plaintiff has no ability to fire the attorney, and his power to opt out of the class has no material impact upon the claim as a whole.[195] The class action is the attorney's lawsuit, making the prosecuting attorney a "private attorney general."[196] Thus, in class-action suits, the control issue should have dictated against inclusion.

The issue of who has control over particular property is a very fact-intensive inquiry, and the relevant facts are dependent on the exact property at issue. This is clearly shown by the difference of opinion as to the relevance of the state attorney's lien statutes. As can be gleaned from the above synopses, the circuits were split four and one-half to three and one-half on this question. In the Sixth and Eleventh Circuits, which excluded fees from income, the decisions rested at least partially on the strength of the attorney's lien statutes in those states.[197] The Ninth Circuit, which included fees in income, also rested its decisions on state law but found that those two states—Alaska and California—did not give attorneys superior lien rights.[198] The Seventh Circuit seemed to have done the same, looking at the state lien statute but deciding that it gave insufficient rights.[199] The halves came from the Fifth Circuit.[200]

(citations omitted)).

194. *See Kenseth*, 114 T.C. at 444 (Beghe, J., dissenting) (discussing the "contract of adhesion" concept of class action lawsuit contracts).

195. *Id.*

196. *But see* Sinyard v. Comm'r, 76 T.C.M. (CCH) 654, at *7 (1998) (rejecting the argument that a class action attorney, who is essentially a private attorney general, should affect the includability of contingency fees), *aff'd*, 268 F.3d 756 (9th Cir. 2001).

197. *See* Foster v. United States, 249 F.3d 1275, 1279 (11th Cir. 2001) (concluding that Alabama law controlled, which gave the attorney control over the claim (citing ALA. CODE § 34-6-61 (2000))), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856 (6th Cir. 2000) (excluding contingency fees from income because the common law attorney's lien in Michigan operated "in more or less the same way as the Alabama lien in *Cotnam*"), *abrogated by Banks*, 543 U.S. 426.

198. Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (holding that California law did not give an attorney any right or power over the suit or judgment (citing Isrin v. Superior Court of L.A. Cnty., 403 P.3d 728, 732, 733 (Cal. 1965))); Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000) (distinguishing *Cotnam* on the grounds that the Alaska attorney's lien statute at issue did not give proprietary rights to the attorney), *cert. denied*, 532 U.S. 972 (2001).

199. *See* Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001) (concluding that the attorney is not a joint owner under Wisconsin law because Wisconsin law simply gives the attorney a security interest rather than a proprietary interest (citing WIS. STAT. § 757.36

Cotnam was at least somewhat based on the state attorney's lien statute.[201] However, *Srivastava* clearly said that state law was irrelevant to this question.[202] The Third, Fourth, Tenth, and Federal Circuits all quite adamantly held that state law was irrelevant, and all included fees in income.[203] The United States Tax Court, while it held state law was irrelevant,[204] was meticulous in distinguishing state laws from those in *Cotnam* when including fees in income.[205]

(2001))).

200. *Compare* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (concluding that Alabama's attorney's lien statute gives the attorney ownership over the cause of action (citation omitted)), *abrogated by Banks*, 543 U.S. 426, *with* Srivastava v. Comm'r, 220 F.3d 353, 364 (5th Cir. 2000) ("We therefore agree with the Tax Court that, irrespective of whether it is proper to tax contingent attorney's fees under the anticipatory assignment doctrine, the answer does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." (citing O'Brien v. Comm'r, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam))), *abrogated by Banks*, 543 U.S. 426.

201. *See Cotnam*, 263 F.2d at 125 (stating that an Alabama statute gave attorneys such an interest in the lawsuit that they could be considered to own part of the lawsuit).

202. *Srivastava*, 220 F.3d at 364.

203. *See* Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001) (concluding that state attorney's lien statutes do not have any effect on this analysis); Young v. Comm'r, 240 F.3d 369, 378 (4th Cir. 2001) (holding that state law was irrelevant for determining the tax consequences of a contingency fee arrangement); Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (dismissing an argument that a state attorney's lien statute gives the attorney a proprietary interest in the cause of action); *O'Brien*, 38 T.C. at 712 (opining that state law is likely inapplicable because "it [is] doubtful that the Internal Revenue Code was intended to turn upon such refinements").

204. *See O'Brien*, 38 T.C. at 712 (rejecting the argument that state law is controlling).

205. *See* Kenseth v. Comm'r, 114 T.C. 399, 414–15 (2000) (concluding that Wisconsin law does not allow for an exclusion of the attorney's fees from income (citing WIS. SUP. CT. R. 20:1.2(a) (2007); Goldman v. Home Mut. Ins. Co., 126 N.W.2d 1, 5 (Wis. 1964))), *aff'd*, 259 F.3d 881 (7th Cir. 2001); Sinyard v. Comm'r, 76 T.C.M. (CCH) 654, at *5 (1998) ("The parties, however, have not cited any provision of Arizona statutory law, and we have found none, that pertains to the legal rights of Arizona attorneys in monetary awards recovered on behalf of their clients."), *aff'd*, 268 F.3d 756 (9th Cir. 2001); Coady v. Comm'r, 76 T.C.M. (CCH) 257, at *3 (1998) ("Although both provisions give an attorney a lien to secure his or her compensation, the Alaska provision, unlike the Alabama provision, does not give attorneys the same right and power over suits, judgments, and decrees as their clients had or may have." (citing ALASKA STAT. § 34.35.430 (1996))), *aff'd*, 213 F.3d 1187 (9th Cir. 2000); Estate of Gadlow v. Comm'r, 50 T.C. 975, 980 (1968) (arguing that *Cotnam* is inapplicable because "Pennsylvania does not have any statute similar to the Alabama statute" (citing Laplacca v. Phila. Rapid Transit Co., 108 A. 612, 613 (Pa. 1919))); Petersen v. Comm'r, 38 T.C. 137, 152 (1962) (distinguishing *Cotnam* by contrasting Nebraska and South Dakota attorney's lien statutes with the Alabama statute in *Cotnam* (citing NEB. REV. STAT. § 7-108 (1954))), *acq.*, 1963-2 CB 3, 1963 WL 65824 (1963). *But see* Davis v. Comm'r, 76 T.C.M. (CCH) 46, at *3 (1998) (concluding that

Generally, "state law creates legal interests, but the federal statute determines when and how they shall be taxed."[206] Even where the federal statute does not look to the state law for guidance, the court should "examine the [state] law only for the purpose of ascertaining whether the [property] conform[s] to the standard which the taxing statute prescribes."[207] This is a longstanding principle of tax law because there is no federal common law of property.[208]

There are two possible reasons why three and one-half of the circuits felt that state law was nevertheless irrelevant: (1) they may have been unwilling to condone any attorney acquiring rights in a client's lawsuit;[209] or (2) they may have been applying Section 61 to the claim, rather than the judgment.[210] However, the Tenth Circuit specifically stated that the realization test it used was based on the judgment, but then included the income anyway and allowed a deduction for the attorney's fees.[211]

Cotnam controls for Alabama and therefore the contingency fees were not income), *aff'd*, 210 F.3d 1346, *abrogated by Banks*, 543 U.S. 426.

206. Burnet v. Harmel, 287 U.S. 103, 110 (1932).

207. *Id.*

208. *See* United States v. Capital Tax Corp., 545 F.3d 525, 532 (7th Cir. 2008) (remarking "that state law governs property" because a federal common law of property is "inappropriate, if not impossible"). The Fifth Circuit explained the relationship between state and federal law for income tax purposes:

> It is axiomatic that federal law controls the interpretation of federal statutes and regulations. In the field of federal taxation, however, federal and state law are tightly intertwined. The Internal Revenue Code does not operate in a vacuum; it attaches tax significance to legal rights and transactions that are created under state law.
> When a taxpayer's federal tax liability clearly turns on the characterization under state law of a property interest, a state court's determination of that interest is obviously relevant in a subsequent federal tax controversy.

Brown v. United States, 890 F.2d 1329, 1341 (5th Cir. 1989).

209. *See* MODEL RULES OF PROF'L CONDUCT R. 1.8(i) (2011) ("A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client . . . ."). The American Bar Association explained that this rule "is designed to avoid giving the lawyer too great an interest in the representation." *Id.* R. 1.8 cmt. 16. Furthermore, if a lawyer has a proprietary interest in the cause of action, the client will have difficulty in terminating the representation. *Id.*

210. *Cf. Kenseth*, 259 F.3d at 884 (framing the taxpayer's loss of control argument as a relinquishment of "control over his income-producing asset, namely the . . . *claim*" (emphasis added)).

211. *See* Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001) (remarking that the taxpayer's "judgment is a recovery of lost income," but nonetheless holding that "the attorney['s] fees she paid represent expenses incurred in generating that income" and that these fees are deductible).

5. Attorney's Lien Statutes

The state attorney's lien statute was very relevant to the issue of control over the judgment but was not relevant to the issue of control over the claim. The Fifth Circuit in *Srivastava* stated: "Whatever are the attorney's rights against the *defendant* under Texas law as opposed to Alabama law, the discrepancy does not meaningfully affect the economic reality facing the *taxpayer-plaintiff*."[212] Every state gives an attorney a statutory lien on the judgment proceeds to secure his fees.[213] In some states, these statutes have been interpreted to give the attorney the right to prosecute the client's claim even without the client's consent; however, the cases that stood for this proposition are typically quite old and in a small minority.[214]

When the court focused on the judgment as the relevant property for control purposes, the court used the attorney's lien statutes because they were relevant and sometimes controlling.[215] The security interest granted by the statute, in combination with the attorney's contractual right to receive the judgment and take his fee from those funds directly, eliminated the client's control over that part of the judgment.[216]

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212. Srivastava v. Comm'r, 220 F.3d 353, 364 (5th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).

213. *See* ARK. CODE ANN. § 16-22-304 (West 1989) (amended 2003) (providing a lien in favor of an attorney to recover unpaid fees); 770 ILL. COMP. STAT. ANN. 5/1 (LexisNexis 2010) (same); UTAH CODE ANN. § 38-2-7 (West 2001) (same).

214. *See* Carnes v. Shores, 318 So. 2d 305, 307 (Ala. Civ. App. 1975) ("[T]he Code plainly gives an attorney's lien in suits for money together with the same power as their client to prosecute such suits to judgment so that the lien may be enforced." (citation omitted)); *In re* Agee's Estate, 252 P. 891, 897 (Utah 1927) (giving an attorney the right to prosecute a deceased client's claim without an administrator).

215. *See* Foster v. United States, 249 F.3d 1275, 1279 (11th Cir. 2001) ("Based on [the Alabama lien statute], Foster could never have received the portion of the judgment contracted as attorneys' fees."), *abrogated by Banks*, 543 U.S. 426; Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856 (6th Cir. 2000) ("Although the underlying claim for personal injury was originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment."), *abrogated by Banks*, 543 U.S. 426; Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (Rives & Brown, JJ., concurring) ("In our opinion, it is as illegal as it is unjust to tax her on the remaining $50,365.83 which did not pass through her hands and of which she never had control."), *abrogated by Banks*, 543 U.S. 426.

216. *But see* Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) ("The argument that this statute gives the attorney an ownership interest in those funds is unsound. Maryland courts have not interpreted the state's lien statutes as creating such an interest." (citing Chanticleer Skyline Room, Inc. v. Greer, 319 A.2d 802, 806 (Md. 1974))).

When the court focused on the claim as the relevant property for control purposes, the court disregarded the attorney's lien statute.[217] This may have been due to the difficulty of weighing control over the lawsuit between the client and attorney,[218] an ethical distaste for acknowledging an attorney's property right in a client's lawsuit,[219] or a lack of a nexus between control over a claim and the method of computing the attorney's fee.[220]

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217. *See* Kenseth v. Comm'r, 259 F.3d 881, 883–84 (7th Cir. 2001) ("Wisconsin law does not make the contingent[]fee lawyer a joint owner of his client's claim in the legal sense.... Kenseth no more relinquished control of the claim to his contingent[]fee lawyer than he would have to a fixed[]fee lawyer."); Young v. Comm'r, 240 F.3d 369, 378–79 (4th Cir. 2001) (concluding that "the amount of control state law grants to an attorney over the client's cause of action" was irrelevant because "[t]he attorney does not... own the claim itself"); Kenseth v. Comm'r, 114 T.C. 399, 414 (2000) ("There is no evidence supporting petitioner's contention that he had no control over his claim."), *aff'd*, 259 F.3d 881. The Ninth Circuit analyzed state law but, until *Banaitis*, always held that there was no transfer of control. *See* Banaitis v. Comm'r, 340 F.3d 1074, 1082–83 (9th Cir. 2003) (holding that Oregon law gave an attorney a proprietary interest in the cause of action), *rev'd sub nom. Banks*, 543 U.S. 426; Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (holding that California law did not give an attorney any right or power over the suit or judgment of the client (citing Isrin v. Superior Court of L.A. Cnty., 403 P.3d 728, 732, 733 (Cal. 1965))); Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000) (stating that the Alaska statute did not give the attorney any superior rights or liens against a judgment (citing ALASKA STAT. § 34.35.430 (2004); Hagans, Brown & Gibbs v. First Nat. Bank of Anchorage, 783 P.2d 1164, 1168 (Alaska 1989))). This circuit's holdings seem to encompass judgments as well, but the cited cases do not support such a wide scope. *See Benci-Woodward*, 219 F.3d at 943 ("Under California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." (citing *Isrin*, 403 P.2d at 732)); *Coady*, 213 F.3d at 1189, 1190 ("[U]nder Alaska law, attorneys do not have a superior lien or ownership interest in the cause of action...." (citing ALASKA STAT.§ 34.35.430; *Hagans, Brown & Gibbs*, 783 P.2d at 1168)). In any event, the Ninth Circuit does not appear to be looking carefully at control, but rather whether the claim has been earned. This is covered in the next subsection.

218. *See* Srivastava v. Comm'r, 220 F.3d 353, 360 (5th Cir. 2000) ("[W]hen a client hires an attorney to prosecute a claim on his behalf, control over that claim—the income source or 'tree'—is neither fully divested to the attorney nor fully retained by the taxpayer-client."), *abrogated by Banks*, 543 U.S. 426.

219. *See Kenseth*, 114 T.C. at 414 ("[I]t would be an ethical violation for his attorney to press forward with such a case against the will of the client."). Attorney ethics forbid a lawyer from acquiring an interest in a client's business, except that the lawyer may acquire an interest in the lawsuit if it is for contingency fees. *See* MODEL RULES OF PROF'L CONDUCT R. 1.8(i) (2011) ("A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client...."). In fact, the interest allowed is a proprietary interest. *See Kenseth*, 114 T.C. at 436 (Beghe, J., dissenting) (arguing that the ethical rules allow the lawyer to obtain a proprietary interest in his client's claim because a lien is one of the enumerated exceptions to the rule against proprietary interests (citing WIS. SUP. CT. R. 20:1.8(j) (1998))). *But see Kenseth*, 259 F.3d

6. Is the Income Earned?

The difference in focus on the judgment as opposed to the claim was also indirectly demonstrated by the courts' determinations of when the income was earned. Control was the primary issue for the circuit courts.[221] When courts held that the client relinquished control, the income earned was an issue.[222] These courts also had to conclude that the transfer occurred before the income was earned, or the assignment-of-income doctrine would require inclusion.[223] On the other hand, when courts held that the taxpayer did not give up control, the timing of the income was inconsequential, and the opinions contained broad platitudes concerning the earning of income.[224] Therefore, courts excluding

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at 883–84 ("The rule allows the lawyer to acquire a lien and to make a contingent[]fee contract, but neither a lien nor a contractual right is 'proprietary.'" (internal quotation marks omitted)). Even the Model Rules of Professional Conduct envision that the attorney will acquire a proprietary interest in the lawsuit if the attorney takes the case on a contingency. *See* MODEL RULES OF PROF'L CONDUCT R. 1.8(i)(2) (2011) (recognizing that a lawyer may "contract with a client for a reasonable contingent fee in a civil case" as an exception to rule against acquiring proprietary interests).

220. *See Kenseth*, 259 F.3d at 883–84 ("Wisconsin law does not make the contingent[]fee lawyer a joint owner of his client's claim in the legal sense .... Kenseth no more relinquished control of the claim to his contingent[]fee lawyer than he would have to a fixed[]fee lawyer."); *Young*, 240 F.3d at 378 ("[A]n attorney paid by the hour adds just as much 'worth' to a claim as a contingent fee attorney."); *Srivastava*, 220 F.3d at 363 (stating that a taxpayer "ought not receive preferential tax treatment from the simple fortuity that he hired counsel on a contingent basis, for his attorney's method of compensation did not meaningfully affect the gain he was able to enjoy from a favorable resolution of the litigation" (footnote omitted)).

221. *See supra* Part II.B.4 (discussing control).

222. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (holding that income had not been earned before the assignment because the claim was speculative and the lawyer's work produced the lawyer's income), *abrogated by Banks*, 543 U.S. 426; Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (Rives & Brown, JJ., concurring) (concluding that at the time the taxpayer entered into the contingency fee agreement, she had realized no income from her claim), *abrogated by Banks*, 543 U.S. 426.

223. *See, e.g.*, *Estate of Clarks*, 202 F.3d at 856, 858 (holding that contingency fees should be excluded because the taxpayer gave up control and the income was not earned until the lawyer used "his own personal skill and judgment" to arrive at a judgment).

224. *See Young*, 240 F.3d at 378 ("[S]atisfaction of Mrs. Young's obligation to her attorneys provided her an economic benefit. That an assignment of income involves a contingent or undetermined amount does not exempt it from taxation to the assignor." (citations omitted)); *Srivastava*, 220 F.3d at 361–62 ("There is no questioning the fact that the value of a claim is often uncertain and difficult to predict. But just because a future income stream ... is of uncertain value does not mean a taxpayer cannot achieve gain from anticipatorily assigning it to another." (footnote omitted)); Coady v. Comm'r, 213

contingency fees made definitive statements of why the income was unearned.[225]

C. Banks's *Prior History*

After rejecting petitions for certiorari on five prior cases involving the tax treatment of contingency fees,[226] the Supreme Court finally accepted the government's petition in *Banaitis* from the Ninth Circuit[227] and *Banks* from the Sixth Circuit.[228] The cases were consolidated.

1. *Banks v. Commissioner*

In 1986, the California Department of Education fired educational consultant John W. Banks II.[229] He retained an attorney on a contingency fee basis and filed a civil suit alleging employment discrimination.[230] The parties settled for $464,000

F.3d 1187, 1191 (9th Cir. 2000) ("[T]he fact that such an assignment involves a contingent amount does not alter the conclusion that taxation cannot be escaped by making anticipatory arrangements to prevent earnings from vesting in the person who earned it." (citing Kochansky v. Comm'r, 92 F.3d 957, 959 (9th Cir. 1996))), *cert. denied*, 532 U.S. 972 (2001); Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (stating that the contingency fee is an "estimate [of] the value of the attorney's services"); *Cotnam*, 263 F.2d at 126 (Wisdom, J., dissenting) ("[A]t the time of the assignment to the attorneys all of her services had been rendered and all of the income earned."); *Kenseth*, 114 T.C. at 413 ("[H]is cause of action had value in the very beginning; otherwise, it is unlikely that Fox & Fox would have agreed to represent petitioner on a contingent basis.").

225. *See* Foster v. United States, 249 F.3d 1275, 1280 (11th Cir. 2001) (remarking that "[i]t is due to the hard work and expertise of the attorney that he is paid" because of the speculative nature of the claim), *abrogated by Banks*, 543 U.S. 426; *Estate of Clarks*, 202 F.3d at 857 ("[T]he value of the taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy."); *Cotnam*, 263 F.2d at 125 (stating that the taxpayer did not earn income before the assignment because "[h]er claim had no fair market value, and it was doubtful and uncertain as to whether it had any value").

226. Sinyard v. Rossotti, 536 U.S. 904 (2002), *denying cert. to* 268 F.3d 756 (9th Cir. 2001); Hukkanen-Campbell v. Comm'r, 535 U.S. 1056 (2002), *denying cert. to* 274 F.3d 1312 (10th Cir. 2001); Coady v. Comm'r, 532 U.S. 972 (2001), *denying cert. to* 213 F.3d 1187 (9th Cir. 2000); Benci-Woodward v. Comm'r, 531 U.S. 1112 (2001), *denying cert. to* 219 F.3d 941 (9th Cir. 2000); O'Brien v. Comm'r, 375 U.S. 931 (1963), *denying cert. to* 319 F.2d 532 (3d Cir. 1963).

227. Banaitis v. Comm'r, 541 U.S. 958 (2004).

228. Banks v. Comm'r, 541 U.S. 958 (2004).

229. Banks v. Comm'r, 345 F.3d 373, 375 (6th Cir. 2003), *rev'd on other grounds*, 543 U.S. 426.

230. *Id.*

after the start of the trial.[231] Banks paid $150,000 of this amount to his attorney pursuant to the fee agreement.[232] Banks did not report any of the $464,000 on his tax return.[233] The IRS later gave the taxpayer a notice of deficiency.[234] The United States Tax Court upheld the Commissioner's determination, concluding that all the settlement proceeds, including the $150,000 paid to the attorney, were income to Banks.[235]

The Sixth Circuit reversed in part.[236] The court agreed the net amount received by Banks should be included in gross income but excluded the amount paid to the attorney.[237] The court held that the contingency fee agreement was not an anticipatory assignment of Banks's income because the litigation recovery was not already earned, vested, or even relatively certain when the contingency fee contract was made.[238] Rather than viewing the contingency fee arrangement as a present transfer of future income, the Sixth Circuit viewed the transaction as a transfer of a portion of the underlying cause of action.[239] According to the Sixth Circuit, a contingency fee arrangement is more like a partial assignment of income-producing property rather than an assignment of income,[240] and the attorney earns his fee through his own skill and diligence.[241] The court held that this reasoning applies whether or not state law grants the attorney any special property interest (e.g., a superior lien) in part of the judgment or settlement proceeds: "We . . . are not inclined to draw distinctions between contingency

231. *Id.* at 376.
232. *Id.*
233. *Id.*
234. *Id.* at 377.
235. *Id.*
236. *Id.*
237. *Id.* at 389.
238. *Id.* at 386.
239. *Id.* Specifically adopting assignment-of-income parlance, the court stated that Banks had "transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit." *Id.* (citing Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 858 (6th Cir. 2000), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005)).
240. *See id.* (holding that Banks "transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit" (citing *Estate of Clarks*, 202 F.3d at 858)).
241. *Id.* at 384–85 (quoting *Estate of Clarks*, 202 F.3d at 857–88).

fees based on the attorney's lien law of the state in which the fee originated."[242]

2. *Banaitis v. Commissioner*

In *Banaitis*, Sigitas J. Banaitis sued his former employer and its corporate parent for wrongful discharge from his job as the Bank of California's vice president and loan officer.[243] After trial and the resolution of all appeals, the parties settled.[244] The defendants paid $4,864,547 to Banaitis and an additional $3,864,012 to Banaitis's attorney pursuant to the contingency fee agreement.[245] Banaitis did not include the amount paid to his attorney on his federal income tax return, and the Commissioner issued a notice of deficiency.[246] The United States Tax Court upheld the Commissioner's determination, but the Ninth Circuit reversed, determining that Banaitis had properly excluded the portion of the recovery paid to his attorneys.[247] *Banaitis* viewed state law as pivotal.[248] Where state law confers no special property rights on the attorney for his fee, the whole amount of the judgment or settlement is ordinarily included in the plaintiff's gross income.[249] Oregon law, however, grants attorneys a superior lien in the contingency fee portion of any recovery.[250] Thus, the court held contingency fee agreements under Oregon law operate not as an anticipatory assignment of the client's income but as a partial transfer to the attorney of the lawsuit.[251]

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242. *Id.* at 385.

243. Banaitis v. Comm'r, 340 F.3d 1074, 1076 (9th Cir. 2003), *rev'd on other grounds sub nom. Banks*, 543 U.S. 426.

244. *Id.* at 1077–78.

245. *Id.* at 1078.

246. *Id.*

247. *Id.* at 1083.

248. *See id.* ("Because of the unique features of Oregon law, we conclude that fees paid directly to Merten were not includable in Banaitis's gross income for the relevant year.").

249. *See id.* at 1081 (remarking that the court previously included contingency fees in income where state law did not confer any special property rights on the attorney (citing Coady v. Comm'r, 213 F.3d 1187, 1190–91 (9th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000))).

250. *See id.* at 1082 (distinguishing the Oregon statute from the statutes in previous Ninth Circuit cases because "an attorney's lien in Oregon is 'superior to all other liens' except 'tax liens'" (citing OR. REV. STAT. § 87.490 (West 2003))).

251. *Id.* at 1082–83. The Ninth Circuit's analysis can be charitably described as suspect, particularly given that a prior panel of that court had openly questioned the

3. American Jobs Creation Act of 2004

One month prior to oral arguments for *Banks* and *Banaitis*, Congress passed the American Jobs Creation Act of 2004 (AJCA).[252] The AJCA allowed taxpayers to exclude fees paid to attorneys that were incurred in certain unlawful discrimination cases.[253] Unfortunately, Banks and Banaitis did not qualify for relief under the new code provisions because the effective date of the AJCA was not retroactive.[254] The taxpayers brought the passage of the Act to the Court's attention because it could have warranted dismissal "on the ground[s] that the writs of certiorari were improvidently granted."[255]

Although the Court did not apply the Act, the Court did consider the various implications that the Act would have had on *Banks*. The Court remarked that the Act solved the problem that the AMT had presented because "[t]hese deductions are permissible even when the AMT applies."[256] The Court also opined that, had the AJCA been retroactive, the underlying cases would not have come about and that the AJCA could be applicable to future taxpayers in a similar position of the respondents.[257]

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relevance of state attorney lien law. *See* Sinyard v. Comm'r, 268 F.3d 756, 760 (9th Cir. 2001) ("[W]e do not see how the existence of a lien in favor of the taxpayer's creditor makes the satisfaction of the debt any less income to the taxpayer whose obligation is satisfied."). Perhaps this is why Banaitis relegated the state law argument to secondary status in his arguments before the Supreme Court. *See* Brief for Respondent at 31, Commissioner v. Banks, 543 U.S. 426 (2005) (No. 03-907), 2004 WL 1876293 at *20–21 (refusing to raise the argument under Oregon attorney lien law until Part IV of the brief); Transcript of Oral Argument at 37, *Banks*, 543 U.S. 426 (No. 03-907), 2004 U.S. Trans. LEXIS 58 at *37 (recognizing the argument under Oregon law as one "which I don't think the Court is likely interested in").

252. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of I.R.C.).

253. *Id.* at 1546–47 (codified at I.R.C. § 62(a)(20), (e) (2006)).

254. *See id.* at 1548 ("The amendments made by this section shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date.").

255. Joint Supplemental Brief for the Respondents at 1, *Banks*, 543 U.S. 426 (Nos. 03-097, 03-892), 2004 WL 2407555 at *1.

256. *Banks*, 543 U.S. at 433.

257. *Id.*

III. ANALYSIS OF *COMMISSIONER V. BANKS*

The Supreme Court held that contingency fees generally constitute income when the underlying recovery would also be income to the taxpayer.[258] The Court applied the assignment-of-income doctrine "to prevent taxpayer[s] from avoiding taxation through 'arrangements and contracts however skillfully devised to prevent [income] when paid from vesting . . . in the man who earned it.'"[259] The Court then rejected the Sixth Circuit's reliance on the speculative nature of the claim because "the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance."[260] The Court further explained that the attorney was not a co-venturer with his client, but was rather an agent, and "[t]he portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income."[261] Justice Kennedy stated that "[i]n the case of a litigation recovery[,] the income-generating asset is the cause of action that derives from the plaintiff's legal injury."[262]

The Court's language, "the income-generating asset is the cause of action," raises many questions.[263] This resolved the issue of whether the property was the judgment or the claim.[264] However, tax treatment is unclear if the taxpayer transfers a portion of the value of the cause of action to the attorney; it was not discussed except to state that "[t]he portion paid to the agent may be deductible."[265] The Supreme Court rejected a number of previously asserted arguments: (1) the assignment-of-income doctrine has no relevance to contingency fee arrangements or commercial transactions;[266] (2) the "value of a legal claim is speculative at the moment of assignment, and may be worth

258. *Id.* at 430.

259. *Id.* at 434 (quoting Lucas v. Earl, 281 U.S. 111, 115 (1930)) (first alteration in original).

260. *Id.* at 435 (citing United States v. Basye, 410 U.S. 441, 445, 450–52 (1973); *Earl*, 281 U.S. at 114–15).

261. *Id.* at 436–37 (citing Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001)).

262. *Id.* at 435.

263. *Id.*

264. *See id.* at 437 (holding that contingency fees are includable in income).

265. *Id.*

266. *See id.* at 434 (rejecting the taxpayers' argument that the assignment-of-income doctrine is inapplicable).

nothing at all";[267] (3) the attorney's efforts should be considered as necessary for the claimant to prevail;[268] (4)contingency fee agreements establish a sort of business partnership or joint venture for tax purposes;[269] (5) the attorney is not in an agency relationship for his part of the fee;[270] and (6) the attorney's fees were paid directly to the attorney and therefore, never available to the taxpayer.[271]

We are left, however, with the Court's pronouncement that "[i]n the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury."[272] Because of this, "[t]he plaintiff retains dominion over this asset throughout the litigation."[273] The issue is whether the Court intended for the lawsuit income to be analyzed as a property transfer. If so, was the transfer of the contingency fee a purported assignment of income?

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267. *Id.* at 435.

268. *See id.* at 436–37 (opining that an attorney is an agent of the client and the attorney's skill and expertise, while useful in obtaining a favorable judgment, are no different than an employee's skill in obtaining revenue for an employer (citing Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001))).

269. *See id.* at 436 ("The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal[–]agent relationship." (citing MODEL RULES OF PROF'L CONDUCT R. 1.3, cmt. 1 (2002); *id.* R. 1.7 cmt. 1; RESTATEMENT (SECOND) OF AGENCY § 1, cmt. e (1957))).

270. *See id.* (remarking that the fact that clients rely upon an attorney's expertise "is true of most principal–agent relationships, and it does not alter the fact that the client retains ultimate dominion and control over the underlying claim"). The Court further explained that even when an attorney acts on his own, without client supervision or consultation, the attorney "is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party." *Id.* (citing RESTATEMENT (SECOND) OF AGENCY §§ 13, 39, 387 (1957)). The Court explained that because the attorney is the client's agent, including the entire judgment in income is appropriate. *Id.* In *Kenseth*, Judge Posner noted that "the contingent[]fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable." *Kenseth*, 259 F.3d at 883. The Court held that, in both an employee–employer and a lawyer–client relationship, "the gain realized by the agent's efforts is income to the principal," and this amount may be deductible. *Banks*, 543 U.S. at 437.

271. *See id.* at 435 (using the assignment-of-income doctrine to reject the argument that the taxpayer never had control over the portion of the recovery going to a contingency fee attorney).

272. *Id.*

273. *Id.*

A. *Assignment-of-Income Doctrine*

Section 61 generally defines what is considered income.[274] The assignment-of-income doctrine is a backstop to the direct language of Section 61 for particularly abusive situations and is appropriately analyzed after the determination of income.[275] Many believed the doctrine did not apply to arm's-length commercial transactions because the transactions had no potential for the particular abuses the doctrine was designed to prevent.[276] Prior to *Banks*, this idea had plenty of support[277] but had not been well-recognized by the courts,[278] likely due to courts' distaste for the prospect of an attorney having a stake in his client's lawsuit.[279] Before the Supreme Court's ruling, lower courts included fees in income in most instances where the doctrine applied.[280] This was

274. *See* I.R.C. § 61 (2006) (providing a general definition of gross income that includes "all income from whatever source derived" subject to express exceptions provided elsewhere in the Code).

275. *See* Wilson v. United States, 530 F.2d 772, 778–79 (8th Cir. 1979) (asserting that the doctrine holds that compensation for services cannot be assigned to escape taxation because it is an item of gross income (citing Lucas v. Earl, 281 U.S. 111, 114–15 (1930))); Rauenhorst v. Comm'r, 119 T.C. 157, 163–64 (2002) ("A person cannot escape taxation by anticipatory assignments, however skillfully devised, where the right to receive income has vested." (citing Harrison v. Schaffner, 312 U.S. 579, 582 (1941))).

276. *See* Estate of Stranahan v. Comm'r, 472 F.2d 867, 870 (6th Cir. 1973) (declining to apply the assignment-of-income doctrine to independent parties' commercial transaction because the transaction was not designed to escape taxation); *see also* Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 82 (2002) (arguing that the assignment of income doctrine should not be used for arm's-length commercial transactions because "[a]rm's[-]length parties simply do not engage in artificial arrangements designed to split income"). *But see* Schneer v. Comm'r, 97 T.C. 643, 662–63 (1991) (applying the assignment-of-income doctrine when a taxpayer gave rights to income to an unrelated partnership).

277. *See* Michael Asimow, *Applying the Assignment of Income Principle Correctly*, 54 TAX NOTES 607, 608 (1992) (arguing that the assignment-of-income doctrine should not be used to overturn "economically sensible, nontax avoidance situations"); *see also* Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 82–88 (2002) (discussing the limited use of the doctrine in arm's-length commercial cases).

278. *Compare Estate of Stranahan*, 472 F.2d at 870 (refusing to apply the assignment-of-income doctrine to independent parties' commercial transaction because the purpose of the transaction was not designed to escape taxation), *with Schneer*, 97 T.C. at 662–63 (utilizing the assignment-of-income doctrine where the party gave an unrelated partnership rights to income).

279. *See* MODEL RULES OF PROF'L CONDUCT R. 1.8(i) (2011) (forbidding a lawyer from acquiring a proprietary interest in a client's lawsuit).

280. *See* Raymond v. United States, 355 F.3d 107, 117–18 (2d Cir. 2004) (holding that

a predictable result because the tests assumed an abusive situation.[281] The deviation in results was likely attributable to the fact that the standards applied in the doctrine were very subjective.[282]

1. Rule

The assignment-of-income doctrine aims to limit tax evasion.[283] If the taxpayer transfers only the right to future income, the transfer will be treated under the assignment-of-income doctrine as income taxed to the transferor.[284] Where the taxpayer

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contingency fees could not be excluded from the taxpayer's taxable income because the assignment-of-income doctrine was applicable); Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001) (ruling that the assignment-of-income doctrine applied and including the contingency fees in income); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962) (recognizing that the assignment-of-income doctrine was applicable and that the amount was income to the taxpayer), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam).

281. *See* Foglesong v. Comm'r, 621 F.2d 865, 872 (7th Cir. 1980) (noting that the assignment-of-income doctrine is a method "to remedy potential tax abuse").

282. *See* Greene v. United States, 13 F.3d 577, 581 (2d Cir. 1994) (remarking that the doctrine "is applied on a case-by-case basis"); Jones v. Comm'r, 306 F.2d 292, 303 (5th Cir. 1962) ("The complex and varied ways in which anticipatory assignment cases arise and the decisions which have been based upon such assignments, clearly show that no one fact is usually decisive, but all of the facts, the circumstances and the complete background should be examined . . . .").

283. *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1930) (stating that income tax could not be avoided through an "arrangement by which the fruits are attributed to a different tree from that on which they grew").

284. *See id.* (holding that income transferred to another was income to the transferor). In *Earl*, the seminal assignment-of-income case, the taxpayer and his wife entered into a contract that provided that any future income, including salary and fees, received by either spouse would be owned equally as joint tenants with rights of survivorship. *Id.* at 113–14. Under the contract, one-half of salaries and fees earned by the taxpayer in 1920 and 1921 were paid to his wife. *Id.* at 113. The taxpayer sought to be taxed on only half of the income earned by him. *Id.* The other half, he argued, was income to his wife. *See id.* at 114 (rejecting the taxpayer's argument that the income received was immediately joint property, which would entail taxing the spouse one-half of the taxpayer's income). It should be noted that this case arose before the adoption of a joint tax return for married couples that would have created the desired result for the taxpayer. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 259 (10th ed. 2005) ("The enactment of joint-return legislation in 1948 . . . permit[ed] all married couples . . . to treat the family income as if earned equally by each spouse."). In *Earl*, the Supreme Court rejected the taxpayer's argument and ruled that the husband had to include all his salaries and fees in income. *Earl*, 281 U.S. at 114–15. The contract, even if valid, could not shift the income tax consequences to a party who did not earn the income. *Id.* The statute taxing salaries to the one who earned them could not be avoided by "anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." *Id.* The taxpayer

transfers the income-producing property, there is no assignment of the future income from that property.[285] However, if uncollected income exists that is certain and vested (i.e., "earned"), the transfer of the property may be an assignment of income to the extent of the uncollected income.[286]

Thus, the issues become: (1) whether the income collected by the transferee was actually *earned* before the transfer; and (2)whether the taxpayer retained enough *control* over the property that he has essentially transferred only the future income.

a. Earned

The question of whether income has been earned is a precursor to the control inquiry. A taxpayer may give up full control over a certain property, but if that property constitutes income that has already been earned by the taxpayer, the taxpayer must still include it in income.[287] This sounds relatively complicated, and it is. The confusion dates back to *Helvering v. Horst*,[288] where the Supreme Court stated: "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization of the income by him who exercises it."[289]

In *Horst*, the taxpayer gave his son detached interest coupons as a gift, and the son collected on that interest.[290] Thereafter, the son, not the father, claimed the interest as income.[291] *Horst* is devoid of analysis as to whether the interest on the coupons was

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could not avoid taxation on his earned income by assigning it to his wife. Justice Holmes wrote that the fruits of the taxpayer's labor could not be "attributed to a different tree from that on which they grew." *Id.* at 115.

285. *See* Poe v. Seaborn, 282 U.S. 101, 117 (1930) (distinguishing *Earl* by stating that the property in *Earl* belonged to the husband while the property in this case was community property (citing *Earl*, 281 U.S. at 114–15)).

286. *See* Helvering v. Horst, 311 U.S. 112, 116 (1940) (noting that realized income is recognized by the taxpayer, regardless of whether the taxpayer assigned an uncollected portion of that income to another).

287. *See* Rauenhorst v. Comm'r, 119 T.C. 157, 163–64 (2002) ("A person cannot escape taxation by anticipatory assignments, however skillfully devised, where the right to receive income has vested." (citing Harrison v. Schaffner, 312 U.S. 579, 582 (1941))).

288. Helvering v. Horst, 311 U.S. 112 (1940).

289. *Id.* at 118.

290. *Id.* at 114.

291. *Id.*

earned.[292] This shortcoming is highlighted in Justice McReynolds's dissent.[293] Justice McReynolds did not dispute whether realization had occurred but disagreed as to whether the interest on the coupons was earned because the taxpayer made a complete transfer of unmatured coupons.[294]

As to personal-services income, it is well established that income is earned by the person providing the services regardless of the timing of the assignment because he is the only one who can take "the last step in the performance of [the] contracts."[295] Assignment of such contracts is clearly assignment of income rather than property.[296]

As to income from property, the test is different. Income from property is only earned when the right to receive the income is substantially vested and certain,[297] or the taxpayer has realized an economic benefit from its assignment.[298]

A client does not earn a claim before the attorney is retained because the outcome of the claim is substantially uncertain. The Tenth Circuit has recognized that income is only earned when it is definite and vested.[299] Although attorneys generally screen their

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292. *See id.* at 114–21 (outlining the Court's reasoning for assigning the income to the taxpayer without discussing whether the interest was earned).

293. *See id.* at 121 (McReynolds, J., dissenting) (questioning why the majority would conclude that unmatured coupons would still be in control of the taxpayer, even though they matured after being given to his son).

294. *Id.*

295. Lucas v. Earl, 281 U.S. 111, 114 (1930).

296. *See id.* at 114–15 (holding that there is no doubt salaries could be taxed as income regardless of anticipatory arrangements).

297. *See* Harrison v. Shaffner, 312 U.S. 579, 581–82 (1941) (explaining that the tax acts "are not so much concerned with the refinements of title as with the actual command over the income"); Ferguson v. Comm'r, 174 F.3d 997, 1003 (9th Cir. 1999) ("To determine whether a right has 'ripened' for tax purposes, a court must consider the realities and substance of events to determine whether the receipt of income was practically certain to occur . . . ." (citing Jones v. United States, 531 F.2d 1343, 1346 (6th Cir. 1976))); Cold Metal Process Co. v. Comm'r, 247 F.2d 864, 872 (6th Cir. 1957) (concluding that transfer of an "unliquidated chose in action" was not an assignment of income because the transferor divested itself of all control over the property); Doyle v. Comm'r, 147 F.2d 769, 772 (4th Cir. 1945) (holding that gain from assigned investment was "practically assured," and therefore anticipatory income was assigned); Wellhouse v. Tomlinson, 197 F. Supp. 739, 742 (S.D. Fla. 1961) (determining there was no anticipatory assignment where "there was considerable legal doubt as to when the obligation would be paid, or if it would be paid at all").

298. *See Horst*, 311 U.S. at 118 (recognizing that "the payment of income to another is the enjoyment and hence the realization of the income by him who [assigns] it").

299. *See* First Sec. Bank of Utah v. Comm'r, 436 F.2d 1192, 1197, 1198 (10th Cir.

contingency cases very carefully to reduce the risk involved, every case has a significant chance of failure.[300] Therefore, until that chance of failure is reduced to an immaterial level, the claim is not earned. That kind of reduction does not typically occur until the attorney is retained and litigation commences. The attorney's contingency percentage should reflect the amount of risk involved.[301] An attorney cannot ethically take a large percentage of a claim that is virtually risk-free.[302]

b. Control

The taxpayer's retention of control is the primary factor in determining whether the assignment-of-income doctrine requires inclusion of the income.[303] This is a fact-intensive inquiry into whether the taxpayer retained effective control over how the assigned property produces income.[304] A taxpayer must give away control of the entire tree, not just the fruit from the tree, to avoid taxation.[305] The Supreme Court stated in *Commissioner v.*

1971) (distinguishing *Earl* and *Horst* by clarifying that "[g]eneration of income differs from assignment of income" and that taxpayers should not be "taxed for income which they neither earned nor received").

300. *See* City of Burlington v. Dague, 505 U.S. 557, 565 (1992) ("An attorney operating on a contingency[]fee basis pools the risks presented by his various cases: cases that turn out to be successful pay for the time he gambled on those that did not.").

301. *See* MODEL RULES OF PROF'L CONDUCT R. 1.5 annot. subsec. (a) (2011) (reiterating that bill-padding, double-billing, and charging fees for very miniscule amounts of work violates prescribed rules of ethical conduct); *see also Dague*, 505 U.S. at 559 (recognizing that contingency fee attorneys "assume[] the risk of receiving no payment at all for their service").

302. *See* MODEL RULES OF PROF'L CONDUCT R. 1.5 annot. subsec. (c) (2011) (describing that a contingency fee agreement with a plaintiff who had already entered into a full settlement agreement was unethical because the arrangement lacked any significant risk of no recovery (citing *In re* Sulzer Hip Prosthesis & Knee Prosthesis Liab. Litig., 290 F. Supp. 2d 840 (N.D. Ohio 2003))).

303. *See* Comm'r v. Sunnen, 333 U.S. 591, 603 (1948) (stating that the assignment-of-income doctrine applies when "the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income").

304. *See* Jones v. Comm'r, 306 F.2d 292, 303 (5th Cir. 1962) (highlighting the complex nature of assignment-of-income cases and the need for consideration of the entire background and circumstances of each issue).

305. *See* Helvering v. Horst, 311 U.S. 112, 120 (1940) (applying the assignment-of-income doctrine in part because "the fruit is not to be attributed to a different tree from that on which it grew"). In *Eubank*, a companion case to *Horst*, the Supreme Court expanded the assignment-of-income doctrine to include income to be received in the future as a result of work previously performed. Helvering v. Eubank, 311 U.S. 122, 124 (1940). The taxpayer was a life insurance agent who assigned renewal commissions

Sunnen[306] that "[t]he crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes."[307] In this context, the early Supreme Court cases can also be explained in terms of the taxpayer retaining too much control over the asset.[308]

c. The Assignment-of-Income Doctrine Should Not Apply to Commercial Transactions

The assignment-of-income doctrine should not apply to a contingency fee arrangement unless the client and attorney are related parties or the attorney is functioning as a conduit to a party related to the client. Outside those situations, contingency fee arrangements do not present the potential for abuse that the doctrine was designed to prevent.[309]

The assignment-of-income doctrine was developed to prevent the gratuitous transfer of income between family members who may attempt to take advantage of the graduated rate brackets.[310] Most assignment-of-income cases, including the classic cases of

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payable after the termination of his agency to another. *Id.* There, the taxpayer was under no future obligation to perform services. *Id.* The Supreme Court held that the payments, although received long after services were performed, were income to the assignor. *Id.* at 125. Granting another the power to collect the renewal commissions was not sufficient to transfer the incidence of taxation. *Id.* at 127 (McReynolds, J., concurring).

306. Comm'r v. Sunnen, 333 U.S. 591 (1948).

307. *Id.* at 604.

308. *See Eubank*, 311 U.S. at 125 (relying on *Horst* to illustrate why the taxpayer still had control over the income and reiterating that he must be taxed despite his attempt to assign his future commission); *Horst*, 311 U.S. at 118 (reiterating that control is a key factor by its holding that "power to dispose of income is the equivalent of ownership"); Lucas v. Earl, 281 U.S. 111, 113–15 (1930) (recognizing the taxpayer, an attorney, remained in control of his salary despite "skillfully devised" anticipatory assignments).

309. *See* Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 79 (2002) (explaining that the major purpose and origin of the doctrine is to prevent related parties from evading taxes).

310. *See* Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 632 (1993) ("Here is the essence of the assignment[-]of[-]income doctrine: the concern that the progressive tax rate schedule not be subverted by permitting income to be artificially split among formally separate taxpayers who in fact constitute a single economic unit.").

Earl and *Horst*, involved transfers between related entities,[311] and this doctrine arose in the gratuitous intrafamily transfer context.[312] Enamored by the idea and pushed along by the IRS, courts have taken clippings from Justice Holmes's tree and transplanted it in the commercial setting, where it does not belong.[313] An underlying theory of taxation is that the parties are free to determine the tax consequences of transactions from among the variety of statutory choices through contractual arrangements prior to the consummation of the deal.[314]

This flawed transplantation from gratuitous transfers to commercial transactions may be traced to language from the Supreme Court case, *United States v. Basye*,[315] in which the parties were said to have contracted at arm's-length.[316] Some may argue this case represents why the assignment-of-income doctrine should apply in commercial settings. Upon closer analysis, this is a misleading proposition. In *Basye*, Permanente Medical Group provided services to Kaiser Foundation Health Plan, Inc., which then split the payments between Permanente and a retirement

311. *See Horst*, 311 U.S. at 114 (stating that the taxpayer attempted to give the income from interest coupons from bonds to his son); *Earl*, 281 U.S. at 113–14 (describing a taxpayer who attempted to split income with his wife).

312. *See* Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the Assignment of Income and Personal Service Income*, 1 FLA. TAX REV. 623, 631–32 (1993) (discussing the origin of the assignment-of-income doctrine in preventing tax avoidance via intrafamily transfers); *see also* Helvering v. Clifford, 309 U.S. 331, 335 (1940) (warning that transfers between family members require "special scrutiny"). *But see* Srivastava v. Comm'r, 220 F.3d 353, 361 (5th Cir. 2000) (noting that while previous cases have featured gratuitous transfers, the assignment-of-income doctrine is not limited to such instances), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005).

313. *See* Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57, 62 (2002) ("The assignment[-]of[-]income doctrine is inapplicable to contingent fee arrangements because the doctrine does not apply to arm's[-]length commercial transactions. By immediately jumping to the fruit versus tree analysis, the courts have failed to appreciate this point.").

314. *See* Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) (stating that a "taxpayer is free to organize his affairs as he chooses," but he must "accept the tax consequences of his choice"). *But see Earl*, 281 U.S. at 114–15 (developing the assignment-of-income doctrine to provide a limitation to the ability to contract around tax consequences); Kirchman v. Comm'r, 862 F.2d 1486, 1491–92 (11th Cir. 1989) (using the sham-transaction doctrine as a limitation upon parties' ability to structure the tax consequences of a transaction).

315. United States v. Basye, 410 U.S. 441 (1973).

316. *Id.* at 451.

trust fund for Permanente's partners.[317] The real transfer occurred between Permanente and its retirement fund, clearly related parties.[318] Of particular significance was the fact that Kaiser had no input in how the payments were split.[319] In deciding that Permanente had to include the money contributed to the retirement trust as income, the Court did not state that the assignment-of-income doctrine applied to commercial transactions between parties at arm's-length.[320] To the contrary, the holding emphasized that an assignment of income to a related party cannot be laundered through an unrelated third party.[321]

Moreover, application of a judicial doctrine is inappropriate where Congress has specifically legislated the particular conduct. The application of Sections 61, 482, and 1001 leave no room for the assignment-of-income doctrine in arm's-length transactions. If the right to income is transferred in exchange for a direct economic gain, Section 1001 provides for exchange treatment, and the fair market value of the property received is included in the taxpayer's income.[322] Where value is given for value, the transfer is a taxable event if it is, in reality, an exchange.[323] If the economic benefit is indirect, Section 61 requires the benefit to be recognized in the taxpayer's income when the economic benefit comes to fruition.[324] If related business entities are manipulating

317. *Id.* at 443–44.

318. *See id.* at 444 (describing the plan to have Kaiser fund a retirement plan for Permanente partners in exchange for Permanente's services).

319. *See id.* at 443 (explaining that the arrangement "simply obligated Kaiser to make contributions to such a program").

320. *See id.* at 447–48 (stating that the holding rested on two familiar tax principles but not mentioning arm's-length transactions).

321. *See id.* at 450 (holding that tax cannot be avoided via skillful contract manipulation (citing Lucas v. Earl, 281 U.S. 111, 114–15 (1930))).

322. *See* I.R.C. § 1001 (2006) (providing that the amount realized from the disposition of property is the "money received plus the fair market value of the property (other than money) received").

323. *See* Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 633–34 (1993) (remarking that the assignor in an arm's-length transaction that receives adequate consideration should be taxed on the amount received).

324. *See* Helvering v. Horst, 311 U.S. 112, 115 (1940) ("Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." (citing Burnet v. Wells, 289 U.S. 670 (1933); Corliss v. Bowers, 281 U.S. 376, 378 (1930); Old Colony Trust Co v. Comm'r, 279 U.S. 716 (1929))).

accounting methods to shift income, Section 482 permits the IRS to recharacterize that income.[325] The requirement that the businesses be related implies that unrelated businesses are not subject to reallocations. The only circumstance unaccounted for is when the transfer is gratuitous. Where the transaction is at arm's-length, reallocation of income is inappropriate.

The assignment-of-income doctrine ensures that income is taxed to the person who earns it. The doctrine serves as a "cornerstone of our graduated income tax system,"[326] by ignoring gratuitous transfers of income from the person who earned the income to a lower-bracket donee for tax purposes.[327] This, of course, is not relevant in the contingency fee scenario.

The assignment-of-income doctrine should not apply to attorney–client fee agreements.[328] It cannot be argued that the attorney who secures a favorable verdict or settlement has not earned his or her fee.[329] Nor is it argued that these agreements shift income to a lower bracket taxpayer.[330] Moreover, the issue resolved in *Earl* and *Horst* was whether the income more properly belongs to the taxpayer or the donee.[331] As has been noted, the

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325. *See* I.R.C. § 482 (2006) (giving the Secretary of the Treasury the power to reallocate income, deductions, credits, or allowances to avoid tax evasion).

326. *Basye*, 410 U.S. at 450.

327. *See* Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 629 (1993) (opining that a possible rationale for the development of the assignment-of-income doctrine in *Earl* was that the Court did not want taxpayers to avoid the progressive tax system by transferring income to low-income family members (citing Lucas v. Earl, 281 U.S. 111, 115 (1930))).

328. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857–58 (6th Cir. 2000) (concluding that the assignment-of-income doctrine did not apply to contingency fees because the relationship was a division of property), *abrogated by* Comm'r v. Banks, 543 U.S. 426 (2005); Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (holding that the assignment-of-income doctrine did not apply to contingency fee arrangements), *abrogated by Banks*, 543 U.S. 426.

329. *See Earl*, 281 U.S. at 114 (contending that Earl, an attorney, and not his wife, earned his salary and fees); *Estate of Clarks*, 202 F.3d at 856 (stating that the attorney earned the fee); *Cotnam*, 263 F.2d at 126 (Rives & Brown, JJ., concurring) (stating that the attorneys earned their contingency fees by getting a collection of judgment on the claim).

330. *See* Brief for Petitioner at 20, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1330104 at *20 (noting that the assignment-of-income doctrine prevents taxpayers from shifting income to a lower-bracket taxpayer).

331. *See* Helvering v. Horst, 311 U.S. 112, 120 (1940) (explaining that one cannot escape tax liability through "anticipatory arrangements" with another (quoting *Earl*, 281 U.S. at 115) (internal quotation marks omitted)); *see also Earl*, 281 U.S. at 115 (noting the

assignment-of-income doctrine does not result in attributing the income to both:[332]

> The most crucial distinction, however, is that Lucas and Horst were taxpayers who retained ownership or control over an income-producing asset, while attempting to redirect the stream of income that was produced. Lucas did not give up his job; Horst did not part with his bonds. As the Court in *Horst* stated, "where the donor retains control of the trust property the income is taxable to him although paid to the donee."[333]

The Supreme Court, however, stated that because the client retained control over the cause of action, the entire amount of the settlement or judgment should be included in his income.[334] Any other result would violate the assignment-of-income doctrine.[335] This enlargement of the assignment-of-income doctrine created more uncertainty as to the applicability of the doctrine to commercial transactions.[336]

The real issue should have been that Section 61 applied because the Internal Revenue Code provides no exceptions for attorney's fees.[337] It was not necessary for the Supreme Court to go further in its analysis. The Court's rejection of the partnership theory, the speculative nature of the claim theory, and the attorney's lien statute claims brought all the income back to the taxpayer under Section 61.[338] The sale of part of the interest to the attorney would result in realization at the time of sale to the taxpayer and

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taxpayer cannot escape liability by assigning his income to another).

332. *See Estate of Clarks*, 202 F.3d at 857 (explaining that the doctrine results in taxation only to the donor).

333. Brief for Ass'n of Trial Lawyers of America as Amicus Curiae Supporting Respondents at 19, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1876294 at *19 (quoting *Horst*, 311 U.S. at 119).

334. *Banks*, 543 U.S. at 436–37.

335. *Id.* at 435–37; *accord* Brief for Petitioner at 30, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1330104 at *30 (stating that an assignment of the cause of action would not be an exception to the assignment-of-income doctrine).

336. *But see* Srivastava v. Comm'r, 220 F.3d 353, 361 (5th Cir. 2000) (suggesting that the assignment-of-income doctrine does not recognize distinctions regarding commercial transactions), *abrogated by Banks*, 543 U.S. 426.

337. *See generally* I.R.C. § 61(a) (2006) (defining gross income).

338. *See Banks*, 543 U.S. at 431, 435, 436 (rejecting several theories to exclude attorney's fees from the client's income, thus bringing the contingency fees back into the ambit of Section 61).

then an offset of the purchase price by the basis, which would have the same result.[339]

The ATLA brief "suggests that the significant event is not the signing of the contingency fee agreement, which is a nontaxable event."[340] ATLA argued that the significant event was actually the "payment of the settlement or judgment."[341] ATLA conceded that the Commissioner correctly interpreted this payment as the "value given in exchange for the dismissal of respondents' claims."[342] Thus, Section 61 would tax the entire amount to the taxpayer, and leave the deduction, if any, of the attorney's fees for another discussion.[343]

Contingency fees can be distinguished from *Lucas* and *Horst* because "the taxpayer's cause of action does not produce income while he retains ownership and control of the asset."[344] The taxpayers in *Banks* gave up control over their claims with the contingency fee arrangements.[345] ATLA argued that this made the contingency fee arrangement more like a disposition of property rather than an assignment of income.[346] ATLA asserted "that the tax rules applicable to legal fees in connection with such sales or dispositions should apply."[347] However, ATLA fails to take into consideration the origin-of-the-claim doctrine, which relates to deductions.[348] When *Banks* stated that the cause of action was the income-producing asset, the Court gave credence to

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339. *See generally* I.R.C. § 1001 (1986) (providing that computation of gain is the amount realized minus adjusted basis).

340. Brief for Ass'n of Trial Lawyers of America as Amicus Curiae Supporting Respondents at 19, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1876294 at *19.

341. *Id.*

342. *Id.* (quoting Brief for Petitioner at 12, *Banks*, 543 U.S. 426 (No. 03-892), 2007 WL 1876294 at *26) (internal quotation marks omitted).

343. *See* I.R.C. § 61(a) (2006) (including into gross income "all income from whatever source derived").

344. Brief for Ass'n of Trial Lawyers of America as Amicus Curiae Supporting Respondents at 20, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1876294 at *20.

345. *Id.*

346. *Id.*; *see* Srivastava v. Comm'r, 220 F.3d 353, 359 (5th Cir. 2000) ("[T]he doctrine does not apply to a taxpayer who transfers, sells, or otherwise relinquishes an asset . . . ."), *abrogated by Banks*, 543 U.S. 426.

347. Brief for Ass'n of Trial Lawyers of America as Amicus Curiae Supporting Respondents at 20, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1876294 at *20.

348. *See* United States v. Gilmore, 372 U.S. 39, 49 (1963) (setting forth the origin of the claim as the test of whether an expense is deductible).

the ATLA position.[349] However, nothing was said about overturning the origin-of-the-claim doctrine for deductibility.

Thus, if the Supreme Court meant to say that all lawsuits are the sale or exchange of a capital asset, which could be implied,[350] then the attorney's fees should not be deductible under *Woodward v. Commissioner*.[351] However, if the origin-of-the-claim doctrine still applies to deductions that come about as a result of a lawsuit, then even though the sale of the cause of action gave rise to the income, the deductions will have to be determined by the nature of the underlying claim.[352]

Even assuming *Banks*'s statement that the income-producing asset was the cause of action[353] is taken at face value, it is highly unlikely that the Court was looking at the nature of the income because that issue was not before the Court.[354] Further, because the Court described taking the attorney's fees as an itemized deduction, it is unlikely that they were considering such a major overhaul to the tax scheme.[355] Still, the use of the phrase "the income-producing asset is the cause of action" does appear to resolve the question in favor of sale treatment.[356] The fact that a complete tax analysis was neither presented nor required of the Court is troubling.

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349. *See Banks*, 543 U.S. at 435 ("[T]he income-generating asset is the cause of action derived from the plaintiff's legal injury.").

350. *See generally* I.R.C. § 1221(a) (2006) (amended 2010) (defining a capital asset as "property held by the taxpayer" that is not listed under the exceptions found in Section 1221(a)).

351. *See* Woodward v. Comm'r, 397 U.S. 572, 574–75 (1970) (holding that capital expenditures spent in the acquisition of a capital asset are not deductible but rather should be added to the capital asset's basis).

352. *See generally* I.R.C. § 162 (2006) (amended 2011) (allowing itemized business deductions); *id.* § 262 (disallowing itemized personal deductions); *Gilmore*, 372 U.S. at 48 (developing the origin-of-the-claim doctrine to classify an expense as personal or business, which "depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities").

353. *Banks*, 543 U.S. at 435.

354. *See id.* at 429 (stating that the issue was "whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent[]fee agreement is income to the plaintiff").

355. *See id.* at 432 ("For the tax years in question the legal expenses in these cases could have been taken as miscellaneous itemized deductions . . . ." (citing I.R.C. §§ 67–68 (2000))).

356. *Id.* at 435.

2. Rules Defining Income

Under Internal Revenue Code Section 61, there are two types of cases: (1) cases that interpret the language of the Code; and (2)cases that apply a judicial doctrine in order to supplement the direct reach of the Code.[357] The *Commissioner v. Glenshaw Glass Co.*[358] line of cases define and explain the word "income" and are interpretations of the direct statutory language.[359] *Earl* and its progeny do not interpret what income is, but determine to whom it should be ascribed.[360] The assignment-of-income doctrine created in *Earl* is not a direct interpretation of the statute but a supplemental judicial doctrine.[361] The doctrines espoused in those cases are conceptually and logically distinct and should be applied separately.[362] There simply was no need for *Banks* to address the issue of assignment of income. Presumably, had the Court simply stated that Section 61 applied because no exclusions are provided, there would have been no need to define what the income-producing asset was and no question of what the Court meant.

Sections 104 and 62(a) specifically exclude judgments from income only if they compensate for physical injuries or discrimination.[363] No other specific code sections apply. Thus, the Court could have decided the issue strictly based on an analysis of the law. The only judicial doctrine that may be applicable is the assignment-of-income doctrine. Therefore, in a case for exclusion or inclusion of contingency fees, the potential available rules are the direct sweep of Section 61 or the assignment-of-income doctrine. The Supreme Court apparently felt the need to base inclusion on a judicial doctrine instead of limiting it to the

357. *Cf.* James Edward Maule, Gross Income: Tax Benefit, Claim of Right and Assignment of Income, 502-3d Tax Mgt. (BNA), at A-1 (2007) (remarking that the assignment-of-income doctrine "is substantially a judicial" test).

358. Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

359. *See id.* at 427, 429 (stating that statutory construction was the issue).

360. *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1940) (assigning income not in connection with a statutory provision but rather with a judicial anti-abuse rule).

361. *See id.* (using a judicial rule to determine how to allocate income, rather than simply applying the statute).

362. *See, e.g.*, Hall v. Comm'r, 150 F.2d 304, 306–07 (10th Cir. 1945) (implying a reluctance to use judicially created doctrines when the court described such a rule as "admittedly a judicial extension of the statutory standards").

363. *See* I.R.C. § 62(a)(20) (2006) (amended 2010) (discrimination); *id.* § 104(a)(2) (physical injuries).

application of the law.[364]

Some circuit courts seemed to base their decisions on whether to include contingency fees in the plaintiff's income on tax neutrality.[365] Tax neutrality, though, is not a tax rule but rather a general policy of statutory interpretation.[366] Inequity itself is not enough to justify the judicial creation of a remedy.[367] "[I]t is not a feasible judicial undertaking to achieve global equity in taxation . . . ."[368] The solution to the problem must therefore rely on neutral principles of tax law.[369]

The courts should apply the language, and interpretation, of Section 61 first and then determine whether to apply the assignment-of-income doctrine. The language of a statute, and its judicial interpretation, should always be applied before a judicial doctrine is created to supplement the reach of that statute.[370] This priority serves the function of avoiding excessive judicial legislation; it better effectuates the intent of Congress; and it provides more predictability in the tax law. Had the Supreme Court stopped with the application of Section 61, there would have been no need for the phrase "the income-generating asset is the

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364. *See* Comm'r v. Banks, 543 U.S. 426, 433–34 (2005) (applying both Section 61 and the judicial doctrine of assignment-of-income (citing I.R.C. § 61(a) (2000); Comm'r v. Culbertson, 337 U.S. 733, 739–40 (1949); *Earl*, 281 U.S. at 114)).

365. *See* Srivastava v. Comm'r, 220 F.3d 353, 357 (5th Cir. 2000) (illustrating how the use of tax neutrality can impact the decision), *abrogated by Banks*, 543 U.S. 426. Tax neutrality is part of efficiency, which is one of two competing issues in tax policy. *See* LAURIE L. MALMAN ET AL., THE INDIVIDUAL TAX BASE: CASES, PROBLEMS AND POLICIES IN FEDERAL TAXATION 9 (2d ed. 2010) (remarking that efficiency and fairness are the two competing policy issues and that neutrality is an element of efficiency). For a tax to be neutral, the tax cannot have an effect on taxpayer behavior. *Id.*

366. *See id.* (describing tax neutrality as a part of efficiency, which is a tax policy consideration).

367. *See* Alexander v. Internal Revenue Serv., 72 F.3d 938, 947 (1st Cir. 1995) ("It is well established that equitable arguments cannot overcome the plain meaning of the statute." (citing Okin v. Comm'r, 808 F.2d 1338, 1340–42 (9th Cir. 1987); Rawlins v. Comm'r, 70 T.C.M. (CCH) 1046, 1048 (1995); Warfield v. Comm'r, 84 T.C. 179, 184 (1985))).

368. Kenseth v. Comm'r, 259 F.3d 881, 885 (7th Cir. 2001).

369. *Id.*

370. *See* John F. Manning, *What Divides Textualists from Purposivists?*, 106 COLUM. L. REV. 70, 73 (2006) (stating that textualists believe that purposivists "disrespect the legislative process" when they use outside sources to interpret a statute when "a statute is clear in context" (citing Conroy v. Aniskoff, 507 U.S. 511, 519 (1993) (Scalia, J., concurring); K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 325 (1988) (Scalia, J., concurring in part and dissenting in part); Immigration & Naturalization Serv. v. Cardoza-Fonseca, 480 U.S. 421, 452–53 (1987) (Scalia, J., concurring))).

cause of action."[371] This phrase was used to justify the use of the assignment-of-income doctrine.[372]

Having determined which rule should be applied first, the next question becomes what standard is appropriate for that rule and how it applies to attorney's fees.

3. Section 61

The general rule of inclusion states that the taxpayer who realizes income, through actual or constructive receipt, is taxed on it.[373] Section 61 defines gross income as "all income from whatever source derived."[374] The purpose of the statute is to sweep broadly and pull into gross income all receipts that increase a person's income.[375]

Glenshaw Glass Co. gives our current understanding of this provision. *Glenshaw Glass Co.* held that income includes any "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[376] What Section 61 requires is clear realization of an economic gain.[377] Gains are clearly realized when they are actually or constructively received. Actual receipt occurs when the taxpayer or his agent takes possession of the gained property.[378] Constructive receipt occurs when the taxpayer has not taken possession of the gained property but has exercised his fixed and definite right to receive it

371. Comm'r v. Banks, 543 U.S. 426, 435 (2005).

372. *See id.* (implying that because the taxpayer had control over the cause of action throughout the litigation, the use of the assignment-of-income doctrine was proper).

373. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (holding that taxes paid by an employer on behalf of an employee was income realized by the employee and had to be included in the employee's income).

374. I.R.C. § 61(a) (2006).

375. James v. United States, 366 U.S. 213, 219 (1961) (reasoning that "gross income" was liberally construed by Congress "to tax all gains except those specifically exempted" (citing Comm'r v. Jacobson, 336 U.S. 28, 49 (1949); Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87–91 (1934))).

376. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

377. *See* DANIEL Q. POSIN & DONALD T. TOBIN, PRINCIPLES OF FEDERAL INCOME TAXATION 154 (7th ed. 2005) (stating that before property may be taxed, there must be a realization event).

378. *See* Zorc v. Comm'r, 60 T.C.M. (CCH) 1399, at *7 (1990) ("Actual receipt is income reduced to a taxpayer's possession."). However, the funds must be received for the benefit of the principal and not for the agent's benefit. *See* Al-Hakim v. Comm'r, 53 T.C.M. (CCH) 352, at *23–24 (1987) (illustrating that the receipt of bonus money for signing a professional baseball player was received partly on behalf of the player).

to obtain another form of economic gain.[379] In effect, the taxpayer has taken the last step "by which he obtain[ed] the fruition of the economic gain which has already accrued to him."[380] It is in the context of constructive receipt that the Court stated that "[t]he power to dispose of income is the equivalent of ownership of it."[381] These statements frequently arise in assignment-of-income cases, but they are appropriately cited only to determine whether realization of income has occurred at all and not for whether income has been assigned.[382] It is logical, however, to state that a taxpayer must realize 100% of the income before he can assign a percentage, such as a contingency fee, to another.

This rule tends to be very mechanical because it asks not where the income arose or why, but simply whether the particular taxpayer realized it. The Supreme Court adopted this approach after an earlier experiment that focused on the origin of the income.[383] The rule is both under- and over-inclusive, but the market should operate to even out the inconsistencies so that the net effect is to collect the proper amount of tax. To this extent, the rule is "founded on administrative convenience."[384]

When the attorneys in *Banks* and *Banaitis* asked the Supreme Court to answer the question of whether the taxpayer should have been taxed on the full amount of the recovery, the answer was simple. There was no exception provided in the Internal Revenue Code.[385] Thus, the broad sweep of Section 61 labeled the

379. *See* Reed v. Comm'r, 723 F.2d 138, 142 (1st Cir. 1983) ("[U]nder the constructive receipt doctrine, a taxpayer recognizes taxable income when he has an unqualified, vested right to receive immediate payment." (citing Ross v. Comm'r, 169 F.2d 483, 490 (1st Cir. 1948); Amend v. Comm'r, 13 T.C. 178, 185 (1949); Patricia Ann Metzer, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525, 531 (1974))).

380. Helvering v. Horst, 311 U.S. 112, 115 (1940) (citing Corliss v. Bowers, 281 U.S. 376, 378 (1930); Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929)).

381. *Id.* at 118.

382. *See, e.g.*, S. Lake Farms, Inc. v. Comm'r, 36 T.C. 1027, 1037 (1961) (interpreting *Horst* for the proposition that payments from donated coupons "constituted the *realization* of income taxable to the donor" (emphasis added) (citing *Horst*, 311 U.S. at 115)).

383. *See* Eisner v. Macomber, 252 U.S. 189, 207 (1920) (holding that income included receipts that arose from labor or use of capital (citing Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918))).

384. *Horst*, 311 U.S. at 116.

385. *See generally* I.R.C. § 61(a) (2006) (including income from "whatever source

recovery as income and required its inclusion in income.[386] The next question, which was never asked, should have been, What kind of income was it? Since that question was never addressed, the Supreme Court applied the judicially created assignment-of-income doctrine to seal the deal. However, to define what income was anticipatorily assigned, the Court defined the income-producing asset as the cause of action.[387] Thus, even though the question was never asked, the Court defined the "kind of income" as the cause of action.

4. Types of Income

Income may be classified as earned or unearned.[388] Earned income is generated from the provision of services or the sale of non-depreciable, ordinary income, and business assets such as inventory.[389] Unearned income is generated as earnings from assets such as interest and dividends or from the sale or exchange of capital assets or depreciable business assets or business realty.[390]

The Supreme Court in *Banks* said that the "income-generating asset is the cause of action."[391] Unfortunately, the Court did not elaborate as to whether the nature of the underlying claim in the cause of action should determine the nature and type of the

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derived" unless there is a subsequent exception in the Internal Revenue Code).

386. *See id.* (providing a broad definition of gross income that includes an item in income unless it is later excluded).

387. *See* Comm'r v. Banks, 543 U.S. 426, 435 (2005) (stating that the "income-generating asset is the cause of action").

388. *See* Lester B. Synder, *Taxation with an Attitude: Can We Rationalize the Distinction Between "Earned" and "Unearned" Income?*, 18 VA. TAX REV. 241, 243 (1998) (recognizing the two types of income: earned and unearned); *cf.* 42 U.S.C. § 1382a(a) (2006) ("[I]ncome means both earned income and unearned income . . . .").

389. *See* Lester B. Synder, *Taxation with an Attitude: Can We Rationalize the Distinction Between "Earned" and "Unearned" Income?*, 18 VA. TAX REV. 241, 243 (1998) (stating that earned income is generally income from services and labor); *see also* Lesher v. Comm'r, 53 T.C.M. (CCH) 1333, at *5 (1987) (finding that the taxpayer received earned income as compensation for services), *aff'd on other grounds*, 862 F.3d 304 (2d Cir. 1988).

390. *See* Lester B. Synder, *Taxation with an Attitude: Can We Rationalize the Distinction Between "Earned" and "Unearned" Income?*, 18 VA. TAX REV. 241, 243 (1998) (defining unearned income as "investment income and returns from capital, or income from rent, interest, and other uses of taxpayer's property"); *see also Lesher*, 53 T.C.M. (CCH) 1333, at *5 (finding that the taxpayer received "unearned income from her passive investments"), *aff'd on other grounds*, 862 F.3d 304 (2d Cir. 1988).

391. *Banks*, 543 U.S. at 435.

income or whether the disposition of the cause of action should make that determination.[392] No one has suggested that the income from a lawsuit is earned income, although if the underlying lawsuit were for recovery of wages, it could be.[393] It is assumed that the attorney's fees are earned income to the lawyer, but the plaintiff's recovery is generally not deemed to be earned income. It would appear ludicrous to label a lawsuit recovery as earnings from an asset because the cause of action is extinguished after the lawsuit. Therefore, it appears more reasonable to view a lawsuit recovery as the proceeds from the sale or exchange of an asset.

5. What Type of Property Is a Lawsuit?

"In the case of a litigation recovery *the income-generating asset is the cause of action* that derives from the plaintiff's legal injury."[394] The Court's statement was anything but definitive. What we do know is that the income is generated from the lawsuit rather than from the personal services of the plaintiff. It would also seem to be a stretch to believe that the income was from the sale of an inventory-like asset. This leaves unearned income. The question is whether the income is more like dividends and interest from an asset or more like the proceeds from the sale of an asset. However, it is more complicated if the phrase "that derives from the plaintiff's legal injury" is not simply descriptive.[395]

A vested cause of action is "a species of property."[396] A cause of action, or "chose in action," is classified as intangible personal property.[397] As the Internal Revenue Manual explains: "A chose in action is a personal right not reduced to possession and recoverable by a suit at law. A plaintiff's cause of action in

392. *See generally id.* (discussing several arguments, such as the speculative nature of the income and the attorney–client relationship but not addressing the nature of the underlying cause of action).

393. *Cf.* Coady v. Comm'r, 213 F.3d 1187, 1190–91 (9th Cir. 2000) (ascribing income as gross income because the award was "in lieu of wages and compensation" (citing Comm'r v. Shleier, 515 U.S. 323, 328–30 (1995))), *cert. denied*, 532 U.S. 972 (2001).

394. *Banks*, 543 U.S. at 435 (emphasis added).

395. *Id.*

396. Logan v. Zimmerman Brush Co., 455 U.S. 422, 428 (1982); *accord* Martinez v. California, 444 U.S. 277, 281–82 (1980) ("Arguably, the cause of action for wrongful death that the State has created is a species of 'property' . . . .").

397. INTERNAL REVENUE MANUAL 5.17.2.5.3.4 (2007), *available at* http://www.irs.gov/irm/part5/irm_05-017-002.html.

tort . . . against a defendant is an example of a chose in action."[398]

Courts have long viewed the release by one party of another's legal obligations as a sale or disposition of a property interest. In *Commissioner v. Golonsky*,[399] the court concluded that a chose in action is intangible property, and "it is no longer open to doubt" that the release of such a right falls within the broad definition of a sale or exchange of property.[400] Similarly, in *Appalachian Electric Power Co. v. United States*,[401] the court held that an agreement releasing the defendants' obligations under a prior contract was the sale or exchange of a capital asset and "should receive capital assets treatment for tax purposes."[402]

Thus, payment of a settlement or judgment that releases the defendant from liability constitutes a sale, exchange, or "other disposition" of property under Section 1001,[403] and that property is an intangible asset that qualifies as a capital asset.[404] For example, in *Siple v. Commissioner*,[405] the tax court stated that a payment in exchange for a release of a contingency claim could "involve[] the sale or exchange of capital assets."[406]

In *Herbert's Estate v. Commissioner*,[407] Herbert's claim against a corporation was paid by the corporation to the estate.[408] In the court's view, Herbert's "estate had a chose in action, property, which it got rid of or relinquished upon payment."[409] The court

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398. *Id.*; *accord In re* Jeffrey, 261 B.R. 396, 401 (Bankr. W.D. Pa. 2001) (holding that a taxpayer's "unliquidated medical malpractice cause of action" was intangible personal property (citing Simon v. Playboy Elsinore Assocs., Civ. A. No. 90-6607, 1991 WL 71119, at *2 (E.D. Pa. Apr. 29, 1991))).

399. Comm'r v. Golonsky, 200 F.2d 72 (3d Cir. 1952).

400. *Id.* at 74 n.4.

401. Appalachian Elec. Power Co. v. United States, 158 F. Supp. 138 (Ct. Cl. 1958).

402. *Id.* at 140; *see also* Benedum v. Granger, 180 F.2d 564, 566 (3d Cir. 1950) ("Mr. Benedum having held 'property,' a chose in action, exchanged it for other less valuable property[;] [t]he transaction clearly constitute[d] an exchange of capital assets.") (footnote omitted); Ray v. Comm'r, 18 T.C. 439, 443 (1952) (holding that a lessee's release of a restrictive covenant to lessor was a sale of a capital asset), *aff'd*, 210 F.2d 390 (5th Cir. 1954).

403. *See* I.R.C. § 1001(a) (2006) (implying that payment of a settlement constitutes an "other disposition of property").

404. *See generally id.* § 1221 (amended 2010) (providing a broad definition of capital assets).

405. Siple v. Comm'r, 54 T.C. 1 (1970).

406. *Id.* at 7 n.3.

407. Herbert's Estate v. Comm'r, 139 F.2d 756 (3d Cir. 1943).

408. *Id.* at 756.

409. *Id.* at 758.

further explained that "[w]e have no doubt that the payment here of the claim held by the estate was a 'disposition' of the claim."[410]

Banks stated that the income-producing asset is the cause of action.[411] The courts have held that a lawsuit is an intangible asset which is also a capital asset and that the relinquishment of the cause of action constitutes a sale or exchange of that capital asset.

B. *A Judgment or Settlement of a Personal Injury Cause of Action Is a Disposition of Property*

Section 1001(a) states that the "gain from the sale or other disposition of property shall be the excess of the amount realized there from over the adjusted basis."[412] Section 1012 provides that "[t]he basis of property shall be the cost of such property,"[413] and Section 1016 requires that "[p]roper adjustment in respect of the property shall in all cases be made[] for expenditures, receipts, losses, or other items properly chargeable to capital account."[414]

The Supreme Court has stated that the proper adjustment for recovery of capital expenditures occurs through an offset to the selling price rather than by a deduction.[415] For example, attorney's fees paid in connection with the sale of stock "are an offset against the selling price."[416]

Recognized gains and losses must be properly classified. There are three elements of characterization: (1) tax status of the property; (2) manner of disposition; and (3) holding period of the property. There are three possible tax statuses of property: (1) Section 1221 capital asset;[417] (2) Section 1231 assets used in a

410. *Id.*

411. Comm'r v. Banks, 543 U.S. 426, 435 (2005).

412. I.R.C. § 1001(a) (2006).

413. *Id.* § 1012(a) (amended 2008). The basis is a device used in taxation to prevent double taxation on the disposition of property. Essentially, the tax history is included in the basis of property so that, upon the sale of that property, the taxpayer will be taxed only upon whatever gain exceeds amounts previously taxed. *See generally id.* § 1001(a) (2006) (providing that gain is the amount realized minus the adjusted basis).

414. *Id.* § 1016(a) (amended 2010).

415. Woodward v. Comm'r, 397 U.S. 572, 574–75 (1970).

416. Treas. Reg. § 1.263(a)-2(e) (1987).

417. Section 1221 broadly includes all assets under the definition of capital asset unless that asset falls under one of the exceptions listed under Paragraphs 1 through 8. I.R.C. § 1221(a)(1)–(8) (2006) (amended 2010). The characterization of an asset as either capital or ordinary is especially important because capital gains are taxed at favorable

business;[418] or (3) ordinary income asset.[419]

The first category, capital assets, is defined in Section 1221 as "property held by the taxpayer" that is not excluded by the Internal Revenue Code.[420] The other exceptions to capital gain treatment include items that would otherwise be ordinary income assets including: (1) inventory; (2) accounts and notes receivable; (3) copyrights, literary, musical or artistic compositions, letters or memoranda held by a taxpayer whose efforts created the property or for whom it was produced; (4) U.S. government publications; (5) supplies; (6) any commodities derivative financial instrument held by a commodities derivatives dealer as a dealer; and (7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired.[421] All of these exclusion items give rise to ordinary income.[422] What remains to be characterized as capital assets are personal use and investment assets. Accordingly, intangible personal property would fall within the definition of a capital asset unless it is specifically excluded by Section 1221.[423]

Capital gains are generated by "the sale or exchange of a capital asset."[424] The status of an unliquidated cause of action is property, subject to the tax rules governing the sale or other

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rates. *Compare id.* § 1(c) (amended 2008) (providing that an unmarried individual has a marginal tax rate of 39.6% for ordinary income at the highest income bracket), *with id.* § 1(h) (stating that the highest rate on capital gains is generally 15%). Characterization is also important with respect to losses. Ordinary losses, if they arise out of the taxpayer's trade, business, or "transaction entered into for profit," may be used to reduce gains when arriving at net income. *Id.* § 165 (amended 2010). Capital losses, however, may only be used to offset capital gains, and if the taxpayer is an individual, capital losses may only offset capital gains plus the lower of $3,000 or the excess of capital losses over capital gains. *Id.* § 1211.

418. Section 1231 assets are depreciable business and involuntary conversion property. *Id.* § 1231. Section 1231 property enjoys very favorable treatment because a net gain under Section 1231 is considered a capital gain, and a net loss is considered an ordinary loss. *Id.*

419. An ordinary income asset falls into one of the listed exceptions to the broad definition of capital asset found in Section 1221. *See id.* § 1221(a) (providing exceptions to the broad, inclusive language of the capital asset definition).

420. *Id.*

421. *Id.*

422. *See id.* (stating that the exceptions are not capital assets, which would make them ordinary assets).

423. *Id.*

424. *See generally id.* § 1222 (amended 2010) (providing definitions of capital gains and losses, which require the "sale or exchange of a capital asset").

disposition of property.[425] The question remains whether payment of a settlement or judgment that releases the defendant from liability constitutes a "sale or other disposition of property" under Section 1001.[426] The Commissioner stated that "the settlement proceeds represent the value given in exchange for the dismissal of respondents' claims."[427]

The second category, Section 1231 assets, constitutes depreciable personal or real property used in a business.[428] Intangible personal property could also fall within this category. The third category is applicable only if Sections 1221 and 1231 cannot be used.

Under *Banks*, the income-producing asset is the cause of action.[429] If the suit is property and its settlement or transfer is a sale or exchange, then the characterization of the proceeds should be either a Section 1221 or Section 1231 asset. If it is a business asset, it is a Section 1231 asset;[430] otherwise, it is a capital asset under Section 1221.[431] The sale or exchange of a capital asset gives rise to capital gain or loss treatment.[432] The sale or exchange of a Section 1231 asset may give rise to capital gain or loss treatment.[433] The settlement or judgment proceeds, therefore, occur through the sale or exchange of a capital or Section 1231 asset. As such, the taxpayer should get capital gain treatment or Section 1231 treatment depending on whether the taxpayer is an individual or a business.

C. *Deductibility of Legal Expenses*

The Court, in explaining why the issues in *Banks* are important, considered the possibility of taking legal expenses as itemized

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425. *See* Comm'r v. Banks, 543 U.S. 426, 435 (2005) (stating that the income-producing property is the cause of action); *cf., e.g.*, TEX. PROP. CODE ANN. § 12.014(a) (West 2004) (indicating that a cause of action may be sold). Because capital assets have a broad definition and there is no exclusion for causes of action, causes of action presumably are capital assets. *See* I.R.C. § 1221 (providing a broad definition of capital assets).

426. I.R.C. § 1001(a) (2006).

427. Brief for Petitioner at 12, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-207), 2004 WL 1330104 at *12.

428. I.R.C. § 1231 (2006).

429. *Banks*, 543 U.S. at 435.

430. *See* I.R.C. § 1231 (providing special treatment of depreciable business property).

431. *See id.* § 1221 (amended 2010) (giving a broad definition of capital asset).

432. *Id.* § 1231(a).

433. *Id.* § 1222 (amended 2010).

deductions.[434] The Court stated that itemizing would not have helped because "the AMT establishes a tax liability floor" and would not have allowed the deductions.[435] However, the question of how to deduct the expenses was not before the Court.

Nevertheless, the Court did state that "[i]n the case of a litigation recovery[,] the income-generating asset is the cause of action that derives from the plaintiff's legal injury."[436] Thus, while stating that the income-generating asset is the cause of action, the Court refused to consider that the proceeds occur through the disposition of that property. Since this Article has demonstrated that the resolution of a cause of action would give rise to capital gain, the next step is to examine the deductibility of fees.

1. Previous Law on Deductibility of Fees

Internal Revenue Code Section 104(a)(2), which excludes from income "damages . . . received . . . on account of personal injuries,"[437] was previously viewed as encompassing such nonphysical harms as employment discrimination.[438] In *Commissioner v. Schleier*[439] and in *United States v. Burke*,[440] the Supreme Court set forth a more restrictive reading of the section but also indicated that taxable damages in such cases excluded attorney's fees.[441] The Court subsequently held that the net proceeds of the plaintiffs' punitive damages claims were not excluded under Section 104(a)(2).[442]

In 1997, Congress amended the Code to exclude only damages

434. *Banks*, 543 U.S. at 432.

435. *Id.*

436. *Id.* at 435.

437. I.R.C. § 104(a)(2) (2006).

438. *See* Comm'r v. Schleier, 515 U.S. 323, 338–39 (1995) (O'Connor, J., dissenting) (recognizing discrimination as an invasion of the rights of an individual so as to be a personal injury).

439. Comm'r v. Schleier, 515 U.S. 323 (1995).

440. United States v. Burke, 504 U.S. 229 (1992).

441. *See Schleier*, 515 U.S. at 330 (holding that discrimination based on age was not a personal injury); *Burke*, 504 U.S. at 238 (determining that a backpay award for sexual discrimination was not excludable from gross income).

442. *See* O'Gilvie v. United States, 519 U.S. 79, 81 (1996). The Tenth Circuit made it clear that the net proceeds were net of attorney's fees and expenses. O'Gilvie v. United States, 66 F.3d 1550, 1552 (10th Cir. 1995), *aff'd*, 519 U.S. 79.

received on account of "physical injuries."[443] As a result, many types of nonphysical damages could not be excluded from income.[444] The amendment, however, did not contain a provision excluding attorney's fees from income.[445] Therefore, under the doctrine of Judicial Reenactment,[446] one would reasonably assume that Congress implicitly approved the "net" result previously enunciated by the Supreme Court.

The IRS, however, took the position that a plaintiff's income should also include the contingency fees.[447] The IRS further maintained that attorney's fees should be treated as miscellaneous itemized deductions, which may be deductible under Section 67(a).[448] Miscellaneous itemized deductions are subject to the 2% adjusted gross income (AGI) floor, and are allowed only if the taxpayer elects itemized deductions rather than the standard deduction.[449] Itemized deductions are also subject to a phaseout when AGI exceeds the applicable amount.[450] The IRS takes the position that the attorney's fees are subject to a 2% floor and phaseout in a year when the taxpayer's AGI is increased by the full amount of the recovery, including the attorney's fees.[451]

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443. Small Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (codified as amended at I.R.C. § 104 (2006)).

444. *See* I.R.C. § 104(a)(2) (limiting exclusion of personal injuries to physical injuries and sickness).

445. Brief for Ass'n of Trial Lawyers of America as Amicus Curiae Supporting Respondents at 7, Commissioner v. Banks, 543 U.S. 426 (2005) (Nos. 03-892, 03-907), 2004 WL 1876294 at *7.

446. Reenactment without change of the statute amounts to an implied recognition and approval of the prior executive construction of the statute. Provost v. United States, 269 U.S. 443, 458 (1926); Nat'l Lead Co. v. United States, 252 U.S. 140, 146 (1920); United States v. Cerecedo Hermanos y Compania, 209 U.S. 337, 339 (1908) (citing United States v. G. Falk & Bro., 204 U.S. 143, 152 (1907)); *G. Falk & Bro.*, 204 U.S. at 152.

447. *See* I.R.S. Priv. Ltr. Rul. 98-09-053 (Dec. 2, 1997) ("It is well established that taxpayers must include in income that portion of a damage award that is remitted to attorneys under a contingency fee arrangement."). Private letter rulings are private answers to taxpayer questions sent to the IRS, and these rulings are not binding on the Service. *Private Letter Rulings, Technical Advice Memoranda and Field Service Advice Memoranda Involving Tax Exempt Bond Issues*, INTERNAL REVENUE SERV. (Oct. 15, 2010), http://www.irs.gov/taxexemptbond/article/0,,id=134365,00.html.

448. *See* Brief for Petitioner at 3, *Banks*, 543 U.S. 426 (Nos. 03-892, 03-907), 2004 WL 1330104 at *3 (arguing that contingency fees should be treated as miscellaneous itemized deductions).

449. I.R.C. § 67 (2006).

450. *Id.* § 151(d)(3).

451. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS 165 (2002).

Inclusion of the attorney's fees alone could eliminate the deduction for the attorney's fees due to the phaseout because such fees are often quite substantial.[452]

Furthermore, the taxpayer may be denied any deduction at all for legal fees if he is subject to the AMT.[453] The AMT disallows any miscellaneous itemized deductions[454] and imposes rates of 26% or 28% on the recomputed taxable income.[455] In *Kenseth*, United States Tax Court Judge Chabot argued that applying the AMT in this situation "can raise effective tax rates to hardship levels."[456] In fact, Judge Beghe, also dissenting in *Kenseth*, noted that where total legal fees exceed about 72% of gross recovery, "the tax can exceed the net recovery."[457]

These outcomes prompted the National Taxpayer Advocate[458] to state that the include–deduct method "deviates from the

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452. *See id.* (arguing that a taxpayer cannot deduct "some or all of attorney['s] fees includable in gross income" because of the limitations of miscellaneous itemized deductions and the AMT).

453. *See id.* (stating that allowing a miscellaneous itemized deduction for the contingency fees would have provided no help to the taxpayers because of the AMT).

454. I.R.C. § 56(b)(1)(A)(i) (2006) (amended 2009).

455. *Id.* § 55(b)(1)(A)(i)(I)–(II) (amended 2010).

456. Kenseth v. Comm'r, 114 T.C. 399, 419 (2000) (Chabot, J., dissenting), *aff'd on other grounds*, 259 F.3d 881 (7th Cir. 2001).

457. *Id.* at 425–26 n.17 (Beghe, J., dissenting). For example, the taxpayer in *Alexander v. Internal Revenue Service* obtained a favorable settlement of her employment discrimination suit. 72 F.3d 938, 940 (1st Cir. 1995). However, legal fees and the high costs of her court battle left her with a net recovery of only $5,000, but a tax bill of $53,900. Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1078, 1078 n.16 (2000). Similarly, in *Coady v. Commissioner*, after prevailing in her bench trial on her claim that she was wrongfully discharged, Coady was left with a tax liability greater than her net recovery. Brigid McMenamin, *Legal Trap: The Lawyers Did Just Fine*, Sidebar to *The Killer Tax*, FORBES, Apr. 1, 2002, at 72, 80, *available at* http://www.forbes.com/forbes/2002/0401/072sidebar2.html. Coady subsequently told a reporter, "I won the battle, but I lost the war." *Id.*

458. The Taxpayer Advocate Service (TAS) is an independent arm of the IRS that seeks to advance taxpayers' positions. *The Taxpayer Advocate Service Is Your Voice at the IRS!*, INTERNAL REVENUE SERV. (Apr. 12, 2011), http://www.irs.gov/advocate/article/0,,id=212313,00.html. The National Taxpayer Advocate serves as the head of the TAS and is required to submit an annual report to Congress on taxpayers' problems and recommendations to solve those problems. *See National Taxpayer Advocate "Reports to Congress and Research"*, INTERNAL REVENUE SERV. (Aug. 25, 2011), http://www.irs.gov/advocate/article/0,,id=97404,00.html ("By law, the National Taxpayer Advocate must submit two reports to Congress each year."); *Taxpayer Advocate Service At-a-Glance*, INTERNAL REVENUE SERV. (May 25, 2011), http://www.irs.gov/irs/article/0,,id=101099,00.html (listing the National Taxpayer Advocate as the head of the TAS).

concept of taxing net income" and does not bring about a fair result for taxpayers "in nonphysical personal injury cases."[459] The Advocate added that "[t]he result would be the same whether the attorney's fee arose from a contingent fee agreement or a court-ordered award."[460]

One example of this unfairness was the situation faced by police officer Cynthia Spina, who prevailed in a sex discrimination and harassment lawsuit.[461] The damage award was $300,000, and attorney's fees and costs totaled almost $1 million.[462] Because the IRS required her to report the court-awarded attorney's fees as income, she owed the IRS $99,000 more than she received.[463]

In cases requesting injunctive relief or specific performance and where no monetary damages are requested, the client will be forced to pay tax when there is no prospect of "income" from the judgment with which to pay the tax.[464] Many states have adopted legislation providing court-awarded fees.[465] In divorce cases and employment discrimination cases, taxpayers may find themselves with an unexpected tax burden. This violates the ability-to-pay concept. Contingency fees were originally permitted to allow the poor to have access to the courts, yet the poor may now decide that they cannot afford that access.[466]

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459. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT TO CONGRESS 166 (2002).

460. *Id.* at 162.

461. Spina v. Forest Preserve Dist. of Cook Cnty., 207 F. Supp. 2d 764, 767 (D. Ill. 2002).

462. *Id.* at 776 (limiting compensatory damages to $300,000).

463. Adam Liptak, *Tax Bill Exceeds Award To Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, at A12; *Outrageous Injustice: Congress Must Fix a Legal Tax Quirk that Grossly Penalizes Winners of Civil Rights Cases*, NEWSDAY, Aug. 17, 2002, *available at* http://www.newsday.com/editorial-outrageous-injustice-congress-must-fix-a-legal-tax-quirk-that-grossly-penalizes-winners-of-civil-rights-cases-1.417323.

464. *See* Newman v. Piggie Park Enters., Inc., 390 U.S. 400, 402 (1968) (per curiam) (stating that a plaintiff in a Title II suit for injunctive relief cannot recover damages, but that attorney's fees will be awarded).

465. *See* Abrams v. Lightolier, Inc., 50 F.3d 1204, 1224 (3d Cir. 1995) (applying the New Jersey fee-shifting statute in connection with an employment discrimination claim (citing N.J. STAT. ANN. § 10:5-27.1 (West 1993) (amended 2002))); McGinnis v. Ky. Fried Chicken of Cal., 51 F.3d 805, 808 (9th Cir. 1994) (applying the Washington fee-shifting statute to obtain attorney's fees in an employment discrimination case (citing WASH. REV. CODE § 49.60.030(2) (1993) (amended 1995))); Flannery v. Prentice, 28 P.3d 860, 862 (Cal. 2001) (awarding attorney's fees).

466. The Supreme Court also recognized that if plaintiffs acting as "private attorney[s] general" were forced to bear their own litigation costs, "few aggrieved parties

2. Deductibility Under *Banks*

"In the case of a litigation recovery *the income-generating asset is the cause of action* derived from the plaintiff's legal injury."[467] Because "the taxpayer retained control over the asset," he should have the entire recovery included in his income.[468] But what about the attorney's fees? If the client is deemed to have sold part of the asset to the attorney, the fair market value of what was sold—the amount of the attorney's fees—will be included in his income,[469] but, presumably, the basis of that portion—the fair market value—should be deductible if it is a capital asset. If the taxpayer is deemed to have sold the entire asset when the recovery is paid, then the attorney's fees should, in theory, be offset as a cost of sale.[470]

Legal fees should be treated as capital expenditures and offset against the total recovery to arrive at gross income.[471] The Supreme Court has made it clear that "[d]eductions are exceptions to the norm of capitalization."[472] "[C]apital expenditures, by contrast, are not exhaustively enumerated in the Code .... For these reasons, deductions are strictly construed and allowed only 'as there is a clear provision therefor.'"[473] If the payment of a settlement or judgment constitutes the sale or exchange of a capital asset, we should be in a comfort zone when considering expenses incurred in acquiring, maintaining, improving or selling

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would be in a position to advance the public interest." *Newman*, 390 U.S. at 402. "Congress therefore enacted the provision for counsel fees... to encourage individuals injured by racial discrimination to seek judicial relief...." *Id.* Courts may properly award attorney's fees in such cases in excess of the monetary damages awarded to the plaintiff. *See* City of Riverside v. Rivera, 477 U.S. 561, 581–82 (1986) (upholding award of $245,456 in attorney's fees where a jury awarded damages totaling $33,350); Copeland v. Marshall, 641 F.2d 880, 883, 906, 908 (D.C. Cir. 1980) (upholding attorney's fees of $160,000 for representing a plaintiff who recovered $33,000).

467. Comm'r v. Banks, 543 U.S. 426, 435 (2005) (emphasis added).

468. *Id.* at 427.

469. *See generally* I.R.C. § 1001 (2006) (providing that the taxable gain is the amount realized less the adjusted basis).

470. *See generally id.* § 1012(a) (amended 2008) (providing that the basis of property is generally the cost of obtaining the property).

471. *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 80, 90 (1992) (allowing professional expenses incurred in the takeover of a corporation to be categorized as capital expenditures).

472. *Id.* at 84.

473. *Id.* (quoting New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934)).

the asset.[474] Those expenses are capitalized and then released when the income is recognized.[475]

As the Supreme Court stated in *Woodward v. Commissioner*,[476] "[i]f an expense is capital, it cannot be deducted" under either Section 162 or 212.[477] The Court further explained that "[t]he law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it."[478]

D. *Origin-of-the-Claim Doctrine*

The issue of whether expenses may be deducted or must be capitalized could be resolved by the origin-of-the-claim test.[479] Under the origin-of-the-claim test, "the substance of the underlying claim or transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the motives of the payor or the consequences that may result from the failure to defeat the claim."[480]

United States v. Gilmore[481] laid the foundation for the origin-of-the-claim test.[482] In *Gilmore*, the Supreme Court held that attorney's fees for a divorce were not deductible, regardless of the taxpayer's motives.[483] The Court reasoned that even though there

474. *See id.* at 90 ("[C]ourts more frequently have characterized an expenditure as capital in nature because 'the purpose for which the expenditure is made has to do with the corporation's operations and betterment . . . .'" (quoting Gen. Bancshares Corp. v. Comm'r, 326 F.2d 712, 415 (1964))).

475. *See generally* I.R.C. § 263A (2006) (providing general rules for capitalization and adding capital expenditures to the basis of the capital asset).

476. Woodward v. Comm'r, 397 U.S. 572 (1970).

477. *Id.* at 575.

478. *Id.* at 576.

479. *See id.* at 578 (applying the origin-of-the-claim doctrine to determine capitalization versus deductibility); United States v. Gilmore, 372 U.S. 39, 49 (1963) (approving the use of the origin-of-the-claim test to determine deductibility versus capitalization).

480. Santa Fe Pac. Gold Co. v. Comm'r, 132 T.C. 240, 264–65 (2009) (citing *Woodward*, 397 U.S. at 578; Newark Morning Ledger Co. v. United States, 539 F.2d 929, 935 (3d Cir. 1976); Clark Oil & Ref. Corp. v. United States, 473 F.2d 1217, 1220 (7th Cir. 1973); Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (7th Cir. 1970)).

481. United States v. Gilmore, 372 U.S. 39 (1963).

482. *Id.* at 49 (resolving the "conflict among the lower courts on the question" regarding which criteria to use in favor of the origin and character rather than the claim's potential consequences on the taxpayer).

483. *Id.* at 51–52.

may be effects on investment property, the claims stemmed from the personal context of a divorce.[484] *Gilmore* is often cited for the proposition that the "claim's personal or business character is to be determined by its origin rather than its effects."[485] This doctrine does not feature a "'mechanical search for the first in the chain of events' but requires consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the amounts claimed as deductions were expended, and all other facts relating to the litigation."[486] A determination as to whether expenses are deductible as business expenses or must be capitalized as investment expenses is a fact-intensive inquiry that turns upon the particular facts and circumstances of a particular case.[487]

Settlement payments and legal fees expended to resolve disputes over ownership of assets may be capital expenses.[488] Legal and professional expenses, like settlement payments, are analyzed under the origin-of-the-claim doctrine.[489] Costs incurred in defending title to property are capital expenditures.[490] Moreover, legal expenses incurred in defending against claims challenging a taxpayer's "ownership of assets may be capital expenditures."[491] "A deduction is generally allowed for expenses

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484. *Id.* at 51.

485. Richard C.E. Beck, *Deductibility of Treble Damages Paid for Breach of National Health Service Corps Scholarship Contracts, Part II: The Misuse of I.R.C. § 265(a)(1) in* Stroud v. United States *and of the Origin of the Claim Test in* Keane v. Commissioner, 1 CHARLESTON L. REV. 1, 24 (2006).

486. Santa Fe Pac. Gold Co. v. Comm'r, 132 T.C. 240, 265 (2009) (quoting Boagni v. Comm'r, 59 T.C. 708, 713 (1973)).

487. Wellpoint, Inc. v. Comm'r, 96 T.C.M. (CCH) 260, at *2 (2008) (citing INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 86 (1992); Deputy v. du Pont, 308 U.S. 488, 496 (1940)); *accord* Boagni v. Comm'r, 59 T.C. 708, 713 (1973) (stating that the origin-of-the-claim test "requires an examination of all the facts").

488. *Wellpoint, Inc.*, 96 T.C.M. (CCH) 260, at *1; *see* Anchor Coupling Co. v. United States, 427 F.2d 429, 429 (7th Cir. 1970) (holding that "sale of [a] taxpayer's assets to another was a . . . nondeductible capital expenditure rather than a deductible ordinary and necessary business expense"); Wallace v. Comm'r, 56 T.C. 624, 624 (1971) ("Expenditures to protect one's title to stock or other property are nondeductible capital outlays[] and are not deductible as ordinary and necessary expenses.").

489. *See Wellpoint, Inc.*, 96 T.C.M. (CCH) 260, at *2 (using the origin-of-the-claim test to determine the character of a settlement payment); Mosby v. Comm'r, 86 T.C. 190, 197 (1986) (stressing that "the origin of the claim is the proper test for determining if expenditures incurred in an inverse condemnation must be capitalized").

490. Treas. Reg. § 1.263(a)-2(c) (2003).

491. *Wellpoint, Inc.*, 96 T.C.M. (CCH) 260, at *3 (citing *Anchor Coupling Co.*, 427

incurred in defending a business and its policies from attack."[492]

Between two possible origins in the past, how far back does one go? The authority on this question "is firmly on the side of going back only as far as the breach."[493]

Shortly after the Supreme Court decided *Gilmore*, the United States Tax Court, in *Elliott v. Commissioner*,[494] decided whether attorney's fees incurred for collecting defaulted alimony were deductible.[495] The court allowed the deduction, which prompted an acquiescence from the IRS.[496] Neither this issue nor *Gilmore* was discussed in *Elliott*, but as stated by Richard C.E. Beck:

> [I]t seems fair to read the decision [in *Elliott*] as holding that a separate action for enforcement or collection of alimony long after the divorce is old and cold is independent of the divorce, and has its own origin *in the breach of the obligation*. The chain of origins is cut off at that point, and *Gilmore* does not require reaching further back to the more remote origin in the divorce [or marriage].[497]

In exploring the relationship between deductions and capital expenditures, the Supreme Court has noted the "familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer."[498] Various features of the Internal Revenue

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F.2d at 433; *Wallace*, 56 T.C. at 624); *accord* Duntley v. Comm'r, 54 T.C.M. (CCH) 1138, at *15–19 (1987) (applying the origin-of-the-claim test in holding that legal fees should be capitalized, not deducted).

492. *Wellpoint, Inc.*, 96 T.C.M. (CCH) 260, at *3; *accord INDOPCO, Inc.*, 503 U.S. at 83 (stating that business expenses are deductible while "capital expenditure[s] usually [are] amortized and depreciated"); Comm'r v. Tellier, 383 U.S. 687, 690 (1966) (reiterating that the Supreme Court has established "that counsel fees comparable to those here involved are ordinary business expenses"); Comm'r v. Heininger, 320 U.S. 467, 470–71 (1943) (recognizing that the expenses respondent paid were directly related to his business).

493. Richard C.E. Beck, *Deductibility of Treble Damages Paid for Breach of National Health Service Corps Scholarship Contracts, Part II: The Misuse of IRC § 265(a)(1) in* Stroud v. United States *and of the Origin of the Claim Test in* Keane v. Commissioner, 1 CHARLESTON L. REV. 1, 24 (2006).

494. Elliott v. Comm'r, 40 T.C. 304 (1963), *acq.*, 1964-2 C.B. 3, 1964 WL 71917 (1964).

495. *Id.* at 305, 314.

496. *Id.* at 314.

497. Richard C.E. Beck, *Deductibility of Treble Damages Paid for Breach of National Health Service Corps Scholarship Contracts, Part II: The Misuse of IRC § 265(a)(1) in* Stroud v. United States *and of the Origin of the Claim Test in* Keane v. Commissioner, 1 CHARLESTON L. REV. 1, 24–25 (2006) (emphasis added).

498. Interstate Transit Lines v. Comm'r, 319 U.S. 590, 593 (1943) (citing Deputy v. du

Code support "[t]he notion that deductions are exceptions to the norm of capitalization."[499] The Code provides a complete list of deductions, and these deductions may be disallowed in favor of capitalization.[500] Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures,"[501] Section 263 serves as a general means of distinguishing capital expenditures from current expenses.[502] For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor." [503]

Banks paid $10,000 to acquire his cause of action from the estate in bankruptcy.[504] The tax court subtracted that $10,000 from the settlement to arrive at Banks's gross income.[505] It could be inferred that if Banks had incurred legal expenses in that acquisition, those fees would also have been excluded from income.

So, if all causes of action give rise to capital gain, is the origin-of-the-claim doctrine still viable in determining whether the attorney's fees should be capitalized, deducted, or taken, if at all, as an itemized deduction? If the origin-of-the-claim doctrine is still viable, is it possible to have capital gain from the sale of a capital asset for the income inclusion under *Banks* but have differing outcomes for the deduction of attorney's fees based on the origin of the cause of action?

Pont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934)); *accord du Pont*, 308 U.S. at 493 (discussing that an income tax deduction is a matter of legislative grace (citing *New Colonial Ice Co.*, 292 U.S. at 440)).

499. INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992).

500. *Id.*; *accord* I.R.C. § 161 (2006) ("[T]here shall be allowed as deductions the items specified in this part . . . ."); *id.* § 261 ("[N]o deduction shall in any case be allowed in respect of the items specified in this part.").

501. Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 358 (1971).

502. *See* Comm'r v. Idaho Power Co., 418 U.S. 1, 16 (1974) ("The purpose of [Section] 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income.").

503. *du Pont*, 308 U.S. at 493 (quoting *New Colonial Ice Co.*, 292 U.S. at 440) (internal quotation marks omitted).

504. Banks v. Comm'r, 81 T.C.M. (CCH) 1219, at *3 (2001), *rev'd on other grounds*, 345 F.3d 373 (6th Cir. 2003), *rev'd on other grounds*, 543 U.S. 426 (2005).

505. *Id.* at *9.

E. *Anomaly Created by the Supreme Court*

Banks stated that the income-producing property was the cause of action.[506] The cause of action would then be a capital asset,[507] and the legal expenses should presumably be capitalized as an increase to basis or deducted.[508] However, if the origin-of-the-claim doctrine is applied, the deductions should be ordinary income because they arose due to wrongful discharge claims. The American Jobs Creation Act would make the *Banks* case moot, but the question is still viable for cases that do not involve discrimination or personal injury.[509] Thus, one must ask whether *Banks* was overturning the origin-of-the-claim doctrine.

Presumably, the Supreme Court had no such intention.[510] Deductions were not before the Court.[511] The only question before the Court was the includability of income.[512] It would appear that, in the Court's haste to decide the question of includability, it has created an anomaly.

The Supreme Court went beyond the question of includability and stated that "the income-generating asset is the cause of action."[513] This appears to answer the question of what kind of property the cause of action is. Because Section 1221 and the cases on the issue have made it clear that a cause of action is a capital asset, the income should be capital gain.[514]

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506. *Banks*, 543 U.S. at 435.

507. *See* I.R.C. § 1221(a) (2006) (amended 2010) (providing a broad definition of capital assets with exceptions that do not apply to a cause of action).

508. *See generally id.* § 263A (providing rules on capitalization of expenses for capital assets).

509. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–47 (codified at I.R.C. § 62(e) (2006)) (limiting its application to discrimination and personal injury); *see also Banks*, 543 U.S. at 433 ("Had the [American Jobs Creation] Act been in force for the transactions now under review, these cases likely would not have arisen.").

510. *See* Freda v. Comm'r, No. 10-1555, 2011 WL 3802707, at *4 (7th Cir. Aug. 26, 2011) (describing the origin-of-the-claim doctrine without recognizing any effect from *Banks*); Santa Fe Pac. Gold Co. v. Comm'r, 132 T.C. 240, 264–65 (2009) (same).

511. *See Banks*, 543 U.S. at 437–48 (recognizing that, while various arguments on deductibility were raised in amicus briefs, the Court refused to comment on them because these arguments were not raised in the lower courts).

512. *See id.* at 429 ("The question in [this case] is whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent[]fee agreement is income to the plaintiff under the Internal Revenue Code . . . ." (citations omitted)).

513. *Id.* at 435.

514. *See* I.R.C. § 1221 (2006) (amended 2010) (providing a broad definition of a

It has long been thought that the origin-of-the-claim doctrine also applied to the revenue generated by the claim.[515] Presumably, the Supreme Court changed that with *Banks*. If that is so, all revenue from the settlement of claims would be capital gain.[516] However, because deductions were not before the Court, the origin-of-the-claim doctrine is probably still viable.[517] This would mean that, despite the holding in *Woodward*, which makes deductions for capital transactions capitalizable,[518] attorney's fees and costs will either be deductible under the origin-of-the-claim doctrine or capitalizable depending upon the underlying nature of the claim. Thus, a lawsuit could result in capital gain and ordinary deductions.

Put differently, when the Court stated that the income-producing asset was a capital asset,[519] it determined the nature of the gain. The Court did not, however, decide the nature of the deductions. Deductions apparently remain subject to the origin-of-the-claim doctrine.[520] This gives rise to the possibility of capital gain treatment for the gain and ordinary treatment for the deductions. If the deductions are personal, they will be itemized deductions subject to the AMT disallowance of such expenses.[521]

The dicta in *Banks* discussed deductions as itemized deductions

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capital asset that does not exclude causes of action); Benedum v. Granger, 180 F.2d 564, 566 (3d Cir. 1950) ("Benedum having held 'property,' a chose in action, exchanged it for other less valuable property[, and] [t]he transaction clearly constitute[d] an exchange of capital assets." (footnote omitted)); Ray v. Comm'r, 18 T.C. 439, 443 (1952) (holding that a lessee's release to lessor of a restrictive covenant was a sale of a capital asset), *aff'd*, 210 F.2d 390 (5th Cir. 1954).

515. *See* I.R.S. Priv. Ltr. Rul. 2008-23-012 (Mar. 10, 2008) ("The courts and the [IRS] have typically applied the origin-of-the-claim doctrine in situations involving a recovery received pursuant to a judgment or a settlement.").

516. *Cf. Banks*, 543 U.S. at 435 (stating that the income-producing property, which would presumably create capital gains revenue, is the cause of action).

517. *See* Freda v. Comm'r, No. 10-1555, 2011 WL 3802707, at *4 (7th Cir. Aug. 26, 2011) (declining to note any change in the origin-of-the-claim doctrine from *Banks*); Santa Fe Pac. Gold Co. v. Comm'r, 132 T.C. 240, 264–65 (2009) (same).

518. *See* Woodward v. Comm'r, 397 U.S. 572, 579 (1970) (holding that litigation expenses incurred in connection with the purchase of stock should be capitalized).

519. *See Banks*, 543 U.S. at 435 (stating that "the income-generating asset is the cause of action," which is a capital asset).

520. *See* United States v. Gilmore, 372 U.S. 39, 49 (1963) (approving the use of the origin-of-the-claim test to determine deductibility versus capitalization).

521. *See* I.R.C. § 56(b)(1)(A)(i) (2006) (amended 2009) (excluding miscellaneous itemized deductions for the purpose of calculating AMT liability).

subject to the disallowance under the AMT.[522] This discussion would make sense only if the Court envisioned the continuance of the origin-of-the-claim doctrine.

However, if the Supreme Court did not mean to hold that the income-producing property *is* the cause of action, the Court has created a problem. The Court may have meant that the income produced *by* a cause of action, the nature of which will be determined by the underlying nature of the claim, is the property. That would mean the origin-of-the-claim doctrine applied to both the income and the deductions. However, that is not what the Court said.[523] Instead, the Court defined the property as the cause of action and then assigned an interest to an attorney in the cause of action via the assignment-of-income doctrine.[524] Because the Court defined the asset as the cause of action, rather than the underlying claim, the Supreme Court created a two-pronged analysis for lawsuits: one for income and another for deductions.

F. *Plaintiff or Defendant: Is There a Difference?*

This Article previously discussed that the cause of action is a capital asset for the plaintiff.[525] But what is a cause of action for a defendant? Obviously, a counterclaim would be an asset in this context for the defendant as well, but the claim against the defendant is more in the nature of a contingent liability that becomes fixed as a result of the resolution of the issue either by settlement or suit.

For some reason, the IRS, the courts, and the plaintiffs' representatives have failed to see a difference between the plaintiff's and defendant's causes of action.[526] Thus, we have a set of rules, generally laid down for defendants, which have been applied against plaintiffs without differentiation.

Payouts from a cause of action, which qualify as a capital asset, may be deemed to be capital and should be capitalized. Because

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522. *Banks*, 543 U.S. at 432–33.

523. *See id.* at 435 ("[T]he income-generating asset is the cause of action . . . .").

524. *Id.* at 435–36.

525. *See supra* text at Part III.B (discussing the characterization of a cause of action).

526. *See* Wellpoint, Inc. v. Comm'r, 96 T.C.M. (CCH) 260, at *5 (2008) (agreeing with the Commissioner that the defendant in the settlement was not able to deduct either the settlement payments or the legal expenses incurred with respect to the settlement because they are capital expenditures), *aff'd*, 599 F.3d 641 (7th Cir. 2010).

there is no real asset upon which to capitalize the costs, presumably, the costs should be capital losses. However, *Banks* was not looking at the deductibility of the defendant's payouts, and it seems that these would still be subject to the origin-of-the-claim doctrine.[527]

IV. CONCLUSION

Banks has created an anomaly with respect to the taxation of lawsuit proceeds and the deduction of the attendant attorney's fees and costs. The Court held that the taxpayer was taxed on the entire amount of the recovery, which included the attorney's fees that were paid under a contingency fee agreement.[528] However, the Court did not stop at including the income under Section 61.[529] Instead, the Court held that the taxpayer retained control of the income-producing asset, the cause of action, and therefore it would be an assignment of income if he were not taxed on the whole.[530]

Defining the income-producing asset as the cause of action has resulted in the classification of the income as a capital gain or Section 1231 income. This was a dramatic departure from existing law. Further, the issue was not before the Court, and it is therefore possible that the Court unintentionally changed the nature of lawsuit income.[531]

Further, even though the Court supposedly determined the nature of the income, the Court did not claim to overturn the origin-of-the-claim doctrine with respect to the deduction of attorney's fees and costs.[532] The Court created separate analyses for the income from lawsuits and for the attendant deductions.

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527. *See Banks*, 543 U.S. at 437–38 (declining to look at deductibility of Banks's attorney's fees as another solution to the matter).

528. *See id.* at 433–35 (using the assignment-of-income doctrine to include contingency fees in income).

529. *Id.* at 433 (citing I.R.C. § 61(a) (2006)).

530. *Id.* at 434–35.

531. *See id.* at 429 (stating that the issue "is whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent[]fee agreement is income to the plaintiff under the Internal Revenue Code").

532. Subsequent cases have continued to use the origin-of-the-claim doctrine. *See* Freda v. Comm'r, No. 10-1555, 2011 WL 3802707, at *4 (7th Cir. Aug. 26, 2011) (describing the origin-of-the-claim doctrine without recognizing any effect from *Banks*); Santa Fe Pac. Gold Co. v. Comm'r, 132 T.C. 240, 264–65 (2009) (same).