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## An Assignment by Any Other Name: Contingent-Fee Agreements as Partial Assignments of the Claim

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# NOTE

## An Assignment by Any Other Name: Contingent-Fee Agreements as Partial Assignments of the Claim

Andrew P. Lycans

### TABLE OF CONTENTS

INTRODUCTION.....	1102
I. (MIS)APPLYING THE ANTICIPATORY ASSIGNMENT OF INCOME DOCTRINE.....	1106
A. <i>Lack of an Assignment Satisfying a Debt</i> .....	1106
B. <i>Enjoyment of Income</i> .....	1109
II. IF IT LOOKS LIKE AN ASSIGNMENT, WALKS LIKE AN ASSIGNMENT, AND QUACKS LIKE AN ASSIGNMENT . . . ..	1112
A. <i>The Indications of a Partial Assignment</i> .....	1112
B. <i>The Case for Partial Assignment of the Claim</i> .....	1116
III. ESTABLISHING A VALUE FOR THE CAUSE OF ACTION .....	1122
A. <i>Section 83 Mainly Applicable to the Employee-             Attorney</i> .....	1122
B. <i>No Substantial Risk of Forfeiture Exists</i> .....	1125
C. <i>Barter Analysis: The Better Approach</i> .....	1127
CONCLUSION .....	1130

### INTRODUCTION

In 1959, Mrs. Ethel West Cotnam of Alabama won a groundbreaking lawsuit against the Internal Revenue Service when the Fifth Circuit Court of Appeals allowed her to subtract her legal fees, paid to her lawyer on a contingency basis, from her gross income.<sup>1</sup> Mrs. Cotnam sued the estate of her former employer when the administrator refused to honor the decedent's promise to pay her one-fifth of his estate if she would care for him the rest of his life.<sup>2</sup> Upon the successful disposition of this suit,<sup>3</sup> the Supreme Court of Alabama awarded Mrs. Cotnam \$120,000.<sup>4</sup> Of that amount, \$50,365.83 went to her attor-

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

2. Her employer, T. Shannon Hunter, died intestate. *Id.* at 120.

3. Mrs. Cotnam successfully fended off allegations Mr. Hunter never made the promise, and that, if he did, part of her duties were sexual in nature. *Id.* at 121 n.2.

4. *Id.* at 121.

ney, and the Internal Revenue Service determined she owed \$36,985.02 in taxes.<sup>5</sup> The Tax Court upheld this decision.<sup>6</sup> Mrs. Cotnam appealed, claiming she possessed no control over the funds diverted to her attorney, and that, once she signed the contingent-fee contract,<sup>7</sup> she never could lay claim to the money.<sup>8</sup> In a two-to-one decision, the Fifth Circuit agreed, reasoning that, because Mrs. Cotnam never enjoyed the benefit of this alleged income, it in fact did not constitute income as to her.<sup>9</sup> This decision created a split between the circuits<sup>10</sup> that has irked the Internal Revenue Service and a majority on the Tax Court to this day.<sup>11</sup>

For nearly forty years, the Fifth Circuit stood alone in holding that plaintiffs can subtract attorneys' fees from gross income.<sup>12</sup> The majority of circuit courts, less sympathetic to those in Mrs. Cotnam's position,<sup>13</sup> distinguished her case based on the unique attributes of the attorney charging-lien statute under which her lawyers collected.<sup>14</sup> In their view, a contingent-fee agreement constitutes nothing more than an anticipatory assignment of income, whereby the taxpayer transfers his or her right to income to someone else in order to decrease tax liability.<sup>15</sup> The taxpayer remains firmly in control of the income-

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5. *Cotnam v. Comm'r*, 28 T.C. 947 (1957).

6. *Id.*

7. A contingent fee is defined as "[a] fee charged for a lawyer's services only if the lawsuit is successful or is favorably settled out of court. Contingent fees are usu[ally] calculated as a percentage of the client's net recovery (such as 25% of the recovery if the case is settled, and 33% if the case is won at trial). BLACK'S LAW DICTIONARY 315 (7th ed. 1999).

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

9. See *id.*

10. See *Kenseth v. Comm'r*, 114 T.C. 399, 408 (2000) [hereinafter *Kenseth I*] (listing circuit court decisions where the IRS pursued arguments similar to the one used in *Cotnam* and prevailed).

11. See *id.* at 408-12 (expounding at length on the continued wisdom of the tax court's original position).

12. The Eleventh Circuit, created when the old Fifth Circuit was split into the current Fifth and Eleventh Circuits, remains bound by the pre-split Fifth Circuit precedents such as *Cotnam*. See *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc).

13. The First, Third, Fourth, Eighth, Ninth, and Federal Circuits all rejected similar approaches by taxpayers. See *Young v. Comm'r*, 240 F.3d 369, 379 (4th Cir. 2001); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Alexander v. Internal Revenue Service*, 72 F.3d 938 (1st Cir. 1995); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); *Bagley v. Comm'r*, 105 T.C. 396, 418-19 (1995) (holding without mentioning *Cotnam* that settlement portion paid to attorneys pursuant to contingent fee was income to client), *aff'd* 121 F.3d 393 (8th Cir. 1997); *O'Brien v. Comm'r*, 38 T.C. 707 (1962), *aff'd* 319 F.2d 532 (3d Cir. 1963).

14. See *Kenseth I*, *supra* note 10, 114 T.C. at 408-09 (claiming Judge Wisdom's opinion rested on the language of the Alabama statute). The Alabama statute in question gives attorneys the same rights as their clients in regard to collecting judgments. See ALA. CODE § 64 (1940). In general, such attorney charging-lien laws displace the common-law liens described in footnote 24, *infra*.

15. See *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001) [hereinafter *Kenseth II*]; *Coady*, 213 F.3d at 1191; *Kenseth I*, *supra* note 10, 114 T.C. at 411 n.5; *O'Brien*, 38 T.C. at 712.

generating vehicle, the lawsuit, and merely directs the proceeds to another, either in order to satisfy a debt,<sup>16</sup> or to divert the funds to someone in a lower tax bracket.<sup>17</sup> Under such an analysis, taxpayers do possess dominion over the portion of their awards going toward legal fees. They have simply chosen to direct these proceeds to others in order to settle debts or lower their tax burden.<sup>18</sup> Although taxing successful litigants in this manner may seem unfair, a number of circuits have made it clear that, because Congress remains in control of tax policy, the courts should not make ad hoc adjustments in an attempt to promote equity.<sup>19</sup>

Rejecting this analysis, the Sixth Circuit, in 2000, decided to follow *Cotnam v. Commissioner*<sup>20</sup> in *Estate of Clarks ex rel. Brisco-Whitter v. United States*,<sup>21</sup> stating to do otherwise would constitute double taxation.<sup>22</sup> The *Estate of Clarks* court noted that, in the anticipatory assignment of income cases cited by other courts, the Internal Revenue Service either taxed the donor or the donee, but not both.<sup>23</sup> Significantly, though the panel briefly discussed the Alabama attorney charging-lien statute, Michigan, where *Estate of Clarks* originated, has only a common law attorney lien, not a statute.<sup>24</sup> Attributing no great

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16. Justice Stone condemned such arrangements, reasoning that, even if the money never came within the taxpayer's physical control, he nevertheless determined the fate of this income. See *Helvering v. Horst*, 311 U.S. 112, 116 (1940).

17. See *id.* at 114 (diverting funds to a son in a lower tax bracket); *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930) (attempting to split husband's income between husband and wife before paying taxes).

18. See *Horst*, 311 U.S. at 116 (stating that taxpayers realize a gain when they exchange the power to receive income for something of economic worth).

19. See *Kenseth II*, *supra* note 15, 259 F.3d at 885; *Chapman v. Comm'r*, 618 F.2d 856, 874 (1st Cir. 1980); *Nassau Lens Co. v. Comm'r*, 308 F.2d 39, 45-46 (2nd Cir. 1962); Darren J. Campbell, Comment, *Wiping the Slate Clean: An Examination on How a Court's Characterization of Contingent Attorney's Fees Implicates the Alternative Minimum Tax and Affects the Taxpayers*, 35 U.C. DAVIS L. REV. 171, 200 (2001) (arguing that the Fifth Circuit violated the separation of powers doctrine when it misapplied federal tax law to alleviate the harsh results to the taxpayer); see also *Comm'r v. Estate of Church*, 335 U.S. 632, 653 (1949) (condemning courts that try to mold tax policy); *Kenseth I*, *supra* note 10, 114 T.C. at 407 (noting the dangers in judicial modification of established tax law principles).

20. 263 F.2d 119 (5th Cir. 1959).

21. 202 F.3d 854 (6th Cir. 2000).

22. *Estate of Clarks*, 202 F.3d at 857.

23. See *id.*

24. *Id.* at 856. The common law attorney lien:

was a device invented by the courts for the protection of attorneys against the knavery of their clients, by disabling clients from receiving the fruits of recoveries without paying for the valuable services by which the recoveries were obtained. The lien was never enforced like other liens. If the fund recovered was in possession or under the control of the court, it would not allow the client to obtain it until he had paid his attorney, and in administering the fund it would see that the attorney was protected. If the thing recovered was in a judgment, and notice of the attorney's claim had been given, the court would not allow the judgment to be paid to the prejudice of the attorney.

weight to this issue, the court noted, "Michigan law operates in more or less the same way as the Alabama lien in *Cotnam*."<sup>25</sup> Thus, the court refused to require any statutory grant of power to the plaintiff's attorney over the judgment award before finding that the plaintiff lacked sufficient control over the portion paid to the attorney to avoid tax on this amount.

Another significant decision in 2000 arose in *Srivastava v. Commissioner*<sup>26</sup> when the Fifth Circuit considered a Texas case and refused to limit *Cotnam* to Alabama.<sup>27</sup> The Internal Revenue Service sought to isolate Alabama residents as the only taxpayers entitled to take advantage of the *Cotnam* decision.<sup>28</sup> The panel found the differences in the Texas and Alabama attorney charging laws irrelevant in regard to the taxpayer-plaintiff.<sup>29</sup> The sole consideration before the court in regard to the anticipatory assignment of income doctrine consisted of the "degree of control and dominion over the asset."<sup>30</sup> Finding *Cotnam* controlling in this case, the panel concluded that a contingent-fee agreement constitutes a significant shift of control from the plaintiff to the attorney.<sup>31</sup>

This Note argues that plaintiffs assign a portion of their cause of action to their attorneys when they sign contingent-fee agreements. Part I argues the anticipatory assignment of income doctrine is inapplicable to contingent-fee agreements. Part II contends the Fifth and Sixth Circuits have already implicitly held that plaintiffs assign a portion of their claims to their attorneys upon signing contingent-fee agreements, and explains why this approach is correct. Part III concludes that section 83 of the Internal Revenue Code — property transferred in connection with performance of services — is ill suited to contingent-fee arrangements, and supports a barter analysis for determining the tax liability of each party.

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*Id.* (quoting RAY ANDREWS BROWN, *THE LAW OF PERSONAL PROPERTY* § 116, at 559 (2d ed. 1955) in turn quoting *Goodrich v. McDonald*, 19 N.E. 649 (N.Y. 1889) (internal quotation marks omitted)).

25. *Id.*

26. 220 F.3d 353 (5th Cir. 2000).

27. *Srivastava*, 220 F.3d at 364-65 (stating the Commissioner's belief that *Cotnam* should be distinguished because the Alabama statute gave attorneys more power to enforce their rights than the Texas statute did).

28. *See id.* at 363.

29. *See id.* at 363-64.

30. *Id.*

31. *Id.* at 364-65. The court, however, also announced that what the attorney's rights were had no bearing on the situation. *Id.*

## I. (MIS)APPLYING THE ANTICIPATORY ASSIGNMENT OF INCOME DOCTRINE

This Part examines the anticipatory assignment of income theory applied by courts in the majority from two perspectives — paying off a debt by assigning income previously earned, and the actual enjoyment of the income test — and finds both inapplicable to contingent-fee situations. Section I.A argues that a contingent-fee agreement does not pay off a debt in such a way as to trigger the anticipatory assignment of income doctrine. Section I.B contends that whether or not the taxpayer enjoys the income should be irrelevant to a court's holding, and reveals that the courts actually disagree on whether the taxpayer realizes the income.

### A. *Lack of an Assignment Satisfying a Debt*

For over seventy years courts have policed transactions with an eye toward preventing tax evasion in the guise of transferred assets.<sup>32</sup> Justice Holmes first enunciated the anticipatory assignment of income doctrine in *Lucas v. Earl*,<sup>33</sup> concluding “tax[ation] . . . [can]not be escaped by anticipatory arrangements and contracts however skilfully [sic] devised.”<sup>34</sup> The dissent in *Cotnam* itself asserted that such language should prevent successful plaintiffs from using contingent-fee arrangements with their lawyers to avoid paying income taxes on these amounts.<sup>35</sup> Later courts have advocated this position insisting that to allow such results would permit litigants to avoid taxation.<sup>36</sup> Courts use phrases such as “but for the taxpayer's effort to shift the receipt” of the proceeds of the lawsuit, the taxpayer would have come into the entire amount.<sup>37</sup> Other ways, however, exist to interpret *Lucas* in these situations.

In fact, one can easily distinguish *Lucas* and its progeny from the typical arrangement in a contingent-fee case.<sup>38</sup> As others have noted,

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32. See, e.g., *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (establishing the assignment of income doctrine).

33. *Kenseth I*, *supra* note 10, 114 T.C. 399, 411 n.5 (2000) (recounting the origins of the anticipatory assignment of income doctrine).

34. *Lucas*, 281 U.S. at 115.

35. See *Cotnam v. Comm'r*, 263 F.2d 119, 126-27 (5th Cir. 1959) (Wisdom, J., dissenting).

36. See *Kenseth I*, *supra* note 10, 114 T.C. at 413-14 (stating that anticipatory assignment by the taxpayer of the proceeds of the lawsuit must be included in the taxpayer's gross income); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962) (insisting that *Lucas* applies even if the taxpayer is not entitled to the attorney's part of the award for a split second).

37. *Kenseth I*, *supra* note 10, 114 T.C. at 417.

38. *Id.* at 417 (Beghe, J., dissenting) (detailing ways to distinguish assignment of income cases).

“it is not clear that the rationale of the assignment of income cases should apply to contingency-based attorneys’ fees.”<sup>39</sup> This implication arises because of what the *Lucas* Court sought to prevent.<sup>40</sup> When Justice Holmes referred to “skillfully devised contracts to avoid paying wealth,”<sup>41</sup> he meant just that. Mr. Earl attempted to reduce his income tax liability by relying on a contract with his wife to share all wealth, however acquired, equally.<sup>42</sup> The Court refused to allow contractual arrangements to shift the tax burden from the source of the income.<sup>43</sup>

Unlike arrangements meant to reduce tax liability, contingent-fee agreements do not attribute income to anything other than the source of the income.<sup>44</sup> Plaintiffs do not hire lawyers with the goal of avoiding taxation on the money due them by transferring a portion of their claims to their lawyers as a gratuity.<sup>45</sup> Some, such as the dissenters in *Cotnam*, argue these arrangements amount to an anticipatory assignment of income because they discharge a debt to the client’s attorney.<sup>46</sup> This argument misconstrues the contingent-fee arrangement. Attorneys have no recourse against their clients when seeking payment until the defendant makes good on the judgment. When plaintiffs prevail, their attorneys look solely to their portion of the judgment, not to their client’s. In fact, the whole structure of the anticipatory assignment of income doctrine rests on the notion that the taxpayer would have received the income, but for the assignment.<sup>47</sup> Here, but for the assignment, neither would have received the income

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39. Thad Austin Davis, Note, *Cotnam v. Commissioner and the Income Tax Treatment of Contingency-Based Attorneys’ Fees — The Alabama Attorney’s Charging Lien Meets Lucas v. Earl Head-on*, 51 ALA. L. REV. 1683, 1706 (2000).

40. See Davis, *supra* note 39, at 1706 (claiming the *Lucas* Court was concerned only with abusive assignments of income).

41. *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

42. *Id.* at 114. It should be noted that the Earls’ contract was not one of the “carefully devised plots” of which Justice Holmes warned. They formed the contract approximately seventeen years before Congress implemented the federal income tax. See Lauren E. Sheridan, Note, *Trees in the Orchard or Fruit From the Trees?: The Case for Excluding Attorneys’ Contingent Fees from the Client’s Gross Income*, 36 GA. L. REV. 283, 291 (2001).

43. See *Lucas*, 281 U.S. at 115.

44. See *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (noting purpose not to shift tax liability).

45. As those wishing to distinguish *Lucas* frequently note, most, if not all, anticipatory assignment of income cases involve transfers between family members, or between debtors and creditors. See, e.g., *id.*

46. See Davis, *supra* note 39, at 1703 (discussing dissenter’s reasoning).

47. See *Helvering v. Horst*, 311 U.S. 112, 116-17 (1940) (stating, but for the taxpayer’s transfer of interest coupons to his son, the taxpayer would have received the interest); *Coady v. Comm’r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (but for diversion of funds to her creditor — the lawyer — the taxpayer would have received the money); *Kenseth I*, *supra* note 10, 114 T.C. 399, 417-18 (2000) (Chabot, J., dissenting) (reciting the origin of the assignment of income line of cases).

because payment would not have been forthcoming. Simply put, the “skillfully devised” scheme arises from an attempt to collect the money, not an attempt to avoid taxation.<sup>48</sup> Thus, the correct analysis of contingent-fee agreements does not involve the anticipatory assignment of income doctrine.

Considering what role the attorney plays in recovery clarifies the objections to applying the anticipatory assignment of income doctrine in these situations.<sup>49</sup> While the client may have earned the right to the income, collecting these funds requires an attorney’s efforts.<sup>50</sup> The lawyer earns the contingent fee through skill and judgment.<sup>51</sup> Taxes should accrue only to those who earn the money.<sup>52</sup> Nominal owners who serve as funnels without real access to the money should not suffer the taxation of such “income.”<sup>53</sup> This proposition holds the most sway in areas such as punitive damages.<sup>54</sup> Though detractors maintain an attorney does not earn any part of the award,<sup>55</sup> they surely cannot claim the plaintiff “earns” punitive damages either.<sup>56</sup> Such payments

48. See *Srivastava v. Comm’r*, 220 F.3d 353, 362 (5th Cir. 2000) (speculating the goal is to secure an attorney’s services without putting capital at risk, not the avoidance of taxation); *Cotnam v. Comm’r*, 263 F.2d 119, 125 (5th Cir. 1959) (assigning part of the claim to obtain legal services is not within the doctrine of *Lucas v. Earl*); cf. *Kenseth I*, *supra* note 10, 114 T.C. at 409-10 (listing and explaining contingent-fee cases but holding assignment of income doctrine still applies). *But see* *Young v. Comm’r*, 240 F.3d 369, 377 (4th Cir. 2001) (claiming *Lucas* was concerned with skillfully devising the method of payment); *Robinson v. Comm’r*, 102 T.C. 116, 117 (1994) (condemning settlement purposefully coordinated with the defendant in order to reduce taxes).

49. *Cf. Estate of Clarks*, 202 F.3d at 856-58 (reviewing case law and emphasizing attorney’s role).

50. *See id.* at 857.

51. *Id.* at 858.

52. *Kenseth I*, *supra* note 10, 114 T.C. at 413-14.

53. *See* *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978) (stating that the Court “looked to the objective economic realities of a transaction rather than to the particular form the parties employed”); *Escobar v. Comm’r*, 45 T.C.M. (CCH) 1326 (1983); *Davis*, *supra* note 39, at 1703.

54. *Cf. Kenseth I*, *supra* note 10, 114 T.C. at 447-48 (Beghe, J., dissenting).

[T]he recovery is determined in a dynamic process in which the exercise of the experience and skill of the attorney results both in some recovery and in an increase in the value of that recovery. The attorney creates and adds value; the efforts of the attorney contribute to — indeed he may be solely responsible for — both the recovery and its augmentation. Attenuated subtleties and refinements of title have nothing to do with the practical realities of contingent fee agreements and the relative interests of attorney and client in any recovery that may ultimately be realized.

*Id.* (Beghe, J., dissenting); Note, *An Economic Analysis of the Plaintiff’s Windfall from Punitive Damages Litigation*, 105 HARV. L. REV. 1900, 1909 (1992) [hereinafter *Plaintiff’s Windfall*] (claiming that attorneys are attracted to punitive damages cases because of a desire to capture the windfall).

55. *Kenseth I*, *supra* note 10, 114 T.C. at 413.

56. *See Plaintiff’s Windfall*, *supra* note 54, at 1903 (describing punitive damages as windfalls).



result from the defendant's, not the plaintiff's, past acts or omissions.<sup>57</sup> The augmentation of the award above the plaintiff's actual damages results from the attorney's efforts in the suit.<sup>58</sup> The plaintiff did not "earn" the punitive damages, and, between the client and the attorney, if either one can be said to have earned them, it was the attorney.

### B. *Enjoyment of Income*

When read properly, *Helvering v. Horst*<sup>59</sup> is distinguishable from the contingent-fee line of cases. In an effort to clarify what constitutes a taxable event, the Supreme Court created a trap for the unwary. In *Horst*, the Supreme Court noted that the complaining taxpayer enjoyed his income by transferring the interest coupons from bonds to his son, just as surely as if he would have retained the income bearing instruments for himself.<sup>60</sup> The Court took pains to point out that a taxpayer could enjoy income "when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth."<sup>61</sup> This statement led many courts into the thicket of trying to determine whether or not taxpayers truly enjoyed their alleged income, or whether in fact someone else had dominion over the money.<sup>62</sup> This inquiry misconstrues the Court's reasoning in *Horst*.

The Fifth and Sixth Circuits particularly have insisted on unnecessarily debating whether taxpayers enjoyed their income under the meaning of *Horst*.<sup>63</sup> For example, in *Estate of Clarks* the Sixth Circuit noted that in *Horst* and *Lucas* "the income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor."<sup>64</sup> From here, the argument proceeds, because the plaintiff's enjoyment of the income depended upon the lawyer winning the

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57. See Thomas J. Stipanowich, *Punitive Damages in Arbitration: Garrity v. Lyle Stuart Inc. Reconsidered*, 66 B.U. L. REV. 953, 955-56 (1986); *Plaintiff's Windfall*, *supra* note 54, at 1903.

58. See *Kenseth I*, *supra* note 10, 114 T.C. at 447-48 (Beghe, J., dissenting) (attributing increase to attorney's experience and skill).

59. 311 U.S. 112 (1940).

60. *Helvering*, 311 U.S. at 117.

61. *Id.* at 116.

62. See *Srivastava v. Comm'r*, 220 F.3d 353, 360 (5th Cir. 2000) (discussing who controls the income producing source); *Estate of Clarks ex rel. Brisco-Whittér v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (same); *Cotnam v. Comm'r*, 263 F.2d 119, 126 (5th Cir. 1959) (reasoning that, because Mrs. Cotnam had not fully enjoyed the benefit of her economic gain, she did not realize the gain).

63. See *Estate of Clarks*, 202 F.3d at 857; *Cotnam*, 263 F.2d at 126.

64. *Estate of Clarks*, 202 F.3d at 857.

lawsuit and earning any fee received, the plaintiff could not possibly have enjoyed the income by assigning it to the lawyer.<sup>65</sup>

The majority of circuit courts have correctly noted this argument has little to do with whether the lawyer's fee was income as to the taxpayer.<sup>66</sup> Few categorize the paying of bills as an enjoyable activity, yet that is not the point. The outcome should hinge on whether taxpayers control the flow of funds, no matter that they could not rightly deem many of these payments discretionary.<sup>67</sup> Under such an analysis, the Internal Revenue Service should prevail.<sup>68</sup> But in truth, this debate centers on when a taxpayer realizes income, which is what the *Horst* Court attempted to define.<sup>69</sup> Trying to figure out when someone enjoys the benefit of the economic gain<sup>70</sup> amounts to an attempt at objectively determining if the taxpayer controls it.<sup>71</sup> Thus, those circuits applying the anticipatory assignment of income doctrine believe that if taxpayers can direct the funds to their lawyers, they obviously control those funds.<sup>72</sup> Those critical of such an approach maintain this criteria falls short of satisfying the complete "dominion over the asset" language in the Supreme Court's *Glenshaw Glass*<sup>73</sup> decision.<sup>74</sup> The Fifth Circuit in *Cotnam* found it dismaying to argue Mrs. Cotnam controlled an asset when she could only apply the "gain" from it to a single, and not very attractive situation.<sup>75</sup> The taxpayer's options consisted of exchanging a fraction of the amount due for a chance to reclaim the whole amount, or retaining a worthless, albeit

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65. See *Srivastava*, 220 F.3d at 361; *Estate of Clarks*, 202 F.3d at 858; *Cotnam*, 263 F.2d at 125-26.

66. See *Coady v. Comm'r*, 213 F.3d 1187, 1191 (9th Cir. 2000) (stating that not directly receiving payment from obligor does not prevent full enjoyment of the benefit).

67. *Coady*, 213 F.3d at 1191 (procuring payment directly to creditors cannot prevent taxation); *Kenseth I*, *supra* note 10, 114 T.C. 399, 409 (2000) (listing cases where the IRS prevailed under this theory).

68. Cf. *Coady*, 213 F.3d at 1191; *Kenseth I*, *supra* note 10, 114 T.C. at 409-10.

69. *Helvering v. Horst*, 311 U.S. 112, 115-16 (1940).

70. *Srivastava*, 220 F.3d at 359; *Coady*, 213 F.3d at 1191; *Cotnam*, 263 F.2d at 126.

71. See *Horst*, 311 U.S. at 116. This led some to ask if the plaintiff acts merely as a remote, or proximate, owner. See, e.g., *Davis*, *supra* note 39 at 1702.

72. See *Cotnam*, 263 F.2d at 126 (Wisdom, J., dissenting) (noting the taxpayer benefited through prosecution of her claim).

73. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (finding the taxpayer liable for taxes because the gain had clearly been recognized and the taxpayer had complete dominion over it).

74. See *Davis*, *supra* note 39, at 1691; cf. Benjamin C. Rasmussen, Note, *Taxation of an Attorney's Contingency Fee of a Punitive Damage Recovery: The Srivastava Approach*, 15 *BYU J. PUB. L.* 301, 301 (2001) (framing the question as whether an undeniable accession to wealth occurred, clearly realized, with the taxpayer having complete dominion).

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

complete, right to the asset.<sup>76</sup> Therefore, even though the taxpayer could direct to whom the potential proceeds would go, she had not yet realized the gain, and once the gain did occur, the contingent-fee portion was beyond her control. "It seems intuitive that when the goal of a tax system is to subject net income to taxation, expenditures used to produce that income should be [deductible]."<sup>77</sup>

The disagreement over the nature of a contingent-fee agreement does not, however, end with the anticipatory assignment of income doctrine, or the requisite level of control to establish dominion. The Seventh Circuit failed to acknowledge the controversy involving whether a contingent-fee agreement assigns a portion of the claim when Mr. Kenseth, the plaintiff in *Kenseth v. Commissioner*,<sup>78</sup> appealed the decision of the Tax Court.<sup>79</sup> In summarizing the taxpayer's claim, the court wrote: "In essence, Kenseth wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent-fee contract is not an assignment."<sup>80</sup> Despite the confident tone of this proclamation, the status of contingency-fee contracts remains a matter of much contention.<sup>81</sup> Upon closer analysis, the circuits in the minority view contingent-fee agreements as coming harrowingly close to doing just that — assigning a part of the claim.<sup>82</sup> In light of their opinions, they apparently feel such agreements cross the line.

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76. *Id.* at 126.

77. Carol Duane Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. CIN. L. REV. 1199, 1210-11 (1986). I.R.C. § 162 (1999) implements such an approach for businesses.

78. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 412 n.6 (2000) (dismissing the possibility of an assignment with minimal discussion); Recent Case, *Seventh Circuit Holds that Contingent Attorneys' Fees Must Be Included in a Taxpayer's Gross Income*, 115 HARV. L. REV. 2357, 2361 (2002) (claiming the *Kenseth II* court "failed to appreciate the reality of contingent fee arrangements as transferring substantive ownership of a portion of a claim").

79. See *Kenseth II*, *supra* note 15, 259 F.3d 881 (7th Cir. 2001).

80. *Id.* at 882.

81. See, e.g., *Baylin v. United States*, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (referring to a contingency-fee contract as a vehicle of assignment); Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?*, 71 CHI.-KENT L. REV. 625, 639-44 (1995). Few commentators or courts analyze the issue; most simply make *ipse dixit* statements then move on. *But see* Recent Case, *supra* note 78, at 2362 (applying a burdens-benefits analysis and concluding the attorney displays many of the indicia of ownership).

82. See *Srivastava v. Comm'r*, 220 F.3d 353, 360 (5th Cir. 2000) (discussing assignment as a division of property); *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (characterizing what the lawyer received as an assignment); *Cotnam v. Comm'r*, 263 F.2d 119, 125 (5th Cir. 1959) ("[S]he, in effect, assigned to her attorneys forty percent of the claim . . .").

## II. IF IT LOOKS LIKE AN ASSIGNMENT, WALKS LIKE AN ASSIGNMENT, AND QUACKS LIKE AN ASSIGNMENT . . .

This Part analyzes the opinions finding the lawyer's contingency fee outside of the plaintiff's income. Section II.A concludes that the Fifth and Sixth Circuits, while avoiding saying so explicitly,<sup>83</sup> have concluded contingency-fee agreements amount to a partial assignment of the claim. Section II.B offers support for ruling contingency-fee agreements are partial assignments by considering the features of the contingency-fee agreement.

### A. *The Indications of a Partial Assignment*

The proper categorization of contingent-fee agreements remains unclear, despite pronouncements to the contrary. Though the Seventh Circuit stated that a contingent-fee agreement is not a partial assignment of the claim, it did not arrive at this conclusion through an independent analysis.<sup>84</sup> Instead, the opinion points out that Wisconsin law prohibits the assignment of a claim to a lawyer.<sup>85</sup> Many states do so because the common law barred the assignment of a cause of action.<sup>86</sup> Originally, such bars were meant to prevent the rich and landed nobility from harassing others by financing lawsuits.<sup>87</sup> When contingent-fee agreements first arose, the judiciary predominantly found such agreements champertous.<sup>88</sup> Although later jurisprudence decided contingent-fee agreements were sufficiently distinguishable from

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83. The *Cotnam* court came very close to holding so explicitly. See 263 F.2d at 125.

84. The court cited to *Young* for this proposition. *Kenseth II*, *supra* note 15, 259 F.3d at 884.

85. *Kenseth II*, *supra* note 15, 259 F.3d at 883-84. *But see* Recent Case, *supra* note 78, at 2361 (asserting that the court misread the applicable Wisconsin law because of its failure to read the comments following the ethical rule the court utilized in its interpretation). See generally Rebecca L. Morlock, Note, *Bowen v. American Family Insurance Group: An Unsettling Change in South Dakota Subrogation Law*, 41 S.D. L. REV. 335 (1996) (discussing whether subrogation amounts to an assignment of the claim and citing to cases where courts found that it does).

86. Painter, *supra* note 81, at 631, 639. *But see* Amy E. Douthitt, Comment, *Selling Your Attorney's Negligence: Should Legal Malpractice Claims Be Assignable in Texas?*, 47 BAYLOR L. REV. 177, 180 (1995) ("The general common law rule of nonassignability of a cause of action never applied in Texas.").

87. Peter Karsten, *Enabling the Poor to Have Their Day in Court: The Sanctioning of Contingency Fee Contracts, History to 1940*, 47 DEPAUL L. REV. 231, 232-33 (1998).

88. Champerty is defined as: "1. An agreement between a stranger to a lawsuit and a litigant by which the stranger pursues the litigant's claim as consideration for receiving part of any judgement proceeds. 2. The act or fact of maintaining, supporting, or promoting another person's lawsuit." BLACK'S LAW DICTIONARY 224 (7th ed. 1999).

champerty, the courts never established a principle on which to differentiate between them.<sup>89</sup>

In opinions granting taxpayers relief from being taxed on their attorneys' contingent fees, the Fifth and Sixth Circuits obscure the true import of their holdings by couching their arguments in terms meant to fend off attacks under *Lucas* and *Horst*.<sup>90</sup> The opinions frequently refer to whether the taxpayer had any right to the income when it was assigned.<sup>91</sup> Thus, the Sixth Circuit notes "the value of the taxpayer's lawsuit was entirely speculative and dependent on the services of counsel,"<sup>92</sup> while the Fifth Circuit finds it important that the taxpayer "was a long way from having the equivalent of cash," and it "was uncertain as to whether it [the claim] had any value."<sup>93</sup>

In fact, the Fifth and Sixth Circuits have implicitly held that plaintiffs assign a portion of their claim to the attorney upon signing a contingent-fee agreement.<sup>94</sup> This can be difficult to discern from the cases, given that the courts themselves often seem confused about the basis and impact of their holdings.<sup>95</sup> The Fifth Circuit in *Cotnam* came close to explicitly recognizing an assignment when it stated the taxpayer "in effect, assigned to her attorneys forty percent of the claim."<sup>96</sup> The "in effect" language, however, indicates the court's unwillingness to state flatly that a partial assignment of the claim had occurred.<sup>97</sup> In *Estate of Clarks*, the Sixth Circuit used a less direct approach stating "the client as assignor has transferred some of the

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89. See Karsten, *supra* note 87, at 240 (recounting how states allowed contingency fees by statute but kept champerty laws); Susan Lorde Martin, *Financing Plaintiffs' Lawsuits: An Increasingly Popular (and Legal) Business*, 33 U. MICH. J.L. REFORM 57, 58-59 (2000) (describing what the champerty doctrine prohibits but claiming exceptions have been common place); Robert N. Amkraut, Note and Comment, *Taxing Contingency Fee Attorneys as Investors: Recognizing the Modern Reality*, 71 WASH. L. REV. 745, 752 (1996) (discussing practical reasons why champerty faded in regard to contingent-fee agreements but offering no theoretical grounds for the exception). Largely, it seems courts simply ignored the matter when it was expeditious to do so. In fact, Maine barred contingent-fee lawsuits up until 1965, though few champerters likely were prosecuted. See Ted Schneyer, *Legal-Process Constraints on the Regulation of Lawyer's Contingent Fee Contracts*, 47 DEPAUL L. REV. 371, 372 n.6 (1998).

90. See *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (discussing extensively the import of these cases); *Cotnam v. Comm'r*, 263 F.2d 119, 125-26 (5th Cir. 1959) (same).

91. See *Estate of Clarks*, 202 F.3d at 857; *Cotnam*, 263 F.2d at 125-26.

92. *Estate of Clarks*, 202 F.3d at 857.

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

94. See Gregg D. Polsky, *Taxing Contingent Attorney's Fees: Many Courts Are Getting It Wrong*, 89 TAX NOTES 917, 919 (2000) (claiming that these courts found an assignment of income).

95. See *supra* notes 63-76 and accompanying text.

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

97. *Id.*

trees in his orchard.”<sup>98</sup> When the Fifth Circuit revisited the issue in *Srivastava*, its reasoning was considerably less clear. After discussing assignment in general, the court stated “control over that claim — the income source or ‘tree’ — is neither fully divested to the attorney nor fully retained by the taxpayer-client.”<sup>99</sup> This effort to characterize the transaction as a tenancy in common, after earlier having called it an assignment,<sup>100</sup> only serves to confuse the issue. The *Estate of Clarks* court made a similar effort, indicating the attorney and the client had formed a partnership in order to prosecute the claim.<sup>101</sup>

Whatever their reasoning, these courts clearly reject the idea that an assignment of income occurred,<sup>102</sup> unless one concludes that these courts do not think assigned income taxable unless done in an anticipatory fashion meant to avoid taxation. The only coherent theory rests on the plaintiff exchanging a portion of her claim for her attorney’s services. This theory, however, presents a problem. States other than Wisconsin still legally bar attorneys from receiving an assignment of part of the claim.<sup>103</sup> In fact, the bar was almost universal throughout the legal systems descended from the English common law.<sup>104</sup> Describing these transfers, when the law apparently bars categorizing them as partial assignments, remains a dilemma.

Faced with this quandary, the Fifth and Sixth Circuits have sided with reality, treating the contingent-fee agreement as a partial transfer. The well-intentioned but dubious notion that preventing lawyers from acquiring causes of action will reduce frivolous lawsuits against the innocent<sup>105</sup> should not impede the use of contingency-fee agreements. Many potential plaintiffs with a valid cause of action

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98. *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 858 (6th Cir. 2000) (utilizing the tree analogy from *Lucas*). In *Lucas*, Justice Holmes attacked arrangements “by which the fruits are attributed to a different tree from that on which they grew.” *Lucas v. Earl*, 281 U.S. 111, 115 (1930). Subsequent cases have attempted to determine if the trees themselves, or solely the fruit have been transferred. See, e.g., *Estate of Clarks*, 202 F.3d at 858.

99. *Srivastava v. Comm’r*, 220 F.3d 353, 359-60 (5th Cir. 2000).

100. See *id.* at 360.

101. *Estate of Clarks*, 202 F.3d at 858.

102. *Id.* at 857; *Cotnam*, 263 F.2d at 125.

103. See, e.g., *Drake v. Northwest Natural Gas Co.*, 165 A.2d 452, 453 (Del. Ch. 1960). Apparently the fear is if lawyers could sue on others’ causes of action, frivolous litigation would increase because lawyers would sue in situations where those actually injured would not. See *id.* at 454; Amkraut, *supra* note 89, at 751-52. But, as applied, this results in a very narrow ban. New York seems mainly concerned that lawyers will take cases involving minimal damages and try to profit by forcing the defendant to pay huge legal fees. See *Drake*, 165 A.2d at 453-54.

104. See *Martin*, *supra* note 89, at 75-79 (discussing champerty laws in Canada and Australia); Painter, *supra* note 81, at 639 (stating that champerty, including contingent-fee agreements, is still illegal in England).

105. See *Martin*, *supra* note 89, at 58 (describing the intent behind champerty doctrines).

cannot afford the great cost of litigating the matter in court.<sup>106</sup> For the legal system to fulfill its societal function it must hold wrongdoers accountable for their actions.<sup>107</sup> Access to justice requires the availability of contingent-fee agreements, as does the State's ability to influence behavior through the granting of private rights of action.<sup>108</sup> So in the name of equity, and in the interest of society, courts give a wink and a nod toward contingent-fee contracts — and even enforce them.<sup>109</sup> Courts do so despite the fact these contracts assign part of the claim and give attorneys rights even when, under a pure contingent-fee agreement, they would have none.<sup>110</sup>

The best indicator that the partial assignment of the claim argument needs careful attention is how the courts that deny that a partial assignment occurred have insisted on treating the issue. They distinguish their opinions based, not on their dislike for the partial assignment of the claim legality,<sup>111</sup> but on how the state in question applies its attorney lien laws.<sup>112</sup> This effort to distinguish *Cotnam* has led many observers astray. One adherent of the majority approach meticulously analyzed each state's attorney-charging statute to predict whether *Cotnam* might apply there.<sup>113</sup> This analysis included a section stating

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106. Karsten, *supra* note 87, at 239-42; Martin, *supra* note 89, at 58; Schneyer, *supra* note 89, at 376.

107. See Schneyer, *supra* note 89, at 376 (stating that contingent-fee agreements allow enforcement through liability rules thus easing the state's need for administrative rules). Professor Schneyer states that civil suits function not only to avoid injustice; they also allow the State to deter wrongful conduct by granting a private right of action in lieu of costly administrative rules or penal statutes. *Id.*

108. See Schneyer, *supra* note 89, at 376 (claiming elimination of contingent-fee agreements would weaken the State's power).

109. See, e.g., *Kenseth II*, *supra* note 15, 259 F.3d 881, 883-84 (7th Cir. 2001) (explaining that because attorneys are barred from acquiring ownership of a claim, an assignment of the claim obviously did not occur, and contingent-fee agreements do not offend champerty doctrines because they are equivalent to any other form of debt).

110. See Painter, *supra* note 81, at 640 (“[A] partial assignment of course occurs when a lawyer charges a contingent fee.”); Donna A. Schneiter, Note, *Attorney's Divorces: Are Their Pending Contingency Fee Cases Marital Assets or Not?*, 37 BRANDEIS L.J. 829, 840 (1999) (“[A] contingency fee contract is ‘a valuable property right’ even when the underlying case has not settled or been adjudicated.”); see also Schneyer, *supra* note 89, at 376-77 (claiming that lawyers are investing in claims).

111. The *Young* court specifically considered and rejected the proposition that a contingent-fee arrangement constitutes a partial assignment, but then went on to say *Cotnam* and *Estate of Clarks* relied on state law for their holdings. *Young v. Comm'r*, 240 F.3d 369, 378 (4th Cir. 2001).

112. See *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000) (pointing out Alaska's attorney lien statute grants no ownership interest to attorneys over the judgment); *Kenseth I*, *supra* note 10, 114 T.C. 399, 409 (2000) (stating that the tax court ignores the concurrence offered by Judges Rives and Brown despite the fact the dissenting judge wrote the holding itself); Davis, *supra* note 39 (exploring various courts' focus on the attorney lien issue); Rasmussen, *supra* note 74, at 310 (claiming the First, Ninth and Federal Circuits are especially likely to use this approach).

113. See Davis, *supra* note 39.

that Texas lien laws were distinguishable, with a cite to the Tax Court's treatment of *Srivastava*.<sup>114</sup> The analysis failed, not because the statutes are not distinguishable, but because, in truth, no one really cares about these statutes or their common law equivalents. These statutes merely provide courts a convenient means of distinguishing *Cotnam* without reaching the Fifth Circuit's problematic conclusion that contingent-fee agreements assign part of the claim. As the *Kenseth I* dissent pointed out, the courts have distinguished *Cotnam* on the narrow ground so often that they have obscured the broader holding.<sup>115</sup>

Thus, the Fifth and Sixth Circuits almost completely disregard that which so many other courts feign so much interest in. On appeal, the *Srivastava* Court found *Cotnam* indistinguishable from the case at bar, despite Texas attorneys' rights being wholly derivative of their clients' rights.<sup>116</sup> As noted earlier, the Sixth Circuit in *Estate of Clarks* glossed over any differences in attorney-charging statutes saying Alabama's — supposedly highly distinguishable<sup>117</sup> — statute and Michigan's common law version were “more or less” the same.<sup>118</sup> In fact, when *Kenseth* tried to use this approach with the Seventh Circuit, Judge Posner tartly replied that every state, to his knowledge, gave the attorney “a lien on the proceeds of any settlement or judgment to the extent of the contingent fee.”<sup>119</sup>

### B. *The Case for Partial Assignment of the Claim*

Because contingent-fee agreements transfer so much control over the handling of a claim, it is difficult to argue that the plaintiff transfers a mere interest in the judgment to the attorney. The exact level of control an attorney exercises over a claim upon accepting a case

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114. *Davis*, *supra* note 39, at 1716.

115. The narrow ground being the specific statute at issue in *Cotnam*. Judge Beghe also noted the record remains unclear whether anyone even mentioned the Alabama statute in the Tax Court phase of the *Cotnam* saga. *Kenseth I*, *supra* note 10, 114 T.C. 399 at 434 n.34 (2000) (Beghe, J., dissenting).

116. *Srivastava v. Comm'r*, 220 F.3d 353, 364 n.33 (5th Cir. 2000). The dissent argued that the case was distinguishable from *Cotnam* on this basis. *Id.* at 367-68. (Dennis, J., dissenting). One commentator believes the Fifth Circuit implicitly held no future decisions would be based on the attorney lien laws. *See* Polsky, *supra* note 94, at 918 n.16.

117. Title 46, section 64 of the Code of Alabama allows the attorney's lien to attach when he files the complaint, rather than at judgment like other states. *Davis*, *supra* note 39, at 1689-90. The attorney's lien also takes precedence over the plaintiff's set off and other liens, except tax liens. *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Davis*, *supra* note 39, at 1687.

118. *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 856 (6th Cir. 2000).

119. *Kenseth II*, *supra* note 15, 259 F.3d 881, 882 (7th Cir. 2001).



remains a subject of debate.<sup>120</sup> The fact that the attorney gains a great deal of control at the signing of a contingent-fee contract, however, stands as a given. Those not qualified to press their own claims hire attorneys familiar with the system and capable of working within it to achieve a particular goal.<sup>121</sup> The attorney is the expert in this situation, estimating the claim's worth,<sup>122</sup> and determining how to handle discovery and pretrial.<sup>123</sup> The client will generally defer to the attorney on trial strategy, and even on whether or not to accept or reject settlement offers.<sup>124</sup> Clients generally do not have any concept of what a reasonable fee should be, or what the lawyer's fee will be in the end.<sup>125</sup> Practically speaking, the attorney's de facto level of control is almost total.

The counter argument that the ultimate control over the suit remains with the plaintiff-client fails to adequately consider the reality of the situation. Those who do not wish to view contingency-fee lawsuits as partial assignments of the claim dismiss lack of control arguments.<sup>126</sup> They note clients retain ultimate control over the case because they can fire their attorneys if displeased with their efforts.<sup>127</sup>

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120. See Amkraut, *supra* note 89 at 763; Douthitt, *supra* note 86, at 183 (recounting the court's fear that clients lose control of litigation upon signing of contingent-fee agreement); Arthur R. Miller, *The Adversary System: Dinosaur or Phoenix*, 69 MINN. L. REV. 1, 18 (1984) (stating that the mystique of high stakes litigation deters control); Schneyer, *supra* note 89, at 374 (discussing the use of contingent-fee agreements to discourage the changing of counsel — thus retaining control of the litigation).

121. Cf. Karsten, *supra* note 87, at 241-42 (quoting historical material saying rights mean nothing without the ability to enforce them through legal representation).

122. See Painter, *supra* note 81, at 663-64, 691; cf. Schneyer, *supra* note 89, at 403 (implying attorneys evaluate the worth of claims but withhold this estimate from clients); Amkraut, *supra* note 89 at 763 (treating lawyers as investors who use contingent-fee agreements to get a good return on their investment).

123. Cf. F.B. MACKINNON, CONTINGENT FEES FOR LEGAL SERVICES: A STUDY OF PROFESSIONAL ECONOMICS AND RESPONSIBILITIES 62 (1964) (claiming contingent fees give lawyers control of litigation); Richard M. Birnholz, Comment, *The Validity and Propriety of Contingent Fee Controls*, 37 UCLA L. REV. 949, 955 (1990) (claiming that lawyers can control litigation because of clients' ignorance); Miller, *supra* note 120, at 18 (discussing pretrial hyperactivity which "keeps the meter running"); Schneyer, *supra* note 89, at 377, 394 (accusing lawyers of shirking by pursuing clients' claims less vigorously than they should).

124. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 445 (2000) (Beghe, J., dissenting); MACKINNON, *supra* note 123 at 196 (maintaining lawyers control settlements and some plaintiffs never figure out what they got); Schneyer, *supra* note 89 at 389, 394; Philip J. Havers, Student Article, *Take the Money and Run: Inherent Ethical Problems of the Contingency Fee and Loser Pays Systems*, 14 NOTRE DAME J.L. ETHICS & PUB. POL'Y 621, 626 (2000).

125. See Birnholz, *supra* note 123, at 954.

126. See *Kenseth II*, *supra* note 15, 259 F.3d 881, 884 (7th Cir. 2001); *Young v. Comm'r*, 240 F.3d 369, 378 (4th Cir. 2001).

127. See *Young*, 240 F.3d at 378; Amkraut, *supra* note 89, at 378; Douglas G. Hickel, Comment, *Losing in the Tax System After You Win in the Court System: Should Contingent Fees Paid to the Attorney Be Included in the Taxpayer-Client's Gross Income?*, 20 ST. LOUIS

Yet this right often proves illusory in practice. The contingent-fee lawyer dropped from a case does not go away empty handed.<sup>128</sup> Courts routinely handle such situations by forcing the client to reimburse the fired attorney at an hourly rate for any work already done on the case.<sup>129</sup> Other courts willingly enforce the contingent-fee contract, granting the lawyer whatever share the agreement calls for out of the final judgment.<sup>130</sup> One court went so far as to allow the lawyer to press the claim even after the client no longer wished to pursue it,<sup>131</sup> while another stated if a partial assignment did occur, the attorney had a right against being discharged.<sup>132</sup> To maintain that the client still retains control in such situations reduces control to a theoretical, rather than an actual, right. Control is of little practical consequence when its exercise would cause two sets of lawyers' fees to eat up the entire award. Add to this the fact that the courts advocating the ultimate control theory also force taxpayers to pay taxes on both their share and the attorneys' contingent fees, and one can easily see why any client who needs the money in controversy cannot possibly afford to switch attorneys in most situations.<sup>133</sup>

To clarify the nature of these agreements, it proves useful to consider how the contingent-fee contracts themselves address ownership of the claim issues. The contract at issue in *Srivastava* stated the client agreed to "sell, transfer, assign and convey to my said attorneys the respective undivided interests in and to my said claim."<sup>134</sup> Attorneys also routinely include language to retain control over settlement talks.<sup>135</sup> Because of a real possibility the lawyer's and client's interests will

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U. PUB. L. REV. 477, 487 (2001) (maintaining clients retain a high level of actual control because they can always discharge the lawyer).

128. See MACKINNON, *supra* note 123, at 80 (claiming courts protect contingent-fee attorneys at clients' expense).

129. See, e.g., *Chase v. Superior Court*, 27 Cal. Rptr. 383, 385 (Dist. Ct. App. 1962) (holding attorney was entitled to actual and reasonable price for services); *Phelps v. Elgin*, 184 N.E.2d 799, 801 (Ill. App. Ct. 1962).

130. See *Phelps*, 184 N.E.2d at 802-03 (English, J., concurring) (stating that the contract should be enforced as written); *Maw v. Noble*, 354 P.2d 121, 123 (Utah 1960).

131. See *Tex. Cent. R.R. Co. v. Andrews*, 67 S.W. 923, 924 (Tex. Civ. App. 1902) (allowing the attorney-assignee to prosecute to judgment in the name of the assignor).

132. See *Chase*, 27 Cal. Rptr. at 386 (involving cases of a contract coupled with an interest).

133. Such was the case in Paula Jones's lawsuit against President Clinton. Based on the reported amounts involved, if Jones must pay tax on the portion of her settlement going towards attorneys' fees, her entire \$850,000 settlement would go towards attorneys' fees and taxes, plus she would have to pay another \$38,000 out of pocket. James Serven, *The Federal Income Tax Treatment of Contingent Legal Fees in Personal Injury Cases*, 30 COLO. LAW. 81, 82 (2001).

134. *Srivastava v. Comm'r*, 220 F.3d 353, 368 (5th Cir. 2000).

135. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 401 (2000); *Ward v. Orsini*, 152 N.E. 696, 697 (N.Y. 1926); *Karsten*, *supra* note 87, at 252.

diverge,<sup>136</sup> attorneys often insert clauses forbidding the client from compromising or settling the case without the attorney's consent.<sup>137</sup> Although courts generally will not allow contracts that prohibit clients from settling, they do allow clauses saying clients must consult their attorney before settling.<sup>138</sup> Other courts allow implicit bars by permitting the plaintiff's attorney to sue a defendant who settles directly with a plaintiff despite knowing of the contingent-fee agreement.<sup>139</sup> Thus, although the client supposedly decides if a settlement has been reached and for how much, in reality the attorney usually makes such decisions.<sup>140</sup>

One should not, however, view control as a monolithic entity, incapable of being split between numerous people. The crucial question hinges on whether the plaintiff retained enough control to attribute the portion of the award dedicated to the lawyer to the client also.<sup>141</sup> Obviously, a complete assignment did not occur,<sup>142</sup> but this fact does not indicate the plaintiff retained sole control.<sup>143</sup> Plaintiffs' lawyers now commonly refuse to take a case on anything but a contingency basis,<sup>144</sup> and such contracts inevitably constitute adhesion contracts — where the courts typically view the party purchasing services as vulnerable and lacking options and control.<sup>145</sup> Thus, clients have little control over payment methods.<sup>146</sup> Attorney control over other aspects of the case becomes clear in situations where the client

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136. Painter, *supra* note 81, at 671-72.

137. See *Kenseth I*, *supra* note 10, 114 T.C. at 401; *Ward*, 152 N.E. at 697 (stating that the lawyer gets half of any settlement concluded without his consent); Karsten, *supra* note 87 at 252. *But see id.* at 251 ("Courts decisively and consistently held contingency fee contracts that prohibited clients to settle to be void as contrary to public policy.")

138. See *Ward*, 152 N.E. at 697-99 (allowing attorney to claim half of settlement because plaintiff settled without lawyer's consent).

139. See *Kenseth I*, *supra* note 10, 114 T.C. at 438 (Beghe, J., dissenting); *Tex. Cent. R.R. Co. v. Andrews*, 67 S.W. 923, 925 (Tex. Civ. App. 1902). *But see Henslee, Monek & Henslee v. D.M. Cent. Transp., Inc.*, 870 F. Supp. 764, 767-68 (E.D. Mich. 1994) (refusing to allow contingent-fee attorney action in tort against insurance company which settled with client without attorney's input; any agreement barring plaintiff from settling without attorney permission is void as against public policy).

140. See *Havers*, *supra* note 124, at 626.

141. See *Kenseth I*, *supra* note 10, 114 T.C. at 442, 448 (Beghe, J., dissenting).

142. See *Rasmussen*, *supra* note 74, at 303 (noting that this would require a complete divestment of control).

143. See *supra* notes 120-124 and accompanying text.

144. See *Kenseth I*, *supra* note 10, 114 T.C. at 422 (Beghe J., dissenting); Painter, *supra* note 81, at 662-63.

145. *Cf. Kenseth I*, *supra* note 10, 114 T.C. at 422 (Beghe, J., dissenting) (noting contingent-fee agreement is a standard form contract without which plaintiff's attorney would not have represented him).

146. See *id.* (Beghe, J., dissenting); Painter, *supra* note 81, at 662-63; Sheridan, *supra* note 42, at 300 n.139.

has little legal knowledge.<sup>147</sup> A lawyer might file in a court of general jurisdiction on the chance that it will lead to a higher award when a court of limited jurisdiction would be better for the client's overall chances of recovery.<sup>148</sup> A lawyer may settle quickly after doing little work for a high hourly fee, or drag the case out in hopes of a huge payoff.<sup>149</sup> A client unsophisticated in legal strategies will not even know such issues exist.<sup>150</sup> This list does not even consider cases where the lawyer manipulates the clients themselves.<sup>151</sup> Some courts try to get around such realities by asking who the bona fide owner is, thus ignoring who the actual owner is.<sup>152</sup> But in the end, no matter the semantic intricacies, the system gives the attorney a strong financial interest in the claim.<sup>153</sup> Attorneys become almost a separate party, with their own interests and motivations.<sup>154</sup>

Faced with this difficult situation, the Fifth and Sixth Circuits adopted an equitable solution with a minimum of legal analysis.<sup>155</sup> They followed the example of earlier courts, confronted with champerty cases, who avoided classifying the matter before them by declaring what categories it did not fall into.<sup>156</sup> Thus, the Fifth and Sixth Circuits state that these cases do not implicate the anticipatory assignment of income doctrine and then move on from there.<sup>157</sup> Left

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147. See Miller, *supra* note 120, at 18 (claiming the mystique of litigation deters control).

148. MACKINNON, *supra* note 123, at 201.

149. See Havers, *supra* note 124, at 630 (citing MACKINNON, *supra* note 123, at 198-99).

150. Cf. Painter, *supra* note 81, at 671-74, 691 (claiming lawyers have an informational advantage over client). While such acts may be unethical, see MODEL RULES OF PROF'L CONDUCT R. 1.4 (1983), pretending they do not occur helps no one — except the unethical lawyers.

151. See, e.g., Schneyer, *supra* note 89, at 389 n.76 (discussing a study claiming New York personal injury lawyers tend to tell their clients the defendant offered less than they truly did, then later reveal this higher number as a second offer and persuade the client to take it (citing DOUGLAS ROSENTHAL, LAWYER AND CLIENT: WHO'S IN CHARGE? 110-11 (1974))).

152. See Drake v. Northwest Natural Gas Co., 165 A.2d 452, 454 (Del. Ch. 1960) (finding that claimant was the bona fide owner of a claim derailed champerty claim). Whether a court would make such a distinction after *Frank Lyon* is open to debate. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978) (mandating looking to the economic realities of a situation); see also Ray A. Knight & Lee G. Knight, *Substance over Form: The Cornerstone of Our Tax System or a Lethal Weapon in the IRS's Arsenal?*, 8 AKRON TAX J. 91, 92-97 (1991) (detailing the Supreme Court's development of the substance over form distinction).

153. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 450 (2000) (Beghe, J., dissenting).

154. Havers, *supra* note 124, at 625.

155. See *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 857 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119, 126 (5th Cir. 1959).

156. See *Cotnam*, 263 F.2d at 125; *Srivastava v. Comm'r*, 220 F.3d 353, 360 (5th Cir. 2000); *Estate of Clarks*, 202 F.3d at 857.

157. See *Cotnam*, 263 F.2d at 125; *Srivastava*, 220 F.3d at 360; *Estate of Clarks*, 202 F.3d at 857.

unsaid, or stated with little further attention, if not an anticipatory assignment of income, the transaction must be a partial assignment of the claim itself.<sup>158</sup> These federal courts find it galling to make plaintiffs pay taxes on the portion of their claims surrendered for the privilege of vindicating their rights.<sup>159</sup>

If, however, the plaintiff has in fact assigned a portion of the claim to his attorney, this assignment also has tax consequences.<sup>160</sup> Because this matter ultimately turns on a tax issue, one should remember the Internal Revenue Service (“IRS”) traditionally looks to the substance of a transaction, deeming the form utilized irrelevant to tax liability.<sup>161</sup> If one accepts that a partial assignment occurred, then applicable case law exists to deal with this situation.<sup>162</sup> While the anticipatory assignment of income doctrine does not apply, the anticipation of income doctrine does.<sup>163</sup> In contingent-fee cases, the IRS should not tax the plaintiff on what the attorney collects because that portion of the claim was transferred irrevocably and forever.<sup>164</sup> The plaintiff, as well as the attorney, did, however, recognize a gain when the transfer occurred.<sup>165</sup>

The attorney’s payment to the plaintiff for a portion of the claim — legal services — should trigger the same tax consequences as would a payment from the judgment itself.<sup>166</sup> Though one can think of this as

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158. See *Cotnam*, 263 F.2d at 125; *Srivastava*, 220 F.3d at 359; *Estate of Clarks*, 202 F.3d at 858.

159. See *Srivastava*, 220 F.3d at 362 n.28 (quoting *Cotnam* and *Estate of Clarks* passages concerning worthlessness of the claim without an attorney and stating that the only economic benefit of an attorney is to collect a portion of what plaintiff really deserves); *Estate of Clarks*, 202 F.3d at 857; *Cotnam*, 263 F.2d at 126.

160. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 411 n.4 (2000) (maintaining that even if the Sixth Circuit is correct, a taxable event has occurred); *Polsky*, *supra* note 94, at 917 (claiming that a proper analysis includes the attorney’s fee in plaintiff’s gross income because of § 83).

161. *Amkraut*, *supra* note 89, at 763.

162. See generally *Hort v. Comm’r*, 313 U.S. 28 (1941) (discussing anticipation of income); *Blair v. Comm’r*, 300 U.S. 5 (1937) (same).

163. See *Hort*, 313 U.S. at 28.

164. While the client could conceivably get the claim back, see, e.g., *Chase v. Superior Court*, 27 Cal. Rptr. 383, 385 (Cal. Dist. Ct. App. 1962) (stating plaintiff has to pay fired attorney at hourly rate but will get entire judgment for himself), it will not return in the normal course of events, cf. *Evans v. Comm’r*, 54 T.C. 40 (1970) (placing repeated emphasis on the fact that the taxpayer transferred everything he had, not just the right to interest). While the court may in effect force the attorney to sell that portion of the claim back, the client will have to pay to get it back. See *Chase*, 27 Cal. Rptr. at 385. Provisions for a buyback upon the occurrence of a given event do not prevent recognizing that a transfer occurred.

165. See *Hort*, 313 U.S. at 31 (holding that transfer caused realization of gain); *Cotlow v. Comm’r*, 22 T.C. 1019, 1022 (1954) (stating that realization occurs upon the complete alienation of title to property for valuable consideration).

166. See *Hort*, 313 U.S. at 31-32 (holding that payment for early cancellation of a lease is treated the same as lease payments would be); *Cotlow*, 22 T.C. at 1022 (holding that insur-

an “in lieu of” test,<sup>167</sup> it derives from long-established tax principles.<sup>168</sup> This proposal, however, presents a problem in regard to measuring the amount of gain realized.<sup>169</sup>

### III. ESTABLISHING A VALUE FOR THE CAUSE OF ACTION

This Part argues that applying section 83 of the Internal Revenue Code to contingent-fee situations, while seemingly reasonable, proves inappropriate upon closer inspection. Section III.A concludes that sections 83 and 162 are not well suited to deal with the current dilemma. Section III.B disputes whether a contingent-fee agreement can be considered an unvested interest in property, thus avoiding the ambit of section 83 altogether. Section III.C advocates viewing the exchange of a portion of the claim for legal services from a barter perspective.

#### A. Section 83 Mainly Applicable to the Employee-Attorney

The solution proposed by some scholars, to tax the transfer under section 83,<sup>170</sup> would fail to adequately address the problem at hand. Though section 83 deals with the transfer of property for services,<sup>171</sup> it was not designed for the contingent-fee situation. Section 83 deals with employers' payments to employees or independent contractors.<sup>172</sup> While this section might seem to apply at first, a careful reading of the language implies otherwise.<sup>173</sup> Consider that section 83 deals mainly with the tax consequences of receiving income not redeemable until sometime in the future.<sup>174</sup> The main proponent of applying section 83

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ance agent who purchased other agents' rights to renewal commissions is taxed as those agents would be).

167. See Hickel, *supra* note 127, at 498 (advocating applying the Raytheon “in lieu of” test).

168. See *Hort*, 313 U.S. at 31 (“Where . . . the disputed amount was essentially a substitute for rental payments . . . it must be regarded as ordinary income . . .”).

169. See Hickel, *supra* note 127, at 495-96 (describing the difficulty ensuing because the cause of action does not have a definite value).

170. Polsky, *supra* note 94, at 917. *But see* Robert W. Wood, Letter to the Editor, *Leave Section 83 out of this Mess*, 89 TAX NOTES 1187, 1187-88 (Nov. 27, 2000) (claiming this would be a strain).

171. I.R.C. § 83 (1999) (regarding property transferred in connection with performance of services).

172. See I.R.C. § 83(a). Reading Polsky's article one rather gets the impression he thinks the plaintiff should be taxed under this section. Polsky, *supra* note 94, at 920. That is not possible. This section deals with the taxation of the employee — the lawyer — not the employer — the plaintiff. See I.R.C. § 83.

173. See I.R.C. § 83.

174. See I.R.C. § 83(a). Rasmussen makes a similar error when he cites to Polsky. See Rasmussen, *supra* note 74, at 315-16. He says *transferors* should have to include the fair market value of what they gave up in their *own* income. *Id.*

acknowledges that section 83 was meant to deal primarily with stock options,<sup>175</sup> and a quick glance at the section and the accompanying Treasury regulations easily bears this out.<sup>176</sup> The proposition that the legislative history of this section indicates it was meant to deal with all transfers of property for services is not well taken.<sup>177</sup> Simply because it could be stretched to deal with this situation, does not make it the only, let alone the best, solution.

Within section 83, only section 83(h) deals with the tax consequences to the employer making the expenditures.<sup>178</sup> Section 83(h), in turn, refers the reader to section 162, where the code allows a deduction for business and trade expenses.<sup>179</sup> If section 83 did truly apply to contingent-fee agreements, it would explain what the courts in the minority have already been doing, allowing the plaintiffs to deduct collection fees — in the form of attorneys' fees — from their gross income.<sup>180</sup> The idea that these taxpayers can fit in under this section presents an extremely questionable proposition. A hobby or occasional pursuit does not qualify as a trade or business.<sup>181</sup> The suggestion that taxpayers can create a business by suffering harms and then litigating to procure judgments or settlements offers an unrealistic scenario at best.<sup>182</sup> Even if the judge did accept this proposition, it appears unlikely the taxpayer could engage in this behavior frequently enough to meet the definition of trade or business.<sup>183</sup> It should be noted, however, the courts do give trade or business under this section

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175. Polsky, *supra* note 94, at 919 (referring to the legislative history).

176. See I.R.C. § 83(c)(3) (regarding sales which may give rise to suit under § 16(b) of the Securities and Exchange Act); Treas. Reg. § 1.83-1(f) (1978) (listing three examples, all involving stock); Treas. Reg. § 1.83-3(a)(7) (as amended in 1985) (listing five examples, all involving stock); Treas. Reg. § 1.83-3(c)(4) (as amended in 1985) (listing five examples, all involving stock); Treas. Reg. § 1.83-5(c) (1978) (listing four examples, all involving stock); Treas. Reg. § 1.83-7 (1978) (dealing specifically with the taxation of nonqualified stock options).

177. Polsky, *supra* note 94, at 919.

178. I.R.C. § 83(h) (2003) (dealing with deduction by employer).

179. I.R.C. § 162 (1998).

180. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 407 n.3 (2000) (noting that if recovery is received in a business setting, attorneys' fees are fully deductible).

181. See *Comm'r v. Groetzinger*, 480 U.S. 23, 24, 36 (1987) (finding man who spent sixty to eighty hours a week gambling was in the trade or business of gambling); *Olson*, *supra* note 77, at 1208-10 (sustaining IRS's contention that horse breeding operation was not a business because no true business would operate at such losses for such a long time, and it must therefore be an operation not engaged in for profit under § 183). *But see id.* at 1209 n.57 (saying taxpayers who use business-like methods will almost always be found to be in trade or business because of good faith standard).

182. See *Groetzinger*, 480 U.S. at 35 (“to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity. . .”).

183. *See id.*

a truly expansive definition.<sup>184</sup> One professor even proposed that O.J. Simpson could subtract his legal fees resulting from the criminal and civil cases against him arising out of his wife's murder under section 162.<sup>185</sup>

The origin of the claim test may actually apply to a number of the contingent fee line of cases, including *Srivastava*, *Cotnam* and *Estate of Clarks*, by allowing them in the backdoor of section 162. The origin of the claim test asks if the expenditure arose "in connection with the taxpayers' business or income producing activities rather than their personal activities[.]"<sup>186</sup> Though the Court never established an exact definition of business activity,<sup>187</sup> it reads the "income producing activities" language broadly.<sup>188</sup> In fact, the Eleventh Circuit has noted "various courts, including the Tax Court have implicitly held that a taxpayer may be engaged in the trade or business of being an employee,"<sup>189</sup> and the Seventh Circuit concluded "it is well settled that an employee's activities constitute a trade or business. . . ."<sup>190</sup> The legal system long ago accepted that employees engage in a trade or business.<sup>191</sup> The Supreme Court considers business a comprehensive term, that which occupies the time, attention and labor of men.<sup>192</sup> Some commentators contend that courts often actually apply a connectedness or motive test to reach these unusual results.<sup>193</sup>

Under such a generous reading as this, Mrs. Cotnam, Dr. Srivastava, and possibly the estate of Mr. Clarks could all subtract their legal fees from their gross income if section 83 — and thereby

184. *See id.* at 33 ("If a taxpayer . . . devotes his [full time to the] activity . . . and it is his intended livelihood source . . . basic concepts of fairness . . . demand that his activity be regarded as a trade or business . . .").

185. Dorocak bases this argument on Simpson's contention that the police framed him because of his status as a minority celebrity. Thus, the police would be motivated by the goal of ruining Simpson and his trade of marketing himself as a likable personality and spokesperson. Defending against the criminal charges and lawsuit would constitute the only way to protect his trade. *See* John R. Dorocak, *Sports and Entertainment Figures (and Others) May Be Able to Deduct Legal Expenses for Criminal Prosecutions (and Wrongful Death Suits)*, 13 AKRON TAX J. 1, 4-5 (1997).

186. Edward J. Schnee & Nancy J. Stara, *The Origin of the Claim Test: A Search for Objectivity*, 13 AKRON TAX J. 97 (1997). The origin of the claim test originated in *United States v. Gilmore*, 372 U.S. 39 (1963).

187. *See* Schnee & Stara, *supra* note 186, at 107-08.

188. The IRS has actually characterized some people as being in a trade or business against their wishes. *See* Olson, *supra* note 77, at 1220-25.

189. *Steffens v. Comm'r*, 707 F.2d 478, 482 (11th Cir. 1983).

190. *Groetzinger v. Comm'r*, 771 F.2d 269, 276 (7th Cir. 1985).

191. Olson, *supra* note 77, at 1224 & n.160.

192. *Comm'r v. Groetzinger*, 480 U.S. 23, 27-28 (1987). *But see* Olson, *supra* note 77, at 1212-13 (stating that the IRS has held profit motive alone is not enough).

193. *See* Dorocak, *supra* note 185, at 3.



section 162 — applies.<sup>194</sup> All of their suits emerged from their “trade or business” of working.<sup>195</sup> Mrs. Cotnam sued when she was not bequeathed her promised share of Mr. Hunter’s estate for her work as his attendant.<sup>196</sup> Dr. Srivastava’s suit emerged from a local television investigative report of his medical practice.<sup>197</sup> The estate of Mr. Clarks could possibly use section 162, depending on what capacity he was acting in when struck on the head while unloading his truck.<sup>198</sup> This interpretation, while interesting, and certainly beneficial to the plaintiff, seems an unlikely reading, and stands little chance of being accepted by the Internal Revenue Service or the courts.<sup>199</sup> Additionally, section 162(a)(1)’s requirement that salaries paid must be reasonable might prevent plaintiffs from utilizing this section.<sup>200</sup> Much of the controversy surrounding contingency fees and their taxation springs from the sometimes astronomical per hour rates.<sup>201</sup>

### B. *No Substantial Risk of Forfeiture Exists*

Another potential problem emerges in considering whether to apply section 83 to the situation at hand. Section 83 only applies when an employer offers an employee an unvested interest in property.<sup>202</sup> This includes situations entailing a substantial risk of forfeiture.<sup>203</sup> Gaining a partial assignment of a claim, however, may very well not fall under this heading. The text does make clear that, if the employee

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194. See *Kenseth I*, *supra* note 10, 114 T.C. 399, 407 n.3 (2000) (discussing the differences in tax treatment in regard to businesses and individuals).

195. See *Srivastava v. Comm’r*, 220 F.3d 353, 355 (5th Cir. 2000) (doctor); *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 855 (6th Cir. 2000) (trucker); *Cotnam v. Comm’r*, 263 F.2d 119, 120-21 (5th Cir. 1959) (personal attendant).

196. *Cotnam*, 263 F.2d at 120-21.

197. *Srivastava*, 220 F.3d at 355.

198. It is unclear from the appellate opinion whether Mr. Clarks was shopping at K-Mart in a personal capacity, making a delivery, or if he in fact worked for K-Mart. See *Estate of Clarks*, 202 F.3d at 855. The facts given in the district court opinion, however, imply that he was working at the time. *Estate of Clarks ex rel. Brisco-Whitter v. United States*, No. 96-CV-60446-AA, 1998 WL 839415, at \*1 (E.D. Mich. Nov. 23, 1998).

199. See *Purdey v. United States*, 39 Fed. Cl. 413, 418 (1997) (saying ordinary and necessary expenses of conducting a business are deductible under § 162 unless the trade or business consists of service performed as an employee).

200. See I.R.C. § 162(a)(1) (1999); Robert I. Keller, *The Taxation of Barter Transactions*, 67 MINN. L. REV. 441, 443 n.10 (1982) (discussing “reasonable allowance” for salaries and other compensation).

201. See *Schneyer*, *supra* note 89, at 372 (explaining the argument that contingent fees produce windfalls for the lawyer); *Painter*, *supra* note 81, at 635, 652-53 (advocating regulation of contingent fees to curb excessive fees); *Schneiter*, *supra* note 110 (stating contingent fee may work out to much more than a reasonable hourly fee).

202. See I.R.C. § 83(a) (1999).

203. I.R.C. § 83(a)(1).

must still perform substantial work before the property vests in him, then a substantial risk of forfeiture exists.<sup>204</sup> But the Treasury regulations explain that a nonlapsing condition does not represent a substantial risk of forfeiture if such forfeiture would occur only if the employer discharged the employee for cause.<sup>205</sup> Some imply that if leaving voluntarily would cause a forfeiture, there is a substantial risk of forfeiture as envisioned by section 83.<sup>206</sup> Treasury Regulation section 1.83-3(c)(2), however, states that if an employee must return the property upon accepting a job with a competing firm, this possibility will generally not qualify as a substantial risk of forfeiture.<sup>207</sup> By extension, if the employee only loses the property because of a voluntary resignation, for any reason before vestment, this should not qualify as a substantial risk of forfeiture.<sup>208</sup>

Once the attorney and client sign the contingent-fee agreement, a substantial risk of forfeiture no longer exists.<sup>209</sup> The law barring potential plaintiffs from assigning their claims to attorneys developed because policy makers judged it unwise to give lawyers that level of control over a claim.<sup>210</sup> Applying section 83, however, indicates an acceptance of the proposition that such an assignment did occur. To then turn around and then argue a substantial risk of forfeiture exists seems, at the least, inconsistent. If clients fire their lawyers for anything but cause, the courts will order reimbursement of either the entire contingent fee specified in the contract, or at the very least at an hourly rate.<sup>211</sup> And if the court decides to base its decision on whether a substantial amount of work was still required, this would necessitate a case-by-case analysis. Although ethical rules often prohibit taking cases on a contingent-fee basis when the case will require very little work and when such an arrangement is clearly not in the client's best

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204. I.R.C. § 83(c)(1) (1999).

205. Treas. Reg. § 1.83-3(c)(2) (as amended in 1985).

206. See Polsky, *supra* note 94, at 921.

207. Treas. Reg. § 1.83-3(c)(2).

208. *Cf. id.* (stating that a chance of voluntary departure does not constitute a substantial risk of forfeiture).

209. Amkraut refers to this as a limited risk of forfeiture. Amkraut, *supra* note 89 at 763 n.88.

210. See *id.* at 751-52 (recounting common law concerns about lawyers owning their clients' claims).

211. See *Chase v. Superior Court*, 27 Cal. Rptr. 383, 385 (Cal. Dist. Ct. App. 1962); *Phelps v. Elgin*, 184 N.E.2d 799, 802-03 (Ill. App. Ct. 1962) (English, J., concurring); *Maw v. Noble*, 354 P.2d 121, 123 (Utah 1960). One could argue that if the lawyer cannot collect the entire contingent fee and must settle for her normal hourly rate instead, she did not truly receive an assignment of a part of the claim. In fact, this pay discrepancy lies at the heart of some courts' decisions insisting on enforcing the contingent-fee agreement and refusing to calculate judgments based on an hourly rate. See *Phelps*, 184 N.E.2d at 802-03 (English, J., concurring) (advocating contract enforcement over a quantum meruit approach).

interest,<sup>212</sup> not all lawyers walk the straight and narrow in this regard.<sup>213</sup> With an individual analysis, the claim could vest immediately upon signing for cases requiring very little work, or well into trial preparation for cases necessitating more work. Despite all this, the fact remains that the lawyers will collect a fee in all cases except where they quit or are discharged for cause.<sup>214</sup>

### C. Barter Analysis: The Better Approach

The case against using section 83 to approach the tax repercussions of contingent-fee agreements becomes even clearer when one considers that an alternative method more closely fits the facts and allows for a middle ground. The Internal Revenue Service already requires those engaged in barter exchanges to count their increase in wealth as income.<sup>215</sup> This describes exactly what occurs when plaintiffs exchange a share in their claim for legal services.<sup>216</sup> After the exchange, the plaintiffs have legal representation and the lawyers have the right to press the claim and collect a portion of the proceeds.<sup>217</sup> Internal Revenue Code section 1001(b) requires taxpayers to report the fair market value of services provided in exchange for property.<sup>218</sup>

While many rightly claim the tax code can make no claims to fairness,<sup>219</sup> a barter approach can remove some of the inequities of other approaches in this instance.<sup>220</sup> No convincing reason exists to link the

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212. See Havers, *supra* note 124, at 629 (citing Model Code of Professional Responsibility § 2-106(A) barring "clearly excessive fees"); cf. Schneyer, *supra* note 89, at 407 (discussing cases which pose no genuine risk of nonrecovery).

213. See Havers, *supra* note 124, at 628-29 (claiming that many cases where the outcome is not in doubt involve high contingency fees).

214. If they quit for cause, they could very well bring a restitution suit.

215. See I.R.C. § 61(a) (1999); Treas. Reg. § 1.61-2(d) (as amended in 1992) (dealing with services paid for with property).

216. Rev. Rul. 79-24, 1979-1 C.B. 60 outlines the general requirements for reporting barter income.

217. Karsten, *supra* note 87, at 231.

218. I.R.C. § 1001(b) (1999).

219. "Not to appear humorous or flip, but if these were equitable proceedings, the undersigned doubts the government could ever win because some might never view the tax structure as equitable." *Riverton Inv. Corp. v. United States*, 5:99CV00089, 2000 U.S. Dist. LEXIS 20770, at \*23 (W.D. Va. Oct. 26, 2000). Justice Blackmun in *Groetzing* wrote, "basic concepts of fairness (if there be much of that in the income tax law) . . ." *Comm'r v. Groetzing*, 480 U.S. 23, 33 (1987). Another snide court has observed, "common sense and the tax law are rarely even waving acquaintances." *Skoglund v. United States*, 230 Ct. Cl. 833 (1982).

220. Many would not agree, claiming the tax code can only achieve horizontal equity if plaintiffs who hire lawyers on a contingency basis receive the same treatment in the tax system as those who pay an hourly rate. See, e.g., Rasmussen, *supra* note 74, at 317. In tax law, however, form can matter greatly when it comes to qualifying for deductions. See Bernard J. Grant, III, Recent Development, *No Taxation Without Realization*: Srivastava v.

values of the two things being exchanged, unless establishing value in a more realistic manner proves impractical.<sup>221</sup> When the government can independently value the gain of each party, it should use the actual gain each received.<sup>222</sup> Such a solution holds particular appeal in a legal setting once a court renders a verdict. "Reliance on the value of the property given up as the sole and conclusive evidence of the value of the property received should clearly be limited to cases where the value of the property received cannot be reasonably ascertained in other ways."<sup>223</sup>

Contingent-fee arrangements often charge clients an exorbitant rate.<sup>224</sup> If the barterer lacks knowledge in the area in which the barter arises, this detracts from the rationale of using his or her valuation of the transaction for tax purposes.<sup>225</sup> The case law supports this sentiment as well, with the courts placing much emphasis on the fair market value of the services provided — not what the parties actually paid.<sup>226</sup>

Because the Internal Revenue Service can easily determine how much each party actually benefited, these gains should represent the amount of reportable income. Attorneys obviously will have to report as income whatever their portion of the judgment was.<sup>227</sup> Then the Internal Revenue Service should determine whether these amounts were the clients' actual gains. At this point, an objective method exists

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Commissioner, *the Fifth Circuit's Answer to Tax Treatment of Attorney's Fees Under a Contingency Fee Agreement*, 32 ST. MARY'S L.J. 363, 364 (2001). Those who view contingent-fee plaintiffs and hourly-fee plaintiffs as similarly situated have a strange notion of similar. First, lawyers in many fields simply refuse to take a case on an hourly basis. Second, anyone who can afford an attorney at an hourly rate is by no means similarly situated to those forced to use contingent-fee lawyers. Finally, if the wealthy believe giving up 30-50% of their award to a lawyer produces tax benefits justifying the cost, they should not have any trouble finding a lawyer to accommodate them.

221. Keller, *supra* note 200, at 446-47, 453 (stating that both parties should look to the value of what they received as opposed to what they gave up). This has justly been called a circular exercise because no real reason exists for applying the value of one thing exchanged over the value of the other when determining the tax rate for the exchange. *Id.* at 455. See also *Amerada Hess Corp. v. Comm'r*, 517 F.2d 75, 88 (3rd Cir. 1975) (noting "obvious dangers in evaluating the consideration involved in one side of a barter by determining the worth of the consideration on the other side").

222. See Keller, *supra* note 200, at 446-47, 453-54.

223. *Id.* at 454.

224. See Schneyer, *supra* note 89, at 372.

225. Keller, *supra* note 200, at 455. But see *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (stating that the "fee arrangement signifies the value that the parties placed on attorney's services").

226. See, e.g., *Badell v. Comm'r*, 80 T.C.M. (CCH) 422 (2000).

227. See I.R.C. § 61(a) (1999).

to find out.<sup>228</sup> If the attorneys kept track of their billable hours on the case, as most will in the hope attorney's fees will be awarded, the clients' actual gains can be measured.<sup>229</sup> In many cases, the figure will represent a much lower amount than what the attorney actually received.<sup>230</sup> The clients' tax liabilities should rest on this.<sup>231</sup> The value of what the plaintiffs gave up, though easier to ascertain, provides little value in determining their gain.<sup>232</sup> The contingent-fee agreement transfers a portion immediately.<sup>233</sup> Nothing, however, bars uncoupling the parties' gains and measuring them at the time a court renders a judgment.<sup>234</sup> Professor Keller specifically advocates a rule of valuation of what the barterers would have paid in cash if they had used cash.<sup>235</sup> One need not stretch to believe if clients were paying in advance, or at least at an hourly rate, they would pay much less than what a contingent-fee lawyer eventually gains.<sup>236</sup>

The Internal Revenue Service should tax plaintiffs on the amount they actually received from their attorneys in exchange for a portion of their claims. If an attorney charges \$250 per hour and spent 100 hours on the case, the client received a benefit of \$25,000.<sup>237</sup> To argue that because the attorney actually receives one million dollars that this amount was the benefit to his client borders on the absurd.<sup>238</sup> It also demonstrates that a partial assignment occurred.<sup>239</sup> Otherwise the

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228. See Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 277 (1998) (indicating that contingent-fee lawyers keep track of their billable hours).

229. See *id.* at 282 (finding that thirty-nine of forty-three contingent-fee lawyers had the information necessary to estimate effective hourly rate — including billable hours).

230. "Experience tells us that a presumption of equality is simply not appropriate in many barter transactions. Often one side outbargains the other and in no sense can it be said the two sides of the exchange are equal." Keller, *supra* note 200, at 452 n.49.

231. Cf. *Badell*, 80 T.C.M. (CCH) at 424 (using fair market value of services received).

232. See Keller, *supra* note 200, at 446-47.

233. See *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 857-58 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119, 126 (5th Cir. 1959); *Painter*, *supra* note 81, at 640.

234. See *Davis v. Comm'r*, 210 F.3d 1346, 1348 (11th Cir. 2000) (relating IRS request that court apply the open transaction doctrine from *Burnet v. Logan*, 283 U.S. 404 (1931), to a case where *Cotnam* will apply).

235. Keller, *supra* note 200, at 455-56.

236. See Joel S. Newman, *Determining Value in Barter Transactions: A Response to Robert Keller's The Taxation of Barter Transactions*, 68 MINN. L. REV. 711, 713 (1984) (claiming that most barter services "are items that could not have been sold for cash, or certainly not for a cash price the seller would have accepted").

237. Schneyer would adjust the benefit upward based on the chances of recovery at the time the case was taken — sound theory but difficult to implement in practice. See Schneyer, *supra* note 89, at 396.

238. See Keller, *supra* note 200, at 446-47 (arguing that both parties should look to the value of what they received).

239. See *Painter*, *supra* note 81, at 674.

“owner” of the claim could dismiss the attorney on the eve of victory.<sup>240</sup> Courts do not allow this because they realize in a suit for restitution, the attorney would lose \$975,000.<sup>241</sup> The attorney outbargained the client. For the government to tax plaintiffs, not on the fair market value of what they received, but on the fair market value of what they gave up, adds insult to injury.

### CONCLUSION

The circuits disagree about the propriety of allowing plaintiffs to assign a portion of their claim to an attorney. These concerns constitute a historical artifact, the pressing issues of the Middle Ages gumming up the judicial machinery of the twenty-first century. Recognizing that lawyers largely control the course and outcome of suits and settlements will allow courts to respond to the reality of the situation instead of how they think the system should work. Partial assignments of the claim already exist, and to call them a lien on the judgment changes nothing. The government allegedly levies taxes on the fair market value of what the taxpayer receives. Here, taxpayers receive legal services in exchange for a part of their claim and should have to pay taxes on this amount. The taxpayers do not, nor will they ever, receive the full portion going to the attorney. The fact they once had a right to this amount does not change the reality they will never realize the gain. Esau sold his birthright to Jacob for a pottage of lentils.<sup>242</sup> Esau should have been taxed on the value of the lentils received, while Jacob should have been taxed based on the value of Isaac’s estate.

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240. See Painter, *supra* note 81, at 674 n.223 (discussing clients who discharge their attorneys “on the courthouse steps”).

241. See *id.* (noting that in such situations the quantum meruit award should equal the agreed upon fee).

242. *Genesis* 25: 29-34.