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Return to Sharecropping: Lawyers and Clients as Tenants and Landlords in the Tax Treatment of Contingency Fees

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I. Introduction

In 1993, after filing suit against his employer, Eldon Kenseth received $229,501.37 from his employer pursuant to a settlement agreement.[1] Of that $229,501.37, Kenseth's attorneys kept $91,800 in accordance with the contingency fee agreement they had with Kenseth.[2] The question that emerges from this transaction is deceptive and ultimately difficult to answer: Is the $91,800 part of Kenseth's gross income for tax purposes?[3] This question becomes very important as the negative tax implications of the alternative minimum tax (AMT) factor into the equation.[4] Given the Internal Revenue Code's standard that "gross income means all income from whatever source derived," the answer would seem to be a straightforward yes.[5] Yet, various courts have struggled with that question and reached divergent conclusions, resulting in a circuit split.[6]

1. Kenseth v. Comm'r, 114 T.C. 399, 404 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

2. *Id.* at 405.

3. *Id.* at 400.

4. *See id.* at 406 (noting that AMT increases Kenseth's tax burden by $17,198 if contingency fee is included in Kenseth's gross income); *see also* I.R.C. §§ 55-56 (1994) (providing statutory basis for AMT); Campbell v. Comm'r, 274 F.3d 1312, 1313 (10th Cir. 2001) (noting that "[i]f the AMT did not apply, any fees Petitioner paid to his attorneys would qualify as a deductible expense" but that "under the AMT's provisions, certain miscellaneous deductions, including attorney fees, are eliminated"); Alexander v. IRS, 72 F.3d 938, 946 (1st Cir. 1995) (stating that application of AMT "smacks of injustice" when clients' gross income includes contingency fees). The potential "injustice" of the AMT comes into play after a court classifies a contingency fee as gross income to a client. The client may classify the contingency fee as an itemized deduction under § 212(1) of the Internal Revenue Code, which permits an itemized deduction for expenses incurred "for the production and collection of income." I.R.C. § 212(1) (1994). Although the 2% floor of § 67 and the overall limitation of § 68 restrict the amount of the deduction, the taxpayer may still take a substantial deduction for the legal fee. I.R.C. §§ 67-68 (1994). However, the deduction is unavailable to any taxpayer subject to the AMT. I.R.C. § 56(b)(1)(A)(i) (1994); *see Alexander*, 72 F.3d at 946-47 (finding that AMT provisions disallow itemized deductions for payment of legal fees); *see also* Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1076-79 (2000) (discussing negative impact of AMT's disallowance of miscellaneous itemized deductions on "national policy of encouraging meritorious civil rights claims"); 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, 185-89 (2001) (explaining how AMT disallows deductions for attorney's fees, which has effect of greatly increasing taxpayer's gross income). Sager and Cohen note that the disallowance of a miscellaneous itemized deduction for attorneys' fees under the AMT's statutory structure "would convert a $5,000 before-tax gain into a $48,900 after-tax loss" in *Alexander*. Sager & Cohen, *supra*, at 1078.

5. I.R.C. § 61(a) (1994); *see also* Helvering v. Clifford, 309 U.S. 331, 334 (1940) (explaining that statutory definition of gross income indicates that Congress intended to use "the full measure of its taxing power").

6. *Compare* Baylin v. United States, 43 F.3d 1451, 1452 (Fed. Cir. 1995) (affirming lower court's ruling that portion of condemnation award paid to attorneys pursuant to contin-

Courts have utilized two primary theories of attribution to determine who bears the tax liability for contingency fees: the assignment of income doctrine[7] and state attorney's liens laws.[8] As courts have used these theories of

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gency fee agreement constitutes gross income to client) *with* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (holding contingency fees paid to attorneys are not gross income to plaintiff). *See also* Foster v. United States, 249 F.3d 1275, 1279 n.7 (11th Cir. 2001) (recognizing existence of circuit split on issue of taxation of contingency fees paid to attorneys); Young v. Comm'r, 240 F.3d 369, 377-79 (4th Cir. 2001) (acknowledging divergence of views among circuit courts as to taxation of contingency fees); Srivastava v. Comm'r, 220 F.3d 353, 358 (5th Cir. 2000) (acknowledging existence of circuit split on issue of taxation of attorneys' contingent fees); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856 (6th Cir. 2000) (noting existence of circuit split on issue of taxation of attorneys' contingent fees). The circuit split does not involve the issue of the inclusion of the contingency fee in the attorney's gross income. Any legal fees paid to the attorney are gross income to the attorney as compensation for professional services. I.R.C. § 61(a)(1) (1994).

7. *See* Helvering v. Horst, 311 U.S. 112, 117-18 (1940) (explaining that assignment of income doctrine attributes income to party with ultimate control over disposal of income); Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (establishing assignment of income doctrine); Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000) (stating that assignment of income doctrine prevents taxpayers from avoiding taxation on income by "making anticipatory arrangements"), *cert. denied* 532 U.S. 972 (2001); Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (relying on both Maryland's attorney's lien law and judicial assignment of income doctrine to conclude that plaintiff's gross income includes contingency fees); *see also infra* notes 79-127 and accompanying text (discussing assignment of income doctrine).

8. *See* Hukkanen-Campbell v. Comm'r, 274 F.3d 1312, 1314-15 (10th Cir. 2001) (ruling that contingency fees constitute gross income to client irrespective of state attorney's lien statute but noting that Missouri lien statute would favor same outcome); Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001) (concluding that contingency fee is includable in client's gross income because North Carolina law does not grant attorney "rights to the cause of action or a right equal to that of the client"); Srivastava v. Comm'r, 220 F.3d 353, 363-65 (5th Cir. 2000) (concluding that taxpayer's gross income excludes contingency fees despite attorney's limited rights to client's recovery under Texas law and despite assignment of income doctrine); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (concluding that because California's attorney lien's law does not give attorney ownership interest in client's recovery, client's gross income includes contingency fee paid to attorney), *cert. denied* 531 U.S. 1112 (2001); Davis v. Comm'r, 210 F.3d 1346, 1348 (11th Cir. 2000) (affirming determination that contingency fees paid to attorney are not gross income to client); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856-58 (6th Cir. 2000) (concluding that because Michigan's common law attorney's lien provides attorneys with ownership interest in their clients' recoveries and because assignment of income doctrine is inapplicable to contingency fee arrangement, contingency fee paid to attorney is not gross income to client); Cotnam v. Comm'r, 263 F.2d 119, 125-26 (5th Cir. 1959) (determining that because Alabama's attorney's lien statute gives attorneys ownership interest in their clients' recovery and because assignment of income doctrine is inapplicable, contingency fee is not gross income to client); Foster v. United States, 106 F. Supp. 2d 1234, 1237-38 (N.D. Ala. 2000) (following *Cotnam* as precedent in finding that amount of contingency fee is to be excluded from taxpayer's gross income), *aff'd*, 249 F.3d 1275 (11th Cir. 2001); Sinyard v. Comm'r, 76 T.C.M. (CCH) 654, 658-59 (1998) (noting that attorneys in Arizona "are not permitted to acquire proprietary interests in funds recovered on behalf of their clients" and finding attorneys' fees to be gross income to client), *aff'd*, 268 F.3d 756 (9th Cir. 2001); *see also infra* notes 128-54 and accompanying text (discussing state attorney's lien doctrine).

attribution, the resulting disagreement over the tax consequences of contingency fees has emerged as a by-product of the courts' failure to characterize accurately the attorney-client relationship under a contingency fee agreement.[9] Courts have suggested that the attorney and client are involved in a partnership, a joint venture, or a division of property.[10] Yet, none of these analogies have successfully characterized the relationship between an attorney and a client bound by a contingency fee agreement.[11] Courts have struggled to ascertain who is really in control of the client's lawsuit, the client or the attorney.[12] The relative amount of control that an attorney maintains over the client's cause of action is the key to understanding the tax consequences of any contingency fee.[13]

Clients often surrender a large degree of control over their claim to their attorney by signing a contingency fee agreement.[14] Under these agreements, an attorney agrees to work for the client in exchange for a portion of any recovery obtained through the representation.[15] The attorney handles almost all aspects of the client's case: filing the complaint, taking depositions, nego-

9. *See* Kenseth v. Comm'r, 114 T.C. 399, 453-55 (2000) (Beghe, J., dissenting) (discussing failure of current analogies to explain adequately attorney-client relationship for tax purposes), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

10. *See* Srivastava v. Comm'r, 220 F.3d 353, 360 (5th Cir. 2000) (describing contingency fee arrangement between attorney and client as "a sort of virtual co-ownership" of client's claim); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (explaining that Clarks' contract with his lawyer is similar to "an interest in a partnership agreement or joint venture"). The *Estate of Clarks* court also stated that "[t]he present transaction under scrutiny is more like a division of property than an assignment of income." *Id.* at 857-58.

11. *See infra* notes 203-12 and accompanying text (discussing failure of certain analogies to meet necessary requirements for explaining tax consequences of contingency fees); *see also* Susan Kalinka, A.L. Clarks Est. *and the Taxation of Contingent Fees Paid to an Attorney*, TAXES, Apr. 2000, at 16 (questioning use of joint venture and co-ownership analogies for characterizing contingent fee arrangements for tax purposes).

12. *See generally infra* notes 250-55 and accompanying text (discussing failure of assignment of income doctrine and attorney's lien laws to determine who controls client's lawsuit).

13. *See* Comm'r v. Sunnen, 333 U.S. 591, 604 (1948) ("The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes."); Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (emphasizing degree of control granted attorney over client's cause of action by Alabama attorney's lien statute).

14. *See Kenseth*, 114 T.C. at 401-03 (quoting portions of Kenseth's contingency fee agreement, which gave broad control to attorneys and restricted Kenseth's ability to settle his case without his attorneys' consent).

15. *See* F.B. MACKINNON, CONTINGENT FEES FOR LEGAL SERVICES 18 (1964) (describing contingency fee agreements).

tiating, and, if necessary, going to trial.[16] Upon the successful completion of legal action, an attorney's lien immediately controls the disbursement of the recovery to insure the attorney's compensation.[17] This shift in control often obscures the fact that it is the client's underlying claim and rights that are to be vindicated with the assistance of counsel.[18] In contingency fee cases, with control over the claim constantly flowing to the attorney, none of the previously suggested analogies answer all the federal income tax and ethical questions arising from contingency fee-based representation.[19]

However, in a recent case heard by the United States Tax Court, Judge Renato Beghe offered a new analogy as the solution to the problem.[20] In his dissent in *Kenseth v. Commissioner*,[21] Judge Beghe suggested that the attorney-client relationship be analogized to sharecropping.[22] Sharecropping is an

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16. Kenseth v. Comm'r, 114 T.C. 399, 424 (2000) (Beghe, J., dissenting) (explaining that Kenseth's attorneys "made all strategic and tactical decisions in the management" of Kenseth's claim), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

17. *See e.g.*, ALA. CODE § 34-3-61 (1975) (giving attorney lien until client's debt to attorney is discharged); ALASKA STAT. § 34.35.430 (Michie 1995) (noting that "attorney has a lien for compensation"); MD. CODE ANN., BUS. OCC. & PROF. § 10-501 (2000) (giving attorney lien on client's claim or award if client owes legal fee or compensation); MO. ANN. STAT. § 484.130 (West 1987) (allowing attorney automatic lien on client's cause of action); WIS. STAT. ANN. § 757.36 (West 2001) (allowing attorney to place lien on recovery "as security for fees in the conduct of the litigation").

18. *See Kenseth*, 114 T.C. at 443 (Beghe, J., dissenting) (explaining that Kenseth's claims originate from his "constitutionally or statutorily protected status" and not from any bargain with his attorneys).

19. *See id.* at 413 (rejecting joint venture or partnership characterization); *id.* at 453-54 (Beghe, J., dissenting) (noting possibility that "partnership or joint venture characterization would open the door to tax avoidance by attorneys"); *id.* at 454 (Beghe, J., dissenting) (stating that local bar rules may prohibit partnership or joint venture characterization of attorney-client relationship); *id.* (Beghe, J., dissenting) (calling for "exploring the consequences of other arrangements that don't amount to partnerships or joint ventures and yet result in the division of the proceeds or income from an activity"); *id.* at 456-57 (Beghe, J., dissenting) (explaining that refusing to treat attorneys and clients as partners assures that attorney's fee "retains its character as compensation ordinary income").

20. *See Kenseth*, 114 T.C. at 454-55 (Beghe, J., dissenting) (suggesting analogy of sharecropping to characterize attorney-client relationships involving contingency fees); *see also* 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, 307-09 (2001) (noting applicability of sharecropping analogy to taxation of contingency fees).

21. 114 T.C. 399 (2000).

22. *See* Kenseth v. Comm'r, 114 T.C. 399, 417 (2000) (concluding that Kenseth's gross income includes portion of settlement for age discrimination paid to attorneys under contingency fee agreement), *aff'd*, 259 F.3d 881 (7th Cir. 2001). In *Kenseth*, the court considered the issue of whether a client bears the tax liability for contingency fees paid out of the client's recovery to the client's attorneys. *Id.* at 400. Kenseth alleged that his former employer practiced age discrimination against him by terminating his employment. *Id.* at 403. Kenseth and

arrangement between a landlord and a tenant-farmer in which the landlord rents land to the tenant-farmer for a portion of the crop that the tenant-farmer returns to the landlord as rent.[23] This practice calls for a distinct treatment of income from the arrangement.[24] For the landlord, the income is rental income; for the tenant-farmer, it is farm income.[25]

For any analogy to work successfully in this area of law, it must work with both[26] the assignment of income doctrine from federal court decisions[27]

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sixteen other plaintiffs entered into contingency fee agreements with a law firm in which they agreed to pay the attorneys 40% of any recovery. *Id.* at 400-01. The attorneys successfully recovered a total settlement of $2,650,000. *Id.* at 404. Kenseth's portion of the recovery was $229,501.37, and he included only the $32,476.61 allocated to back wages in his income for the taxable year. *Id.* at 404-05. The IRS alleged that Kenseth had a tax deficiency. *Id.* at 405-06. The majority, after noting the existence of a circuit split on the issue, explained that the case fell within the doctrine of assignment of income as expressed in *O'Brien v. Commissioner*, 38 T.C. 707, 712 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963). *Kenseth*, 114 T.C. at 408-12. The majority also refused to decide the case on the basis of "various States' attorney's lien statutes," although it noted that the relevant Wisconsin attorney's lien statute would not support the plaintiff's argument. *Id.* at 412, 415-16. The majority further rejected the plaintiff's argument that he lacked sufficient control over his claim to be taxed on the portion of his recovery paid to his attorneys. *Id.* at 414. The court dismissed the reasoning that the speculative nature of the claim and the reliance on the assistance of counsel placed the contingency fee arrangement outside of the doctrine of assignment of income. *Id.* at 410-11, 413. The majority concluded that Kenseth must include in his income the contingency fees paid to his attorneys. *Id.* at 417. Judge Chabot dissented, arguing that the assignment of income doctrine is not applicable to the facts of the case. *Id.* at 417-21 (Chabot, J., dissenting). In his dissent, Judge Beghe called for a reevaluation of the federal income tax treatment of recoveries obtained through contingency-fee-based representation, arguing that attorneys' contingency fees should not be taxable to the client. *Id.* at 421-58 (Beghe, J., dissenting). Judge Beghe suggested the sharecropper-landlord relationship as an appropriate analogy to the contingency fee arrangement between an attorney and his client. *Id.* at 454-55 (Beghe, J., dissenting).

23. *See* BLACK'S LAW DICTIONARY 1380 (7th ed. 1999) (defining sharecropping as "[a]n agricultural arrangement in which a landowner leases land and equipment to a tenant who, in turn, gives the landlord a portion of the crop as rent").

24. *See* Harlan E. Moore Charitable Trust v. United States, 9 F.3d 623, 624-25 (7th Cir. 1993) (concluding that landowner's share of crops under sharecropping contract is rental income); Trust U/W Oblinger v. Comm'r, 100 T.C. 114, 123 (1993) (holding that landlord's shares of crop are rental income); IRS Publication 225, Farmer's Tax Guide 15-16, 84 (2001) (providing that landlord's shares of crop are generally rental income but are farm income if landlord materially participates in farming operation).

25. IRS Publication 225, Farmer's Tax Guide 16-17 (2001).

26. *See generally* Stephen D. Feldman, Comment, *Exclusion of Contingent Attorneys' Fees from Gross Income*, 68 U. CHI. L. REV. 1309 (2001) (discussing impact of assignment of income doctrine and state law of attorney's liens on taxation of contingency fees).

27. *See* Helvering v. Horst, 311 U.S. 112, 116-17 (1940) (interpreting assignment of income doctrine to mean "that income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the

and the state law doctrine of attorney's liens on recoveries.[28] These two theories of attribution pull courts in one of two directions. If a court follows the state law route concerning an attorney's lien, the result guarantees a lack of uniformity across the nation.[29] If the court instead utilizes the assignment of income doctrine and requires clients to include contingency fees in their gross income, the tax consequences for the client can effectively deprive the client of any economic redress obtained through the lawsuit.[30] Equally frustrating to clients, courts disagree as to whether the assignment of income doctrine is even applicable to the taxation of contingency fees.[31]

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satisfaction of his wants"); Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (developing assignment of income doctrine by refusing to allow "anticipatory arrangements and contracts however skillfully devised" to permit taxpayer to avoid income tax consequences for income he earned but assigned to another); Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995) (applying implicitly doctrine of assignment of income from *Horst* and *Earl* to conclude that portion of recovery paid to attorney as contingency fee is gross income to client). *But see* Cotnam v. Comm'r, 263 F.2d 119, 125-26 (5th Cir. 1959) (concluding that "[assignment of income] doctrine can have no just or realistic application to a case like this, where the only economic benefit to the taxpayer was as an aid to the collection of a part of an otherwise worthless claim").

28. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856-57 (6th Cir. 2000) (explaining that Michigan attorney's liens grant attorneys ownership interests in part of their clients' recoveries, making contingency fee gross income to attorney alone); *Cotnam*, 263 F.2d at 125 (concluding that Alabama's attorney's lien statute grants attorneys ownership interests in their clients' recoveries, allowing clients to exclude contingency fees from their gross income); Dreiband v. Candler, 131 N.W. 129, 129 (Mich. 1911) (explaining that common law attorney's lien operates to assign portion of "the fruit of the litigation" to attorney).

29. *Compare Estate of Clarks*, 202 F.3d at 856-57 (relying on Michigan attorney's lien law in finding that contingency fee is not part of client's gross income), *and Cotnam*, 263 F.2d at 125 (concluding that Alabama attorney's lien statute prevents contingency fees from being gross income to client), *with* Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001) (finding that North Carolina common law attorney's lien permits contingency fee to be included as gross income for client), Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (finding that California attorney's lien law does not require exclusion of contingency fee from client's gross income), *cert. denied*, 531 U.S. 1112 (2001), Coady v. Comm'r, 213 F.3d 1187, 1190-91 (9th Cir. 2000) (concluding that because Alaska attorney's lien law does not confer any property interest in client's recovery on attorney, contingency fee is includible in client's gross income), *cert. denied*, 532 U.S. 972 (2001), *and Baylin*, 43 F.3d at 1455 (concluding that Maryland attorney's lien statute allows contingency fees to be gross income to client). *But see infra* notes 144-54 and accompanying text (noting states in which attorney's lien laws give attorneys no equitable interest in clients' recoveries).

30. *See* Kenseth v. Comm'r, 114 T.C. 399, 419 (2000) (Chabot, J., dissenting) (arguing that application of assignment of income doctrine to contingency fees "can raise effective tax rates to hardship levels" under AMT), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *id.* at 425-26 (Beghe, J., dissenting) (explaining how mechanics of itemized deduction rules and AMT can result in effective tax rates in excess of 100% of clients' net recoveries); Sager & Cohen, *supra* note 4, at 1076-78 (explaining how income tax law and AMT can significantly reduce plaintiff's recovery); *supra* note 4 (explaining AMT's effect on tax consequences of contingency fees).

31. *Compare Estate of Clarks*, 202 F.3d at 857-58 (finding assignment of income doctrine inapplicable), *and* Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (same), *with* Coady

This Note will show how the sharecropping analogy not only properly characterizes the attorney-client relationship but also handles both theories of attribution used by courts to address the tax questions surrounding contingency fees. It will argue that contingency fees are not gross income to clients, but are solely the income of the attorney who earned them. Part II will discuss the *Kenseth* majority opinion, focusing particularly on its factual circumstances and the court's reasoning.[32] Part III will analyze the two theories of attribution utilized by courts in determining a successful plaintiff's tax liability for contingency fees.[33] Part IV will examine the cases that preceded *Kenseth* and caused the current circuit split.[34] Part V will analyze the sharecropping analogy suggested in Judge Beghe's dissenting opinion in *Kenseth*.[35] Part VI will draw conclusions and offer recommendations for future contingency fee cases.[36]

II. Kenseth v. Commissioner

In March of 1991, APV Crepaco (APV) terminated the employment of Eldon R. Kenseth, a forty-five year-old master scheduler who had worked at APV for twenty-one years.[37] Kenseth, who was earning $33,480 per year at the time of his discharge, filed a complaint with the Wisconsin Department of Industry, Labor, and Human Relations alleging that APV engaged in age discrimination when it terminated his employment.[38] Kenseth and sixteen other former APV employees retained the law firm of Fox & Fox, S.C., to seek damages from APV.[39] The employees all signed contingency agreements with Fox & Fox, agreeing to allocate 40% of any recovery to the firm.[40] Fox & Fox filed a complaint in the United States District Court for the Western District of Wisconsin alleging that APV deprived the class members of their rights

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v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000) (finding assignment of income doctrine applicable to contingency fees), *cert. denied*, 532 U.S. 972 (2001), *and Baylin*, 43 F.3d at 1454-55 (same).

32. *See infra* Part II (discussing majority opinion in *Kenseth*).

33. *See infra* Part III (discussing assignment of income doctrine and state attorney's lien laws).

34. *See infra* Part IV (explaining and analyzing cases involved in circuit split).

35. *See infra* Part V (discussing sharecropping analogy as method to characterize attorney-client relationship in contingency fee cases).

36. *See infra* Part VI (noting conclusions and recommendations for future contingency fee taxation cases).

37. Kenseth v. Comm'r, 114 T.C. 399, 400 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

38. *Id.*

39. *Id.*

40. *Id.* at 401-02.

under the Age Discrimination in Employment Act of 1967 (ADEA).[41] The plaintiffs sought back pay, liquidated damages, reinstatement (or front pay in lieu of reinstatement), and attorney's fees and costs.[42]

After negotiations, Fox & Fox eventually reached an agreement with APV, in which APV agreed to pay the plaintiffs $2,650,000.[43] The settlement included $1,590,000 for the plaintiffs and a $1,060,000 fee for Fox & Fox.[44] Kenseth's share of the gross settlement was $229,501.37.[45] APV paid $32,476.61 of the settlement directly to Kenseth as lost wages, which after taxes amounted to a net of $21,246.20.[46] The settlement agreement designated the remaining $197,024.76 of Kenseth's portion as a recovery "for personal injury damages which the parties intend as those types of damages excludable from income under section 104(a)(2) of the Internal Revenue Code as damages for personal injuries."[47] After deducting its attorney's fees, Fox & Fox issued Kenseth a check in the amount of $105,724.22.[48] Kenseth included only the part of the settlement allotted to back pay on his 1993 federal income tax return.[49] Furthermore, Kenseth did not claim any deductions for any of his legal fees.[50]

The Internal Revenue Service (IRS) issued a notice of deficiency to Kenseth regarding his 1993 return.[51] The notice adjusted Kenseth's gross income by including the $197,024.76 not allocated to lost wages.[52] This amount included the contingency fee paid to Fox & Fox.[53] The deficiency notice allowed a miscellaneous itemized deduction of $91,800 for the contingency fee.[54] However, pursuant to § 67 of the Internal Revenue Code and the overall limitation on itemized deductions under § 68, the IRS reduced the

41. *Id.* at 403-04; *see also* Age Discrimination in Employment Act, 29 U.S.C. §§ 621-634 (1994) (outlawing workplace discrimination based on age).

42. *Kenseth*, 114 T.C. at 404.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at 404-05; *see also* I.R.C. § 104(a)(2) (West Supp. 2001) (excluding from gross income damages received "on account of personal physical injuries or physical sickness"). *But see* Comm'r v. Schleier, 515 U.S. 323, 327 (1995) (finding that recoveries under ADEA are not excludable from plaintiff's gross income).

48. Kenseth v. Comm'r, 114 T.C. 399, 405 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

deduction for the fees by $9,992.[55] Yet, with the AMT's disallowance of miscellaneous itemized deductions, Kenseth lost his deduction for legal fees and had a deficiency of $17,198 arising from his recovery from APV.[56] Kenseth's total alleged tax deficiency was $55,037.[57]

Kenseth challenged the IRS's determination that his gross income included the contingency fee paid to his attorney.[58] The outcome of Kenseth's challenge would have a major impact on the scope of his recovery, especially given the impact of the AMT.[59] The majority, although recognizing the possible unfairness resulting from the AMT, noted that redrafting the law to address such iniquities is the province of Congress, not the Tax Court.[60]

The majority looked to both the assignment of income doctrine and to Wisconsin's attorney's lien statute to reach its decision.[61] The court concluded that "contingent fee agreements . . . come within the ambit of the assignment of income doctrine and do not serve . . . to exclude the fee from the [client's] gross income."[62] According to the majority, Kenseth earned all of his recovery,

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55. *Id.* at 405-06. For Kenseth's tax purposes, § 67 reduced the amount of legal fees that he could deduct by $5,298. *Id.* at 405. Section 68 further reduced the amount of legal fees that he could deduct by $4,694. *Id.* at 406; *see also* I.R.C. § 67 (1994) (permitting miscellaneous itemized deductions only to extent such deductions exceed 2% of taxpayer's adjusted gross income); I.R.C. § 68 (1994) (placing cap on taxpayer's overall amount of itemized deductions).

56. Kenseth v. Comm'r, 114 T.C. 399, 406 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *see* I.R.C. § 56(b)(1)(A)(i) (1994) (eliminating miscellaneous itemized deductions in calculating AMT); *see also* Sager & Cohen, *supra* note 4, at 1077-78 (noting dramatic increase in clients' tax liabilities under AMT if they are forced to include contingency fees in their gross income); *supra* note 4 (discussing mechanics of AMT).

57. *Kenseth*, 114 T.C. at 406.

58. *Id.* at 406-07. Kenseth conceded that the proceeds from the settlement were not excludable under § 104(a)(2) of the Internal Revenue Code because the payment was not for physical injury. *Id.* at 406; *see also* I.R.C. § 104(a)(2) (West Supp. 2000) (excluding from gross income damages received "on account of personal physical injuries or physical sickness"). Prior to the 1996 amendment altering § 104(a)(2) to limit the exclusion from gross income to damages paid for "physical injury or physical sickness," the Supreme Court found that "a recovery under the ADEA is not excludable from gross income." Comm'r v. Schleier, 515 U.S. 323, 327 (1995).

59. *See Kenseth*, 114 T.C. at 407 (noting "substantial difference in the amount of tax burden that may result from the [two] parties' approaches"). Including the contingency fee in Kenseth's gross income and assuming his full payment of the $55,037 tax deficiency, Kenseth received only roughly 31%, or $71,433.42, of his $229,501.37 recovery. *See id.* at 404-06 (noting amounts). The remaining 69%, or $158,067.95, went to pay taxes, including the AMT, and his attorneys. *Id.*

60. *Id.* at 407.

61. *See Kenseth*, 114 T.C. at 412, 415-16 (using assignment of income doctrine to determine tax consequences of contingency fees and noting that Wisconsin attorney's lien statute supports majority's conclusion).

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

and his attorney simply helped him collect the damages.[63] Furthermore, the majority rejected Kenseth's assertions that he lacked sufficient control over his claim and recovery.[64] In Wisconsin, an attorney cannot obtain an ownership interest in the client's claim or recovery that would allow the attorney to take control of the case away from the client.[65] Despite this conclusion, the majority refused to base its decision about the federal income tax consequences of a contingency fee on a state statute.[66] For all these reasons, the court concluded that the entire amount of Kenseth's award, including the contingency fee, was gross income to Kenseth.[67] As shall be shown, many of these conclusions are not as certain as they may appear.[68] Kenseth was not always in a position to be in complete control of his lawsuit and recovery, especially in view of the doctrine of assignment of income and state attorney's lien statutes.[69] On appeal to the United States Court of Appeals for the Seventh Circuit, Judge Richard Posner, writing for the majority, affirmed the Tax Court's decision.[70]

III. The Conflicting Doctrines

To best understand the cases involving the taxation of contingency fees, one must have a firm grasp on two theories of apportionment. The first is the assignment of income doctrine.[71] The second is the analysis of attorney's

63. *Id.* at 413.

64. *Id.* at 414.

65. *Id.* at 414-16.

66. *Id.* at 412.

67. *Id.* at 417.

68. *See infra* notes 261-86 and accompanying text (discussing Kenseth's relative control over his case).

69. *See infra* notes 318-22 and accompanying text (noting dissent's application of assignment of income doctrine and state attorney's lien statutes to facts of *Kenseth*).

70. *See* Kenseth v. Comm'r, 259 F.3d 881, 885 (7th Cir. 2001) (affirming Tax Court's decision). The Seventh Circuit based its decision on this analogy:

> If a taxpayer obtains income of $100 at a cost in generating that income of $25, he has gross income of $100 and a deduction of $25, yielding taxable income of $75; he does not have gross income of $75. If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income of $100.

Id. at 883 (citations omitted). Under the Seventh Circuit's analysis, if the AMT causes the taxpayer to lose his or her deduction, it is not for the courts to rectify. *Id.* at 885. The tax code provisions causing this discrepancy are for the Congress to deal with, not the courts. *Id.* at 885. The court found that the contingency fee agreement was neither an assignment of a portion of the claim to the attorney nor a property interest of the attorney via Wisconsin's attorney's lien law. *Id.* at 883-84. The Seventh Circuit firmly sided with the Tax Court, calling its interpretation "clearly correct," and stated that cases "reject[ing] the Tax Court's position seem based on little more than sympathy for taxpayers." *Id.* at 883, 885.

71. *See infra* notes 79-127 and accompanying text (discussing assignment of income doctrine).

liens under state law to determine if the attorney obtains an ownership interest in the contingency fee.[72] While the term "doctrine" is often associated with assignment of income, it is better to think of the assignment of income principles, as well as state attorney's lien statutes, as control devices.[73] They establish the boundaries of control over the underlying legal claim and the contingency fee.[74] If, under either theory, the attorney gains a sufficient degree of control over the fee, the fee becomes gross income to the attorney alone.[75] Absent that necessary level of control, the fee is gross income to the client as well as to the attorney.[76] The difficulty is in determining the level of control involved.[77] The historical development of each theory helps to explain this difficulty.[78] Each theory will be examined in turn.

A. Assignment of Income Doctrine

The Supreme Court first explained the doctrine of assignment of income in *Lucas v. Earl*,[79] in which Justice Oliver Wendell Holmes, Jr. described the doctrine with the famous, yet eventually troubling, metaphor of an improper transfer of fruit (income) between two parties.[80] In 1901, Earl entered into a

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72. *See infra* notes 128-54 and accompanying text (describing analysis of attorney's liens from various states).

73. *See* Cotnam v. Comm'r, 263 F.2d 119, 126 (5th Cir. 1959) (Rives & Brown, JJ., concurring) (referring to assignment of income as "doctrine"); Kenseth v. Comm'r, 114 T.C. 399, 427 (2000) (Beghe, J., dissenting) (mentioning "assignment of income doctrine"), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

74. *Cf. Kenseth*, 114 T.C. at 432 (Beghe, J., dissenting) (emphasizing that control over contingency fee by either client or attorney should determine tax liability for contingency fee).

75. *See Cotnam*, 263 F.2d at 125 (noting that Alabama attorney's lien statute gave Cotnam's attorney sufficient control over Cotnam's claim and recovery, allowing Cotnam not to realize gross income from contingency fees); *id.* at 125-26 (Rives & Brown, JJ., concurring) (arguing assignment of income doctrine does not shift tax liability for contingency fee to Cotnam).

76. *See* Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995) (applying assignment of income doctrine to give client control over contingency fee and making fee gross income to client); *id.* at 1455 (explaining that Maryland attorney's lien statute does not confer ownership over claim or fee to attorney, causing client to have gross income to extent of contingency fee).

77. *See Kenseth*, 114 T.C. at 425 (Beghe, J., dissenting) (explaining that purpose of his dissent was to demonstrate that Kenseth lacked sufficient control over his claim and recovery to be required to include contingency fees in his gross income).

78. *See infra* notes 79-102 and accompanying text (noting historical development of assignment of income doctrine); *infra* notes 130-31 and accompanying text (noting historical reasons for development of attorney's lien statutes).

79. 281 U.S. 111 (1930).

80. *See* Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (concluding that Earl's contract with his wife to divide his income evenly between them did not allow Earl to escape payment of

contract with his wife in which they agreed that they would own any property that either of them acquired as joint tenants with a right of survivorship.[81] Because of this contract, Earl asserted that he should only be taxed on one-half of his salary for the years 1920 and 1921.[82] He argued that the contract specified that his salary immediately became marital joint property at the moment he earned it.[83] The Court rejected this approach and refused to decide the case on the picayune details of the voluntary contract between Earl and his wife.[84]

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federal income tax for his entire income). In *Earl*, the Supreme Court considered the issue of Earl's federal income tax liability on income he earned while he had a contract apportioning that income evenly between his wife and himself. *Id.* at 113. In 1901, Earl and his wife entered into a contract stating:

> [T]hat any property either of us now has or may hereafter acquire . . . in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.

Id. at 113-14. The Court did not question the validity of the contract. *Id.* at 114. Earl offered a "forcible argument" that the statute only taxes income that is "beneficially received" by one person. *Id.* Earl's argument hinged on the fact that technically his salary became the joint property of his wife and himself from the moment it was received. *Id.* The Court rejected this analysis with language that would resonate in future cases by saying that "this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act." *Id.* The Court rejected the idea that an "anticipatory arrangement" could be used to prevent Earl from owing tax on his salary because his agreement with his wife prevented his salary from ever being his own property. *Id.* at 114-15. The Court likened this arrangement by Earl as one "by which the fruits are attributed to a different tree from that on which they grew." *Id.* at 115; *see also* Ernest J. Brown, *The Growing "Common Law" of Taxation*, 13 U.S. CAL. TAX INST. 1, 15 (1961) (arguing that Holmes's decision to use metaphor to explain assignment of income doctrine added to difficulties of later courts tackling similar issues); Sheridan, *supra* note 20, at 305-09 (discussing metaphors used by courts to describe tax treatment of assignment of income doctrine and contingency fees).

81. *See Earl*, 281 U.S. at 113-14 (noting contract provisions between Earl and wife).

82. *Id.* at 113.

83. *See* Earl v. Comm'r, 30 F.2d 898, 898-99 (9th Cir. 1929) (noting issue of whether interval passed between moment Earl earned his salary and moment it became joint property of Earl and his wife), *rev'd sub nom.*, Lucas v. Earl, 281 U.S. 111 (1930).

84. *See Earl*, 281 U.S. at 114 (refusing to decide case on "attenuated subtleties" of Earl's contract with his wife). The Court's ultimate decision had a great deal to do with the question of who was going to be taxed. *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION § 8.01(a), at 195 (rev. 8th ed. 1999) (discussing decision in *Earl*). The government feared that, if Earl had succeeded with his plan, such a result would undermine the progressive rate structure of the federal income tax. *Id.* at 196. By voluntarily splitting his income between his wife and himself, both would be responsible for income tax at lower marginal rates. When the Court found for the government, Earl was forced to pay taxes on his entire income at a higher marginal rate. As Chirelstein notes, "minor children and perhaps other family dependents could be made

Justice Holmes instead stated that the decision in the case should be based on the "import and reasonable construction of the taxing act."[85] The "reasonable construction" of the taxing law applied by the Court is that those who earned the income owe the tax on it.[86] According to the Court, taxpayers cannot avoid the tax with clever, pre-arranged contracts that prevent the ownership of the salary from ever completely vesting in the one who earned it, even for one second.[87] Earl, despite his efforts to assign his income to his wife, was liable for the payment of income tax on his entire salary.[88] In his famous metaphor, Holmes likened Earl's contract to an "arrangement by which the fruits are attributed to a different tree from that on which they grew."[89]

In *Helvering v. Horst*,[90] the Supreme Court again commented on the assignment of income doctrine.[91] In *Horst*, the taxpayer made a gift of the

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parties to contracts like Earl's, thus further multiplying the width of the income tax brackets. Since the great bulk of family income comes from personal services, a government defeat in *Earl* would seriously have damaged the entire concept of graduated rates." *Id.*

85. *Earl*, 281 U.S. at 114.

86. *Id.* at 114-15; *see also* United States v. Basye, 410 U.S. 441, 449 (1973) ("[I]ncome must be taxed to him who earns it." (quoting Comm'r v. Wilbertson, 337 U.S. 733, 739-40 (1949))).

87. *Earl*, 281 U.S. at 115.

88. *Id.* at 113, 115.

89. *Id.* at 115.

90. 311 U.S. 112 (1940).

91. *See* Helvering v. Horst, 311 U.S. 112, 120 (1940) (concluding donor who gave donee right to payment of interest from investments held by donor realizes income within doctrine of *Earl*). In *Horst*, the Supreme Court considered the federal income tax consequences to a donor who gives a donee the right to receive interest payments from an investment held by the donor. *Id.* at 114. Horst owned negotiable bonds, and in the years 1934 and 1935 he removed the interest coupons from the bonds prior to the maturity date on the bonds and gave the coupons to his son as a gift. *Id.* Horst's son collected the interest at the time of the maturity of the bonds. *Id.* The IRS argued that the interest paid to the son was gross income to Horst. *Id.* The court stated that a bondholder holds "two independent and separable kinds of rights." *Id.* at 115. One is the right to receive payment for the principal amount of the bond at maturity, and the other is the right to receive payment of the interest at times specified by the bond agreement. *Id.* The Court explained that the revenue laws of the United States have been interpreted as making the realization of income the event that triggers the tax as opposed to the moment when the potential taxpayer acquires the right to receive income. *Id.* However, the Court noted that the revenue laws do not allow a taxpayer, who has enjoyed the economic benefit of his income, to escape taxation on that income because the taxpayer has not actually received the income. *Id.* at 116. The economic benefit of income includes the right to make dispositions of that income in a manner that satisfies the taxpayer. *Id.* Applying the assignment of income doctrine, the Court concluded that Horst could not escape taxation on the income from the interest coupons simply by giving it away to his son. *Id.* at 119-20. Despite never actually realizing the income, Horst was able to control its disposition, and the Court equated this to the actual ownership of such income. *Id.* at 118. Thus, the Court reasoned that the tax laws will not allow the distinctions drawn by the donor as to how he will use his income let the donor escape tax liabilities. *Id.* at

interest coupons on negotiable bonds to his son just prior to the maturity date of the bonds.[92] Upon the maturity date, the son collected the interest and later included it as part of his gross income.[93] The Court found that such an assignment of the right to receive interest income from the bonds did not allow Horst to escape federal income tax for the interest income.[94] Had Horst been allowed to follow through with his plan, he would have controlled the disposition of the income without suffering any federal income tax consequences.[95] The Court ruled that Horst was liable for the tax on the interest income regardless of whether he used it for his own purposes or gave it to his son.[96]

Horst attempted to argue that this scenario was outside of the parameters of *Earl* because Horst's assignment of the income rights in the interest coupons preceded the actual event – the maturity date of the bonds – that triggered the income in question.[97] In contrast, Earl had to perform additional services, beyond his contract to split his income with his wife, to obtain his salary.[98] Thus, the income technically vested immediately in Earl at the very moment he earned it.[99] The *Horst* Court rejected such a distinction based on

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119-20. This is especially true when the donor still enjoyed the benefits of the income by being able to make a gift of it. *Id.* Horst was liable for the income tax on the interest, for the Court stated that, in the vein of *Lucas v. Earl*, such an interpretation as advocated by Horst would have the fruit (income) "attributed to a different tree from that on which it grew." *Id.* at 120.

92. *Id.* at 114.

93. *Id.* at 114; *id.* at 121 (McReynolds, J., concurring).

94. *Id.* at 120.

95. *See id.* at 116-17 (noting that "the rule that income is not taxable until realized has never been taken to mean that the taxpayer, . . . who . . . enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor").

96. *Id.* at 116-17.

97. *See id.* at 119-20 (stating that Horst's agreement occurred prior to maturity date of bonds that triggered interest income, preventing that income from ever vesting in Horst).

98. *See* Lucas v. Earl, 281 U.S. 111, 113-14 (1930) (noting that contract between Earl and his wife only took effect on income acquired at time of contract formation or at any time afterwards). The distinction that Horst attempted to draw between his case and *Earl* depends on the nature of the income involved. A salary is payment for services performed. In *Earl*, the assignment of income to his wife occurred prior to Earl performing the services necessary to earn his salary. *Id.* at 113-14. Earl had to work to earn his salary, allowing the salary to vest in him at least briefly before passing to his wife. *See* Helvering v. Horst, 311 U.S. 112, 119-20 (1940) (discussing distinction between *Earl* and *Horst*). In contrast, Horst, as a holder of interest bearing coupons, had done everything necessary to be entitled to the interest income. *See id.* (explaining that "the right of the assignor to receive the income antedated the assignment which transferred the right and thus precluded such an instantaneous vesting" as was found in *Earl*). With the transfer of the coupons to his son, the interest income would not vest in Horst, even for a moment. *Id.*

99. *See Horst*, 311 U.S. at 119-20 (noting difference in timing of transactions in *Horst* and *Earl*); *see also Earl*, 281 U.S. at 114-15 (showing that timeline involved in transfers

the facts of *Earl* as just the sort of "attenuated subtleties" that the court and the tax laws sought to avoid.[100] No "anticipatory arrangements . . . however skillfully devised" allowed Horst to escape taxation on the interest earned by the coupons.[101] Seizing on Holmes's metaphor in *Earl*, the *Horst* Court noted that the "import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew."[102]

These two cases formed the backbone of the assignment of income doctrine.[103] Under the doctrine, a party cannot divert a portion of his income to other recipients, such as creditors, and escape taxation on that income.[104] Despite being a prominent doctrine, the facts upon which the assignment of income doctrine was built have raised questions as to the doctrine's ultimate usefulness in dealing with the taxation of contingency fees.[105] Both *Earl* and *Horst* involved intra-family donative transfers.[106] In both cases, the Court utilized the doctrine to prevent tax avoidance.[107] The income in question in each case was both certain and secure.[108] Finally, in each case, the donor's control over the income was complete and never in doubt.[109] Either Earl or Horst could have retained the income for his own use if he so desired.[110]

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required Earl to perform additional work after making contract with his wife, allowing income to vest in him for at least briefest of moments).

100. *Horst*, 311 U.S. at 120.

101. *Id.* (quoting Lucas v. Earl, 281 U.S. 111, 115 (1930)).

102. *Id.* at 120.

103. *See id.* at 115-20 (1940) (applying assignment of income doctrine); *Earl*, 281 U.S. at 114-15 (establishing assignment of income doctrine).

104. *See* Helvering v. Horst, 311 U.S. 112, 120 (1940) (noting assignment of income doctrine prevents avoidance of federal income tax by shifting income to other parties).

105. *See* Kenseth v. Comm'r, 114 T.C. 399, 411 n.5 (2000) (describing assignment of income doctrine as "well-established"), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *see also* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (distinguishing *Earl* and *Horst* and refusing to apply assignment of income doctrine to contingency fees).

106. *See Horst*, 311 U.S. at 114 (stating that transfer of interest coupons was from father to son); *Earl*, 281 U.S. at 113 (noting contract was between Earl and his wife).

107. Lucas v. Earl, 281 U.S 111, 114 (1930); *see also Horst*, 311 U.S. at 120 (utilizing doctrine of *Earl* to prevent tax avoidance by Horst's plan to shift interest coupons to his son).

108. *Compare Horst*, 311 U.S. at 114 (noting that Horst's bonds did pay interest at maturity), *and Earl*, 281 U.S. at 113 (noting that income in question was Earl's salary), *with Estate of Clarks*, 202 F.3d at 857 (noting speculative nature of recovery at time Clarks hired attorney on contingency fee basis).

109. *See Horst*, 311 U.S. at 114 (noting Horst's complete ownership of negotiable bonds prior to transferring interest coupons from bonds to his son); *Earl*, 281 U.S. at 113 (noting that Earl alone earned his salary).

110. *Cf. supra* note 98 (noting Horst gave interest coupons to his son). For example, if Horst wished to retain the interest income from the coupons, he simply would not have trans-

Furthermore, a strict statutory construction was not the primary basis for the doctrine.[111] Because of Justice Holmes's reliance on a loose construction of the tax laws, the doctrine developed as a federal common law doctrine.[112] In that vein, the *Earl* decision may have been based more on outside considerations than a strict reading of the tax code.[113]

The Supreme Court may have established the assignment of income doctrine in *Lucas v. Earl* to preserve the progressive rate structure of the federal income tax.[114] The tax years at issue in the case were 1920 and 1921.[115] At that time, the constitutional authority for a federal income tax was only seven years old.[116] The government saw Earl's contract with his wife as a direct challenge to the progressive rate structure of the income tax.[117] The Earls actually entered into the contract in 1901, well before both the ratification of the Sixteenth Amendment and the passage of the Internal Revenue Act of 1918.[118] The Earls argued that their contract was valid under California law and that the Revenue Act only taxed income that Earl directly received solely for his benefit.[119] As a result, the Supreme Court faced the option of either holding for the Earls and effectively defeating the graduated income tax rate system, or finding for the government and preserving the graduated rates despite the Earls' legal contract.[120] The Court made the judicial choice to uphold the progressive statutory rates.[121]

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ferred them to his son. Earl would have had to breach his contract with his wife in order to keep his income. *See Earl*, 281 U.S. at 113 (noting contract between Earl and wife).

111. *See Earl*, 281 U.S. at 115 (noting that "import of the [tax] statute" was basis for assignment of income doctrine).

112. *See* Kenseth v. Comm'r, 114 T.C. 399, 427 (2000) (Beghe, J., dissenting) (emphasizing that assignment of income doctrine is "judge-made" and not based on strict statutory construction), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

113. *See infra* notes 114-21 and accompanying text (focusing on possible motives for decision in *Earl*).

114. *See* Brown, *supra* note 80, at 13 (noting choice made by Supreme Court to preserve graduated income tax rate structure).

115. Lucas v. Earl, 281 U.S. 111, 113 (1930).

116. *See* U.S. CONST. amend. XVI (noting ratification in 1913).

117. Brown, *supra* note 80, at 13 (explaining that government saw Earl's contract "as a threat to the statutory scheme of graduated [income tax] rates").

118. *See* Lucas v. Earl, 281 U.S. 111, 113 (1930) (noting date of contract); *see also* Act of Feb. 24, 1919, 40 Stat. 1057 (noting date of passage). The government accused Earl of violating this revenue law. *Earl*, 281 U.S. at 114.

119. *See Earl*, 281 U.S. at 114 (noting Earl's argument that income tax only taxes income "beneficially received"); Brown, *supra* note 80, at 13 (noting Earl's reliance on California law).

120. *See* Brown, *supra* note 80, at 13 (explaining choice facing Supreme Court).

121. *Id.*; *see also* CHIRELSTEIN, *supra* note 84, at 196 (noting that government's victory in *Earl* prevented "the taxpayer from effectively reducing the applicable rate of tax by splitting his salary income with his wife").

The *Earl* decision and the use of the "fruit of the tree" analogy opened the door for more tax decisions to be decided on common law doctrines as opposed to the tax statutes alone.[122] Judges, not always experts in the intricacies of the tax statutes, often fell back on common law ideas, especially property concepts, to validate a transfer of income and avoid the assignment of income doctrine.[123]

The common law background of the assignment of income doctrine opens the door for current courts to alter or amend the doctrine as circumstances warrant.[124] If there is a change in circumstances, such as the increasing hardship imposed on clients by the AMT, the courts can alter the assignment of income doctrine.[125] When courts factor the client's true level of control over his case into the assignment of income doctrine, altering the common law doctrine may not be enough.[126] Where a lawyer's control over a client's lawsuit supersedes the client's level of control over his own case, the assignment of income doctrine should not even apply.[127]

B. Attorney's Liens Under State Law

The second theory of attribution used in contingency fee tax cases is the state law of attorney's liens. In some states, attorney's liens act as a control-

122. *See* Brown, *supra* note 80, at 15-17 (explaining courts' reliance on common law doctrines to decide tax issues). Brown's argument suggests that once a court found a common law rationale, such as a property concept for allowing a taxpayer to shift income to another party, the court could then use this common law rationale to shift income while staying within the doctrine of assignment of income as found in *Lucas v. Earl*. *Id.*; *see also* Lum v. Comm'r, 147 F.2d 356, 357 (3d Cir. 1945) (finding taxpayer liable for income tax on rents assigned to wife but finding wife liable for income tax on rental income coming from property which taxpayer transferred "rights as 'landlord'" to his wife).

123. *See* Brown, *supra* note 80, at 15 (noting that courts often searched for "a property concept which could constitute a tree capable of being transplanted. If they could discover an income-producing property 'tree' capable of being transplanted and which had been transplanted or transferred, then the deflection [of income from the assignor to the assignee] was successful.").

124. *See* Kenseth v. Comm'r, 114 T.C. 399, 427 (2000) (Beghe, J., dissenting) (noting that judges "need not wait for Congress" to alter application of assignment of income doctrine), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

125. *Id.* (Beghe, J., dissenting) (emphasizing that "what the courts have created and applied, courts can interpret, refine, and distinguish to determine whether in changed circumstances the conditions for application of the doctrine have been satisfied").

126. *See id.* (Beghe, J., dissenting) (discussing level of control issue); *id.* at 430-31 (Beghe, J., dissenting) (asking whether client's control over his lawsuit is sufficient to include contingency fees in client's gross income).

127. *See id.* at 446 (Beghe, J., dissenting) (noting that contingency fee agreement reduced Kenseth's control over his lawsuit, making assignment of income doctrine inapplicable). Judge Beghe's dissent also stated that other factors found in *Earl* and *Horst* were not present in *Kenseth*, namely that "the contingent fee agreement . . . was not an intrafamily donative transaction and did not occur within an economic group of related parties." *Id.* (Beghe, J., dissenting).

shifting device, transferring powerful rights of control over a client's lawsuit to the client's attorney.[128] In other states, the lien fails to transfer these interests.[129] These liens originated at common law to insure compensation to the attorney for services provided to the client.[130] The lien operates by allowing attorneys to obtain their legal fees and costs from the funds recovered through the legal action, and the lien also permits the attorney to postpone distribution of any part of the recovery to the client until the attorney is paid.[131] An attorney's lien is often a part of a contingency fee contract that a client signs in order to hire an attorney.[132] For the client, the attorney's lien, when coupled with other language in a standard contingency fee form contract, works to shift a large degree of control over the case to the attorney.[133] With the codification of attorney's liens in state statutes, an attorney's control over her client's case has become absolute in some states.[134]

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128. *See* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (noting that Alabama attorney's lien statute grants "[attorneys . . . the same rights as their clients" as to control over client's lawsuit and recovery).

129. *See infra* notes 145-54 and accompanying text (discussing states with attorney's liens that do not transfer strong control rights over client's claims and recoveries to attorneys).

130. *See* Goodrich v. McDonald, 19 N.E. 649, 651 (N.Y. 1889) (explaining that attorney's liens originated to "protect . . . attorneys from the knavery of their clients"). See Thad Austin Davis, Comment, 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, 1688-1700 (2000), for a detailed analysis and discussion of state attorney's lien statutes and the tax repercussions of such liens on contingency fees.

131. *See* Davis, *supra* note 130, at 1688-89 (noting general operation of attorney's lien).

132. *See* Kenseth v. Comm'r, 114 T.C. 399, 400-03 (2000) (explaining that contract for contingency fee representation was form contract containing attorney's lien provision), *aff'd*, 259 F.3d 881 (7th Cir. 2001). The language explaining the lien in *Kenseth* states that the "attorney shall have a lien against any damages, proceeds, costs and fees recovered in the client's action for the fees and costs due the attorney under this agreement and said lien shall be satisfied before or concurrent with the dispersal of any such proceeds and fees." *Id.* at 402.

133. *See id.* at 401-02 (noting provisions restricting client's ability to settle without attorneys' consent and placing attorney's lien on all fees due attorneys if client opts to change attorneys); *id.* at 443-45 (Beghe, J., dissenting) (explaining effects of attorney's lien and other contract provisions on Kenseth's ability to control destination of his case). Contingency fee contracts often amount to adhesion contracts. Such contracts are defined as a "standard-form contract prepared by one party, to be signed by the party in a weaker position, usually a consumer, who has little choice about the terms." *Id.* at 444 (Beghe, J., dissenting) (quoting BLACK'S LAW DICTIONARY 318-19 (7th ed. 1999)).

134. *See* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (construing Alabama attorney's lien statute to grant attorney same rights and control over client's claims as client possesses); U.S. Fid. & Guar. Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935) (construing Alabama attorney's lien statute to grant attorney "an equitable assignment (or) equitable lien" in plaintiff's cause of action); Denson v. Ala. Fuel & Iron Co., 73 So. 525, 528-31 (Ala. 1916) (explaining extent of attorney's rights under Alabama attorney's lien statute); W. Ry. Co. v. Foshee, 62 So. 500, 503-04 (Ala. 1913) (explaining attorney's right under Alabama attorney's lien statute to prosecute his client's suit to final judgment even after client has settled); *see also*

For example, Alabama's attorney's lien statute grants sweeping and atypical rights of control over the client's lawsuit to the client's attorney.[135] The current Alabama statute states:

> (b) Upon actions and judgments for money, [attorneys] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said action or judgment, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys-at-law shall have the same right and power over action or judgment to enforce their liens as their clients had or may have for the amount due thereon to them.[136]

Under this statute, an attorney has an ownership interest in the client's recovery and identical rights of control as the client has over the prosecution of the claim.[137] If a contingency fee contract grants an attorney rights similar to those granted by the Alabama statute, those rights prevent the contingency fee from vesting in the client, and the client has no gross income from the contingency fee.[138] The attorney's lien shifts control and ownership of the fee from the client to the attorney.[139] As with assignment of income, tax liability follows those who control the income.[140] Thus, the presence of a strong attorney's lien is a key factor that courts have used to conclude that clients do not have gross income from contingency fees.[141]

Conversely, courts have viewed the absence of a strong attorney's lien statute as a major factor in cases determining that contingency fees are gross income to clients.[142] In these cases, the statutory lien does not shift control

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Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856 (6th Cir. 2000) (explaining that Michigan common law attorney's lien "operates in more or less the same way as the Alabama lien in *Cotnam*").

135. *See Kenseth*, 114 T.C. at 435 (Beghe, J., dissenting) (noting "unusual" characteristics of Alabama's attorney's lien law and their contribution to *Cotnam's* result).

136. ALA. CODE § 34-3-61(b) (1975).

137. *Kenseth*, 114 T.C. at 435 (Beghe, J., dissenting); *see also* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (construing Alabama's attorney's lien statute to give attorneys "the same rights as their clients" over clients' lawsuits and recoveries).

138. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 856 (6th Cir. 2000) (explaining *Cotnam* holding and that "Michigan law is not inconsistent with [Alabama's] view of the attorney's lien").

139. *See Cotnam*, 263 F.2d at 125 (noting that attorney's rights become equivalent to client's under lien).

140. *See id.* at 125-26 (concluding that because Alabama attorney's lien statute transfers control over taxpayer's claim and contingency fee to her attorney, her attorney alone should bear tax liabilities for contingency fees).

141. *See Estate of Clarks*, 202 F.3d at 856 (relying on strength of interests granted to attorneys under Michigan common law attorney's lien); *Cotnam*, 263 F.2d at 125 (noting emphasis on equitable interests granted to attorneys under Alabama attorney's lien statute).

142. *See, e.g.*, Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) ("Under California law, an attorney lien does not confer any ownership interest upon attorneys or grant

from the client to the attorney.[143] For example, Maryland's attorney's lien statute simply gives an attorney a security interest in a client's recovery.[144] It does not grant the attorney an ownership interest in the fee.[145] Indeed, most attorney's lien statutes fail to provide the ownership interest and subsequent control to the attorney that are necessary to shift tax liability for the contingency fee to the attorney alone.[146] Specifically, courts have found that the attorney's lien laws of Alaska,[147] Arizona,[148] California,[149] the District of Columbia,[150] Maryland,[151] Pennsylvania,[152] North Carolina,[153] Nebraska, and South Dakota[154] fail to grant attorneys an equitable interest in their clients'

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attorneys any right and power over the suits, judgments, or decrees of their clients."), *cert. denied*, 531 U.S. 1112 (2001); Coady v. Comm'r, 213 F.3d 1187, 1190 (9th Cir. 2000) (stating that Alaska attorney's lien statute does not grant attorneys ownership interests like attorney's liens in Alabama and Michigan), *cert. denied*, 532 U.S. 972 (2001); Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (noting that Maryland attorney's lien statute fails to grant attorney ownership interests in fees).

143. *See infra* notes 145-54 and accompanying text (noting states in which attorney's lien laws do not shift control over clients' claims and recoveries to attorneys).

144. *See* MD. CODE ANN., BUS. OCC. & PROF. § 10-501 (repl. 2000) (codifying attorney's liens); Chanticleer Skyline Room, Inc. v. Greer, 319 A.2d 802, 806 (Md. 1974) (explaining that Maryland's attorney's lien statute "merely places a charge upon the [recovery] as security for the debt which is owed to the attorney by his client").

145. *Chanticleer*, 319 A.2d at 806.

146. *See* Davis, *supra* note 130, at 1716 (explaining that "the vast majority of charging lien law fails to meet the first requirement for *Cotnam* treatment under the Tax Court's strict construction of the *Cotnam* decision").

147. *See* Coady v. Comm'r, 76 T.C.M. (CCH) 257, 259 (1998) (finding that Alaska's attorney's lien statute fails to give attorneys "the same right and power over suits, judgments, and decrees as their clients"), *aff'd*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001).

148. *See* Sinyard v. Comm'r, 76 T.C.M. (CCH) 654, 658 (1998) (stating that no provision exists under Arizona law to provide attorneys with legal interests in their clients' recoveries), *aff'd*, 268 F.3d 756 (9th Cir. 2001).

149. *See* Benci-Woodward v. Comm'r, 76 T.C.M. (CCH) 787, 790 (1998) (explaining that California case law fails to "transfer to the attorney an ownership or proprietary interest in the client's cause of action"), *aff'd*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001).

150. *See* Smith v. Comm'r, 26 T.C.M. (CCH) 1017, 1020 (1967) (noting that District of Columbia lacks attorney's lien statute granting attorneys equitable interests in their clients' causes of action).

151. *See* Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (finding Maryland attorney's lien statute fails to grant attorney ownership interest in client's recovery).

152. *See* Estate of Gadlow v. Comm'r, 50 T.C. 975, 980 (1968) (noting that, unlike Alabama, Pennsylvania lacks statute granting attorney ownership in client's recovery).

153. *See* Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001) (finding that North Carolina common law attorney's lien is distinguishable from Alabama attorney's lien statute).

154. *See* Petersen v. Comm'r, 38 T.C. 137, 152 (1962) (explaining that neither South Dakota nor Nebraska has attorney's lien statute granting "attorneys . . . the same right and power over suits, judgments, and decrees as the clients had or may have").

recoveries. The differences in state attorney's lien laws and in the application of the assignment of income doctrine have led to a circuit split over the proper taxation of contingency fees.

IV. The Origins of the Circuit Split

A. Cotnam v. Commissioner

In *Cotnam v. Commissioner*,[155] the United States Court of Appeals for the Fifth Circuit became the first circuit to address the federal income tax consequences of a plaintiff's recovery under a contingency fee agreement with her attorneys.[156] Ethel Cotnam had promised to serve T. Shannon Hunter of Mobile, Alabama, as a "friend" for the rest of his life in return for his promise to give her one-fifth of his estate.[157] Cotnam performed her part of the bargain by serving Hunter for four and one-half years, but Hunter died intestate.[158] After bringing suit against the administrator of Hunter's estate, Cotnam and her attorneys obtained a judgment of $120,000.[159] Attorneys' fees amounted to $50,365.83, based on a 40% contingency fee arrangement.[160] The Commis-

155. 263 F.2d 119 (5th Cir. 1959).

156. *See* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (holding that sum plaintiff paid to her attorneys under contingency fee agreement "should not be included in [plaintiff's] gross income. This sum was income to the attorneys but not to Mrs. Cotnam."). In *Cotnam*, the Fifth Circuit considered the tax consequences of Mrs. Cotnam's $120,000 judgment against the estate of a man for whom she had served as an "attendant" for four and one-half years. *Id.* at 120-21. The court first found that the verdict in Cotnam's favor represented the enforcement of a contract for personal services, not the enforcement of a will. *Id.* at 122. Because this recovery represented payment for personal services, the court found that it was taxable income to Cotnam. *Id.* at 125. However, a majority of the court held that the IRS should not have included a portion of the $120,000 recovery, (namely an amount of $50,365.83 paid to her attorneys) in her gross income. *Id.* This amount was income to her attorneys only. *Id.* To justify this conclusion, the court noted that Alabama law granted attorneys "the same right and power over" the suits of their clients as their clients possessed. *Id.* As a result, Cotnam never could have obtained the $50,365.83 portion of the recovery (even if she had settled the case herself) because of the Alabama attorney's lien statute, which the court construed as forbidding Cotnam to realize as income the contingency fee paid to her attorneys. *Id.* Furthermore, the court explained that the contingency fee contract did not fall within *Earl*'s assignment of income doctrine. *Id.* at 125. Because Cotnam could not have recovered anything without the aid of her attorneys, the only way she could have obtained any money was by agreeing to give her attorneys 40% of any recovery. *Id.* at 126. The court reasoned that Cotnam had not fully enjoyed the economic benefit of her claim because her attorneys were entitled to 40% of it. *Id.* at 125-26. As a result, the court found that the portion of the recovery paid to the attorneys was not taxable income to Cotnam. *Id.* at 126.

157. *Id.* at 120 & n.1.

158. *Id.*

159. *Id.* at 121; *see also* Merchs. Nat'l Bank v. Cotnam, 34 So. 2d 122, 132 (Ala. 1948) (affirming judgment for Cotnam).

160. Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959).

sioner of Internal Revenue viewed the entire $120,000 as income to Cotnam, and assessed an income tax deficiency against her for $36,985.02.[161] The Tax Court found for the Commissioner, and Cotnam appealed to the Fifth Circuit.[162]

The Fifth Circuit first concluded that Cotnam's agreement to serve Hunter did not allow her to claim the $120,000 as a non-taxable bequest; instead, it was taxable ordinary income.[163] Judge John Minor Wisdom, in his majority opinion, then tackled the issue of whether the portion of the recovery Cotnam paid to her attorneys should be taxable to her.[164] Judge Wisdom noted that, under Alabama law, Cotnam could not have received the contingency fee even if she had settled the case herself.[165] Given the strong control rights that Alabama's attorney's lien statute granted to attorneys, Judge Wisdom concluded that Cotnam was unable to recognize income from the 40% of the recovery she paid as a contingency fee.[166]

In their concurrence, Judges Rives and Brown further reasoned that Cotnam's contingency fee arrangement with her attorneys was her only feasible method of recovering against Hunter's estate.[167] Because Cotnam's claim had no certain value, her only choice was to shift a future portion of it to her attorneys as part of a plan to obtain the rest of the value of her claim.[168] According

161. *Id.* at 121.

162. *Id.*; *see also* Cotnam v. Comm'r, 28 T.C. 947, 954 (1957) (concluding that amounts Cotnam paid to her attorneys constituted gross income to Cotnam under *Earl*'s assignment of income doctrine), *rev'd*, 263 F.2d 119, 121 (5th Cir. 1959).

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

164. *See id.* at 125 (concluding that sum was not gross income to Cotnam). Interestingly, Judge Wisdom wrote both a majority and a dissenting opinion in this case. *See id.* at 120 (giving Judge Wisdom's majority opinion); *id.* at 126 (Wisdom, J., dissenting) (giving Judge Wisdom's dissent). The majority opinion focused on the Alabama attorney's lien statute as a reason to conclude that the attorneys' fees paid by Cotnam should not be included in her taxable income. *Id.* at 125. Arguing that the assignment of income doctrine did not apply in this case, Judges Rives and Brown concurred with a brief addition. *Id.* at 125-26 (Rives & Brown, JJ., concurring). Judge Wisdom's dissent also focused on the assignment of income doctrine, but he concluded that the doctrine did apply in *Cotnam*. *Id.* at 126-27 (Wisdom, J., dissenting); *see generally* Kenseth v. Comm'r, 114 T.C. 399, 434 n.35 (2000) (Beghe, J., dissenting) (listing cases in which judge or justice writes both majority and dissenting opinions), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

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

166. *See id.* (noting conclusion drawn by Judge Wisdom in his portion of majority opinion); *see also* ALA. CODE § 64 (1940) (noting Alabama statute at issue in *Cotnam*). See Davis, *supra* note 130, at 1700-08, for an additional discussion of the *Cotnam* decision.

167. *Cotnam*, 263 F.3d at 125 (Rives & Brown, JJ., concurring).

168. *See id.* (Rives and Brown, JJ., concurring) (stating that "[h]er claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder.").

to Judges Rives and Brown, this transfer of a right to a portion of her recovery was not within the assignment of income doctrine as explained by the Supreme Court in *Earl*.[169] Cotnam already had earned the income in question by fulfilling her bargain with Hunter to serve him for the remainder of his life.[170] However, without the assistance of an attorney, all she had was a claim for payment; her attorneys helped her realize the value of her claim and collect it.[171] Thus, the judges concluded that the doctrine of assignment of income did not apply in a case such as this one in which only 60% of the judgment ever passed through Cotnam's hands.[172] The other 40% of the recovery was income to Cotnam's attorney, whose assistance had enabled Cotnam to recover her portion.[173] The concurring judges also dismissed the Commissioner's argument that Cotnam legally had obligated herself to pay her attorneys the fee.[174] Cotnam had to pay the fee only if the suit was successful; defeat would have removed any obligation to pay her attorneys.[175]

In his dissent,[176] Judge Wisdom asserted that Cotnam's case was clearly within the bounds of the assignment of income doctrine.[177] The crux of Wisdom's argument was that Cotnam had exercised enough control over the disposition of the funds to her attorneys to conclude that she had received a direct benefit from those funds.[178] Furthermore, Cotnam had already earned

169. *Id.* (Rives and Brown, JJ., concurring); *see also* Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (explaining assignment of income doctrine); *supra* notes 79-127 and accompanying text (explaining development of assignment of income doctrine).

170. Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (Reves & Brown, JJ., concurring).

171. *See id.* at 126 (Rives & Brown, JJ., concurring) (noting that "[t]he services of her attorneys resulted in converting that claim into a judgment and the collection of the judgment").

172. *See id.* (Rives & Brown, JJ., concurring) ("That doctrine can have no just or realistic application to a case like this, where the only economic benefit to the taxpayer was as an aid to the collection of a part of an otherwise worthless claim.").

173. *Id.* (Rives & Brown, JJ., concurring).

174. *See id.* (Rives & Brown, JJ., concurring) (noting that Commissioner's argument was based on "false premise").

175. *See id.* (Rives & Brown, JJ., concurring) (noting that Cotnam fully paid her attorneys by transferring part of "doubtful claim" to them). Noting the fruit of the tree metaphor used in *Earl*, Judges Rives and Brown explained that Cotnam's tree "had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit." *Id.* (Rives & Brown, JJ., concurring).

176. *See supra* note 164 (explaining that Judge Wisdom wrote both majority and dissenting opinions).

177. *See* Cotnam v. Comm'r, 263 F.2d 119, 127 (5th Cir. 1959) (Wisdom, J., dissenting) (noting that "[t]his case is stronger than *Horst* . . . since Mrs. Cotnam assigned the right to income already earned").

178. *Id.* (Wisdom, J., dissenting).

the income she assigned to her attorneys.[179] Thus, finding the facts in *Cotnam* indistinguishable from those in *Horst*, Judge Wisdom felt compelled to apply the assignment of income doctrine.[180]

B. Cotnam*'s Successors*

1. Estate of Clarks ex rel. Brisco-Whitter v. United States

Two recent court of appeals cases have followed the holding in *Cotnam*.[181] In *Estate of Clarks ex rel. Brisco-Whitter v. United States*,[182] Arthur Clarks recovered $11,307,875.55 from K-Mart for personal injuries.[183] Of that

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179. *Id.* (Wisdom, J., dissenting).

180. *See id.* at 126 (Wisdom, J., dissenting) (stating that "this case is governed by the principles set forth in *Helvering v. Horst*"); *see also supra* notes 90-102 (discussing *Horst*).

181. *See* Srivastava v. Comm'r, 220 F.3d 353, 364-65 (5th Cir. 2000) (refusing to distinguish *Cotnam* and reversing Tax Court's decision that contingency fees are included in client's gross income); Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (stating "[w]e follow *Cotnam*" and refusing to include contingency fees in client's gross income).

182. 202 F.3d 854 (6th Cir. 2000).

183. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 855, 858 (6th Cir. 2000) (concluding that attorney's contingency fee was not gross income to client who had received personal injury award). In *Estate of Clarks*, the court considered whether $1,901,314.67 of interest Clarks paid to his attorney as part of a contingency fee agreement was includible as gross income for Clarks. *Id.* at 855. Clarks had recovered a large judgment from K-Mart for personal injuries as well as $5,707,837.55 in interest on that judgment. *Id.* The principal amount of the award and Clarks's attorney's part of it were not at issue in the case because Internal Revenue Code § 104(a)(2) does not include any award for personal physical injuries in gross income. *Id.*; *see also* I.R.C. § 104(a) (1994 & Supp. V. 1999) (mandating exclusion from gross income for damages paid for physical personal injuries). From the interest award, Clarks paid $1,901,314.67 (33.3%) directly to his attorney pursuant to a contingency fee agreement. *Estate of Clarks*, 202 F.3d at 855. Interest awards are includable in gross income, and the IRS claimed that the entire interest award, including the attorney's portion, was gross income to Clarks. *Id.* This finding subjected Clarks's estate to additional taxes and the AMT. *Id.* Challenging the government's determination of his tax liabilities and seeking a refund, Clarks's estate filed suit in federal court. *Id.* The district court granted summary judgment for the government. *Id.* at 856. The Sixth Circuit, after noting the existence of a circuit split, found that Michigan's common law of attorney's liens operated "in more or less the same way as the [statutory] Alabama lien in *Cotnam*." *Id.* Therefore, Michigan law caused Clarks's estate to receive no gross income from the attorney's portion of the recovery. *See id.* (adopting this result from *Cotnam*). Turning to the assignment of income doctrine, the court concluded that the *Cotnam* court had properly distinguished the Supreme Court's decisions in *Earl* and *Horst*. *Id.* at 857. Explaining the differences between the instant case and *Earl* and *Horst*, the Sixth Circuit said that Clarks's estate did not seek to use the contingency fee to shift tax liabilities among family members and that the value of Clarks's claim against K-Mart was "entirely speculative and dependent on the services of counsel." *Id.* Thus, the Michigan common law attorney's lien and the speculative nature of Clarks's claim operated in tandem to transfer to Clarks's attorney an ownership interest in the contingency fee, an interest that makes the attorney alone liable for federal income taxes on the sum. *Id.*

amount, K-Mart paid $5,707,837.55 as interest.[184] K-Mart paid $1,901,314.67 directly to Clarks's attorney pursuant to a contingency fee agreement that Clarks had previously signed with the attorney.[185] Clarks's estate sought to exclude from his gross income the amount paid to his attorney.[186]

The Sixth Circuit agreed with Clarks and based its reasoning squarely on the *Cotnam* decision.[187] The court found that Michigan's common law attorney's lien operated similarly to the Alabama statute in *Cotnam*.[188] That is, the Michigan attorney's lien gave Clarks's attorney an ownership interest in the contingency fee portion of the recovery.[189]

The court also concluded that the majority in *Cotnam* had properly distinguished *Earl* and *Horst*.[190] In particular, the Sixth Circuit agreed with the *Cotnam* court's reasoning that both *Earl* and *Horst* involved intrafamily donative transfers that were motivated solely to avoid income tax liability.[191] Clarks's hiring an attorney and agreeing to a contingency fee contract clearly did not involve an intrafamily transfer and was not part of a tax avoidance scheme.[192]

Additionally, the court focused on the speculative nature of Clarks's claim and the necessity of relying on the work of counsel in order for the claim to come to fruition.[193] The court explained that Clarks's only practical use of his claim was to transfer part of its value to an attorney in the hopes of collecting the remaining value through legal action.[194] Reasoning that

184. *Estate of Clarks*, 202 F.3d at 855.

185. *Id.*

186. *Id.* at 855.

187. *See id.* at 856-57 (giving court's decision and noting its reliance on *Cotnam* for guidance); *see also* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (relying on Alabama attorney's lien statute to exclude contingency fee from client's gross income); *id.* at 125-26 (Rives & Brown, JJ., concurring) (distinguishing *Cotnam* from *Earl* and *Horst* and arguing that assignment of income doctrine does not apply to contingency fees).

188. *Estate of Clarks*, 202 F.3d at 856.

189. *Id.*

190. *Id.* at 857; *see also supra* notes 79-89 and 114-23 and accompanying text (discussing *Earl*); *supra* notes 90-102 and accompanying text (discussing *Horst*).

191. Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000); *see also Cotnam*, 263 F.2d at 125 (Rives & Brown, JJ., concurring) (distinguishing facts of *Cotnam* from *Earl* and *Horst*).

192. *See Estate of Clarks*, 202 F.3d at 857 (stating that Clarks's purpose in entering into contingency fee agreement was not to shift tax liabilities among his family members, but was made with "a hope to receive money from the lawyer's efforts and the client's right").

193. *See id.* (explaining speculative nature of Clarks's claim and his reliance on his attorney to obtain any recovery).

194. *See id.* (stating that "[t]he only economic benefit Clarks could derive from his claim against the defendant . . . was to use the contingent part of it to help him collect the remainder").

Clarks's conveyance of a percentage interest in his recovery to his attorney was more like a division of property than an assignment of income, the court excluded the contingency fee from Clarks's gross income.[195]

2. Srivastava v. Commissioner

In *Srivastava v. Commissioner*,[196] the Fifth Circuit rejected an attack on *Cotnam* and found that contingency fees are not included in a client's gross income.[197] Dr. Srivastava and his wife recovered damages for defamation in a settlement with the insurers of a Texas television station.[198] Srivastava sought to exclude from his gross income the contingency fees he paid to his

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195. *See id.* at 858 (likening contingency fee to division of property by saying that "the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract."). *But see infra* notes 208-12 and accompanying text (discussing problems with division of property analogy).

196. 220 F.3d 353 (5th Cir. 2000).

197. *See* Srivastava v. Comm'r, 220 F.3d 353, 355 (5th Cir. 2000) (concluding that attorneys' contingent fees are excluded from client's gross income). In *Srivastava*, the court considered whether a contingency fee was gross income to a client. *Id.* at 355. Srivastava received $8.5 million to settle his defamation claims against a television station. *Id.* The parties did not separate the settlement into portions for actual damages (non-taxable) versus punitive damages and interest (taxable). *Id.* at 356. Arguing that the entire settlement represented payment for actual damages, Srivastava reported no income from the settlement. *Id.* The Fifth Circuit affirmed the Tax Court's division of the settlement between taxable and non-taxable damages and then turned to the tax issues surrounding the contingency fee. *Id.* at 356-57, 367. First the court observed that if it was deciding this case "on a *tabula rasa*, [it] might be inclined to include contingent fees in gross income." *Id.* at 357. The court discussed the assignment of income doctrine and concluded that the doctrine should not allow Srivastava to escape taxation on the portion of his recovery paid to his lawyer. *Id.* at 360-63. The court reasoned that, absent a contingency fee agreement, Srivastava would have had to pay his attorney out of his own pocket, so the "simple fortuity" of signing a contingency fee agreement ought not give him "preferential tax treatment" over individuals who actually do pay their lawyers with their own funds. *Id.* at 363. However, the court noted the *Cotnam* decision, finding it "substantially indistinguishable" from the instant case, and decided to reverse the Tax Court and find that contingent fees governed by Texas law are excludable. *Id.* at 357-58. The court found its own reasoning using the assignment of income doctrine to be contrary to the *Cotnam* decision and refused the Commissioner's request to overturn that case. *Id.* at 363, 365. Finally, the court rejected an attempt by the Commissioner to distinguish *Cotnam* by the fact that the Texas attorney's lien statute granted fewer ownership rights over clients' recoveries than the Alabama statute. *Id.* at 363-64. The Fifth Circuit did not consider an attorney's power to pursue relief against a party opposing his client to be relevant to an assignment of income analysis, which focuses on a taxpayer's degree of control over an asset. *Id.* For a further discussion on the reasoning of the *Srivastava* decision, see generally Benjamin C. Rasmussen, Note, *Taxation of an Attorney's Contingency Fee of a Punitive Damages Recovery: The* Srivastava *Approach*, 15 BYU J. PUB. L. 301 (2001).

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

attorneys.[199] The court noted that if the case had been one of first impression, it probably would have forced Srivastava to include the fees in his gross income.[200] However, the court found the facts in *Srivastava* practically identical to those in *Cotnam* and, given *Cotnam*'s value as precedent in the Fifth Circuit, ruled for the plaintiffs.[201] The court refused to overrule *Cotnam* despite its reservations about the *Cotnam* court's reasoning precisely because of stare decisis.[202]

In deciding whether to apply the assignment of income doctrine, the *Srivastava* court considered two analogies to characterize the contingent fee attorney-client relationship.[203] First, relying on *Estate of Clarks*, the Fifth Circuit suggested that the client's claim and recovery is subject to co-ownership by the attorney and client in a partnership.[204] Under a partnership analogy, the attorney and client would share the profits of any recovery.[205] The court rejected this analogy, stating that the fiduciary duty of an attorney to his client cannot be converted easily into a partnership.[206] Further, professional rules of conduct also prohibit an attorney from forming a partnership with a non-lawyer if the partnership will involve the practice of law.[207]

Second, the court considered analogizing the contingent fee attorney-client relationship to a division of property.[208] Under this analogy, the client

199. *Id.* at 357.

200. *See id.* (noting that court was not deciding this case "on a *tabula rasa*"). The Fifth Circuit stated in dictum that, absent the *Cotnam* precedent, it might have found the assignment of income doctrine applicable to Srivastava, forcing him to include the contingency fees in his gross income. *Id.* at 363.

201. *See id.* at 357-58 (stating that *Cotnam* is "substantially indistinguishable" from *Srivastava*); *see also* Cotnam v. Comm'r, 263 F.2d 119, 120-21 (5th Cir. 1959) (giving facts in *Cotnam*).

202. *Srivastava*, 220 F.3d at 363, 365. One could infer from *Srivastava* that attorneys and clients engaged in similar future litigation may need another theory to supplement *Cotnam*'s rationale because the Fifth Circuit all but repudiated the reasoning of *Cotnam* in *Srivastava*. *See id.* at 357-63 (considering assignment of income doctrine at length in dictum).

203. *See id.* at 360 (noting use of partnership or joint venture analogy and division of property analogy).

204. *See id.* (quoting Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (2000)); *see also* Kalinka, *supra* note 11, at 20-21 (explaining possible formation of partnership between attorney and client).

205. Kalinka, *supra* note 11, at 21.

206. *See* Srivastava v. Comm'r, 220 F.3d 353, 360 n.21 (5th Cir. 2000) (quoting Kenseth v. Comm'r, 114 T.C. 399, 413 (2000)).

207. *See* MODEL RULES OF PROF'L CONDUCT R. 5.4(b) (2000) ("A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law."); Kalinka, *supra* note 11, at 21-22 (stating ethical restrictions on attorney-client partnerships for contingency fee cases).

208. *Srivastava*, 220 F.3d at 360.

transfers a portion of his income-producing claim to the attorney.[209] Yet, as the *Srivastava* court notes, "contingent fee provisions assign more than just the fruit – and yet divest clients of something less than the entire tree."[210] The court rejected this analogy because of the ambiguity as to what exactly the client transfers to the attorney.[211] Despite the court's rejection of both analogies, the division of property analogy laid a foundation upon which a sharecropping metaphor can be built.[212]

Srivastava stands as a warning to future taxpayers who seek to exclude contingency fees from their gross income.[213] Excluding contingency fees from a client's gross income raises questions of horizontal equity.[214] Despite its

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209. *Id.*; *see also* Estate of Clarks *ex rel.* Brisco-Whitter, 202 F.3d 854, 857-58 (6th Cir. 2000) (explaining that contingency fees are like "a division of property").

210. *Srivastava*, 220 F.3d at 360.

211. *Id.* The *Srivastava* court's use of the division of property analogy implied that the property transferred to the attorney is guaranteed to produce income. *See id.* ("[C]ontingent fee arrangements, to be sure, assign a percentage of the proceeds of any judgment or settlement agreement . . . to the attorney."). As *Estate of Clarks* suggests, the property transferred is like "some of the trees in [client's] orchard." 202 F.3d at 857-58. For the division of property analogy to work, those trees must be full of ripe fruit in order to guarantee payment to the attorney. However, at the time a contingency fee contract is signed, there is no guarantee of payment for the attorney. The client's fruit trees are bare and will require the work of a careful and dedicated grower to insure that they do bear fruit. Likewise, a client's claim at the signing of a contingency fee contract actually is an unproven claim of potential, not certain, value. Therein lies the failure of the division of property analogy. The analogy does not explain the true contingent nature of the claim and the control that the attorney must necessarily have over it. The sharecropping analogy does. In a sharecropping agreement, like a contingency fee agreement, neither the tenant (attorney) nor the landlord (client) are certain of the amount of income that the cropland will produce. However, with the tenant controlling the raising of the crops, income can be generated for both tenant and landlord. This more accurately characterizes a contingency fee agreement. *See infra* notes 256-337 and accompanying text (explaining sharecropping analogy).

212. *See* Srivastava v. Comm'r, 220 F.3d 353, 360 (5th Cir. 2000) (noting that "contingent fee provisions assign more than just the fruit and yet divest clients of something less than the entire tree"). The next step to reach the sharecropping analogy is to add the full analysis of the attorney's work on the case. The attorney brings the claim to fruition through his skill and effort. *See* Kenseth v. Comm'r, 114 T.C. 399, 450 (2000) (Beghe, J., dissenting) (noting that attorneys, through their work, add "substantial value" to clients' claims), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

213. *See supra* note 202 (noting almost complete repudiation of *Cotnam* by *Srivastava* court).

214. *Srivastava*, 220 F.3d at 363 ("[I]f there were no contingent fee arrangement, Srivastava presumably would have had to compensate counsel out of his own pocket . . . . He ought not receive preferential tax treatment from the simple fortuity that he hired counsel on a contingent basis."). For a further argument that the *Srivastava* decision impugns the doctrine of separation of powers, see 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).

reservations, the court relied on *Cotnam* to find for the client.[215] Future taxpayers will need stronger arguments to overcome state attorney's lien statutes and the assignment of income doctrine if they want to exclude contingency fees from their gross income.[216]

C. Baylin v. United States

In *Baylin v. United States*,[217] the United States Court of Appeals for the Federal Circuit, while not even acknowledging the *Cotnam* decision, reached the opposite conclusion of *Cotnam* regarding the tax liabilities for contingency fees.[218] Baylin and his partnership, Painters Mill Venture, contested

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Campbell argues that Congress alone has the power to define the concept of gross income; a court that excludes contingency fees from gross income "violate[s] the separation of power doctrine by diminishing congressional taxing power." *Id.*

215. *See Srivastava*, 220 F.3d at 365 (refusing to challenge *Cotnam* decision).

216. *See id.* at 363 (noting that court, if *Cotnam* did not exist as precedent, "might apply the anticipatory assignment [of income] doctrine to hold that contingent fees are gross income to client"); *id.* at 364 (arguing that tax liability for contingency fees "does not depend on the intricacies of an attorney's bundle of rights" under state law).

217. 43 F.3d 1451 (Fed. Cir. 1995).

218. *See* Baylin v. United States, 43 F.3d 1451, 1452 (Fed. Cir. 1995) (affirming order that "portion of the condemnation award paid to [Baylin's] attorney under a contingency fee agreement was gross income to the [plaintiff]"). In *Baylin*, the Federal Circuit considered the tax implications arising for Baylin, the tax-matters partner of a partnership that owned 137 acres of land condemned by the Maryland State Highway Administration, following a dispute over the fair value of the land. *Id.* at 1452. The government of Maryland paid the partnership \$2,699,775 for the land pursuant to the state's condemnation law. *Id.* The partnership filed suit, contesting the condemnation award, and a jury awarded them \$3,899,000, as well as interest and costs. *Id.* The partnership appealed this award to the state appeals court, but the parties reached a settlement in the amount of \$16,319,522.91. *Id.* at 1453. The amount was divided between \$10,625,850 in principal for the land and \$6,358,418 in interest. *Id.* While the partnership originally reported a capital gain on the sale of the land of \$7, 297,828, the IRS classified all of the legal fees as capital expenditures, leaving the partnership with a reformulated capital gain of \$5, 274,964. *Id.* The IRS classified the interest as taxable interest income in the amount of \$6, 205, 273. *Id.* The parties agreed that the legal fees expended in an effort to increase the amount paid for the land by the Highway Administration were capital expenditures. *Id.* However, the partnership argued that, because it was working with its attorneys on a contingency fee basis, it "should be allowed to deduct from interest income an amount of its attorney's fees proportionally equivalent to the amount of the settlement classified as interest." *Id.* The partnership sought to deduct approximately one-half of their legal fees, about \$2,000,000, because one-half of the partnership's recovery after the appeal represented interest on the condemnation award. *Id.* The court, however, rejected the partnership's argument that the fees were deductible because those particular fees were used to generate the interest portion of the award. *Id.* at 1454. The court noted that the record reflected that the attorney spent only a small amount of his time trying to increase the amount of the interest award. *Id.* The partnership then argued that the portion of the recovery paid to the attorney was never part of the partnership's gross income. *Id.* The court, citing *Lucas v. Earl*, stated that such an argument would allow a "skillfully devised" arrangement to avoid federal income taxes. *Id.* The

the Maryland State Highway Administration's condemnation of 137 acres of land owned by the partnership.[219] The partnership eventually recovered \$16,319,522.19 as the fair market value of the land.[220] The partnership's legal fees amounted to \$4,048,424.[221] In the tax dispute that followed, Baylin and the IRS agreed that the portion of the fees attributed to the attorney's efforts to increase the principal amount of the condemnation award was a nondeductible capital expense pursuant to § 263(a) of the Internal Revenue Code.[222] However, the parties disagreed over the tax consequences of the portion of the attorney's fees attributable to interest.[223]

The partnership argued that it should not have to include the portion of the recovery paid to its attorney in its gross income because the Maryland State Highway Administration paid the attorneys directly.[224] The partnership never possessed the money with which it paid its attorney.[225] The court quickly dismissed this argument as being the very sort of carefully crafted contingency fee agreement that valued form over substance in permitting the partnership to avoid taxation.[226] The court emphasized in its reasoning the value that the partnership received from the attorney's services constituted income, even if the money never actually came into the possession of the partnership.[227] This benefit and value that the partnership received from the agreement was evidence to the court that the arrangement fell under the assignment of income doctrine illustrated in *Horst*.[228]

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court found that the partnership exercised enough power and control over the recovery as to allow the income to be assigned to the partnership within the guidance of *Helvering v. Horst*. *Id.* at 1454-55. Alternatively, the court rejected the partnership's attempt to rely on the Maryland attorney's lien statute as creating an ownership interest in the potential fee for the attorney. *Id.* at 1455. The court noted that Maryland courts have not construed the statute to grant such an interest to attorneys. *Id.* The court concluded that the entire condemnation award was gross income to the partnership. *Id.*

219. *See id.* at 1452-53 (noting Baylin filed suit in state court and appealed jury's award to state appellate court).

220. *Id.* at 1453.

221. *Id.*

222. *Id.*; *see* I.R.C. § 263(a) (1994) (denying deductions for expenses "made to increase the value of any property or estate").

223. *See Baylin*, 43 F.3d at 1453-54 (noting that Baylin argued that he should deduct from his gross income attorney's fees attributed to trying to increase interest award).

224. *See id.* at 1454 (noting partnership's argument).

225. *Id.* at 1454.

226. *Id.*

227. *See id.* (noting that "partnership received the benefit" of contingency fee funds and that fee arrangement signified "the value that the parties placed on the attorney's services").

228. *See id.* (stating that partnership "assigned a portion of its condemnation recovery to its attorney"); *see also* Helvering v. Horst, 311 U.S. 112, 119-20 (1940) (explaining assignment of income doctrine).

The speculative nature of Baylin's claim did not sway the court.[229] According to the court, the uncertain nature of the contingency fee had no place in an analysis of the tax liabilities for the fee.[230] In the eyes of the Federal Circuit, the contingency fee arrangement did not mean that the portion of the fee paid to the attorney never constituted income to the partnership.[231] The contingency fee agreement merely served as a method for both parties to estimate the value of the legal services that the attorney provided.[232] The fact that the state, instead of the partnership, paid the fee directly to the attorney simply demonstrated that the agreement allowed the state to discharge the partnership from having to make the actual payment of the fee.[233]

Baylin and his partnership also argued that the Maryland attorney's lien statute gave the attorney an ownership interest in the fee.[234] As the owner of that portion of the fee, the fee would be gross income to the attorney and not to the partnership.[235] The court found this argument groundless.[236] It noted that Maryland courts had not interpreted the statute as granting such a strong and controlling interest in a possible fee to an attorney.[237] The court, while not expressly rejecting the idea that an attorney's lien statute could determine the tax consequences of a contingency fee, found the Maryland statute unsupportive of the partnership's claims.[238]

229. *See* Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (noting that partnership did not know final amount it would owe its attorney when legal action commenced). *But see* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (stating that assignment of income doctrine does not apply to Clarks's "speculative claim"); Cotnam v. Comm'r, 263 F.2d 119, 125-26 (5th Cir. 1959) (Rives and Brown, JJ., concurring) (concluding that assignment of income doctrine does not apply to Cotnam's "doubtful and uncertain" claim).

230. *See Baylin*, 43 F.3d at 1455 (noting that "[t]he temporary uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees").

231. *See id.* at 1455 (rejecting claim that attorney's contingency fee is not gross income to partnership).

232. *Id.*

233. *Id.*

234. *Id.*; *see also* MD. CODE. ANN., BUS. OCC. & PROF. § 10-501 (1989) (codifying attorney's liens).

235. *See* Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) (noting implication of partnership's argument).

236. *Id.*

237. *Id.*; *see also* Chanticleer Skyline Room, Inc. v. Greer, 319 A.2d 802, 806 (Md. 1974) (noting that "[l]ike any other lien, this lien does not create an ownership interest in the attorney, but merely places a charge upon the fund as security for the debt which is owed to the attorney by the client").

238. *See Baylin*, 43 F.3d at 1455 (reaching conclusion solely utilizing Maryland's statute and taking no position on use of state attorney's lien statutes for determining tax consequences for contingency fees).

D. Coady v. Commissioner

In *Coady v. Commissioner*,[239] the United States Court of Appeals for the Ninth Circuit followed *Baylin* and Judge Wisdom's dissent in *Cotnam*.[240] Coady recovered a large judgment for back pay and benefits from the Alaska Housing Finance Corporation for wrongful termination.[241] Coady and her husband sought to exclude the legal fees from their gross income, arguing that the legal fees were gross income to their attorney alone.[242] The court rejected this argument and the Coadys' reliance on *Cotnam*.[243]

The court first distinguished the Alaska attorney's lien statute from the Alabama statute at issue in *Cotnam*.[244] Alaska's attorney's lien statute neither

239. 213 F.3d 1187 (9th Cir. 2000).

240. *See* Coady v. Comm'r, 213 F.3d 1187, 1187, 1190 (9th Cir. 2000) (concluding that plaintiff's gross income includes amounts paid to attorneys under contingency fee agreement), *cert. denied*, 532 U.S. 972 (2001). In *Coady*, the court confronted the question of whether the Coadys could exclude from their gross income the portion of Nina Coady's recovery they paid their attorney pursuant to a contingency fee agreement. *Id.* at 1187. Nina Coady recovered a judgment from the Alaska Housing Finance Corporation (AHFC) for wrongful termination in the amount of $373,307. *Id.* The AHFC, after withholding appropriate federal taxes, issued her a check for $259,610.89. *Id.* Of that amount, $221,338.32 went to the Coadys' attorneys for litigation costs and a one-third portion of the recovery as called for in the contingency fee agreement. *Id.* at 1187-88. In the suit in the United States Tax Court, the parties agreed that $53,121 of those legal fees were properly deductible as a miscellaneous deduction. *Id.* at 1188. However, they disagreed over the tax treatment of the remaining $168,217, with the Coadys arguing that the amount should be excluded from gross income. *Id.* The Coadys relied on *Cotnam* and argued that the amount should not be included in their gross income because "they 'assigned' that portion of their settlement to counsel." *Id.* However, the court, noting that *Cotnam* had been rejected by the Federal Circuit in *Baylin* and the First Circuit in *Alexander*, concluded that the facts of the instant case were distinguishable from *Cotnam*. *Id.* at 1190. The Alaska attorney's lien statute does not create the ownership interest that such a lien does in Alabama or Michigan. *Id.* The court found that the Coadys' award was in lieu of wages and compensation, which are both clearly included in gross income, so that its subsequent exclusion would defeat the purpose of the income tax laws. *Id.* The Coadys simply used a portion of that income to pay their attorneys. *Id.* at 1191. The court then cited *Horst* and *Earl* for the proposition that income taxes cannot be avoided by arrangements to shift income to other parties. *Id.* The assignment of income doctrine forced the Coadys to include the contingency fee in their gross income. *Id.* The Ninth Circuit followed *Coady* in its brief opinion in *Benci-Woodward v. Comm'r*, 219 F.3d 941, 942-43 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001), concluding that the California attorney lien statute operates similarly to the Alaska statute.

241. *Coady*, 213 F.3d at 1187.

242. *Id.* at 1188. The Coadys specifically sought to exclude the legal fees included in their gross income despite the application of § 67 of the Internal Revenue Code. The Coadys took a miscellaneous itemized deduction for the legal fees, but § 67 only allows the deduction to the extent the fees exceed 2% of their adjusted gross income. *See* I.R.C. § 67 (1994) (noting provisions on miscellaneous deductions).

243. *Coady*, 213 F.3d at 1190.

244. *Id.* *Compare* Hagans, Brown & Gibbs v. First Nat'l Bank, 783 P.2d 1164, 1168 (Alaska 1989) (explaining that no ownership interest in client's recovery passes to attorney

grants any ownership rights over the recovery nor transfers control over clients' lawsuits, judgments, or decrees to an attorney.[245] Second, the court found that the assignment of income doctrine governed the transaction between Coady and her attorney.[246] Coady asserted that the uncertainty of recovering any damages at the time she entered into the contingency fee agreement with her attorney distinguished her case from the assignment of income precedents.[247] However, the Ninth Circuit previously held that an assignment of a potentially contingent amount of income was not grounds for denying the application of the assignment of income doctrine.[248] The court concluded that the Coadys could not avoid federal income tax liability for the legal fees by diverting them to her attorney through a pre-arranged contingency fee agreement.[249]

According to both *Baylin* and *Coady*, the client retained ultimate control over the recovery at issue.[250] Under such an analysis, the assignment of income doctrine made the contingency fee part of the client's gross income.[251] The applicable attorney's lien statutes kept the attorneys from gaining any ownership and control interests over the recovery.[252] The question emerging

under Alaska's attorney's lien statute), *appeal after remand*, 810 P.2d 1015 (Alaska 1991), *and* ALASKA STAT. § 34.35.430 (Michie 2000) ("This lien is . . . subordinate to the rights existing between the parties to the action or proceeding."), *with* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (discussing Alabama attorney's lien statute), *and* ALA. CODE §§ 34-3-61(b) (1975) ("[A]ttorneys at law shall have the same right and power over action and judgment . . . as their clients.").

245. *Coady*, 213 F.3d at 1190.

246. *Id.* at 1191.

247. *Id.*

248. *See* Kochansky v. Comm'r, 92 F.3d 957, 959 (9th Cir. 1996) (noting that "uncertain, doubtful, and contingent" fee remains income to assignor under assignment of income doctrine). The Federal Circuit also rejected the argument that the uncertainty of a contingency fee prevents the application of the assignment of income doctrine. *See* Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995) ("The temporarily uncertain magnitude of the legal fees under [a contingency fee agreement] and the vehicle of an assignment cannot dictate the income tax treatment of those fees.").

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

250. *See id.* at 1190 (explaining that control over recovery vested solely in Coady as her attorney obtained no ownership rights over recovery); *Baylin*, 43 F.3d at 1455 (stating that attorney had no control interests over Baylin's recovery); *see also* Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (noting that attorney acquires "no more than a professional interest" in client's claim and recovery), *cert. denied*, 531 U.S. 1112 (2001).

251. *See Coady*, 213 F.3d at 1191 (using assignment of income doctrine to include contingency fee in Coady's gross income); *Baylin*, 43 F.3d at 1454-55 (explaining that assignment of income doctrine makes contingency fee gross income to Baylin).

252. *See Coady*, 213 F.3d at 1190 (stating that Alaska's attorney's lien statute does not give attorneys ownership interests in clients' recoveries); *Baylin*, 43 F.3d at 1455 (noting that

from these cases and other cases involving the taxation of contingency fees is whether the results accurately characterize the attorney-client relationship.[253] In *Baylin* and *Coady*, the client was in complete control.[254] A more accurate description of the attorney-client relationship is one where neither party has complete control, but the attorney's share of control grows over time.[255] A new analogy is needed to properly demonstrate that shift in control and to better apportion the tax burden for the recovery.

V. The Sharecropping Analogy

In his dissent in *Kenseth*, Judge Beghe suggests that an analogy to sharecropping is the most accurate way to characterize the relationship between a client and his contingent fee attorney.[256] In the sharecropping analogy, the client is the landlord, and, instead of cropland, the client/landlord has a legal claim.[257] The attorney is the tenant-farmer, and he works on the client's claim to produce a fruitful recovery that both can share.[258] This analogy is accurate because it properly characterizes the relative amount of control that each party in the relationship has.[259] It also appropriately handles the assignment of income doctrine and state law governing attorney's liens.[260] Each of these points will be discussed in turn.

A. Attorneys' Control over Kenseth's Claim

On the issue of relative control, Kenseth's attorneys effectively removed him from control of his own lawsuit and from any control over the eventual

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Maryland attorney's lien statute prevents attorneys from obtaining ownership interest over clients' recoveries).

253. *See* Kenseth v. Comm'r, 114 T.C. 399, 422 (2000) (Beghe, J., dissenting) (arguing that lawyers handling contingency fee cases have strong degree of control over clients' claims), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

254. *Supra* note 250.

255. *See infra* notes 261-279 and accompanying text (explaining how attorney's control over client's claim grows as claim progresses through legal channels).

256. *Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting).

257. *Id.* (Beghe, J., dissenting).

258. *Id.* (Beghe, J., dissenting).

259. *See infra* notes 261-305 and accompanying text (discussing attorney's control over client's underlying legal claim).

260. *See infra* notes 317-31 and accompanying text (discussing how sharecropping analogy handles assignment of income doctrine); *infra* notes 332-37 and accompanying text (discussing how sharecropping analogy deals with doctrine of state attorney's lien statutes).

contingency fee.[261] Control over the lawsuit and recovery was the most important fact of the case.[262] Before Kenseth contacted any attorney to deal with his claim, he had complete dominion over it.[263] From the moment he obtained legal representation to seek redress on his claim, he began to cede control over the claim to his attorneys.[264] Kenseth likely could not have afforded to hire a lawyer on an hourly basis.[265] Instead, he obtained representation by signing a contingency fee agreement.[266] Indeed, his attorneys would not have represented him unless he signed the contingency fee agreement.[267]

The agreement had several provisions that drastically reduced Kenseth's control over his claim.[268] Most restrictive was Clause VI of the agreement, which denied the client the right to settle his case without contacting his attorneys.[269] The agreement contained another provision giving Fox & Fox a lien for its fees against any money recovered through the suit.[270] This lien made payment of legal fees a priority over distributions of the recovery to the plaintiffs.[271] Furthermore, had Kenseth chosen to terminate the agreement

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261. Kenseth v. Comm'r, 114 T.C. 399, 443 (2000) (Beghe, J., dissenting), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *see also id.* at 441-47 (Beghe, J., dissenting) (discussing application of assignment of income doctrine to control issues in contingency fee case).

262. *See id.* at 422 (Beghe, J., dissenting) (noting that "elements of control over the prosecution of the ADEA claims ceded by Mr. Kenseth and assumed and exercised by Fox & Fox under the contingent fee agreement make it reasonable to include in petitioner's income only Mr. Kenseth's net share of the settlement proceeds").

263. *See id.* at 422-23 (Beghe, J., dissenting) (explaining that Kenseth's attorneys' interest in his case only took shape after he retained their services). Prior to Kenseth retaining his attorneys, they could not have taken any action in an attempt to obtain redress for Kenseth's claim. Kenseth alone could have sought damages from his employer, but his efforts likely would have been futile.

264. *Id.* at 401 (discussing contingency fee agreement between Kenseth and Fox & Fox and restrictions on Kenseth's ability to settle without Fox & Fox's consent).

265. *See id.* at 400-02 (discussing contingency fee agreement agreed to by Kenseth and fact that $500 win-or-lose retainer was all Kenseth had to advance to his attorneys out of his own pocket).

266. *Id.* at 400.

267. *See* Kenseth v. Comm'r, 114 T.C. 399, 400 (2000) (characterizing contingency fee contract as one "routinely used"), *aff'd*, 259 F.3d 881 (7th Cir. 2001); *id.* at 422 (Beghe, J., dissenting) (explaining that Fox & Fox would not represent Kenseth without Kenseth first signing contingency fee agreement). The relevant portions of the contingent fee agreement as cited by the Tax Court are located at 114 T.C. 401-02.

268. *See id.* at 401 (discussing contingency fee agreement and provisions).

269. *See id.* at 401 (noting that contingency fee agreement restricts client's right to "compromise or settle the case without the written consent of the attorneys").

270. *Id.* at 402.

271. *See id.* (noting Clause VIII of contingency fee agreement between Kenseth and his attorneys).

with Fox & Fox, he would have owed the firm for all of his outstanding costs.[272]

Kenseth's suit was part of a class action, and each member of the class signed an identical agreement with Fox & Fox.[273] Fox & Fox thus had control over the direction, legal strategy, and handling of all seventeen individuals' claims.[274] As the case progressed, with the attorneys filing more documents and conducting discovery, Kenseth and the other sixteen plaintiffs began to lose their right to control the ultimate destiny of their suit.[275] Kenseth lost the flexibility to hire and fire his attorney at will that a single plaintiff enjoys.[276] Given his obligation to pay all accrued legal fees if he terminated the representation of Fox & Fox, the size of the suit, and the number of plaintiffs, Kenseth's potential liability was quite substantial.[277] Regardless of the amount, however, the effect was clear.[278] Once Fox & Fox was heavily engaged in representing Kenseth, he effectively lost the ability and lacked the resources to change or discharge the attorneys handling his constitutional claim.[279]

The level of control that Kenseth ceded to his attorneys regarding the handling of his case is neither surprising nor especially troubling.[280] The record in *Kenseth* reflected no evidence that Kenseth was upset with the

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272. *See id.* (stating that "all outstanding costs and disbursements" would be due to Fox & Fox "within ten . . . days of the termination of the contract").

273. *Id.* at 400.

274. *See id.* at 400-02 (commenting that all class members signed identical contingency fee agreements, which included restrictions on plaintiffs' right to settle their case without knowledge or approval of Fox & Fox).

275. *See id.* at 424 (Beghe, J., dissenting) (stating that plaintiffs relied on "guidance and expertise" of their attorneys in their dealings with APV).

276. *See id.* at 423 (Beghe, J., dissenting) (explaining that presence of sixteen other plaintiffs was "additional practical impediment" to Kenseth's individual ability to hire and fire his attorney).

277. *See id.* at 423 (Beghe, J., dissenting) (stating that "impediment" to Kenseth's ability to change his representation grew as Fox & Fox became more involved in case and as claim progressed through administrative and court channels); *id.* at 402 (noting Kenseth's obligation to pay attorney's fees in event he fires his attorneys).

278. *See id.* at 444 (Beghe, J., dissenting) ("All these factors contributed, as a practical matter, to the creation of substantial barriers to Mr. Kenseth's ability to fire Fox & Fox and to hire other attorneys or to try to settle his case himself.").

279. *See id.* (noting that Kenseth lost control of his age discrimination claim).

280. *See id.* at 400 (stating that contingency fee agreement entered into by Kenseth "was a form contract prepared and routinely used by" his attorneys). This level of control granted to attorneys is quite common in attorney-client relationships involving contingency fees. *See* MACKINNON, *supra* note 15, at 63 (explaining that contingency fees routinely give attorneys contract rights to perform any legal tasks necessary to obtain redress for client).

representation of Fox & Fox,[281] and the result in the case was a clear victory for both Kenseth and his attorneys.[282] They recovered a total of $2.65 million, of which Kenseth's share was $229,501.37.[283] His share of the attorneys' fees was $91,800.54.[284] Of course, the question was how to classify the recovery and contingency fee for determining Kenseth's tax liability.[285] The sharecropping analogy provides an ideal solution.[286]

B. Tenant's Control over Landlord's Croplands

Prior to the planting season, a landlord has complete control over his croplands. The fields are his, and he may do with them whatever he pleases. However, once the landlord commits to a sharecropping agreement, he largely relinquishes dominion over the crops and land to the tenant-farmer.[287] The tenant-farmer prepares the soil and plants the crop, using his judgment to proceed in a manner that will maximize the crop yield.[288] Once the tenant-farmer is substantially involved in the planting, the landlord has effectively lost control over the crops growing in his fields.[289] Of course, he could seize control of the crops from the tenant-farmer, but he would be liable for damages.[290] The situation was the same for Eldon Kenseth.[291]

281. *See* Kenseth v. Comm'r, 114 T.C. 399, 425 (2000) (Beghe, J., dissenting) (noting that neither Kenseth nor any other class member had "expressed dissatisfaction with the services of Fox & Fox or tried to bring in other attorneys to participate in or take over the prosecution of any of the . . . claims"), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

282. *See id.* at 404 (noting that Equal Employment Opportunity Commission recommended that Kenseth's and other class members' ADEA claims be settled "for less than $1 million in the aggregate").

283. *Id.*

284. *Id.* at 405.

285. *See id.* at 400 (noting main issue in case).

286. *See id.* at 454-55 (Beghe, J., dissenting) (suggesting that solution to tax consequences of contingency fees can be found by using analogy to sharecropping).

287. *See* Stewart v. Young, 103 So. 44, 45-46 (Ala. 1925) (noting that tenant-farmer in sharecropping arrangement has right to possession of crops "while growing and being gathered" to exclusion of landlord).

288. *See* Sledge v. Potts, 32 So. 2d 262, 263 (Miss. 1947) (explaining that sharecropping tenant is to use "wisdom and standards of good husbandry" in working landlord's croplands); 52A C.J.S. *Landlord & Tenant* § 802 (1968) (noting that "implied covenant . . . for a reasonably diligent operation of the premises" by tenant-farmer exists between landlord and tenant-farmer).

289. *Stewart*, 103 So. at 45-46; *see also* 52A C.J.S. *Landlord & Tenant* § 802 (1968) (stating that if landlord objects to tenant-farmer's method of cultivation, he must make such objection prior to planting of crop by tenant-farmer).

290. *Stewart*, 103 So. at 45-46.

291. *See* Kenseth v. Comm'r, 114 T.C. 399, 402 (2000) (noting Kenseth's liability for legal fees in event he fires his attorneys), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

At harvest time, sharecropping calls for a division of the year's bounty between the landlord and the tenant-farmer.[292] The tenant-farmer gives the landlord a portion of the crop as rent for the use of the land.[293] The gross income resulting from the sale of the crop is then divided on a percentage basis between the landlord and tenant pursuant to their agreement.[294] The tenant-farmer's portion of the gross income is classified as farm income while the landlord's percentage constitutes rental income.[295] Although the income originates from a single crop, the IRS treats it as two different kinds of income for the parties involved in the transaction.[296]

For an attorney and her client, the sharecropping analogy would allow a favorable division of the recovery.[297] The client, with his underlying claim, shifts to the attorney an interest in the recovery that is very similar to the portion of the crop a tenant-farmer provides his landlord in rent.[298] An analogy to this transfer solves several problems for both the attorney and the client.[299]

First, it conforms to any bar's ethical rules that require an attorney to refrain from obtaining an ownership interest in a client's cause of action.[300] The attorney would no more own the underlying claim than a tenant-farmer would own the land upon which he farms.[301] Second, the analogy properly

292. *Id.* at 455 (Beghe, J., dissenting).

293. *See* IRS Publication 225, Farmer's Tax Guide 16-17 (2001) (noting division of crops).

294. *Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting).

295. IRS Publication 225, Farmer's Tax Guide 16-17 (2001).

296. *Id.*; *see Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting) (emphasizing unique treatment of income for both landlord and tenant-farmer).

297. *See* Kenseth v. Comm'r, 114 T.C. 399, 455 (2000) (Beghe, J., dissenting) (emphasizing that if clients and attorneys were treated similarly to landlords and tenant-farmers, attorney would have ordinary income from contingency fee and client would not be charged with gross income for attorney's contingency fee), *aff'd*, 259 F.3d 881 (7th Cir. 2001). The portion of the recovery not paid to the attorney may be gross income to the client if the underlying claim seeks recovery "on account of personal physical injuries or physical sickness" and if the recovery is for "physical injuries suffered." *See* I.R.C. § 104(a)(2) (West 2001) (excluding from gross income damages, other than punitive damages, paid as compensation for physical injury or physical sickness).

298. See *Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting) (discussing contingency fee agreement as "transfer[s] to the attorney [of] an interest in the recovery that is analogous to the tenant farmer's share of the crop generated by his farming activities on the land leased or made available to him by the non-active owner or sublessor").

299. *See id.* at 453-54 (Beghe, J., dissenting) (noting ethical and legal difficulties that analogy to attorney-client relationship must answer).

300. *Id.* at 455 (2000) (Beghe, J., dissenting); *see also* MODEL RULES PROF'L CONDUCT R. 5.4(b) (2000) (forbidding attorney to form partnership with nonlawyer if partnership intends to practice law).

301. *See* Stewart v. Young, 103 So. 44, 46 (Ala. 1925) (explaining that tenant-farmer has only "a leasehold estate in the lands" of landlord); Heaton v. Slaten, 141 So. 267, 268 (Ala. Ct.

explains the speculative nature of a client's claim while still demonstrating the work that may be required of the attorney to bring the claim to fruition.[302] Just as planting thousands of dollars of seed into the ground and relying on good weather and faith to bring the crop to maturity is a venture fraught with risk, lawsuits are risky propositions with uncertain results.[303] Nevertheless, careful, skilled, and dedicated work by an attorney can raise the value of the client's potential recovery and eventually increase the benefit to both client and counsel.[304] Similarly, a tenant-farmer's work in caring for his crops – preventing the growth of weeds, providing irrigation, and applying fertilizers – can increase the yield of the crop, thus raising the amount of income for both the farmer and his landlord.[305]

C. Division of Recovery in Sharecropping Analogy

Most importantly, the sharecropping analogy clearly divides the recovery between the attorney and client for tax classification purposes.[306] The landlord, who owns all of the crop-bearing land, is not charged with having a gross income equal to the entire value of the crop;[307] instead, he is attributed only the gross income from the percentage of the crop allotted to him in the sharecropping agreement.[308] Likewise, the agreement restricts the tenant-farmer's gross income to the percentage of the crop which he is to take under the agreement.[309]

App. 1932) (noting that tenant-farmer possesses only leasehold interest in landlord's lands); 52A C.J.S. *Landlord & Tenant* § 801 (1968) (stating that landlord in sharecropping agreement gives tenant-farmer estate in lands being used for growing crops, but not absolute ownership).

302. *See Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting) (noting "farming activities" that tenant-farmer must undertake to insure successful crops); *id.* at 450 (Beghe, J., dissenting) (explaining that Kenseth's attorneys "added substantial value to [his] claim").

303. *See* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (noting that value of Cotnam's legal claim was "doubtful and uncertain").

304. *Id.* at 125-26 (explaining that "the aid of skillful attorneys . . . resulted in converting [Cotnam's] claim into a judgment and the collection of the judgment. The amount of the contingent fee was earned, and well earned by the attorneys.").

305. *See* Sledge v. Potts, 32 So. 2d 262, 263 (Miss. 1947) (discussing tenant-farmer's duty to farm landlord's land under sharecropping arrangement with intent to benefit both landlord and tenant-farmer); *Heaton*, 141 So. at 268 (noting tenant-farmer's duty to work in "good faith" to improve crops).

306. *See* IRS Publication 225, Farmer's Tax Guide 16-17 (2001) (explaining division of income between landlord and tenant-farmer).

307. *See* Kenseth v. Comm'r, 114 T.C. 399, 455 (2000) (Beghe, J., dissenting) (noting that sharecropping arrangement does not call for landlord to include total value of all crops in his gross income), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

308. *See id.* (Beghe, J., dissenting) (drawing conclusions as to portion of income included by landlord).

309. *Id.* (Beghe, J., dissenting).

For an attorney and client, the result would be the same. The client/landlord would not have gross income in the amount of the entire recovery.[310] Instead, the client would have gross income of only that percentage he agreed to take in the contingency fee agreement.[311] This achieves a very desirable and fair result for the client.[312]

An attorney's daily task in a contingency fee relationship is to work the client's claim and prepare it to bear fruit.[313] It is his or her normal professional task.[314] The payment for such work, then, is clearly ordinary income to the attorney and should not be income to the client.[315] Additionally, as the attorney performs her work in an effort to earn ordinary income, the nature of that work deprives the client of control over his claim.[316]

D. The Sharecropping Analogy and the Assignment of Income Doctrine

This allotment of control is crucial to determining whether the assignment of income doctrine applies to the client.[317] The penultimate question is whether the potential assignor has enough control over the income at issue to be liable for the tax on that income.[318] In *Kenseth*, Judge Beghe's dissent

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310. *See id.* (Beghe, J., dissenting) (interpreting implications of analogy on gross income calculations for client).

311. *See id.* (Beghe, J., dissenting) (analogizing tax implications of landlord to those of client).

312. The result is desirable to the client because the client does not have his gross income increased by the amount of the contingency fee paid to his attorney. This may reduce the complications of the AMT. *See supra* note 4 (explaining calculation of AMT).

313. *See* Kenseth v. Comm'r, 114 T.C. 399, 449-50 (2000) (Beghe, J., dissenting) (arguing that Kenseth's attorneys worked diligently on all aspects of case to prepare legal documents and negotiate eventual settlement), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

314. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2000) ("A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for representation.").

315. *See* I.R.C. § 61(2)(1) (2001) (noting fees constitute income to taxpayer); *Kenseth*, 114 T.C. at 450 (Beghe, J., dissenting) (noting that attorneys' "shares of the recovery should be taxed to them directly and not run through [Kenseth] . . . who never even had the chance to kiss goodbye what [he] never became entitled to receive").

316. *See supra* notes 261-84 and accompanying text (noting how attorneys' responsibilities deprive clients of control over clients' lawsuits and recoveries).

317. *See Kenseth*, 114 T.C. at 425 (Beghe, J., dissenting) (noting that "the governing law permits – indeed compels – the ultimate finding that Mr. Kenseth did not retain enough control over his claim to justify including in his gross income any part of the contingent fee paid to his attorneys").

318. *See* Comm'r v. Sunnen, 333 U.S. 591, 604 (1948) (noting that "[t]he crucial question remains whether the assignor retains sufficient power and control over the assigned property or

answers this question with a definitive "no."[319] As the sharecropping analogy demonstrates, the work that the attorney expends on behalf of the client effectively denies the client control over his claim.[320] The client is not assigning a stream or source of income to the attorney.[321] Instead, the client allows the attorney to work on the client's claim just as a landlord allows a tenant-farmer to work on his land.[322]

In the seminal assignment of income cases, *Earl* and *Horst*, the "assignees" of the income had to expend no effort to obtain the income.[323] They were the recipients of a definite and secure source of income, whether it was a salary or interest coupons on negotiable bonds.[324] By contrast, the underlying claim for a contingency fee agreement is inherently speculative, and neither the attorney nor the client has any assurance of obtaining a recovery.[325] While the assignment of income doctrine clearly governs cases such as *Earl* and *Horst*, in which the assignee has not essentially earned his income, it is not clear that the doctrine should apply to contingency fee arrangements.[326]

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over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes").

319. Kenseth v. Comm'r, 114 T.C. 399, 440 (2000) (Beghe, J., dissenting), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

320. *See* Sledge v. Potts, 32 So. 2d 262, 263 (Miss. 1947) (explaining that tenant in sharecropping arrangement utilizes his "wisdom" as guide to control cultivation of crops); *supra* notes 261-79 and accompanying text (emphasizing that attorneys' work on contingency fee cases often shifts control over claims and recoveries to attorneys and from clients).

321. *See Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting) (stating that in sharecropping analogy client only transfers to attorney underlying claim (land in sharecropping analogy) for attorney to work and bring about gain for both attorney and client).

322. *See Kenseth*, 114 T.C. at 455 (Beghe, J., dissenting) (analogizing attorney's work on client's claim to tenant-farmer's work on landlord's land); *see also Sledge*, 32 So. 2d at 263 (explaining duty of tenant to provide "reasonable rental" to landlord in the form of "a diligent tillage" of croplands using "the wisdom and standards of good husbandry").

323. *See* Helvering v. Horst, 311 U.S. 112, 114 (1940) (noting that transfer of interest coupons to Horst's son was gift from Horst to his son); Lucas v. Earl, 281 U.S. 111, 113-14 (1930) (noting that Earl's wife had to expend no effort or work to obtain one-half of her husband's salary).

324. *See Horst*, 311 U.S. at 114 (noting son collected interest at maturity date of bonds); *Earl*, 281 U.S. at 114 (noting that Earl's source of income was salary). Neither opinion makes any reference to any speculative or uncertain attribute of the sources of income for the assignments. One can safely assume that the sources of income at issue in *Horst* and *Earl* were more secure than a claim of age discrimination in employment.

325. Kenseth v. Comm'r, 114 T.C. 399, 439 (Beghe, J., dissenting), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

326. *See Horst*, 311 U.S. at 120 (emphasizing that doctrine of assignment of income governs gift of interest coupons to Horst's son); *Earl*, 281 U.S. at 114-15 (noting essentially that Earl's salary cannot be assigned, for tax purposes, to one who did not earn it).

Furthermore, the historical background of the assignment of income doctrine reveals that the doctrine originated in cases involving intrafamily donative transfers.[327] Contingency fee agreements, to the contrary, are generally not intrafamily donative transactions undertaken for tax avoidance.[328] Both an attorney who agrees to represent a new client on a contingency fee basis and the new client enter into a common business transaction in which neither had a previous interest.[329] Based on the lack of control that Kenseth had over his claim and the obvious distinction between the *Earl* and *Horst* cases and contingency fee cases, the assignment of income doctrine should not apply to contingency fees.[330] Kenseth's lawyers earned their contingency fee; Kenseth did not assign it to them.[331]

E. The Sharecropping Analogy and Attorney's Lien Law

As for the state attorney's lien doctrine, Judge Beghe asserted that Wisconsin's attorney's lien statute should be construed similarly to the Alabama statute in *Cotnam*, allowing an attorney to obtain an equitable interest in his client's suit and recovery.[332] This assertion alone provides sufficient support for Kenseth's argument that his gross income should not include his attorney's contingency fee.[333] However, Judge Beghe refused to rest the ultimate outcome of the decision on the Wisconsin statute: "To make the result depend upon whether a technical ownership interest was transferred under state law would make the outcome depend on 'attenuated subtleties' and 'refinements'

327. *See Horst*, 311 U.S. at 114 (noting that gift of interest coupons was to Horst's son); *Earl*, 281 U.S. at 113-14 (noting that contract at issue was between Earl and his wife).

328. *See* Estate of Clarks *ex rel.* Brisco-Whitter v. United States, 202 F.3d 854, 857 (6th Cir. 2000) (noting that contingency fee agreement had "no purpose to shift tax liability among members of a family").

329. *See* Kenseth, 114 T.C. at 440 (Beghe, J., dissenting) ("[A] contingent fee agreement is a commercial transaction between parties with no preexisting common interest .... ").

330. *See id.* at 446 (Beghe, J., dissenting) ("The contingent fee agreement did not effect an assignment of income . . . under . . . *Helvering v. Horst* and *Lucas v. Earl*" (citations omitted)).

331. *See supra* notes 313-16 and accompanying text (discussing how attorneys earn their contingency fees).

332. Kenseth v. Comm'r, 114 T.C. 399, 436 (2000) (Beghe, J., dissenting) ("Wisconsin law arguably gives attorneys the two unusual interests in their clients' lawsuits relied on by the majority opinion in *Cotnam v. Commissioner*." (citation omitted)), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

333. *See id.* (noting implication of Beghe's argument); *see also* Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959) (deciding that interests of attorney, granted by Alabama attorney's lien statute, in client's claim and recovery allows client to exclude contingency fees from gross income).

that . . . should be disregarded."[334] Further reliance on state law standards for determining federal income tax questions will only lead to a greater lack of uniformity for both clients and attorneys.[335] As Judge Beghe argues, future clients who challenge the inclusion of contingency fees in their gross income will be able to rely on the broad standard of the sharecropping analogy to properly characterize clients' lack of control over their claims.[336] In essence, the sharecropping analogy supersedes the state law doctrine, rendering it moot. Using the sharecropping analogy, all clients, whether they reside in Alabama or Alaska, will be able to exclude contingency fees from their gross income.[337]

VI. Conclusion

Contingency fees, like any other form of income, should be taxed solely to the person who earns them.[338] Courts should determine who bears the tax liability for contingency fees by asking who controls the underlying claim and, thus, the recovery at issue; control is the key issue in this tax analysis. In a lawsuit, the attorney controls almost every aspect of the client's case. The attorney devises a strategy for handling the claim, files the briefs, takes depositions, negotiates, and prepares for trial. The entire course and direction of the client's claim is in the attorney's hands.

A lawyer does not immediately accrue this strong degree of control over her client's case just by signing a contingency fee agreement. However, once the parties sign that agreement, an inevitable and irreversible shift of control begins. The lawyer's control over the case grows on a daily basis. As the lawyer becomes more heavily invested in the case, the ability of the client to terminate the relationship fades. The potential legal fees that a client may owe if he chooses to fire his attorney prior to a final resolution of the case effectively keep the client and his claim firmly within the control of the attorney. Soon, the effect is all too apparent: the client is no longer in complete control of his case and recovery.

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334. *Kenseth*, 114 T.C. at 447 (Beghe, J., dissenting).

335. *See id.* at 446-47 (Beghe, J., dissenting) (noting that decisions based on attorney's lien laws are neither necessary nor desired); *supra* notes 135-54 and accompanying text (emphasizing differences in rights granted by state attorney's lien statutes).

336. *See Kenseth*, 114 T.C. at 446 (Beghe, J., dissenting) (noting that future decisions can rely on rationale of *Cotnam*, *Estate of Clarks*, and rationale and analogies in Beghe's dissent).

337. *See id.* (Beghe, J., dissenting) (noting that if attorney obtains "only the usual security interest in the claim," client will be able to exclude contingency fees from gross income). The client need not live in a state such as Alabama or Michigan where "local law allows a transfer of a 'proprietary' interest in the claim to the attorney." *Id.* (Beghe, J., dissenting).

338. United States v. Basye, 410 U.S. 441, 449 (1973) ("Income must be taxed to him who earns it." (citation omitted)).

As a result of this control-shifting process, contingency fees are not property attributable to a client's gross income. A client only has income to the extent that he can control the underlying source of that income. As future courts analyze contingency fee cases, they should take into account the control shift that is inherent in a contingency fee agreement. However, many courts evaluate control over contingency fees using modes of analysis that are couched solely in terms of absolutes. Under the assignment of income doctrine, either the client has complete control over the disposition of the contingency fee or he does not. Under the attorney's lien doctrine, the attorney either has an ownership interest in the contingency fee or she does not. These methods of analysis fail to address the middle ground. The level of control that either an attorney or client has in an attorney-client relationship cannot be described in absolute terms. Thus, any analysis of this relationship must allow room for a shift in control.

In meeting this requirement, the sharecropping analogy comes into its own. Sharecropping, like almost any agricultural endeavor, is seldom a certain undertaking. The seasons and the weather may change unexpectedly, varying the return that a sharecropper and his landlord receive for their efforts. Likewise, in a contingent fee attorney-client relationship, nothing about the return is certain. Viewing clients as landlords and attorneys as tenants has many positive results. First, it accurately characterizes the shift in control that occurs as the attorney delves further into the client's case. Like a tenant-farmer who has planted his crops, the attorney invests his time and energy in the client's claim. Like a landlord, the client cannot discharge the attorney without making payment of accrued attorney's fees. Second, the sharecropping analogy provides for distinct treatment of the income generated by the agreement for both parties. The attorney will have ordinary income in the contingency fee, and the client will have income in the amount he actually recovers. This approach can lessen the devastating impact of the AMT. Finally, the sharecropping analogy characterizes the true speculative nature of a contingency fee case. In sharecropping, the final yield of the crop determines the landlord's as well as the tenant's portion of the income. Likewise, the amount of the final recovery determines the attorney's take in a contingency fee case.

The sharecropping analogy succeeds because it properly characterizes the relationship between a client and his contingency-fee attorney. They are not partners or co-owners, they are not involved in a joint venture, and they are not dividing up concrete, value-certain property. They are trying to obtain redress for a legal wrong. The client knows that alone, he will not be able to obtain compensation for the wrong. Only with an attorney does the client have a genuine chance of recovery. With an attorney, however, the client also loses control over his case in exchange for the opportunity to obtain monetary damages.

Judge Beghe predicts the outcome of future cases in which clients rely on the sharecropping analogy and the control analysis: The sharecropping analogy and the broad national standard

> provide[ ] an independent and sufficient ground for the holding, decoupled from the narrow ground of *Cotnam* and *Estate of Clarks* regarding attorneys' ownership interests in lawsuits under State law, that [the client's] gross income in the case . . . does not include any part of the settlement proceeds paid to [the client's attorneys] and retained by [the attorneys] as [their] contingency fee.[339]

This broad, new federal standard for evaluating the tax consequences of contingency fees should be applied in all contingency fee cases. Such an approach will bring uniformity to an unsettled issue of federal taxation and reduce the need for reliance on state law. It will reduce the tax burden on clients and help lessen the impact of the AMT. Last, but certainly not least, the client can hope to recognize the true economic value of his underlying claim.

339. Kenseth v. Comm'r, 114 T.C. 399, 446 (2000) (Beghe, J., dissenting), *aff'd*, 259 F.3d 881 (7th Cir. 2001).