Are Attorney Contingency Fees Included In A Client's Gross Taxable Income?

Robert S. Schwartz

Who wants to explain to clients that they have to pay taxes on money they never see?

THIS ARTICLE REVIEWS IMPORTANT DECISIONS concerning whether the attorney contingency fee portion of a recovery fund ought to be included in or excluded from a client's federal gross income. The case law is still developing. This article suggests tax-friendly terms for contingency fee agreements and discusses how a client's tax reporting of gross income exclusion, if any, should be done in light of the "no fault" substantial underpayment tax penalty that applies once an individual client's unreported taxes exceed the greater of $5,000 or 10 percent of the correct amount of taxes.

Robert S. Schwartz is a Partner and Tax Attorney in Lindabury, McCormick & Estabrook, P.A., Westfield, New Jersey.
The author thanks his colleague, Bruce P. Ogden, Esq. for direction and insight.

Contingency fee agreements ordinarily provide for the attorney's receipt of a stated percentage of any recovery obtained by the attorney pursuing a client's claims or counterclaims. Recovery may be by means of a settlement or by means of an administrative or mediated resolution or by judgment by a trial or appellate court. Assuming recovery funds involve hundreds of millions of dollars per annum, and the attorney contingency fee percentages paid out of those funds average 33⅓ percent, a very important question of federal income taxation is whether the attorney contingency fee portion of a recovery fund is included or excluded from a client's federal gross income.

The question has relevance for contingency fee attorneys and their clients in any legal actions for damages not involving physical injury or sickness, and when physical injury or sickness is involved, the question may still have relevance. For example, in case of gross income inclusion of damages recovered for age discrimination, and a corresponding so-called regular income tax deduction, many clients will find they are liable for substantial federal alternative minimum income tax, because, unlike for regular income tax purposes, attorney contingency fees cannot be deducted for "alt. min." purposes. In case of gross income exclusion under section 104 of the Internal Revenue Code of 1986 (the "Code") of damages recovered for, for example, being run over by an automobile, the contingency fee agreement might state the attorney's contingency fee is payable solely out of post-judgment interest, which may result in exclusion also of this interest from the client's gross taxable income. *See, Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001), *rev'g & rem'g,* 106 F. Supp. 2d 1234 (N.D. Ala. 2000).

For the record, attorneys always include contingency fees in their gross incomes, aside from the tax treatment of contingency fees to the client. (All section references are to the Code unless otherwise indicated.)

REVIEW OF SELECTED FEDERAL TAX DECISIONS • In *Cotnam v. Commissioner*, 28 T.C. 947 (1957), *aff'd in part & rev'd in part,* 263 F.2d 119 (5th Cir. 1959), a client entered into a contingency fee agreement with her attorneys under which the attorneys were entitled to 40 percent of any amount recovered on a claim for unpaid compensation against the estate of her former employer. The attorneys pursued the claim on her behalf and received approximately $50,000 in contingency fees. Citing *Lucas v. Earl*, 281 U.S. 111 (1930), the Tax Court held that because the claim for unpaid compensation belonged to the client, she had to include the entire recovery fund, including the $50,000 contingency fee, in her gross income.

In *Lucas v. Earl*, 281 U.S. 111 (1930), an attorney entered into an admittedly valid contract with his wife during 1901 providing that all future earnings by either spouse would be considered as received and owned by them as equal joint tenants with a right of survivorship. The issue before the Court was whether the attorney realized gross income taxable for the whole of his salary and attorneys' fees for the tax years 1920 and 1921 or instead for only one-half. The Court framed the issue as one of statutory interpretation of section 213(a) of the Revenue Act of 1918, the direct predecessor of section 61(a) of today's Code, which provided in relevant part for the inclusion in gross income of "income derived from salaries, wages or compensation for personal service…of whatever kind and in whatever form paid." The taxpayer argued Congress intended for section 213(a) to include in a person's gross income only income the person actually or at least beneficially receives. The taxpayer further argued that the compensation became the joint property of both the client and his wife on the very in-

stant it was first collected. Therefore, the taxpayer received and owned only one-half of the income, and could be lawfully required to include in gross income only this one-half share. The Court brushed aside the effects of the creation of joint ownership in all future income to be received by the husband, "but this case is not to be decided by attenuated subtleties." The Court reasoned, "It [the case] turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earn them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." Held: judgment for the IRS. The court laid down as a rule of law, still vital in the tax law, that income in the nature of compensation for services is taxed to the person who earns it, even when assigned to another before it is earned or collected.

Similarly, the Tax Court in *Cotnam* brushed aside the client's very fundamental arguments that her attorneys, not she, had earned the $50,000 contingency fee, and to the effect that, at the time the contingent fee agreement was executed, she could not have impermissibly assigned her taxable income to the attorneys because the amount thereof was speculative and could have been zero. The Tax Court also stated with reference to the Alabama attorneys' lien law: "They [the attorneys] only had a lien on the fund payable to petitioner.… [T]hey had no right in or title to the amount recovered which would permit petitioner to treat it other than a part of her recovery and of her gross income." The client appealed to the Fifth Circuit.

In *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), the Fifth Circuit quoted the Alabama statute concerning attorneys' liens: "attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them." It also cited *United States Fidelity & Guaranty Co. v. Levy*, 77 F.2d 972 (5th Cir. 1935), which held that in Alabama, attorneys' contingency fees were not subject to a defendant's right of set off against the attorneys' client's judgment recovery against the defendant. The *Cotnam* court concluded that the Alabama statute considered in its entirety and the Fifth Circuit precedent created a charge in the nature of an equitable assignment or an equitable lien such that an attorney possessed property rights recognized in equity both in the cause of action and the recovery fund. Based upon this analysis of Alabama law, the court held that the client "did not realize income" as to her attorney's contingency fees. Under *Eisner v. Macomber*, 252 U.S. 189 (1920), income unrealized is income untaxed, unless a Code section specifies otherwise (such as section 1256, which requires tax recognition by dealers each tax year-end of their then gain or loss inherent in yet-to-be-settled futures contracts).

In a further opinion in *Cotnam,* two judges took pains to address the seemingly relevant cases of *Lucas v. Earl, Helvering v. Horst*, 311 U.S. 122 (1940), and *Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929). Regarding *Lucas*, the judges reasoned the client had "assigned" a right to income that was doubtful and uncertain as to receipt and amount. (*See also*, *Commissioner v. LoBue*, 351 U.S. 243 (1956), holding the value of stock options so contingent on future conditions and circumstances that no income was realized on their receipt by employees.) Furthermore, as to *Horst*, her "assignment" of the doubtful prospect of participation in her claim did not amount to her sufficiently enjoying the economic benefits or fruits of her claim, or satisfaction of her desires, upon execution of the fee agreement so as to conclude she realized as gross taxable income the contingency fee portion of the re-

covery when later collected. Finally, addressing *Old Colony Trust*, the judges concluded that the client had not obligated herself to pay the attorney's contingency fee, but rather assigned a portion of an open-ended claim, the realization of income from which was contingent upon the *attorney's* (emphasis added) work and success in handling the case.

The dissenting judge in *Cotnam* sided with the Tax Court, which in relevant part focused not on who earned the recovery fund, but upon the basis or origin of the client's claim. That basis was the client's having earned the compensation which she later sued to collect. The dissent concluded that the client controlled the disposition of the entire possible recovery and diverted a portion of the recovery from herself to the attorneys via the contingency fee agreement, which is an ineffective assignment of income under *Lucas v. Earl*. The dissent also concluded that the client fully enjoyed the economic benefits of the portion of the recovery destined for payment of the contingency fee within the meaning of *Horst*. In *Horst* the holder of a coupon bond detached the interest coupons before the interest had accrued and become payable and made gifts of the coupons to family members. He retained the right to repayment of bond principal. The taxpayer argued the donees should pay taxes on the interest income when received. The court, however, reasoned to the contrary:

"Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event rather than the acquisition of the right to receive it. And 'realization' is not deemed to occur until the income is paid. But…receipt of cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. … Underlying the reasoning in these cases [referring to a limited number of earlier Supreme Court decisions] is the thought 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. … The taxpayer has equally enjoyed [viz, realized] the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as a means of procuring them. … [Taxation] may occur when he has made such…disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth."

Finally, the dissenting judge in *Cotnam* adopted the IRS's alternative argument that the client had become obligated to pay her attorneys under the contingency fee agreement, and the defendant's payment to them of the contingency fees was a discharge of her obligation, which in turn is the equivalent of her receipt of the amount of the contingency attorneys' fees.

O'Brien: Contingency Fee Still In Gross Income

In *O'Brien v. Commissioner*, 38 T.C. 707 (1962), *aff'd per curiam,* 319 F.2d 532 (3d Cir. 1963), the Tax Court again held that the attorney contingency fee portion of a settlement recovery fund, this time relating to a client's wrongful discharge claim against the United States, constituted gross income to the client, "under the familiar principles of [*Lucas v. Earl*, *Horst*, and *Helvering v. Eubank*, 311 U.S. 122 (1940)]." The Tax Court noted in passing that under Pennsylvania law (the state where the client and his attorney resided, where the contingency fee agreement was executed, and where the client had worked) there was no equivalent to the Alabama statute held controlling by the majority in *Cotnam*. The court brushed aside state law considerations: "However, we think it doubtful

that the Internal Revenue Code was intended to turn upon such refinements." A per curiam panel of the Third Circuit affirmed the Tax Court without discussion, "in all respects…on the excellent opinion of Judge Raum." 319 F.2d 532 (3rd Cir. 1963).

Fast forward to the period from 1963 to the present time. Of the twelve (12) Circuit Courts, which includes the Federal Circuit, nine (9) have by now addressed the question under review, as has most recently the District Court of Vermont. The First, Second and Eighth Circuits have yet to address the question.

Current Circuit Cases

The first of the current generation of cases is *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995), *aff'g*, 30 Fed. Cl. 248 (1993). *Baylin* involved contingency fees for a partnership's appeal of an inadequate condemnation award. The appeal was successful: The partnership received approximately $10.6 million in principal and $6.4 million in interest; and incurred contingency fees of approximately $4 million. The IRS made a complicated adjustment to the partnership's tax return that had the effect of greatly increasing the client's gross income. The client sued for a tax refund and advanced an alternative argument in both the Claims Court and the Federal Circuit that the attorney contingency fee portion of the condemnation recovery was excluded from the partnership's gross income.

The client carefully reasoned, pursuant to the contingency fee agreement, that it had assigned its right to a portion of any *additional* (judgment had been entered) condemnation recovery obtained by its attorneys on appeal. This assigned right was a property right which is merely measured by the contingency fee dollar amount; there was no impermissible assignment of income. In addition, under Maryland statutory and case law, the attorney contingency fee constituted a lien on the condemnation award in favor of the attorney. The client cited the *Cotnam* decision in support of its arguments.

Both the Claims Court and the Federal Circuit courts disagreed, mainly because they concluded that the U.S. Supreme Court decision in *Horst* controlled. That is, the partnership "made such use or disposition of [its] power to receive…the income (*i.e.*, the condemnation recovery) as to procure in its place other satisfactions which are of economic worth." The courts also reasoned that *Horst* does not require for gross income inclusion that the amount of the attorney contingency fee portion of the recovery be ascertainable at the time of execution of a contingency fee agreement. The Federal Circuit broadly interpreted section 61(a) ("gross income means all income from whatever source derived, including"; there is no mention of claim recoveries), as it read the Supreme Court doing in *Lucas v. Earl* and *James v. United States*, 366 U.S. 213 (1961). In *James* the Court held that embezzled funds are included in the gross income of the embezzler despite his being required to disgorge the embezzled funds. The *James* court reviewed some of its precedent and stated that Congress intended to exert "the full measure of its taxing power" (*see*, *Helvering v. Clifford*, 309 U.S. 331 (1940)). Moreover, liberal statutory construction is to be made in recognition of the intention of Congress to tax all gains except those specifically exempted. The principle then is that although a client may not keep the contingency fee portion of a recovery, the client realizes it as taxable income.

Lien, Not Ownership

Both courts in *Baylin* further concluded that both under the Maryland statutory attorney lien law and Maryland jurisprudence a Maryland contingency fee attorney merely has a lien in the nature of a security interest upon a recovery fund, rather than a broader claim to

ownership in the recovery fund. Both courts found the attorney had no ownership interest in the recovery fund or the client's claims. Reminiscent of *Old Colony Trust*, but without citing the case, the Federal Circuit stated that the partnership received the benefit of the contingency fee funds insofar as, when the attorney was paid directly by the defendant, the partnership was discharged of the obligation to pay the attorney under the contingency fee agreement. Finally, harkening back to *Lucas v. Earl*, the *Baylin* court commented that the vehicle of the purportedly valid gross income assignment, *i.e.*, the contingency fee agreement terms, cannot dictate the income tax treatment of the contingency fees. It observed that allowing the contingency fee agreement to form the basis for exclusion of the attorney contingency fee portion of the recovery from the partnership's gross income would elevate form over substance. It believed that is precluded by the Supreme Court's views of income realization in *Horst*. The author believes the Federal Circuit would have decided the question as it did even if under Maryland statutory or case law the attorney could be said to have an ownership interest in the claim or the recovery fund or both.

Clarks: *Contingency Fee Taxed to the One Who Earns It*

In the next circuit court decision, *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), the Sixth Circuit addressed the federal income tax principles of income realization head on. The client had been awarded a judgment for personal injuries consisting of approximately $5.6 million plus $5.7 million in interest. His attorney was paid one-third of each pursuant to a contingency fee agreement entered into at the outset of the attorney's representation. At issue was whether the attorney's share of the interest portion of the recovery had to be included in the gross income of the decedent under section 61(a). The court first reviewed Michigan attorney lien law, both observing that the attorney's right to payment of his contingent fee was a "peculiar lien" invented by the courts for the protection of attorneys against "the knavery of their clients," and summarizing Michigan jurisprudence to the effect that a contingency fee agreement amounts to an assignment of a portion of the judgment (or presumably settlement as well) sought to be recovered at a time when a recovery was uncertain. The court was comfortable enough with these conclusions to eschew consideration of such further refinements, such as whether the attorney possessed an ownership interest in the claim itself or a lien of sufficient weight in the recovery or the claim so as to deprive the plaintiff of the incidents of Federal taxation of the attorney contingency fee portion of the recovery.

The court read both *Horst* and *Lucas v. Earl* narrowly as addressing aspects of income realization as to the gross income items of interest and salary or other compensation, respectively. The court acknowledged either constituted gross income to the person who owned the bonds or who provided the services, respectively, and also acknowledged and agreed these particular gross income items could not be assigned to other person for federal income tax purposes. Agreeing with *Cotnam*, supra, however, the court concluded that the contingency fee attorney earns the contingency fee portion of the income through the performance of services. Thus, the income should be charged only to the ones who earned it––the attorneys. In addition, the Sixth Circuit saw as the sole economic benefit the client could derive from his claim the use of a part of it to help him collect the remainder. The client does not realize an economic benefit of a magnitude that would result in his income realization upon recovery. In the court's view, the claim itself was no more than "an intangible, contingent expectancy" at

the time of execution of the contingency fee agreement. The court believed that the contingency fee agreement was more like a division of property—the intangible, contingent expectancy it identified—than an impermissible assignment of the client's gross income that had been realized upon execution.

In *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir. 2000), the Eleventh Circuit (an outgrowth of the Fifth Circuit, the precedent of which it expressly follows), followed *Cotnam* in respect of an Alabama plaintiff awarded approximately $6.1 million in punitive damages, one-half of which was paid to her attorneys under a contingency fee agreement entered into at the outset of representation. The court would not overrule *Cotnam. See also, Foster,* supra.

Ninth Circuit: Contingency Fees Part Of Client's Gross Income

Six per curiam Ninth Circuit decisions, three with opinions, support the includability of the attorney contingency fee portion of a recovery in the gross income of clients. In *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied,* 532 U.S. 972 (2001), the court analyzed both Alaska attorney lien law and the federal tax law principles of gross income realization as discussed in *Horst* and *Lucas v. Earl*. The court distinguished both *Cotnam* (interpreting Alabama attorney lien law) and *Clarks* (interpreting Michigan attorney lien law) by reference to the Alaska attorney lien statute, which the court construed as granting a contingency fee attorney a mere security interest in a recovery fund, but not conferring "any ownership interest upon attorneys or grant[ing] attorneys any right and power over the suits, judgments or decrees of their clients." In addition, the court believed the aforementioned Supreme Court decisions were controlling of the outcome. The same court took the same tack in *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied,* 531 U.S. 1112 (2001), where the court drew upon the California Supreme Court's understanding of that state's attorney lien law to the effect that contingent fee contracts do not operate to transfer a part of the cause of action to the attorney but only give the attorney a lien upon the clients' recovery.

Going beyond these decisions, in *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), *cert. denied,* 536 U.S. 904 (2002), the court addressed whether attorney contingency fees incurred in connection with a claim under the Federal Age Discrimination in Employment Act were included in the client's gross income. The court applied *Old Colony Trust,* holding that since the client had become obligated to pay a one-third contingency fee under the agreement, upon payment to the attorney by the defendant, the client was discharged by a third person of an obligation to the attorney which is equivalent to the client's receipt of gross income. In addition, the court declined to follow Alabama attorney lien law, which was arguably applicable because the plaintiff was a resident of Alabama at the time he entered into the contingency fee agreement. The court stated, "We do not dispute the old Fifth Circuit's statement of Alabama law, but we do not see how the existence of a lien in favor of the taxpayer's creditor makes the satisfaction of the debt any less income to the client whose obligation is satisfied." The *Sinyard* court's reliance on *Old Colony Trust* indicates that if the Ninth Circuit sits en banc, it will strive to reach a gross income inclusion view of the attorney contingency fee portion of recovery funds solely upon federal income tax principles, state law notwithstanding. However, this observation is speculative.

Fourth, Seventh, And Tenth Circuits: Includable In Client's Gross Income

In *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001), the court addressed whether the attorney contingency fee portion of a payment in

settlement of a divorce matter could be excluded from the spouse's gross income. The Fourth Circuit held the contingency fee portion of the settlement includable in client gross income on the federal income tax principles set forth in *Horst*, *Lucas v. Earl,* and *Old Colony Trust.* The court stated, "Nor do we agree with *Cotnam* and *Clarks* (and Mrs. Young's) reliance on state law to settle this Federal tax issue."

In *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied,* 535 U.S. 1056 (2002), the court considered the question whether the Missouri attorney's lien statute had the effect of removing the contingency fee from a judgment in respect of a Title VII lawsuit against a former employer. The court broadly construed section 61(a) as including in client gross income all attorneys' fees paid in the settlement. The court also applied the *Old Colony Trust* principle that the recovery permitted the client to discharge a personal obligation she had incurred in entering into a contingent fee agreement. Finally, the Tenth Circuit reviewed the Missouri attorney lien statute and concluded it does not create a proprietary interest in a recovery fund on an attorney's behalf in contradistinction to Alabama's attorney lien statute. Beyond this review of the Missouri lien statute, the court added, "The correct approach is much more simple," referring to the federal income tax principles applicable to the question in contradistinction to the unique provisions of a particular state's attorney lien statute or jurisprudence.

In *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001), the court addressed the question in the context of an age discrimination suit brought against a former employer. The client entered into a contingent fee agreement with his attorney before the assertion of his claims. As the Tax Court has been doing, the Seventh Circuit cited *Lucas v. Earl* as authority for the conclusion that all of the settlement recovery constituted gross income to the client. It expressly rejected the rationale of *Cotnam.* In addition, the court reviewed the Wisconsin attorney lien law, finding that there an attorney possesses a mere security interest in the recovery fund. Moreover, Wisconsin Supreme Court Rule 20:1.8(j) prohibits lawyers from acquiring "a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client." In other words, the attorney lien cannot be an ownership interest in the client's claim. It is a mere lien on the recovery fund. Finally, the court was very uncomfortable with a result that would exclude attorney contingency fees from client gross income, in light of its apparently unchallenged observation that per-hour attorneys' fees charged clients in the same type of lawsuits did not result in a client's exclusion from gross income of those attorneys' fees when paid out of the recovery.

Majority For Inclusion

The majority of circuits that have considered the question under review have concluded, based upon an application of the federal income tax principles of gross income realization set forth in *Lucas v. Earl* and *Horst,* and in some decisions *Old Colony Trust* as well, that the attorney contingency fee portion of a recovery fund is included in the gross income of the client. Some of the courts reaching this conclusion believed it necessary to further address the question of the exact nature of the attorney's interest under applicable state law. A minority of circuits have taken the view that client federal gross income realization does not occur in the context of contingency fee agreements and subsequent recoveries. They further support their holdings by finding the attorney's interest in the contingency fee portion of the recovery fund rises to the level of a legal or equitable proprietary interest in the recovery fund, or in the

client's claim, or both. However, in *Clarks*, the court may not have relied upon state law in reaching a conclusion of exclusion from gross income. The Supreme Court has relatively recently denied certiorari to consider the question in *Hukkanen-Campbell* and *Codey*. The opportunity therefore remains for a case presenting the question to the Supreme Court.

Another Court Addresses The Question

The most recent decision to address the question, and it does so most completely, is *Raymond v. U.S.*, 247 F. Supp.2d 548 (D. Vt. 2002). The client and his attorneys entered into a one-third contingency fee agreement at the outset of a wrongful termination claim against a former employer. The case resulted in a judgment for the client. The attorneys' contingency fee was paid directly to the attorneys. The IRS assessed an alternative minimum tax deficiency against the client, who argued that the attorneys' contingency fee portion of the recovery fund was excluded from his gross income. *Raymond* is significant because while it is the last decision in the line, it is the first decision to cite and (selectively) quote from *Nutt v. Knut*, 200 U.S. 12 (1906), to the effect that the (typical) contingency fee agreement gives attorneys an interest in the claim.

In *Nutt*, the Supreme Court reviewed a contract entered into between a contingency fee attorney and an estate executrix specifying that the client's obligation under the contract to pay the attorney 33⅓ percent of any recovery "is hereby made a lien upon said claim [against the United States] and upon any draft, money, or evidence of indebtedness which may be issued thereon." The Court held this contract wording violated section 3477 of the United States Revised Statutes, which bars "transfers and assignments made of any claim upon the United States, or of any part or share thereof, or interest therein." The Court viewed the contractually created lien to be an "interest in" the client's claims themselves (within the meaning of the statute), not merely an interest in some possible recovery fund.

Thus, the *Raymond* court concluded, "the contingent fee agreement operates more like an assignment of income producing property than an [impermissible] assignment of…income from property." (The court agreed with the Sixth Circuit in *Clarks*.) Moreover, the transfer occurs before the claim "has…matured or ripened into a right to enjoy a gain," or put another way, the client does not enjoy a satisfaction of sufficient economic worth to result in income realization. *Compare*, *Horst*. *Raymond* also expressly rejects the relevancy of *Old Colony Trust* to the question, based upon a factual finding that under the (typical) contingency fee agreement the client has no personal debt or obligation to the contingency fee attorney from which to be relieved as a gross income equivalent receipt. *Raymond* also expressly rejects the notion in *Baylin* that a judicial recognition of (typical) contingency fee agreements exalts tax-motivated forms over the economic substance upon which income taxation rests. The court concluded: "contingent fee contracts are not employed as a 'skillfully devised'…tax avoidance scheme, but to provide greater access to legal services, often in doubtful and risky cases, where the clients cannot afford to pay attorneys to pursue their claims." The client merely shares recovery funds as pre-agreed, and if he or she breaches that promise, the attorney has special rights enforceable in equity as both a charging lien holder against the fund and an equitable assignee of the client to the extent of the contingency fee. The wide-ranging views of the *Raymond* court could persuade the Supreme Court or the Circuit Courts that have yet to address the question.

Ignored Precedent?

Some of the rationale of *Raymond* is reminiscent of the rationale of *Blair v. Commissioner*, 300 U.S. 5 (1937) (not cited by the court) and *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962), *rev'g*, 35 T.C. 617 (1961) (not cited by the court). *Blair* and *Ferrer* heretofore seem to have been ignored by the courts deciding the question, at least as far as can be gleaned from the opinions themselves.

In *Blair v. Commissioner*, 300 U.S. 5 (1937), the Court addressed the following facts: the taxpayer was an income beneficiary of a trust created under another's will. In 1923 the taxpayer assigned his interest in the trust to his daughter. The IRS sought to tax the taxpayer-assignor on trust income when later received by his daughter. The Supreme Court very carefully reasoned, "The will creating the trust entitled the petitioner during his life to the net income of the property held in trust. He thus became the owner of an equitable interest in the corpus of the property [citations omitted]. By virtue of that interest he was entitled to enforce the trust, to have a breach of trust enjoined and to obtain redress in case of breach. The interest was present property alienable like any other. … The assignment of the beneficial interest is not the assignment of a [mere] chose in action but of the 'right, title and estate in and to property.'" Based upon this reasoning, the court held the taxpayer-assignor was not taxable on the income received by his daughter. *Blair*, in effect, distinguishes *Lucas v. Earl* as having to do only with the impermissible assignment of compensation for services.

Blair also characterized what the taxpayer assigned to his daughter as not being a mere "chose in action" (such as would be a negotiable, assignable promissory note or claims for damages for personal injuries), thus emphasizing its conclusion that "property" has been assigned rather than "income" impermissibly assigned. The court, in effect, avoided the question it later framed in *Horst,* of under what circumstances an assignor of some possible future income of some kind should realize gross income in the absence of his actual eventual receipt of it. However, characterization of what is assigned as "property" remains important to the question under review because *Blair* remains good law. Thus, from the attorney's perspective an interest in a claim or recovery via a contingency fee agreement looks and feels like property, because of the range of equitable remedies available to the attorney to collect his contingency fee. Some courts have put the emphasis here, holding for the client-taxpayer. *Blair* lends further support. On the other hand, some circuit courts have invoked the holding of *Horst* against the client-taxpayer, in part, by assuming that the client-taxpayer claims were choses in action not "property." This emphasis results in holdings against the client-taxpayer. *Blair* is not discussed.

In *Ferrer*, the taxpayer received a 17 percent interest in the net profits of a yet-to-be-produced film based upon the novel "Moulin Rouge," in exchange for a release of his contractual rights (among others) to produce a stage version of the novel and prevent the author's disposition of motion picture rights for a specific time and radio and television production rights for a longer period of time. The question was whether by releasing his contractual rights Ferrer had sold property eligible for capital gains taxation for each year of receipt of payments or whether instead he had to report a "collapsed anticipation of ordinary income." The Second Circuit parsed through the contract and found that Ferrer:

- Possessed the right to enjoin others from interfering with his contractual right to produce the play, that is, he "had an 'equitable interest' in the copyright of the play"'; and
- Could prevent the author's disposition of motion picture, radio, and television production

rights (for a time) until after his production of the play. Under applicable New York case law, "[Ferrer]…would be protected in equity…and [this judicial recognition of his rights] would thus constitute an 'equitable interest' in this portion of the copyright." Amazingly, *Blair* is not cited, because the property found in *Ferrer* is of a similar equitable nature to the property found in *Blair*.

Thus, the equitable interests held by contingency fee attorneys under the state case law, as "claims to equitable interference by the courts" or "as equitable assignee(s) of the recovery fund," and as now embodied in many attorneys' charging lien statutes, as well as the equitable interests identified in *Ferrer* and *Blair* are too close to one another to dismiss *Ferrer* or *Blair* as irrelevant to the question. Rather, attorneys entering into typical contingency fee agreements before pursuing claims do have an interest recognized by statute or by equity in the portion of the recovery fund, if any, representing the contingency fee. In a reverse derivative sense, so too in the client's claim: If the attorney pursues the claim for the client and earns a recovery, a portion of the recovery fund belongs to the attorney who earned it, and he can specifically enforce his right, or seek injunctive relief to bar funds transfer or be granted other appropriate equitable relief.

Ferrer discusses a number of "assignment of income" decisions, which in turn discuss other decisions in the area of "assignment of income," including these analogous cases. In *Paul A. Teschner v. Commissioner*, 38 T.C. 1003 (1962), the taxpayer entered an essay prize contest the rules of which precluded him from personally receiving the prize, but allowed him to name his daughter under age 17 and 1 month as prize beneficiary. In *Henry Braunstein v. Commissioner*, 21 T.C.M. (CCH) 1132 (1962), the taxpayer made a pre-race gift of his Irish Sweepstakes ticket. In both cases the prize was awarded after the alleged assignment, and the courts held only the assignee is taxed on the income realized. In *Teschner*, *Lucas v. Earl,* and *Horst* were both distinguished on the grounds that under the contest rules the taxpayer could not receive the prize and lacked dominion and control over prize disposition. In *Braunstein*, the court held that *Lucas v. Earl* did not apply to the facts because "this is not an assignment of the 'fruit' of the 'tree' which earned the income…but the transfer of an asset [*i.e.*, property] the ultimate value of which is wholly contingent."

A contingency fee client may be likened to a contest participant or a prize-ticket buyer.

A contingency fee client may be likened to a contest participant or a prize-ticket buyer. For example, just as a lottery ticket is bought for anticipated winnings, the incident giving rise to damage claims sparks an anticipated recovery. Each event requires some acts by others beyond the dominion and control of the claimant: In the case of a lottery ticket, a drawing by a solvent obligor, and in case of legal claims, the attorney success made possible, in relevant part, by a contingency fee agreement.

TIPS FOR CONTINGENCY FEE AGREEMENTS • In light of the case law and legal arguments, an attorney contingency agreement can be drafted to favor a client's tax return position of excluding the contingency fee portion of a recovery from gross income, by means of the following:

Following these guidelines eliminates significant tax issues that might lead to an adverse determination of client gross income inclusion in a litigated tax case.

- Start with a contingency fee agreement like that in *Nutt* (which is set forth in the opinion), and if permitted by relevant state law and attorney ethics rules, include that the attorney shall have a lien upon the client's claims;
- Modify it to include non-recourse wording such that the attorney is looking only to any and all recoveries for payment of contingency fees, and not the client, and that the payment by any person of the amount due the attorney under the agreement shall not be in discharge of any obligation or liability of the client to the attorney for legal fees;
- If and as permitted by the state law in question, modify the agreement to state that the attorney shall have the same right and power over the suit and any recoveries as the client has or may have, and that the (contingency) fee serves only as the measure of the attorneys' interests therein;
- Draft the agreement so that no portion of the recovery fund shall be paid to the client via check (even joint check with the attorneys), wire transfer, or by any other means. Instead, the attorneys are to receive the whole of any recovery and disburse it to the client net of attorneys' fees and expenses. Expressly bar the client's direct receipt of the attorney contingency fee portion of the recovery fund.

Following these guidelines eliminates significant tax issues that might lead to an adverse determination of client gross income inclusion in a litigated tax case. The author acknowledges that from the litigation attorney's perspective adoption of the foregoing suggestions may be yet another case of the "tax tail" wagging the "business dog."

TAX REPORTING OF GROSS INCOME EXCLUSION • If a client excludes the attorney contingency fee portion of a recovery from federal gross income, the IRS will likely issue a federal income tax deficiency notice, assuming it audits the client's tax return and spots the issue. This fact raises questions about tax return disclosure to the IRS.

In the case of any individual client, section 6662(d) imposes a "no fault" substantial understatement tax penalty if for any taxable year the amount of the tax understatement exceeds the greater of:

- 10 percent of the tax required to be shown on the return; or
- $5,000. The substantial understatement tax penalty equals 20 percent of the underreported tax.

The imposition of the substantial understatement penalty does not depend upon client negligence or client disregard of the income tax laws. Section 6662(d)(2)(B), however, provides that the penalty does not operate to the extent the client's reporting position is (or was as of the close of the tax year in question) supported by "substantial authority," or in its absence, if the relevant facts affecting the tax treatment of the item in question are adequately disclosed in the return or in a statement attached to the tax return and there is a reasonable basis for the tax treatment of such item by the taxpayer.

Substantial Authority

Treasury Regulation 1.6662-4(d) fleshes out the meaning of "substantial authority." The regulation provides that there exists substantial authority for the tax treatment of an item only if the weight of authority supporting the treatment is substantial in relation to the weight of authority supporting contrary treatment. Moreover, the regulations point out there may be substantial authority for more than one position with respect to the tax treatment of an item. Because two circuits have issued decisions excluding the attorney contingency fee portion of a recovery fund from a client's federal gross income, while seven others have required gross income inclusion, there is, depending on the particulars of the situation, in general substantial authority for more than one position with respect to the tax treatment of the attorney contingency fee portion. In addition, Treas. Reg. §1.6662-4(d)(3)(iv)(B) states that the applicability of court cases to the client by reason of the client's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. This rule is important for clients in the Third Circuit, which is included owing to *O'Brien*. Elsewhere, the regulations provide that an authority merely stating a conclusion ordinarily is less persuasive than one reaching a conclusion by cogently relating the applicable law to the pertinent facts. Again, for residents of the Third Circuit this statement is important owing to the very short opinion of the Third Circuit in *O'Brien*.

Although there is yet no direct authority on point, in *Wise v. Commissioner*, 73 T.C.M. 2324 (1997), the court held that one circuit court opinion constituted substantial authority for the inclusion of the guaranteed debt of an S Corporation in the guarantor's S Corporation tax basis (resulting in favorable tax treatment), despite the fact that the United States Tax Court and several circuits previously had ruled to the contrary in interpreting the same statutory provision. Based upon *Wise*, and the fact that two circuits have decided for gross income exclusion, the weight of authority supporting exclusion of attorney contingency fees is relatively substantial.

For those clients (or their accountants) who have residual doubts owing to the absence of any case yet discussing the adequate disclosure standard in the context of the question under discussion, or who face "bad facts," the filing of the right IRS disclosure form is the proper approach to tax reporting. Treas. Reg. §1.6662-4(f) requires the use of prescribed Forms 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement). Furthermore, if the client is not particularly concerned about tax penalties, but the estimated substantial underpayment penalty can be expected in the range of tens of thousands to hundreds of thousands of dollars, an adequate disclosure on Form 8275 is also sensible as a precaution.

PRACTICE CHECKLIST FOR

Are Attorney Contingency Fees Included In A Client's Gross Taxable Income?

Assuming recovery funds involve hundreds of millions of dollars per annum, and that the attorney contingency fee percentages paid out of those funds average 33⅓ percent, a very important question of federal income taxation is whether the attorney contingency fee portion of a recovery fund is included or excluded from a client's federal gross income.

• In light of the case law and legal arguments, an attorney contingency agreement can be drafted to favor a client's tax return position of excluding the contingency fee portion of a recovery from gross income, by means of the following:

__ Start with a contingency fee agreement like that in *Nutt v. Knut,* 200 U.S. 12 (1906) (which is set forth in the opinion), and if permitted by relevant state law and attorney ethics rules, include that the attorney shall have a lien upon the client's claims;

__ Modify it to include non-recourse wording such that the attorney is looking only to any and all recoveries for payment of contingency fees, and not the client, and that the payment by any person of the amount due the attorney under the agreement shall not be in discharge of any obligation or liability of the client to the attorney for legal fees;

__ If and as permitted by the state law in question, modify the agreement to state that the attorney shall have the same right and power over the suit and any recoveries as the client has or may have, and that the (contingency) fee serves only as the measure of the attorney's interests therein; and

__ Draft the agreement so that no portion of the recovery fund shall be paid to the client via check (even joint check with the attorneys), wire transfer, or by any other means. Instead, the attorneys are to receive the whole of any recovery and disburse it to the client net of attorney fees and expenses. Expressly bar the client's direct receipt of the attorney contingency fee portion of the recovery fund.

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