THE SUPREME COURT'S CASUAL USE OF THE ASSIGNMENT OF INCOME DOCTRINE

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In early 2005, the U.S. Supreme Court answered a question that had been plaguing courts for years: whether plaintiffs should be taxed on the portion of contingent fee awards paid to their attorneys. The Court determined that they should. In this article, Professor Brant J. Hellwig focuses on the analysis employed by the Court to reach its conclusion in Commissioner v. Banks *and the implications of that analysis for future cases. Although Professor Hellwig believes that the Court correctly ascertained the plaintiff's tax burden, he suggests that the Court's use of the assignment of income doctrine was both unnecessary to the final determination of the question before the Court and costly in its potential to confuse the issues of income realization and assignment of income. By applying the assignment of income doctrine to a commercial transaction and employing the doctrine as a means of determining income realization, the Court broke with the foundational principles of equity that originally supported the assignment of income doctrine and instead created a potential conflict with statutory authority on the question of income realization. Professor Hellwig calls for courts to restrict expansion of this unfortunate trend, noting the potential of the Court's decision to create more problems than it solves.*

I. INTRODUCTION

The Supreme Court has described as the "first principle of income taxation" the tenet that "income must be taxed to him who earns it."[1] This simple statement captures the anticipatory assignment of income doctrine, a doctrine developed by courts to fill the dearth of statutory

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1. Comm'r v. Culbertson, 337 U.S. 733, 739–40 (1949). The origin of the maxim lies in the Supreme Court's seminal decision in *Lucas v. Earl*, in which the Court reasoned that the statutory definition of gross income "could tax salaries to those who earned them." 281 U.S. 111, 114 (1930).

guidance regarding who should report as income an item that has been the subject of a prior transfer. While a tax-avoidance motive is not a prerequisite to the application of the doctrine, the potential to undermine the progressive rate structure is a predominant concern in the seminal cases that formed the doctrine—all of which involved the gratuitous transfer of payment rights among family members or related entities. Based on its origins and purpose, many viewed the assignment of income doctrine as inapplicable in the context of an arm's length assignment for consideration.[2] That is, until the Court issued its decision in *Commissioner v. Banks*.[3]

In *Banks*, the Court finally weighed in on the taxation of contingent attorney's fees, an issue that had divided the Tax Court[4] and had generated a pronounced split among the Circuit Courts of Appeals.[5] The specific question before the Court was whether a plaintiff was required to include in gross income the portion of the recovery retained by his attorney as a contingent fee, as opposed to including in gross income only the net recovery.[6] In fairly short order, the Court resolved the case in favor

2. *See* Charles Davenport, *Applying Gratuitous Assignment Rules Is a Goofy Idea*, 104 TAX NOTES 568 (2004); Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 633 (1993); Elliott Manning, *The Service Corporation—Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351*, 37 U. MIAMI L. REV. 657, 668–69 (1983); Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruit and Trees*, 37 GA. L. REV. 57, 78–88 (2002).

3. 543 U.S. 426 (2005). For prior commentary on the *Banks* decision, see Stephen B. Cohen, *Misassigning Income: The Supreme Court and Attorneys' Fees*, 25 VA. TAX REV. 415 (2005); Leah Witcher Jackson, *Won the Legal Battle, but at What Tax Cost to Your Client: Tax Consequences of Contingency Fee Arrangements Leading up to and After* Commissioner v. Banks, 57 BAYLOR L. REV. 47 (2005); Philip N. Jones, *Supreme Court Finally Rules—Against Taxpayers—on Contingent Attorney's Fees*, 102 J. TAX'N 169 (2005); James A. Doering, *Supreme Court Rules on the Taxation of Contingent Attorney Fees*, TAXES, Aug. 2005, at 41.

4. *See* Kenseth v. Comm'r, 114 T.C. 399 (2000). Judge Ruwe authored the majority opinion in *Kenseth*, which was joined by seven other judges. Judge Chabot dissented in an opinion joined by four other judges. Judge Beghe, the judge who presided over the case at trial, filed a dissenting opinion that spanned thirty-eight pages and supplied its own index.

5. The majority of circuits to address the issue sided with the government. *See* Raymond v. United States, 355 F.3d 107, 117–18 (2d Cir. 2004); Campbell v. Comm'r, 274 F.3d 1312, 113–14 (10th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881, 885 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001); Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532, 532 (3d Cir. 1963). A minority of circuits, however, sided with the taxpayer. *See* Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003); Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959); *see also* Srivastava v. Comm'r, 220 F.3d 353, 357–65 (5th Cir. 2000) (following *Cotnam* as binding precedent, albeit reluctantly); Davis v. Comm'r, 210 F.3d 1346, 1347–48 (11th Cir. 2000) (following *Cotnam* as binding precedent from the former Fifth Circuit). The Ninth Circuit occupied a unique category, issuing split decisions based on the particulars of the governing state attorney lien law. *See* Banaitis v. Comm'r, 340 F.3d 1074, 1081–83 (9th Cir. 2003) (holding for the taxpayer based on the Oregon law); Benci-Woodward v. Comm'r, 219 F.3d 941, 943–44 (9th Cir. 2000) (holding for the government based in part on California law); Coady v. Comm'r, 213 F.3d 1187, 1190–91 (9th Cir. 2000) (holding for the government based in part on Alaska law).

6. At first glance, the distinction may appear to be a mere technicality, as under either characterization the plaintiff would, in theory, be left with taxable income of only the net recovery. The distinction can have a profound practical effect, however, based on the various limitations on the tax benefit of deductions. If the litigation does not relate to the plaintiff's trade or business, or if it relates

of the government, relying on the classic assignment of income doctrine to determine that the taxpayers' gross income included the entire amount of the litigation proceeds.[7]

The Supreme Court's decision in *Banks* was a disappointment. Although the Court reached the correct result in *Banks*,[8] it did so for the wrong reason. Simply put, the assignment of income doctrine had no proper application in the case. Whereas the doctrine had developed as a means of equitably attributing an item of income to one other than its recipient based on the assignor's level of control over the assigned payment stream or its source, the contingent attorney's fee issue presented a question of realization as opposed to attribution. As explained in this article, the contingent fee issue could have been resolved using well-established rules of income realization, with the exact analysis turning on whether the execution of the contingent fee agreement could be viewed as effecting a completed transfer of an interest in the cause of action or its proceeds. Nonetheless, the Court shunned this more rigorous examination of the case, instead invoking the vague analogies associated with the assignment of income doctrine to justify including the contingent fee portion of the recovery in the plaintiff's gross income. In the process, the Court elevated the doctrine from a statutory gap filler to one that potentially conflicts with statutory authority.

The Supreme Court's invocation of the assignment of income doctrine to resolve the tax consequences of a commercial transaction in *Banks* was not without precedent. It arguably can be supported by the Court's 1973 decision in *United States v. Basye*, wherein the Court turned to the assignment of income doctrine to explain its holding that a service partnership realized income by reason of contributions its client made to a retirement trust created for its partners and employees.[9] This article will illustrate, however, that the reasoning in *Basye* also was deficient, as

to the plaintiff's trade or business of performing services as an employee, then the deduction is labeled a miscellaneous itemized deduction under § 67(b). As such, the deduction would be subject to the 2% floor on miscellaneous itemized deductions under § 67(a). In addition, the deduction is subject to reduction by reason of the income-based phaseout provided in § 68(a). Most significantly, the deduction is disallowed in its entirety for purposes of calculating the plaintiff's liability under the alternative minimum tax. *See* I.R.C. § 56(b)(1)(A). Thus, a plaintiff could be taxed on her gross recovery at AMT rates, something that flies in the face of the traditional notion of taxing an individual on her net income only. The harsh treatment of the deduction for certain legal fees was ameliorated to a large extent by the American Jobs Creation Act of 2004, which created a new above-the-line deduction for legal fees paid or incurred in prosecuting a claim of "unlawful discrimination." For a full analysis of this legislation, see Brant J. Hellwig & Gregg D. Polsky, *Litigation Expenses and the Alternative Minimum Tax*, 6 FLA. TAX REV. 899, 940–47 (2004). The legislation, however, was not made retroactively applicable. The corrective legislation thus had no direct bearing on the *Banks* and *Banaitis* cases before the Supreme Court.

7. *Banks*, 543 U.S. at 433–35.

8. This assessment of the holding in *Banks* is by no means universally shared. *See*, *e.g.*, Cohen, *supra* note 3, at 415; Stephen Cohen & Laura Sager, *Kafka at the Tax Court: The Attorney's Fee in Employment Litigation*, 96 TAX NOTES 1503 (2002); Charles Davenport, *Why Tort Legal Fees Are Not Deductible*, 97 TAX NOTES 703 (2002); Jackson, *supra* note 3, at 126–31.

9. 410 U.S. 441, 449–53 (1973).

the Court's use of the assignment of income doctrine in that case was both strained from a factual standpoint and superfluous from a legal one.

The *Banks* and *Basye* decisions represent an emerging trend of the Supreme Court somewhat nonchalantly invoking the assignment of income doctrine to justify what it views—accurately, so far—to be the correct tax consequences of certain commercial transactions. This article argues that the use of the assignment of income doctrine as a substantive rule of income realization, however, should not be viewed as benign. First, such use of the doctrine introduces additional complexity to the task of predicting the tax consequences of transferring future payment streams for consideration. Furthermore, the Court's expanded use of the doctrine may have unintended consequences, as the taxpayer could use the Court's recent analysis to argue for deferred taxation of the benefit realized from a commercial assignment of income rights. Thus, the Supreme Court should end its recent application of the assignment of income doctrine in the commercial context, leaving the doctrine instead to its intended purpose of equitably attributing gratuitously assigned income to the assignor in order to achieve a fair imposition of the tax burden while protecting the progressive rate structure.

II. THE *BANKS* DECISION

A. Background

After refusing to accept taxpayers' petitions for certiorari on five prior occasions in cases involving the tax treatment of contingent attorney's fees,[10] the Supreme Court finally accepted the government's petition in two such cases: *Commissioner v. Banaitis* from the Ninth Circuit,[11] and *Commissioner v. Banks* from the Sixth Circuit.[12] The cases were consolidated for argument before the Court. A brief history of each case follows.

1. Commissioner v. Banaitis

Sigitas Banaitis sued his former employer and its corporate parent on wrongful discharge and other theories relating to his termination as vice president and loan officer with the Bank of California.[13] After the case was tried and the appeal exhausted, the parties entered into a confidential settlement agreement whereby the defendants agreed to make

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

11. 340 F.3d 1074 (9th Cir. 2003), *cert. granted*, 541 U.S. 958 (2004).

12. 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 541 U.S. 958 (2004).

13. *Banaitis*, 340 F.3d at 1076.

the following payments: $4,864,547 to Banaitis and $3,864,012 to his attorneys.[14] These payments were consistent with the parties' contingent fee agreement based on a gross recovery of $8,728,559.[15]

On the issue of whether Banaitis' gross income was limited to the $4.9 million he netted from the litigation or included the entire $8.7 million gross proceeds of the litigation, the Ninth Circuit reversed the Tax Court and determined that Banaitis had properly excluded the portion of the recovery paid to his attorneys.[16] This decision from the Ninth Circuit was somewhat surprising, given that prior panels of that court had ruled in the government's favor on what appeared to be the identical issue.[17] The court in *Banaitis*, however, determined that those prior decisions turned on the scope of the applicable state attorney lien law.[18] It then proceeded to distinguish the Oregon attorney lien law implicated in the case from the California and Alaska laws that were addressed in its prior decisions. Citing certain "unique features" of the Oregon statute that prevented the litigation from being resolved until the attorney lien had been satisfied, the court concluded that Banaitis had transferred a portion of his claim to his attorneys upon execution of the fee agreement.[19] Accordingly, the portion of the award paid to the attorneys constituted a recovery on their portion of the underlying claim—as opposed to any portion of the claim retained by Banaitis. In this manner, the Ninth Circuit viewed the plaintiff and the contingent fee attorney as cotenants of

14. *Id.* at 1078.

15. The original fee agreement called for a payment of 33% of the gross proceeds of the litigation if the case was settled prior to trial or arbitration, and 40% of the gross proceeds thereafter. The case was tried to a jury, which returned a verdict awarding Banaitis roughly $1.3 million in compensatory damages and $5 million in punitive damages. The trial judge granted the defendants' judgment notwithstanding the verdict in part, setting aside the punitive damage awards. Before prosecuting the appeal, Banaitis and his attorneys renegotiated the fee agreement to provide the attorneys with 50% of any compensatory recovery and roughly 43% of any punitive damages recovery. *Id.* at 1076–78.

16. *Id*. at 1081–83.

17. *See* Benci-Woodward v. Comm'r, 219 F.3d 941, 944 (9th Cir. 2000); Coady v. Comm'r, 213 F.3d 1187, 1191 (9th Cir. 2000).

18. *Banaitis*, 340 F.3d at 1081 (claiming that prior cases employed a "state-law-specific" analysis). This characterization to a certain extent oversimplifies the analysis of the prior Ninth Circuit decisions. Although *Coady* did contrast the governing attorney lien statute under Alaska law with the Alabama statute at issue in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), and the Michigan statute at issue in *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), the bulk of the analysis in *Coady* was devoted to cases interpreting the reach of gross income under § 61. *See Coady*, 213 F.3d at 1190–91. Similarly, the court in *Benci-Woodward* incorporated the analysis from *Coady* after determining that the California attorney lien statute did not confer an ownership interest upon the attorney. *Benci-Woodward*, 219 F.3d at 943.

19. *Banaitis*, 340 F.3d at 1082–83. The Ninth Circuit's analysis of the case can be charitably described as suspect, particularly given that a prior panel of that court had openly questioned the relevance of state attorney lien law. *See* Sinyard v. Comm'r, 268 F.3d 756, 760 (9th Cir. 2001) (stating "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 taxpayer whose obligation is satisfied"). Perhaps this is why Banaitis relegated the state-law argument to secondary status in his arguments before the Supreme Court. *See* Brief for Respondent Banaitis at 31, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-907) (not raising the argument under Oregon attorney lien law until Part IV of the brief); Transcript of Oral Argument at 41, *Banks*, 543 U.S. 426 (No. 03-907) (Banaitis' attorney raising the argument under Oregon law as his third point, recognizing it as one "which I don't think the Court is likely interested in").

the cause of action, each of whom collected their respective proceeds of the claim.[20]

2. Commissioner v. Banks

John W. Banks II worked as a consultant to the California Department of Education for fourteen years until he was terminated in 1986.[21] He filed suit against the department, claiming that his termination was in violation of federal employment discrimination laws and federal civil rights protections.[22] Nine days into the trial, the parties settled the case for $464,000.[23] Of this amount, Banks paid his attorney $150,000 pursuant to their contingent fee agreement.[24]

Similar to the Ninth Circuit in *Banaitis*, the Sixth Circuit reversed the Tax Court and held that Banks was not required to include in gross income the portion of the recovery paid to his attorney.[25] However, the Sixth Circuit based its decision on an altogether different theory. In particular, the Sixth Circuit shunned the relevance of state law: "We . . . are not inclined to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated."[26] Instead, the court decided the case by rejecting the government's proposed application of the assignment of income doctrine to tax Banks on the portion of the claim proceeds that were paid to his attorney. The court cited the following reasons as justifications for why the doctrine should not be applied in the contingent fee context: (1) at the time the fee agreement was executed, the claim amounted to nothing more than an intangible, contingent expectancy; (2) the claim was analogous to a joint venture in which the plaintiff assigned one-third in hopes of recovering two-thirds; (3) the absence of a tax-avoidance motive; and (4) double-taxation would

20. Although the court concluded that the Oregon attorney lien statute operated to transfer a proprietary interest in the underlying cause of action to the attorney, at no point did the court in *Banaitis* address the tax consequences of the transfer or so much as recognize that the transfer may have tax consequences. *Banaitis*, 340 F.3d at 1081–83.

21. Banks v. Comm'r, 345 F.3d 373, 375 (6th Cir. 2003).

22. Banks further asserted various state law tort claims, including intentional infliction of emotional distress and slander. However, he dropped these claims as the case proceeded toward trial. *Id.* at 375.

23. As an aside, the defendant argued that Banks should be willing to accept such amount (far lower than his demand) because it could be characterized as a nontaxable recovery for personal injuries excludable from gross income pursuant to § 104(a)(2). *Id.* at 376. Banks ended up taking this position on his return, to no avail. *Id.* at 378–82.

24. *Id.* at 376.

25. *Id.* at 386.

26. *Id*. at 385. Whereas the Sixth Circuit had previously ruled for the taxpayer based in part on the relevant Michigan attorney lien statute in *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000), the court was forced to abandon state law as a basis for its decision in *Banks* if it wanted to rule for the taxpayer. That is because Banks' original case was litigated in California, and the Ninth Circuit had previously determined that the California attorney lien statute did not operate to confer upon the attorney a property interest in the plaintiff's cause of action. *See* Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000).

otherwise result.[27] Rather than viewing the contingent fee arrangement as a present transfer of future income, the Sixth Circuit viewed the transaction as effecting a transfer of a portion of the underlying cause of action.[28] Thus, like the Ninth Circuit, the Sixth Circuit also viewed the plaintiff and attorney as cotenants of the claim following execution of the fee agreement; however, the Sixth Circuit's characterization in no way depended on applicable state attorney lien law.

B. The Supreme Court's Opinion

The Supreme Court consolidated the *Banks* and *Banaitis* cases, granting *certiorari* to address the question of whether a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.[29] In a unanimous 8-0 decision, the Court answered this question in the affirmative.[30] The Court's decision is analyzed below.

1. Use of the Assignment of Income Doctrine

After first explaining why the issue in the case was "of any consequence for tax purposes,"[31] the Court began its analysis by laying out the foundations of the anticipatory assignment of income doctrine. The Court declared that "[a] taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party,"[32] citing three of its seminal cases in the assignment of income arena: *Lucas v. Earl*,[33] *Commissioner v. Sunnen*,[34] and *Helvering v. Horst*.[35] Honing in on its 1930 decision in *Lucas v. Earl*, the Court recalled that the doctrine stands for the principle "that gains should be taxed 'to those who earn

27. *Banks*, 345 F.3d at 386.

28. Specifically, adopting assignment of income parlance, the court stated that Banks had "transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit." *Id.* (citation omitted).

29. *See* United States Supreme Court Docket Nos. 03-892 & 03-907, Question Presented, *available at* http://www.supremecourtus.gov/qp/03-00892qp.pdf. Justice Kennedy rephrased the issue slightly in the opening paragraph of the opinion. *See* Comm'r v. Banks, 543 U.S. 426, 429 (2005).

30. Chief Justice Rehnquist did not participate in the decision of the cases. *Id.* He was absent from the argument of the cases due to health-related complications. *See* Shankar Vedantam & Charles Lane, *Rehnquist's Illness Forces Absence: Chief Justice's Treatment Suggests Thyroid Cancer at Its Most Serious*, WASH. POST, Nov. 2, 2004, at A1.

31. First, the Court outlined the limitations on deductions that would be implicated if the contingent fee were first included in the taxpayers' gross income. *Banks*, 543 U.S. at 432. For discussion of these limitations, see *supra* note 6. Next, the Court noted that corrective legislation passed by Congress after certiorari was granted in the cases did not apply to the taxpayers before it, as the legislation did not have retroactive effect. *Banks*, 543 U.S. at 433. For a discussion of this corrective legislation, see Hellwig & Polsky, *supra* note 6, at 940–47.

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

33. 281 U.S. 111 (1930) (concerning the assignment of salary).

34. 333 U.S. 591 (1948) (concerning the assignment of royalties).

35. 311 U.S. 112 (1940) (concerning the assignment of interest coupons from a corporate bond).

them'"[36] and that the intent of the doctrine is to "prevent taxpayers from avoiding taxation through 'arrangements and contracts however skillfully devised to prevent [income] when paid from vesting even for a second in the man who earned it.'"[37] The Court noted that the doctrine is intended to serve administrative as well as substantive concerns, again quoting *Earl* for the proposition that a tax-avoidance motive is not a prerequisite to the doctrine's application.[38]

Although the Court framed the assignment of income doctrine in terms of the established holding in *Lucas v. Earl* regarding the assignment of earned income,[39] the Court did not attempt to resolve the contingent fee issue on the basis of *Lucas v. Earl* alone. That is not surprising, because the question of which party "earns" a damages recovery procured through litigation has no clear resolution. On one hand, the plaintiff is being compensated for the injuries that the plaintiff suffered which gave rise to the cause of action. Thus, to the extent the recovery was "earned" by anyone, it was earned by the plaintiff.[40] On the other hand, there is no question that the retention of an attorney generally increases, often substantially, the amount of the total recovery obtained by the plaintiff. As stated by Judge Beghe in his dissent in *Kenseth v. Commissioner*, "the efforts of the attorney contribute to—indeed he may be solely responsible for—both the recovery and its augmentation."[41] In that regard, the Fifth Circuit's statement in *Cotnam v. Commissioner* that "[t]he amount of the contingent fee was earned, and well earned, by the attorneys"[42] has a certain commonsense appeal.[43]

Perhaps the awkwardness of analyzing an assignment of a damages recovery in terms of an assignment of earned income is what led the Court to employ an altogether different theory, one pertaining to the assignment of investment income generated from property. The Court framed the pertinent inquiry to be whether the taxpayers retained dominion over the income-generating asset, borrowing from its prior decision in *Helvering v. Horst* to explain that "the taxpayer 'who owns or

36. *Banks*, 543 U.S. at 433 (quoting *Earl*, 281 U.S. at 114).

37. *Id*. at 434 (quoting *Earl*, 281 U.S. at 115).

38. *Id*. (quoting *Earl*, 281 U.S. at 115, for the proposition that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree on which they grew").

39. *See* Ralph S. Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes*, 64 YALE L.J. 991, 1005 (1955) ("[I]t may be said that the general doctrine that income must be taxed to the earner thereof is basically sound.").

40. *See* Davenport, *supra* note 8, at 703 (arguing that the income from the damage recovery was "produced" upon the occurrence of the underlying tort).

41. 114 T.C. 399, 447 (2000) (Beghe, J., dissenting).

42. 263 F.2d 119, 126 (5th Cir. 1959).

43. Not surprisingly, the taxpayers in the *Banks* case echoed this argument. *See* Brief for Respondent Banks at 7, Comm'r v. Banks, 543 U.S. at 426 (2005) (No. 03-892) ("Mr. Banks's attorney, not Mr. Banks, earned and properly retained the contingent fee."); Brief for Respondent Banaitis, *supra* note 19, at 10 ("It defies reality to assert, as the government does, that only [Banaitis] earned [his settlement].").

controls the source of 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 satisfaction of his wants.'"[44] In the Court's view, analyzing who controlled the income-producing property was faithful to the bedrock principle articulated in *Lucas v. Earl* because it "preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits."[45]

Having framed the decisive inquiry to be whether the taxpayers retained sufficient dominion and control over the income-generating asset, the Court's resolution of the tax consequences of the contingent fee arrangement was all but concluded. After identifying the relevant income-generating asset in the damages recovery context as the cause of action itself,[46] the Court observed that the plaintiff retains dominion over the cause of action throughout the litigation.[47] The Court did not immediately elaborate on this point; rather, it merely remarked that it did not understand the taxpayers in the case to argue otherwise.[48] In this man-

44. *Banks*, 543 U.S. at 434 (quoting Helvering v. Horst, 311 U.S. 112, 116–17 (1940)).

45. *Id.* at 435.

46. Given that the cause of action represents nothing more than a legal claim to a payment of damages that would be included in gross income when received, it is somewhat curious that the Court chose to employ the property-versus-income framework of prior assignment of income cases. In cases that have employed this framework, there existed a clear distinction between the underlying property and the income stream it generated. *See, e.g.*, *Horst*, 311 U.S. at 114 (interest payments on a corporate bond). In this case, however, the cause of action had no significance apart from the payment of damages it could generate. Once the damages payment was received, the cause of action was extinguished. *See* 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 75.3.3, at 75-40 (3d ed. 2003) ("The distinction between an assignment of income-producing property and an assignment of income is especially troublesome if the assignor's rights consist solely of a series of items that will be income on collection . . . because in this situation the two concepts collapse."). Of course, the property-versus-income dichotomy that is a fixture of the federal income tax system is flawed to start with, as the value of all property is determined by reference to the present value of the payment or benefit stream the property will generate. Thus, property and income are not separate and distinct concepts in theory, and their treatment to the contrary for federal income tax purposes represents a result-driven determination to treat certain payments as a return of capital and others as accessions to wealth.

A more principled analysis in this context would have focused on the assignor's retained control over the assigned income stream. In that regard, the Court's prior decision in *Commissioner v. Sunnen*, 333 U.S. 591 (1948), is instructive. In *Sunnen*, the Court recognized that tracing income to property that is its true source may be a matter "more metaphysical than legal." *Id.* at 604. Accordingly, the Court identified the critical inquiry to be "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." *Id.* (emphasis added).

47. *Banks*, 543 U.S. at 435. The ease with which the Court reached this conclusion is somewhat surprising, given the divergent characterizations of the contingent fee arrangement articulated in the Circuit Courts of Appeals. In *Srivastava v. Commissioner*, the Fifth Circuit recognized that there existed no ready answer to the dominion and control inquiry in this context: "[C]ontingent fee contracts defy easy categorization, standing as they do somewhere in between [sic] the two poles—on the one hand, an obvious scheme to evade taxation through diversion of future income streams to another, and on the other hand, full and complete divestment of an income source." 220 F.3d 353, 360 (5th Cir. 2000).

48. *Banks*, 543 U.S. at 435. This remark had to come as somewhat of a surprise to Respondent Banks, who on brief argued that, by executing the contingent fee contract, he "effectively surrendered an undivided interest in his claim, the income-producing property." Brief for Respondent Banks, *supra* note 43, at 7. In fairness to the Court, however, the balance of the brief phrases this argument in

ner, the Court essentially resolved the issue before it—one that had divided the Tax Court and produced a pronounced split at the Circuit Court of Appeals level—in less than two full pages of its slip opinion.

2. *Counterarguments the Court Addressed*

The Court addressed two of the taxpayers' arguments why the assignment of income doctrine should not be applied in the contingent fee contract. The first argument focused on the predictability of the transferred income stream. The taxpayers highlighted that in *Horst* the amount of the transferred interest payments was ascertainable upon their assignment and that in *Earl* the husband was relatively certain to continue earning salary that he had partially assigned to his wife. The taxpayers argued that these cases were inapposite in the contingent fee context, because the value of the contingent fee portion of the claim was speculative at the time the fee agreement was executed and there existed no relative assurance that the attorney would receive any payment whatsoever.[49] The Court, however, was not persuaded. It determined that the predictability of the transferred income stream bore no relevance in the overall assignment of income calculus.[50] The Court observed that *Horst* involved the assignment of a predetermined payment of income, but it determined that the holding in that case did not depend on this fact. In other words, the Court viewed the existence of an ascertainable income stream in *Horst* as merely incidental. Instead, the Court determined that *Horst* stood for the proposition that the assignment of income doctrine applied when a taxpayer realized a benefit by assigning income from an asset over which the taxpayer maintained control.[51]

The taxpayers' second argument focused on the relationship between the plaintiff and attorney in a contingent fee case. The taxpayers characterized the relationship as a joint venture or partnership, one to which the plaintiff contributes property (the claim) and the attorney contributes services in a joint effort to reduce the claim to a monetary payment.[52] This argument had found favor with the Sixth Circuit, which in

terms of relinquishing control over the contingent portion of the recovery—as opposed to the underlying claim. *See id*. at 13 ("Mr. Banks ceded all practical control over the disposition of the contingent fee portion of any potential future recovery earned by his attorney."). The distinction between the income and the income-producing property in this context is precarious, however, given that the property (the underlying cause of action) represents nothing more than the legal claim to a payment of income (damages). For elaboration on this latter point, see *supra* note 46.

49. *See* Brief for Respondent Banks, *supra* note 43, at 7, 12–14; Brief for Respondent Banaitis, *supra* note 19, at 24–25. A succinct statement of the argument from a court that accepted it can be found in *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000).

50. The Court deemed the lack of certainty as to the amount of income the asset would produce at the time the income was assigned to be "of no consequence." *Banks*, 543 U.S. at 436.

51. *Id*. at 435–36 (referring approvingly to Judge Wesley's analysis in *Raymond v. United States*, 355 F.3d 107, 115–16 (2d Cir. 2004)).

52. Brief for Respondent Banaitis, *supra* note 19, at 8–9, 12–15; Brief for Respondent Banks, *supra* note 43, at 15–16.

its decision in *Banks* stated that the "taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds."[53] The potential advantage of the partnership characterization is that the litigation proceeds would be gross income to the entity, to be divided among the participants according to their partnership agreement (in this case, the contingent fee agreement).[54]

Suffice it to say that the characterization of the attorney-client relationship as a partnership or joint venture for tax purposes did not resonate with the Supreme Court.[55] Rather, the Court viewed the arrangement as a "quintessential principal-agent relationship."[56] The Court was not troubled that the client, in retaining an attorney to prosecute the case, may often obtain a better result than the client could achieve alone, noting that this is true of most principal-agent relationships.[57] Returning to its central finding in the case, the Court furthermore explained that the retention of an attorney did not alter the fact that the client retains "ultimate dominion and control" over the cause of action.[58] At this point, however, the Court elaborated on why it viewed the plaintiff as

53. Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003); *see also Estate of Clarks*, 202 F.3d at 857 (similarly characterizing the contingent fee arrangement as a partnership or joint venture).

54. *See* Brief for Respondent Banaitis, *supra* note 19, at 14 (arguing that the litigation proceeds would be divided among the plaintiff and the attorney pursuant to I.R.C. § 704(a)); Brief for Respondent Banks, *supra* note 43, at 15 (same). Neither party addressed the tax consequences that would result from the parties' formation of the purported partnership.

55. This sentiment was predictable based on the following exchange at oral argument, in which Banaitis' attorney was essentially forced to abandon the partnership argument:

> JUSTICE SCALIA: It's a partnership theory when you talk about two persons joining together. I don't like this—this gold mine view of litigation, that it's, you know, like two prospectors. You know, there's money to be obtained.
>
> (Laughter.)
>
> Mr. Jones: I—
>
> JUSTICE SCALIA: That's—that's not what I view . . . a chosen [sic] action as. I view it as a legal right—
>
> Mr. Jones: Yes.
>
> JUSTICE SCALIA:—that the person is entitled to money, and ultimately the amount he's entitled to is determined by the litigation. And I'm not about to adopt a—a legal theory that—that views this as a—as a search for buried treasure.
>
> (Laughter.)
>
> JUSTICE SCALIA:—in—in which the—the lawyer and the person who has been wronged are—are simply co-prospectors. I—I just think that that's—
>
> MR. JONES: Well, the—
>
> JUSTICE SCALIA: Maybe that's how you view the—the enterprise—
>
> MR. JONES: I would like to—
>
> JUSTICE SCALIA:—but I don't think the law does.
>
> MR. JONES: I would like to suggest to the Court three avenues to reach this result that I have just suggested and the partnership/joint venture theory is only one of these.
>
> JUSTICE O'CONNOR: Well, let's move on to something else because I have a couple—
>
> (Laughter.)
>
> MR. JONES: Okay. I will move on to that, and I will not mention that again.
>
> (Laughter.)

Transcript of Oral Argument, *supra* note 19, at 32–34.

56. *Banks*, 543 U.S. at 436.

57. *Id*.

58. *Id*.

maintaining sole ownership of the claim for tax purposes following the execution of the fee agreement. First, the plaintiff retained exclusive authority over critical decisions regarding the prosecution of the case, such as whether to settle the litigation or proceed to trial and judgment.[59] Furthermore, even though the attorney may exercise independent judgment over tactical decisions in the course of litigating the action, the attorney at all times was obligated to subordinate his or her own interests to that of the client.[60]

The Court concluded its rejection of the partnership argument by borrowing the analogy employed by Judge Posner in *Kenseth v. Commissioner*: "'The contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable.'"[61] This analogy provided the Court with an opportunity to essentially restate its holding in express terms of realization. The Court reasoned that, in each case, "a principal relies on an agent to realize an economic gain, and the gain realized by the agent's efforts is income to the principal."[62]

3. *Counterarguments on Which the Court Declined Comment*

Almost as interesting as what the Court stated in its opinion in *Banks* is the Court's reluctance to address various alternative theories raised by respondents and their *amici* that would have produced a result in the taxpayers' favor. Those arguments included the following: (1) the contingent fee arrangement gives rise to a partnership governed by the provisions of Subchapter K of the Internal Revenue Code;[63] (2) the contingent attorney's fee is a transaction cost incurred in the disposition of property, permitting the fee to be netted against the recovery in determining gross income;[64] and (3) legal fees paid in connection with the

59. *Id*.

60. *Id*.

61. *Id.* at 436–37 (quoting Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001)). This particular analogy may not be entirely appropriate: a commission salesman helps create an asset the collection of which will produce the commission payment. In the contingent fee context, however, the asset already exists before the attorney is retained, and the attorney assists in liquidating it. Thus, the more appropriate analogy utilizing an employer's accounts receivable would have been to the collection agency utilized by the employer.

62. *Id.* at 437.

63. This was the leading argument in the brief submitted by respondent Banaitis. *See* Brief for Respondent Banaitis, *supra* note 19, at 5–21. For an argument alleging that the invocation of the partnership income tax regime would not produce the result intended by taxpayers, see Gregg D. Polsky, *Contingent Fees: Why the Partnership Theory Doesn't Work*, 104 TAX NOTES 1089 (2004). For additional debate over the merits of the partnership tax theory, see John A. Bogdanski, *Contingent Fees: The Partnership Theory Is Sound*, 105 TAX NOTES 426 (2004); Douglas Kahn, *Partnership Theory Won't Help Taxpayers in Contingent Attorney Fee Cases*, 105 TAX NOTES 885 (2004).

64. This argument was advanced by Professor Charles Davenport in his *amicus curiae* filing. *See* Brief for *Amicus Curiae* Professor Charles Davenport in Support of Respondents, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892). Davenport's argument piqued the Court's interest, as Justice O'Connor and Justice Scalia inquired about it on numerous occasions at oral argument. *See* Transcript of Oral Argument, *supra* note 19, at 12–15, 21–22, 27, 41–43; *see also* Sheryl Sratton, *Justices*

prosecution of an employment-related claim are above-the-line deductions pursuant to § 62(a)(2)(A).[65] Noting that these arguments apparently had not been raised in the lower courts, the Court explained that it was "especially reluctant to entertain novel propositions of law with broad implications for the tax system" that were not examined by the Courts of Appeals.[66] Accordingly, the Court officially "decline[d] comment" on those theories.[67]

The merits of the alternative theories on which the Court declined comment are beyond the scope of this article. However, the Court's treatment of the first such argument—that the tax consequences of the contingent fee arrangement are governed by the partnership tax provisions of Subchapter K of the Internal Revenue Code—is so perplexing that it warrants mention. The linchpin of this argument is that the client and the contingent fee attorney form a partnership as that term is defined in § 761(a).[68] Yet the Court had previously declared that it rejected the suggestion to treat the attorney-client relationship "as a sort of business partnership or joint venture *for tax purposes*."[69] Thus, far from declining comment on the taxpayers' Subchapter K argument, it appears that the Court had already expressly rejected it.

Perhaps the Court's prior rejection of the partnership characterization of the contingent fee arrangement was intended to be narrow in focus. That is, the Court was signaling only that the arrangement did not constitute a partnership for purposes of state law. Under that interpretation, it would be consistent for the Court to later decline comment on whether the arrangement constituted a partnership under § 761(a), a statutory definition that encompasses far more than mere state law partnerships.[70] Yet if that is what the Court had in mind, then at a minimum

Search for Legal Theory to Exclude Attorney Fees, 105 TAX NOTES 778, 778–79 (2004) (describing the questions raised by the Justices concerning Professor Davenport's theory, but incorrectly attributing the comments of Justice O'Connor to Justice Ginsburg). Although Professor Davenport's argument makes perfect sense as a matter of theory, the author believes the argument to be foreclosed under current law. *See* Hellwig & Polsky, *supra* note 6, at 915–21. In particular, the transaction-cost theory has been considered and rejected by two courts. *See* Alexander v. I.R.S., 72 F.3d 938, 941–44 (1st Cir. 1995); Glassman v. Comm'r, 74 T.C.M. (CCH) 1106, 1107–08 (1997). However, Professor Davenport's argument has support within the academic community. *See, e.g.*, Deborah A. Geier, *Davenport Has the Right Idea*, 97 TAX NOTES 1627 (2002); Jackson, *supra* note 3, at 126–32.

65. This argument was advanced by Professor Stephen Cohen in his *amicus curiae* filing. *See* Brief for *Amicus Curiae* Professor Stephen B. Cohen in Support of Respondents, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892). The argument was the subject of the litigation in *Biehl v. Commissioner*, where it was rejected by both the Tax Court and the Ninth Circuit. 118 T.C. 467 (2002), *aff'd*, 351 F.3d 982 (9th Cir. 2003). Roughly a month after issuing its decision in *Banks*, the Supreme Court denied the taxpayer's petition for certiorari in *Biehl v. Comm'r*, 543 U.S. 1145 (2005).

66. *Banks*, 543 U.S. at 438.

67. *Id*.

68. *See* Brief for Respondent Banaitis, *supra* note 19, at 6.

69. *Banks*, 543 U.S. at 436 (emphasis added).

70. The regulations state that a "partnership" for purposes of § 761 means a partnership as determined under Treas. Reg. §§ 301.7701-1, 301.7701-2, and 301.7701-3. Treas. Reg. § 1.761-1(a). In that regard, Treas. Reg. § 301.7701-1(a) provides that the determination of whether an entity exists

its prior determination that the contingent fee arrangement did not constitute a partnership "for tax purposes" necessitated some form of qualification. As the opinion stands, it appears that the Court simply did not appreciate the impact of its earlier characterization of the contingent fee arrangement on the Subchapter K argument. This apparent obliviousness does not exactly engender confidence in the opinion as a whole.

The Court's reluctance to address the alternative legal theories raised by the taxpayers and the various parties filing *amicus curiae* briefs in their support can be interpreted in a variety of ways. On one hand, the Court can be viewed as displaying an admirable degree of self-restraint in deciding a case involving a technical body of law falling far from its core area of expertise, constitutional interpretation. The Court's "reluctance" to entertain these alternative theories can be seen as tacit recognition of its own limitations, along with an intentional decision not to exceed them.[71] On the other hand, the Court's disinclination to address all available theories favoring the taxpayers can be viewed in less charitable terms—that is, as a simple refusal to undertake the analytical effort necessary to afford full consideration to the taxpayers' case.[72] Due to the limitations that applied to the taxpayers' deduction for attorney's fees, determining that the taxpayers' gross income included the portion of the recovery retained by the attorney as a contingent fee meant that they would be taxed, at AMT rates, on amounts they never received. This result clearly troubled the Court, as captured in Justice O'Connor's comment at oral argument: "I mean, this is an appalling situation."[73] Given that members of the Court openly mused about potential constitutional violations in this application of the tax laws,[74] one would have expected them to address less radical theories that would reach an equitable result in the taxpayers' favor. The Court's unwillingness to address those theories came as somewhat of a surprise, disappointing many who went to great lengths in advocating on behalf or in support of the taxpayers.

Regardless of how one views the Court's decision to decline comment on the alternative theories offered for why the contingent fee should be excluded from gross income, this portion of the opinion pro-

separate from its owners "is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law."

71. The following statement by Justice Kennedy at oral argument supports this interpretation: "[I]t does seem to me that we—we have to be very careful in this case not to distort the revenue law for other transactions that are not before the Court." Transcript of Oral Argument, *supra* note 19, at 39–40.

72. In informal conversations the author has had with individuals who favor this view, many attribute the Court's "cop out," so to speak, to the enactment of the prospective legislative relief that likely would have mooted the taxpayers' arguments had the legislation been given sufficient retroactive effect. For a discussion of the corrective legislation, see Hellwig & Polsky, *supra* note 6, at 940–47.

73. Transcript of Oral Argument, *supra* note 19, at 28.

74. *See id*. at 24 (Justice Breyer asking whether the tax exceeded the limits of the Sixteenth Amendment); *id*. at 28 (Justice O'Connor questioning whether the Fifth Amendment Takings Clause could be implicated).

vides some context for the Court's reliance on the assignment of income doctrine to reach its holding. The Court's reluctance to address a theory that had not been examined at the Circuit level indicates that the Court was not willing to adopt its own, independent analysis of the issue. In that regard, the majority of the decisions from the Courts of Appeals concluding that the plaintiff's gross income included the portion of the recovery paid to the attorney as a contingent fee relied on the assignment of income doctrine, at least in part.[75] Furthermore, it was the primary theory advanced by the government.[76] Thus, the Court's use of the assignment of income doctrine to resolve the contingent attorney's fee question is not surprising. If the Court believed the intuitively correct result to be including the contingent fee in the plaintiff's gross income,[77] then the assignment of income was the most clearly marked path to that end.

III. THE ASSIGNMENT OF INCOME DOCTRINE AND ITS INAPPROPRIATE APPLICATION IN *BANKS*

This Part will argue that the assignment of income doctrine was unnecessary to the Court's decision in *Banks*. As explained below, the doctrine is best understood as an equitable doctrine of income attribution that arose from the need to prevent taxpayers from undermining the progressive rate structure through the expedient of deflecting receipt. The doctrine is implicated in the context of a gratuitous transfer of a payment stream, due to the statutory ambiguity regarding the proper party to report the resulting income.[78] No need for the doctrine exists in the context

75. *See* Raymond v. United States, 355 F.3d 107 (2d Cir. 2004); Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 376 (4th Cir. 2001); Coady v. Comm'r, 213 F.3d 1187, 1190–91 (9th Cir. 2000); Baylin v. United States, 43 F.3d 1451, 1454–55 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532, 532 (3d Cir. 1963) (affirming the Tax Court's opinion "in all respects," presumably including its reliance on the assignment of income doctrine); *cf.* Campbell v. Comm'r, 274 F.3d 1312, 1313 (10th Cir. 2001) (focusing on "the end result . . . that the recovery of legal fees benefited [Petitioner]"); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000) (specifying the attorney's lack of ownership interest in the petitioner's award).

76. *See* Brief for Petitioner at 18–22, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892).

77. Perhaps the most compelling intuitive argument in favor of including the contingent fee portion of the recovery in the plaintiff's gross income is the desire to maintain parity in the tax treatment of attorney's fees paid on an hourly basis and those paid pursuant to a contingency contract. The disinclination to afford preferable tax treatment to contingent attorney's fees has been expressed by a number of Circuits. *See* Raymond v. Comm'r, 355 F.3d 107, 117 (2d Cir. 2004) ("When a client pays an attorney on an hourly basis, the same fund generates gross income for each; the fund simply passes through the client's hands first. There seems no reason to treat contingent fee arrangements differently."); Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001) ("The principal effect of the rule for which [the taxpayer] contends would be to create an artificial, a purely tax-motivated, incentive to substitute contingent for hourly legal fees."); Srivastava v. Comm'r, 220 F.3d 353, 357 (5th Cir. 2000) ("There is no apparent reason to treat *contingent* fees differently [than hourly fees] or to believe that Congress intended to subsidize contingent fee agreements in such a fashion.").

78. Section 61 defines gross income to include "all income from whatever source derived," and then follows with a nonexhaustive list of specific items of gross income. The statute, however, does not speak to the issue of who should report the resulting gross income. Thus, the statute is of no assis-

of a bona fide transfer of a future payment stream for consideration, where the tax consequences of the transaction can be resolved under well-established rules of income realization. In that regard, this Part will explain how the decision in *Banks* could have been rather easily resolved by looking first to appropriate statutes and regulations for guidance. This Part concludes that the Court's use of the assignment of income doctrine in *Banks* constitutes an unwarranted expansion of the judicial doctrine into the realm of commercial transactions, one that potentially pits the doctrine against the statutes it was originally intended to backstop.

A. An Equitable Doctrine of Income Attribution

Any examination of the assignment of income doctrine must begin with *Lucas v. Earl*,[79] the seminal decision from which the doctrine emerged and which continues to shape the doctrine's current application.[80] In *Earl*, a husband and wife entered into a presumably valid contract by which each of them agreed to receive and own their combined earnings as joint tenants with right of survivorship.[81] Interestingly enough, this agreement was devoid of any tax-avoidance motive. The agreement was entered into in 1901, after the Supreme Court had declared the income tax of 1894 unconstitutional through its 1895 decision in *Pollack v. Farmers' Loan and Trust Co.*[82] and well before the Sixteenth Amendment was ratified in 1913. However, the agreement had the potential to effect tax avoidance. Had the agreement been respected for tax purposes, the husband's salary would have been fragmented between him and his wife and each resulting half of the husband's earnings would have enjoyed an independent run through the progressive marginal brackets.

The task before the Court was to determine who was to be taxed on the salary and fees earned by the husband but beneficially received by the wife pursuant to their contractual agreement. The statute at issue defined gross income to include "income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form,"[83] but, like its modern-day counterpart,[84] the statute did not spe-

tance in resolving ambiguous situations, such as where the recipient of the income items differs from the party that can be best characterized as its source.

79. 281 U.S. 111 (1930). For a recent, thorough examination of the *Lucas v. Earl* decision, see Patricia A. Cain, *The Story of* Earl*: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*, *in* TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES 275, 275–311 (Paul L. Caron ed., 2003).

80. *See* BITTKER & LOKKEN, *supra* note 46, ¶ 75.2.1, at 75-10 (remarking that "[r]arely has a judicial decision shaped an entire area of tax practice as conclusively as *Lucas v. Earl*").

81. *See Earl*, 285 U.S. at 113–14.

82. 157 U.S. 429 (1895).

83. *Earl*, 281 U.S. at 114 (quoting § 213(a) of the Revenue Act of 1918).

84. *See* I.R.C. § 61(a).

cifically identify the taxpayer responsible for including such items—the earner or the recipient. Recognizing that a "very forcible argument" had been made that the statute sought to tax only that income that was beneficially received by an individual and that the wife obtained a beneficial interest in half the husband's salary the moment it was earned,[85] the Court nonetheless rejected this position. Writing for the Court, Justice Holmes explained the decision in the following terms:

> There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory assignments and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.[86]

In this manner, the Court articulated the oft-quoted principle that earnings should be taxed "to those who earned them,"[87] a principle that would later be described as "the first principle of income taxation."[88]

Although the holding from *Lucas v. Earl* has become ingrained in our tax system,[89] it is important to keep in mind that the principle that income is to be taxed to the person who earned it does not constitute an immutable legal truth.[90] In *Poe v. Seaborn*, a case decided just months after *Lucas v. Earl*, the Court determined that a husband's earnings in a

85. *See* Stanley S. Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 COLUM. L. REV. 791, 794 (1933) (explaining that, because the statute merely enumerates the potential sources of income, a plausible interpretation of the statute could have taxed the recipient of such income).

86. *Earl*, 281 U.S. at 114–15. The late Professor Boris Bittker described the opinion by Justice Holmes in *Lucas v. Earl* as "late-vintage Holmes, magisterial in tone, studded with quotable phrases, and devoid of analysis." Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1401 (1975).

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

88. Comm'r v. Culbertson, 337 U.S. 733, 739–40 (1949).

89. This phenomenon has been artfully described as follows: "It is by now so entrenched in the thought of tax experts that an income tax system without *Lucas v. Earl* is hard to imagine, rather like envisioning the English language without Shakespeare or the King James translation of the Bible." Bittker, *supra* note 86, at 1401. The holding of *Lucas v. Earl* has been codified in § 83, concerning transfers of property in consideration for the provision of services. The statute provides that if property is transferred "to any person other than the person for whom such services are performed," the fair market value of the transferred property is to be included in the gross income "of the person who performed such services." I.R.C. § 83(a). As for the general gross income statute that *Lucas v. Earl* interpreted, the regulations under § 61 expressly adopt the case's holding in the context of fringe benefits. Treas. Reg. § 1.61-21(a)(4) provides that a fringe benefit is to be included in the gross income of the person performing the services that related to the provision of the benefit, expressly recognizing that "a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit." In the partnership context, § 704(e) is designed to safeguard against certain assignments of income. *See* Treas. Reg. § 1.704-1(e)(1)(i) ("The provisions of Subchapter K . . . are to be read in the light of their relationship to section 61, which requires, *inter alia*, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.").

90. Indeed, it is worth noting that the opinion in *Earl* never states that salary *must* be taxed to the person who earned it; rather, the Court declared that there existed no doubt that the statute "*could* tax salaries to those who earned them." *Earl*, 281 U.S. at 114 (emphasis added).

community property state were properly taxed in equal shares to him and his wife.[91] The holding in *Seaborn* simply cannot be reconciled with the Court's reasoning in *Earl* that personal service income should be taxed to the party who generates it. The Court in *Seaborn* nonetheless attempted to square its holding with that of *Earl* by noting that the husband in *Seaborn* never had a property interest in more than half of his earnings that would have been capable of his assignment.[92] This purported reconciliation of the two cases—based on the legal ownership of the service provider's earnings—is not convincing. The husband in *Earl* similarly lacked an ownership interest in half of his earnings, as the spousal contract operated to immediately transfer one-half of his earnings to his wife the moment they were earned. The conflicting results in *Earl* and *Seaborn* thus cannot be explained alone in terms of legal or beneficial ownership of the income payment.

In its 1944 decision in *Commissioner v. Harmon*,[93] the Court once again attempted to reconcile its conflicting decisions in *Earl* and *Seaborn*. *Harmon* involved a married couple in an elective community property state that had made the irrevocable election to have their property and earnings governed by the community property regime.[94] The husband argued that, under *Seaborn*, he was permitted to report only half of the couple's community earnings.[95] The government, on the other hand, cited *Earl* to support its determination that the husband's earnings could not be split for income tax purposes.[96] The Court approached the issue by first segregating potential communities into two types: (a) consensual communities that arise out of contract between the spouses, and (b) legal communities that are imposed by the State.[97] The Court determined that the elective community property regime at issue fell into the former category, noting that the spouses "by contract" could alter the status of the otherwise prevailing state law.[98] Because the elective regime was not an incident of marriage dictated by the state, the Court found the case to be governed by *Lucas v. Earl*.[99] The Court's rationale in *Harmon* was by no means flawless. To start, community property regimes that are created by the incident of marriage are also consensual at some level, as spouses in community property states can opt out of the system by con-

91. 282 U.S. 101, 118 (1930).

92. *See id*. at 117 ("That case [*Earl*] presents quite a different question from this, because here, by law, the earnings are never the property of the husband, but that of the community.").

93. 323 U.S. 44 (1944).

94. *Id.* at 44.

95. *Id.* at 45.

96. *Id.* at 45–46.

97. *Id.* at 46.

98. *Id.* at 47.

99. *Id*. at 47–48.

tractual agreement.[100] Furthermore, if an affirmative election by spouses to opt in to a state law community property system was enough for the community to be viewed as a contractual arrangement, one just as easily could argue that the contract of marriage renders all community law regimes similarly consensual in nature.[101]

At the end of the day, the analyses in *Lucas v. Earl* and *Poe v. Seaborn* remain irreconcilable. Although the propriety of *Seaborn* has been questioned by scholars,[102] the decision was reaffirmed by the Supreme Court through its 1971 decision in *United States v. Mitchell*.[103] Thus, so long as courts recognize the doctrine of stare decisis, it is not enough to describe the assignment of income doctrine in terms of *Earl* alone while dismissing *Seaborn* as a bastardization or anomaly.[104] Rather, both cases were central to the formation of the doctrine, and each case continues to exert its influence. Any description of the doctrine therefore must make room for the conflicting decisions. In that regard, the assignment of income doctrine is best understood not as a rigid rule of law, but rather as a flexible tool permitting courts to attribute the taxation of a payment stream to one other than the party who received the payment. The doctrine ultimately rests in fairness; that is, the attribution of income away from its recipient is necessary to achieve a fair or reasonable imposition of the tax burden.[105] In *Earl*, it was reasonable to tax the husband on his entire salary, given that he performed the services giving rise to the payment and that it was his affirmative act of assignment that transferred a beneficial interest in those earnings to his wife.[106] Indeed, the Court's decision in the case turns on this value judgment, as no other express justification for the holding exists.[107] Viewed from the

100. *See* JOSEPH WILLIAM SINGER, INTRODUCTION TO PROPERTY 411 (2d ed. 2005) (noting that community property spouses can convert community property into separate property through a valid premarital agreement or by contract during marriage).

101. This point was made by Justice Douglas in dissent. *See Harmon*, 323 U.S. at 53–55 (Douglas, J., dissenting). Justice Douglas was not a staunch advocate of the *Seaborn* decision; rather, he simply felt that if the Court was going to abandon the decision, it should do so openly. *See id.* at 56–57.

102. The Court's decision in *Poe v. Seaborn* has been the subject of criticism—both for its dubious reasoning and for the practical inequities its holding can inflict on community property spouses. *See*, *e.g.*, Susan Kalinka, *Taxation of Community Income: It Is Time for Congress to Override* Poe v. Seaborn, 58 LA. L. REV. 73 (1997); John A. Miller, *Federal Income Taxation and Community Property Law: The Case for Divorce*, 44 SW. L.J. 1087 (1990).

103. 403 U.S. 190, 194–96 (1971).

104. *See* Patricia A. Cain, *Relitigating* Seaborn*: Taxing the Community Income of California Registered Domestic Partners* 7 (Univ. of Iowa Legal Studies Research Paper, No. 05-39, 2006) (stating that "whether or not [*Seaborn*] is a *good* or *wise* decision, it remains a decision of the United States Supreme Court that has been followed faithfully for 75 years.").

105. *See* Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733, 760–64 (1978) (arguing that the doctrine is not best explained as one of tax avoidance, but rather that the doctrine is justified in terms of "convenience and fairness").

106. *See* Surrey, *supra* note 85, at 794 (noting that the Court's interpretation of the statute in *Earl* "appeals to one's sense of fairness since it results in taxation of the salary to the person whose services produced it.")

107. Whether unstated justifications for the decision or merely positive externalities of the holding, the decision in *Lucas v. Earl* can be supported on grounds of administrative convenience and a

standpoint of fairness, the apparent contradictory holding in *Poe v. Seaborn* becomes less difficult to stomach. Barring the somewhat extraordinary step of electing out of the community property regime by agreement with his wife,[108] the husband in *Seaborn* was at no point after his marriage capable of beneficially owning more than half of his earnings.[109] Given this fact, the Court found it reasonable to permit the tax burden to track legal ownership. In other words, the attribution of income to the earner would actually conflict with fairness in this context, as the earner was never capable of exercising unfettered dominion and control over that portion of his earnings assigned by operation of law to his spouse.

The notion of the assignment of income doctrine as an equitable tool of income attribution is not limited to income generated from personal services. It also appears in a separate line of cases that apply the assignment of income doctrine to transferred investment income. The decisions in *Corliss v. Bowers*[110] and *Commissioner v. Sunnen*[111] provide two such examples.

In *Corliss v. Bowers*, the taxpayer transferred property to a revocable trust, the income from which was payable to his wife.[112] The taxpayer argued that it was improper to tax him on income generated by the trust that was paid over to his wife pursuant to the trust's terms.[113] The Court, however, showed little in the way of sympathy. It announced that "income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he

desire to protect the progressive rate structure. A rule that taxed salary or wage income to the earner is far simpler for the government to administer, as the government does not have to investigate the existence and effect of any contractual assignment of the earnings to determine the proper party to return the income. Furthermore, the principle of taxing service income to the individual who earned it precludes the voluntary fractionalization of income so as to avoid or undermine the impact of the progressive marginal tax rates. This author, however, views protection of the progressive rate structure not as the exclusive factor, but rather as one of many factors to be considered by a court in determining whether to employ the assignment of income doctrine to achieve a fair imposition of the tax burden. *See infra* text accompanying notes 124–29.

108. If the assignment of income doctrine is viewed as a flexible tool to be exercised by courts when attribution of income to a party other than its recipient is necessary to achieve a fair and reasonable imposition of the tax burden, then the credence afforded to default state law rules in *Seaborn* and *Harmon* is understandable. Given the force of inertia and the overwhelming likelihood that most couples would be governed by the default state law property system, it is reasonable to permit income splitting that is accomplished by such default law while denying such benefit to those who go out of their way to elect an alternate state law regime—an election that may well be undertaken for tax purposes. Furthermore, administrative concerns (apart from overruling *Seaborn* altogether) support the government being able to rely on default state law to determine the proper party to return income.

109. To the extent the husband in *Seaborn* exerted any control over the income beneficially received by his wife by operation of the community property laws, it was in his ability to terminate the entire income stream by refusing to work. Given that significant practical friction on the exercise of this power, however, it is not surprising that the Court did not treat the husband's decision to work as an affirmative assignment of a portion of his earnings.

110. 281 U.S. 376 (1930).

111. 333 U.S. 591 (1948).

112. *Corliss*, 281 U.S. at 377.

113. *Id.* at 377–78.

sees fit to enjoy it or not."[114] From a standpoint of tax neutrality, this holding was virtually inescapable. Due to his right of revocation, the taxpayer in *Corliss* stood in the same position as one who received the income stream and then made a gift of it to his wife.[115] Recognizing the absence of any meaningful distinction between the two, the Court refused to permit a unilaterally revocable payment designation to determine the identity of the proper party to report the income.

In *Commissioner v. Sunnen*, the taxpayer was a majority shareholder of a corporation that was engaged in the manufacture and sale of patented tools.[116] The taxpayer owned the patents individually, and he licensed them to the corporation in exchange for a royalty payment; the license contracts could be terminated by either party upon adequate notice.[117] At various times, the taxpayer assigned his entire interest in the license contracts to his wife.[118] In arguing that the assignment should be respected for tax purposes so as to tax the wife on the royalty income, the taxpayer stressed that he had transferred his entire beneficial interest in the source of the income, the license contracts.[119] The Court was not persuaded. First, it shunned any formalistic inquiry into whether the license contracts or the patents were the true source of the royalty income, recognizing that the matter "may be more metaphysical than legal."[120] Instead, the Court framed the critical inquiry to be "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."[121] Later in the opinion, the Court recited principles from prior assignment of income cases as establishing guideposts to be applied in particular instances to determine whether the transferor retains sufficient control over the property or over the receipt of the income it generates "*to make it fair* to impose income tax liability on him."[122] From this standpoint, the Court had no trouble finding that the taxpayer had retained sufficient control over the assigned contracts and the resulting royalty payments to render the assignment ineffective for tax purposes.[123]

The assignment of income doctrine thus emerged as a flexible doctrine of attributing income to one other than its actual recipient when

114. *Id.*

115. In this regard, the Court's decision in *Corliss* can be viewed as a straightforward application of substance over form.

116. *Sunnen*, 333 U.S. at 593.

117. *Id.* at 593–94.

118. *Id.* at 595.

119. *Id.* at 604.

120. *Id.*

121. *Id*. (emphasis added).

122. *Id.* at 606 (emphasis added).

123. The Court closed its analysis with a touch of sarcasm, noting that the taxpayer's transfer of the license contracts "may properly be said to have left him with something more than a memory." *Id.* at 608.

necessary to achieve a fair imposition of the tax burden. Although it is imprecise to describe the doctrine purely in terms of tax avoidance, given the Court's statement in *Lucas v. Earl* that "no distinction can be taken according to the motives leading to the arrangement"[124] together with the Court's sanctioning income splitting by operation of law in *Poe v. Seaborn*, it also would be naive to deny that tax-avoidance concerns animate the doctrine and influence its application.[125] One of the primary factors driving a court's willingness to undertake an inquiry into the identity of the proper taxpayer is the potential for an assignment, if respected, to be employed by taxpayers to undermine the progressive nature of the tax system.[126] While the Court may have been reluctant to articulate this concern in its early decisions employing the doctrine,[127] it overcame any such hesitation in its decision in *Helvering v. Clifford*.[128] In analyzing whether the taxpayer could deflect income to his wife by transferring the securities to himself as trustee for her benefit, the Court in *Clifford* declared that "special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more."[129] Thus, although the assignment of income doctrine is best un-

124. 281 U.S. 111, 115 (1930). The author recognizes that this statement from *Earl* can be interpreted in an altogether different manner; that is, not as indicating the irrelevance of a tax-avoidance motive, but rather as a presumption of a tax-avoidance motive so as to alleviate the Commissioner and future courts from the practical difficulties of ascertaining subjective intent. Nonetheless, the Court's emphasis in *Earl* on the propriety of taxing income to the party who earns it undercuts any argument that tax-avoidance concerns are the exclusive motivation behind the doctrine. In other words, it is difficult to imagine the case being decided differently had the subject been Mrs. Earl's salary income, half of which had been assigned to her higher-bracket husband.

125. *See* Cain, *supra* note 79, at 310 ("protection of progressivity . . . should guide us today as we determine whether it is appropriate to tax income to the assignor or the assignee"); Jensen, *supra* note 2, at 627 (describing the assignment of income doctrine as a "remedial doctrine designed to prevent high income taxpayers from fragmenting their taxable income among related and lower income taxpayers thereby undermining the graduated nature of the income tax"); *see also* Raymond v. United States, 355 F.3d 107, 112 (2d Cir. 2004) ("The [assignment of income] doctrine is a practical necessity in a system of graduated taxation; without it, a taxpayer in a high tax bracket could avoid heightened levels of taxation by simply shifting income to a lower-bracket taxpayer.").

126. In this regard, Professor Patricia Cain commented that "Holmes got [*Lucas v. Earl*] right because he understood the ramifications of the alternative. Congress intended to enact a tax system that was progressive and Holmes believed strongly in carrying out Congressional intent." Cain, *supra* note 79, at 310. Indeed, in the absence of progressive rates, the Commissioner would have no systemic reason to litigate assignment of income cases. Rather, the Commissioner's only concern would be to ensure that some party—whether assignor or assignee—was reporting the income.

127. Professor Marvin Chirelstein attributes this reluctance to the Court's concern over exceeding its judicial mandate:

> The problem throughout, perhaps, was how the Court could aid in developing a set of anti-tax avoidance rules—how it could act to give protection to the graduated rate structure—without directly admitting that it was engaged in judicial law-making. Operating under a limited mandate, the Court sought to safeguard the rates by manipulating the legal concepts of "income," "property," and "ownership . . . ." But the quoted terms are inherently confusing and indefinite; they can be used to mean almost anything.

MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 241–42 (10th ed. 2005).

128. 309 U.S. 331 (1940).

129. *Id*. at 335. The notion of the assignment of income doctrine serving as a backstop to the progressive rate structure was later echoed in *United States v. Basye*, in which the Court declared that the principle articulated in *Lucas v. Earl* "stands today as a cornerstone of our *graduated* income tax system." 410 U.S. 441, 450 (1973) (emphasis added) (citations omitted).

derstood as a flexible tool of income attribution to be exercised when necessary to achieve a fair imposition of the tax burden, fairness in this context is not limited to issues surrounding the taxpayers at issue. Rather, it includes the ramifications on the integrity of the income tax system as a whole.

B. Inapplicability to Transfers for Consideration

The foundational cases that make up the assignment of income doctrine all arose in the context of gratuitous transfers of income streams. That stands to reason, as gratuitous assignments of income within a family group or related parties presented the opportunity to undermine the progressive rate structure with the least amount of change in actual substance.[130] Furthermore, no need for the doctrine exists in the context of an arm's length transfer of payment rights for consideration, as the tax consequences of such a transaction are governed by general principles of income realization. Commenting on the Tax Court's somewhat tortured opinion in *Schneer v. Commissioner*,[131] in which the court struggled with the potential application of the assignment of income doctrine in the context of a contribution of payment rights to a partnership, Professor Ronald Jensen appropriately observed that "the courts and the Internal Revenue Service have lost sight of the crucial distinction between *gratuitous* assignments of income and assignments of income for *value* in personal service cases and as a result have produced a collection of irreconcilable and inexplicable cases and rulings."[132]

One court that did not lose sight of the fundamental distinction between gratuitous assignments and those for consideration is the Sixth Circuit in *Estate of Stranahan v. Commissioner*.[133] The taxpayer in *Stranahan* had assigned to his son $122,820 in future dividends payable on his stock in Champion Spark Plug Company.[134] The assignment was not a gift: the taxpayer's son issued him a check for $115,000 as consideration for the future payment stream.[135] The taxpayer intentionally

130. The Court in *Helvering v. Clifford* commented on the absence of any substantive change resulting from the trust arrangement as follows: "We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position." 309 U.S. at 335–36 (1940).

131. 97 T.C. 643 (1991).

132. Jensen, *supra* note 2, at 627. To the extent an argument can be made that the assignment of income doctrine applies in the context of an arm's length transfer for consideration, the Supreme Court decision in *Basye*, 410 U.S. at 441, constitutes the supporting authority. *See* Srivastava v. Comm'r, 220 F.3d 353, 361 (5th Cir. 2000) (observing that in *Basye*, the fact that the assignment was part of an arm's length transaction as opposed to a gratuity was "of no significance"). The Court's use of the assignment of income doctrine to support its decision in *Basye*, however, is flawed. This critique of the *Basye* decision is the subject of Part V *infra*.

133. 472 F.2d 867 (6th Cir. 1973).

134. *Id.* at 868.

135. *Id.*

sought to accelerate his income in the year of the assignment to utilize a hefty interest deduction then available to the taxpayer.[136] In the following taxable year, the taxpayer's son received approximately $40,000 in dividends pursuant to the assignment.[137] The Service included this amount in the taxpayer's gross income, rationalizing that the dividend assignment could be disregarded because it constituted a mere temporary shift of funds within the family unit that did not change the beneficial ownership of the underlying stock.[138] The Sixth Circuit, however, refused the government's invitation to apply the assignment of income doctrine to defeat the taxpayer's plan to minimize his tax liability.[139] The court distinguished *Lucas v. Earl* and *Helvering v. Horst* on the basis that the transactions in those cases involved gratuitous assignments, whereas the assignment at issue was made for adequate consideration that was in fact paid by the assignee: "Hence, the fact that valuable consideration was an integral part of the transaction distinguishes this case from those where the simple expedient of drawing up legal papers and assigning income to others is used."[140] Beyond this factual distinction, however, the assignment of income doctrine had no application to *Stranahan*, because there was no question that the taxpayer would recognize the assigned dividend stream as income.[141] Rather, the only issue was determining the appropriate year in which such recognition took place.

The most significant flaw in the Supreme Court's decision in *Banks* lies in its failure to address the argument, raised repeatedly in the taxpayers' briefs,[142] that the assignment of income doctrine is inapposite in the context of a commercial transaction for consideration. The closest the Court came to doing so was its passing reference to *Earl* for the proposition that the doctrine is not limited to transactions that have a tax-avoidance motive.[143] This response, if it can be so labeled, is far from sufficient. Equitable attribution of income in the context of a gratuitous assignment of a payment stream is necessary even if such assignment is not motivated by a desire to reduce taxes because the same mechanism used benignly in one context easily could be employed by others in an

136. *Id.* In 1964, the year the assignment took place, the taxpayer entered into a closing agreement whereby he agreed to pay the Service approximately $750,000 in interest owing on various tax deficiencies attributed to trusts he created in 1932. The taxpayer paid such amount later that same year. *Id*.

137. *Id.*

138. *Id.* at 868–69.

139. *Id.* at 869–70.

140. *Id*. at 870.

141. *Id*.

142. *See* Brief for Respondent Banaitis, *supra* note 19, at 22 ("The transfers in *Earl* and *Horst* were between family members and apparently lacked any commercial purpose."); *id.* at 23 ("The execution of the contingent fee agreement in this case was an arms-length transaction between unrelated parties in a commercial setting, for valuable consideration."); Brief for Respondent Banks, *supra* note 43, at 24 ("A contingent fee contract . . . is an arm's length transaction not involving any tax avoidance purpose.").

143. *See* Comm'r v. Banks, 543 U.S. 426, 434 (2005).

effort to reduce their collective tax liability. Furthermore, removing tax-avoidance motives from consideration prevents the Service, and consequently the courts, from having to undertake a fact-specific inquiry into the subjective intentions of the parties to determine the most appropriate party to report the income. The mere irrelevance of a tax-avoidance motive therefore does not support expanding the reach of the assignment of income doctrine to commercial transactions. Furthermore, in the context of an arm's length transaction for consideration, no need exists to equitably attribute income to one party who otherwise would not recognize it. Rather, the assignor in such a transaction will always recognize income—it is just a matter of when.

Had the Supreme Court analyzed the execution of the contingent fee agreement on its own terms—that is, as an arm's length transfer by which the plaintiff agrees to compensate the attorney for providing legal representation on an out-of-pocket basis—it would have realized that it had no need for the assignment of income doctrine to determine that the plaintiff realized gross income from the payment of the attorney's contingent fee. Rather, the Court could have reached the same holding in a more principled manner, utilizing general tax principles reflected in the Code, regulations, and case law to do so. This analysis is described below.

C. Proper Analytical Framework

The key to resolving the proper tax treatment of a contingent attorney's fee is to determine the proper characterization of what, if anything, occurs when a plaintiff executes a contingent fee agreement with an attorney. In an attempt to avoid the contingent fee portion of the recovery being attributed to them when paid to the attorney, taxpayers have argued that the execution of the fee agreement operated to transfer something—typically a portion of the cause of action—to the attorney. Given that this purported transfer was undertaken to secure the services of the attorney in prosecuting the case, the starting point in analyzing the taxpayers' argument is § 83.[144] Section 83 governs the tax treatment of property transferred in connection with the performance of services, both to the service provider and the service recipient. In general, the statute provides that the service provider must include the fair market value of the property in gross income when the individual's rights to the property

144. *See* Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fee Arrangements: Enough with the Fruits and the Trees*, 37 GA. L. REV. 57 (2002). Together with Professor Polsky, the author filed an *amicus curiae* brief with the Supreme Court in *Banks* demonstrating how § 83 impacts the analysis of the contingent fee issue. *See* Brief for *Amici Curiae* Professor Gregg D. Polsky and Professor Brant J. Hellwig in Support of Petitioner, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892).

are no longer subject to a substantial risk of forfeiture.[145] At that point, the service recipient is deemed to have transferred the property to the service provider as compensation.[146]

The crucial inquiry framed by the statute is whether the plaintiff has made a transfer of "property" to the attorney upon executing the contingent fee agreement. Property for purposes of § 83 is defined broadly under the regulations to include all real and personal property other than (a) money or (b) "an unfunded and unsecured promise to pay money or property in the future."[147] Section 83 thus would constitute the exclusive means of resolving the tax treatment of the contingent attorney's fee, unless the fee agreement can be properly described as a mere promise to pay that falls outside the scope of the statute.

In that regard, the most plausible characterization of the contingent fee agreement is that it constitutes nothing more than the plaintiff's promise to pay the attorney a contingent amount of money in the future—that is, a percentage of any recovery on the claim if and when obtained. This characterization finds support on a number of fronts. To start, the reasons articulated by the Supreme Court in *Banks* to support its determination that the plaintiff maintains dominion and control over the cause of action indicate that no portion of the claim is transferred through the mere execution of the fee agreement. The plaintiff maintains ultimate authority over critical decisions regarding the prosecution of the claim, such as whether to settle the cause of action or take it to trial, and whether to terminate counsel and seek alternate representation. These facts are not consistent with the attorney being a co-owner of the claim. Furthermore, if the plaintiff exercises his or her unilateral right to terminate the attorney and seek alternate representation, the terminated attorney is not entitled to compensation calculated as a percentage of the overall recovery. Rather, the attorney's remedy is limited to recovering the fair value of his or her services on a *quantum meruit* ba-

145. I.R.C. § 83(a); Treas. Reg. § 1.83-1(a)(1). Although the statute provides that the service recipient must include the fair market value of the property in gross income when the property is either transferable or not subject to a substantial risk of forfeiture, property is "transferable" for purpose of § 83 only if the property is not subject to a substantial risk of forfeiture in the hands of the transferee. I.R.C. § 83(c)(2); Treas. Reg. § 1.83-3(d). Thus, the timing aspects of § 83 turn on whether the property is subject to a substantial risk of forfeiture. According to the statute, property is subject to a substantial risk of forfeiture if the person's full enjoyment of the property is conditioned upon the future performance of substantial services. I.R.C. § 83(c)(1); *see also* Treas. Reg. § 1.83-3(c).

146. Section 83(h) achieves this result by deferring the service recipient's deduction to the taxable year in which the fair market value of the transferred property is included in the service provider's gross income. I.R.C. § 83(h).

147. Treas. Reg. § 1.83-3(e). The regulation goes on to provide that the term property also includes a beneficial interest in assets that are transferred or set aside from the claims of the transferor's creditors. *Id*. For discussion of the common-law origins of the definition of property under § 83, see Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1116–25 (2005).

sis,[148] a remedy which belies the notion that the attorney irrevocably acquired an interest in the cause of action or its future proceeds upon execution of the fee agreement.[149]

Thus, from a tax perspective, nothing of substance occurs when the plaintiff and attorney execute the contingent fee agreement. Rather, the plaintiff merely promises to pay the attorney a portion of the recovery (backstopped by an implied contract to pay the attorney the reasonable value of his or her services if the contract is terminated prior to liquidation of the claim) in exchange for the attorney's agreement to provide services in prosecuting the case.[150] The characterization of the fee agreement as a mere promise to pay, however, is not alone sufficient to take the transaction outside the scope of § 83. The promise also must be unfunded and unsecured to fall outside of the definition of property to which the statute applies. Each of these additional conditions, however, is satisfied. The plaintiff's promise would not be funded unless the plaintiff paid the attorney an irrevocable retainer from which to satisfy the contingent fee. That would seem rarely to be the case in a typical contingent fee situation. Similarly, it would be unusual for the plaintiff to pledge collateral to secure the payment obligations under the contingent fee agreement. Although state law generally provides the attorney with an equitable lien on any recovered amounts, that security interest cannot arise until the recovered fund comes into existence.[151] Thus, when the

148. For a survey of cases addressing this issue, see George L. Blum, Annotation, *Limitation to Quantum Meruit Recovery, Where Attorney Employed Under Contingent-Fee Contract is Discharged Without Cause*, 56 ALR 5th 1 (1998).

149. Some courts have supported the above-described analysis by noting that the existence of a state attorney lien law establishes that the attorney is a mere creditor of the plaintiff, not an owner of the cause of action. *See* Raymond v. United States, 355 F.3d 107, 114 (2d Cir. 2004) ("One does not—indeed need not—have a security interest in one's own property.") (footnote omitted); *see also* Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001) (observing that "ownership of a security interest is not ownership of the security"). That the attorney is a creditor under state law is not necessarily determinative of ownership for tax purposes, however. Ownership for tax purposes is a matter of federal tax law that defies a standard, uniform analysis. *See* Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U. L. REV. 431, 432 (2005) ("One of the central concepts of tax law, [ownership] is as complex as it is confused."). Suffice it to say that ownership for federal tax purposes is not dictated by state law labels; rather, at its most basic level, ownership for tax purposes involves examining the parties' state law rights in the property to determine, on balance, who bears sufficient benefits and burdens of the property to be regarded as its owner. *See*, *e.g.*, Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939) (each examining whether the purported lessee of property should be regarded as the owner for tax purposes). Thus, it is not enough merely to point to the attorney's security interest in any recovered amounts and declare that the attorney's status as a potential future creditor under state law negates treating the attorney as an owner of the claim for federal tax purposes.

150. The government advanced this characterization of the contingent fee arrangement in its brief to the Court in *Banks*. *See* Brief for Petitioner, *supra* note 76, at 29 (arguing that the contingent fee agreement "merely constitutes a promise by the client to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered").

151. Suppose the claim were settled, and the defendant made out a check payable to the attorney's trust account established on behalf of the plaintiff. At that point, the plaintiff's promise under the fee agreement becomes both funded and secured, resulting in a transfer of property for purposes of § 83. The resulting tax consequences would be as follows: the attorney would have compensation income equal to the value of the promise (that is, the amount of the contingent fee that is to be dis-

plaintiff executes the fee agreement, the promise to pay the contingent fee embodied therein is both unfunded and unsecured. Section 83 therefore does not apply to the execution of the contingent fee contract.

If § 83 does not apply to the contingent fee arrangement, then why exactly is the statute critically important to resolving whether the plaintiff must include in gross income the portion of the recovery retained by the attorney? It is critical because the process of determining the statute's inapplicability solidifies the appropriate analysis and the ensuing result. If the contingent fee arrangement falls outside of § 83 because it constitutes the plaintiff's unfunded and unsecured promise to pay, then the satisfaction of this payment obligation by the defendant constitutes gross income to the plaintiff. As articulated by the Supreme Court in *Old Colony Trust v. Commissioner*, "the discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."[152] The defendant's satisfaction of the plaintiff's obligation to pay the attorney a contingent fee thus constitutes gross income to the plaintiff, just as it would have had the defendant paid the entire recovery to the plaintiff directly. In short, the tax consequences of the transaction are determined by its substance as opposed to its form.

There is nothing particularly novel about the relevance of *Old Colony Trust* to resolving the contingent attorney's fee issue. Rather, it has been cited by a number of Circuit Courts that have addressed the issue.[153] The Fourth Circuit in *Young v. Commissioner* relied on the third-party payment rule from *Old Colony Trust* when it characterized as "undisputed" the notion that the satisfaction of the taxpayer's obligation to her attorney provided her with an economic benefit.[154] In *Baylin v. United States*, the Federal Circuit did not cite to *Old Colony Trust* but nonetheless employed its rationale when it determined that the taxpayer-partnership "received the benefit of [the contingent fee] in that the funds served to discharge the obligation of the partnership owing to the attorney as a result of the attorney's efforts to increase the settlement amount."[155] Last, the Tenth Circuit in *Hukkanen Campbell v. Commissioner* disposed of the taxpayer's argument in relatively short order, concluding that the recovery of the legal fees benefited the taxpayer by per-

bursed from the account), *see* I.R.C. § 83(a), and the plaintiff would be entitled to a deduction equal to the attorney's compensation income (provided the proceeds of the litigation constitute gross income to the plaintiff). *See* I.R.C. §§ 83(h), 265(a)(1). From a practical perspective, this application of § 83 is relevant only if the payment of the settlement proceeds into the attorney's trust account and the disbursement of the trust account proceeds occur in separate taxable years.

152. 279 U.S. 716, 729 (1929).

153. *See* Raymond v. United States, 355 F.3d 107, 111, 116 (2d Cir. 2004); Young v. Comm'r, 240 F.3d 369, 378 (4th Cir. 2001); Srivastava v. Comm'r, 220 F.3d 353, 363 n.29 (5th Cir. 2000); Cotnam v. Comm'r, 263 F.2d 119, 127 (5th Cir. 1959) (Wisdom, J., dissenting); *see also* Hukkanen Campbell v. Comm'r, 274 F.3d 1312, 1313–14 (10th Cir. 2001) (not citing *Old Colony Trust* but employing its debt-discharge reasoning); Baylin v. United States, 43 F.3d 1451, 1454 (Fed. Cir. 1995) (same).

154. 240 F.3d at 378 (citations omitted).

155. 43 F.3d at 1454.

mitting her to discharge her personal obligation to her attorneys.[156] Thus, it is somewhat surprising that the Supreme Court never mentioned *Old Colony Trust* or its debt-discharge rationale in the *Banks* decision, particularly given that the government offered it as a rationale to support a decision in its favor.[157]

Taxpayers have advanced two primary arguments as to why *Old Colony Trust* does not support including the contingent attorney's fee in the plaintiff's gross income. The first is that the contingent fee agreement does not create a payment obligation in the plaintiff, as the plaintiff owes the attorney nothing if a recovery is not ultimately secured. This argument borders on frivolous.[158] The plaintiff's ability to insure against the risk of a zero-recovery outcome through the terms of the fee agreement does not in any way contradict the plaintiff's obligation to pay the attorney a portion of the recovery if one is obtained.[159] The second argument—a more refined version of the first—is that the plaintiff fully satisfied any payment obligation owing to the attorney by assigning the attorney a portion of any future recovery through the fee agreement.[160] This is the argument that leads courts back to the assignment of income doctrine. If a court accepts that the plaintiff satisfied its obligation to the attorney through the assignment contained in the fee agreement, the court often will turn to the assignment of income doctrine to determine if the purported assignment was effective to deflect the tax liability.[161] This reaction, however, is inappropriate.

156. 274 F.3d at 1313–14. In the author's view, the Tenth Circuit's decision in *Hukkanen Campbell* represents the most succinct and appropriate analysis of the tax treatment of contingent attorney's fees issued by a court to date.

157. *See* Brief for Petitioner, *supra* note 76, at 30 ("Thus, under the rule set forth in *Old Colony Trust Co.*, it follows that the direct payment to the client's attorney pursuant to a contingent fee agreement of a portion of the client's recovery is the taxable discharge of the debt owed by the client to his attorney.").

158. Nonetheless, this argument was accepted by the Fifth Circuit majority in *Cotnam v. Commissioner*, wherein the court characterized the government's invocation of *Old Colony Trust* as being based on the "false premise that Mrs. Cotnam obligated herself to pay the attorneys' fee." 263 F.2d 119, 126 (5th Cir. 1959); *see also* Raymond v. United States, 247 F. Supp. 2d 548, 555 (D. Vt. 2002) ("Because the client has not incurred a personal obligation, it scarcely seems logical to conclude . . . that payments under contingent arrangements serve to discharge clients' personal obligations to their attorneys . . . .").

159. The Second Circuit in *Raymond v. United States* was similarly reluctant to discount the existence of a payment obligation from a plaintiff that is party to a contingent fee contract, concluding that a direct payment of the fee to the attorney "arguably satisfies an obligation for which the client contracted when agreeing to the fee arrangement." 355 F.3d 107, 116 (2d Cir. 2004).

160. *See Cotnam*, 263 F.2d at 126 (claiming that the attorney's fee was "fully paid by the assignment of a portion of a doubtful claim").

161. Courts favoring the taxpayer describe the assignment as one of property. *See, e.g.*, Estate of Clarks v. United States, 202 F.3d 854, 857–58 (6th Cir. 2000) ("The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees."). On the other hand, courts favoring the government describe the assignment as one of income. *See, e.g.*, Kenseth v. Comm'r, 259 F.3d 881, 884 (7th Cir. 2001) ("[W]hat Kenseth really is asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.").

If the contingent fee agreement is viewed not as a mere promise to pay but instead as effecting a present transfer of something from the plaintiff to the attorney, then the arrangement constitutes a transfer of property for purposes of § 83. Whether that "something" is characterized as a portion of the future income stream or a portion of the income-generating asset (fruit or tree in shopworn assignment of income parlance) is irrelevant. Each would constitute personal property covered by the statute. In somewhat ironic fashion, the tax treatment of the contingent attorney's fee under § 83 generally is the same as if the fee agreement were regarded as an unfunded and unsecured promise to pay. Recall that from a tax perspective, a transfer of property under § 83 is effectively disregarded until the property is no longer subject to a substantial risk of forfeiture. In the contingent fee context, the attorney's risk of forfeiture does not lapse until the claim is prosecuted to a recovery.[162] At that point, the attorney would include the value of the transferred property (that is, the amount of the contingent fee) in gross income as compensation for services. The plaintiff, on the other hand, would be treated as having compensated the attorney through the transfer of an appreciated asset.[163] Because the plaintiff has a zero basis in this asset, the plaintiff would recognize gross income equal to the amount of the contingent fee.[164] Last, the plaintiff would be left with a deduction for the amount included by the attorney in gross income.[165]

Thus, there are two plausible interpretations of the assignment of income doctrine. Under the first one (preferred by the author), the fee agreement constitutes nothing more than the plaintiff's conditional promise to compensate the attorney for services rendered. In that case,

162. A substantial risk of forfeiture exists so long as the service provider's rights in the transferred property are conditioned upon (a) the future performance of substantial services, or (b) the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. I.R.C. § 83(c)(2); Treas. Reg. § 1.83-3(c)(1). Under either test, the risk of forfeiture is not eliminated until the cause of action is liquidated. In terms of the first test, the attorney cannot withdraw from the case prior to obtaining a recovery for the client and remain entitled to his or her contingent fee. Rather, the attorney must continue to prosecute the case until a recovery is obtained. In terms of the second test, the very nature of the contingent fee contract is that the attorney gets paid nothing unless the claim is successfully reduced to a monetary sum. Thus, the attorney's contingent fee is conditioned upon the liquidation of the claim. Furthermore, the possibility of forfeiture is substantial, as the attorney will receive nothing if a recovery is not obtained. While the attorney's potential claim to recover fees on a *quantum meruit* basis if the attorney is terminated without cause complicates this analysis somewhat, a *quantum meruit* recovery is designed to compensate the attorney for the value of the services rendered, which generally is determined by the amount of time spent on the case as opposed to a fractional portion of the value of the claim. Thus, the potential for a *quatum meruit* recovery does not cause the attorney's interest in the contingent fee portion of the recovery to become vested.

163. *See* Treas. Reg. § 1.83-6(b) (providing that the transferor recognizes gain when the transferee includes the property in gross income to the extent the value of the property—as of that date—exceeds the transferor's basis therein).

164. Because the proceeds of the lawsuit would be characterized as ordinary income, the gain realized from the disposition of a portion of the proceeds to the attorney will maintain that same characterization under the substitute doctrine. *See* Comm'r v. P.G. Lake, Inc., 356 U.S. 260, 264–65 (1958).

165. I.R.C. § 83(h).

the tax consequences to the plaintiff resulting from the payment of the contingent attorney's fee are easily resolved under the third-party payment rationale articulated in *Old Colony Trust*. Under the second interpretation, the fee agreement evidences a completed transfer from the plaintiff to the attorney of a beneficial interest in the cause of action or its future proceeds. In that case, the tax consequences to the plaintiff resulting from the payment of the contingent attorney's fee are governed by the statutory scheme laid out in § 83, as clarified in the regulations thereunder. Under neither scenario is there any need, or room, for the assignment of income doctrine.

D. Potential Unintended Consequences

The assignment of income doctrine arose out of the need for the courts to fill the void contained in the Internal Revenue Code regarding the proper party to report income in ambiguous situations. However, the Court's use of the doctrine in *Banks* elevates it from one that plugs statutory gaps to one that potentially conflicts with statutory authority. Assuming the Court employed the assignment of income doctrine in *Banks* because it viewed the fee agreement as effecting a completed transfer of a portion of the future proceeds, the Court's use of the doctrine adds a judicial gloss to the definition of property for purposes of § 83. Now, instead of § 83 applying to all transfers of personal property other than an unsecured and unfunded promise to pay, the definition of property for purposes of this statute seemingly has another, judicially created, exclusion: any transfer of a future payment stream that would be ineffective to shift the taxation to the assignee under the assignment of income doctrine.[166] In that case, the assignor of the payment stream will be taxed when the payments are received by the assignee, potentially overriding the timing regime articulated in the statute.

One of the hallmarks of the assignment of income doctrine is that the assignor is taxed on the income stream when it is paid. A simple example demonstrates how this aspect of the doctrine could conflict with the otherwise applicable timing regime provided in § 83. Suppose an individual formally transfers to her attorney $5,000 in future dividends payable on stock owned by the individual as payment for services the attorney has rendered in connection with a residential real estate closing. The assignment occurs in Year 1, the same year that the attorney provided the contracted services. The assigned dividends, however, are not paid by the corporation until Year 2. If § 83 governs the transaction (as it should), the individual would realize the present value of the $5,000 fu-

166. This, in turn, incorporates the inquiry as to whether the transferor has relinquished sufficient dominion and control over the income-generating asset to render the assignment effective for income tax purposes. If so, then presumably the transfer would then be regarded as a transfer of property to which § 83 applies provided the transfer is made in connection with the provision of services.

ture dividend payment in the year of the assignment—the same year in which the individual appropriated the future payment stream to obtain an economic benefit. However, if the assignment of income doctrine overrides the application of § 83 because the assignor has retained dominion and control over the income-generating asset, then the individual would not be taxed on the dividend income until Year 2 when the dividend payment was received by the assignee.[167] In this manner, the Supreme Court's use of the assignment of income doctrine to determine the tax consequences of an arm's length commercial transaction could be employed offensively by taxpayers as a means of achieving self-help deferral[168] through use of income transfers.

If the Supreme Court was ever concerned that its use of the assignment of income doctrine would exceed its judicial mandate,[169] those fears were realized in the *Banks* decision. By utilizing the doctrine as a substantive rule of income realization, the Court ended up using its judicial doctrine to override an otherwise applicable statute. The transformation of the doctrine from one of equitable income attribution to a substantive rule of income realization, however, occurred long before the *Banks* decision. The roots of this transformation are traced in the next Part.

IV. THE DOCTRINE'S ILL-ADVISED FLIRTATION WITH THE REALIZATION PRINCIPLE

The Supreme Court in *Banks* concluded that the taxpayers diverted a portion of the income from their income-generating assets to their attorneys and "realized a benefit by doing so."[170] Concluding that the plaintiff realized a taxable benefit when the defendant satisfied the contingent attorney's fee would have been rather unremarkable, had that been the import of the Court's observation. Yet the Court's statement, taken as a whole, implies that the realization event occurred not upon payment of the attorney's fee but upon the diversion of the future income—that is, upon the assignment. With respect to the facts before the

167. The only reason why the timing consequences of income realization to the plaintiff resulting from payment of the attorney's contingent fee do not differ under application of § 83 and application of the assignment of income doctrine is the presence of a substantial risk of forfeiture pertaining to the attorney's interest in the contingent fee. *See supra* note 162. Because this risk of forfeiture is not removed until the claim is liquidated, the tax consequences of the transaction are held in abeyance until the taxable year in which the contingent fee is paid to the attorney—the same year it would be taxed to the assignor under the assignment of income doctrine.

168. Deferral in this regard is not used in the classic sense of obtaining a time-value-of-money advantage, as the amount of the benefit the taxpayer realized in Year 1 is the present value of the income payment on which he would be taxed in Year 2 pursuant to the assignment of income doctrine. Nonetheless, there still exists an advantage to delaying payment of the tax, because it amounts to the taxpayer receiving a forced loan from the government for the proper Year 1 tax liability. Though this forced loan bears an effective time-value-of-money component, it does not compensate the government for the taxpayer's credit risk.

169. *See supra* note 127.

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

Court in *Banks*, this assignment occurred several years before the taxable year at issue. Thus, the Court's application of the assignment of income doctrine in *Banks* combined present realization with deferred taxation, a gauntlet that generally cannot be run without the aid of a statutory nonrecognition provision.

The Court's invocation of realization as a justification for applying the doctrine is nothing novel, however, as it stems directly from the Court's 1940 decision in *Helvering v. Horst*.[171] In *Horst*, the Court determined that the owner of a corporate bond was the proper party to report income payments attributable to interest coupons that he had gratuitously assigned to his son prior to payment.[172] In justifying its holding, however, the Court overstated its case by clothing its analysis in terms of the benefit the owner realized by way of the assignment.

This Part will analyze the *Horst* decision and, in particular, the misguided rationale the Court used to support its holding. It will then illustrate the analytical shortcomings of the Court's use of the assignment of income doctrine as a substantive rule of income realization in *Banks*.

A. Helvering v. Horst—*A Case of Attempting to Prove Too Much*

If *Lucas v. Earl* is viewed as the seminal precedent in the assignment of income doctrine, the Court's decision in *Helvering v. Horst* must be considered a not-too-distant second. The decision serves as the leading authority concerning the taxation of gratuitously assigned investment income. Once the Court in *Banks* decided that the contingent attorney's fee issue was properly analyzed as an assignment of income with the cause of action as the income-producing property, it is no surprise that the Court relied extensively on its prior decision in *Horst*.

The central facts of *Horst* possess a simplistic beauty. The taxpayer owned negotiable bonds bearing interest coupons, which he detached and gave to his son.[173] The son collected the interest payments later that year as they came due.[174] Whereas prior assignment of income cases had employed the doctrine to attribute income to one other than its actual recipient, the question framed by the Court in *Horst* was whether the father realized a taxable benefit through the mere act of making the gift.[175]

The Court opened its analysis of the realization issue by noting that receipt of cash or property is not the only method through which a cash-

171. 311 U.S. 112 (1940).
172. *Id.* at 119–20.
173. *Id.* at 114.
174. *Id.*
175. Justice Stone opened the majority opinion with the following: "The sole question for decision is *whether the gift*, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, *is the realization of income* to the donor." *Id.* (emphasis added).

basis taxpayer could realize income.[176] Rather, the Court observed that realization could occur when the enjoyment of the income was consummated by some event other than the taxpayer's personal receipt of money or property,[177] citing as supporting authority its decisions in *Old Colony Trust Co. v. Commissioner*[178] and *Corliss v. Bowers*.[179] The Court surmised the rationale of these and other supporting cases to be that "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 satisfaction of his wants."[180] On these terms, the Court determined that the father, by way of his gift of the interest coupons, procured the "non-material satisfactions" that may result from bestowing a gift upon a family member in the same manner he would have had he received the interest payments himself and then given the proceeds to his son.[181]

Although the Court framed the case in terms of income realization, the Court was by no means consistent in referring to the point at which such realization took place. On one hand, the Court is quite clear that the realization event was the assignment itself. It declared that "[t]he exercise of power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it."[182] On the other hand, the Court later remarked that "[t]he dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it . . . *when paid*."[183] This is consistent with the actual result in the case, which was to sustain the Commissioner's determination that the interest payments were taxable to the father "when paid."[184] If the case had been otherwise, the Court would have been forced to discount the value of the interest coupons to reflect the time remaining to maturity, as the father could not have enjoyed nonmaterial satisfaction in excess of the present value of the income stream transferred.[185] Thus, although the Court grounded its decision in *Horst* on the act of assignment constituting a realization event, the effect of the decision was the same as prior assignment of income cases—the

176. *Id.* at 115.
177. *Id.* at 116.
178. 279 U.S. 716 (1929). In *Old Colony Trust*, the Court held that the discharge of the taxpayer's obligation by a third party was equivalent to receipt by the taxpayer. *See id.* at 729.
179. 281 U.S. 376 (1930). In *Corliss*, the Court determined that the income generated by assets placed in a revocable trust was properly taxed to the settlor, based on the settlor's ability to direct that the income be paid to him individually if he so desired. *See id.* at 378. The *Corliss* decision is discussed in Part III.A. *supra*.
180. *Horst*, 311 U.S. at 116–17.
181. *Id*. at 117.
182. *Id*. at 118.
183. *Id*. at 119 (emphasis added).
184. *Id*. at 120.
185. *See* Robert N. Miller, *Gifts of Income and of Property: What the* Horst *Case Decides*, 5 TAX L. REV. 1, 9 (1949).

transferred income stream was attributed to the assignor as it was received by the assignee.

The Court in *Horst* could afford to be somewhat vague about whether the interest income was realized by the father upon his act of assignment or upon its receipt by his son, as both events occurred in the same taxable year.[186] Yet closer examination of the Court's characterization of the act of assignment as the income realization event demonstrates that this analysis must be discounted, and heavily so. Simply put, the rationale proves too much. Although the act of assignment would constitute a realization event if it were made for valuable consideration, the same cannot be said about a gratuitous assignment. The notion that a donor is taxed upon the value of nonmaterial satisfactions obtained through the act of making the gift would necessitate treating the gratuitous transfer of appreciated property as a realization event to the donor. This treatment, however, is demonstrably inappropriate as it would directly conflict with the carry-over basis regime provided in § 1015.[187]

Perhaps recognizing that it may have overstated the case for taxing the father in *Horst*, just two years later the Court undertook a not-so-subtle about-face with respect to the notion of whether the receipt of nonmaterial satisfactions constitutes a realization event through its opinion in *Helvering v. Stuart.*[188] In *Stuart*, two brothers had transferred stock to irrevocable trusts benefiting their respective children.[189] After noting that the distributions and accumulations of trust income were to be used for the economic advantage of the children, thereby satisfying the normal desire of a parent to make gifts to his children, the Court posed the following question: "Is this alone sufficient to make the income of the trusts taxable to the settlors?"[190] The Court resolved this in the negative when it declared that "the 'non-material satisfactions' (gifts-contributions) of a donor are not taxable as income."[191] The Court cited *Horst* for this proposition, even though the opinion in *Horst* held exactly the opposite.[192] The Court in *Stuart* refocused the inquiry on the degree of control retained by the assignor over the source of the income, observing that "economic gain for the taxable year, as distinguished from the non-

186. This fact is made clear in the opinion issued by the Board of Tax Appeals. *See* Horst v. Comm'r, 39 B.T.A. 757, 758 (1939).

187. *See* Rice, *supra* note 39, at 993 (noting that the principle of taxing the donor based on the material and non-material satisfactions obtained through the act of the transfer "extends taxation of the donor too far"). However, this did not stop the government from using *Horst* to argue that the donor of appreciated livestock realized income upon the act of gratuitously transferring them to his son. *See* I.T. 3932, 1948-2 C.B. 7. This ruling is discussed and criticized in Miller, *supra* note 185, at 8 n.16.

188. 317 U.S. 154 (1942).

189. *Id.* at 156.

190. *Id*. at 168.

191. *Id*.

192. *Id.* Professor Ralph Rice characterized the Court's attempt in *Stuart* to harmonize its decision with *Horst* as "expressive of a confusion seldom equaled in Supreme Court history." Rice, *supra* note 39, at 994.

material satisfactions, may be obtained through a control of a trust so complete that it must be said the taxpayer is the owner of its income."[193] In this manner, the assignment of income doctrine's detour in *Horst* into the income realization arena appeared at an end, with the doctrine returning to its roots of equitable income attribution.

Even before the Court effectively reversed its rationale in *Horst*, the Board of Tax Appeals had already discredited the notion of a gratuitous assignment constituting a realization event. In *Colby v. Commissioner*, the taxpayer assigned a promissory note and the rights to accrued interest payable thereunder to a trust for her children in 1935.[194] Although the interest payments were not collected by the trustee until succeeding years, the Commissioner asserted that the donor was taxable on such interest in the year of assignment—citing *Helvering v. Horst* as primary authority.[195] The Board rejected the government's reading of *Horst*, however, first noting that the *Horst* case did not require deciding whether the income event lay in the assignment or the receipt by the donee.[196] Recognizing that certain statements in the *Horst* decision, "separated from their context and from the facts of the case," could be interpreted as indicating that the Court determined that realization occurred upon the act of making the gift, the Board nonetheless found sufficient statements in the *Horst* opinion to reject the Commissioner's suggested application of the case.[197] In short, the Board declared that the opinion in *Horst* "should not be read as if the gift alone were sufficient realization."[198] The Board was undoubtedly guided by the results of prior assignment of income cases, noting that it was unaware of a single case where income had been taxed to the donor prior to its actual receipt by the donee.[199]

Thus, not long after the Court issued its decision in *Horst*, the statements therein suggesting that the gratuitous assignment of income constituted a realization event to the donor were effectively declared anomalous. The rationale employed by the Court to justify the result in the *Horst* decision has been so thoroughly discredited that, in good conscience, it should be considered effectively stricken from the record. As the holding in *Horst* undoubtedly stands firm, the case is most appropriately viewed as another in a long line of earlier assignment of income cases in which the Court equitably attributed the receipt of a gratuitously assigned income item to the assignor based on the degree of control retained by the assignor over the income stream or its source. As stated by

193. *Stuart*, 317 U.S. at 168.
194. 45 B.T.A. 536, 537 (1941).
195. *Id.*
196. *Id*. at 537–38.
197. *Id*. at 538.
198. *Id*.
199. *Id*. at 539.

one commentator, the issue before the Court in *Horst* "was thus not one of realization but of attribution."[200]

B. Resurrecting the Flaws of Horst

The Court's depiction in *Horst* of a gratuitous assignment of a future income stream as constituting a realization event on account of the nonmaterial satisfactions enjoyed by the donor by the very act of making the gift ran headlong into the statutorily implied rule that the transfer of appreciated property does not give rise to a realization event. No such conflict exists if the assignment is made in exchange for material satisfactions instead of nonmaterial ones—that is, if the assignment is supported by consideration. Rather, one is left with a straightforward taxable transaction. Therefore, at first glance, there appears nothing objectionable about the Court's statement in *Banks* that the contingent fee plaintiffs, like the taxpayer in *Horst*, "retained control over the income-generating asset, diverted some of the income produced to another party, and realized a benefit by doing so."[201]

The problem, however, once again lies in the timing of the realization. The Court's depiction of the transaction points to the diversion of the future income as the act by which the plaintiffs realized a taxable benefit. The result in the case, however, indicates that the gain was not taxed to the plaintiffs until payment was received by their attorneys. Thus, the incongruent combination of present realization and deferred taxation blithely employed in the *Horst* opinion was resurrected by the Court in *Banks*. Whereas the conflict between the two principles in *Horst* was ultimately resolved by dropping the characterization of the gratuitous transfer as a realization event, the proper resolution of the conflict in the context of the nongratuitous transaction in *Banks* is exactly the opposite. Assuming the execution of the contingent fee agreement constituted more than the plaintiff's promise to pay the attorney a contingent amount of any recovery and instead constituted the complete payment for the attorney's future services, then the principle that must yield is deferred taxation. This assessment is explained below.

The central statement in the *Banks* decision is the Court's conclusion that the taxpayers realized a benefit from diverting to their attorneys a portion of the future income from their causes of action. Although the Court did not elaborate on the particular benefit realized by the taxpayers, the Fifth Circuit's similar description of the transaction is instructive:

200. *See* Miller, *supra* note 185, at 7.

201. Comm'r v. Banks, 543 U.S. 426, 435 (2005). Indeed, the holding in *Banks* is most appropriately justified by the economic benefit the taxpayers received when their obligation to compensate their attorneys was discharged. *See supra* Part III.C.

> The fact that a contingent fee arrangement has the added benefits of risk-shifting and realignment of incentives does not alter the economic reality. Such an arrangement diverts a portion of the litigation proceeds from the client to the attorney, thereby accruing to the client non-monetary gain from enjoying the assistance of counsel without otherwise having to pay for it.[202]

Thus, what the client received in exchange for the assignment was the attorney's agreement to prosecute the case for no additional charge. If that constitutes the substance of the transaction, then under general tax principles, the transaction would be presently taxable to all parties involved.[203] By appropriating the future income stream to obtain the services of the attorney, the plaintiff would be taxable on the value of the contracted services. Although the value of such services may not be capable of immediate valuation, they would be considered to be worth at least the estimated present value of the transferred payment stream.[204] On the other side, the attorney would realize prepaid compensation income on the transaction, even assuming the attorney reports income on the cash method. If the future income stream constitutes something more than a promise to pay from the plaintiff, then the assigned payment rights are property the receipt of which is presently taxable. Note that none of the aforementioned results would change if plaintiff's claim ultimately yielded no recovery.[205] That stands to reason, as the plaintiff

202. Srivastava v. Comm'r, 220 F.3d 353, 362–63 (5th Cir. 2000) (footnote omitted); *see also* Cotnam v. Comm'r, 263 F.2d 119, 127 (5th Cir. 1959) (Wisdom, J., dissenting) ("By virtue of the assignment Mrs. Cotnam enjoyed the economic benefit of being able to fight her case through the courts and discharged her obligation to her attorneys."). Interestingly, both the quoted portions of the *Srivastava* decision and Judge Wisdom's dissent in *Cotnam* cite to *Old Colony Trust* as authority, which paradoxically suggests that the realization event occurred not upon the assignment of the claim proceeds, but upon discharge of the obligation to pay the attorney.

203. The ensuing discussion takes the Court's analysis on its own terms by ignoring the application of § 83. Due to the risk of forfeiture on the attorney's contingent fee, § 83 would apply to hold the assignment in abeyance until the risk of forfeiture lapses—that is, when the claim is prosecuted to a recovery. *See supra* text accompanying notes 162–65. In effect, the application of § 83 would have supplied the bridge between present realization and deferred taxation that the Court needed.

204. *See* Int'l Freighting Corp. v. Comm'r, 135 F.2d 310, 313 (2d Cir. 1943). Even though the task of valuing the plaintiff's claim would not be without its administrative difficulties, the inability to value an asset with precision does not defeat current taxation. Certainly the value of the claim can be estimated with some degree of accuracy; indeed, attorneys representing clients on a contingent fee basis undoubtedly are quite skilled at valuing claims in determining whether to accept a case on such basis and, if so, how much of their own resources to advance in the prosecution of the claim.

Outside of recognizing the application of § 83 to the transaction, the only way to reconcile the realization of gain by reason of the assignment with taxation deferred until payment of the contingent fee is to conclude that neither the attorney's services nor the transferred potential claim proceeds are capable of reasonable valuation, and therefore to employ the open-transaction doctrine articulated in *Burnet v. Logan*, 283 U.S. 404, 412–14 (1931). The problem in applying the open-transaction doctrine in this context, however, is that the risk-shifting element of the fee agreement could undermine the goal of obtaining a more accurate valuation by waiting until the transfer of cash. In other words, it would be difficult to conclude that the attorney's services received by reason of the assignment were worthless just because a jury returned a verdict in favor of the defendant.

205. In one sense, the attorney would be made whole from a tax standpoint, as the attorney would get to deduct under § 165 his tax-cost basis in the claim upon its dismissal. Nonetheless, the attorney

nonetheless received the benefit of the attorney's services by way of the assignment of the contingent fee.

A brief consideration of the tax ramifications of treating a plaintiff who is party to a contingent fee agreement as realizing the benefit of the attorney's services upon assigning a portion of the claim proceeds to the attorney illustrates the fallacy of treating the fee agreement as effecting a present assignment of anything for tax purposes. It is far more likely that the plaintiff and attorney each viewed the fee agreement as memorializing the plaintiff's conditional promise to compensate the attorney based on a predetermined formula, a characterization which would not yield tax consequences unless and until the attorney was actually paid the contingent fee.[206] Furthermore, this must have been what the Court had in mind in *Banks*, as it regarded the taxpayers as realizing gross income from the payment of their attorney's fees in the year of payment. In that regard, perhaps the Court's statement in *Banks* that the taxpayers "diverted some of the income produced to another party, and realized a benefit by doing so" is sufficiently vague to interpret the realization of the benefit as not occurring until payment of the fee.[207] Yet if that were how the Court viewed the transaction, then it had no need for the assignment of income doctrine whatsoever. It could have simply relied on *Old Colony Trust* for the proposition that the taxpayers realized a taxable benefit when their obligation to compensate their attorneys was discharged. To the extent the Court was bent on citing *Horst*, it should have done so for the proposition that "receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis."[208]

The Court in *Banks* likely was drawn to the assignment of income doctrine because of its standard formula: (a) the existence of an assignment, and (b) the taxation of the assignor when and to the extent the assignee receives payment. Yet the Court's nonchalant importation of assignment of income principles into the commercial setting in order to swiftly dispose of the contingent attorney's fee issue produced an opinion that is difficult to digest. If the Court truly believed that the fee agreement effected a completed assignment for tax purposes, then the act of

would have lost from a timing standpoint, as the government had the interest-free use of the tax liability from the year of inclusion to the year of deduction.

206. Under this characterization, the plaintiff would never realize gross income from the value of the services provided by the attorney. The risk-shifting aspects of the contingent fee agreement could be characterized in hindsight as a bargain purchase, and purchasing an asset or services at a bargain does not give rise to gross income so long as the transaction was at arm's length.

207. Comm'r v. Banks, 543 U.S. 426, 435 (2005). The Supreme Court in *Banks* relied on the Second Circuit's determination in *Raymond v. United States* that *Horst* applied fully to a contingent fee contract. The decision in *Raymond*, in turn, concluded that the plaintiff's income "was 'realized as completely as it would have been if he had collected the [judgment] in dollars' and then paid his attorney." Raymond v. United States, 355 F.3d 107, 116 (2d Cir. 2004) (quoting Helvering v. Horst, 311 U.S. 112, 117 (1940)). The Second Circuit thus viewed the realization event as occurring not upon the assignment, but upon the payment of the attorney's fee.

208. *Horst*, 311 U.S at 115.

assignment should have generated a taxable transaction given that the assignment was supported by consideration. Although the application of § 83 would have permitted the Court to bridge the gap between present realization and deferred taxation,[209] this statute was never mentioned in the *Banks* decision. Thus, the only way to reconcile the result in *Banks* of not taxing the plaintiffs until their attorneys received payment is to conclude that the Court did not truly mean what it said. Specifically, the Court did not view the fee agreement as effecting a completed assignment, but rather as constituting a promise to pay in the future. This leap of faith negates the relevance of the assignment of income doctrine to the transaction. This reconciliation of the *Banks* decision seems appropriate, as the assignment of income doctrine is best understood as an equitable doctrine to be used to attribute gratuitously assigned income to the assignor when necessary to achieve a reasonable and fair imposition of the tax burden.

V. USE OF THE DOCTRINE AS ECONOMIC BENEFIT SHORTHAND—*UNITED STATES V. BASYE*

To the extent the Court in *Banks* employed assignment of income principles as a means of achieving what it knew to be the intuitively correct tax treatment of a transaction, it was not the first panel of the Court to do so. In its 1973 decision in *United States v. Basye*, the Court used the assignment of income doctrine to tax a service partnership on amounts paid directly to a trust providing for the retirement benefit of the partnership's members and employees.[210] The Court arrived at this unquestionably correct result by employing the assignment of income doctrine, even though the factual record indicated that the partnership was never capable of receiving directly the funds that were paid into the trust. The facts thus provided a weak factual basis for applying the assignment of income doctrine. In any event, the Court did not need the assignment of income doctrine to resolve the case properly. The Court could have achieved the same result by simply characterizing the economic benefit the partnership realized through the funding of the trust as compensation income to the partnership. The *Basye* decision is discussed below.

The transaction at issue in *Basye* involved a contract between a partnership of physicians and a health plan that provided prepaid medical care to its members. The partnership agreed to provide medical services to members of the plan through its partner physicians and its nonpartner physician employees.[211] In exchange, the health plan agreed to pay two forms of compensation.[212] The first constituted a monthly per

209. *See supra* text accompanying notes 162–65.
210. 410 U.S. 441 (1973).
211. *Id.* at 443.
212. *Id.*

capita payment based on the number of members enrolled in the health plan.[213] The second called for the health plan to make an additional monthly per capita payment to a trust established for the benefit of the partnership's partner and nonpartner physicians, in the event the partnership established such a trust.[214] Not surprisingly, the partnership created a retirement plan to receive the additional payments.[215] The contributions made by the health plan to the trust were irrevocable.[216] Those amounts could not be recovered by the health plan or paid for its benefit; rather, the funds were permanently committed to the benefit of the partnership's participating physicians.[217]

Whereas the Ninth Circuit analyzed the issue from the perspective of the individual physicians by treating the partnership as a mere agent that contracted on their behalf,[218] the Court righted the ship by recognizing the partnership as a separate entity for tax purposes and as the appropriate party for purposes of determining realization of income.[219] With the issue thus properly framed, the Court proceeded to determine whether the partnership had indeed realized gross income by reason of the health plan's contribution to the trust. In doing so, the Court returned to the "'first principle of taxation: that income must be taxed to him who earns it.'"[220] The Court quoted the traditional passage from *Lucas v. Earl*, noting that it had repeatedly invoked the fundamental lesson from the case that earned income could not escape taxation through the mere expedient of anticipatory assignment.[221] Finding that the partnership had diverted a portion of its compensation income to the trust by way of negotiating with the health plan, the Court concluded that the transaction was "certainly within the ambit of *Lucas v. Earl*."[222]

213. *Id.*

214. *Id.*

215. *Id*. at 443–44. Although the retirement trust maintained a separate nominal account for each participating physician, the beneficiaries' interests in the trust were nonvested. The physician was entitled to receive payment from the trust only if eligible upon retirement. A retiring physician became eligible upon providing fifteen years of continuous services, or upon providing ten years of continuous service and attaining the age of sixty-five. Any physician's interest that was forfeited in the plan was redistributed among the remaining participants. *Id*. at 444–45.

216. *Id.* at 445–46.

217. *Id*.

218. *See* Basye v. United States, 450 F.2d 109, 115 (9th Cir. 1971). From the perspective of the individual physician, the Ninth Circuit determined that the payments to the trust were not currently taxable due to the forfeiture provisions contained in the plans. *Id*. at 112.

219. *Basye*, 410 U.S. at 448.

220. *Id*. at 449 (quoting Comm'r v. Culbertson, 337 U.S. 733, 739–40 (1949)).

221. *Id.* at 450. Thereafter, the Court lionized the principle of *Lucas v. Earl* as "stand[ing] today as a cornerstone of our graduated income tax system." *Id*. The Court's apparent recognition of the role of the assignment of income doctrine in protecting the progressive rate structure in this case is interesting because the facts in *Basye* did not involve an attempt to shift income to lower brackets but instead to defer its realization.

222. *Id*. at 451.

A. Assignment of Income—A Questionable Paradigm

The Court's resolution of the case under the *Lucas v. Earl* principle appears reasonable at first glance.[223] Questions arise, however, once attention is devoted to the circumstances that gave rise to the compensation arrangement. The health plan agreed to pay the additional amount of compensation to the retirement trust only; the partnership could not elect under the agreement to receive such compensation directly. Although the simple response to this point is that such agreement was the product of the negotiating efforts of the partnership, the health plan cannot be described as a mere accommodation party to the partnership's attempted tax planning. The health plan was willing to pay the additional compensation to the retirement trust because the incentives created by the existence of the physicians' forfeitable interests therein would serve to provide the health plan with a stable source of experienced physicians. By paying the additional compensation to the trust, the health plan effectively purchased, in the words of the Ninth Circuit, "the continued, long-term services of individual physicians."[224]

The evidence in *Basye* suggesting that the payments to the retirement trust had not been so much diverted by the partnership as they were directed by the health plan weakens the case for utilizing the assignment of income doctrine to determine the tax consequences of the arrangement. Although the principle from *Lucas v. Earl* has been much lauded by courts, it is not sacrosanct.[225] Recall that the Court refused to apply the principle in *Poe v. Seaborn*,[226] where the husband's earnings were automatically assigned to his wife by operation of community property laws. Thus, in utilizing the doctrine as one of equitable income attribution, the Court is slow to attribute income to one who could have never exercised dominion and control over it. The Court in *Basye* resolved this point by distinguishing deflection of income by operation of law and assignments arrived at by way of consensual, negotiated agreement. The distinction, however, is dubious.[227] Whether the barrier to receipt lies in state law or is the product of market forces should be of no moment, as the resulting inability to control the income stream remains the same.

223. That being said, there exists a touch of irony in using the *Lucas v. Earl* principle of taxing income to those who earned it to tax income to a service partnership, which derived its income from the services provided by its members and employees.

224. Basye v. United States, 450 F.2d 109, 115 (9th Cir. 1971).

225. As stated in a leading treatise, "the supremacy of this 'first principle' must be taken with a grain of salt." BITTKER & LOKKEN, *supra* note 46, ¶ 75.1, at 75-6.

226. 282 U.S. 101 (1930). The *Seaborn* decision is discussed *supra* text accompanying notes 89–109.

227. Although the distinction might find support in Justice Holmes' statement in *Lucas v. Earl* that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew," 281 U.S. 111, 115 (1930), that statement appears directed at the motives for undertaking an assignment as opposed to whether the arrangement is, in fact, the product of an assignment.

The tenuousness of treating any payment to a third party made in connection with the provision of services as an assignment subject to the assignment of income doctrine is illustrated in the Tax Court decision of *Armantrout v. Commissioner*.[228] In *Armantrout*, the taxpayers worked for an employer that provided an education benefit plan.[229] Pursuant to the plan, children of the employer's key employees would be entitled to receive distributions to defray the costs of obtaining a college education, subject to certain per family and per child limitations.[230] Key employees who did not have children incurring college-related expenses received no benefit from the plan.[231] Importantly, the compensation package of key employees who did not have children was not enhanced to counterbalance for their lack of any prospective benefit from the plan.[232] Nonetheless, the Tax Court determined that distributions from the trust to the taxpayers' children were the product of "anticipatory arrangements designed to deflect income away from the proper taxpayer," citing none other than *United States v. Basye* and *Lucas v. Earl* as authority.[233] The court reasoned that, by accepting employment or continuing to be employed, the taxpayers acquiesced to the payments being made into the education benefit plan so as to bring the transaction within the ambit of the anticipatory arrangement prohibited by *Lucas v. Earl*.[234] This characterization reeks of an attempt to shoehorn the transaction into the assignment of income realm so as to achieve a predetermined result. For reasons described below, this strained characterization was unnecessary, as the same result could have been achieved without resort to the assignment of income doctrine.

B. Economic Benefit as the Proper Justification

The *Basye* decision presented a weak case for applying the assignment of income doctrine to attribute the amounts received by the trust to the partnership. The Court, however, did not need the doctrine to tax the partnership on the trust contributions. It could have reached the same conclusion by simply observing that the contributions to the trust constituted an indirect form of compensating the partnership for its provision of current and future services through its partner and nonpartner

228. 67 T.C. 996 (1977).
229. *Id.* at 997–99.
230. *Id.* at 998–99.
231. *Id.* at 1001–02.
232. *Id*.
233. *Id*. at 1005.
234. *Id*. at 1005–07. Similar to the Supreme Court in *Basye*, the Tax Court stressed the consensual nature of the employment relationship pursuant to which the education benefit plan was provided. *Id*. at 1006–07.

physicians.[235] The contributions provided the partnership with a present economic benefit in the form of an irrevocably funded pool of assets that would provide retirement income to its partners and employees.[236] Although each participating physician's interest in the trust was nonvested, the trust contributions were complete from the perspective of the partnership. As the Court observed, under no circumstances could the health plan recoup the payments it made into the trust.[237] Thus, the economic benefit of the trust contributions to the partnership was as tangible as if the partnership had received the funds directly and then served as the trust settlor.

There are numerous passages in the *Basye* opinion indicating that the above-described analysis—that is, that the trust contributions simply constituted a form of indirect compensation to the partnership—was exactly what the Court had in mind. For instance, the Court correctly observed that the health plan's motivations for making the contributions to the trust were "irrelevant to the determination whether those amounts may fairly be viewed as compensation for services rendered."[238] In a similar vein, the Court later remarked that "[d]espite the novelty and ingenuity of this arrangement, [the partnership's] 'base compensation' in the form of payments to a retirement fund was income to the partnership."[239] The Court concluded its opinion as follows: "There being no doubt about the character of the payments as compensation, or about their *actual receipt*, the partnership was obligated to report them as income presently received."[240] The Court's reference to actual receipt in its conclusion is somewhat curious, as the partnership quite obviously did not actually receive the payments. The Court must have been referring to actual receipt of the economic benefit of such payments, or, in other words, the actual receipt of compensation income by reason of the pay-

235. Indeed, the parties' agreement characterized the health plan's payments to the trust as one of the components of the partnership's "base compensation." United States v. Basye, 410 U.S. 441, 443 (1973).

236. *See* Larry E. Shapiro, *The* Basye *Decision One Year Later: Judging Its Effect upon Related Areas*, 39 J. TAX'N 376, 377 (1973) (stating that the partnership recognized income from the contributions to the retirement trust "specifically because the payments were irrevocably set aside for it"); *see also* Andrew H. Cox, *Supreme Court in* Basye *Taxes Partnership on Plan Payments Made for It by Corporation*, 38 J. TAX'N 270, 272 (1973) ("All payments to the trust were irrevocable so far as [the partnership] was concerned and, therefore, were compensation income to the partnership."). Although *Basye* related to taxable years prior to the 1969 enactment of § 83, it is worth noting that the application of § 83 would produce the same result. The health plan's contributions to the trust provided the partnership with "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Treas. Reg. § 1.83-3(e). The health plan's contributions to the trust thus constituted the receipt of property to the partnership for purposes of § 83. Given that the partnership did not have to perform any additional services to retain the benefit of the trust assets, the amount of the trust contributions would have been presently taxable to the partnership pursuant to § 83(a).

237. *Basye*, 410 U.S. at 445.

238. *Id.* at 452 (footnote omitted).

239. *Id*. at 453.

240. *Id.* at 457 (emphasis added).

ments.[241] Indeed, ample authority existed at the time to support the conclusion that a taxpayer could recognize compensation in the form of funds irrevocably set aside for its benefit.[242]

In the end, the Court's use of the assignment of income doctrine in *Basye* was a red herring. In the first place, it was not altogether clear that the transaction could be accurately described as an anticipatory assignment. Yet beyond that debatable issue, the Court's use of the doctrine was superfluous, as the Court appeared to resolve the case on the ground that the trust contributions constituted a form of indirect compensation to the partnership.[243] Thus, the Court's decision in *Basye* is not appropriately interpreted as an expansion of the assignment of income doctrine into the realm of commercial transactions. Rather, the case simply constitutes an additional embodiment of the principle that literal receipt of cash or property is not the *sine qua non* to the realization of income by a cash-basis taxpayer.[244]

VI. CONCLUSION

The assignment of income doctrine is a necessary fixture of the income tax. In situations where the proper party to report an income payment is not entirely clear, the doctrine permits the Commissioner and courts to attribute assigned income to one other than its actual recipient in order to achieve a fair and reasonable allocation of the tax burden. Although the fairness inquiry in this context starts with an examination of the degree of control the assignor retains over the assigned income stream or its source, the same inquiry must also take into consideration the effect the assignment, if respected, would have on the integrity of the progressive nature of the income tax system.

Although the assignment of income doctrine is a necessary feature of the federal income tax, it does not serve as a panacea to resolve the tax consequences of any and all cases involving transferred income streams. Rather, the doctrine is properly limited to gratuitous assignments of payment rights, where the issue concerned not whether income had been realized, but rather the proper party to report the realized income. In the case of assignments of income for consideration, the tax

241. In this regard, one commentator offered two possible resolutions of the Court's reference to actual receipt at the conclusion of its opinion in *Basye*: first, the Court meant to say constructive receipt; second, the Court meant to invoke the economic benefit doctrine. *See* Shapiro, *supra* note 236, at 378 n.20. This author favors the latter interpretation.

242. *See* Sproull v. Comm'r, 16 T.C. 244 (1951); McEwen v. Comm'r, 6 T.C. 1018 (1946); Rev. Rul. 60-31, 1960-1 C.B. 174, 176–77 Ex. 4, 179–80 Ex. 4.

243. Similarly, the Tax Court in *Armantrout v. Commissioner* could have easily characterized the payments from the employer's education benefit plan to the taxpayers' children as an additional form of compensation, given that those payments clearly were made on account of the taxpayers' status as valuable employees.

244. *See* Surrey, *supra* note 85, at 795 (recognizing cases establishing that "the receipt of something tangible is not always a *sine qua non* to the receipt of income by one on the cash basis").

consequences of the transaction are resolved under general principles of income realization. As the identity of the proper taxpayer is not in doubt, there exists no need for the doctrine's attribution feature.

The Supreme Court's recent cases employing the assignment of income doctrine indicate that it has lost sight of the doctrine's proper role. The Court's decisions in *Banks v. Commissioner* and *Basye v. Commissioner* establish an ill-conceived pattern of the Court blithely importing the doctrine into the context of commercial assignments, employing it as a substantive rule of realization as opposed to a flexible tool of income attribution. In *Banks*, the Court resurrected its discredited analysis from its early decision in *Helvering v. Horst* when it determined that the taxpayer-plaintiff "realized a benefit" by diverting a portion of the income to be produced from a cause of action to the attorney by way of a contingent fee agreement. Yet if that were truly the substance of the arrangement, there would exist no need for the assignment of income doctrine to tax the plaintiff on the benefit received through the attorney's services. Rather, the general rules regarding the realization of gain upon the disposition of an appreciated asset would have sufficed. Indeed, if the plaintiff were viewed as making a completed transfer of a portion of the future proceeds upon execution of the fee agreement, the resulting tax analysis would have been far different from that articulated by the Court.[245]

Unfortunately, the Court's suspect use of the assignment of income doctrine in *Banks* cannot be dismissed as an anomaly. It was reminiscent of its prior decision in *United States v. Basye*, wherein the Court first invoked the assignment of income doctrine in the context of an arm's length transaction. Close examination of the Court's opinion in *Basye*, however, reveals that the Court's use of the assignment of income doctrine was superfluous. The proper analysis in *Basye*—one that the Court actually intertwined with its assignment of income rationale—was that the taxpayer-partnership realized a taxable benefit when its client irrevocably transferred payments to a trust benefiting the partnership's members and employees. The taxpayer-partnership's direct realization of compensation income obviated the need for attribution of income under the assignment doctrine.

245. Indeed, the only way to reconcile the result in *Banks* with the notion of the plaintiff effecting a completed transfer of a portion of the future claim proceeds upon executing the fee agreement is through the application of § 83(a) on the assumption that the attorney's interest in the claim proceeds was subject to a substantial risk of forfeiture until the claim was liquidated. The Court never mentioned § 83 in the *Banks* opinion. Another way to rationalize the Court's holding would be to treat the contingent fee arrangement as nothing more than the plaintiff's promise to pay the attorney a contingent amount of money in the future; that is, in other words, to assign no tax significance whatsoever to the execution of the fee agreement. This latter characterization of the transaction, however, runs headlong into the Court's statement that the plaintiff assigned a portion of the income from the claim while retaining control over the income-generating asset. *See supra* Part IV.B. So while the result in *Banks* can be adequately supported, to do so necessitates redrafting the Court's opinion.

It may be tempting to excuse the Supreme Court's recent imprecise use of the assignment of income doctrine, given that the Court reached the correct result in both *Banks* and *Basye*. However, the Court's recent forays into the assignment of income arena should not be dismissed as benign analytical foot-faults. The doctrine arose from the need to fill the lack of clarity in the statute concerning the proper identity of the party to report gratuitously assigned income. Yet as illustrated in this article, resorting to the assignment of income doctrine in the context of commercial transactions simply because there is an actual or suspected transfer of income rights creates the potential for the doctrine to conflict with statutory authority. Thus, in addition to expanding the judicial assignment of income doctrine beyond its rightful bounds, use of the doctrine in this manner unnecessarily complicates the tax treatment of commercial transfers of income streams. Given the importance of the assignment of income doctrine in the body of federal tax common law, the Supreme Court should be expected to exercise better care when employing it.