

## Attorney Fees and Partnership Theory: Another View

To the Editor:

I'm writing concerning the recent article by Gregg Polsky, "Contingent Fees: Why the Partnership Theory Doesn't Work," *Tax Notes*, Sept. 6, 2004, p. 1089. I understand the fundamental issues with which Polsky grapples, but I'm not sure I understand (even from an academic viewpoint) his conclusion that "even assuming that this partnership characterization is proper, the taxpayer should still lose." I reach a different conclusion.

It is understandable that taxpayers attempt to use as many arguments as possible to avoid including contingency attorney fees in income. The panoply of arguments includes (among others) a partnership (or quasipartnership) theory maintaining that the lawyer and client enter a joint venture when the contingency fee agreement is executed.

Under section 761(a), joint venturers are generally taxed under subchapter K (meaning that for tax purposes they are taxed as partnerships even if they are not considered partnerships under applicable state law). Nowhere in section 761(a) is there any requirement that a joint venture must be formally designated. According to the Fifth Circuit in *Haley v. Commissioner*, 203 F.2d 815, 818 (5th Cir. 1953), a joint venture is nothing more than a "special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation."

For that matter, nowhere in section 761(a) is there a requirement that a joint venture must be a separate legal entity. Joint ventures frequently have a singular purpose, as in the case of a joint venture between attorney and client.

The Tax Court in *Podell v. Commissioner*, 55 T.C. 429, 431 (1970), determined that a joint venture must have three elements: (1) each of the participants must agree to contribute in a significant manner to the effort of the venture, such as by providing services, money or property; (2) the participants' entitlement to payment must depend on the success of the venture; and (3) the amount of each participant's entitlement must depend at least to some degree on the amount of income generated by the venture.

Those standards don't seem too difficult when applied to the attorney-client model. Both the attorney and client must make significant contributions if they are to be successful in their venture. The client must provide the underlying claim and assist the attorney in his presentation of the case, and the attorney must provide legal services. It is also clear that neither the attorney nor the client will be entitled to any payment unless the venture is successful. That they have chosen to allocate the success of their venture in accordance with predetermined allocations does not alter that fact. Indeed, that is usually the case in a partnership.

Lastly, in the case of an attorney/client relationship, the amount of both the attorney's and client's entitlement depends exclusively on the amount of income generated by the venture. If the attorney/client venture is not

successful, neither the attorney nor the client will receive any income from the venture.

Ultimately, people who are true joint venturers should be taxed as such. A close examination of the attorney/client relationship suggests that contingency fee attorneys and their clients can be viewed as joint venturers for federal income tax purposes. Moreover, unlike Prof. Polsky, my limited understanding of partnership taxation suggests that applying this treatment would solve the attorney fee issue.

### No Gain on Formation of Attorney/Client P'ship

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners on a contribution of property in exchange for an interest in the partnership. Even so, section 721(b) provides that section 721(a) shall not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.

Treas. reg. section 1.351-1(c)(1) provides that a transfer to an investment company will occur when: (i) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is a regulated investment company, real estate investment trust, or a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.

The attorney and client's transfer of their respective intangible assets in exchange for a 100 percent ownership interest in their newly formed attorney/client partnership should not be deemed to be a transfer to an "investment company." Section 721(b) should not apply because: (i) the transfer will not result, directly or indirectly, in diversification of the transferors' interests and (ii) the partnership contemplated by an attorney/client relationship is not a RIC, REIT, or a corporation more than 80 percent of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in RICs or REITs.<sup>1</sup>

Thus, the general rule of section 721(a) should prevent gain or loss being recognized by the attorney/client partnership, or by the transferors (the attorney and client) on their contribution of their respective intangible assets in exchange for a 100 percent ownership interest in a newly formed attorney/client partnership.

### What About Basis?

Under section 722, the attorney and client will take an outside basis in the attorney/client partnership equal to their adjusted basis in the respective intangible assets they contributed. Under section 723, the attorney/client partnership's inside basis will be a transferred basis; that is, the attorney/client partnership's basis in the transferred intangible assets will be equal to the transferors' basis in the intangible assets immediately before contribution.

<sup>1</sup>Treas. reg. section 1.351-1(c)(1).

### Allocation of Partnership Income

Section 704(a) provides that a "partner's distributive share of income, gain, loss, deduction or credit shall . . . be determined by the partnership agreement." Section 704(b) provides that, if the partnership agreement fails to provide for a partner's distributive share of a particular allocation, or if the allocation lacks "substantial economic effect," the partner's distributive share will be determined in accordance with the partner's interest in the partnership determined by taking into account all facts and circumstances.

In essence, section 704 permits the partners, through their partnership agreement (or arguably in the case of an attorney and client, through their contingency fee agreement), to allocate among themselves the income tax effects of overall partnership income or loss as described in section 702(a)(8)<sup>2</sup> or any of the items of income, gain, loss, deduction, or credit described in sections 702(a)(1) through 702(a)(7) in any desired manner that has substantial economic effect. Surely allocating the attorney/client partnership's income in accordance with the contingency fee agreement would suffice.

The Treasury regulations under section 704(b) provide detailed rules for determining whether an allocation will be respected. An allocation of partnership income and loss, or items thereof, within a partnership agreement (for our purposes, the contingency fee agreement) will be respected if it satisfies one of three tests set forth in the regulations: (1) the allocation satisfies the "substantial economic effect" test in Treas. reg. section 1.704-1(b)(2)(ii)(b); (2) the allocation satisfies the "alternate economic effect test" in Treas. reg. section 1.704-1(b)(2)(ii)(d); or (3) the allocation is in accordance with the partners' respective interests in the partnership, or is deemed to be in accordance with the partners' interest in the partnership under Treas. reg. section 1.704-1(b)(4). If an allocation pursuant to the partnership agreement is not respected under any of the foregoing tests, the Service has the right to reallocate items of income and loss to the partners in accordance with their respective interests in the partnership, determined by taking into account all relevant facts and circumstances.<sup>3</sup>

### The 'Substantial Economic Effect' Test

Under section 704(b) and Treas. reg. section 1.704-1(b), allocations of a partnership's items of income, gain, loss, or deduction provided for in the partnership agreement, which are not made in proportion to the partners' ownership interest, are respected if the allocations have substantial economic effect. Of course, the easiest way for an attorney and client to satisfy the substantial economic

<sup>2</sup>It is clear that allocation of overall partnership income or loss, as defined in section 702(a)(8), is subject to section 704(b). Treas. reg. section 1.704-1(b)(1)(vii) specifically provides that section 704(b) applies to allocations of partnership net income and loss as well as to items of income, gain, loss, deduction, and credit. Because an allocation of partnership income based on the partners' respective ownership interests will conform to the partners' interest in the partnership, it will be presumptively valid.

<sup>3</sup>Section 704(b); Treas. reg. section 1.704-1(b)(1).

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effect test is to simply divide all profits in direct proportion to their respective ownership interests (40 percent to the lawyer and 60 percent to the client, or whatever their agreement dictates); if that is the case the allocation should be respected for purposes of Treas. reg. section 1.704-1(b)(4) and section 704(b).

Let's assume that an agreement between lawyer and client is silent on this matter. Treas. reg. section 1.704-1(b)(2) sets forth a two-part test to determine whether an allocation has substantial economic effect: (1) the allocation must have economic effect, and (2) the economic effect of the allocation must be substantial.

Treas. reg. section 1.704-1(b)(2)(ii)(a) provides that for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners, here the attorney and client. Treas. reg. section 1.704-1(b)(2)(ii)(b) provides that an allocation of overall partnership net income or loss<sup>4</sup> to a partner will have economic effect if, throughout the full term of the partnership,<sup>5</sup> the partnership agreement provides that: (1) the partnership maintains a capital account for each partner under the rules of Treas. reg. section 1.704-1(b)(2)(iv);<sup>6</sup> (2) the partnership will liquidate according to positive capital account balances;<sup>7</sup> and (3) the partners are unconditionally obligated to restore any deficit balances in their capital accounts following the liquidation of the partnership or of the partners' interest in the partnership.<sup>8</sup> The attorney/client agreement could generally be drafted to satisfy the requirements of Treas. reg. section 1.704-1(b)(2)(ii)(b). As such, I don't think it's necessary to discuss the alternate economic effect test contained in Treas. reg. section 1.704-1(b)(2)(ii)(d).

Under Treas. reg. section 1.704-1(b)(2)(iii)(a), the economic effect of an allocation is substantial if there is a "reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."

<sup>4</sup>See section 702(a)(8).

<sup>5</sup>See Treas. reg. section 1.704-1(b)(5) example (1)(ii), in which an allocation failed the regulatory standard, even though for the year in question it complied with the requirements, because liquidation proceeds for the first five years would follow capital accounts but thereafter would be split equally without regard to capital account balances.

<sup>6</sup>Treas. reg. section 1.704-1(b)(2)(ii)(b)(1). Treas. reg. section 1.704-1(b)(2)(iv) generally requires that each partner's capital account be increased by: (1) the amount of money and the fair market value of property the partner contributes to the partnership (net of liabilities assumed by the partnership or to which the contributed property is subject); and (2) the partner's allocated share of partnership income and gain, including income and gain exempt from tax. Each partner's capital account must be decreased by: (1) the amount of money and the fair market value of property the partnership distributes to the partner (net of liabilities assumed by the partner or to which the distributed property is subject); (2) the partner's allocated share of partnership loss or deduction; and (3) the partner's allocated share of partnership expenditures described in section 705(a)(2)(B).

<sup>7</sup>Treas. reg. section 1.704-1(b)(2)(ii)(b)(2).

<sup>8</sup>Treas. reg. section 1.704-1(b)(2)(ii)(b)(3).

To be valid, the attorney/client partnership's allocation of income to the partners (the attorney and the client) must either satisfy: (1) the "substantial economic effect" test (or alternate test);<sup>9</sup> or (2) be made in accordance with the partners' respective interests in the partnership or be deemed to be in accordance with the partners' interest in the attorney/client partnership under Treas. reg. section 1.704-1(b)(4).

### Inapplicability of Section 83

I see no reason why the execution of a contingency fee agreement on the inception of a case cannot create a partnership (or joint venture) for federal income tax purposes between attorney and claimant. The Sixth Circuit easily found a partnership in *Estate of Clarks*, 202 F.3d 854, Doc 2000-1776, 2000 TNT 10-21 (6th Cir. 2000). I hope there are others out there who believe this argument has merit.

Prof. Polsky plainly disagrees. He suggests that section 83 offers the IRS yet another avenue to cast aside the equitable treatment of attorney fees. I would direct Prof. Polsky to the compelling dissenting opinions in *Kenseth v. Commissioner*, 114 T.C. 399, Doc 2000-14845, 2000 TNT 102-6 (2000). *Kenseth* was a reviewed decision of the Tax Court. The 8 to 5 majority held that the entire settlement (including the attorney fee portion) was includable in the plaintiffs' gross income. The five dissenting judges (in well-reasoned and thoroughly embraceable opinions) found that they need not look to legislative changes. Quite simply, the reality of the circumstance was that the plaintiff was not entitled to any of the contingency fee recovery that clearly was to be directly paid to the lawyer. The assignment of income doctrine, those five judges found, was judicially created and can be judicially changed. For a discussion on this point, see Wood, "Even Tax Court Itself Divided on Attorneys' Fees Issue!" *Tax Notes*, July 24, 2000, p. 573.

If assignment of income as the IRS's flavor of the month is going out the window (as I hope the Supreme Court will find when it hears *Banks* and *Banaitis* in its October 2004 term) the last thing we need is section 83. I am frustrated with the nuances of arguments concerning the assignment of income doctrine, the discharge of indebtedness theory, and the asserted applicability of section 83 (I find the latter analysis particularly strained).

Ultimately, practitioners and academics should be looking for ways to make this difficult and expensive burden to taxpayers go away. The Tax Court (at least five judges) went a long way toward advocating such a pragmatic approach in the *Kenseth* dissents. Whether or not the alternative minimum tax is ever repealed (which it clearly should be), five Tax Court judges have said that they do not believe the assignment of income doctrine requires that they tax the plaintiff on the attorneys' portion of the award. Particularly when you view the relative value of the claim at the time the typical contingency fee agreement is executed (usually then of speculative value), I agree with the dissenting judges in *Kenseth*.

<sup>9</sup>Treas. reg. section 1.704-1(b)(2)(ii)(b).

I suppose it is possible, as Prof. Polsky advocates, to invoke section 83, and then to analyze whether section 83 would tax anything at the time of the assignment to the contingency fee lawyer (surely no income then because there are restrictions, and/or the suit then has no ascertainable value). Yet, following through the tortured section 83 analysis leads Prof. Polsky to conclude that the entire amount at the conclusion of the case has to be taxable to the plaintiff. Even if section 83 was intended to apply in this context (which I doubt), I find this unacceptable.

### **Until Next Time**

I admit that I have just very clumsily walked through partnership tax doctrine, attempting to show that it is not clear that the archetypal attorney-client relationship isn't similar to many partnerships. I admit I've never considered myself much of a partnership tax lawyer, generally feeling much more at home in subchapter C than in subchapter K.

Ultimately, I still believe it is possible to treat lawyer and client as coventurers who file no partnership returns, have no income tax consequences until the case is resolved, and then each report their pro rata share of the recovery (whether on a partnership return or not).

I'm not sure the partnership argument is the most persuasive for the taxpayer, though it may be more sensible than focusing on attorneys' lien laws. However, regardless of where the partnership theory stands in the panoply of plaintiff's tax arguments, I hope that the Supreme Court will reject Prof. Polsky's views on this issue.

Very truly yours,

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