Attorney and Client as Partners

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter, San Francisco (http://www.woodporter.com), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. Tax Institute 2005 with 2008 update), and *Legal Guide to Independent Contractor Status* (4th Ed. Tax Institute 2007), both available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

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The tax treatment of contingent attorney fees has engendered considerable controversy. Understandably, plaintiffs do not want to pay taxes on the portion of their recovery received by their attorneys. A plaintiff who owes a one-third contingency to his lawyer expects to pay tax only on the two-thirds he gets to keep. To think otherwise seems almost un-American.

The very real possibility that a plaintiff will pay tax on fees that he will never see has led to a variety of attempted end-runs around the tax problem. The goal is to make it more likely that the plaintiff will be taxed only on his net recovery. Most plaintiffs' attorneys arrange settlement checks so that the client never receives the lawyer's share of the settlement. Instead, the client receives only a net check.

Of course, taxes often do not hinge on physical receipt. In *Commissioner v. Banks*,[1] the Supreme Court held "as a general rule" that the full amount of the plaintiff's recovery, including contingent attorney fees, is gross income to the plaintiff. In the wake of this landmark case, many tax practitioners shifted their focus from whether the fees are gross income to whether the attorney fees are tax deductible.

Income vs. Deduction

If the legal fees are income to the plaintiff, as *Banks* says they generally are, one must address whether and how the fees are deductible. Deductions come in many guises. Shortly before the Supreme Court's *Banks* opinion, Congress amended section 62 to allow plaintiffs to deduct attorney fees paid to pursue unlawful discrimination claims and certain claims against the government.[2]

This above-the-line deduction achieves the same economic result as netting the fees: a complete wash. Moreover, many business taxpayers were already able to

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[1]543 U.S. 426 (2005), *Doc 2005-1418*, *2005 TNT 15-10*.
[2]Section 62(a)(20) and (e).

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deduct attorney fees as ordinary and necessary business expenses.[3] Here, too, the result should generally be the same as netting the fees.

Nevertheless, many categories of attorney fees are caught by the general rule announced in *Banks*. If a plaintiff does not qualify for the statutory above-the-line deduction, and the legal fees were not paid or incurred in pursuing a trade or business, the income inclusion is a much bigger problem. Attorney fees that do not fit within those provisions may still be deductible as miscellaneous itemized deductions.[4] Yet all deductions are not created equal. Miscellaneous itemized deductions are far from equivalent to deductions above the line.

There are three types of discrimination to which miscellaneous itemized deductions are subject. First, miscellaneous itemized deductions are deductible only to the extent they exceed 2 percent of the taxpayer's adjusted gross income.[5] Second, they may be limited by the itemized deduction phaseout.[6] Third, they may increase the taxpayer's alternative minimum tax liability[7] because legal expenses are nondeductible for purposes of the AMT.

Plaintiffs claiming attorney fees as miscellaneous itemized deductions may even run the risk of the IRS asserting that the expenses are nondeductible personal expenses.[8] The federal income tax liability produced by the inclusion of contingent attorney fees can significantly reduce the plaintiff's recovery. In some cases, the federal income taxes due can even exceed the plaintiff's net (post-attorney-fees) recovery, so the plaintiff actually loses money by ''winning'' the case.[9]

Few persons looking at such a situation are likely to find it equitable. However, our tax system is highly complex and compartmentalized. Whether an item constitutes gross income to the plaintiff (for example, the attorney fees) is entirely distinct from whether and how the plaintiff can deduct it.

The years leading up to the *Banks* case produced an array of confusing and disparate tax treatment. There was a vitriolic and highly publicized split in the circuits.[10] There were five previous denials of certiorari, despite the customary rule that a split in the circuits merits a Supreme Court response.[11]

There was even public outcry over the ways in which this tax treatment undercut notions of fundamental fairness, and possibly even constitutionality.[12] When the Supreme Court finally did consider the issue in *Banks*, the Court had 18 amicus briefs before it. Yet, in a decision that was not the Court's finest hour, it announced only a ''general rule'' and sidestepped several arguments contained in briefs for the taxpayers and the amicus curiae.[13]

Understandably, creative plaintiffs have advanced several arguments about why *their* attorney fees should be outside the *Banks* rule. If the *Banks* general rule is that legal fees are generally income for federal tax purposes,[14] surely some exceptions apply.

The Partnership Theory

Can a plaintiff's financial relationship with his attorney be construed as a partnership rather than a contractual agreement to pay for services? Even if a ''regular'' contingent fee arrangement is not a partnership, can such a relationship be structured as a partnership? In many joint ventures, the parties contribute assets and/or services. Surely a plaintiff could contribute his legal claim to a partnership, and the attorney could contribute his skill and effort.

If an attorney-client relationship is a partnership for federal income tax purposes, then any recovery should presumably be allocated to the partners in accordance with their interests in the partnership. A partnership is not a taxpaying entity. It allocates income and loss to its partners, who themselves pay tax. That means a plaintiff/client in partnership with a lawyer should not recognize the attorney fee portion of the recovery as gross income, thus avoiding the limitations on miscellaneous itemized deductions.

Does this work in theory or in practice? If it works in practice, how must it be implemented? In large part, those issues remain untested. In the years to come, they are likely to face much scrutiny.

Assignment of Income Lore

The courts created the assignment of income doctrine to prevent taxpayers from avoiding tax by transferring income to another person. It can even prevent one from assigning property to another person before the property produces income.[15] Put another way, that doctrine allows the courts to determine who actually earned income produced by property.[16] The courts have applied the

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[3]Section 162.

[4]Section 67(a).

[5]*Id*.

[6]Section 68.

[7]Section 56(b)(1)(A)(i).

[8]Section 262.

[9]*See Spina v. Forest Preserve District of Cook County*, 207 F. Supp.2d 764 (N.D. Ill. 2002).

[10]*See* Robert W. Wood, ''Taxation of Contingent Attorneys' Fees Altered by the Jobs Act and the Supreme Court,'' Chpt. 4, Vol. 1, *57th Annual Tax Inst.*, USC Law School, 2005 Tax Inst.

[11]*See* Wood, ''Will the IRS Pursue Attorney Fees Post-*Banks*?'' *Tax Notes*, July 18, 2005, p. 319, *Doc 2005-14789*, *2005 TNT 133-36*.

[12]*See, e.g.,* 2002 National Taxpayer Advocate report to Congress, at 166.

[13]For example, the Supreme Court declined to consider the suggestion in a brief that a contingent-fee agreement establishes a subchapter K partnership, on the basis that it was one of many arguments being presented for the first time to the Court that had not been presented at the trial or appellate court level. *Commissioner v. Banks*, 543 U.S. 426, 437-438 (2005).

[14]The taxpayer and amicus briefs submitted in *Banks* advanced several different arguments, including that litigation recoveries are: (1) proceeds from the disposition of property; (2) capital expenses that reduce capital gains; and (3) governed by statutory fee shifting provisions in which a court pays the attorney directly independent of any relationship between the attorney and client.

[15]*Horst v. Commissioner*, 311 U.S. 112 (1940).

[16]*Id*.

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assignment of income doctrine in various contexts, including the receipt of lease payments,[17] bond interest,[18] capital gains,[19] and recoveries under contingent attorney fee agreements.[20] There has long been debate about whether plaintiffs and their contingent-fee attorneys implicate the assignment of income doctrine.

To some, contingent attorney fee agreements readily fit the assignment of income problem. The legal claim itself may be seen as the underlying property, and the recovery may be viewed as the income eventually produced by the property. However, part of the difficulty in applying that concept involves determining whether a fee agreement should be considered to assign a portion of the plaintiffs' chose in action, or rather a portion of the recovery.

Another difficulty relates to the uncertainty of the recovery viewed at the outset of the litigation. One encounters significant factual variation, as lawyers are hired at different times and with different expectations. Yet, axiomatically, attorneys working under contingent-fee agreements do so on contingency and risk receiving nothing.

Conversely, if there is a recovery, the plaintiff is indebted to the attorney according to the terms of the fee agreement. When a recovery occurs, the plaintiff has transferred something of value to the attorney in satisfaction of his debt. Several courts have considered these issues. Moreover, the *Banks* Court ultimately used the assignment of income doctrine as its rationale for taxing the plaintiff.

Partnership vs. Assignment of Income

Only a few courts have considered the possibility that an attorney-client relationship could constitute a partnership, avoiding the assignment of income doctrine. Some believe the assignment of income doctrine was created by the courts to curb abuses between family members, not unrelated persons.[21] Dealings between clients and their unrelated attorneys, who are licensed and regulated professionals, should not be pulled within the assignment of income net.

In one Tax Court case, a dissenting judge recommended viewing a contingent attorney fee agreement as the joint ownership of property, or as analogous to a crop-sharing agreement between a tenant farmer and a landowner.[22] The tenant generally bears all of the direct and overhead expenses of the venture, and the landowner generally bears only the real estate carrying costs.[23]

Before *Banks* reached the Supreme Court, the Sixth Circuit ruled that the assignment of income doctrine did not apply to the attorney fee portion of the taxpayer's recovery.[24] The Sixth Circuit reasoned that the taxpayer's claim was like a partnership or joint venture to which the taxpayer assigned one-third of his claim, in hopes of recovering the other two-thirds.[25] The Supreme Court disagreed with the Sixth Circuit, holding the full amount of the plaintiff's recovery (including the contingent attorney fees) to be includable in the plaintiff's gross income.

The Supreme Court in *Banks* initially rejected the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes.[26] The Court reasoned that the attorney-client relationship, "regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship."[27] Although the client may not be able to reap value from his claim without the attorney's assistance, the Supreme Court saw that as the situation in any principal-agent relationship.

In the Supreme Court's view, the client retains control over the underlying claim to ultimately determine when and whether to settle. Because the attorney is duty-bound to act only in the interest of the client, "it is appropriate to treat the full amount of the recovery as income to the principal,"[28] it wrote. However, only a few paragraphs later, the Court acknowledges the receipt of briefs from the respondents and amicus curiae that argued that a contingent-fee agreement establishes a subchapter K partnership under sections 702, 704, and 761.[29] The opinion then says that the arguments in those briefs, "it appears, are being presented for the first time into this Court."[30]

The Supreme Court therefore declined to entertain what it called "novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of litigation and not examined by the Courts of Appeal."[31] The following questions come to mind:

- If the suggestion that a contingent-fee arrangement establishes a partnership for federal income tax purposes is something the Supreme Court was declining to consider, why did its opinion (just a few

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[17] *Halkraft Home Inc. v. Commissioner*, 336 F.2d 701 (9th Cir. 1964).

[18] *Helvering v. Horst*, 311 U.S. 112 (1940).

[19] *Salvatore v. Commissioner*, 434 F.2d 600 (2d Cir. 1970).

[20] *See Banks*, 543 U.S. 426 (2005).

[21] The dissent in *Kenseth* supports the idea that the assignment of income doctrine should be primarily concerned with intrafamily transfers. *Kenseth v. Commissioner*, 114 T.C. 399, 441-442 (2000) (Beghe, J., dissenting) *majority opinion aff'd*, 259 F.3d 881 (7th Cir. 2001), *Doc 2001-21203, 2001 TNT 154-9*. This idea was also alluded to in *Estate of Clarks v. United States*, 202 F.3d 854, 856-858 (6th Cir. 2000), *overruled in part by Commissioner v. Banks,* 543 U.S. 426, 431 (2005). Restricting the assignment of income doctrine to family members is not favored by all. For example, Stephen B. Cohen, in "Missassigning Income: The Supreme Court and Attorneys' Fees," 25 *Va. Tax Rev*. 415, 434 (2005), quotes oral arguments before the Supreme Court in *Banks* that reject the idea that the assignment of income doctrine should apply only to family members.

[22] *See* dissent of Judge Renato Beghe in *Kenseth*, 114 T.C. 399 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

[23] *Id*.

[24] *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000).

[25] *Banks v. Commissioner*, 345 F.3d 373, 385-386 (6th Cir. 2003).

[26] *Banks*, 543 U.S. at 436.

[27] *United States v. Banks,* 543 U.S. 426, 436 (2005).

[28] *Id*.

[29] *Id* at 437.

[30] *Id*.

[31] *Id*.

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paragraphs earlier) reject the possibility that Banks' attorney-client relationship could be a business partnership or joint venture?
- Was the Supreme Court making a subtle distinction?
- Was it suggesting that the fundamental attorney-client relationship (which focuses on privileged legal advice) is distinct from the contingent-fee arrangement to which attorney and client agree merely to facilitate payment for that legal advice? After all, if an attorney is faithfully performing his job in compliance with his professional and ethical duties, the substance of his legal advice to his client should not change because of the fee arrangement.

Regardless of how those questions may be answered, most observers believe the Supreme Court expressly declined to decide the partnership issue. Plainly, its one-sentence rebuke of the partnership notion, the Court says it is declining to consider those issues. Interestingly, a perusal of some of the briefs of the respondents and amicus curiae in support of attorney-client partnerships reveals a focus on the fee arrangement between Banks and his attorneys, not the substantive legal advice he received.

One brief argued that Banks's contingent-fee arrangement shifted "practical and legal control of the contingent-fee portion of the settlement proceeds from Mr. Banks to his attorney."[32] The brief espoused many theories of why the arrangement constituted a partnership or joint venture. It argued that Banks had given up control for the attorney fee portion of his recovery, which had therefore become (essentially) a property right of his attorneys.[33]

Another amicus brief argued that the contingent-fee arrangement is a partnership because the attorney's services are critically important to adding value to the underlying claim, and both the attorney and client share the risk in pursuing the asset.[34] In the same way that tax law distinguishes between partners and service providers, the "same result should obtain where the risk-taking partner is a lawyer working on a contingency fee basis,"[35] the brief said. These arguments, which the Supreme Court declined to consider, do not focus on the substance of the attorney-client relationship (the legal advice), but on the ownership of the underlying claim and/or fees associated with that arrangement.

Intent of Parties

What constitutes a partnership? This question would seem to invite a simple and clear answer, particularly if one refines it, asking what constitutes a partnership for federal income tax purposes. Surprisingly, the answer is neither simple nor clear. To begin to address what constitutes a partnership, one must venture down a historical path.

What constitutes a partnership for tax purposes historically occupied many volumes of authority. A mere summary of the area occupied many pages in a huge number of tax opinions and offering memoranda. Readers may remember that from the 1960s through the 1990s, many tax opinions covering issues such as tax credits, passive activity losses, depreciation, and amortization began by discussing whether the vehicle was a partnership for federal income tax purposes.

In effect, the partnership is often the railroad that transports the substantive tax goods. Historically, the courts examined the parties' intent to determine whether a partnership was created under federal tax law.[36] Intent sounds inherently subjective. Yet in *Commissioner v. Culbertson*, the Court established factors to consider in determining whether the parties intended to create a partnership.[37] Those factors include:

- the agreement;
- the conduct of the parties in execution of the agreement's provisions;
- statements of the parties;
- the testimony of disinterested persons;
- the relationship of the parties;
- the abilities and capital contributions of the parties;
- the control of income and the purposes for which it is used; and
- any other facts throwing light on the parties' true intent.[38]

The courts have generally applied similar factors to determine whether a partnership was created under state law.[39] Given the history and import of this partnership determination, one would expect the authorities to be voluminous and well-defined, even when it comes to something specific, such as applying this fundamental question to attorney-client arrangements. Yet surprisingly, there is a paucity of case law.

Indeed, the Tax Court has considered the merits of the attorney-client partnership argument in only a few cases. In *Bagley v. Commissioner*[40] and *Allum v. Commissioner*,[41] the taxpayers argued the presence of an attorney-client partnership to exclude attorney fees from their gross incomes. Neither taxpayer presented significant evidence that he had intended to create a partnership with his

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[32]Brief for the respondent, 2004 U.S. S. Ct. briefs Lexis 512, **24-26.

[33]*Id.* at Lexis 512, **27-31.

[34]Brief for amicus curiae Taxpayers Against Fraud Education Fund in support of respondents, 2004 U.S. S. Ct. briefs Lexis 514, **10-16.

[35]*Id.* at Lexis 514, **16.

[36]*Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Commissioner v. Tower*, 327 U.S. 280 (1946).

[37]*Id.*

[38]*See also Allum v. Commissioner*, T.C. Memo. 2005-177 (2005), *Doc 2005-15466*, *2005 TNT 139-9*, *aff'd*, 231 F. Appx. 550 (9th Cir. 2007), *Doc 2007-10844*, *2007 TNT 86-16* (which cites the partnership factors in *Culbertson*).

[39]For example, California law provides that the elements of a joint venture or partnership are (1) a community of interest in the subject of the undertaking; (2) a sharing in profits and losses; (3) an "equal right" or a "right in some measure" to direct and control the conduct of each other and of the enterprise; and (4) a fiduciary relation between or among the parties. *See, e.g., Stilwell v. Trutanich*, 178 Cal. App. 2d 614, 618-619 (Cal. App. 2d Dist. 1960).

[40]105 T.C. 396 (1995), *Doc 95-11034*, *95 TNT 241-12*.

[41]T.C. Memo. 2005-177 (2005).

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attorney. In each case, the court applied the *Culbertson* intent factors to find that no partnership was created.

Intent, however, is not the only point of relevance. Going beyond intent requires venturing further into partnership tax law.

Partnership Definitions

The code includes guidelines about what constitutes a partnership, and they predate the case law considered here.[42] One general definition applies to the entire code,[43] defining a partnership as a ''syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on . . . which is not . . . a trust or estate or a corporation.''[44] The other definition applies specifically to subchapter K, although its definition is essentially the same.[45]

The courts have said that ''carried on'' implies some business activity.[46] Indeed, the courts have said that business activity, not ownership of property, is decisive.[47] Yet common sense would seem to dictate that the phrase ''any business, financial operation, or venture'' should include nearly any financial transaction. It is very broad.

Similarly, the phrase ''which is not . . . a trust or estate or a corporation'' is also expansive, suggesting that partnership classification is a true catchall for everything that is not a trust, estate, or corporation.[48] These requirements set a low threshold for the creation of a partnership under federal income tax law.

Do these minimalist requirements for the existence of a partnership mean an arrangement between lawyer and client should be included? In the few cases to consider the argument, the courts have not even applied these foundational definitions. That seems odd. Ethical issues aside (which are addressed below), it does seem more than merely arguable that a plaintiff and attorney can forge a relationship sufficient to satisfy the code's partnership definitions.

Check-the-Box Regulations

The rules changed radically in 1997, when Treasury issued final regulations to eliminate many difficult entity classification issues.[49] These regulations are often referred to as the check-the-box regulations, signaling a change from amorphous facts and circumstances inquiries to a meant-to-be-idiot-proof one-page multiple-choice form. Significantly, the regulations specify when a partnership has been created for purposes of federal income tax law.

The check-the-box regulations depart from established case law and, in some respects, even from the definition of a partnership provided in the code. The check-the-box regulations make it clear that federal tax law determines whether a separate partnership entity exists for tax purposes, and notably, this determination does not depend on whether the partnership is recognized under local law.[50] The linchpin for whether a partnership exists is whether individuals have teamed together for purposes of making and dividing profits.

For example, the check-the-box regulations provide that merely carrying on a trade or business, financial operation, or venture and dividing the profits therefrom can be sufficient to create a separate entity for tax purposes.[51] However, the mere sharing of expenses does not create a partnership,[52] nor does mere co-ownership of property ''that is maintained, kept in repair, and rented or leased.''[53]

However, if co-owners of a rental property also provide services to the occupants directly or through an agent, a partnership has been formed.[54] The regulations' view of what constitutes a partnership can encompass a wide range of financial arrangements.[55] For example, a contractual arrangement to divide profits can qualify as a partnership.[56] This conforms to prior case law.[57]

Also, the regulations identify partnerships as entities that are not trusts, corporations under state or other law, or corporations under an election by the owners.[58] This language makes partnerships a default classification, as they are a business entity with at least two members that is not a trust or corporation.[59] A partnership usually results when two or more parties are involved in a financial arrangement, and when the type of entity is not otherwise clear.[60]

An eligible domestic business entity with at least two members that is not otherwise classified as a corporation constitutes a partnership unless it elects to be treated as an association (and thus a corporation) for purposes of federal income tax.[61] For example, a limited liability company that does not elect otherwise is a partnership by default.[62] To elect not to be treated as a partnership, those

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[42]The foundational definitions in section 7701 were added to the code in 1959.

[43]Section 7701(a)(2).

[44]*Id*.

[45]Section 761(a).

[46]*Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 441 (1943).

[47]*Tomlinson v. Miles*, 316 F.2d 710, 714 (5th Cir. 1963).

[48]McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, section 3.02[1] (4th ed. 2007).

[49]Reg. section 301.7701-1.

[50]Reg. section 301.7701-1(a)(1).

[51]Reg. section 301.7701-1(a)(2).

[52]*Id*.

[53]*Id*.

[54]*Id*.

[55]*Id*.

[56]*Id*.

[57]*See, e.g., Meehan v. Valentine,* 145 U.S. 611 (1892) (a Supreme Court case that's over 100 years old, yet which still appears to be good law, which commented that ''it appears to be settled that the written contract entitling Perry to a share of the net profits, at least, makes out a prima facie case of partnership''); *see also Hanson v. Birmingham*, 92 F. Supp. 33, 42 (D. Iowa 1950) (''A partnership is contractual in nature, a contract being essential to the formation of a partnership'').

[58]Reg. section 301.7701-2(a), (b), and (c)(1).

[59]Reg. section 301.7701-2(a) and (c)(1).

[60]Reg. section 301.7701-3(a) and (b)(1).

[61]Reg. section 301.7701-3(a) and (b)(1)(i); *see also People Place Auto Hand Carwash, LLC v. Commissioner*, 126 T.C. 359, 364 (2006), *Doc 2006-11521*, *2006 TNT 115-15*.

[62]*See People Place Auto Hand Carwash, LLC v. Commissioner*, 126 T.C. 359, 364 (2006). Similarly, an eligible foreign entity with

(Footnote continued on next page.)

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entities should file a Form 8832. Otherwise, their default classification is a partnership.[63]

Every domestic business partnership must file a partnership return (Form 1065).[64] The required Form 1065 must be signed by at least one general partner (or managing member in the case of an LLC).[65] The form requests information on the partnership's principal business activity, contact information, employee identification number, method of accounting, etc., but it is nothing particularly complex.[66]

Given the low threshold for what constitutes a partnership, there seems to be no reason (at least under federal income tax law) why a contingent attorney fee agreement could not qualify as a partnership under the check-the-box regulations. Some plaintiff's attorneys may not wish to file a partnership return because they fear negative consequences from the state bar. It may be possible, however, for lawyer and client to individually include their share of partnership income, deductions, and credits on their personal returns without filing a partnership return.

Failure to file a partnership return subjects a partnership to specified penalties, which are relatively minimal: $85 times the number of partners per month, but not to exceed 12 months.[67] A willful failure to file a partnership return can incur greater penalties.[68] Nevertheless, no penalty will be imposed for failure to file a partnership return if the partnership can show the failure was for reasonable cause.[69]

A small partnership is presumed to have reasonable cause for its failure to file a partnership return if (1) each partner has fully reported his share of income, deductions, or credits on his timely filed income tax return; (2) the partnership consists of 10 or fewer partners who are either individuals (other than nonresident aliens), C corporations, or estates of deceased partners; and (3) each partner's interest in the partnership items corresponds with his proportionate share of all other items.[70]

This reasonable cause exception would seem to cover a broad range of partnership arrangements between a contingent attorney and his client. And the IRS has indicated that even if this reasonable cause exception is not met, a small partnership may still be able to show reasonable cause for its failure to file a partnership return.[71]

State Laws

Federal, state, local, and foreign laws can all affect tax considerations. Generally, state laws grant property rights, and federal tax law determines the federal income tax implications of those rights.[72] Oddly enough, however, this appears not to be the case on the threshold question whether a partnership exists for federal income tax purposes. Although state law plainly provides for the creation of partnerships, federal income tax law does not look to state law to determine whether a partnership has been created.[73]

The mere fact that you have a state law partnership does not mean you also have a partnership for federal income tax purposes. Conversely, even if you have a partnership under federal income tax law, it may not be recognized that way under state law. Several of the courts that have either explicitly or implicitly addressed the attorney-client partnership argument appear to have overlooked this important concept.[74] In *Banks*, the Supreme Court looked to state law to determine that the attorney-client relationship was that of a principal-agent.

The Court's reference to agency law may indicate that courts will (in my opinion, erroneously) look to state law for the existence of a partnership. Indeed, in *Kenseth*,[75] the Tax Court looked to state law to rule that an attorney-client relationship was that of fiduciary and beneficiary, not partnership. The *Kenseth* case was bitterly divided in the Tax Court and was a reviewed opinion, so all available judges participated in the case.[76] The Tax Court judges could not even agree whether state law or federal tax law should control.

In *Estate of Clarks v. United States*,[77] the Sixth Circuit looked to Michigan's attorney lien statute, finding that it created joint ownership of the claim equivalent to a partnership. Indeed, many of the cases preceding *Banks* considered state attorneys' lien laws in assessing federal income tax treatment.[78] Some states even considered

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two or more members (with at least one member that has no limited liability, and which does not elect otherwise) is also treated as a partnership. Reg. section 301.7701-3(b)(2)(i)(A).

[63]*See* Form 8832 (rev. Mar. 2007), *available at* http://www.irs.gov.

[64]Section 6031; reg. section 1.6031(a)-1(a); "2007 Instructions for Form 1065," *available at* http://www.irs.gov.

[65]*See* "2007 Instructions for Form 1065," *available at* http://www.irs.gov.

[66]*See* 2007 Form 1065, *available at* http://www.irs.gov.

[67]Section 6698(a), (b), and (c).

[68]Section 7203.

[69]Section 6698(a).

[70]Rev. Proc. 84-35, 1984-1 C.B. 509; S.C.A. 200135029, 2001 SCA Lexis 12; 2-15 *Tax Planning for Partners, Partnerships, and LLCs*, section 15.05 (Matthew Bender 2008); Alan J. Tarr and Pamela Jensen Drucker, *Civil Tax Penalties and A-10* (BNA Tax Management Portfolios 2005).

[71]Rev. Proc. 84-35, section 3.03.

[72]*United States v. Craft*, 535 U.S. 274 (2002), *Doc 2002-9398*, *2002 TNT 75-9*; *see also United States v. Rodgers*, 461 U.S. 677, 683 (1983).

[73]*Commissioner v. Tower*, 327 U.S. 280, 288 (1946), *Nichols v. Commissioner*, 32 T.C. 1322, 1330 (1959), cite for the reg.

[74]Stephen B. Cohen, "Misassigning Income: The Supreme Court and Attorneys Fees," *Tax Notes*, Jan. 23, 2006, p. 355, *Doc 2005-25325*, *2006 TNT 15-29*; *see also Young v. Commissioner*, 240 F.3d 369, 378 (4th Cir. 2001), *Doc 2001-1324*, *2001 TNT 9-24*.

[75]*Kenseth*, 114 T.C. 399 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001).

[76]The "reviewed by the court" process is rare with Tax Court cases and is limited to exceptional circumstances. *See* discussion on p. 14 of the reply brief for petitioners submitted to the Supreme Court in *Kanter v. Commissioner,* No. 03-1034, *available at* http://supreme.lp.findlaw.com/supreme_court/briefs/03-1034/03-1034.mer.pet.rep.pdf.

[77]*Estate of Clarks*, 202 F.3d 854 (6th Cir. 2000).

[78]*See Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *see also* cases collected in Wood, *supra* note 10.

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amending their attorney lien laws as an accommodation to plaintiffs facing tax problems associated with attorney fees.[79]

The courts may have looked to state laws because of how the partnership argument was presented. Courts have generally considered this argument in the context of the assignment of income doctrine and state statutory fee shifting laws. The courts focused primary attention on those arguments, commenting only in passing that an attorney-client relationship might constitute a partnership for tax purposes.

Attorneys' Rules of Professional Conduct

One large area of confusion concerns the rules of professional ethics and how they affect a putative partnership between lawyer and client. Can you do it, and if so, how? Just as state law does not dictate whether a partnership is created for purposes of federal tax law, the professional rules of conduct for attorneys shouldn't either.[80]

By their terms, those rules do not govern the substantive rights of the attorney or the client.[81] And historic federal partnership tax law suggests that federal tax rules trump everything, codes of professional conduct included. The professional conduct rules are largely disciplinary rules for attorneys.[82] An attorney who violates them may be subject to discipline. States exercise this power to regulate the profession and to protect the public.

Although the courts may use those rules to void contractual agreements between attorneys and clients,[83] a partnership between lawyer and client (for federal income tax purposes or otherwise) should not be prejudiced. Indeed, that seems especially true when a partnership (at least for federal income tax purposes) was created (mostly or wholly) for the federal income tax benefit of the client. If the client asks the attorney to recast what would otherwise be the lawyer's boilerplate one-third contingent-fee agreement into a two-thirds and one-third ''partnership agreement,'' has the client been damaged? From a tax perspective, the answer is clearly no.

Indeed, the taxpayer may have benefited materially. Of course, rules of professional conduct can prevent attorneys from entering into particular arrangements with clients. They can also require the attorney to withdraw from representation. Clearly, those issues should be considered by an attorney before entering into an attorney-client partnership.

Attorneys should protect their law license too. However, those issues should have no relevance in determining whether a partnership exists for federal income tax purposes. In fact, courts that have considered an attorney-client partnership for tax purposes seem to assume that the rules of professional conduct for attorneys actually prohibit attorneys from entering into partnerships with clients for all purposes.[84]

Attorneys should check their own state rules, but the ''no partnership'' assumption may be incorrect.[85] To begin with, the state bar has no reason to prohibit partnerships for federal income tax purposes, even if a partnership under state law is verboten. Often, however, a closer look at the bar rules will reveal that there is no outright prohibition on a lawyer-client partnership even for purposes of state law.

Instead, the rules may contain express disclosure requirements that the attorney must observe when entering into a business transaction with a client.[86] These rules generally provide that the transaction or acquisition must be fair and reasonable to the client. They may also require the attorney to advise the client in writing to seek independent counsel to review the transaction or acquisition. The client may also have to consent in writing to the terms of the transaction or acquisition.[87]

Some concern is also voiced over attorney-fee-splitting rules.[88] The rules of professional conduct prohibit attorneys from splitting legal fees with nonlawyers.[89] If the partnership is to practice law, the attorney may be found to have impermissibly split legal fees with a nonlawyer.[90] Yet the lawyer-client partnership is not what those rules were designed to address.

Those rules were presumably intended to prevent nonattorneys who have entered into a partnership with an attorney from providing legal advice to clients who are not members of the partnership. Those rules should not be interpreted to prevent an attorney from establishing a partnership with his own client (especially for the sole tax benefit of the client). If the client knowingly and willingly agrees to a partnership, and does so to derive tax benefits, how could that be prohibited?

Indeed, if a partnership (recognized at least for federal income tax purposes) consists solely of the attorney and the plaintiff, it would be difficult to argue that the attorney is helping (or allowing) the plaintiff/client to practice law. That same plaintiff would not be viewed as practicing law regarding his own claim, for plaintiffs can represent themselves in *pro per*. An attorney helping a

[79]*See* Wood, ''Washington's Attorney Lien Law,'' *The Tax Adviser* (Dec. 2004), p. 729.

[80]*See* Model Rules of Prof'l Conduct, Preamble.

[81]*Id*.

[82]*Id*.

[83]*See, e.g., Grausz v. Farber*, 2002 Cal. App. Unpub. LEXIS 6091 (Cal. App. 1st Dist. 2002).

[84]For example, based on the fiduciary relationship between an attorney and his client, the Tax Court in *Kenseth* commented that it ''is difficult, in theory or fact, to convert that relationship into a joint venture or partnership.'' *Kenseth*, 114 T.C. 399, 413 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001). Even Judge Beghe in his dissent concluded that ''local laws and ethical rules prohibiting the assignment of claims to attorneys would be obstacles to the making of the capital contribution that is the prerequisite to the formation of a partnership.'' *Kenseth*, 114 T.C. at 454 (Beghe J., dissenting).

[85]Comment to Rule 1-310 Calif.; *cf*. Model Rules of Prof'l Conduct R. 1.8(i).

[86]Rule 3-300 — Calif.; Rule 1.08 — Texas.

[87]*Id*.

[88]*See, e.g., Polland & Cook v. Lehmann*, 832 S.W.2d 729, 735 (1992).

[89]*See* Rules 2-200, 1-320 — Calif.

[90]*See, e.g.,* Rule 1-310 — Calif.; San Diego County Bar Association, Ethics Opinion 1984-1.

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plaintiff represent himself presumably does not violate professional rules of conduct.

Control of the Case

Another ethical sticky wicket relates to control over settlement authority and other decision-making. State bar rules may prohibit an attorney from depriving the client of the power and authority to decide whether and for how much to settle. Even if the attorney stands to make one-third or more on the case, it is the client's decision. That control factor may be a fundamental stumbling block on which courts may reject the attorney-client partnership theory.

For example, before *Banks*, Judge Richard Posner of the Seventh Circuit (in affirming *Kenseth*) eviscerated Kenseth's argument that he had given up control of his claim (an income-producing asset) to his attorney. Judge Posner pointed out that regardless of whether Kenseth's attorney worked for a contingent or fixed fee, Kenseth had not relinquished control, because he retained the right to fire his attorney.[91] The Supreme Court in *Banks* seemed to hinge its decision, at least in part, on the fact that Banks had retained ultimate dominion and control over the underlying claim.[92]

In *Allum*, the Tax Court cited *Banks* extensively in rejecting an attorney-client partnership, noting that the taxpayer in *Banks* had not given up control of his underlying claim.[93] In rejecting the taxpayer's de facto partnership theory in *Allum*, the Tax Court noted that the taxpayer did not view his attorney ''as a co-owner of his legal claims, but rather, as a legal representative receiving compensation for his services.''[94]

But the presence or absence of a partnership on this point should be irrelevant. A partnership can allocate decision-making responsibility and authority. Whatever share of partnership income may accrue to a lawyer-partner, the client-partner may retain all of the decision-making power in the case. That should be done in a written partnership agreement.

However, because partnership agreements can be oral, it is hardly clear that those points must be in writing. From a federal income tax perspective, that allocation of responsibility and authority should be irrelevant, except perhaps as an indicator of intent. If the bar queries who has the power to settle 100 percent of the case, lawyer and client will presumably agree that the client does, whether or not the writings say so.

Barratry, Maintenance, and Champerty?

Contingent-fee arrangements and attorney-client partnerships may also warrant a discussion of the common-law concepts of barratry, maintenance, and champerty. Under common law, barratry was a misdemeanor criminal offense resulting when a person stirred up lawsuits or quarrels.[95] Maintenance and champerty were offenses resulting when a stranger to the lawsuit made a deal to assist a litigant by aiding in finance (maintenance) in exchange for a portion of the proceeds (champerty).[96]

Courts in the United States have generally rejected or abandoned the vague common-law concepts of maintenance and champerty, although some retain a prohibition against barratry.[97] Otherwise, any contingent-fee arrangement could violate maintenance or champerty rules. The vestiges of barratry today take the form of state-defined rules against barratry, solicitation, and malicious prosecution.[98]

The overarching goal of such rules is to prohibit an otherwise disinterested third-party promoter from stirring up litigation that benefits him personally, as opposed to benefiting the litigant or the public.[99] Contingent-fee arrangements have coexisted with these barratry-like prohibitions for decades. An attorney-client partnership should raise no greater risk of engaging in barratry than that which already exists.

Conflicts of Interest

Another question is whether an attorney-client partnership to recover on an underlying claim would violate conflict-of-interest rules. The rules of professional conduct require attorneys to avoid conflicts of interest.[100] When the attorney represents an organization such as a partnership, the organization is considered the client.[101] The attorney's duty is to the organization, not its directors, officers, employees, members, shareholders, or other constituents.[102]

If a lawyer-client partnership would result in the client losing the ability to terminate the attorney's services, engage another attorney, or decide when to compromise the claim, conflict-of-interest rules could conceivably be used to block the partnership.[103] Yet partnerships are extraordinarily flexible arrangements that can be structured to avoid those problems. And if state law or ethics rules created some insuperable barrier to a true state-law-sanctioned partnership (which I doubt), then we must return to the question of which law controls.

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[91]*Kenseth v. Commissioner*, 259 F.3d 881, 884 (7th Cir. 2001).

[92]*Banks*, 543 U.S. at 436.

[93]*Allum*, T.C. Memo. 2005-117, *27.

[94]*Allum*, T.C. Memo. 2005-117, *34.

[95]*Rubin v. Green*, 4 Cal. 4th 1187, 1190 (1993).

[96]*See, e.g., Son v. Margolius, Mallios, Davis, Rider & Tomar*, 709 A.2d 112, 120 (Md. 1998); *Abbott Ford v. Sup. Ct.*, 43 Cal. 3d 858, 885 n.26 (1987).

[97]*See Abbott Ford v. Sup. Ct.*, 43 Cal. 3d 858, 885 n.26 (1987); *Accrued Fin. Servs. v. Prime Retail, Inc.*, 298 F.3d 291, 299 (4th Cir. Md. 2002).

[98]*See, e.g., Accrued Fin. Servs. v. Prime Retail, Inc.*, 298 F.3d 291, 299 (4th Cir. Md. 2002); *Crowley v. Katleman*, 8 Cal. 4th 666, 694 (Cal. 1994); *Drum v. Bleau, Fox & Associates*, 107 Cal. App. 4th 1009, 1025 (2003).

[99]*See Accrued Fin. Servs. v. Prime Retail, Inc.*, 298 F.3d 291, 299 (4th Cir. Md. 2002).

[100]Model Rules of Prof'l Conduct R. 1.7.

[101]Model Rules of Prof'l Conduct R. 1.13. Rule 3600 — Calif. The State Bar of California, Standing Committee on Professional Responsibility and Conduct, Formal Opinion No. 1994-137.

[102]*Id.*

[103]*Cf. Kenseth*, 114 T.C. at 414-415 (noting that under Wisconsin law, the client retained the ability to settle his claims, and that it would be an ethical violation for an attorney to press on with a client's claim against the client's will).

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Recall that our objective here — for the sole benefit of the plaintiff/client who may otherwise face an inequitable tax burden — is to form a partnership for purposes of federal income tax law. A financial arrangement between lawyer and client may not rise to the level of a partnership under pertinent state law, even though a partnership is deemed to exist for purposes of federal income tax law. In fact, maybe that is an optimal design. If the partnership is recognized as a partnership only for purposes of federal income tax law, there may be no need to look to the state attorney professional conduct rules.

However, other ethical considerations may actually suggest that the attorney has a duty to explore the partnership form. Consider that for tax purposes, the attorney-client partnership benefits only the client, not the attorney. After all, the amount the attorney receives will clearly constitute income regardless of whether the attorney receives fees from the client (after the client includes them in his own income) or as part of the profits of a partnership.

Given the fiduciary and ethical concerns, the attorney may be wary about what he sees as the slippery slope of a partnership with his client, even though it is in the client's best interest. But if such an arrangement is possible, isn't it conceivable that the attorney may have a duty to try to effectuate it?

Planning the Attorney-Client Partnership

It is rare for plaintiffs and their counsel to consider tax issues when they formalize their relationship in a fee agreement and when they file a complaint. Any tax planning and tax projections usually are done as settlement offers are being considered. In fact, tax planning is often considered for the first time *after* the plaintiff receives his recovery, or even in the next calendar year, at tax return time.

The optimal time to address these issues is when the lawyer-client relationship is commenced. However, even an amendment to a fee agreement right before settlement — a clarification of what lawyer and client intended by their joint venture — may be enough to change the tax result. If planning is done from the beginning of the attorney-client relationship, or at the latest, before the case is completed (after all, the attorney doesn't earn his fee under a fee agreement until legal rights are released), a partnership (for federal income tax purposes) may be achievable.

One avenue is presumably for a plaintiff and attorney to enter into a formal partnership agreement under state law. Even if attorney-client partnerships are prohibited by *some* state laws, it is worth questioning whether that prohibition is a feature of the *partnership* law (unlikely), or is a dictate of state bar rules. It may be possible to design a legal fee agreement that looks like a partnership agreement, or a partnership agreement that looks like a fee agreement. The economics and control issues should not be difficult to address.

If it is unclear whether the attorney is committing an ethical violation by agreeing to cast his relationship with his client as a partnership, a savings clause in the agreement may prevent violation. For example, the agreement may provide that "notwithstanding anything herein to the contrary, this agreement shall be interpreted as a partnership between lawyer and client only to the extent permitted by law."

Deciding whether to make a fee agreement like a partnership in character, or to opt more for a "real" partnership agreement, involves a judgment call. There may be no need to adopt a partnership-or-bust mantra. After all, the threshold under federal income tax law for what constitutes a partnership seems to be low.

Several variables in formation are possible. Some practitioners may want the plaintiff to contribute his claim to the partnership. The client, attorney, or both could contribute funds to the partnership to cover the costs of prosecuting the claim. If the partnership was formed before the claim was filed, the partnership might itself be a plaintiff. Otherwise, the partnership may simply own all or a portion of the claim the plaintiff contributed to it, although the case proceeds solely in the plaintiff's name.

A partnership agreement could include many of the standard terms the attorney would otherwise include in the fee agreement. The attorney should consider the language on withdrawing from representation, conflicts of interest, and the manner in which fees, costs, and recoveries are allocated between partners. The income or loss associated with prosecuting the claim would flow through to the partners in accordance with the terms of the partnership agreement.

Such an arrangement should satisfy most, if not all, of the *Culbertson*[104] intent factors, the partnership definition in the code, and even the check-the-box regulations. Whatever the applicable state bar rules say about such an arrangement, it may be hard to argue that it should not be respected for federal income tax purposes.

Assigning Portion of Claim to Attorney

Rather than contributing his claim to a partnership, a plaintiff could assign a portion of it directly to his attorney. That assignment may create a partnership solely for purposes of federal income tax law, or could help avoid the partnership altogether. If the attorney accepts a share of an inchoate claim in exchange for an agreement to pursue that share (the client riding along on his coattails), perhaps each person could be taxed separately on a recovery without the need for partnership analysis. Plaintiffs can generally assign legal claims to third parties, and they should not be subject to federal income tax on the assignment if it is made at a time when the recovery is inchoate or uncertain.[105]

The agreement used to assign all or a portion of the claim to the attorney could include many of the terms in the attorney's standard fee agreement. That "assignment agreement" could be in lieu of a formal partnership agreement. Under the assignment of income doctrine, one question would be whether the claim was assigned to the attorney when the claim was uncertain or inchoate.

But if the claim was inchoate when it was assigned, the owners should (presumably) each report and pay tax

[104]337 U.S. 733 (1949).
[105]*See, e.g., Schulze v. Commissioner*, T.C. Memo. 1983-263.

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on the portion attributable to their ownership interest when the recovery later accrues. Unless the assignment is made on the eve of settlement when the value of the case is certain, such an assignment should be respected. However, a note of caution comes from the Court of Appeals for the Federal Circuit, which addressed that type of arrangement in *Baylin v. United States*.[106]

In *Baylin*, an employer assigned a portion of its claim to its in-house attorney.[107] The attorney prosecuted the claim and obtained a recovery.[108] The IRS considered the attorney fees to be a capital expenditure by the partnership, which reduced the partnership's capital gain.[109] The court said that even though —

> the partnership assigned a portion of its . . . recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership; it means simply that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery and by having the obligation of the client to the attorney discharged by having the state pay the attorney his fees directly from the recovery. The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees.[110]

Interestingly, the *Baylin* case does not square with most of the other cases exploring the assignment of income doctrine. The case law has generally concluded that assigning assets to third parties at a time when the income therefrom is uncertain will result in the income being eventually taxed to the assignee, not the assignor.[111]

An arrangement similar to the one considered in *Baylin* may well satisfy the code's partnership definition and the check-the-box regulations, although it is disturbing that the court did not agree. The parties could presumably increase the odds that the IRS or the courts would recognize this arrangement as a partnership by establishing that the *Culbertson* intent factors were satisfied.

Many of the perceived impediments to an attorney-client partnership stem from the fiduciary and ethical hurdles it could create. As discussed above, ethical rules may prevent a client from giving an attorney partial control over his claim. They may also prevent a partnership between attorney and nonattorney that involves the practice of law, and they may prevent perceived conflicts of interest, etc. Even so, none of those barriers should prevent a partnership of lawyer and client for federal income tax purposes.

Nevertheless, for those fearing impediments to a partnership arrangement, a partial sale of a claim could provide an alternative. To me, however, the partnership model is easier, cleaner, and preferable in many respects to some kind of sale contract model.

Relevance of Attorney Fee Agreement

Can one have a partnership for federal income tax purposes even though the document signed by lawyer and client is titled a fee agreement? That question may invoke substance versus form inquiries. The most common way to embody an attorney-client relationship is in an attorney fee agreement. According to the Tax Court in *Allum*, a standard fee agreement alone will generally not qualify as a partnership under federal income tax law.[112] That is not surprising, in view of the lack of partnership-like criteria (or intent) present on *Allum's* facts.

Nevertheless, the courts might recognize a fee agreement as a partnership agreement if the fee agreement (and the parties' conduct) indicated that they intended to create a partnership. It may be enough for the contingent-fee agreement to include language specifying that the parties intend the agreement to constitute a partnership for federal income tax purposes, and to constitute a partnership for all other purposes to the maximum extent allowed by law. That, along with complying with other business formalities, may be enough to satisfy the code's partnership definition, the check-the-box regulations, and the *Culbertson* intent factors.

Even with a regular fee agreement with one sentence devoted to the partnership idea, can — or should — a check-the-box form be filed? Because the check-the-box regulations permit contractual arrangements to be cast as partnerships, there should be no problem with the permissibility of such an act. Whether it is a good idea may be debated, but there seems to be little downside to filing it (especially in situations where the contemplated attorney-client partnership may not meet the reasonable cause exception to partnership return filing requirements).

Will the lawyer-client partnership want to obtain an EIN and file partnership tax returns? Perhaps, but that can be debated. A partnership may be recognized for federal income tax purposes, even if it has not filed a Form 1065.[113] In *S.O. Clagget, Liquidating Trustee for S.O. Claggett, Inc.*,[114] the Tax Court addressed the question whether an agreement affected a contractual relationship or rather a partnership. The tax issue involved personal holding company issues, not the tax treatment of attorney fees. Yet the court addressed the sum and substance of the arrangement, and despite the lack of partnership tax returns, found a partnership for federal income tax purposes.

Of course, the more of those steps lawyer and client take, the more secure the plaintiff may feel that he will

[106] 43 F.3d 1451, 1455 (Fed. Cir. 1995), *Doc 95-342*, *95 TNT 4-23*.
[107] *Id*.
[108] *Id*.
[109] *Id*.
[110] *Id*.
[111] *See, e.g., Baylin v. United States*, 43 F.3d 1451, 1452 (Fed. Cir. 1995).

[112] *Allum v. Commissioner*, T.C. Memo. 2005-177, 2005 Tax Ct. Memo Lexis 178, *35-36 (2005), *aff'd,* 231 F. Appx. 550 (9th Cir. 2007).
[113] *See, e.g., Clagget v. Commissioner*, 44 T.C. 503 (1965) (in which the Tax Court recognized the existence of a partnership that never filed Form 1065 partnership returns, but which had a partnership agreement).
[114] 44 T.C. 503 (1965).

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not be attributed the lawyer's share of the income on the resolution of the case. On the other hand, to satisfy the minimal threshold for what constitutes a partnership, it may not be necessary to take those steps. We don't have a litmus test for what is enough to work. We know the taxpayer in *Allum* had nothing going for him.

In *Allum*, the Tax Court's list of partnership-like actions showing the intent to create a partnership is essentially the same as the list from *Culbertson*:

- the agreement;
- the conduct of the parties in execution of the agreement's provisions;
- statements of the parties;
- the testimony of disinterested persons;
- the relationship of the parties;
- the abilities and capital contributions of the parties;
- the control of income and the purposes for which it is used; and
- any other facts throwing light on the parties' true intent.[115]

In *Allum*, the Tax Court also cited to another Tax Court case, *Luna v. Commissioner*,[116] for additional partnership factors:

- whether each party was a principal and co-proprietor;
- whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income (a factor that weighs against a partnership determination);
- whether the parties filed federal partnership returns or otherwise represented to a respondent or to persons they dealt with that they were joint venturers; and
- whether the parties exercised mutual control over, and assumed mutual responsibilities for, the enterprise.[117]

Plainly, one need not satisfy all of those criteria. And it is difficult to rate the importance of each, as none of them is conclusive. Whether the parties intended a partnership "is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct in execution of its provisions."[118] In *Allum*, not one single point was satisfied, leading the Tax Court to the easy conclusion that there was no partnership in that case.

Some practitioners may read *Allum* as setting the bar high for what constitutes a partnership in this context. That reading is erroneous, in my opinion. *Allum* stands only for the proposition that there are many partnership indices, and Allum had not satisfied his evidentiary burden to meet even one of them. That should leave plenty of room for practitioners to do more planning, and to receive partnership tax treatment, even if they fail many of the *Allum* criteria.

Conclusions

The courts have yet to fully consider whether an attorney-client partnership can be created, so the plaintiff can avoid gross income on the portion of a recovery his attorney receives. The Supreme Court in *Banks* failed to fully consider that question. Given the language of the code regarding what constitutes a partnership, the case law, and the check-the-box regulations, it should be possible for such an arrangement to accomplish this goal.

Indeed, I believe the only debatable point is what is necessary to invoke partnership tax treatment. Intent is important. Timing is, too. There are many actions one might take to bolster what might be seen as a partnership in name only. The stakes can be high, and the IRS is likely to be hostile to what it may perceive as sticking a square partnership peg in a round contingent-fee agreement hole. Thus, the more steps you take, the better you may feel.

In reflecting on how much is enough, you may wish to consider:

- executing a written partnership agreement;
- keeping books that reflect the partnership's allocations of contributions and distributions;
- filing a statement of partnership with the county recorder, secretary of state, or other office under state law;
- filing a dba form;
- obtaining an EIN;
- filing a check-the-box form; and
- filing partnership tax returns.

Those actions may all solidify a partnership position that, without at least some of these items, may appear to be a bootstrap. Yet I still do not believe most of those steps are necessary. They may be wise, and *Allum's* litany of partnership traits may make overachievers want to satisfy every point. There is nothing wrong with that.

However, an Olympic performance seems unnecessary when the hurdle to achieving partnership tax treatment appears to be simpler. The IRS and the courts will eventually have to face the question of how much is enough for partnership tax treatment, to allow lawyer and client to be taxable only on their personal shares. In the meantime, plaintiffs and their attorneys should consider the range of possibilities this type of arrangement may offer, particularly for taxpayers who would otherwise be unable to obtain a full tax deduction for their attorney fees.

Finally, how much lawyer and client are willing to do may also hinge at least in part on what other exceptions from the *Banks* general rule may be available. The client may argue that the fee paid to his lawyer is a statutory fee, that it is outside the *Banks* general rule, and that it represents the sole property of the lawyer. The client may also argue that the legal fees (if gross income to the client) arise out of a trade or business and thus could be netted against a recovery on the client's Schedule C. The client may even argue that his recovery is capital rather than

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[115]*Allum v. Commissioner*, T.C. Memo. 2005-177, *33; *see also Commissioner v. Culbertson*, 307 U.S. 733, 742 (1949), *clarification of error in citing to Fifth Circuit*, 194 F.2d 581, 592 (1952).

[116]*See Luna v. Commissioner*, 42 T.C. 1067, 1078 (1964).

[117]*Allum v. Commissioner*, T.C. Memo. 2005-177, *33 (citing *Luna v. Commissioner*, 42 T.C. 1067, 1077-1078 (1964)).

[118]*Commissioner v. Tower*, 66 S. Ct. 532, 536 (1946) (citing *Drennen v. London Assurance Co.*, 113 U.S. 51, 56 (1885)); *see also Estate of Smith v. Commissioner*, 313 F.2d 724, 729 (8th Cir. 1963); *Luna v. Commissioner*, 42 T.C. at 1078.

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ordinary, thus creating the possibility that related legal fees could be offset against such a recovery on the client's Schedule D.

All those issues are likely to go into the mix in assessing the merits of, and need for, a lawyer-client partnership.

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