16 T.C. 105 (1951)

The receipt of funds representing a purchased interest in a contingent legal fee is considered ordinary income, not capital gain, because the collection of the fee does not constitute a “sale or exchange” of a capital asset as required by the Internal Revenue Code.

Summary

Pat Fahey, a member of a law firm, purchased an interest in a contingent legal fee from another attorney involved in ongoing litigation. When the litigation concluded and the fee was paid, Fahey reported his share as a long-term capital gain. The Commissioner of Internal Revenue determined that the income should be treated as ordinary income. The Tax Court agreed with the Commissioner, holding that the collection of the fee was not a “sale or exchange” of a capital asset, a prerequisite for capital gains treatment under Section 117 of the Internal Revenue Code. The court relied on the principle that merely receiving funds due under a contract or debt obligation does not constitute a sale or exchange.

Facts

- In 1942, Pat Fahey joined a law firm that was representing clients in a lawsuit on a contingent fee basis.
- Fahey initially agreed not to participate in the suit or share in its fees due to a conflict of interest.
- Another attorney, Parkerson, was also involved in the case and entitled to half of the contingent fee.
- Due to financial difficulties, Parkerson sold half of his interest in the contingent fee to Fahey and two other members of his firm for $800.
- Fahey contributed to the purchase price, even though his name wasn’t explicitly on the assignment.
- Fahey did not perform any legal work on the case.
- In 1945, the lawsuit was settled, and the firm received fees, a portion of which was attributable to the interest purchased from Parkerson.
- Fahey received $2,916.50, representing his share of the Parkerson fee, and reported a long-term capital gain of $2,649.84 ($2,916.50 – $266.66 (1/3 of $800)).

Procedural History

- The Commissioner of Internal Revenue determined a deficiency in Fahey’s income tax for 1945.
- The Commissioner argued that the entire amount Fahey received from the settlement constituted ordinary income.
- Fahey contested this adjustment, arguing that it should be treated as a long-term capital gain.

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- The Tax Court heard the case to determine the proper tax treatment of the income.

Issue(s)

Whether the gain realized by Fahey from the collection of his purchased interest in a contingent legal fee constitutes a capital gain, eligible for preferential tax treatment under Section 117 of the Internal Revenue Code, or ordinary income?

Holding

No, because the collection of a purchased interest in a contingent legal fee does not constitute a "sale or exchange" of a capital asset as required by Section 117 to qualify for capital gains treatment.

Court's Reasoning

The Tax Court reasoned that even assuming Fahey's purchased interest in the contingent fee was a capital asset, the income he received was not the result of a "sale or exchange." The court emphasized that the relevant section of the Internal Revenue Code (Section 117) defines long-term capital gain as "gain from the sale or exchange of a capital asset." Fahey merely collected his interest in the fee when the underlying litigation was settled; he did not sell or exchange anything to receive the funds. The court distinguished this situation from a scenario where Fahey might have sold his interest in the contingent fee to a third party before the settlement, which could potentially qualify for capital gains treatment. The court cited *Hale v. Helvering*, 85 F.2d 819, which held that the compromise of notes for less than face value does not constitute a sale or exchange. As the court in *Hale* stated, "There was no acquisition of property by the debtor, no transfer of property to him. Neither business men nor lawyers call the compromise of a note a sale to the maker. In point of law and in legal parlance property in the notes as capital assets was extinguished, not sold."

Practical Implications

This case clarifies that the mere receipt of funds representing a right to income, even if that right was purchased, does not automatically qualify the income for capital gains treatment. It emphasizes the importance of the "sale or exchange" requirement in Section 117 of the Internal Revenue Code. Legal practitioners and investors need to be aware that simply buying a right to future income and then collecting on that right will likely result in ordinary income, not capital gains. This ruling affects how legal fees, contract rights, and other similar assets are treated for tax purposes. Later cases applying this principle often involve scenarios where taxpayers attempt to characterize the collection of debts or contractual payments as capital gains. The case illustrates that the form of the transaction matters, and a true sale or exchange must occur to trigger capital gains treatment.

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