Nos. 03-892 and 03-907

# In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

SIGITAS J. BANAITIS

*ON WRITS OF CERTIORARI*
*TO THE UNITED STATES COURTS OF APPEALS*
*FOR THE SIXTH AND NINTH CIRCUITS*

## BRIEF FOR THE PETITIONER

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## QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), 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.

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No. 03-892

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### OPINIONS BELOW

The opinion of the court of appeals in No. 03-892 (*Banks*) (Pet. App. 1a-33a) is reported at 345 F.3d 373. The opinion of the Tax Court (Pet. App. 34a-57a) is unofficially reported at 81 T.C.M. (CCH) 1219.

The opinion of the court of appeals in No. 03-907 (*Banaitis*) (Pet. App. 1a-17a) is reported at 340 F.3d 1074. The opinion of the Tax Court (Pet. App. 18a-33a) is unofficially reported at 83 T.C.M. (CCH) 1053.

### JURISDICTION

The judgment of the court of appeals in No. 03-892 (*Banks*) was entered on September 30, 2003. The

petition for a writ of certiorari was filed on December 19, 2003. The judgment of the court of appeals in No. 03-907 (*Banaitis*) was entered on August 27, 2003. On November 14, 2003, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and including December 29, 2003, and the petition for a writ of certiorari was filed on December 24, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATUTORY PROVISIONS INVOLVED

Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), and Section 87.445 of the Oregon Revised Statutes are reprinted in the appendix to this brief. App., *infra*, 1a-2a.

## STATEMENT

The courts of appeals in these cases held that a taxpayer can avoid inclusion of a portion of litigation proceeds in his gross income by entering into a contingent fee agreement with his attorney. Well established principles of federal tax law make clear, however, that the entire taxable amount of litigation proceeds is includable in a taxpayer's gross income, regardless of whether he has directed that a portion of those proceeds be paid directly to his attorney under a contingent fee agreement.

**No. 03-892.** 1. Respondent John W. Banks, II, worked as an educational consultant for the California Department of Education from 1972 until 1986, when his employment was terminated. In response to his termination, respondent filed a civil action against the state agency and various of its past and present employees in the United States District Court for the Eastern District of California. He claimed (i) that his termination violated state and federal prohibitions

against employment discrimination (42 U.S.C. 1981, 1983; Cal. Gov't Code § 12965 (West Supp. 2003)); and (ii) that, in connection with his termination, the defendants committed slander and intentional infliction of emotional distress. Respondent sought general damages, future medical and hospital expenses, punitive and exemplary damages, back pay and related employee benefits, an injunction, and attorney's fees. Respondent's attorney agreed to represent him in the action for a contingent fee.[1] Pet. App. 2a.

Prior to trial, respondent abandoned his state law tort claims. Pet. App. 3a. On May 30, 1990, after trial had begun, respondent entered into an agreement to settle all of his remaining employment discrimination claims against the defendants for $464,000. Pursuant to the contingent fee agreement, respondent paid $150,000 of the settlement proceeds to his attorney. *Id.* at 4a-5a.

Respondent did not include any of the $464,000 settlement proceeds in his gross income on his 1990 federal income tax return. Pet. App. 5a. On audit, the Commissioner determined that the entire amount of the settlement proceeds constituted gross income to respondent under 26 U.S.C. 61(a). The Commissioner further determined that the amount payable to his attorney pursuant to the contingent fee agreement was a deductible expense in earning that income but, since attorney's fee expenses fall within the category of "miscellaneous itemized deductions," they are not deductible in computing the alternative minimum tax (AMT). See 26 U.S.C. 56(b)(1)(A)(i). As a consequence of these determinations, a tax deficiency in the amount

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[1] The contingent fee agreement was not made part of the record here, but its terms are not disputed. Similarly, it is undisputed that the agreement was executed in California.

of $10,625 was issued for respondent's AMT liability. Pet. App. 35a.[2]

2. Respondent sought review of the Commissioner's determinations in the Tax Court. See J.A. 5-8. The Tax Court agreed with the Commissioner that respondent was required to include the entire settlement proceeds in his gross income, including the portion paid to his attorneys as a contingent fee. The court therefore sustained the Commissioner's determination of respondent's AMT liability. Pet. App. 49a-52a.

3. a. The court of appeals affirmed the Tax Court's holding that the portion of the damages retained by respondent represented taxable income to him. Pet. App. 8a-17a. The court of appeals, however, reversed the Tax Court's decision that respondent was required to include in his gross income the portion of the settlement proceeds paid to his attorney under the contingent fee agreement. Pet. App. 17a-25a.

The contingent fee agreement involved in this case was made under California law. In *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001), the Ninth Circuit held that, "[u]nder California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 943. The Ninth Circuit therefore concluded that the portion of the damages paid to the attorneys under a contingent fee agreement

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[2] In addition, the Commissioner determined that the portion of the damages award that respondent received and retained was taxable income that is not exempt from tax as a recovery for "personal injuries" under Section 104 of the Code, 26 U.S.C. 104 (2000 & Supp. I 2001). The courts below upheld that determination. Pet. App. 8a-17a; see *United States* v. *Burke*, 504 U.S. 229, 239-241 (1992).

in California was part of the gross income of the plaintiff.

In the present case, the Sixth Circuit accepted the Ninth Circuit's holding in *Benci-Woodward* that "California's lien statute confers no ownership interest on attorneys" and that "[c]ontingent fee contracts do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery." Pet. App. 23a (quoting *Benci-Woodward*, 219 F.3d at 943 (internal quotation marks omitted)). The Sixth Circuit disagreed, however, with the ultimate conclusion reached by the Ninth Circuit in *Benci-Woodward*. The court stated that it instead found "persuasive" the reasoning of the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353 (2000), that the federal tax consequences of a contingent fee "do[] not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." Pet. App. 23a-24a (quoting *Srivastava*, 220 F.3d at 364). The Sixth Circuit stated that "[w]e likewise are not inclined to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated." *Id.* at 24a. Given the variations in state law treatment of attorney's liens, "such a 'state-by-state' approach would not * * * provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards." *Ibid.*

The Sixth Circuit had previously held in *Estate of Clarks* v. *United States*, 202 F.3d 854 (2000), that the portion of a lawsuit recovery paid as contingent attorney's fees in Michigan should be excluded from the plaintiff's gross income. The Sixth Circuit concluded in this case that *Estate of Clarks* did not "primarily rest on the rationale that separate state lien laws governing

attorneys' rights determine the correct characterization of an attorney contingency fee." Pet. App. 25a. Accordingly, the court concluded that *Estate of Clarks* was controlling here, "notwithstanding the difference in Michigan's and California's respective attorney's lien laws." *Ibid.* The court made clear that, under its view of the law, there was no need for "protracted inquiries into 'the intricacies of an attorney's bundle of rights.'" *Ibid.* (quoting *Srivastava*, 220 F.3d at 364).

The court thus concluded that the $150,000 portion of respondent's recovery that was paid to his attorney as a contingent fee was not part of his gross income and therefore not subject to tax under the Internal Revenue Code. Pet. App. 25a.

b. Judge Moore dissented on the ground that "California law, as explained by the California Supreme Court and the Ninth Circuit [in *Benci-Woodward*], clearly treats the attorney's contingency-fee contract as simply a security interest and not as an ownership interest." Pet. App. 32a. Accordingly, she concluded that "the proceeds the taxpayer paid to his attorney as a contingency fee should be included in the taxpayer's income." *Ibid.*

**No. 03-907.** 1. From 1980 until late 1987, respondent Sigitas J. Banaitis, an Oregon resident, worked as a vice president and loan officer for the Bank of California. In his job, respondent had access to confidential financial information regarding the loan customers with which he worked. To ensure the security of this information, respondent and the Bank of California executed confidentiality agreements. Pet. App. 1a-2a.

In 1984, Mitsubishi Bank acquired a controlling interest in the Bank of California. Mitsubishi Bank's parent company controlled and operated firms that competed with a number of respondent's loan customers. In

anticipation of the potential exposure of sensitive financial information that could result from the acquisition, respondent's loan customers requested that he keep their financial information confidential. Respondent complied with their wishes, and he refused to disclose confidential data when asked to do so by employees of Mitsubishi Bank and the Bank of California. Pet. App. 2a.

Soon thereafter, respondent received a performance review at the Bank of California that accused him of dishonesty and improper conduct. After that review, he was placed on probation by the Bank. By December 1987, his work situation had grown intolerable and he left his job. Pet. App. 2a-3a.

2. In November 1989, respondent retained attorneys to pursue legal action against Mitsubishi Bank and the Bank of California. Respondent entered into a contingent fee agreement with his attorneys. Under the agreement, the attorneys were to receive one-third of any recovery prior to commencement of a trial or arbitration and forty percent thereafter. Pet. App. 3a.

Respondent filed a lawsuit against Mitsubishi Bank and the Bank of California in state court in Oregon. His suit alleged that Mitsubishi Bank intentionally and willfully interfered with his employment agreement with the Bank of California, and further alleged that the Bank of California had wrongfully discharged him and improperly attempted to force him to breach his fiduciary duty to his customers. Pet. App. 4a.

The state court jury found in respondent's favor on his wrongful discharge and tortious interference with contract claims. The jury awarded respondent $196,389 for lost compensation and $450,000 for lost future compensation; a total of $625,000 for "noneconomic" damages attributable to emotional distress and injury to

reputation; and a total of $5 million in punitive damages. The defendants were held to be jointly and severally liable for the economic damages award and severally liable for their portions of the noneconomic and punitive damages awards. Pet. App. 4a-5a.

3. In response to post-trial motions, the trial court set aside the punitive damages award against each defendant. All parties then appealed to the Oregon Court of Appeals. Pet. App. 5a. In connection with the appeal, respondent entered into a second fee agreement with his attorneys. Under that revised agreement, the attorneys were to receive, as compensation for their services, 50% of all compensatory damages and 42.9% of all punitive damages. *Ibid.*

4. The Oregon Court of Appeals affirmed the award of compensatory damages and reversed the trial court order that set aside the jury's punitive damages award. *Banaitis* v. *Mitsubishi Bank, Ltd.*, 879 P.2d 1288 (1994). Mitsubishi Bank and the Bank of California then sought review in the Oregon Supreme Court, which initially granted review but subsequently dismissed review as improvidently granted. *Banaitis* v. *Mitsubishi Bank, Ltd.*, 900 P.2d 508 (Or. 1995). See Pet. App. 5a-6a.

Shortly thereafter, the parties entered into a confidential settlement agreement. Pursuant to the settlement agreement, Mitsubishi Bank and the Bank of California issued checks that together totaled $8,728,559: the Bank of California paid $3,864,012 directly to respondent's attorneys and Mitsubishi Bank paid the remaining $4,864,547 directly to respondent. Pet. App. 6a.

5. On his 1995 income tax return, respondent did not include in his gross income any part of the $3,864,012 settlement proceeds paid to his attorneys. The Commissioner determined that $8,103,559 of the settlement

proceeds constituted gross income to respondent under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a). The Commissioner further determined that the amount paid to his attorneys pursuant to the contingent fee agreement was a deductible expense, but that such deductions are given no consideration in computing the AMT. The Commissioner accordingly determined a deficiency of $288,798 in respondent's AMT liability. Pet. App. 7a.

Respondent sought review of the Commissioner's determination in the Tax Court. The Tax Court agreed with the Commissioner that respondent was required to include in his gross income the entire settlement relating to economic damages and punitive damages, including the portion paid to his attorneys as a contingent fee. The court therefore sustained the Commissioner's determination of respondent's AMT liability. Pet. App. 8a, 18a-33a.

6. The court of appeals agreed with the Tax Court that "the portions of the settlement representing economic and punitive damages were to be included in the taxpayer's gross income" and rejected respondent's claim that they fell within the exclusion from income for "damages * * * received * * * on account of personal physical injuries" (26 U.S.C. 104(a)(2)). Pet. App. 8a. The court further held, however, that "[t]he Tax Court erred in holding that the attorneys fees paid to [the attorneys] should be included in [respondent's] gross income total." *Id.* at 12a.

On the attorney's fee issue, the court noted that it had held in *Coady* v. *Commissioner*, 213 F.3d 1187, 1190 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001), and in *Benci-Woodward*, 219 F.3d at 943, that the portion of damages paid as attorney's fees under contingent fee agreements made in Alaska and California,

respectively, *must* be included in the taxpayers' gross incomes, because Alaska and California law did not provide the attorney with an ownership interest in the litigant's cause of action or with any right or power over the suit. See Pet. App. 12a-13a. In those decisions, the Ninth Circuit had distinguished cases in other circuits that had reached the opposite conclusion. See *Coady*, 213 F.3d at 1190 (distinguishing, *inter alia*, *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), which held that, under Alabama law, attorney acquired ownership of a portion of client's cause of action and therefore attorney's fees portion of award was excludable from gross income).

In this case, however, the Ninth Circuit held that, under Oregon law, the portion of respondent's recovery that was paid to his attorneys pursuant to the contingent fee agreement was not includable in his gross income. The court distinguished its prior decisions in *Coady* and *Benci-Woodward* by stating that Oregon law with respect to contingent attorney's fees "is unlike the laws of California and Alaska." Pet. App. 15a. The court opined that the statutory lien for attorney's fees under Oregon law "mirrors Alabama law [at issue in *Cotnam* v. *Commissioner*, *supra*] in that it affords attorneys generous property interests in judgments and settlements." *Ibid.* The court stated (*ibid.*) that "[u]nlike California and Alaska law, an attorney's lien in Oregon is 'superior to all other liens' except 'tax liens.' O.R.S. § 87.490." It further noted (Pet. App. 15a-16a) that "Oregon law, like Alabama law, provides that attorneys shall have 'the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount of judgment due thereon to them.' O.R.S. § 87.480." In fact, the court asserted, "Oregon

goes even further than does the Alabama law at issue in *Cotnam*," by "recogniz[ing] that an attorney has a right to sue a third party for attorneys fees that were left unsatisfied by a private settlement with the attorney's clients." Pet. App. 16a (citing *Potter* v. *Schlesser Co.*, 63 P.3d 1172, 1174 (Or. 2003)). Thus, the court concluded, "[b]ecause of the unique features of Oregon law," the contingent attorney's fees portion of respondent's settlement proceeds was not to be included in his gross income for federal income tax purposes. *Ibid.*

## SUMMARY OF ARGUMENT

1. As a matter of federal law, the contingent-fee portions of the proceeds from respondents' suits are includable in their gross income. It is a fundamental rule of taxation that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). It is similarly well settled that, when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929). Thus, as the Court explained in *Helvering* v. *Horst*, 311 U.S. 112, 116-117 (1940), "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." Accordingly, where a taxpayer assigns to another "an obligation to pay compensation" to the taxpayer, he has "divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants" and is subject to tax on the diverted proceeds. *Id.* at 117, 118.

Here, respondents had the sole power to assert and to settle their claims; their claims sought recoveries in the form of taxable income; and the settlement proceeds represent the value given in exchange for the dismissal of respondents' claims. Respondents therefore controlled—and, indeed, were—"the source of the income" at issue, and they "divert[ed] the payment [of a portion of that income] from [themselves] to others as the means of procuring the satisfaction of [their] wants." *Horst*, 311 U.S. at 116-117. Accordingly, whatever the precise nature and scope of the right obtained by an attorney pursuant to a contingent fee agreement, the proceeds from respondents' litigation awards are "recover[ies] of lost income; the attorney fees [they] paid represent expenses incurred in generating that income"; and "[l]ike any other taxpayer, [respondents] must report the entire amount as gross income." *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312, 1314 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002).

2. The Sixth Circuit below attempted to distinguish those fundamental principles of federal tax law, but its efforts are unavailing. As this Court's decision in *Lucas* v. *Earl*, *supra*, makes clear, the fact that respondents had only an "intangible contingent expectancy" at the time they entered into their contingent fee agreements provides no justification for deviating from those principles, because *Earl* itself involved an intangible, contingent interest.

Equally misguided is the Sixth Circuit's suggestion (03-892 Pet. App. 24a-25a) that a contingent fee agreement operates "like a partnership or joint venture" and "transfer[s] some of the trees from the [plaintiff's] orchard [to the attorney], rather than simply transferring some of the orchard's fruit." As the agreements in these cases demonstrate, a contingent fee agreement is

merely a promise by the client to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered; the relationship between the client and his attorney is simply that of debtor and creditor. Even if the contingent fee agreement could be characterized as effecting an assignment to the attorney, moreover, at most it would be an assignment of "an obligation [on the part of the defendant] to pay compensation" to the plaintiff, *Horst*, 311 U.S. at 117, and thus would not reduce the gross income of the assignor. And even if the contingent fee agreement could be viewed as assigning an ownership interest in an income-producing asset to the attorney—which it plainly cannot—the same result would obtain. Respondents at all times exercised sufficient power and control over both the underlying causes of action and the receipt of the income to make it reasonable to treat the entire awards as gross income.

3. Even if this Court were to follow the approach of some courts of appeals and look to state law to determine the tax treatment of the contingent-fee portion of the litigation proceeds in these cases, reversal would still be required. California law is clear that the relationship between respondent Banks and his attorney was simply that of debtor and creditor, rather than partners or co-proprietors. Therefore, the entire amount of respondent Banks's litigation award must be included in his gross income.

Similarly, Oregon law does not confer on the attorney any ownership interest in his client's cause of action or otherwise give the attorney control over the action. Rather, it defines the attorney's interest in his fees as nothing more than that of a lienholder, not that of a part-owner or co-venturer. The concepts of lienholder and property owner necessarily are mutually exclusive,

because a property owner cannot have a lien on his own property. Thus, even taking into account Oregon's laws protecting an attorney's interest in his fees, it is clear that respondent Banaitis retained sufficient control over the amount and timing of the contingent fee to require inclusion of the entire taxable portion of his litigation award in his gross income.

## ARGUMENT

### I. AS A MATTER OF FEDERAL LAW, THE CONTINGENT-FEE PORTION OF A DAMAGES RECOVERY IS INCLUDED IN THE LITIGANT'S TAXABLE INCOME UNDER SECTION 61(a) OF THE INTERNAL REVENUE CODE

Fundamental, long-standing principles of federal tax law compel the conclusion that litigation proceeds do not lose their status as income to the successful litigant merely because they are paid as fees to the litigant's attorney. The tax treatment of contingent fees is a question of federal law, because, although state law is relevant to defining the taxpayer's interest in property, "the tax consequences [of the receipt or disposition of property] are dictated by federal law." *United States* v. *National Bank of Commerce*, 472 U.S. 713, 722 (1985). Federal tax law makes clear that income is taxed to the person who earned it—here, the plaintiff whose lawsuit is predicated on his right to recover lost wages or other taxable income to which he is entitled by law—regardless of any arrangements made by the taxpayer transferring the right to receive that income to a third party. Accordingly, the courts below erred in excluding from gross income the portions of the litigants' recoveries that were paid to their attorneys.

### A. The Tax Treatment Of The Contingent-Fee Portion Of A Damages Recovery Is A Question Of Federal, Not State, Law

The determination whether an amount is includable in gross income is governed by Section 61(a) of the Internal Revenue Code (26 U.S.C. 61(a)), which provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." That statutory definition of gross income is "sweeping" in its scope, reflecting Congress's intent to exert "the full measure of its taxing power." *Commissioner* v. *Schleier*, 515 U.S. 323, 327-328 (1995); *Helvering* v. *Clifford*, 309 U.S. 331, 333 (1940). This Court has therefore given a "liberal construction" to this "broad" definition of gross income "in recognition of the intention of Congress to tax *all* gains except those specifically exempted." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955) (emphasis added).[3]

Section 61(a), like the Internal Revenue Code more generally, "creates no property rights but merely attaches consequences, federally defined, to rights created under state law." *National Bank of Commerce*, 472 U.S. at 722 (quoting *United States* v. *Bess*, 357 U.S. 51, 55 (1958)). Accordingly, although state law determines the nature of legal interests in property, federal law determines the tax consequences of the receipt or disposition of property. See *ibid.*; *Aquilino* v. *United*

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[3] Recoveries for "personal physical injuries or physical sickness" are excluded from gross income. 26 U.S.C. 104(a)(2). Where that exclusion applies, of course, the issue presented here does not arise. Both courts of appeals held that respondents' recoveries do not fall within that exclusion. 03-892 Pet. App. 8a-17a; 03-907 Pet. App. 8a. Respondents did not petition this Court to review that issue, nor did they raise it in their briefs in opposition, and accordingly it is not before the Court. See Sup. Ct. R. 15.2.

*States*, 363 U.S. 509, 513-514 (1960). As this Court has explained, "'[o]nce it has been determined that state law creates sufficient interests in the [taxpayer] to satisfy the requirements of [the federal revenue statute], state law is inoperative,' and the tax consequences thenceforth are dictated by federal law." *National Bank of Commerce*, 472 U.S. at 722 (citation omitted).

There is no doubt that, under any view of state law, respondents were the sole plaintiffs in their causes of action and would have been required to include the entire taxable proceeds from those causes of action in their gross income if the proceeds had been paid directly to them. Indeed, by their nature, the basis of respondents' claims was the recovery of lost income. It necessarily follows, therefore, that the recoveries based on those claims represented income to respondents. As this Court explained in *Commissioner* v. *Sunnen*, 333 U.S. 591, 604 (1948), "[a]s long as the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income, he remains taxable."

The only remaining question is whether a plaintiff can reduce his gross income by arranging to have a portion of those proceeds paid directly to his attorney pursuant to a contingent fee contract. As the Second, Fourth, Seventh, and Tenth Circuits have correctly concluded, the question of the tax treatment of the contingent-fee portion of a damages recovery is fundamentally a matter of federal, not state, law. See *Raymond* v. *United States*, 355 F.3d 107 (2d Cir. 2004), petition for cert. pending, No. 03-1415 (filed Apr. 9, 2004); *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Kenseth* v. *Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312

(10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002).[4] The Fourth Circuit in *Young*, for example, explained that "whether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action." 240 F.3d at 378.

Similarly, the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353 (2000), emphasized that the fact that one State may "give[] its contingent fee *attorneys*

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[4] The First and Third Circuits also appear to have adopted the view that federal, not state, law governs the tax treatment of the contingent-fee portion of the proceeds of a lawsuit. Thus, in *Alexander* v. *IRS*, 72 F.3d 938, 944-946 (1995), the First Circuit held that the contingent-fee portion of a taxable damages recovery was includable in the taxpayer's gross income under federal tax law principles without any reference to state law.

The Third Circuit, in *O'Brien* v. *Commissioner*, 319 F.2d 532, cert. denied, 375 U.S. 931 (1963), affirmed the decision of the Tax Court, 38 T.C. 707 (1962), which, among other things, had held that the tax treatment of the contingent-fee portion of a litigation award for back pay was a question of federal law. After noting that "there is room for argument * * * under Pennsylvania law" about the attorney's interests in the recovery and the underlying suit, the Tax Court concluded: "[I]t [is] doubtful that the Internal Revenue Code was intended to turn upon such refinements. For, even if the taxpayer had made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto even for a split second, it would still be gross income to him under the familiar principles of *Lucas* v. *Earl*, 211 U.S. 111, *Helvering* v. *Horst*, 311 U.S. 112, and *Helvering* v. *Eubank*, 311 U.S. 122." *O'Brien*, 38 T.C. at 712. In its per curiam order, the court of appeals stated that "the decision of the Tax Court is correct in all respects," and it therefore "affirmed [based] on the excellent opinion of" the Tax Court. 319 F.2d at 532.

a greater degree of power to enforce their rights than does" another "should not affect the analysis required by the [federal] anticipatory assignment of income doctrine, which looks to the *taxpayer's* degree of control and dominion over the asset." *Id.* at 363-364 (emphases added). Thus, although the Fifth Circuit in *Srivastava* recognized that it could not decide that case "on a clean slate," but instead was required to "follow the contrary approach [it] endorsed in *Cotnam*," it went out of its way to note that "were we to decide this case as an original matter, we might apply the [federal] anticipatory assignment doctrine to hold that contingent fees are gross income to the client." *Id.* at 363.

Even the Sixth Circuit below correctly concluded that the proper tax treatment of contingent fee proceeds "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." 03-892 Pet. App. 23a-24a (citation omitted). But unlike each of the circuits discussed above, the Sixth Circuit held that as a matter of federal law such proceeds are never includable in the litigant's gross income. *Id.* at 25a. That approach is plainly mistaken.

### B. This Court's Decisions Require That Income Be Taxed To The Person Who Earned It, Notwithstanding Any Attempt To Transfer The Right To Receive Such Income To Another

#### *1. The Assignment-Of-Income Doctrine Ensures Taxation Of Income To The Person Who Earns It Or Is The Source Of The Right To Receive And Enjoy It*

It is axiomatic that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S.

111, 114-115 (1930); *Helvering* v. *Horst*, 311 U.S. 112, 115-116 (1940). For example, in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), the taxpayer's employer paid all the income taxes on the taxpayer's salary directly to the Government, and the taxpayer excluded the payment from his gross income on the ground that the payment was not made to him. The Court held that, because the payment was made in consideration of services rendered by the taxpayer, the payment was includable in the taxpayer's gross income, notwithstanding that it had been made by the taxpayer's employer directly to the Government. The Court explained that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.* at 729.

In *Lucas* v. *Earl*, *supra*, this Court established that a taxpayer cannot avoid the rule that income is taxed to the person who earns it by making an anticipatory assignment of income, even where the taxpayer assigns income that he has not yet earned the right to receive. In *Earl*, a husband and wife contracted in 1901 that they would hold all of their future income as joint tenants. Based on that contract, the husband reported on his tax returns only one-half of the income he had earned in 1920 and 1921. The Court held that, notwithstanding the husband's anticipatory assignment of his income, he was required to include in his gross income the entire amount of his earnings during the years at issue. Writing for the Court, Justice Holmes explained that the "import" of the income tax statutes was to "tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." 281 U.S. at 114-115.

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 simply by shifting income to a lower-bracket taxpayer. This apparently was not the intention of the husband and wife in *Earl* (their 1901 assignment predated the income tax), but the Court declined to give weight to "the motives leading to the arrangement," 281 U.S. at 115, presumably because such a "motives" test would be judicially intractable and subject to abuse. See *Raymond*, 355 F.3d at 112.

This Court reaffirmed and further explained the assignment-of-income doctrine in *Helvering* v. *Horst*, *supra*, where the taxpayer made a gift of bond coupons (reflecting the right to receive interest payments) to his son, while retaining the bonds for himself. The son redeemed the coupons in the same year, receiving in return the interest payments due. The taxpayer excluded from his gross income the coupon redemption proceeds paid to his son. 311 U.S. at 114. The Court held that, notwithstanding the fact that the redemption proceeds were paid to the son, the taxpayer was obligated to include them in his gross income. *Id.* at 120. Writing for the Court, Justice Stone explained that "[t]he power to dispose of income is the equivalent of ownership of it." *Id.* at 118. Because the taxpayer had retained control of the bonds, he retained control of the source of the income, and in those circumstances a taxpayer "has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." *Id.* at 117.

In so holding, the Court in *Horst* distinguished between the assignment of "income-producing property"

and the assignment of income derived from "an obligation to pay compensation" to the taxpayer. *Horst*, 311 U.S. at 118. When a taxpayer assigns all of his rights to income-producing property, he is not properly treated as the recipient of income subsequently derived from the property; in such a case, the taxpayer has wholly relinquished control over the disposition of the future income. But when he assigns the right to receive income derived from an obligation to pay compensation *to him*, he is properly treated as the recipient of the income despite having "shifted" it to another.

The Court in *Horst* also emphasized that the "realization" of income—*i.e.*, the "gain" derived from control of income-producing property or from an obligation to pay compensation—can take many forms. The key is that through controlling the disposition of income, the taxpayer has received the benefit thereof, and is accordingly subject to tax. Referring to the taxpayer's gift of interest coupons in *Horst*, the Court explained that when a taxpayer uses his "right to receive income[] to procure a satisfaction which can be obtained only by the expenditure of money or property," he has "enjoy[ed] * * * the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son." 311 U.S. at 117. That is true, moreover, even though the taxpayer "never receives the money," because "he derives money's worth from the disposition of the [income] which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth." *Ibid.* The taxpayer in *Horst* enjoyed "the economic benefit" from his right to receive income from the

coupons "as completely as * * * if he had collected the interest in dollars and expended them for any of the purposes named." *Ibid.*

Thus, where a taxpayer assigns income-producing property to another, thereby relinquishing all control over it, that taxpayer gives up the power to use that property in such a way as to realize a gain. But where a taxpayer retains control over an income-producing asset, that taxpayer has the power to gain through the satisfaction of assigning its income to whomever he pleases. Such a gain is gross income. *Horst*, 311 U.S. at 117; see *Sunnen*, 333 U.S. at 610 (assignments of license contracts merely involved a transfer of the right to receive income rather than a complete disposition of all the taxpayer's interest in the contracts and royalties from the contracts; "[t]he existence of the taxpayer's power to terminate those contracts and to regulate the amount of the royalties rendered ineffective for tax purposes his attempt to dispose of the contracts and royalties"). Likewise, where a taxpayer assigns to another "an obligation to pay compensation" to the taxpayer, *Horst*, 311 U.S. at 118, the taxpayer has "divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants" and is therefore subject to tax on the diverted proceeds, *id.* at 117.

**2. As Most Courts Of Appeals To Consider The Question Have Held, All Taxable Litigation Proceeds Must Be Included In The Plaintiff's Gross Income**

The majority of the courts of appeals that have addressed the question have correctly held that the fundamental tax principles discussed above mandate the inclusion of the entire amount of a taxable damages recovery, including the portion of the recovery paid to

the plaintiff's attorney pursuant to a contingent fee agreement, in the plaintiff's gross income under Section 61 of the Internal Revenue Code. *Raymond*, 355 F.3d at 112 (Second Circuit); *Hukkanen-Campbell*, 274 F.3d at 1314 (Tenth Circuit); *Kenseth*, 259 F.3d at 883 (Seventh Circuit); *Young*, 240 F.3d at 378 (Fourth Circuit); *Baylin* v. *United States*, 43 F.3d 1451 (Fed Cir. 1995); *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g 38 T.C. 707 (1962), cert. denied, 375 U.S. 931 (1963). See also *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001); *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001). But see *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959).

As the Second Circuit explained in *Raymond*, "[t]he analysis of whether something is 'gross income' begins with whether it can reasonably be considered a 'gain' to the taxpayer under 26 U.S.C. 61(a)." 355 F.3d at 115 (citing *Glenshaw Glass*, 348 U.S. at 429-430). The fact that the taxpayer, in light of his assignment, never actually receives the funds, or even that he has no right to receive them in light of a lien placed on them under state law, does not preclude those funds from being considered a gain to the taxpayer and therefore part of his gross income. As this Court's decision in *Horst* makes clear, "a taxpayer can realize a gain subject to taxation where, although he 'never receives the money, he derives money's worth from the disposition of [the source of the income] which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth.'" *Ibid.* (quoting *Horst*, 311 U.S. at 117). Respondents "control[led] the source of the income

[and] * * * divert[ed] the payment from [themselves] to others as the means of procuring the satisfaction of [their] wants." *Horst*, 311 U.S. at 116-117. Specifically, they diverted a portion of their recovery of income to their attorneys in the furtherance of receiving the remainder of that recovery for themselves, which was "certainly a result 'procurable only by the expenditure of money or money's worth.'" *Raymond*, 355 F.3d at 115 (quoting *Horst*, 311 U.S. at 117).

Whatever the precise nature and scope of the right obtained by an attorney pursuant to a contingent fee agreement, it remains true that the plaintiff's right to a recovery from the defendant is, by definition, a claim for a recovery that would unquestionably be includable in gross income if paid to the plaintiff.[5] As the Tenth Circuit explained in *Hukkanen-Campbell*, 274 F.3d at 1314, "irrespective of a particular state's attorney lien statute's provisions," the proceeds from respondents' litigation awards are "recover[ies] of lost income; the attorney fees [they] paid represent expenses incurred in generating that income." Accordingly, "[l]ike any other taxpayer, [respondents] must report the entire amount as gross income, and, but for the AMT's provisions, [they] would be allowed to deduct [their] attorney fees as an expense." *Ibid.; Helvering* v. *Eubank*, 311 U.S. 122 (1940).

As Judge Posner explained for the Seventh Circuit in *Kenseth* v. *Commissioner*, 259 F.3d at 883, moreover, the fact that respondents elected to pay their attorneys

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[5] Not every type of litigation recovery constitutes gross income to the plaintiff within the meaning of the Internal Revenue Code. The question presented in these cases, accordingly, arises only in cases, like those at issue here, in which the plaintiff is seeking a recovery that would qualify as gross income in one form or another.

a contingent rather than a fixed fee provides no basis for excluding those fees from respondents' gross income. Rather, like the taxpayer in *Kenseth*, respondents "concede[] * * * that had [they] paid the law firm[s] on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, [their] gross income." *Ibid.* With respect to their tax liabilities, it makes no difference "that the expense happened to be contingent rather than fixed." *Ibid.*

In sum, it is undisputed that respondents had the sole power to assert and settle their causes of action; that the sums they claimed fell within the category of taxable income; and that the settlement proceeds represented the value given in exchange for the dismissal of their claims. The entire taxable amount of those proceeds is therefore income to respondents, subject to whatever deductions are allowable under the Code. *Hukkanen-Campbell*, 274 F.3d at 1313-1314; *Kenseth*, 259 F.3d at 884-885; *Young*, 240 F.3d at 378; *Raymond*, 355 F.3d at 115. That Congress has not seen fit to allow any deduction for attorney's fees for purposes of the AMT provides no basis to create the fiction, as did the courts of appeals below, that the gross income received by a plaintiff from the successful prosecution of a cause of action includes only the net amount recovered after payment of the plaintiff's attorney's fees. *Raymond*, 355 F.3d at 115; *Kenseth*, 259 F.3d at 883; *Hukkanen-Campbell*, 274 F.3d at 1314; see *Alexander* v. *IRS*, 72 F.3d 938, 944-946 (1st Cir. 1995).

### C. Respondents' Attempts To Distinguish The Tax Principles Established By *Old Colony*, *Earl*, And *Horst* Are Unavailing

In reaching its erroneous conclusion that the portion of respondent Banks's damages recovery paid at his direction to his attorney is not part of his gross income, the Sixth Circuit did not attempt to refute the settled law in California (where Banks's contingent fee agreement was executed) that the attorney acquired only a lien, and not a proprietary interest, in the cause of action under the contingent fee agreement. See *Benci-Woodward*, 219 F.3d at 943; see also *Isrin* v. *Superior Court of Los Angeles County*, 403 P.2d 728 (Cal. 1965); *Cooper* v. *Equity Gen. Ins.*, 268 Cal.Rptr. 692, 696 (Ct. App. 1990) ("[a] contingent fee contract does not transfer to the attorney any rights to the client's cause of action, but rather gives the attorney a lien on the client's prospective recovery"). Instead, the Sixth Circuit, alone among all of the courts of appeals that have addressed the question, held that gross income as defined in Section 61(a) *never* includes the portion of a taxable damages recovery that is paid to the plaintiff's attorney under a contingent fee agreement.

The Sixth Circuit concluded that its across-the-board exclusion for the portions of damages awards paid to plaintiffs' attorneys under contingent fee agreements was not precluded by the decisions of this Court in *Old Colony*, *Earl*, and *Horst* and was justified by the following factors: (1) the plaintiff's claim, at the time the contingent fee agreement is signed, is "an intangible, contingent expectancy"; (2) the plaintiff's claim is "like a partnership or joint venture" in which the plaintiff assigns away part of his claim in hope of recovering the remaining portion; (3) no "tax-avoidance purpose" is

at work in a contingent fee arrangement; and (4) "double taxation would otherwise result by including the contingency fee in taxpayer's income." 03-892 Pet. App. 24a (citation omitted); see 03-892 Br. in Opp. 3-4, 6-8 (repeating Sixth Circuit's arguments). None of those four factors, however, which the court derived from its earlier decision in *Estate of Clarks*, provides any justification for the Sixth Circuit's refusal to follow the fundamental rule of taxation that income is taxed to the person who earns it, even when it is paid at that person's direction to someone else.

***1. The Contingent Nature Of The Fee Provides No Basis For An Exclusion From Gross Income***

Contrary to the Sixth Circuit's conclusion, it is of no moment that, at the time a contingent fee agreement is executed, the client has no right to receive any income, but instead has only an unproven claim that he is entitled to income. *Earl* itself concerned an uncertain, future right to receive income. There, the husband and wife agreed to co-own any future income each might earn. At the time of the agreement, the amount of future income, if any, was necessarily uncertain. The question before this Court in *Earl* therefore was whether an *anticipatory* assignment of income, *i.e.*, an assignment made of contingent *future* income that had not yet been earned or even ascertained by the taxpayer-assignor, would be effective to shift the incidence of tax away from the taxpayer on subsequently earned income that was paid directly to the taxpayer's assignee. The Court answered that question in the negative. As the Second Circuit concluded in *Raymond*, "[i]n both this case and *Earl*, the taxpayers assigned the right to receive a portion of as yet unascertained income to another. And in both cases, the

assignment was 'ineffective to shift . . . tax liability.'" 355 F.3d at 117 (citation omitted); see *Baylin*, 43 F.3d at 1455 ("That 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 * * *. 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.").

Similarly, this Court applied the assignment-of-income doctrine in *Commissioner* v. *Sunnen*, 333 U.S. at 594, 603-610, to an assignment of royalty contracts that provided for a royalty of 10% of gross sales of certain devices, even though the agreements did not require the manufacture or sale of any particular number of devices and did not specify a minimum amount of royalties. Indeed, the fact that the amount of royalties was uncertain and would turn, in large part, on the actions of the assignor was a significant factor in support of the Court's conclusion that the assignor retained sufficient control over the income that the funds should be included in his gross income. The same is true here: although the amount of the recovery, and hence the contingent fee, was uncertain at the time the fee agreement was executed, respondents, by retaining the ultimate authority to decide whether and when to settle and for how much, enjoyed substantial control over the amount and timing of the contingent fee. Thus, even assuming *arguendo* that a contingent fee agreement could be considered to be an assignment of a portion of the income that the client expects to realize in the future, *Earl* is controlling and requires the client to

include in his gross income the entire taxable amount recovered on his cause of action.

***2. A Contingent Fee Arrangement Does Not Provide The Attorney An Ownership Interest In His Client's Action Or Otherwise Convert The Attorney-Client Relationship Into A Partnership Or Joint Venture***

Equally misconceived is the Sixth Circuit's suggestion (03-892 Pet. App. 24a-25a) that a contingent fee agreement operates "like a partnership or joint venture" and that "[b]y signing the contingency fee agreement * * * [respondent] transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit." There is no authority (and none was cited by the Sixth Circuit below) supporting the notion that when respondent signed the contingent fee agreement in California he thereby formed a partnership or joint venture with his attorney, or otherwise transferred to his attorney a proprietary interest in his cause of action.

To the contrary, it is clear that a contingent fee agreement does not even effect an actual assignment of the client's future income to his attorney. See *Kenseth*, 259 F.3d at 884; *Young*, 240 F.3d at 378. Instead, it merely constitutes a promise by the client to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered. *Ibid.* The relationship between the client and his attorney is simply that of debtor and creditor. Although States provide attorneys with a lien on the proceeds of the client's cause of action, the effect of such a lien is merely to make the attorney a secured creditor, rather than a general one. It does not provide the attorney with a proprietary interest in the client's cause of action. See *Young*, 240 F.3d at 378 n.7.

Indeed, the concepts of lienholder and property owner are mutually exclusive, since a property owner obviously cannot have a lien on his own property. See *Black's Law Dictionary* 933 (7th ed. 1999) (defining "lien" as "[a] legal right or interest that a creditor has *in another's property*, lasting usu[ally] until a debt or duty that it secures is satisfied" (emphasis added)). 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. See 279 U.S. at 729 ("The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."); see also *Hukkanen-Campbell*, 274 F.3d at 1313-1314; *Baylin*, 43 F.3d at 1454.

Moreover, even assuming—contrary to the foregoing principles—that a contingent fee agreement could properly be characterized as "an assignment of a portion of the potential judgment" to the attorney (03-892 Pet. App. 21a), that would not convert the attorney-client relationship into a partnership or provide any other basis for creating an exception to the assignment-of-income doctrine. The "judgment" in this context is nothing more than the plaintiff's judicially determined right to receive income from the defendant. Any assignment of a portion of that right, therefore, is necessarily an assignment *of income* subject to the rule in *Earl* and *Horst*. The fact that the attorney agrees to provide services under the contingent fee agreement in order to enforce the defendant's obligation to pay compensation to the plaintiff is not a legitimate basis on which to distinguish *Earl* and *Horst*. The litigant in a contingent-fee case "controls the source of the income [and] * * * diverts the payment from himself to

others as the means of procuring the satisfaction of his wants." *Horst*, 311 U.S. at 116-117. As the Second Circuit put it in *Raymond*, "[h]e divert[s] a portion of his judgment to his attorney in the service of receiving the remainder of that judgment—certainly a result 'procurable only by the expenditure of money or money's worth.'" 355 F.3d at 115 (quoting *Horst*, 311 U.S. at 117).

Nor does the fact that the attorney must perform services in order to generate any recovery of income on the taxpayer's cause of action justify treating contingent fees differently from fixed attorney's fees. The attorney's efforts are equally necessary to the realization of income regardless of whether he is paid a fixed or contingent fee. As the Seventh Circuit noted in *Kenseth*, a litigant "no more relinquishe[s] control of the claim to his contingent-fee lawyer than he [does] to a fixed-fee lawyer. He could fire either one and would owe either one for work done but not paid for." 259 F.3d at 884.

In any event, even if a contingent fee agreement could be viewed as an "assignment" of "income-producing property" within the meaning of *Horst*—which it plainly cannot—the result would be the same. As this Court explained in a somewhat analogous context in *Commissioner* v. *Sunnen*, 333 U.S. at 604-605, "[t]he crucial question" in applying the assignment-of-income doctrine to a purported assignment of income-producing property is not "trac[ing] income to the property which is its true source" or identifying what property, if any, "has [truly] been assigned." Rather, the key question in that context "remains 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." *Ibid.* As the Court observed in *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930), quoted in *Sunnen*, 333 U.S. at 604, "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid."

Here, it is clear that respondents and their causes of action were at all times "the source of the right to receive and enjoy the income." *Sunnen*, 333 U.S. at 604. Regardless of how one characterizes the contingent fee agreement or the rights of the attorney to collect his fee, moreover, it is clear that respondents at all times exercised "sufficient power and control" over both the underlying cause of action and the receipt of the income to make it reasonable to treat them as the recipients of the entire award of income for tax purposes. Among other things, respondents "could have fired [their] attorney[s]. [They] could have dropped the case[s]. [They], and only [they], had the power to authorize a settlement of the claim[s]." *Raymond*, 355 F.3d at 116.

In addition, any right or interest the attorneys received under the contingent fee agreements was necessarily limited by their overriding fiduciary duty to respondents to act only in the best interests of respondents in prosecuting respondents' claims. At a minimum, therefore, these cases fit squarely within this Court's "recogni[tion] that the assignor may realize income if he controls the disposition of that which he could have received himself and diverts payment from himself to the assignee as a means of procuring the satisfaction of his wants, the receipt of income by the assignee merely being the fruition of the assignor's economic gain." *Sunnen*, 333 U.S. at 605-606. Respondents' income was "realized as completely as it would

have been if [they] had collected the [awards] in dollars" and then paid their attorneys. *Horst*, 311 U.S. at 117.

### *3. A Taxpayer's Motive In Entering A Contingent Fee Agreement Is Irrelevant For Tax Purposes*

Nor do the tax consequences of a contingent fee agreement turn in any way on whether tax avoidance was the motive for the agreement. This Court in *Earl* expressly held 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. at 115. The anticipatory assignment of income between the husband and wife in *Earl* was made in 1901, well before the advent of the individual income tax, and thus evidently was not motivated by tax avoidance. Nevertheless, the Court refused to give any weight to that fact. *Ibid.*

The Sixth Circuit's attempt to resurrect a "purpose" inquiry in this context is contrary to *Earl* and should be rejected; "to rest the applicability of a rule of law on ascertaining the 'motives' of the parties is to court procedural unmanageability." *Raymond*, 355 F.3d at 117. Such an approach would put courts "in the position of having to divine the unknowable—and would open the door to abuse," *ibid.*, by "creat[ing] an artificial, a purely tax-motivated, incentive to substitute contingent for hourly legal fees," *Kenseth*, 259 F.3d at 884. Accordingly, respondents' motives for entering into a contingent fee arrangement with their attorneys are irrelevant to the tax treatment of the proceeds of their lawsuits. If a portion of a wage earner's income is paid directly by his employer to the wage earner's creditor pursuant to a garnishment, the direct payment is obviously not motivated by a tax avoidance purpose, yet it would be absurd to contend that the garnished amount

should be excluded from the wage earner's gross income. See *Old Colony Trust Co.*, 279 U.S. at 729. Respondents' situation is no different.

#### *4. The Court Of Appeal's Concern About "Double Taxation" is Entirely Misplaced*

The Sixth Circuit's final basis for distinguishing the assignment-of-income doctrine—the court's objection to what it characterized as "double taxation"—similarly provides no basis for the result reached below. Respondents, of course, have not been subjected to double taxation on the same item of income. The court's reference to "double taxation" apparently refers to the fact that, because respondents' attorney's fees are not deductible for purposes of the AMT, the amounts paid as attorney's fees will be taxed both to respondents and to their attorneys. This purported "double taxation," however, is neither anomalous nor harsh, but is instead a commonplace result inherent in the very nature of an income tax. Whenever an individual uses taxable income to purchase goods or services for which the Internal Revenue Code does not allow a deduction, that amount is taxed both to the individual purchaser and to the provider of the goods or services.

Thus, when an individual uses a portion of his salary to pay for the services of a plumber, the same income is taxed to both the individual and the plumber. And, of course, when an individual uses his salary income to pay for legal services rendered on an hourly-fee basis, the same income is taxed to both the individual and the attorney. In short, respondents' damages recoveries "replaced lost income, which would have been taxable; and many of the expenses of producing that income, such as the cost of commuting, would not have been deductible. So incomplete deductibility here is not sur-

prising or anomalous or inappropriate." *Kenseth*, 259 F.3d at 884. That is particularly true in the context of the AMT, the purpose of which is "to limit otherwise allowable deductions, so that * * * everybody who has income pays some federal income tax." *Ibid.*

There is no dispute that if respondents had arranged to pay their attorneys a fixed, rather than a contingent, fee, respondents would have been required to include the entirety of their taxable litigation awards in their gross income. There is no reason why the result should be any different when payment to the attorney is made pursuant to a contingent fee agreement. *Kenseth*, 259 F.3d at 883. That is particularly true given that under both California and Oregon law an hourly fee arrangement gives rise to precisely the same type of attorney lien as a contingent fee arrangement. See Or. Rev. Stat. § 87.445 (2004); *Isrin*, 403 P.2d at 732.

## II. EVEN IF THE COURT WERE TO LOOK TO THE MEANING OF STATE LAW TO DEFINE A TAXPAYER'S GROSS INCOME, THE DECISIONS BELOW SHOULD STILL BE REVERSED

As explained above, some courts, most notably the Fifth, Ninth, and Eleventh Circuits, have relied primarily on the varying provisions of state law in determining whether the contingent-fee portion of taxable litigation proceeds should be included in the litigant's gross income. That approach is mistaken for the reasons explained in Part I.A. above. In any event, however, if this Court were to look to California and Oregon law to determine the tax treatment of the contingent-fee portions of the litigation proceeds in these cases, it should nevertheless hold that those proceeds are includable in gross income.

### A. California Law Confirms That The Entire Amount Of Respondent Banks's Litigation Proceeds Should Be Included In His Gross Income

It is clear in *Banks* that if the proper tax treatment of contingent fee proceeds turns on the content of state law, then the Sixth Circuit's decision below was wrong and the entire amount of respondent Banks's litigation proceeds must be included in his gross income. That is precisely the conclusion reached by the Ninth Circuit in *Benci-Woodward*, *supra*, which considered the identical issue and held that under California law (where respondent Banks's fee agreement was executed) the attorney lien that arises upon the execution of a contingent fee agreement "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." 219 F.3d at 943. The *Benci-Woodward* court therefore concluded that there was no basis upon which the taxpayer in that case could exclude from her gross income the portion of her damages recovery paid to her attorneys pursuant to a contingent fee agreement.

The Sixth Circuit in *Banks* did not take issue with the Ninth Circuit's interpretation of California law. Nor could it have done so in light of the California Supreme Court's decision in *Isrin* v. *Superior Court of Los Angeles County*, *supra*, where the court explained:

> [I]n whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a security interest in the proceeds of the litigation. * * * While there is occasional language in cases in the effect that the attorney also becomes the equitable owner of a share of the client's cause of action, we stated more accurately in *Fifield Manor* v. *Finston* (1960), 54 Cal.2d 632, 641, 7 Cal.

> Rptr. 377, 383, 354 P.2d 1073, 1079, 78 A.L.R.2d 813, that contingent fee contracts "do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery."

403 P.2d at 732; accord *Cooper*, 268 Cal.Rptr. at 696 ("[a] contingent fee contract does not transfer to the attorney any rights to the client's cause of action, but rather gives the attorney a lien on the client's prospective recovery").

Accordingly, California law confirms that the relationship between respondent Banks and his attorney was simply that of debtor and creditor. They were not partners, and the attorney acquired no proprietary interest in respondent Banks's cause of action by virtue of the contingent fee agreement. *Benci-Woodward*, 219 F.3d at 943. Therefore, even the courts of appeals that look to state law to decide the issue would hold that the entire amount of respondent Banks's litigation award must be included in his gross income.

### B. Oregon Law Confirms That The Entire Taxable Amount Of Respondent Banaitis's Litigation Proceeds Should Be Included In His Gross Income

Unlike the Sixth Circuit, the Ninth Circuit in *Banaitis* relied on state law to support its conclusion that the attorney's fees portion of respondent's damages recovery was not includable in his gross income, applying the same analysis as a line of cases from the Fifth and Eleventh Circuits. See *Cotnam*, 263 F.2d at 119; *Davis*, 210 F.3d at 1346; *Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001); *Srivastava*, 220 F.3d at 353; see also *Estate of Clarks*, 202 F.3d at 854. The Ninth Circuit erred, however, as did those other courts of appeals, because state law pertaining to contingent

fee agreements provides no basis for the exclusion recognized by those courts.

Specifically, the Ninth Circuit below likened the statutory lien for attorney's fees under Oregon law to Alabama's statutory lien interpreted by the Fifth Circuit in *Cotnam*, stating that "Oregon law mirrors Alabama law in that it affords attorneys generous property interests in judgments and settlements." 03-907 Pet. App. 15a. The court noted, for example, that Oregon law, like Alabama law, provides that "an attorney's lien * * * is 'superior to all other liens'" except "tax liens"; that "a party to the action, suit or proceeding, or any other person, does not have the right to satisfy * * * any judgment, decree, order or award entered in the action * * * until the lien, and claim of the attorney for fees based thereon, is satisfied in full"; and that attorneys have "the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount of judgment due thereon to them." *Id.* at 15a-16a (quoting Or. Rev. Stat. §§ 87.490, 87.475, 87.480 (2004)). Thus, based on the "unique features of Oregon law" defining the attorney's interest in his fees, the Ninth Circuit concluded that the contingent fee portion of respondent's taxable litigation proceeds should be excluded from the calculation of respondent's gross income. *Id.* at 16a.

Contrary to the Ninth Circuit's conclusion, however, under Oregon law an attorney does *not* acquire a property interest in a client's cause of action upon the execution of a contingent fee agreement. Section 87.445 of the Oregon Revised Statutes, for example, merely confers upon attorneys "a lien upon actions, suits and proceedings after the commencement thereof," and upon "judgments, decrees, orders and awards entered

therein in the client's favor and the proceeds thereof" to the extent of the attorney's agreed-upon fees or, in the absence of an agreement, the reasonable value of services rendered. Or. Rev. Stat. § 87.445 (2004). Moreover, an attorney's lien will "cease to exist" if the attorney does not file a notice of his claim of lien in accordance with Oregon statutes. *Id.* § 87.465.

The Oregon statutes therefore establish that an attorney's interest in his client's cause of action is that of a lienor—a holder of a security interest—not that of a part-owner or co-venturer. See *Stearns* v. *Wollenberg*, 92 P. 1079, 1081 (Or. 1907) (a contingent fee agreement does not act as an assignment in favor of the attorney without express stipulation and does not create any "legal or equitable right in the subject-matter of the contract"). Indeed, the concepts of lienholder and property owner necessarily are mutually exclusive, since a property owner cannot have a lien on his own property. See *Black's Law Dictionary*, *supra*, at 933. That States such as Oregon or Alabama grant attorneys somewhat broader powers than other States to enforce their liens does not make the attorneys co-owners of their clients' claims.

Oregon's attorney lien statute, moreover, like those of most States, draws no distinction between contingent fees and fees based on an hourly rate. Regardless of the method of payment, the attorney is granted a lien for the amount of the fees. It necessarily follows, therefore, that Oregon's lien statute cannot provide a basis for providing contingent fees different tax treatment than hourly fees.

The non-proprietary nature of the Oregon attorney's lien statute, moreover, is confirmed by Oregon case law, which establishes that prior to a final judgment or decree, the client may compromise the action without

regard to any contract with the attorney. *Campbell's Automatic Safety Gas Burner Co.* v. *Hammer*, 153 P. 475, 478 (Or. 1915); *Jackson* v. *Stearns*, 84 P. 798, 800 (Or. 1906); see also *Potter* v. *Schlesser Co.*, 63 P.3d 1172, 1174 (Or. 2003) (giving the term "lien" in Section 87.445 "its ordinary meaning," namely, a "charge upon real or personal property for the satisfaction of some debt or duty ordinarily arising by operation of law" (quoting *Webster's Third New Int'l Dictionary* 1306 (unabridged ed. 1993))).

Further evidence that the client, not the attorney, owns the cause of action in Oregon is provided by the fact that "[a]n attorney * * * cannot lawfully purchase a claim for the consideration that he will prosecute it in his own name for a part of the amount recovered. He has no right to become attorney and client at the same time. The courts will not aid him to carry out any such questionable scheme, or recognize the legitimacy of the attempted speculation." *Craig* v. *Maher*, 74 P.2d 396, 399 (Or. 1937) (quoting *Dahms* v. *Sears*, 11 P. 891, 898 (Or. 1886)). And the client can choose not to appeal an adverse trial court judgment against his attorney's wishes. *In re Grimes' Estate*, 131 P.2d 448, 454 (Or. 1942); *Smith* v. *United States Nat'l Bank*, 615 P.2d 1119, 1123 (Or. Ct. App. 1980).

Accordingly, under Oregon law, respondent Banaitis was the sole owner of his cause of action, and as such retained ultimate authority to decide whether and when to settle his claims and for how much. That fact is reflected in the terms of the retainer agreement between respondent and his attorney, which provides that the "[a]ttorney will obtain [respondent's] approval before acceptance or rejection of a settlement on [respondent's] behalf." J.A. 95. Respondent therefore enjoyed substantial control over the amount and timing of the

contingent fee. Thus, even assuming *arguendo* that under Oregon law a contingent fee agreement could be considered to be an assignment by the client to his attorney of a portion of the income that the client expects to realize in the future, it is clear that the client retains sufficient control and obtains sufficient gain from the agreement to require inclusion of the contingent-fee portion of any taxable litigation award in the client's gross income.

**CONCLUSION**

The judgments of the courts of appeals should be reversed with respect to the issue of the tax treatment of contingent attorney's fees.

Respectfully submitted.

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## APPENDIX

### 26 U.S.C. 61. GROSS INCOME DEFINED

(a) General Definition.

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

**Or. Rev. Stat. § 87.445. Liens upon actions or judgments**

An attorney has a lien upon actions, suits and proceedings after the commencement thereof, and judgments, decrees, orders and awards entered therein in the client's favor and the proceeds thereof to the extent of fees and compensation specially agreed upon with the client, or if there is no agreement, for the reasonable value of the services of the attorney.