No. 03-892

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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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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PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-33a) is reported at 345 F.3d 373. The opinion of the Tax Court (App., *infra*, 34a-57a) is unofficially reported at 81 T.C.M. (CCH) 1219.

JURISDICTION

The judgment of the court of appeals was filed on September 30, 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), provides as follows:

SECTION 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.

STATEMENT

This case presents the question whether litigation proceeds paid as attorneys fees pursuant to a contingent fee agreement constitute income to the plaintiff for federal income tax purposes. That question has divided the circuits, and the decision of the Sixth Circuit in this case exacerbates that conflict on an issue of recurring importance.

1. Respondent worked as an educational consultant with 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 the state-law torts of 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 that action for a contingent fee. App., *infra*, 2a.

On May 30, 1990, after trial had begun, respondent entered into an agreement with defendants that settled all of his claims for $464,000. Pursuant to the contingent fee agreement, respondent paid $150,000 of the settlement proceeds to his attorney. App., *infra*, 4a-5a.

Respondent did not include any part of the $464,000 settlement proceeds in his gross income on his 1990 federal income tax return. App., *infra*, 5a. On audit, the Commissioner determined that the entire amount 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 (i) that the amount paid to his attorney pursuant to the contingency fee agreement was a deductible expense in earning that income but, (ii) since attorney's fee expenses fall within the category of "miscellaneous itemized deduction[s]," they are given no consideration in computing the alternative minimum tax (AMT) under 26 U.S.C. 56(b)(1)(A)(i). As a consequence of these determinations, a tax deficiency in the amount of $10,625 was issued for respondent's AMT liability. App., *infra*, 35a.[1]

2. Respondent sought review of the Commissioner's determinations in the Tax Court. 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. App., *infra*, 49a-52a.

3. a. The court of appeals sustained the Tax Court's holding that the portion of the damages that respondent received and retained represented taxable income

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[1] 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 a "personal injury" under Section 104 of the Code, 26 U.S.C. 104. The courts below upheld that determination. App., *infra*, 8a-17a; see *United States* v. *Burke*, 504 U.S. 229, 239-241 (1992). That determination is not at issue in this petition.

to him. App., *infra*, 8a-17a; see note 1, *supra*. The court of appeals, however, reversed the Tax Court's holding that respondent may not exclude from his gross income the portion of the settlement proceeds that were paid to his attorney under the contingent fee agreement. App., *infra*, 17a-25a.

The contingent fee agreement involved in this case was made under California law. In *Benci-Woodward* v. *Commissioner*, 219 F.3d 941, 943 (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." The court therefore concluded that the portion of the damages paid to the attorneys under a contingent fee agreement in California was part of the gross income of the plaintiff. The Ninth Circuit reached a similar conclusion under Alaska law in *Coady* v. *Commissioner*, 213 F.3d 1187, 1190 (2000), cert. denied, 532 U.S. 972 (2001), where the court held that the entire award of damages obtained under a contingent fee agreement is included in the taxpayers' gross income because Alaska law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients."

In the present case, the Sixth Circuit noted that the Ninth Circuit had held 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." App., *infra*, 23a (quoting *Benci-Woodward*, 219 F.3d at 943 (internal quotation marks omitted)). The Sixth Circuit, however, disagreed with the 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 (5th Cir. 2000), and concluded that the answer to this question "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." App., *infra*, 23a-24a (quoting *Srivastava* v. *Commissioner*, 220 F.3d at 364). The Sixth Circuit panel stated in this case (App., *infra*, 24a):

> We 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. Given the various distinctions among attorney's lien laws among the fifty states, 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.

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 panel stated in this case that (App., *infra*, 25a):

> The *Estate of Clarks* holding does not primarily rest on the rationale that separate state lien laws governing attorneys' rights determine the correct characterization of an attorney contingency fee. We therefore hold that *Estate of Clarks* is controlling in the present case, notwithstanding the difference in Michigan's and California's respective attorney's lien laws. In so holding, we will follow our precedent without protracted inquiries into "the intrica-

> cies of an attorney's bundle of rights." *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. App., *infra*, 25a.

b. Judge Moore dissented on this issue. She stated 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." App., *infra*, 32a. She concluded that "the proceeds the taxpayer paid to his attorney as a contingency fee should be included in the taxpayer's income." *Ibid.*

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals is in direct conflict with the decision of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001). In *Benci-Woodward*, the Ninth Circuit held that the portion of a damages award that was paid to the taxpayer's attorneys under a contingent fee agreement governed by the laws of California was to be included in the taxpayer's gross income. In the instant case, which also involved a contingent fee agreement executed in California, the Sixth Circuit majority held that the portion of respondent's settlement proceeds that was paid to his attorney was to be excluded from his gross income. The court concluded in this case that, regardless of any differences in state law concerning the rights of attorneys under contingent fee agreements, the portion of a damage award paid to the plaintiff's attorneys pursuant to a contingent fee agreement is always to be excluded from the plaintiff's gross income. In so holding, the Sixth Circuit created a direct conflict not only with the Ninth Circuit's decision in *Benci-Woodward*, but also with the Fourth Circuit's decision in *Young* v. *Commissioner*, 240 F.3d 369 (2001), the Seventh Circuit's decision in *Kenseth* v. *Commissioner*, 259 F.3d 881 (2001), and the Tenth Circuit's decision in *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312 (2001), cert. denied, 535 U.S. 1056 (2002). The broad rule of exclusion adopted by the court of appeals in this case also cannot be reconciled with the decisions in *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), and *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001).

Contingent fee agreements are a standard feature in tort litigation and are common in other types of litigation as well. The issue presented in this case therefore recurs frequently and has substantial importance to the proper administration of the tax laws. This Court has stressed the importance of avoiding "inequalities in the administration of the revenue laws." *Commissioner* v. *Sunnen*, 333 U.S. 591, 599 (1948). Resolution by this Court of the widespread and irreconcilable conflict among the courts of appeal is needed to eliminate the disparate treatment of similarly situated taxpayers that now exists.

1. The decision of the Sixth Circuit in this case fails properly to apply elementary tax principles. 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). Respondent was the sole

plaintiff of the causes of action that were settled by him for $464,000. The settlement proceeds represent the value given in exchange for the dismissal of his claims. The entire amount of that value is income to respondent, subject to whatever deductions are allowed under the Code. *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d at 1313-1314; *Kenseth* v. *Commissioner*, 259 F.3d at 884-885; *Young* v. *Commissioner*, 240 F.3d at 378. While attorneys fees are ordinarily deductible in calculating taxable income, they are not deductible in calculating the alternative minimum tax, which applies in this case. 26 U.S.C. 56(b)(1)(A)(i); see *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d at 1313; *Benci-Woodward* v. *Commissioner*, 219 F.3d at 944.

The Sixth Circuit incorrectly held in this case that the portion of the damage recovery paid, at respondent's direction, to his attorney is *not* part of respondent's gross income. In reaching that conclusion, the court of appeals did not reject or attempt to refute the settled law in California that the attorney acquired only a lien, and not a proprietary interest, in respondent's cause of action under the contingent fee agreement. See *Benci-Woodward*, 219 F.3d at 943. The court instead stated that a contingent fee has the effect of "a partnership or joint venture" and, as a consequence, permits the income to be paid directly to the attorney from the proceeds of the litigation without ever coming into the possession of the client. App., *infra*, 24a.

The fact that a direct payment of the attorneys fees was made out of the proceeds of the litigation, however, does not support the exclusion from income established by the Sixth Circuit in this case. This Court has made clear that an "anticipatory assignment" of income—that directs that income to be received in the future is to be paid directly to the taxpayer's assignee—is ineffective to shift the incidence of the tax away from the party who assigned the right to receive the income. *Lucas* v. *Earl*, 281 U.S. at 114-115; *Helvering* v. *Horst*, 311 U.S. 112, 114 (1940). In several cases involving facts similar to this case, courts have applied this basic tax principle in concluding that the gross amount of a damages recovery is income to the plaintiff, subject to such deductions for attorneys fees as the Code allows. See *Kenseth* v. *Commissioner*, 259 F.3d at 884-885; *Young* v. *Commissioner*, 240 F.3d at 378; *Baylin* v. *United States*, 43 F.3d at 1451.

There is, moreover, nothing to support the suggestion of the court of appeals in this case that a contingent fee agreement operates "like a partnership or joint venture" and effects an assignment to the attorney of a portion of the proceeds of the cause of action. App., *infra*, 24a. Under California law, which applies to the fee agreement in this case, a contingent-fee contract does *not* effect an assignment of a portion of the cause of action. *Kenseth* v. *Commissioner*, 259 F.3d at 884. Instead, the contingent fee agreement constitutes a promise by respondent to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered. *Ibid*. The relationship between respondent and his attorney was thus simply that of debtor and creditor. It is 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); see *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d at 1313-1314; *Baylin* v. *United States*, 43 F.3d at 1454.

Even if it were assumed, for purposes of argument, that respondent made an *actual* assignment to his attorney of a portion of the proceeds of his cause of action, an assignment of a right to receive income, for services rendered, would not shift the incidence of tax away from respondent. The taxpayer cannot avoid tax on the income he has earned by the simple artifice of having it paid, for his benefit, to someone else. See, *e.g.*, *Helvering* v. *Horst*, 311 U.S. at 114; *Lucas* v. *Earl*, 281 U.S. at 114-115; *Kenseth* v. *Commissioner*, 259 F.3d at 884-885; *Young* v. *Commissioner*, 240 F.3d at 378; *Baylin* v. *United States*, 43 F.3d at 1451.[2]

2. a. In short, an exclusion from gross income for amounts paid from a damages recovery to satisfy a contingent attorneys fees obligation is not defensible on any ground. As Judge Posner explained in *Kenseth* v. *Commissioner*, 259 F.3d at 883:

> Taxable income is gross income minus allowable deductions. 26 U.S.C. § 63(a); *United States* v. *Whyte*, 699 F.2d 375, 378 (7th Cir. 1983). If a taxpayer obtains income of $100 at a cost in generating that income of $25, he has gross income of $100 and a deduction of $25, see § 162(a), yielding taxable income of $75; he does not have gross income of $75. If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income

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[2] For example, if a professional athlete agreed to assign 10% of his compensation to his agent as a commission, and that commission was thereafter paid directly to the agent by the athlete's employer, the player obviously would not be allowed to exclude the amount of the commission from his gross income. Similarly, if an employer withholds a portion of an employee's wages and pays the withheld amount to the employee's former spouse in satisfaction of the employee's child-support obligation, the employee could not claim an exclusion for the portion of his wages that was paid directly to his former wife. These examples, however, are indistinguishable in character from respondent's claim in this case.

> of $100. See § 62(a)(1) and, with specific reference to legal fees incurred for the production of income, *Alexander* v. *IRS*, 72 F.3d 938, 944-46 (1st Cir. 1995). That is Kenseth's situation under the alternative minimum tax.
>
> He concedes as he must that had he paid the law firm on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, his gross income, as held in the *Alexander* case. We cannot see what difference it makes that the expense happened to be contingent rather than fixed.

While numerous courts have properly applied these basic tax principles in cases involving contingent fee recoveries, a few courts have incorrectly held that, if state law treats the contingent fee arrangement as effecting an "assignment" or transfer of a portion of the cause of action, that anticipatory assignment avoids the requirement that such income be recognized by the tort plaintiff upon the distribution of the recovery to his attorney. See *Srivastava* v. *Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959). See also *Banaitis* v. *Commissioner*, 340 F.3d 1074 (9th Cir. 2003); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000). Judge Wisdom correctly pointed out in dissent in *Cotnam*, 263 F.2d at 126-127, that such decisions (as well as the decision in this case) cannot be reconciled with this Court's assignment-of-income decisions. Under the governing "principles set forth in *Helvering* v. *Horst*," the tort plaintiff must include the entire recovery in income when she (*ibid.*):

> controlled the disposition of the entire amount [of the claim] and diverted part of the payment from herself to the attorneys. By virtue of the assignment [the plaintiff] enjoyed the economic benefit of being able to fight her case through the courts and discharged her obligation to her attorneys (in itself equivalent to receipt of income, under *Old Colony Trust Co.* v. *Commissioner*, [279 U.S. 716 (1929)).]

b. The decision of the court of appeals in this case also directly conflicts with the decision of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d at 943. In *Benci-Woodward*, the Ninth Circuit explained that a contingent fee agreement made under California law does not transfer to the attorney any proprietary interest in the client's cause of action; instead, it gives the attorney only a lien on the client's prospective recovery. The court reasoned that it therefore necessarily follows that the entire amount of the damages awarded to the taxpayer, including the portion that is paid directly to the taxpayer's attorneys under the contingent fee agreement, must be included in the taxpayer's gross income. *Ibid.*

In reaching the opposite conclusion in this case, the Sixth Circuit did not take issue with the Ninth Circuit's interpretation of California law. Instead, the Sixth Circuit held (i) that the state laws that determine the nature of contingent fee agreements are irrelevant and (ii) that attorney fees paid directly out of the proceeds of the plaintiff's cause of action should not, in any event, be regarded as income to the plaintiff. App., *infra*, 23a. In reaching that conclusion, the court made no effort to reconcile its decision in this case with the Ninth Circuit's contrary holding in *Benci-Woodward*.[3]

c. The decision of the Sixth Circuit in this case also directly conflicts with the decisions of the Fourth and Seventh Circuits in *Young* v. *Commissioner*, *supra*, and *Kenseth* v. *Commissioner*, *supra*. In *Young*, the Fourth Circuit agreed with the Sixth Circuit 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. Contrary to the decision of the Sixth Circuit in this case, however, the court in *Young* held that basic principles of federal tax law require the entire amount of a plaintiff's recovery —including the portion paid directly to the plaintiff's attorney under a contingent fee agreement—to be included in the plaintiff's gross income. The court held in *Young* that anticipatory assignment principles require this conclusion and explained that (*id.* at 377-378):

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[3] The Sixth Circuit court suggested (App., *infra*, 23a) that its holding in this case is consistent with the decision of the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353, 363-364 (2000). The *Srivastava* court indicated that, if it were writing on a clean slate, it would be inclined to hold that the entire amount of a damages award, including the portion paid to the plaintiff's attorney, is includible in the plaintiff's income. 220 F.3d at 363. That court held, however, that it was bound to follow the earlier decision of the Fifth Circuit in *Cotnam* v. *Commissioner*, *supra*, in which the court held, under Alabama law, that a contingent fee represents an assignment of a portion of the action and that fees paid out of the proceeds of the plaintiff's lawsuit were therefore excludable from her income. 263 F.2d at 125.

> If her attorneys charged an hourly rate, Mrs. Young would certainly have to include within her gross income any income used to pay her legal fees, whether the income came from the settlement proceeds or otherwise. We see no reason to allow her to escape taxation on a portion of the settlement proceeds simply because she arranged to compensate her attorneys directly from the proceeds through a contingent fee arrangement.

The Seventh Circuit in *Kenseth* reached the same conclusion as the Fourth Circuit in *Young*. The court noted in *Kenseth* that, under Wisconsin law (as under the California law applicable in this case), a contingent fee agreement does not give the attorney a proprietary interest in his client's cause of action. 259 F.3d at 883-884. The court explained that there was therefore no basis for excluding the portion of the recovery paid to the attorney under a contingent fee agreement from the income of the plaintiff (*id.* at 884):

> [I]f a contingent-fee lawyer expends effort on behalf of his client, who then terminates the contingent-fee contract, in effect confiscating the lawyer's work, the lawyer has a claim against the client; but he is no different in this respect from any other trade creditor stiffed by his debtor. In essence, Kenseth wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent-fee contract is not an assignment, *Young* v. *Commissioner*, *supra*, 240 F.3d at 378; and in Wisconsin the lawyer is prohibited from acquiring ownership of his client's claim. So what Kenseth really is asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the

assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.

d. The decision of the Sixth Circuit in this case also cannot be reconciled with the decision of the Tenth Circuit in *Hukkanen-Campbell* v. *Commissioner*, *supra*. The Tenth Circuit held in *Hukkanen-Campbell* that the taxpayer could *not* exclude from her gross income the portion of her taxable recovery that was retained by her attorneys under a contingent fee agreement. The court agreed that the question of federal tax law addressed in these cases should not turn on the provisions of state law dealing with the rights of attorneys under contingent fee agreements. The court concluded, however, that federal tax principles require the tort plaintiff to recognize as income the portion of the recovery that she used to pay her attorneys fees (274 F. 3d at 1314):

> We agree with Petitioner that a universal standard independent of the "intricacies of any attorney's bundle of rights," or the unique provisions of a particular state's attorney lien statute is desirable. However, her proposed solution is inconsistent with the Tax Code. The correct approach is much more simple. Petitioner's judgment is a recovery of lost income; the attorney fees she paid represent expenses incurred in generating that income. Like any other taxpayer, Petitioner must report the entire amount as gross income, and, but for the AMT's provisions, she would be allowed to deduct her attorney fees as an expense. The Tax Code mandates this result irrespective of a particular state's attorney lien statute's provisions.

e. The decision in this case also conflicts with the appellate decisions that rejected an exclusion from gross income for contingent attorneys fees on the rationale that, under the state law that governed the fee agreement, no assignment of any portion of a cause of action had occurred. See *Baylin* v. *United States*, 43 F.3d 1451; *Coady* v. *Commissioner*, 213 F.3d 1187. The Sixth Circuit held in this case that the portion of a recovery paid as contingent attorneys fees is to be excluded from gross income in *every* case, regardless of how state law may vary in defining the rights of attorneys under such agreements. App., *infra*, 23a-24a.

3. The question addressed in these cases has substantial importance to the proper administration of the tax laws. Contingent fee agreements are a common feature in many types of litigation. The question presented in this case therefore recurs with significant frequency. Moreover, the extensive litigation over this issue has yielded a steady diet of conflicting decisions. Because of the widespread conflict in the decisions of the courts of appeals, taxpayers who are otherwise similarly situated have received disparate tax treatment based solely on the circuit in which they reside. Review by this Court of the decision below is warranted to eliminate this inconsistent treatment of taxpayers and to prevent "inequalities in the administration of the revenue laws." *Commissioner* v. *Sunnen*, 333 U.S. at 599.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 2003

APPENDIX A

UNITED STATES COURT OF APPEALS
SIXTH CIRCUIT

Nos. 01-2171, 01-2177

JOHN W. BANKS, II, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Decided and Filed: Sept. 30, 2003

OPINION

CLAY, Circuit Judge.

This is a consolidated appeal from a decision of the United States Tax Court. In Case Nos. 01-2171 and 01-2177, Petitioner John W. Banks, II appeals from the tax court's decision in favor of the Commissioner of Internal Revenue finding, *inter alia*, deficiencies in Petitioner's income tax due for the taxable year 1990 in the amount of $99,068.00. In an accompanying memorandum opinion, the tax court ruled, *inter alia*, that (1) Petitioner could not exclude from gross income money he received pursuant to an out-of-court settlement, including the portion thereof his attorney had received as a contingency fee; and (2) Petitioner was not entitled to an income tax deduction in the taxable year 1990 for payments made to his former spouse as part of their divorce settlement. *See Banks* v. *Comm'r*, 81 T.C.M. (CCH) 1219, 2001 WL 196751, 2001 Tax Ct. Memo LEXIS 68 (Feb. 28, 2001). We **AFFIRM** in part and **REVERSE** in part the tax court's decision.

I. FACTUAL BACKGROUND

A. Petitioner's California Federal Court Lawsuit and Settlement

Petitioner worked as an educational consultant with the California Department of Education ("CDOE") from 1972 to 1986, when he was terminated. In response to his termination, Petitioner filed a civil action against the CDOE (and various past and present employees therein) in the federal district court for the Eastern District of California. Petitioner's second amended complaint alleged six counts. Counts 1, 2, and 3 alleged employment discrimination in violation of 42 U.S.C. §§ 1981 and 1983; Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. §§ 2000e to 2000e-17 (2000); and California Government Code § 12965, respectively. Counts 4, 5, and 6 asserted state law tort claims; specifically, Count 4 alleged intentional infliction of emotional distress, and Counts 5 and 6 alleged slander. Petitioner's lawsuit sought general damages, future medical and hospital expenses, punitive and exemplary damages, back pay and related employee benefits, various injunctions, and attorney's fees. In bringing the lawsuit Petitioner retained an attorney who agreed to represent Petitioner pursuant to a contingency fee agreement.

Settlement attempts failed, and Petitioner's case proceeded toward trial. The district court entered a final pretrial conference order on September 22, 1989. Under the "Abandoned Issues" section, the pretrial order stated, "[Petitioner] has abandoned all claims for damages relative to state tort claims, including a claim for intentional and negligent imposition of emotional distress, tortious interference with business relations, and defamation." (J.A. at 148.) Thus, according to the pretrial order, Petitioner abandoned Counts 4, 5, and 6 of the second amended complaint, leaving the remaining claims (by process of elimination) as Counts 1, 2, and 3, *i.e.*, the violations of Title VII, 42 U.S.C. § 1981, and 42 U.S.C. § 1983. The fact that the §§ 1981 and 1983 claims were still being litigated was evidenced elsewhere in the order, both in the "Points of Law" section (where the district court directed the parties to brief "[t]he elements, standards and burdens of proof relative to" §§ 1981 and 1983 claims) (J.A. at 147-48), and in the "Disputed Factual Issues" section (which includes the issue of "[w]hether the defendants acted under color of state law to deprive [Petitioner] of his rights, privileges and immunities secured by the Constitution by engaging in discriminatory practices").[1] (J.A. at 141- 42.) Abandoning counts 4, 5, and 6, in itself, did not eliminate any of the forms of relief Petitioner originally had requested in his second amended complaint. However, the "Relief Sought" section of the pretrial order indi-

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[1] The phrasing of this issue fairly represents the language of § 1983, which provides that "[e]very person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress."

cated the following: "[Petitioner] seeks only reinstatement, back pay, and attorneys' fees." (J.A. at 147.) The limitation on relief sought was also confirmed in the part of the pretrial order calling for a non-jury trial: "Although plaintiff had heretofore demanded a jury trial, he concedes that *since he now seeks only back pay and equitable relief*, a jury trial is not appropriate." (J.A. at 132) (emphasis added).

Petitioner's trial commenced, and nine days into the trial, at the court's urging, the parties held a settlement conference. Testimony at the tax court trial from Petitioner's attorney in the California federal court action, as well as a letter from Petitioner to an Internal Revenue Service ("IRS") agent, indicated that Petitioner had initially requested $850,000 during settlement discussions, and that he and his attorney had arrived at that proposed settlement figure based on Petitioner's salary. The defendants countered with an offer of $464,000, apparently arguing that Petitioner should take less money because he could designate the amount as personal injury damages and render it non-taxable. Petitioner and his attorney agreed to the $464,000 settlement amount, so long as it could be characterized in the settlement agreement as compensation for personal injury damages. However, Petitioner's attorney testified at the tax court trial that he warned Petitioner that although the settlement agreement could characterize the $464,000 proceeds as personal injury damages, there was no guarantee that the IRS would subsequently agree to this characterization.

On May 30, 1990, Petitioner and the CDOE entered into an agreement that settled all of Petitioner's outstanding claims for $464,000. The agreement provided, in part, as follows:

> 1. The [CDOE] agrees object [sic] to pay to [Petitioner] of the sum of $464,000.00 in full and complete satisfaction of his claims. [Petitioner] characterizes this payment of $464,000.00 as payment for personal injury damages suffered after [Petitioner's] discharge on July 14, 1986.

(J.A. at 159.) Of this $464,000, Petitioner paid $150,000 to his attorney in fees, pursuant to the contingency fee arrangement between them. Petitioner did not include any of the $464,000 settlement proceeds as gross income on his 1990 federal income tax return.

B. Petitioner's Alimony Payment to His Former Spouse and Deduction

On November 1, 1984, the marriage of Petitioner and his first wife, Verna Banks, was dissolved. In adjudicating the impending dissolution, the California Superior Court issued an order, dated January 2, 1984, declaring that Verna Banks was entitled to 43.95% of Petitioner's gross monthly military retirement payments. Pursuant to this order, Petitioner began making payments to Verna Banks, but the payments did not start until 1987 and only constituted 43.95% of Petitioner's net, rather than gross, retirement payments. Consequently, arrears immediately began to accrue to Verna Banks. On April 6, 1988 and December 4, 1989, Verna Banks obtained orders for the arrearage, plus attorney's fees, and she later returned to court to enforce the orders in 1990. On October 30, 1990, the California Superior Court, taking note of Petitioner's recent out-of-court settlement with the CDOE, ordered Petitioner to pay Verna Banks $12,156.81 out of the

$464,000 settlement proceeds from the civil lawsuit Petitioner had filed in federal district court in California. The court further ordered Petitioner to place an additional $20,000, plus $3,850 in attorney's fees, in an interest-bearing account until Petitioner began to make timely payments to Verna. The amounts the court ordered Petitioner to pay totaled $36,006.81.

In 1990, Petitioner paid $72,013.62 (double the $36,006.81 of the court's order in lieu of posting an appellate bond) into California Superior Court and filed several appeals, all of which ultimately proved unsuccessful. Eventually, Verna Banks agreed to receive Petitioner's $72,013 deposit in satisfaction of all arrears (except for $45,987 in arrears Petitioner owed Verna from 1979 to 1986). The court transferred the $72,013.62 to Verna in 1993, and Petitioner deducted the $72,013.62 in the 1993 tax year as an alimony payment deduction. However, at the tax court trial Petitioner argued that he was entitled to claim that deduction for the 1990 tax year.

C. The Commissioner's Notices of Deficiency and the Tax Court's Decision

On May 30, 1997, the Commissioner issued a Notice of Deficiency to Petitioner for the tax year ending December 31, 1990,[2] in the amount of $101,168.00. Petitioner filed a petition in the tax court, requesting a redetermination of the deficiencies. The cases were consolidated, and the matter proceeded to trial.

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[2] The Notice actually determined deficiencies for three tax years: 1988, 1990, and 1991. However, only tax year 1990 is at issue in this appeal.

February 28, 2001, the tax court filed a Memorandum Findings of Fact and Opinion ("tax court opinion" or "opinion"). For purposes of this appeal, the tax court opinion made three relevant rulings. First, it determined that the entire $464,000 amount Petitioner received in settlement of his California federal court lawsuit constituted taxable income because, contrary to Petitioner's arguments, none of the settlement amount was attributable to a claim of personal injury. Second, the tax court determined that the $150,000 Petitioner had paid out of the $464,000 settlement amount to his lawyer as an attorney contingency fee was not excludable from income. Third, the tax court agreed with Petitioner that an alimony payment to Verna Banks could have been deducted from his gross income for the 1990 tax year, but it further held that Petitioner was now precluded by the "duty of consistency" doctrine from taking the deduction.

Consequently, the tax court held Petitioner liable for taxes on the full $464,000 settlement amount, and it disallowed any relevant deductions therefrom. A decision embodying these three rulings was entered on May 21, 2001.[3] Petitioner's timely appeal followed.

II. STANDARD OF REVIEW

We review the tax court's legal conclusions de novo and its factual findings for clear error. *Zack* v. *Comm'r*, 291 F.3d 407, 412 (6th Cir. 2002) (citing *MTS Int'l, Inc.* v. *Comm'r*, 169 F.3d 1018, 1021 (6th Cir. 1999)). We will conclude that a factual finding is clearly erroneous only if, upon our review of the entire record,

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[3] Pursuant to these rulings (and other rulings which neither side appealed), the tax court ruled that there existed a deficiency for Petitioner's 1990 tax year in the amount of $99,068.000.

we are "left with the definite and firm conviction that a mistake has been committed." *Id.* (quoting *Sanford* v. *Harvard Indus., Inc.*, 262 F.3d 590, 595 (6th Cir. 2001)) (internal quotation marks omitted).

III. ANALYSIS

A. Whether the Amount Paid in Settlement of Petitioner's Lawsuit was Attributable to a Claim of Personal Injury.

Petitioner challenges on appeal the tax court's ruling that the $464,000 he received in settling his California federal civil action was not excludable from income under Internal Revenue Code § 104(a), 26 U.S.C. § 104(a). Specifically, Petitioner argues that the tax court erred in determining that no portion of the $464,000 settlement amount was attributable to personal injuries he alleged in that lawsuit. We are not persuaded by Petitioner's arguments and therefore affirm the tax court as to this issue.

Section 61 of the Internal Revenue Code states that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." 26 U.S.C. § 61(a). In determining what constitutes gross income, we construe § 61 "liberally 'in recognition of the intention of Congress to tax all gains except those specifically exempted.'" *Greer* v. *United States*, 207 F.3d 322, 326 (6th Cir. 2000) (quoting *Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430, 75 S. Ct. 473, 99 L.Ed. 483 (1955)).

Nevertheless, the Internal Revenue Code provides for a number of exclusions from income. One of these exclusions is found in § 104(a)(2), which permitted a taxpayer to exclude from income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." 26 U.S.C. § 104(a)(2).[4] Damages received "on account of personal injuries" are to be distinguished from those received on account of back pay damages, for which no exclusion from income exists. *Comm'r* v. *Schleier*, 515 U.S. 323, 329-30, 115 S. Ct. 2159, 132 L.Ed.2d 294 (1995).

The Supreme Court has held that a § 104(a) exclusion is warranted only where a two-prong test has been satisfied. First, the taxpayer must have received the damages amount through the litigation of an action (or a settlement thereof) based on tort or tort-type rights. Second, the amount must be paid on account of personal injuries or sickness. *Schleier*, 515 U.S. at 337, 115 S. Ct. 2159. Moreover, regarding the second prong, a taxpayer must present "concrete evidence demonstrating the precise causal connection between" the taxpayer's asserted personal injuries and the settlement payment he or she received. *Greer*, 207 F.3d at 334. More recently, we "disaggregate [d]" the *Schleier* two-prong test into "its disparate elements," as follows:

To satisfy *Schleier*, the taxpayer must show that

(1) there was an underlying claim sounding in tort;

(2) the claim existed at the time of the settlement;

(3) the claim encompassed personal injuries; and

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[4] Section 104(a)(2) was amended in 1996 to limit exclusions from income for personal injuries or sickness to physical injuries or sickness. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838. However, because Petitioner's lawsuit settlement occurred prior to the passage of this amendment, this new limitation on § 104(a)(2) does not apply here. *See Greer*, 207 F.3d at 328.

(4) the agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" the personal injury.

Id. at 327, 115 S. Ct. 2159.

Turning our attention to the first prong of the *Schleier* test, we observe that the proper inquiry "focus[es] on the origin and characteristics of the claims settled in determining whether such damages are excludible under § 104(a)(2)." *Id.* (quoting *Pipitone* v. *United States*, 180 F.3d 859, 862 (7th Cir. 1999)). A relevant aspect of this inquiry requires us to consider whether the claim at issue provides for remedies that "recompense [a plaintiff] for any of the . . . traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages," *i.e.*, remedies other than economic damages. *See United States* v. *Burke*, 504 U.S. 229, 239, 112 S. Ct. 1867, 119 L.Ed.2d 34 (1992). Because Petitioner abandoned the state tort claims prior to trial, the relevant claims to examine in this case are Counts 1 through 3 of Petitioner's second amended complaint, which represent Petitioner's claims brought under Title VII, 42 U.S.C. § 1981, and 42 U.S.C. § 1983.

Applying this analysis, we agree with the Commissioner and the tax court that Petitioner's Title VII claim does not constitute "an underlying claim sounding in tort" for purposes of § 104(a)(2). Greer, 207 F.3d at 327. The Supreme Court has held that Title VII, at the time of Petitioner's civil lawsuit, "focuse[d] on legal injuries of an economic character," given that its "sole remedial focus [wa]s the award of back wages," and therefore did not "redress[ ] a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations." *Burke*, 504 U.S. at 239, 241, 112 S. Ct.

1867. It is true that Congress amended Title VII in 1991 to provide Title VII plaintiffs with additional monetary relief beyond back pay. *See* Civil Rights Act of 1991, Pub. L. No. 102-166, § 102, 105 Stat. 1071, 1072-74 (1991) (codified at 42 U.S.C. § 1981a). However, Petitioner had sued the CDOE under the old version of Title VII ("pre-1991 Title VII"), and *Burke* directly controls the applicability of § 104(a)(2) to pre-Title VII damages. *Id.*[5]

Petitioner alternatively argues that his §§ 1981 and 1983 claims provide the requisite tort or tort-like claims on which to base his § 104(a)(2) exclusion. We agree with Petitioner. The Supreme Court has indicated (albeit in the statute of limitations, not the § 104(a)(2), context) that § 1983 claims constitute tort or tort-like actions. *See Wilson* v. *Garcia*, 471 U.S. 261, 280, 105 S. Ct. 1938, 85 L.Ed.2d 254 (1985) (holding that § 1983 claims "are best characterized as personal injury actions"); *see also City of Monterey* v. *Del Monte Dunes at Monterey, Ltd.*, 526 U.S. 687, 724-25, 119 S. Ct. 1624, 143 L.Ed.2d 882 (1999) (Scalia, J., concurring in part and concurring in the judgment) (applying Wilson's rule to a Seventh Amendment inquiry).[6] Furthermore,

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[5] Although Burke's authority has been questioned since the amendments to Title VII, its authority as to pre-1991 Title VII claims seems to be intact. *See, e.g., Abrams* v. *Lightolier Inc.*, 50 F.3d 1204, 1220 (3d Cir. 1995) ("We note that amendments to Title VII made by the Civil Rights Act of 1991 allow a plaintiff to recover compensatory and punitive damages and thus throw doubt on the continued validity of the Burke holding.") (emphasis added).

[6] Several other circuits have held that § 1983 actions are tort actions within the meaning of § 104(a)(2). *See Wulf* v. *City of Wichita*, 883 F.2d 842, 872-73 (10th Cir. 1989) (holding that the settlement proceeds of the taxpayer's § 1983 civil action compensated him for personal injuries and was excludable under

although the Supreme Court has not expressly designated § 1981 as constituting a tort or tort-like action, the Court strongly hinted in its Burke decision that it deemed § 1981 to fit into this category. *See Burke*, 504 U.S. at 240, 112 S. Ct. 1867 (observing that the remedies available under pre-1991 Title VII "st[ood] in marked contrast not only to those available under traditional tort law, but under other federal antidiscrimination statutes," for instance § 1981, which offered as potential remedies "both equitable and legal relief, including compensatory and, under certain circumstances, punitive damages").

The tax court had rejected Petitioner's alternative argument. Although the court conceded that § 1981 and 1983 claims constitute tort or tort- like actions, it found that, based on the district court's pretrial order entered in connection with his lawsuit against the CDOE, Petitioner had abandoned all of his tort claims, including the §§ 1981 and 1983 claims. The tax court therefore concluded that Petitioner's §§ 1981 and 1983 claims could not provide a basis for a § 104 exclusion because such claims did not exist at the time of settlement, as required by prong two of the § 104 analysis. Petitioner points to several places in the pretrial order as proof that, contrary to any ambiguous abandonment language in the pretrial order, his §§ 1981

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§ 104(a)(2)); *Metzger* v. *Comm'r*, 88 T.C. 834, 1987 WL 49302 (1987), aff'd, 845 F.2d 1013 (3d Cir. 1988) (holding that claims under 42 U.S.C. §§ 1981 and 1983, among others, constituted "personal injury" claims within the meaning of § 104(a)(2)); *Bent* v. *Comm'r*, 835 F.2d 67, 70 (3d Cir. 1987) (holding that the portion of the taxpayer's damages award pertaining to his § 1983 claim compensated him for his personal injuries and could properly be excluded under § 104(a)(2)).

and 1983 claims were pursued at trial and were in existence at the time of the parties' settlement in 1990.

We agree with Petitioner that the tax court erred in determining that Petitioner had abandoned his 42 U.S.C. §§ 1981 and 1983 actions. Both the "Points of Law" and the "Disputed Factual Issues" sections of the pretrial order indicated that issues related to §§ 1981 and 1983 causes of action were still being litigated. Therefore, Petitioner satisfied his burden regarding prong one, because he had litigated a claim sounding in tort, to wit, the §§ 1981 and 1983 claims. Similarly, Petitioner also satisfied prong number two because his §§ 1981 and 1983 claims existed at the time he settled his case with the CDOE, and the $464,000 amount he received was in settlement of those claims.

As to the third prong, we find that Petitioner's §§ 1981 and 1983 claims "potentially involved injuries that were personal." *Greer*, 207 F.3d at 328. As we have previously observed, §§ 1981 and 1983 claims can encompass such personal injuries as mental anguish, damage to character, or damage to a personal or professional reputation, *id.* (collecting cases), and these types of tangible and intangible harms were contemplated by § 104(a)(2) at the time that Petitioner's settlement agreement was executed. Petitioner specifically requested in his second amended complaint, among other forms of relief, general damages (for harassment, humiliation, and embarrassment suffered by Plaintiff), and future medical and hospital expenses. Any relief granted for these harms Plaintiff suffered could fairly be construed as compensating personal injuries within the meaning of § 104(a)(2). *See id.*

However, we find that Petitioner failed to meet his burden to show that the settlement agreement was executed "on account of personal injuries or sickness." *Greer*, 207 F.3d at 334 (quoting *Schleier*, 515 U.S. at 330, 115 S. Ct. 2159) (internal quotation marks omitted). Our inquiry in this regard requires us to examine the settlement agreement's purpose and, absent a clear purpose, the payor's intent in settling the claims. *Greer*, 207 F.3d at 329 (citations omitted). A determination regarding a payor's intent requires us to "consider[ ] the amount paid, compar[e] the circumstances and amount paid to other agreements the company has entered into, consider[ ] the factual circumstances that led to the agreement, and weigh[ ] other facts that may reveal the employer's intent." *Greer*, 207 F.3d at 329 (citing *Pipitone*, 180 F.3d at 864-65).

In support of his contention that he satisfied the burdens set forth under the third and fourth prongs, Petitioner points to language in the settlement agreement, to wit, "[Petitioner] characterizes this payment of $464,000.00 as payment for personal injury damages suffered after [Petitioner's] discharge on July 14, 1986." (J.A. at 159.) The tax court rejected this language as self-serving and contradicted by other evidence in the record. Petitioner argues that the tax court clearly erred in failing to give appropriate weight to the characterization in the settlement agreement.

We agree with Petitioner that language in a settlement agreement can offer some probative evidence of how a settlement payment should properly be characterized for purposes of § 104(a)(2). *See, e.g.*, *Bent* v. *Comm'r*, 87 T.C. 236, 246, 1986 WL 22165 (1986), *aff'd*, 835 F.2d 67, 70 (3d Cir. 1987). However, in this case the settlement agreement did not attempt to assess the damages of the lawsuit and allocate

Petitioner's recovery accordingly. *See Robinson* v. *Comm'r*, 102 T.C. 116, 128-29, 1994 WL 26303 (1994) (rejecting a settlement agreement's characterization of the settlement amount, which allocated 95% to mental anguish and 5% to lost profits, as "uncontested, non-adversarial, and entirely tax-motivated" and not accurately "reflect[ing] the realities of . . . [the parties'] settlement"). In the present case, Petitioner can point to no other evidence in the record that supports his characterization of the settlement payment. For instance, his second amended complaint sought general damages for future (presumably, anticipated) medical and hospital expenses, but at the time of settlement he offered no receipts or other information indicating that he had suffered medical expenses or intended to do so in the near future. Similarly, there is nothing in the record to reflect a numerical value Petitioner placed on his mental anguish. Indeed, the settlement agreement does not even indicate the CDOE's intent in paying the settlement amount; the agreement merely indicates that Petitioner characterizes the $464,000 payment as compensating him for personal injuries. The only intent on CDOE's part reflected in the record is its intent to dispose of the case in an expeditious manner and a willingness to acquiesce in Petitioner's tax-favorable characterization of the settlement proceeds. Petitioner's characterization of his own settlement payment, with no further support in the settlement agreement or elsewhere record, cannot control the issue.

Not only does Petitioner fail to point to any evidence in the record to support his characterization of the $464,000 settlement payment, the record contains several indicia tending to contradict Petitioner's characterization. In particular, the pretrial order pertaining to Petitioner's California federal court lawsuit stated that the only "[r]elief [s]ought" at trial was "reinstatement, back pay, and attorneys' fees." (J.A. at 147.) This would suggest that the claim, at least at the time of settlement, no longer encompassed personal injuries, and that the settlement agreement was executed on account of non-personal injuries, to wit, economic injuries. Moreover, testimony from Petitioner's lawyer, as well as a letter from Petitioner to an IRS agent, indicated that Petitioner offered to settle for $850,000, a figure he computed based on salary, which represents economic damages as opposed to personal injuries. Petitioner nevertheless agreed to the defendants' counteroffer of $464,000, so long as he could characterize the payment amount in the settlement agreement as covering personal injuries. Based on the evidence favoring the Commissioner, the tax court's finding on this point was not clearly erroneous, and we decline to overturn it.

We agree with the Commissioner that the 1990 settlement of Petitioner's California federal court action against the CDOE and other defendants for $464,000 does not fall under the § 104(a)(2) exclusion from income. Although some of Petitioner's claims, at the time of the settlement, were "based upon tort or tort type rights," *Schleier*, 515 U.S. at 337, 115 S. Ct. 2159, Petitioner failed to meet his burden of showing that his §§ 1981 and 1983 claims were settled on account of his personal injuries. Specifically, Petitioner has not met his burden of establishing a causal connection between his $464,000 settlement payment and any personal injuries he may have suffered. Because the settlement amount could not be excluded under § 104(a)(2), it was properly included as income under 26 U.S.C. § 61(a). We therefore affirm the tax court's determination on this issue.

B. Whether the Portion of Petitioner's Lawsuit Settlement Paid to His Attorney Under a Contingency Fee Arrangement was Excludable from Income.

Next, Petitioner argues that the tax court erred in holding that the $150,000 in contingency fees he paid to his attorney as part of the California federal court settlement was not excludable from his gross income. Petitioner specifically contends that the tax court's ruling in this regard contravened our precedent. The Commissioner argues that the tax court acknowledged our precedent but properly distinguished it based on differing facts. We agree with Petitioner and reverse the tax court's determination as to this issue.

There is a circuit split on the issue of whether contingency fees must be included in gross income.[7] The Commissioner has always taken the position that contingency fees must be included, based on the anticipatory assignment of income doctrine. This theory is most typically exemplified in two Supreme

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[7] The Fifth, Sixth, and Eleventh Circuits have held that contingency fees are excludable. *See Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001); *Srivastava* v. *Comm'r*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000). The Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits have taken the opposite view. *See Campbell* v. *Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth* v. *Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young* v. *Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Benci-Woodward* v. *Comm'r*, 219 F.3d 941 (9th Cir. 2000); *Coady* v. *Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995); *O'Brien* v. *Comm'r*, 38 T.C. 707, 1962 WL 1147 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam).

Court cases: *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L.Ed. 731 (1930), and *Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L.Ed. 75 (1940). In Lucas, the taxpayer assigned one-half of his future salary to his wife to avoid paying taxes on the entire salary, and argued in litigation that because he had never actually received the income before distributing it to his wife, it was not income to him. The Supreme Court disagreed, reasoning that because the taxpayer had earned and created the right to receive and enjoy the benefit of the income before assigning it, he was subject to taxation on the entire salary. 281 U.S. at 114-15, 50 S. Ct. 241. The Court further emphasized that the fundamental purpose of the tax code—to tax income to those who create, earn and enjoy it—"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." *Id.* at 115, 50 S. Ct. 241. Thus, the Court declined to honor attempts to attribute fruits "to a different tree from that on which they grew" and held the entire salary, not just half, constituted taxable income to the taxpayer. *Id.*

Similarly, in *Horst*, the taxpayer owned negotiable bonds. Shortly before their maturity date, he removed the interest coupons from the bonds and gave them to his son, who subsequently collected interest on them. 311 U.S. at 114, 61 S. Ct. 144. During litigation, the taxpayer argued that the interest payments were not taxable to him because he never received the interest payments. Again, the Supreme Court disagreed. Observing that "[t]he dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid," it concluded that the tax established by the 1934 Revenue Act could not "fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received." *Id.* at 119, 61 S. Ct. 144 (alterations in original). Therefore, the Court reasoned, because the taxpayer had earned and created the right to receive and enjoy the benefit of the income by virtue of the fact that he owned the bonds and the interest generated therefrom was guaranteed to him when he transferred the coupons, the income could fairly be attributed to him for taxation purposes. *Id.* at 117-20, 61 S. Ct. 144. Again reasoning that "the fruit is not to be attributed to a different tree from that on which it grew," *id.* at 120, 61 S. Ct. 144 (citing *Lucas*, 281 U.S. 115, 50 S. Ct. 273, 74 L.Ed. 733), the Court held that the transferred coupons constituted taxable income to the taxpayer. *Id.*

Nevertheless, the first case to address the tax treatment of contingency fee arrangements declined to apply the assignment of income doctrine to contingency fee payments. In *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), following a successful Alabama court lawsuit to enforce a contract, the taxpayer paid her legal counsel a portion of the judgment award, pursuant to a contingency fee arrangement between them. The Commissioner subsequently treated the taxpayer's entire judgment award, including the contingency fee portion, as taxable income and assessed tax deficiencies accordingly. The court held that the contingency fee portion of the judgment award was not income to the taxpayer. In concluding that the anticipatory assignment of income doctrine did not apply to the contingency fee the taxpayer paid to her legal counsel, the *Cotnam* court looked to Alabama's attorney's lien statute, which at the time provided that

> [u]pon suits, judgments, and decrees for money, [attorneys] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.

Id. at 125 n. 5 (citing Ala. Code § 64 (1940)). In other words, the *Cotnam* court reasoned, the statute provided an attorney with an equitable lien that effectively transferred part of the taxpayer's claim to the attorney. The practical consequence of Alabama's attorney's lien law was that an attorney in Alabama held an equity interest in both the cause of action and the judgment, and the taxpayer, as the client, was precluded from ever realizing income on that percentage of the judgment representing the contingency fee.

The *Cotnam* court declined to apply the anticipatory assignment of income doctrine, noting that, unlike the circumstances in *Lucas* and *Horst*, the attorneys' claim to payment lacked fair market value and that it was uncertain as to when or whether the attorneys' claim would attain value (given that contingency fees are only paid in the event of a successful outcome of the taxpayer's lawsuit). Indeed, the court noted, the claim was "worthless without the aid of skillful attorneys." *Id.* at

125. Therefore, the *Cotnam* court concluded, because (1) the contingency fee never passed through the taxpayer's hands or was controlled by the taxpayer, and (2) only the attorney's services resulted in converting the uncertain claim into an item of value, the taxpayer properly excluded the contingency fee portion of his judgment from his income. *Id.* at 127.

We adopted the *Cotnam* doctrine in *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000). In that case, the taxpayer received a jury award in a Michigan state court personal injury suit, and the attorney received one-third of the judgment award and interest as a contingency fee. The taxpayer soon thereafter died, and the estate, when filing the taxpayer's income tax return, properly included in gross income the interest portion of the judgment, but excluded the portion of the amount contingency fee attributable to interest. *Id.* at 855. In holding that the exclusion was proper, we rejected the Commissioner's position for reasons similar to those articulated in *Cotnam*. First, we pointed out that Michigan's attorney lien law operates in essentially the same way as the Alabama statutory lien examined in *Cotnam*, and essentially amounted to an assignment of a portion of the potential judgment. The record had indicated that the client originally owned the underlying claim but then relinquished his right to receive payment for the lawyer's contingency fee portion of any judgment upon signing the contingency fee contract.

Like the *Cotnam* court, we then proceeded to reject the anticipatory assignment of income doctrine as applied to contingency fees. In distinguishing the *Earl* and *Horst* decisions, we reasoned that a contingency fee, as part of a litigation claim, was not already earned, vested, or even relatively certain to be paid to the assignor, but instead was merely "an intangible, contingent expectancy," dependent upon the attorney's skills to realize any value from it. *Id.* at 857. We then compared the contingency fee arrangement to a division of property:

> Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not . . . to one who neither received it nor earned it.

Id. at 858.

We then distinguished *Earl* and *Horst* on three additional grounds. First, unlike the true income assignments in *Earl* and *Horst*, no tax avoidance purpose motivated the contingency fee arrangement; rather a business purpose motivated it. *Id.* at 858, 202 F.3d 854. Second, unlike the *Earl* and *Horst* assignees who performed no services to earn their income, the attorney earned his income because the income resulted from his own skill and judgment. We also were motivated by the fact that applying the assignment of income doctrine to contingency fees would result in double taxation, whereas in *Earl* and *Horst*, the assignees could exclude what they received as gifts. *Id.* at 857, 858.

In the instant case, the tax court acknowledged the *Estate of Clarks* decision but distinguished it on the grounds that Petitioner's underlying lawsuit, from which his attorney's contingency fee was generated, took place in California. California's law on attorneys' contingency fees, unlike Alabama's law, does not operate under a lien theory. Rather, California's lien statute confers no ownership interest on attorneys, and "[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.'" *Benci-Woodward*, 219 F.3d at 943 (citations omitted). Thus, in California an attorney who is entitled to a contingency fee "acquires no more than a professional interest," *id.*, and is no different from an ordinary creditor who, if "stiffed" on his payment, would have to enforce the contract judicially. On appeal, Petitioner urges this Court not to draw distinctions based on the lien theory of the particular state in which an action arises. We agree with Petitioner.

We find persuasive the reasoning of the Fifth Circuit, which recently faced similar factual circumstances. In *Srivastava* v. *Comm'r*, 220 F.3d 353, 363-64 (5th Cir. 2000), the Commissioner argued that *Cotnam* was not controlling because the taxpayer's contingency fee agreement was controlled by Texas law, and Texas' attorney's lien statute did not provide attorneys with a superior claim lien against their clients' judgments or any ownership interests. The *Srivastava* court declined to distinguish *Cotnam* based on the differing state attorney's lien laws, instead determining that "the answer [as to whether to apply *Cotnam*] does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." *Id.* at 364. We 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. Given the various distinctions among attorney's lien laws among the fifty states, such a "state-by-state" approach would not provide reliable precedent regarding our adherence to the *Cotnam* doctrine or provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards. *Cf. O'Brien* v. *Comm'r*, 38 T.C. 707, 712, 1962 WL 1147 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (*per curiam*) (rejecting distinctions in applying the *Cotnam* doctrine, based upon differing state attorney's lien laws because it doubted "that the Internal Revenue Code was intended to turn upon such refinements").

More importantly, the reasoning in *Estate of Clarks* case seems to have been based on more than the nature of Michigan's lien law. To be sure, the similarity between Michigan's attorney's lien statute in *Estate of Clarks* and Alabama's attorney's lien statute in *Cotnam* played a role in the outcome. *Estate of Clarks*, 202 F.3d at 856. However, we found other factors persuasive in distinguishing contingency fees from *Lucas* and *Horst*, including the following: (1) the fact that the claim, at the time the contingency fee agreement was signed, was "an intangible, contingent expectancy," (2) taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds; (3) no tax-avoidance purpose was at work with the contingency fee arrangement, as there ostensibly was in *Lucas* and *Horst*; and (4) double taxation would otherwise result by including the contingency fee in taxpayer's income. *Id.* at 857-58.

The *Estate of Clarks* holding does not primarily rest on the rationale that separate state lien laws governing attorneys' rights determine the correct characterization of an attorney contingency fee. We therefore hold that *Estate of Clarks* is controlling in the present case, notwithstanding the difference in Michigan's and California's respective attorney's lien laws. In so holding, we will follow our precedent without protracted inquiries into "the intricacies of an attorney's bundle of rights." *Srivastava*, 220 F.3d at 364. The nature of Petitioner's attorney's rights notwithstanding, the facts of this case are within the scope *Estate of Clarks* contemplated: By signing the contingency fee agreement, Petitioner transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit. *Estate of Clarks*, 202 F.3d at 858.

We therefore hold that *Estate of Clarks* is not distinguishable based on the distinctions between California's attorney's lien law and Michigan's lien law. Thus, consistent with our prior precedent in *Estate of Clarks*, we hold that the $150,000 Petitioner paid in contingency fees to his attorney is excludable from his gross income. Because the tax court erred in determining that the $150,000 was not excludable, we reverse the tax court as to this issue.

C. Whether the Tax Court Properly Denied Petitioner's 1990 Alimony Deduction Pursuant to the "Duty of Consistency" Doctrine.

Finally, Petitioner appeals the tax court's ruling regarding the deductibility of his alimony payments. At trial, Petitioner had sought to claim as a deduction for the 1990 tax year the $72,013.62 alimony payment he made to Verna Banks. He had argued that although he took the deduction in 1993 (when the California Superior Court had transferred the funds to Verna), because he had paid the funds into court in 1990 he should have taken the deduction then, pursuant to § 461(f) of the Internal Revenue Code, 26 U.S.C. § 461(f).[8] In denying Petitioner the deduction, the tax court had agreed with Petitioner that an alimony deduction would properly have been taken in 1990. However, the tax court continued, because the Commissioner was now precluded by the § 6501 statute of limitations from adjusting Petitioner's 1993 tax year, the duty of consistency doctrine prevented Petitioner from "taking one position on one tax return and a contrary position on another return for which the limitation period has run." 81 T.C.M. (CCH) 1219, 2001 Tax Ct. Memo LEXIS 68, at *29, 2001 WL 196751. On appeal, Petitioner asserts that this ruling was erroneous as a matter of law. Because the tax court failed to follow our precedent as to the "duty of consistency" rule, we reverse the tax court's ruling with respect to this issue and remand for further consideration.

The "'duty of consistency' rule prevents a taxpayer who has already had the advantage of a past misrepresentation in a year now closed to review by the government from changing his position and, by claiming

[8] Section 461 provides a deduction for payment of alimony. Specifically, § 461(f) provides that where the alimony payment is a "contested liability," then a transfer of such contested funds is deductible if the following four criteria are met: (1) taxpayer contests an asserted liability, (2) he transfers money or other property to provide for the satisfaction of such liability, (3) the contested nature of the liability still exists after the transfer has been completed, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed in the taxable year of the transfer. 26 U.S.C. § 461(f).

he should have paid more tax before, avoiding the present tax." *Lewis* v. *Comm'r*, 18 F.3d 20, 26 (1st Cir. 1994) (citing *Beltzer* v. *United States*, 495 F.2d 211, 212-13 (8th Cir. 1974)). When this situation arises, "the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary." *Eagan* v. *United States*, 80 F.3d 13, 17 (1st Cir. 1996). The rule's purpose is to "preclude[ ] parties from 'playing fast and loose with the courts' " by taking a position in a given tax year, then taking a contrary position once the statute of limitations has run on that taxable year. *Estate of Ashman* v. *Comm'r*, 231 F.3d 541, 543 (9th Cir. 2000) (quoting *Russell* v. *Rolfs*, 893 F.2d 1033, 1037 (9th Cir. 1990)).

The controlling case on this doctrine is *Crosley Corp.* v. *United States*, 229 F.2d 376 (6th Cir. 1956), which instructs that for the "duty of consistency" doctrine to apply,

> the taxpayer by his conduct must knowingly make a representation or conceal a material fact which he intends or expects will be acted upon by taxing officials in determining his tax, and the true or concealed material facts are unknown to the taxing officials or they lack equal means of knowledge with the taxpayer, and act on his representation or concealment, and to retrace their steps on a different state of facts would cause loss of taxes to the Government. A material factor is the availability of the necessary facts to the parties involved.

Id. at 380-81. Additionally, "[e]stoppel is an affirmative defense and the burden of proof is on the person asserting it." *Id.* at 381 (citing *Helvering* v. *Brooklyn*

City R.R. Co., 72 F.2d 274, 275 (2d Cir. 1934)). In *Crosley*, the taxpayer had erroneously deducted certain expenses over one year, instead of capitalizing them over two years. He therefore filed a claim for refund with respect to the lost year. *Id.* at 378. The district court granted summary judgment in favor of the government based on the duty of consistency doctrine. We reversed, noting that "[t]here was no misrepresentation of any fact by the taxpayer," *id.* at 381, and that, "[u]nder the facts which were known to the Commissioner, or were readily available to him, it was a question of law whether the deduction was properly taken in 1939 or should have been treated as a capital expenditure. A mutual mistake of law on the part of the taxpayer and the Commissioner in treating it as a cost of manufacturing does not create an estoppel." *Id.* We therefore reversed the judgment and remanded for further proceedings. *Id.*[9]

The *Crosley* case controls the present matter and mandates a reversal of the tax court's finding on this issue. We note that the tax court made no finding that Petitioner engaged in a misrepresentation, as *Crosley* requires. Moreover, as Petitioner correctly asserts, his mistake in taking the alimony deduction in 1993 instead of 1990 was a mistake of law, not of fact. Finally, there

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[9] Other circuits similarly have required that evidence of a misrepresentation be presented in order for the duty of consistency doctrine to apply. *See, e.g.*, *Eagan*, 80 F.3d at 17 ("The duty of consistency arises when the following elements are present: '(1) a representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner.' ") (quoting *Herrington* v. *Comm'r*, 854 F.2d 755, 758 (5th Cir. 1988)).

is an open issue as to whether the Commissioner had the same facts on hand as did Petitioner when he took the § 461 deduction in 1993. The tax court made no findings as to these issues. Instead, it declared that because 1993 was a closed tax year and the circumstances satisfied all the elements of the "duty of consistency" rule, Petitioner was precluded from arguing the deductibility of the alimony payment as to the 1990 tax year. However, aside from noting that 1993 was a closed tax year, the court did not address the other elements of the "duty of consistency" rule as articulated in *Crosley*, most particularly our requirement that Petitioner seeks to make a contrary factual representation, as opposed to correcting an earlier erroneous interpretation of the law. Thus, it appears that the tax court was applying a standard other than the standard established by *Crosley*. Application of a rule contrary to our own is erroneous, because the tax court is bound to follow Sixth Circuit precedent. *See Golsen* v. *Comm'r*, 54 T.C. 742, 756-57, 1970 WL 2191 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). We therefore hold that the tax court must reconsider this issue in light of our precedent in *Crosley*.

The Commissioner invites us to affirm the tax court's denial of a § 461 deduction to Petitioner on the alternative ground that Petitioner failed to establish on the record that his $72,013 payment constituted alimony within the meaning of § 71(b). The Commissioner argues that Petitioner failed to meet the § 71 standard because the record indicates that Petitioner's payments were for Verna's divisible community property share of Petitioner's military retirement benefits, and that this really was "a non-deductible division of community property between the divorced spouses." (Commissioner's Br. at 45.) The Commissioner adds that the $72,013 represented security for satisfaction of the arrears on Verna's payments, but also attorney's fees, which are not deductible.

We decline the Commissioner's invitation. First of all, it does not appear that the Commissioner contested at the tax court trial the issue of whether Petitioner's $72,013 payment to his former spouse constituted alimony within the meaning of § 71. Moreover, although the tax court indicated that Petitioner should have taken the § 461 deduction in 1990 as opposed to 1993, the tax court did not elaborate on the analysis, and in particular the tax court offered no detailed discussion as to whether the $72,013 payment constituted alimony within the meaning of § 71, as required by § 461. Therefore, while the Commissioner may be correct as to the proper

characterization of the $72,013 payment, it is not clear on the present record whether the tax court made a specific factual finding as to whether Petitioner's $72,013 payment constituted § 71 alimony, or whether the court was assuming arguendo that the $72,013 payment constituted alimony for purposes of rejecting Petitioner's argument based on the "duty of consistency" doctrine. Further, it is not clear on this record whether such a finding was erroneous, if indeed the tax court made such a finding. We are not inclined, on this limited record, to determine the character of the $72,013 payment or the propriety of a § 461 deduction (notwithstanding the "duty of consistency" doctrine) in reviewing the tax court's ultimate resolution of the issue.

Because the tax court did not follow our precedent in *Crosley* in determining that the doctrine of consistency applies, we reverse the tax court's denial of the § 461 deduction Petitioner seeks. However, on remand, the tax court, if it deems appropriate, may revisit the issue of whether the $72,013 payment constituted alimony within the meaning of § 71. In making this determination, the court may consider any new evidence the Commissioner or Petitioner wishes to present on the issue.

IV. CONCLUSION

For the foregoing reasons, we **AFFIRM** the tax court's decision that Petitioner's California federal court suit settlement proceeds were not excludable from gross income under 26 U.S.C. § 104. However, we **REVERSE** the tax court's determination that the contingency fees Petitioner paid to his attorney constituted taxable income, and we **REVERSE** the tax court's ruling that Petitioner could not deduct his alimony payments for the 1990 taxable year based on the "duty of consistency" doctrine. We **REMAND** this case to the tax court for further consideration consistent with this opinion.

MOORE, Circuit Judge, concurring in part and dissenting in part.

Although I agree with much of the majority's thoughtful opinion, I write separately to express my disagreement regarding the contingency-fee issue.

As the majority holds, we are bound by our circuit's recent decision in *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000), which held that the lawyer's contingency fee operated as a lien on the client's recovery that under Michigan law transferred part of the ownership of the client's claim to the attorney, such that the client never realized income on the contingency-fee part of the judgment. We are dealing here, however, not with Michigan law but with California law regarding the characterization of the lawyer's contingency-fee interest in taxpayer Banks's employment-related claim. California's law has been authoritatively and persuasively construed by a panel of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), which 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 (relying on *Isrin* v. *Superior Court*, 63 Cal.2d 153, 45 Cal. Rptr. 320, 403 P.2d 728, 732, 733 (1965)). California law, as explained by the California Supreme Court and the Ninth Circuit, clearly treats the attorney's contingency-fee contract as simply a security interest and not as an ownership interest. Thus I would affirm the Tax Court's ruling here that the proceeds the taxpayer paid to his attorney as a contingency fee should be included in the taxpayer's income. *See also Srivastava* v. *Commissioner*, 220 F.3d 353, 367-69 (5th Cir. 2000) (Dennis, J., dissenting).

Regarding the issue of the deductibility of the taxpayer's payments to his ex-wife and the duty of consistency, I do not disagree with the majority's assessment that the Tax Court did not appear to apply our half-century-old case, *Crosley Corp.* v. *United States*, 229 F.2d 376 (6th Cir. 1956), and that the Tax Court did not appear to make any relevant factual findings. Therefore I do not disagree with remanding this issue to the Tax Court for further proceedings. I note that this case seems to me to be one where the duty of consistency applies, because the taxpayer has unique knowledge regarding the nature and timing of his payments for his ex-wife, such that he should not be able to take one position on one tax return and a diametrically opposite position on another return on which the statute of limitations has run against the government. I suggest that in revisiting this issue, the Tax Court is free to determine whether there was a representation by the taxpayer as well as to evaluate the other requirements that comprise our version of the duty of consistency. I agree with the majority that on remand the Tax Court also may address the underlying question whether the payment even constituted § 71 alimony at all.

Finally, I concur fully in the majority's determinations that the taxpayer's characterization of the settlement proceeds as payment for personal injuries is worth no weight and that the Tax Court properly determined that no portion of the settlement amount was attributable to personal injuries.

APPENDIX B

UNITED STATES TAX COURT

No. 18096-97, 18097-97

JOHN W. BANKS, II, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JOHN W. BANKS, II, AND NORA J. BANKS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Feb. 28, 2001

MEMORANDUM FINDINGS OF FACT AND OPINION

LARO, J.

The notice of deficiency in docket No. 18096-97 reflects deficiencies of $11,707, $101,168, and $8,772 in the 1988, 1990, and 1991 Federal income tax liabilities, respectively, of John W. Banks, II (petitioner). The notice of deficiency in docket No. 18097-97 reflects a deficiency of $24,654 in the 1992 Federal income tax liability of petitioner and Nora J. Banks. By way of an amendment to the answer in docket no. 18096-97, respondent disallowed deductions of $108,306 including a net operating loss (NOL) carryover of $101,365 that petitioner applied to 1988 and alleged a resulting additional deficiency of $10,596 for that year. Respondent also alleged in the amended answer that petitioner was liable for a $5,576 addition to his 1988 tax under Section 6651(a)(1).[1]

Following the parties' concessions, including one by respondent that Nora J. Banks has no deficiency for 1992 because she qualifies for relief from joint liability on a joint return under section 6015, we must decide:

1. Whether petitioner's gross income includes any of the settlement proceeds which he received from an action based, in part, on Title VII of the Civil Rights Act of 1964 (title VII), Pub. L. 88-352, 78 Stat. 253;

2. Whether petitioner may deduct an NOL in any of the subject years;

3. Whether petitioner's 1992 gross income includes the items of income discussed below;

4. Whether petitioner is entitled to the deductions described below;

5. Whether petitioner is liable for the addition to tax determined by respondent under Section 6651(a)(1); and

6. Whether petitioner is entitled to relief from joint liability on a joint return under Section 6015(c) for 1992.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the years in issue. Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Petitioner resided in Benton Harbor, Michigan, when the petitions in these cases were filed. From 1972 through July 14, 1986, petitioner was employed as an educational consultant by the California Department of Education (DOE). The DOE terminated petitioner's employment effective July 14, 1986. Petitioner's termination was upheld on appeal.

In 1983, petitioner filed a charge against the DOE with the Equal Employment Opportunity Commission. By letter dated April 20, 1984, that commission notified petitioner that he had the right to sue the DOE under title VII. This letter is a jurisdictional prerequisite to filing suit in Federal District Court under title VII.

On June 28, 1984, petitioner filed a complaint in the United States District Court for the Eastern District of California (District Court) against the DOE and others (Banks I). The complaint alleged violations under title VII and 42 U.S.C. sec.1981 (1982). Petitioner filed two amended complaints, the last of which (second amended complaint) was filed by the District Court on January 15, 1985. The second amended complaint alleged unlawful discrimination in employment practices under title VII and 42 U.S.C. secs.1981 and 1983 (1986). The second amended complaint also alleged claims arising under California law, including claims of intentional infliction of emotional distress and slander. The second amended complaint sought the following relief:

ON THE FIRST COUNT

1. For general damages for violation of plaintiff's constitutional rights, harassment, humiliation, and embarrassment in an amount subject to proof;

2. For medical and hospital expenses in an amount subject to proof;

3. For future medical and hospital expenses in an amount subject to proof;

4. For punitive and exemplary damages in an amount determined by the trier of fact;

5. For reasonable attorneys fees incurred in the prosecution of this action;

6. For costs of suit herein incurred;

7. For such other and further relief that the Court may deem just and proper.

ON THE SECOND AND THIRD COUNTS

1. An order requiring defendants and each of them to promote plaintiff to the position of Administrator II, in the State Department of Education;

2. An order requiring defendants, and each of them, to make whole by appropriate back pay and related employee benefits, and damages to plaintiff because of being adversely affected by discrimination on account of race in the part of defendants;

3. For general damages to compensate plaintiff for the harm, humiliation, and discrimination suffered in an amount according to proof;

4. An order granting plaintiff a preliminary and permanent injunction restraining defendants, their agents, successors, employees, attorneys, and all others acting in concert with defendants or under

defendants' direction from discriminating on the basis of race or color, and requiring them to undertake remedial action to eradicate any effects of past discrimination;

5. An order awarding reasonable attorneys' fees and costs; and,

6. An order granting such further relief as the court deems proper.

ON THE FOURTH COUNT

1. For general damages in the sum of $1,000,000.00 (One Million Dollars);

2. For medical, hospital and related expenses according to proof;

3. For lost earnings and losses sustained in the sum of $1,000,000.00 (One Million Dollars);

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred:

6. For such other and further relief that the court may deem just and proper.

ON THE FIFTH COUNT

1. For general damages to plaintiff's reputation in the sum of $1,000,000.00 (One Million Dollars);

2. For special damages for lost profits and losses sustained in the sum of $4,500,000.00 ($4.5 Million);

3. For medical, hospital, and related expenses according to proof;

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred;

6. For such other and further relief that the Court may deem just and proper.

ON THE SIXTH COUNT

1. For general damages to plaintiff's reputation in the sum of $1,000,000.00 (One Million Dollars);

2. For special damages for lost profits and losses sustained [in] the sum of $4,500,000.00 ($4.5 Million);

3. For medical, hospital, and related expenses according to proof;

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred;

6. For such other and further relief that the Court may deem just and proper.

On November 25, 1987, petitioner filed in the District Court a second lawsuit (Banks II) against the DOE and others. Petitioner alleged in Banks II violations under title VII and 42 U.S.C. sec.1983 (1982). Banks II was consolidated with Banks I (Banks cases) on January 19, 1989.

On September 22, 1989, the District Court issued a final pretrial conference order in the Banks cases. The order states, under the heading "RELIEF SOUGHT", that "Plaintiff seeks only reinstatement, back pay, and attorneys' fees." The order also states, under the heading "ABANDONED ISSUES", that "Plaintiff has abandoned all claims for damages relative to state tort claims, including a claim for intentional and negligent imposition of emotional distress, tortious interference with business relations, and defamation."

Petitioner and the DOE settled the Banks cases before judgment and reflected their settlement in a settlement agreement dated May 30, 1990. The settlement agreement provides in relevant part that "Plaintiff characterizes this payment of $464,000.00 as a payment for personal injury damages suffered after plaintiff's discharge on July 14, 1986."

On July 29, 1986, petitioner filed a voluntary petition in the United States Bankruptcy Court in Sacramento, California, under chapter 7 of the United States Bankruptcy Code. When he did so, petitioner owned an interest in a fully developed subdivision known as Frenchtown Hills Subdivision (Frenchtown Hills) and a 15-percent interest in a real estate partnership known as Auburn Bluffs, Ltd. (Auburn Bluffs). Auburn Bluffs' primary asset was an incomplete subdivision that was not ready to be sold as individual lots. Petitioner's interests in Frenchtown Hills and Auburn Bluffs became part of his bankruptcy estate (estate).

On August 8, 1986, the bankruptcy court appointed a trustee, John Roberts, to administer the estate. Mr. Roberts decided not to have the estate develop either Frenchtown Hills or the Auburn Bluffs property. Mr. Roberts asked the bankruptcy court on August 15, 1986, to approve the estate's employment of a firm to market and sell Frenchtown Hills.

Each lot in Frenchtown Hills was sold during the estate's administration at its fair market value. Petitioner did not object to those values. The estate was unable to sell petitioner's Auburn Bluffs' partnership interest. Instead, the trustee reached a stipulated settlement with Auburn Bluffs' partners. Petitioner paid $10,000 to the estate for the claim against the DOE.

At the request of Mr. Roberts, Michael Owen, a certified public accountant, prepared fiduciary income tax returns for each of the estate's taxable years ended June 30, 1986 through 1990, and for a short period ended on December 31, 1990. Mr. Owen obtained from Mr. Roberts, petitioner, and/or third parties information as to the bases of property sold during the relevant years. Mr. Roberts filed with the Commissioner each of the returns prepared by Mr. Owens. The Commissioner destroyed those returns. Mr. Roberts retained unsigned copies of the returns.

On April 19, 1993, Mr. Roberts filed his final report and proposed distribution with the bankruptcy court as to the estate. The purpose of that filing was to put all interested parties, including creditors and the debtor, on notice as to his proposal to wind up the estate. On July 19, 1993, the bankruptcy court entered an order approving Mr. Roberts' final report and payment of dividends. On October 29, 1993, Mr. Roberts filed his report of final account and request for closing and discharge of trustee. In 1993, in winding up the estate, the estate made its final distributions to creditors and distributed to petitioner, the debtor, $3,700.

On December 29, 1993, the bankruptcy court ordered the estate closed. The estate did not disclaim any NOLs or any other property, except for some raw land in Arkansas that was abandoned by the trustee. The closing of the estate was delayed because petitioner sued Mr. Roberts, the trustee.

On his 1985 Federal income tax return, petitioner claimed a $61,592 loss from the sale of subdivision lots in Frenchtown Hills and a $48,589 loss from various Auburn Bluffs partnership interests. On his 1986 return, petitioner claimed a $53,192 loss from the sale of subdivision lots in Frenchtown Hills and a $90,036 loss from various Auburn Bluffs partnership interests. On his 1987 return, petitioner claimed a $17,100 loss from the sale of subdivision lots in Frenchtown Hills, a $9,666 loss from various Auburn Bluffs partnership interests, and a $110,617 deduction for an NOL carryover from 1986.

On or about January 30, 1991, petitioner filed an amended return for 1987 in which he increased by $47,788 the cost of goods sold as to his Frenchtown Hills interest. The increase to the cost of goods sold increased his claimed loss from $17,100 to $64,888 and his claimed remaining NOL carryover to $146,458. On his 1988 return, petitioner claimed a $101,365 deduction for an NOL carryover; he did not report an NOL; nor did he report any losses from Frenchtown Hills or Auburn Bluffs. On his 1988 return, petitioner reported a net profit of $62,304 from the sale of lots in the Frenchtown Hills subdivision.

Shortly before this Court's trial of this case, petitioner raised as an issue whether he was entitled to deduct $450,000 as a bad debt or NOL on account of Mr. Roberts' abandonment of a judgment against Milton

McGhee. Petitioner won a $483,600 judgment against Mr. McGhee in 1984, which became property of the bankruptcy estate. Petitioner abandoned his claim for a bad debt deduction at trial. Petitioner did not inform William Wise, his attorney in this proceeding, that he had deducted the McGhee bad debt on his 1997 return.

In his petitions and at trial, Mr. Banks asserted that he was entitled to additional losses from Frenchtown Hills, losses which he alleges were abandoned by Mr. Roberts and are deductible in 1990. Mr. Banks deducted $1,060,122 on his 1994 return for "involuntary conversion—French Town Hills—106122 near Shingle Springs, CA Loss taken due to court proceedings—details in taxpayers file." Petitioner did not inform Mr. Wise that petitioner had deducted the Frenchtown Hills loss on his 1994 return.

On his 1991 tax return, petitioner showed an NOL carryover of $64,445, which he used to offset $50,843 in income. On his 1992 tax return, petitioner showed an NOL carryover of $182,510, which was used to offset $142,022 in income. In 1988, petitioner was aware he had gross income, including $9,906 in wages, $17,088 in retirement pay, $1,552 in unemployment compensation, and $1,838 in commissions. Not including net profit in the amount of $62,304 reported on Schedule C and shown on line 12, petitioner had gross income in 1988 in the amount of $30,384. Petitioner did not sign his 1988 tax return until March 7, 1990.

OPINION

1. *Taxability of Settlement Proceeds*

We must decide whether petitioner received any of the settlement proceeds on account of a personal injury. To the extent that he did, the funds are excludable from his gross income. See sec. 104(a)(2). To the extent that he did not, the funds are includable in his gross income. See sec. 61(a). Because respondent determined that none of the proceeds are excludable from petitioner's gross income under Section 104(a)(2), petitioner must prove otherwise. See Rule 142(a); *Welch* v. *Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L.Ed. 212 (1933); *Robinson* v. *Commissioner*, 102 T.C. 116, 124, 1994 WL 26303 (1994), *aff'd* in part, revd. in part on an issue not relevant herein and remanded 70 F.3d 34 (5th Cir. 1995).

For 1990, Section 104(a)(2) excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness". Damage recoveries fall within this provision to the extent that: (1) The cause of action giving rise to the damages is based upon tort or tort type rights and (2) the damages are received on account of personal injuries or sickness. See *Commissioner* v. *Schleier,* 515 U.S. 323, 336-337, 115 S. Ct. 2159, 132 L.Ed.2d 294 (1995). For the taxable year under consideration, personal injuries included both physical and nonphysical injuries. *See id.* at 329 n. 4.

The nature of the claim underlying a damage award, rather than the validity of the claim, determines whether damages meet the two-part *Schleier* test. See *United States* v. *Burke*, 504 U.S. 229, 237, 112 S. Ct.

1867, 119 L.Ed.2d 34 (1992); *Robinson* v. *Commissioner*, *supra* at 125-126. Ascertaining the nature of the claim is a factual determination that is generally made by reference to the settlement agreement, in light of the facts and circumstances surrounding it. Key to this determination is the "intent of the payor" in making the payment. *Knuckles* v. *Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), affg. T.C. Memo.1964-33; *Agar* v. *Commissioner*, 290 F.2d 283, 284 (2d Cir. 1961), affg. per curiam T.C. Memo.1960-21; *Seay* v. *Commissioner*, 58 T.C. 32, 37, 1972 WL 2542 (1972). We ask ourselves: "In lieu of what were the damages awarded?" See *Robinson* v. *Commissioner*, *supra* at 126, and the cases cited therein. Although the payee's belief is relevant to this inquiry, the ultimate character of the payment rests on the payor's dominant reason for making the payment. See *Agar* v. *Commissioner*, 290 F.2d at 284; *Fono* v. *Commissioner*, 79 T.C. 680, 1982 WL 11175 (1982), *aff'd* without opinion 749 F.2d 37 (9th Cir. 1984). A payor's intent may sometimes be found in the characterization of the payment in a settlement agreement, but such a characterization is not always dispositive. Such a characterization is not dispositive, for example, when the record proves the characterization was not the product of bona fide adversarial negotiations. See *Bagley* v. *Commissioner*, 105 T.C. 396, 406, 1995 WL 730447 (1995); *Robinson* v. *Commissioner*, *supra*; *Threlkeld* v. *Commissioner*, 87 T.C. 1294, 1306-1307, 1986 WL 22061 (1986), *aff'd* 848 F.2d 81 (6th Cir. 1988); see also *Knuckles* v. *Commissioner*, *supra* at 613; *Eisler* v. *Commissioner*, 59 T.C. 634, 640, 1973 WL 2521 (1973).

Following his abandonment in the District Court of his State law tort claims, petitioner's causes of action in the Banks cases were limited to alleged violations under title VII and 42 U.S.C. secs. 1981 and 1983 (1986). Petitioner settled those claims before the enactment and effective date of the Civil Rights Act of 1991, Pub. L. 102-166, 105 Stat. 1071. As to pre-1991 title VII, the Supreme Court has concluded:

> we cannot say that a statute such as Title VII, whose sole remedial focus is the award of back wages, redresses a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations.
>
> Accordingly, we hold that the backpay awards received by respondents in settlement of their Title VII claims are not excludable from gross income as "damages received . . . on account of personal injuries" under § 104(a)(2). [*United States* v. *Burke*, 504 U.S. 229, 241-242, 112 S. Ct. 1867, 119 L.Ed.2d 34; fn. refs. omitted.]

On the basis of *United States* v. *Burke*, we hold that none of the settlement proceeds attributable to petitioner's pre-1991 title VII claim are excludable from income pursuant to Section 104(a)(2).

We turn next to the portion (if any) of the settlement amount that is attributable to petitioner's remaining claims under 42 U.S.C. secs. 1981 and 1983 (1986).

The Supreme Court in *United States* v. *Burke*, *supra* at 240, noted: "Rev. Stat. § 1977, 42 U.S.C. § 1981, permits victims of race-based employment discrimination to obtain a jury trial at which 'both equitable and legal relief, including compensatory and, under certain circumstances, punitive damages' may be awarded."

The court went on to say unlike title VII actions such actions were tortlike.

With the enactment of 42 U.S.C. sec.1983, the Congress created a "federal cause of action unknown at common law, [for] the deprivation of any rights, privileges, or immunities secured by the Constitution and laws [of the United States.] * * * In the broad sense, every cause of action under § 1983 which is well-founded results from 'personal injuries'." *Almond* v. *Kent*, 459 F.2d 200, 204 (4th Cir. 1972). The Supreme Court has declared that 42 U.S .C. sec. 1983 was intended to create a species of tort liability. See *Carey* v. *Piphus*, 435 U.S. 247, 253, 98 S. Ct. 1042, 55 L.Ed.2d 252 (1978). This Court has held that damages received in a suit under 42 U.S.C. sec. 1983 for a violation of a first amendment right were excludable under Section 104(a)(2). See *Bent* v. *Commissioner*, 87 T.C. 236, 1986 WL 22165 (1986), *aff'd.* 835 F.2d 67 (3d Cir. 1987).

However, in the instant case the pretrial order explicitly limits the remedies sought by petitioner: "Plaintiff seeks only reinstatement, back pay, and attorneys' fees". These remedies are available under title VII. The remedies do not include both equitable and legal relief, including compensatory and punitive damages allowable under 42 U.S.C. secs. 1981 or 1983. On the basis of the pretrial order, we find that petitioner had, at the time of settlement, abandoned his claims under 42 U.S.C. secs. 1981 and 1983. Consequently none of the settlement amount is attributable to a claim of personal injury.

Although the settlement agreement recites petitioner's desired characterization of the entire settlement proceeds as "payment for personal injury damages suffered after plaintiff's discharge on July 14, 1986", we, unlike petitioner, do not accept that statement as a binding characterization of the settlement proceeds.

In *Robinson* v. *Commissioner*, 102 T.C. 116, 1994 WL 26303 (1994), the taxpayers sued a State bank for failing to release a lien on their property. After the jury returned a verdict in their favor for approximately $60 million, including $6 million for lost profits, $1.5 million for mental anguish, and $50 million in punitive damages, the parties to that proceeding settled. In the final judgment reflecting the settlement, which was drafted by the parties and signed by the trial judge, 95 percent of the settlement proceeds was allocated to mental anguish and 5 percent was allocated to lost profits. We held that this allocation did not control the taxability of the proceeds to the taxpayers. We noted that the allocation was "uncontested, nonadversarial, and entirely tax motivated", and that it did not accurately "reflect the realities of * * * [the parties'] settlement." *Id.* at 129; accord *Hess* v. *Commissioner*, T.C. Memo. 1998-240.

The same is true here. While the underlying litigation was certainly adversarial, the parties were no longer adversaries after they agreed on a settlement in principle. Petitioner wanted the settlement payment connected to a tortlike personal injury so that he could maximize his recovery by avoiding taxes on his recovery. The DOE, on the other hand, did not care whether the settlement proceeds were allocated to tortlike personal injury damages vis-a-vis other damages. The DOE's dominant concern was that all of petitioner's claims be settled. The DOE, in effect, gave petitioner the green light to state in the settlement agreement his opinion as to the characterization of the settlement proceeds. Petitioner and the DOE did not prepare the settlement agreement by assessing the damages of the lawsuit and allocating petitioner's recovery accordingly.

In a setting such as this, where the parties to a settlement agreement fail to reflect accurately their agreement in a written document, we need not accept the characterization of one of the parties. That petitioner may have wanted the payment to be characterized as compensation for a tortlike personal injury does not govern the taxation of the payment for purposes of Section 104(a)(2). The key to the payment's taxability, as discussed above, turns on the payor's intent. That intent, we find, is found in the District Court's pretrial order. Pretrial orders, unless modified, control the subsequent course of a lawsuit, see Fed. R. Civ. P. 16(e), and we find nothing in the record to indicate that the District Court's pretrial order was not in effect when the case settled. As the District Court's pretrial order states clearly: "Plaintiff seeks only reinstatement, back pay, and attorneys' fees" and "Plaintiff has abandoned all claims for damage relative to state tort claims, including a claim for intentional and negligent imposition of emotional distress, tortious interference with business relations, and defamation." Because petitioner was not seeking personal injury damages at the time of settlement, we hold for respondent on this issue. None of the settlement proceeds are excludable under Section 104(a)(2).

Petitioner also contends that $150,000 of the proceeds that he paid to his attorney as a contingent fee is excludable from his gross income under *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), revg. in part and affg. in part 28 T.C. 947, 1957 WL 1117 (1957)

(*Cotnam*), and its progeny. *Cotnam* excluded from a taxpayer's gross income the portion of a damage award paid to the taxpayer's attorney under a contingent fee arrangement.

We disagree that the holding of the Court of Appeals in *Cotnam* or its progeny control this case. In *Kenseth* v. *Commissioner*, 114 T.C. 399, 412, 2000 WL 669977 (2000), we reconsidered our view of the *Cotnam* holding in light of the views as to that holding expressed by various Courts of Appeals, including the Court of Appeals for the Sixth Circuit Court of Appeals in *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, 202 F.3d 854 (6th Cir. 2000). We concluded in *Kenseth* v. *Commissioner*, *supra* at 412 that we respectfully continue to believe that *Cotnam* was wrongly decided and that we would "adhere to our holding * * * [contrary to *Cotnam*] that contingent fee agreements * * * come within the ambit of the assignment of income doctrine and do not serve * * * to exclude the fee from the assignor's gross income."

The Court of Appeals for the Sixth Circuit, the court to which an appeal of this case lies, agrees with the holding in *Cotnam* that excludes from a taxpayer's gross income the portion of a damage award paid to the taxpayer's attorney under a contingent fee arrangement. In *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, *supra* at 856, the Court of Appeals for the Sixth Circuit interpreted applicable State (Michigan) law to operate more or less the same way as the applicable State (Alabama) law in *Cotnam*. The court held that a portion of the contingent fee paid to the estate's attorneys was not includable in the estate's income. The court rejected the proposition that the assignment of income doctrine enunciated in *Lucas* v.

Earl, 281 U.S. 111, 50 S. Ct. 241, 74 L.Ed. 731 (1930), is applicable to such contingent fee agreements.

Under our so-called *Golsen* doctrine, see *Golsen* v. *Commissioner*, 54 T.C. 742, 756-757, 1970 WL 2191 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971), we follow the holding of a Court of Appeals to which a case is appealable where that holding is squarely on point. For the reasons stated by the Court of Appeals for the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941, 943 (9th Cir. 2000), affg. T.C. Memo.1998-395, and *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), affg. T.C. Memo.1998-291, we conclude, as did the Court of Appeals in those cases, that *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, *supra*, is distinguishable. Whereas the applicable State law in *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, *supra*, was that of Michigan, the applicable State law here is that of California. Under California law, an attorney's lien does not confer any ownership interest upon an attorney or grant an attorney any right and power over the suits, judgments, or decrees of their clients. As explained by the California Supreme Court, in interpreting its State law:

> in 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 to 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*, 54 Cal.2d 632, 641, 7 Cal. Rptr. 377, 354 P.2d 1073 (1960), * * * 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."
>
> *   *   *   *   *
>
> [t]he conclusion emerges that in litigation an attorney conducts for a client he acquires no more than a professional interest. To hold that a contingent fee contract or any "assignment" or "lien" created thereby gives the attorney the beneficial rights of a real party in interest, with the concomitant personal responsibility of financing the litigation, would be to demean his profession and distort the purpose of the various acceptable methods of securing his fee. * * * [*Isrin* v. Superior Court, 63 Cal. 2d 153, 45 Cal. Rptr. 320, 403 P.2d 728, 732, 733 (Cal. 1965).]

See Benci-Woodward v. Commissioner, supra, where the Court of Appeals for the Ninth Circuit held that California law did not operate to exclude a contingent fee payment from the taxpayers' gross income.

On the basis of California law, as interpreted in *Isrin* v. *Superior Court*, *supra*, and *Benci-Woodward* v. *Commissioner*, *supra*, we hold that all of the settlement proceeds, less the $10,000 paid to the estate for the cause of action, must be included in petitioner's gross income in the year received.

2. *NOL's*

Section 1398 applies to this case because petitioner is an individual who was a debtor in a proceeding under chapter 7 of the U .S. Bankruptcy Code. See sec. 1398(a). Section 1398 provides that a debtor's bankruptcy estate succeeds to the debtor's NOL carryovers and that the debtor succeeds to the NOL carryovers which remain when the bankruptcy estate is terminated. See sec. 1398(g), (i).

Petitioner's estate was created on July 29, 1986, upon his filing of his petition with the bankruptcy court. See 11 U.S.C. sec. 303 (1978). Because the estate did not terminate until it closed on December 29, 1993, see 11 U.S.C. sec. 346(i)(2) (1976); see also *Firsdon* v. *United States*, 95 F.3d 444, 446 (6th Cir. 1996); *McGuril* v. *Commissioner*, T.C. Memo.1999-21; *Beery* v. *Commissioner*, T.C. Memo. 1996-464, we hold that he was not entitled to claim personally in the subject years a deduction for an NOL that arose prior to the estate's commencement; see sec. 1398(g); see also *Kahle* v. *Commissioner*, T.C. Memo.1997-91. (NOL's determined as of the first day of the debtor's taxable year in which the bankruptcy case commences become part of the estate and no longer belong to the debtor-taxpayer).

3. *Income Items*

Items of gross income realized from the assets of a bankruptcy estate after the commencement of a bankruptcy action are generally included in the gross income of the bankruptcy estate rather than the gross income of the debtor. See sec. 1398(e)(1) and (2).

Petitioner's 1988 individual income tax return shows a net profit of $62,304 from the "Sales—subdivision lots French Hills". The Frenchtown Hills subdivision was part of the estate in 1988, and the related sales income was includable in the estate's gross income. We understand Mr. Roberts to have reported that sales income on the estate's 1988 fiduciary return. Accordingly, the

$62,304 is excluded from petitioner's gross income for 1988.

Petitioner also seeks to exclude the following sums of interest income: $6,126 (unreported), $5,847 (reported), and $5,196 (reported) for 1992; and $12,412 and $6,113 (both reported) for 1991. Petitioner argues that these amounts were reported on the estate's tax returns. We disagree. The last return that the estate filed was for 1990. We conclude that all of the interest income, both reported and unreported, was includable in petitioner's gross income for the respective years in which received.

4. *Deductions*

Petitioner seeks deductions for a 1990 or 1991 capital loss, attorney's fees in excess of the $150,000 allowed by the respondent, amounts repaid to his Public Employees Retirement System (PERS) account, amounts allegedly deducted from employee compensation paid to him in an earlier year, and alimony allegedly paid to his ex-wife, Verna Jo Banks. Petitioner has not proved his entitlement to any of these deductions. See Rule 142(a).

As to the capital loss, the record does not support petitioner's claim that he is entitled to deduct such a loss in either 1990 or 1991. The same is true as to the excess attorney's fees. The only evidence petitioner presented to substantiate his claim to a deduction for attorney's fees paid in 1990 (over and above the $150,000 mentioned above) was his uncorroborated testimony that he paid $45,000 of the settlement proceeds to another attorney in the lawsuits. We find that testimony unpersuasive and self-serving. We also find no substantiation (nor perceive any rationale) for petitioner's claim to a $14,000 deduction for alleged loan repayments to his PERS account, or to a $14,000 deduction for alleged withholding from his pay for his wrongful use of his employer's property.

As to the alimony, petitioner claims a deduction of $72,013.62 for alimony paid to his first wife. Petitioner paid that sum into court in 1990 in connection with a judgment rendered in his divorce proceeding with Vera Banks. The court transferred the funds to Vera Banks in 1993. Petitioner concedes that he deducted this alimony for 1993 but claims that section 461(f) provides that the alimony was deductible in 1990.

While we agree that the deduction would otherwise be allowed in 1990, see sec. 461(f), the circumstances of this case prohibit petitioner from claiming the deduction in that year. The "duty of consistency", sometimes referred to as quasi-estoppel, is an equitable doctrine that Federal courts apply in appropriate cases to prevent unfair avoidance of tax. *Beltzer* v. *United States*, 495 F.2d 211, 212 (8th Cir. 1974); *Cluck* v. *Commissioner*, 105 T.C. 324, 1995 WL 634447 (1995); *LeFever* v. *Commissioner*, 103 T.C. 525, 1994 WL 585354 (1994), *aff'd* 100 F.3d 778 (10th Cir. 1996). The doctrine "is based on the theory that the taxpayer owes the Commissioner the duty to be consistent in the tax treatment of items and will not be permitted to benefit from the taxpayer's own prior error or omission." *Cluck* v. *Commissioner*, *supra* at 331. It prevents a taxpayer from taking one position on one tax return and a contrary position on another return for which the limitation period has run. See *id.* If the duty of consistency applies, a taxpayer who is gaining Federal tax benefits on the basis of a representation is estopped from taking a contrary return position in order to avoid taxes. See *id.*

Because petitioner's 1993 taxable year is a closed year, and because all of the elements of the doctrine are satisfied, we hold that petitioner is bound by the duty of consistency and prohibited from arguing that the alimony was deductible in 1990, rather than in 1993 as he originally reported.

5. *Addition to Tax*

Respondent amended his answer to seek an addition to tax for petitioner's failure to file timely his 1988 Federal income tax return. Respondent has the burden of proof on this issue. See Rule 142(a). Section 6651(a)(1) imposes an addition to tax equal to 5 percent per month of the underpayment up to a maximum of 25 percent for untimely filed returns. This addition to tax is not imposed if the failure to file timely was due to reasonable cause and not due to willful neglect. Petitioner's 1988 Federal income tax return was due on April 15, 1989. Petitioner signed his 1988 Federal income tax return on March 7, 1990, and did not file it until September 27, 1990. The record is void of any explicit explanation as to why petitioner failed to file his return in a timely manner or whether there was a reasonable cause for the untimely filing. We find that respondent has not discharged his burden, and therefore, we do not sustain respondent's determination that petitioner is liable for the addition to tax under Section 6651(a).

6. *Relief From Joint Liability on a Joint Return*

On March 13, 2000, petitioner filed with the Commissioner a Form 8857, Request for Innocent Spouse Relief, electing the application of Section 6015(c) to 1992 and requesting that any deficiency owed by him be computed under the provisions of Section 6015(d). Petitioner argues that he "was divorced from Nora Banks and his election was timely and made in the circumstances contemplated by the statute." Respondent denied petitioner's request.

The items that gave rise to the deficiency, *i.e.*, the reported NOL carryforward and the omitted interest, are all items attributable to petitioner. Section 6015(c) provides relief only to the spouse to whom such items are not attributable. See also sec. 6015(b). We hold that petitioner is not entitled to relief under Section 6015.

All arguments not herein addressed have been rejected as irrelevant or without merit. To reflect the foregoing,

Decisions will be entered under Rule 155.