No. 03-907

In The
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR THE RESPONDENT

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QUESTIONS PRESENTED

1. Is the contingent fee agreement entered into by respondent and his attorney a joint venture governed by Subchapter K of the Internal Revenue Code?

2. Under Oregon law, did respondent's attorney own a pro rata share of the cause of action that resulted in the settlement in the prior court action?

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STATUTORY PROVISIONS INVOLVED

In addition to the statutes reproduced by the petitioner, reprinted in the appendix to this brief are 26 U.S.C. §702(a), 26 U.S.C. §704(a), 26 U.S.C. §761(a), and Oregon Revised Statute 87.475.

STATEMENT

Respondent accepts the Commissioner's Statement, except the opening paragraph, which incorrectly states the holding of the court of appeals and incorrectly states the applicable federal income tax law. The court of appeals held that Oregon law granted the attorney a co-ownership in the cause of action, so that no assignment of income took place.

SUMMARY OF THE ARGUMENT

(1) This case is governed by Subchapter K of the Internal Revenue Code.

A joint venture subject to the provisions of Subchapter K generally involves three elements: (a) each participant agrees to contribute to the joint effort to generate income, (b) the participants' right to any income depends on the success of the venture, and (c) the amount of each share depends, at least in part, on the total income generated by the venture.

The lawsuit against the two banks which had dismissed respondent was just such a joint effort to generate income to be shared by the participants in the venture. Respondent contributed to the joint enterprise the cause of action and the cost of out-of-pocket litigation expenses. The attorney contributed to the joint enterprise a very substantial amount of services as well as his attributable overhead costs. The attorney was only entitled to payment if the venture succeeded, and the size of any payment depended on the amount won.

Such a Subchapter K arrangement is readily distinguishable from a case in which a taxpayer agrees to pay his attorney regardless of the outcome of the case. The attorney's remuneration in such a case would not depend on the result of the litigation; that would simply be the payment of a fee for a service.

Similarly, no joint venture would be involved if the taxpayer assigned a portion of a future judgment in return for legal services (rendered in the past or to be rendered in the future) which were unrelated to the generation of the income in question (i.e., obtaining the judgment). In such a case the taxpayer, in assigning the claim, would realize income equal to the fair market value of the legal services obtained, regardless of the later outcome of the litigation.

Section 702(a) expressly provides that under a joint venture governed by Subchapter K, the income generated by the venture is allocated among the participants for income tax purposes on the basis of the terms of their agreement.

(2) The income allocation provided for by section 702(a), based on the terms of the agreement entered into by the participants in the joint venture, is not affected by whether the contribution to the joint venture from one of the parties consisted of a cause of action or any other type of property.

Section 702(a) states expressly that the allocation in the joint venture agreement is controlling "except as otherwise provided in this chapter." Nothing in that chapter authorizes a different standard for allocating the taxable income where one of the participants has contributed a cause of action or another type of property to the venture.

(3) *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst,* 311 U.S. 112 (1940) do not apply here. Neither of those cases involved any form of joint venture.

Neither the assignee in *Earl* nor the assignee in *Horst* had done anything to contribute to the generation of the income in question. In *Horst*, the taxpayer alone had generated the income by providing the capital used to purchase the bonds and resulting interest payments. In *Earl*, the funds in question were the annual earnings of the taxpayer, in which the assignee had no role whatsoever.

Earl and *Horst* might apply if respondent had assigned a 10% interest in his claim in return for an automobile. Those cases might apply if respondent had assigned a 50% interest in his employment claim to a minor child (a purely gratuitous transfer) or to a lawyer in return for preparing a will (an exchange of a part of a cause of action for a service unrelated to that legal claim). But they do not apply to a joint venture.

(4) Under Subchapter K, the income allocation in the joint venture agreement is controlling regardless of which participant has an ownership interest in or initially receives the funds that are the fruits of that joint enterprise.

(5) If the Court concludes that the income allocation in a case such as this turns on which participant owned the cause of action at issue, respondent is entitled to prevail under the circumstances of this case.

Ownership of the cause of action in this case was governed by Oregon law. Oregon Revised Statutes 87.445 and 87.475 give the attorney in a contingent fee case an ownership interest in that portion of the cause of action sufficient to satisfy the agreed-upon fee. The defendant (not merely the plaintiff) has a debt and a direct legal obligation to the attorney for that amount. If the defendant settles the case and pays the entire amount of the settlement to the plaintiff, the attorney continues to have a cause of action against that defendant (not merely against the former plaintiff) for the amount of the fee provided for by the contingent fee agreement. *Potter v. Schlesser,* 335 Or. 209, 63 P.3d 1172 (2003).

The Commissioner errs in asserting that under Oregon law a plaintiff in such a case is at all times in complete control of the litigation; the plaintiff controls, and can settle, at his sole discretion, only the portion of the cause of action to which the plaintiff would be entitled under the contingent fee agreement. Under Oregon law, "[a]n attorney is . . . given 'the same right and power over . . . actions, suits, (and) proceedings . . .' that his client 'had or may have. . . .'" *In re Grimes' Estate*, 170 Or. 204, 209, 131 P.2d 448, 450 (1943).

The Ninth Circuit correctly concluded that "Oregon law vests attorneys with property interests that cannot be extinguished or discharged by the parties to the action except by payment to the attorney." (Pet. App. 16a). The

Ninth Circuit's interpretation of Oregon law is entitled to substantial deference from this Court.

(6) A reversal in this case would have far-reaching harmful implications for a wide variety of federal and state tort claims and other matters, including cases subject to contingent fee agreements, federal and state fee-shifting statutes, hourly fee agreements, contractual attorney fee provisions, and class action attorney fees.

ARGUMENT

I. When two parties combine their assets and efforts to jointly produce income to be shared between them, each is taxed on his respective share of the resulting income, pursuant to Subchapter K of the Internal Revenue Code. As a result, no assignment of income took place in this case.

In 1995, as a result of the combined efforts of respondent and his attorney, a settlement totaling $8,728,559 was reached with two banks that were responsible for the earlier unlawful dismissal of respondent. The Commissioner urges this Court to construe its past decisions regarding the assignment of income to extend to arrangements of the sort that existed between respondent and his attorney. There is, however, no occasion in this case for a consideration or application of those court-made doctrines regarding assignment of income. The particular agreement entered into between respondent and his attorney falls squarely within, and is governed by, the provisions of Subchapter K of the Internal Revenue Code. Under Subchapter K, the income generated by the litigation, for income tax purposes, is allocated between respondent and his attorney according to the terms of their agreement.

Income is often generated as a result of the combined contributions of two or more individuals or entities. The manner in which, for income tax purposes, that income should be allocated between or among the individuals or entities involved will be governed by different provisions of the Internal Revenue Code, depending on the type of arrangement and transaction involved. When the arrangement is governed by Subchapter K, the income attributed to each participant is ordinarily "determined by the . . . agreement" among those participants. 26 U.S.C. §704(a).

Subchapter K itself applies to a wide variety of arrangements under which participants agree to combine their efforts, capital, assets or other contributions to generate shared income. For simplicity, Subchapter K labels all covered arrangements "partnerships," but Subchapter K emphatically is not limited to arrangements which would constitute a partnership under state partnership laws. Rather, 26 U.S.C. §761(a) provides in broad language that:

> For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

This broad definition does not require formal designation as a partnership or joint venture. "A joint venture has been defined as a 'special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation.'" *Podell v. Commissioner*, 55 T.C. 429, 431 (1970) (*quoting Haley v. Commissioner*, 203 F.2d 815, 818 (5th Cir. 1953)). Unlike state law partnerships, joint venture agreements frequently do not contemplate the creation of a separate legal entity. A joint venture is often merely a form of partnership created for one particular joint effort, rather than multiple enterprises. *Brady v. Commissioner*, 25 T.C. 682, 688 (1955). The joint effort to generate income may be carried on by means of the venture only in the sense that the agreement committed the parties to, and defined the terms of, their joint activity; the joint venture might not and need not be the party to any contracts or hold title to any property. *Underwriters Ins. Agency of America v. Commissioner*, T.C.M. 1980-92, P-H T.C.M. ¶80,092. Joint ventures often are not expressly labeled "joint venture," and sometimes are not even memorialized in any written document. Rather, the phrase "joint venture" simply characterizes a type of arrangement between two or more participants for the joint production and sharing of income.

A joint venture usually involves three elements: (1) each of the participants agrees to contribute in a significant manner to the effort of the venture, such as by providing services, money or property; (2) the participants' entitlement to payment depends on the success of the venture; and (3) the amount of each participant's entitlement depends at least to some degree on the amount of income generated by the venture. *Podell v. Commissioner*, 55 T.C. 429, 431 (1970); *S. & M. Plumbing Co. v. Commissioner*, 55 T.C. 702, 707 (1971).

The mere allocation to an individual of some portion of the proceeds of a venture (e.g. assignment of some share of any award in a particular lawsuit) does not by itself create a joint venture. For example: (a) If respondent had assigned 5% of his employment claim to a real estate lawyer, in return for that attorney's assistance in connection with a real estate development respondent was undertaking, there would not be a joint venture, since the work would be unrelated to the venture. Respondent would realize income (equal to the fair market value of the lawyer's services) with an offsetting equal deduction (since such legal services are an ordinary and necessary business expense.) (b) If respondent had assigned 5% of his claim to an estate law practitioner, in return for that attorney's work preparing respondent's will, that would not even have been deductible, since the work would not be related to the generation of income. Rather, in exchanging a speculative 5% share for legal services, respondent would have received income equal to the fair market value of those legal services; both the existence and amount of respondent's resulting tax liability would not have depended on whether, or how much, the attorney ultimately received. (c) If respondent had assigned 10% of his claim to his children, who did not agree to do anything in return, that would have been a naked (albeit speculative) assignment of income, with no tax consequences at all. If the claim had thereafter been won, all the proceeds would still have been income to respondent, and the funds received by the children would have been a gift. (That would be analogous to the facts of *Earl* and *Horst*, discussed below.)

The actual arrangement in the instant case, however, has all the hallmarks of a joint venture. First, both participants were required to make a significant contribution to the venture. Respondent agreed to provide the underlying claim, to pay all out-of-pocket expenses on a monthly basis, and to cooperate in the preparation and presentation of the claim. J.A. 94-95. The attorney was obligated to do all of the legal work and investigation involved, and to absorb his own attributable overhead costs. Second, whether and how much each party would receive depended on the outcome of the case. Under the terms of the agreement, respondent received one percentage of the ultimate settlement, and the attorney received another. J.A. 99. Had the lawsuit failed, the attorney would not have been entitled to anything at all for the extensive legal services that he had provided to respondent.

Under the particular contingent fee agreement in this case, respondent and his attorney jointly devoted their property and services to the pursuit of the cause of action, in a joint effort to convert it into a collectible judgment against the defendant, respondent's former employer. Through that relationship, they combined their efforts for their mutual economic benefit. "Like an interest in a partnership agreement or joint venture, (the client) contracted for services and assigned a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds." *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000).

Such a combination of mutual effort for mutual gain is the very definition of a partnership, both under the broad definition of Subchapter K and under state law. Oregon Revised Statute 67.005(7) (Oregon's version of the Uniform Partnership Act). As this Court stated in *Commissioner v. Tower*, 327 U.S. 280, 286 (1946), a partnership is:

> . . . generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses.

The Commissioner argues that this case is governed by 26 U.S.C. §61(a), which imposes tax on "all income from whatever source derived." Section 61(a), however, does not purport to address *whose* income such income is; that question in this case is governed by Subchapter K. The Commissioner's argument does not take into account the provisions of §61(a)(13), which reflect Subchapter K by providing that each partner is taxed only on that partner's distributive share of partnership income. The Commissioner's proposed application of §61(a) simply ignores how and by whom the income in question was generated. In this case, the attorney and his client combined their efforts to *jointly* earn the income, and each should be taxed on his respective portion. Neither should be taxed on the whole.

The Commissioner asserts that "[f]ederal tax law makes clear that income is taxed to the person who earned it – here, the plaintiff whose lawsuit is predicated on his right to recover lost wages or other taxable income." (Brief p. 14). The premise is correct, but the government's proposed application is not. After years of intensive litigation, with repeated motions, extensive discovery, a lengthy trial, and two appeals, the defendants agreed to settle the case for $8,728,559. It defies reality to assert, as the government does, that only respondent earned that money. The Commissioner does not suggest that the defendants in this case, from the day they dismissed respondent in 1987, wanted to pay him more than $8 million in back pay and damages, were somehow unable to find him for eight years, and then spontaneously produced the check in 1995 when they happened to encounter him in an Oregon courthouse. When the Subchapter K agreement was signed, respondent contributed his claim, but respondent

> . . . was a long way from having the equivalent of cash . . . The services of h(is) attorneys resulted in converting that claim into a judgment and the collection of the judgment. *The amount of the contingent fee was earned, and well earned, by the attorneys.*

Cotnam v. Commissioner, 263 F.2d 119, 125-26 (5th Cir. 1959) (emphasis added). If the attorney representing respondent had not invested hundreds or thousands of hours of his time working on this case, respondent would have received nothing.

The Commissioner relies primarily on *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940). But neither of these cases involved a joint venture, or even a claim of such an arrangement. The stark differences between the circumstances in *Earl* and *Horst*, and the claim in the instant case, sharply illustrate the difference between a joint venture and a mere gratuitous assignment of income. In *Earl* and *Horst*, the assignments were both entirely gratuitous; none of the assignees promised to do, or ever did, anything to generate the income in question. In *Horst*, the taxpayer had already earned the income when he made the assignment; it was a gift of accrued income to a family member. (In the instant case, respondent would assuredly have been taxable on any portion of the settlement which he gratuitously assigned to a family member after the settlement agreement had been signed but before it had been paid.) As this Court stated in *Horst*, "The 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." 311 U.S. 112, 119. Although the earnings in *Earl* were to occur after the assignment, the assignee was a family member who had no role in producing those earnings. *Earl* and *Horst* are discussed in more detail in Part III of this brief.

Respondent and his attorney made quite different contributions to their ultimately successful effort to win funds from the two defendants in question. But that is not the least uncommon. Often the very reason for a joint venture is that the participants are able to make different types of contributions, both essential, and thus they need one another. Owners of undeveloped real estate (capital) frequently enter into joint ventures with real estate developers (know-how), with the goal of dividing the resulting gains. The landowner continues to own the land, but is taxed on only a part of the income. Thus ownership is irrelevant.

Owners of land enter into such relationships with oil drillers. Authors enter into similar relationships with illustrators. Composers enter into comparable relationships with lyricists. Lawyers enter into analogous relationships with lawyers from other firms to co-handle complex litigation. Under the Commissioner's theory, none of those relationships would be viewed as a partnership or a joint venture. The Commissioner would tax *one* of the co-venturers on *all* of the income earned by and received by all of the co-venturers, and then that one would be required to decipher the income tax laws (and the alternative minimum tax laws) to determine whether the amounts received by his co-venturers were deductible. Under the Commissioner's theory, those relationships would be subject to the same double taxation that the Commissioner seeks here.

For decades the most common form of joint venture was share cropping; the landowner provided the land, while the farmer provided the labor, and the two divided the proceeds. The farmer needed land, and the landowner needed labor. In the present case, respondent had a significant legal claim against the two defendants, but without the assistance of an attorney it was virtually worthless. When a farmer grows crops on the land of another and the landowner becomes the owner of a portion of the crop, each is taxed on his respective share. Neither is taxed on the entire crop. Farmer's Tax Guide 2003, IRS Publication 225, pp. 15-17 (2003). The ownership of the land is irrelevant. The same rules apply here.

In this instance, the contribution made to the venture by the attorney consisted primarily of services. But nothing in Subchapter K limits joint ventures to agreements between individuals whose contribution consists of cash, real property, or choses in action. To the contrary, joint ventures in which one or more participants provide services in return for a share of the profits are so common that the Internal Revenue Service has issued specific guidance on the procedures regarding receipt of a profits interest in return for services. Revenue Procedure 93-27, 1993-2 Cumulative Bulletin 343. In *McDougal v. Commissioner*, 62 T.C. 720 (1974), a horse trainer was to receive a 50% interest in a race horse if and when the horse won enough races to cover certain costs and expenses. The court held that a joint venture had been created. The same facts are present in this case: one party contributed services, and the other contributed capital. A joint venture resulted. Similarly, in *Burde v. Commissioner*, 352 F.2d

995 (2nd Cir. 1965), cert. den., 383 U.S. 966 (1966), one individual developed a chemical formula and two other individuals provided services pertaining to the patenting and commercial exploitation of the formula. The Commissioner argued that a joint venture existed, and the court agreed.

Where the arrangement among several persons or entities constitutes a joint venture, Subchapter K characterizes the venture as a "partnership" and the participants as "partners." Under §702(a),

> In determining his income tax, each partner shall take into account separately his distributive share of the partnership's . . . income.

Under §704(a),

> A partner's distributive share of income . . . shall, except as provided in this chapter, be determined by the partnership agreement.

The fact that partners in a partnership or a joint venture are taxed on their proportionate share of the partnership's income is confirmed by 26 U.S.C. §61(a)(13). Neither is taxed on the entire income. Under the agreement at issue in the instant case, the income share for respondent was determined by the agreement. J.A. 99. The amount paid to respondent's attorney was not income to respondent, but was the distributive share of the other participant in the joint venture.

Whether the parties enter into a formal partnership agreement, file a partnership tax return, refer to their enterprise as a partnership, or transfer title to the capital asset to the partnership is not determinative. *Underwriters Ins. Agency of America v. Commissioner*, T.C.M. 1980-92, P-H T.C.M. ¶80,092. In this case, respondent and his attorney did enter into a formal written fee agreement. J.A. 94. The Commissioner has often successfully argued that taxpayers had formed a partnership when the taxpayers had not observed the formalities of a partnership (such as signing a partnership agreement or filing partnership tax returns) and the taxpayers had argued against partnership classification. *See, e.g., Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993); *Madison Gas & Electric Co. v. Commissioner*, 633 F.2d 512 (7th Cir. 1980).

This Court has similarly held that a partnership exists despite the absence of such formalities:

> If, upon a consideration of all of the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. *Commissioner v. Culbertson*, 337 U.S. 733, 744-45 (1949).

The Sixth Circuit in *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003) (Dkt. No. 03-892, Pet. App. 24a-25a; consolidated with this case) correctly recognized that a contingent fee agreement creates a joint venture.

In his brief (pp. 12-13), the Commissioner dismisses Subchapter K in a single sentence:

> As the agreements in these cases demonstrate, a contingent fee agreement is merely a promise by the client to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered; the relationship between the client and his attorney is simply that of debtor and creditor.

This analysis ignores both the actual terms of those agreements and the distinctions drawn by Subchapter K. The agreements do not "merely" promise to pay the attorney a portion of the proceeds for services rendered. This is not a promise to pay a creditor 30% of a claim in return for some unrelated service, such as having painted respondent's house or tuned his car. Rather, the services were directly related to the *creation* of the proceeds in question. And the promise was not for "services render*ed*," i.e. services that had already been performed when the promise was made. The promise was made as part of the overall Subchapter K agreement, under which the attorney agreed to render services *in the future*, for the *joint* production of income. These distinctions are of controlling importance under Subchapter K, which applies only to agreements to provide in the future services, capital, or other contributions to the joint enterprise from which all participants are to benefit. Had the services in question (whenever rendered) been unrelated to generating the proceeds, or had those services been rendered before the agreement, Subchapter K would not apply.

The Commissioner also relies on *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), in which a corporation agreed to pay the income taxes of one of its employees. This Court held that the payment of the employee's personal taxes was additional taxable compensation to the employee. The Court reasoned that a discharge of the employee's obligation to pay income taxes was the equivalent of the receipt of that amount by the employee. In the present case, however, the respondent had no personal obligation to his attorney at the time that they entered into their joint venture. As the Fifth Circuit concluded in

Cotnam v. Commissioner, 263 F.2d 119, 126 (5th Cir. 1959),

> (The Commissioner's) argument seems to us to be based on the false premise that Mrs. Cotnam obligated herself to pay the attorneys' fee. She did not. Their fee was contingent upon success, and was fully paid by the assignment of a portion of a doubtful claim.

In addition, *Old Colony Trust* did not involve a joint venture; the assignee contributed nothing to the generation of the income.

The economic reality in *Old Colony Trust* was that the employer was benefitting the employee when the employer paid the employee's taxes. It did not matter whether the check was payable to the employee or to the taxing authority. In the present case, the economic reality was that portion of the judgment paid to the attorney was attributable to the attorney's share of the joint venture.

Unlike *Old Colony Trust*, in this case the payment of two amounts by the defendants, one to the attorney and one to the respondent, reflected the joint venture agreement and the economic realities of the situation. In contrast, the payment of the employee's taxes by the employer in *Old Colony Trust* did not reflect the economic realities of the situation; it was instead an artifice designed to enable the employee to avoid paying taxes on the portion of his compensation that he otherwise would have used to pay his own taxes. The taxes became a thinly-disguised part of his compensation package. That is not the situation in this case; this is not an artifice designed to avoid income taxes.

For those reasons, *Old Colony Trust* has no application here.

The commercial realities of the situation should be honored. Taxpayers with capital often enter into relationships with other taxpayers who have "know-how" in order to jointly pursue an economic opportunity. In the present case, respondent had the capital (the cause of action) and the attorney had the know-how (the skills to prosecute the cause of action). If an inventor owned a patent (the capital), and he entered into a partnership or a joint venture with a promoter experienced in finding markets for such inventions (the know-how), the resulting profits would be taxable to the two individuals in their respective agreed-upon shares. Certainly, the Commissioner would concede that the inventor should not be taxed on the entire profit, yet that is the result the Commissioner seeks here.

II. When the allocation of income is governed by Subchapter K, it is irrelevant whether one of the parties jointly responsible for generating that income "owned" the cause of action or other property involved.

The Commissioner maintains that, regardless of the nature of the arrangement between respondent and his attorney, the full amount paid by the defendants was income to respondent because he owned the chose in action, and thus the money was "owed" only to respondent.

That rule would severely constrict the application of Subchapter K. A cause of action is merely a form of property. *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 430 (1982). It is equally irrelevant whether the income of the joint venture took the form of one check to the joint venture, or one check to one of the participants in the joint venture, or two checks to the two participants (as was done in this case). It is often the situation that only one of the participants in a joint venture owns the property that is the basis of the venture, and thus only one participant is entitled to the payments from third parties. As noted above, title to the property is irrelevant. If the owner of a horse agreed to share its winnings with a trainer in return for his or her services in training the horse, the winnings would be owed by the racing track to the horse's owner. If a landowner agreed with a wildcat driller to share the funds from any oil sales, in return for the driller's exploring for oil at his own expense, anyone who bought the oil would owe the purchase price to the landowner. Yet both of those arrangements would be joint ventures governed by Subchapter K.

Nothing in Subchapter K permits the Commissioner to treat participants differently according to whether their contribution to a joint venture was a chose in action (or some other property) or services. To the contrary, §704(a) provides that the allocation of distributive share (and thus of taxable income) shall be determined solely by the agreement of the parties "except as otherwise provided in this chapter." Nothing in Subchapter K provides for disregarding the terms of such an agreement because one party's contribution to a venture is a chose in action, because the other party provides only (or primarily) services, or because the profits which the parties have jointly generated, and agreed to divide, will come in the form of a check payable to only one of them. Whatever the appeal of the distinction proposed by the Commissioner, it is not a distinction contained in the terms of Subchapter K, and §704(a) makes clear that the courts are not at liberty to fashion additional "except[ions]," *not* "provided in this chapter," to the rule that the allocation of income in the agreement is controlling.

If ownership of a cause of action or other claim or property could override, for tax purposes, the Subchapter K agreement and the terms of Subchapter K itself, then the validity (for tax purposes) of such agreements would unavoidably vary with state law. The Commissioner contends that the terms of Oregon law are insufficient to make respondent's attorney the owner of the portion of the cause of action equal to the contingent fee. As we explain below, that argument misapprehends Oregon law. But if this Court holds that some different statutory language is required to make the contingent fee share of a judgment the property of the attorney involved, it is likely that some, perhaps many, states will respond by adopting that required terminology.

Correctly anticipating that development, the Commissioner insists that the tax status of a contingent fee cannot depend on state law regarding who owns what portion of a cause of action, regardless of how clear state law might be, because then the tax status of a contingent fee will vary from state to state. But there is not, and could not be, some *federal* common law of cause of action ownership. Certainly the Internal Revenue Code does not purport to determine who owns a cause of action. If the tax treatment of a contingent fee depends on whether the client or the attorney owns the portion of the judgment equal to that fee, *some* body of law must provide the answer to who owns that part of the cause of action and judgment, and only state, not federal, law can do so. As described in detail in Part IV below, property rights are defined by state law, and federal tax law itself determines only how those state-law-based rights are taxed.

The sole way to avoid state-by-state differences in the tax status of contingent fees is to construe Subchapter K literally to provide that the terms of a contingent fee agreement, like the allocation of income in any other Subchapter K agreement, control the allocation of taxable income, regardless of what state law provides regarding who owns the underlying cause of action or any portion thereof.

III. The assignment of income doctrine has no application here; *Lucas v. Earl* and *Helvering v. Horst* are inapposite in this case.

As noted above, the Commissioner relies primarily on *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940). In *Lucas v. Earl*, the taxpayer assigned to his wife one-half of the taxpayer's future income, which could have had the effect of shielding half of his income from his higher income tax rate brackets. (Joint income tax returns were not permitted at that time.) In *Helvering v. Horst*, the taxpayer gifted bond coupons (but not the bonds themselves) to his son, who then redeemed the coupons for the interest accrued on the bonds, all in an apparent attempt to shift income from the father to the son. In both cases, this Court held that the transactions were ineffective attempts to assign income to another taxpayer. Those cases have no application here, for the simple reason that neither of those cases came even close to a relationship in the nature of a partnership or joint venture, where the two taxpayers *jointly* produced income. In particular, neither *Earl* nor *Horst* are applicable here for the following five reasons:

A. The transfers in *Earl* and *Horst* were gratuitous or unrelated to the production of the income. The transfer in the present case required joint effort to produce income, and thus was for valuable consideration.

The transfers in *Earl* and *Horst* lacked consideration and/or were unrelated to the production of the income. In this case, the attorney contributed to the production of the income. The Commissioner has not cited a single opinion of this Court in which the assignment of income doctrine was applied to a transaction in which the assignee of the income provided consideration in any way related to the earning of the income. In the present case, the Commissioner is asking this Court to extend the doctrine to a commercial, arms-length transaction pursuant to which both parties provided valuable consideration, and the parties jointly produced the income that they agreed to share. Respondent (the assignor) agreed to contribute his cause of action, and the attorney (the assignee) agreed to contribute his services, all for the mutual benefit of both parties. The attorney provided valuable consideration to enhance the value of the cause of action; the recipients of the gifts in *Earl* and *Horst* did nothing to enhance the value of the gifts they received.

B. Unlike the present case, the transfers in *Earl* and *Horst* were made between family members and lacked any commercial purpose.

The transfers in both *Earl* and *Horst* were between family members and apparently lacked any commercial purpose. The transfer in *Horst* was clearly designed to improperly shift taxable income to a child's lower income tax bracket. No claim or evidence of such an intent exists in this case. The execution of the contingent fee agreement in this case was an arms-length transaction between unrelated parties in a commercial setting, for valuable consideration. As the Fifth Circuit stated in *Srivastava v. Commissioner*, 220 F.3d 353, 362 (5th Cir. 2000),

> The main reason for a client to sign a contingent fee contract, presumably, is not to avoid taxation by anticipatorily assigning future streams of income to others in exchange for non-monetary benefit. More likely, he signs it to secure the services of an attorney without having to put any capital at risk, and to encourage the attorney to perform well by offering a personal stake in the claim.

In both *Earl* and *Horst*, the assignments were to family members. In the present case, respondent and his attorney had no prior relationship, familial or economic. The contingent fee agreement provided that the attorney would not be paid unless he earned his share of the proceeds by reducing the cause of action to a judgment and collecting on that judgment. J.A. 94. As the Sixth Circuit stated in *Estate of Clarks v. United States*, 202 F.3d 854, 858 (6th Cir. 2000),

> 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 as under the government's theory of the case, to one who neither received it nor earned it.

C. The income in *Earl* and *Horst* had already been earned (as in *Horst*) or was virtually certain to be earned (as in *Earl*); the income in the present case was contingent and speculative.

The exact amount of the income was known in advance in *Horst*. Although the amount of the income was uncertain in *Earl*, income was relatively certain to be earned. In the present case, no income of any kind was guaranteed to ever be earned, because the merits of the cause of action (and the effectiveness of the efforts and skills of the attorney) would not be known until the cause of action had been tested in a court of law, before a jury, in the face of a vigorous defense designed to deprive the plaintiff of any income whatsoever. This difference was noted by the Sixth Circuit in *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000), when the court commented that the cause of action subject to the contingent fee agreement had a value that "was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy." In contrast, that same court observed that,

> In *Earl* and *Horst*, the income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor. It was the gift of accrued income to a family member. 202 F.3d at 857.

This difference is one of timing, and that difference is a significant one. Taxpayers Earl and Horst made their assignments after they had earned their income, or at least after they were certain that the income would be earned. At the time that respondent entered into his contingent fee agreement, neither he nor his attorney knew if any funds would *ever* be received. The result sought by respondent and his attorney, and the fee to be paid, were both contingent. *After* the agreement was entered into, the joint efforts of the attorney and his client produced the income.

The Sixth Circuit agreed with that conclusion in *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864, 872 (6th Cir. 1957), when it held that an assignor would not be taxed on a cause of action because,

> . . . the legal right to the income was being strenuously contested . . . and there was no certainty at the time of the transfer that the transferor's right thereto would ever be established or that the money would ever be paid to either the transferor or transferee . . . It was an unliquidated chose in action.

As the Eleventh Circuit noted in *Foster v. United States*, 249 F.3d 1275, 1280 (11th Cir. 2001), "It is due to the hard work and expertise of the attorney that he is paid, and the attorney accordingly pays income taxes on the fees collected."

In contrast to the Commissioner's position in this case, the Commissioner has been taking the opposite position in recent rulings. In particular, he recently has ruled twice that the assignment of income doctrine would *not* be applied in cases similar to the present one. In Private Letter Ruling 200427009, released just a few weeks ago, the Commissioner reasoned that the assignment of income doctrine should not be applied to the assignment of a claim if (a) the claim was contingent and doubtful when it was assigned, (b) the assignment was not gratuitous, (c) the assignment was made prior to the tax year in which the income was received, and (d) the assignment had a legitimate business purpose. That result, and those facts, stand in sharp contrast to the Commissioner's proposed expansion of the holdings in *Earl* and *Horst*.[1]

Similarly, in Private Letter Ruling 200107019, the Commissioner ruled that a taxpayer's assignment of punitive damages to a charity would be respected, the taxpayer would not be taxed on the damages, and the assignment of income doctrine would not be applied. In that ruling, a trial court had awarded to the taxpayers a judgment which included punitive damages. The defendant appealed, and while the appeal was pending the taxpayers assigned the punitive damages to a charity which they had just formed. When the appeal was later dismissed by a higher court, the defendant paid the punitive damages to the taxpayers and their attorney. The taxpayers and their attorney subsequently paid the punitive damages to the charity. In the Ruling, the Commissioner did not treat the damages as income of the taxpayers for the following reason:

> With respect to the assignment of claims in litigation, a review of the case law shows that anticipatory assignment of income principles require the transferee to include the proceeds of the claim in gross income where recovery on the

[1] Although 26 U.S.C. §6110(k)(3) provides that private letter rulings may not be cited as precedent, this Court has cited such rulings to show inconsistent treatment of taxpayers by the Commissioner, or to show that a position being advanced by a taxpayer has been accepted by the Commissioner in similar situations. *Rowan Cos. v. Commissioner*, 452 U.S. 247, 261 (1981); *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962).

> transferred claim is certain at the time of transfer, *but not where recovery on such claim is doubtful or contingent at the time of transfer*. (emphasis added).
>
> . . .
>
> Citing to *Harrison v. Schaffner*, 312 U.S. 579 (1949), the court [in *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864, 873 (6th Cir. 1957)] stated that "the rule applicable to an assignment of income applies when the assignor is *entitled* at the time of the assignment to receive the income at a future date and is *vested* with such right." (emphasis in original *Cold Metal* opinion). Private Letter Ruling 200107019.

In that Private Letter Ruling, the income was assigned *after* the damages had been awarded by the trial court. In the present case, the contingent fee agreement was executed *before the lawsuit was even filed*. As a result, the income is this case was even more contingent than the income in the ruling. In the Private Letter Ruling, the damages were actually received by the taxpayers and their attorney; the damages were not paid directly to the charity. In the present case, the fee was paid directly to the attorney; it was never received nor controlled by the taxpayer. In the Private Letter Ruling, the charity contributed nothing to the arrangement; the assignment was gratuitous, just as in *Earl* and *Horst*. In the present case, the attorney contributed significantly to the cause of action, and thereby earned his fee.

D. The income in *Earl* and *Horst* was separated from the source of the income, which was retained by the assignor. In the present case, a portion of the source of the income was assigned.

In *Earl*, the husband made an anticipatory assignment of his future income to his wife, but he retained, continued, and controlled his future employment. In *Horst*, the taxpayer assigned the bond coupons to his son shortly before the bond coupons became payable, but the taxpayer retained the bonds themselves. In those cases, this Court held that the assignments separated the income from the source of the income. In the present case, the cause of action became subject to the terms of a partnership or joint venture (discussed in Part I, above), or became the co-owned property of the attorney and his client under the Oregon attorney's lien statute (discussed in Part IV, below), and then the parties *jointly* produced the income.

The Commissioner concedes (Brief p. 21) that an assignment of *all* of the income-producing property (e.g., to a factor) would not cause the assignor to be taxed. In *Earl* and *Horst*, the assignors assigned *none* of the income-producing property. In this case, the Commissioner is attempting to extend the result in *Earl* and *Horst* to a taxpayer who assigned *a portion* of the income-producing property, while retaining a portion. Neither *Earl* nor *Horst* support that extension.

Yet the Commissioner argues that the taxpayer in this case should be taxed because he used his right to collect a judgment to discharge his indebtedness to his attorney. That argument fails because the respondent was never indebted to his attorney. The attorney's right to be paid did not accrue until after the attorney acquired an interest in the cause of action, successfully reduced it to a judgment, and collected the judgment. And the attorney earned the right to be paid by the defendant, not by his own client. In this case, the contingent fee agreement was signed long before the contingent cause of action was reduced to a collectible judgment, and long before anyone knew whether it would ever become a collectible judgment. The contingent, speculative cause of action held by the taxpayer could not be collected until an attorney had reduced it to a judgment. The *only* use to which it could be put was to contribute a portion of the contingent cause of action to a joint venture with a skilled attorney who might be able to reduce it to a judgment after a great deal of joint effort on the part of the taxpayer and the attorney. As the Sixth Circuit observed, "The only economic benefit (the taxpayer) could derive from his claim against the defendant in state court was to use the contingent part of it to help him collect the remainder." *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000). That same conclusion was reached in *Cotnam v. Commissioner*, 263 F.2d 119, 125 (5th Cir. 1959):

> At the time that she entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder.

In contrast, the Commissioner views the cause of action as if it were a credit card, ready to be used to purchase goods and services at a moment's notice. That view is simply inconsistent with the economic realities of the situation.

E. In *Earl* and *Horst*, the income was taxable only to the assignor, not both the assignor and the assignee. In the present case, double taxation results.

In *Earl* and *Horst*, the income was held to be taxable to the assignor. It was not taxable to the assignee, who had merely received a gift, which under 26 U.S.C. §102 is not taxable. In those cases, the funds were taxed once, and only once. In the present case, the fee earned by, and paid to, the attorney was not a gift; it was taxable income to the attorney. The Commissioner is attempting to also tax those same funds to the respondent. Thus, in contrast to *Earl* and *Horst*, in this case the Commissioner seeks to collect a double taxation of the same funds, once from the client and once from the attorney, all on the very same day. *Earl* and *Horst* simply do not support the double taxation the Commissioner is seeking here. As this Court stated in *Supplee-Biddle Hardware Co. v. Commissioner*, 265 U.S. 189, 196 (1924), double taxation "is to be avoided, unless required by express words."

The Commissioner argues (Brief p. 34) that the double taxation occurring in this case is "neither anomalous nor harsh, but is instead a commonplace result." Yet the example provided by the Commissioner involves double taxation resulting from *two* separate transactions (an individual receiving his salary, and then using the funds to hire a plumber). In this case, the same funds are being taxed *twice* as the result of a *single* transaction. The Commissioner cannot justify that double taxation.

IV. Under Oregon law, the attorney owned a portion of the cause of action.

If the Court concludes that the income allocation in a case such as this turns on which participant owned the cause of action at issue, respondent is entitled to prevail under the circumstances of this case. Pursuant to Oregon statute and Oregon case law, the execution of a contingent fee agreement between an attorney and a client creates ownership rights in the attorney, so that the attorney becomes a vested co-owner of the cause of action and the vested sole owner of a portion of the proceeds of the resulting judgment. As a result, no assignment of income takes place, and the portion of the judgment paid to the attorney should not be taxed to the client, as discussed in Part III, above.

It is well established that the federal tax laws operate in the context of state property rights laws. In particular, the laws of the individual states define the property rights of the citizens of those states. Once those rights are defined by state law, then the federal tax laws define how those property rights will be taxed. *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985); *United States v. Mitchell*, 403 U.S. 190, 197 (1971); *Aquilino v. United States*, 363 U.S. 509, 513 (1960); *Heiner v. Mellon*, 304 U.S. 271, 279 (1938); *Burnet v. Harmel*, 287 U.S. 103, 110 (1932). As this Court stated in *United States v. Bess*, 357 U.S. 51, 55 (1958), the federal tax law " . . . creates no property rights but merely attaches consequences, federally defined, to rights created under state law . . ." That is particularly true when (as in this case) the state law has been interpreted by the highest court of the state. As this Court stated in *Commissioner v. Bosch*, 387 U.S. 456, 465 (1967), the application of federal tax laws to state property rights " . . . is but an application of the Rule of *Erie R. Co. v. Thompkins*, [304 U.S. 64 (1938)], where state law as announced by the highest court of the State is to be followed." The Commissioner apparently concedes this point in his brief (p. 14) when he states that " . . . state law is relevant to defining the taxpayer's interest in property . . ." and on page 15 when he states that " . . . the Internal Revenue Code . . . 'creates no property rights but merely attaches consequences, federally defined, to rights created under state law.' " (quoting *National Bank of Commerce*.)

The Oregon attorney's fee lien statute and a recent opinion of the Oregon Supreme Court precisely define the ownership rights of an attorney retained pursuant to a contingent fee agreement. Those rights exceed the rights of a traditional, mere lienholder; they rise to the level of an ownership interest. Oregon Revised Statute 87.445 provides:

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

ORS 87.475 provides that " . . . the lien . . . is not affected by a settlement between the parties to the action, suit, or proceeding . . ." That statute also provides that:

> . . . a party to the action, suit or proceeding, or any other person, does not have the right to satisfy the lien . . . or any judgment, decree, order or award entered in the action, suit, or proceeding

> until the lien, and the claim of the attorney for fees based thereon, is satisfied in full.

The Oregon lien attaches not only to the proceeds of the action, but to the action itself. The ownership interest of the attorney is best illustrated by *Potter v. Schlesser*, 335 Or. 209, 63 P.3d 1172 (2003), in which a plaintiff settled a lawsuit without informing (or paying) his contingent fee attorney. The attorney then sued *the defendant* for the unpaid attorney's fees, even though the defendant had fully paid the agreed-upon settlement to the plaintiff. The Oregon Supreme Court held that the Oregon statute gives the attorney the right to sue the defendant, because the settlement of the action did not affect the attorney's lien *against the cause of action*. The Oregon Supreme Court further held that the plaintiff could not extinguish the lien by settling the case, and that if the plaintiff did attempt to settle the case, the attorney could continue to prosecute the cause of action. In short, under Oregon law the attorney has an ownership interest in the cause of action itself, and the client lacks the power to settle the case.

In the present case, the Ninth Circuit observed that the Oregon statutes and the decision of the Oregon Supreme Court in *Potter v. Schlesser* result in the following conclusion:

> Put simply, Oregon law vests attorneys with property interests that cannot be extinguished or discharged by the parties to the action except by payment to the attorney . . . Because of the unique features of Oregon law, we conclude that fees paid directly to (respondent's attorney) were not includable in respondent's gross income . . . 340 F.3d 1074, 1083 (2003) (Pet. App. 16a).

Thus the salient features of the Oregon law of attorney's fees liens can be summarized as follows:

1. The lien is a charge *on the cause of action*, not just on proceeds of the suit. ORS 87.445; *Potter v. Schlesser*, 335 Or. 209, 213, 63 P.3d 1172, 1174 (2003).

2. The attorney can enforce the lien against either the plaintiff (the attorney's client) or against the defendant. *Potter v. Schlesser*, 335 Or. 209, 215, 63 P.3d 1172, 1175 (2003).

3. The client cannot unilaterally settle the case. An attempted settlement of the case by the client does not extinguish the lien; both the plaintiff and the defendant remain liable to satisfy the lien. *Potter v. Schlesser*, 335 Or. 209, 214-215, 63 P.3d 1172, 1175 (2003).

The rights of an attorney under Oregon law are the same rights found by the court in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), which concluded that, under Alabama law, "Attorneys have the same rights as their clients" and that the attorney "has an equity in the cause of action . . ." 263 F.2d at 125.

That ownership interest is directly contrary to the Commissioner's repeated argument (Brief pp. 12-13, 25, 32, 39, 40) that respondent "had the sole power to assert and to settle" his claim. The Commissioner even goes so far as to state that "at all times" the respondent controlled the cause of action (Brief p. 32). That statement is directly contradicted by ORS 87.475 and *Potter v. Schlesser*. As noted above, Oregon law prevents the client from extinguishing the cause of action by settling the claim; the cause of action *survives* any settlement made by the client without the approval of the attorney. ORS 87.475; *Potter v. Schlesser*, 335 Or. 209, 214-215, 63 P.3d 1172, 1175 (2003).

Thus when the Commissioner states (Brief p. 13) that "Oregon law does not confer on the attorney any ownership interest in his client's cause of action or otherwise give the attorney control over the action," the Commissioner is mistaken, as the defendant in *Potter v. Schlesser* learned. Even though the contingent fee agreement required the attorney to obtain the client's consent to any settlement (J.A. 95), the reverse is also true: under *Potter v. Schlesser* and ORS 87.475, the client could *not* settle the case by himself.

Although the Commissioner cites Oregon cases from 1906, 1907, and 1915 to the effect that a client may settle a case without regard to an attorney's fee agreement and that an attorney does not have an ownership interest in the cause of action, those cases all predate the 1975 Oregon statutes that control this case. 1975 Oregon Laws Ch. 648. For example, one of the cases relied upon by the Commissioner, *Stearns v. Wollenberg*, 51 Or. 88, 91-92, 92 P. 1079, 1080-81 (1907) specifically noted that Oregon law did not then grant a lien on the cause of action. That is contrary to the provisions of ORS 87.445 that now govern this case. As pointed out by *In re Grimes' Estate*, 170 Or. 204, 208-9, 131 P.2d 448, 450 (1943), Oregon's lien against the cause of action first appeared in 1939. That opinion pointed out that, "By the 1939 amendment . . . (a)n attorney is also given 'the same right and power over said actions, suits, proceedings . . .' that his client 'had or may have . . .'" As a result, both the client and the attorney have ownership interests in the cause of action, which they did not have in the 1906, 1907, and 1915 cases cited by the Commissioner.

Nine other states have attorney's fee lien statutes that incorporate those same features.[2]

By honoring state property rights, and by applying the federal tax laws to those state property rights, uniformity is achieved because citizens with similar property rights in different states will be taxed uniformly. Thus similarly-situated taxpayers will be taxed similarly. However, citizens with different property rights established by the laws of different states will naturally be taxed differently. This varying tax treatment, based on differing state laws, exists in other contexts as well. For example, as early as 1930 this Court held that married citizens of community property states could report one-half of their combined family income on the income tax returns of each spouse, thus availing themselves of lower tax rates, a benefit not available to taxpayers of common law states. *Poe v. Seaborn*, 282 U.S. 101 (1930). (Joint income tax returns were not permitted at that time.) Similarly, this Court has held that community property rights in life insurance policies will be honored for purposes of the federal estate tax, significantly reducing the estate tax liability of the holder of the policy. *Lang v. Commissioner*, 304 U.S. 264 (1938). To this day, when a resident of a community property state dies, his surviving spouse receives a stepped-up

[2] Alabama Code of 1975 §34-3-61; Georgia Code of 1981 §15-19-14; Idaho Code of 1947 §3-205; Maryland Business Occupations and Professions Code §10-501; Missouri Revised Statutes §§484.130 and .140; Montana Code §37-61-420; Oklahoma Statutes, Title 5, §§6 through 9; Rhode Island Gen. Laws 1956 §§9-3-1 through 3; and Washington Revised Code §60.40.010. In addition, the Sixth Circuit has found that Michigan law similarly grants the attorney an ownership interest in the cause of action. *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000).

income tax basis (essentially a forgiveness of capital gains tax) on *all* of the community property owned by the married couple, while residents of common law states receive on death a similar tax basis increase on only one-half of the joint property of the spouses. 26 U.S.C. §1014(b)(6) and (9). That tremendous advantage is the result of the adoption of community property laws by some states, and the uniform application of federal tax laws to those community property rights. The results described above constitute significant tax advantages to the residents of only those states, and not to residents of other states.

The property rights created by the laws of those states are real and have both tax and non-tax implications. The same is true of the Oregon law pertaining to attorney's fees. This is not a situation where state laws have created artificial labels, to be disregarded by federal tax laws. See, for example, *Palmer v. Bender*, 287 U.S. 551, 555 (1933); *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940).

As a result, the Ninth Circuit was correct in the present case when it honored the provisions of Oregon law, as stated in the Oregon statutes and as confirmed by the Oregon Supreme Court. Under Oregon law, respondent never had the right to receive the attorney's portion of the judgment, because the attorney owned that portion of the judgment and that portion of the underlying cause of action. As stated in *Foster v. United States*, 249 F.3d 1275, 1279 (11th Cir. 2001), analyzing a similar Alabama attorney fee statute, "Based on this law, (the taxpayer) could never have received the portion of the judgment contracted as attorneys' fees." Yet the Commissioner seeks to tax that portion of the judgment as if the taxpayer still owned the cause of action and had actually received the funds.

As this Court stated in *Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948),

> The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes.

Thus the crucial question is how much control the client retained and how much control was assigned to the attorney. As a result, the Commissioner is incorrect when he argues (Brief p. 17) that the amount of control assigned to the attorney is irrelevant. Under Oregon law, the respondent no longer had sole power or control over the cause of action, and respondent had no power or control over the portion of the cause of action assigned to the attorney. The Commissioner is correct, however, in citing (Brief p. 18) *Srivastava v. Commissioner*, 220 F.3d 353, 363-64 (5th Cir. 2000), when that opinion stated that the assignment of income doctrine "looks to the taxpayer's degree of control and dominion over the asset." In this case, Oregon law had transferred much of the control and dominion to the attorney.

The Commissioner cites (Brief p. 22) the *Sunnen* opinion when it points out that the taxpayer in that case retained the power to terminate the royalty-generating contracts and the power to regulate the amount of royalties paid. In this case, however, the respondent retained *no* such powers.

The Commissioner also argues (Brief p. 26) that the attorney in this case had a mere security interest, rather than ownership of the cause of action. On that same page, the Commissioner quotes a California case which states that "a contingent fee contract does not transfer to the attorney any rights to the client's cause of action . . ." Under Oregon law, however, that statement is simply not correct. The rights granted to the attorney by Oregon law gave the attorney substantial control over the cause of action and complete control over a portion of the proceeds of that cause of action. As noted above, the respondent no longer had the power to settle the case, nor did the respondent have the right to receive the attorney's share of the proceeds. As pointed out by this Court in *Sunnen*, the crucial question is control:

> As was said in *Corliss v. Bowers*, 281 U.S. 376, 378 [1930], "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid." 333 U.S. 591, 604-5.

Thus *Sunnen* and *Corliss* directly answer the Commissioner's argument that the interest of the attorney was a mere lien. Although ORS 87.445 labels the interest as a lien, the actual property rights conferred upon the attorney are far more extensive than the rights normally associated with a lien. Under *Potter v. Schlesser*, the cause of action survives any attempt by the plaintiff to settle the litigation, and thus the attorney has the right to continue to pursue the cause of action even though his client has settled. And under the fee agreement signed by respondent and his attorney, both the client and his attorney must agree to any settlement. J.A. 95.

Sunnen and *Corliss* also directly answer the Commissioner's argument that an attorney cannot possess both a lien and an ownership interest. The correct answer is that "refinements of title" do not outweigh actual command and control. The Commissioner concedes that fact (Brief pp. 31-32). In this case, the attorney had command and control over a portion of the cause of action, so much command and control that the cause of action would survive any attempt by the client to settle the cause of action, just as it did in *Potter v. Schlesser*. In fact, the attorney apparently has the ability to prosecute the cause of action to obtain a judgment in excess of the amount for which the plaintiff settled: *Potter v. Schlesser* noted that the value of the action in that case was *at least* the amount for which the plaintiff settled, and the plaintiff was obligated to satisfy the lien to the extent of the value of the cause of action. 335 Or. 209, 215, 63 P.3d 1172, 1175.

The Commissioner also argues (Brief p. 40) that an attorney cannot acquire an interest in litigation, citing Oregon cases from 1886 and 1937. Of course, those cases predate the 1975 laws now in effect in Oregon. Moreover, Rule 5-103(A)(2) of the Oregon Code of Professional Responsibility specifically provides that a contract for a contingent fee is an exception to the general rule prohibiting an attorney's acquisition of a proprietary interest in a cause of action. As a result, the Oregon ethics rules are consistent with the Oregon attorney's lien statute that gives the attorney an ownership interest in the cause of action.

In the present case, the attorney had control over a portion of the cause of action and a portion of the proceeds of the cause of action, and it was the attorney who received the actual benefit of that portion. The client neither controlled nor received that portion of the judgment. Accordingly, the attorney, not the client, should be (and was) taxed on that portion.

When two parties act in common as co-owners of income-producing property, each is taxed on his respective share of the income. As stated in Treas. Reg. §301.7701-1(a)(2):

> . . . mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

Treas. Reg. §1.761-2(a)(2) similarly provides that co-owners of property do not necessarily create a separate taxable entity. Each is taxed on his share of the income. *Madison Gas & Electric Co. v. Commissioner*, 633 F.2d 512, 515 (7th Cir. 1980). Neither is taxed on the whole.

V. The consequences of reversal would be far-reaching and harmful.

If the Commissioner's position were adopted, then the entire amount of the judgment (unreduced by attorney fees) entered in a wide variety of federal and state tort actions would become taxable to the plaintiff. As is explained below, that result would have far-reaching deleterious effects on a wide variety of claimants seeking to enforce their rights under numerous federal and state civil rights statutes and common law causes of action, including employment discrimination, wrongful termination, tort claims, age discrimination, racial discrimination, gender discrimination, religious discrimination, consumer protection, securities fraud, property claims, and even voting rights. The reversal of this case would also have a chilling effect on persons considering bringing those claims, and a reversal would make settling those claims more difficult and expensive.

The Commissioner is apparently attempting to tax attorney's fees in six situations:

A. When the fees are paid pursuant to a contingent fee agreement, as in the present case.

B. When attorney's fees are paid pursuant to a statute that requires the losing party to pay the attorney's fees of the prevailing party, as in *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003) (Dkt. No. 03-892; consolidated with this case). Such a statute is typically known as a fee-shifting statute.

C. When the fees are paid pursuant to an hourly rate fee agreement.

D. When attorney's fees are awarded by a court pursuant to a contractual clause requiring the losing party to pay the attorney's fees of the prevailing party.

E. When attorney's fees are paid from a common fund in class action litigation.

F. When attorney's fees are paid to *pro bono* attorneys.

Each of these situations will be discussed below. First, a brief explanation regarding the deductibility of attorney's fees. For most businesses, attorney's fees are an ordinary and necessary business deduction for income tax purposes. 26 U.S.C. §162. For individuals, however, attorney's fees are usually a "miscellaneous itemized deduction" under 26 U.S.C. §62, §67(b) and §212. Such deductions are allowed only to the extent they exceed 2% of adjusted gross income. 26 U.S.C. §67(a). In the year in which a taxpayer receives a large judgment, that 2% floor serves as a very significant impediment. The situation is even worse, however, under the alternative minimum tax (AMT), which is a separate "parallel" tax. It is reported and calculated on the income tax return of the individual taxpayer, but it is paid in addition to the regular income tax, because the taxpayer must pay the greater of the regular tax or the alternative minimum tax. 26 U.S.C. §55(a). Miscellaneous itemized deductions, however, are not allowed for purposes of the alternative minimum tax. 26 U.S.C. §56(b)(1)(A)(i). When a deduction is allowed for income tax purposes, but denied for AMT purposes, the income tax deduction becomes ineffective, and the individual is effectively taxed on the income that would have otherwise been protected by the deduction. In general, the AMT rate is 26% of the first $175,000 of income and 28% of any amounts over $175,000. 26 U.S.C. §55(b)(1)(A). When that rate is applied to a substantial attorney's fee, the resulting tax can be very significant.

A. Contingent fee agreements.

Assume an example where a plaintiff is awarded $100,000 after entering into a 33% contingent fee agreement. The plaintiff will receive $66,666, and her attorney will receive $33,333. Under the Commissioner's theory of this case, however, the plaintiff will be obligated to pay income taxes and/or alternative minimum taxes on her own share *plus* her attorney's share. And her attorney will also be taxed on the attorney's share, resulting in a double taxation. In effect, the alternative minimum tax requires a plaintiff to pay a tax equal to 26% of funds the plaintiff never received, in addition to paying the regular income tax on the funds the plaintiff did receive. That is the exact result the Commissioner seeks here.

B. Fee-shifting statutes.

The situation can become even worse under fee-shifting statutes which obligate the defendant to pay the plaintiff's attorney's fees, such as the fee-shifting statute involved in *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003) (Dkt. No. 03-892; consolidated with this case). This subject is explored in greater detail in an *amicus* brief filed by the National Employment Lawyers Association.

Because the fees paid under a fee-shifting statute can exceed the amount awarded to the plaintiff, the tax liability under the Commissioner's theory can approach *or exceed* the amount of the award to the plaintiff. It is difficult to conceive that the prevailing party would owe more in taxes than the funds she received, yet that is the exact result of the theory being advanced by the Commissioner.

Here in Oregon, courts are permitted to award attorney's fees that exceed the amount of the recovery. *Yamaha Store of Bend, Oregon, Inc. v. Yamaha Motor Corp.*, 98 Or. App. 290, 297, 779 P.2d 1061, 1066 (Or. App. 1989).

The same result can occur in federal litigation. In *Spina v. Forest Preserve District of Cook County, Ill.*, 207 F.Supp.2d 764 (N.D. Ill. 2002), a female employee prevailed in a gender discrimination suit under Title VII of the Civil Rights Act of 1964. Under one scenario considered by the court, the net result would have been a tax liability that exceeded the employee's award by $154,322, despite the fact that she had prevailed in the litigation. 207 F.Supp at 777. According to the *New York Times* (Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, August 11, 2002, p. 18), the result actually reached in that case left the employee with net award of a *negative* $99,000 after taxes.

The federal causes of action that include fee-shifting provisions and which would be negatively impacted by a reversal of this case include dozens of federal statutes pertaining to racial discrimination, gender discrimination, labor standards, employment discrimination, fair housing, disabled persons, civil rights, religious discrimination, and consumer product safety. In an appendix to his dissenting opinion in *Marek v. Chesney*, 473 U.S. 1 (1985), Justice Brennan listed *119* such federal fee-shifting statutes.

One such fee-shifting statute requires special mention. Under the Tax Equity and Fiscal Responsibility Act of 1982, 26 U.S.C. §7430, a taxpayer may be awarded attorney's fees if (a) the taxpayer substantially prevails in tax litigation, and (b) the position of the IRS was not substantially justified. Under the Commissioner's theory in this case, a taxpayer satisfying those criteria would be awarded attorney fees, and those fees would be paid to the attorneys. But then that taxpayer would receive an invoice for taxes on those fees, with the taxes to be paid to the very party whose unjustified litigation position was the reason for the award, leaving the taxpayer with a net economic loss in an amount equal to the taxes on the fees.

Here in Oregon, a reversal of the Ninth Circuit decision in this case would also negatively impact a wide variety of state fee-shifting statutes pertaining to labor standards, employment discrimination, consumer protection, securities fraud, and discrimination in public accommodations. *See, e.g.,* ORS 652.200 and .230; ORS 659A.885(5)(d).

C. Hourly fee agreements.

The Commissioner would also apply his theory to cases that involve attorney's fees calculated on an hourly basis (Brief pp. 35, 39). In those cases, the same inequitable results can occur, or the results could be even more inequitable because the fees are not limited to a percentage of the award. In *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), an age discrimination and breach of contract case, $258,000 was paid in legal fees out of a total settlement of $350,000, leaving the taxpayer only $92,000, from which the taxpayer was required to pay income tax and alternative minimum tax on the entire $350,000, resulting in a substantial net economic *loss* for the plaintiff, even though the plaintiff was the prevailing party. *See* Sager and Cohen, "How the Income Tax Undermines Civil Rights Law," 73 So. Cal. Law Rev. 1075, 1078 (2000). Of course, the attorneys were taxed on their $258,000, resulting in the same double taxation the Commissioner seeks in this case. Instead, the taxpayer should be taxed on the $92,000 he received, and his attorneys should be taxed on their $258,000.

The Commissioner argues that the full amount of the judgment should be taxable to the respondent, regardless of whether the respondent had entered into a contingent fee agreement or an hourly fee agreement. The answer to that question depends on whether Oregon law is followed. If this Court were to affirm the Ninth Circuit on the basis of the attorney's ownership interest in the cause of action under Oregon law, then the result would be the same in either case, because the Oregon statutes apply to both contingent fee cases and hourly rate cases. As a result, respondent does not concede (as the Commissioner claims on pages 24-25 and 35 of his Brief) that an hourly fee agreement would have resulted in taxation in the present case.

On the other hand, if this Court were to affirm the Ninth Circuit on the basis of the taxation of a joint venture under Subchapter K, then the result would most likely be different, because a contingent fee agreement is inherently different from an hourly rate agreement. The difference between the two types of agreements is significant, and the results should be different, both from a commercial standpoint and a taxation standpoint. In an hourly arrangement, the fee of the attorney is fixed, regardless of the outcome. In a contingent fee arrangement, if the attorney is unsuccessful, the client has no obligation to the attorney. In an hourly arrangement, the fortunes of the attorney are independent of the fortunes of the client. In a contingent fee arrangement, the fortunes of the two parties to the arrangement rise and fall together. That is the very nature of a partnership or a joint venture: common effort for common gain, or common loss. The tax consequences should not be uniform, but should vary depending on the structure of the transaction.

D. Contractual attorney fee provisions.

In litigation involving a contract containing an attorney fee clause, the result the Commissioner seeks here could happen not only to a plaintiff, but also to a defendant. Under many contracts, a prevailing party (plaintiff or defendant) in litigation is entitled to be awarded his attorney's fees. If a defendant prevails and his attorney is awarded fees, under the Commissioner's theory that defendant will then be required to report the award as income, with no offsetting deduction for attorney's fees. The result would be a net economic loss equal to the alternative minimum tax on the attorney's fees (at a rate of 26%), when those fees were actually paid to and received by the attorney, not the prevailing defendant. Rather than being made whole by the contractual attorney fee provision, the defendant will leave the litigation with a very substantial net economic loss, despite having prevailed in the litigation.

E. Class action attorney fees.

The Commissioner's theory of this case produces particularly strange and inconsistent results in class action suits. In *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), cert. den., 536 U.S. 904 (2002), the Commissioner successfully argued that prevailing members of the class should be taxed on the fees paid to their attorneys. In several other cases, however, the Commissioner has issued Private Letter Rulings which concluded that members of classes need *not* report the fees paid to their counsel. PLR 200222001, PLR 200316040, PLR 200344022, PLR 200106021, PLR 200025023.[3]

F. *Pro bono* attorneys.

In some situations, an attorney agrees to represent a plaintiff *pro bono*, but is later awarded a fee by the court.

[3] See note 2, supra, regarding the citation of Private Letter Rulings.

For example, an attorney may be awarded fees in tax litigation against the Commissioner, even if the attorney is representing the client *pro bono*. 26 U.S.C. §7430(c)(3)(B). In civil rights cases, public interest law firms and other attorneys often represent clients *pro bono*, but are subsequently awarded fees. Would the Commissioner tax the client on those fees, thus taxing the client (who might be indigent) on fees the client never had a legal right to receive and was never obligated to personally pay to the attorney?

CONCLUSION

The decision of the Ninth Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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