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No. 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIGITAS J. BANAITIS

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH 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 Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-17a) is reported at 340 F.3d 1074. The opinion of the Tax Court (App., *infra*, 18a-33a) is unofficially reported at 83 T.C.M. (CCH) 1053.

JURISDICTION

The judgment of the court of appeals was filed on August 27, 2003. On November 14, 2003, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and including December

29, 2003. 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 is also presented in the petition for a writ of certiorari in *Commissioner* v. *Banks*, No. 03-892 (filed Dec. 19, 2003). For the reasons set forth herein, this petition should be granted or, in the alternative, held pending the disposition of *Commissioner* v. *Banks*.

1. From 1980 until late 1987, respondent Sigitas J. Banaitis, an Oregon resident, worked as a vice president and loan officer for the Bank of California. Respondent served clients in the grain business in Portland, Oregon, which was then the largest grain exporting port on the West Coast. In his job, respondent had access to confidential financial information regarding the companies with which he worked. To ensure the security of this information, respondent and the Bank of California executed confidentiality agreements. App., *infra*, 1a-2a.

In 1984, Mitsubishi Bank acquired a controlling interest in the Bank of California. The parent company of Mitsubishi Bank was Mitsubishi Group, Ltd. That company controlled and operated firms that competed directly with a number of respondent's loan customers. Anticipating the potential conflict—and the potential exposure of sensitive financial information—that could result from Mitsubishi Bank's acquisition of the Bank of California, respondent was requested by his loan customers to keep the financial information with which he was entrusted confidential. Some of these customers specifically requested that their financial information be kept under lock and key. Respondent complied with their wishes, and he refused to disclose such confidential data when he was asked to do so by employees of Mitsubishi Bank and the Bank of California. App., *infra*, 2a.

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

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

Respondent filed a lawsuit against Mitsubishi Bank and the Bank of California in state court in Oregon. His suit alleged that Mitsubishi Bank intentionally and willfully interfered with his employment agreement with the Bank of California, and further alleged that the Bank of California had wrongfully discharged him and improperly attempted to force him to breach his fiduciary duty to his customers, for the wrongful purpose of appropriating trade secrets and other confidential information. App., *infra*, 4a.

The state court jury found that: (i) respondent did not voluntarily resign his position; (ii) Mitsubishi Bank, through "improper means or * * * motive," caused the Bank of California constructively to fire or discharge respondent; (iii) because respondent refused to give confidential information to Mitsubishi Bank, the Bank of California forced respondent to resign by making his working conditions unacceptable; (iv) respondent's refusal to give confidential information reflected an "important public policy"; (v) as a result of these tortious acts, respondent suffered emotional distress and injury to his reputation; (vi) respondent was therefore entitled to a damage award of $196,389 for lost compensation and $450,000 for lost future compensation, (vii) respondent was further entitled to $500,000 for "noneconomic" damages attributable to emotional distress and injury to reputation against Mitsubishi Bank, (viii) respondent was similarly entitled to $125,000 against the Bank of California for "noneconomic" damages, and (viii) respondent was entitled to punitive damages of $3 million against Mitsubishi Bank and $2 million against the Bank of California. The defendants were held to be jointly and severally liable for the economic damage award and severally liable for the noneconomic and punitive damages awards. App., *infra*, 4a-5a.

3. In response to post-trial motions, the trial court set aside the punitive damage award against each defendant. All parties then sought review with the Oregon Court of Appeals. App., *infra*, 5a.

In connection with the appeal, respondent entered into a second fee agreement with his attorneys. Under that revised agreement, the attorneys were to receive, as compensation for their services, 50% of all compensatory damages and 42.9% of all punitive damages. App., *infra*, 5a.

4. The Oregon Court of Appeals affirmed the award of compensatory damages and reversed the trial court order that set aside the jury's punitive damage award.

Banaitis v. *Mitsubishi Bank, Ltd.*, 879 P.2d 1288 (Or. Ct. App. 1994). Mitsubishi Bank and the Bank of California then appealed to the Oregon Supreme Court. The Oregon Supreme Court initially granted review but subsequently dismissed review as improvidently granted. *Banaitis* v. *Mitsubishi Bank, Ltd.*, 900 P.2d 508 (Or. 1995). See App., *infra*, 5a-6a.

Shortly thereafter, the parties entered into a confidential settlement agreement. Pursuant to the settlement agreement, Mitsubishi Bank and the Bank of California issued checks that together totaled $8,728,559: (i) the Bank of California wrote a check for $3,864,012 which, pursuant to the terms of the contingent fee agreement, was paid directly to the attorneys; and (ii) Mitsubishi Bank remitted the remaining $4,864,547 directly to Banaitis. App., *infra*, 6a.

5. Respondent did not include any part of the $8,728,559 settlement proceeds on his 1995 income tax return. On audit, the Commissioner determined that these 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 attorneys pursuant to the contingent fee agreement was a deductible expense in earning that income but, (ii) since attorneys fee expenses fall within the category of "miscellaneous itemized deductions," 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 of $288,798 was issued for respondent's AMT liability. App., *infra*, 7a.

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 in gross income the entire settlement relating to economic damages and punitive damages, including the portion paid to his attorneys as a contingent fee. The court therefore sustained the Commissioner's determination of respondent's AMT liability. App., *infra*, 8a, 18a-33a.

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

On this attorney's fee issue, the court noted that it had held in *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001), and in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001), that the portion of damages paid as attorney's fees under contingent fee agreements made in Alaska and California, respectively, *must* be included in the taxpayers' gross incomes. App., *infra*, 12a-13a. In *Benci-Woodward*, 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." 219 F.3d at 943. The court reached a similar conclusion in *Coady*, holding that the entire award of damages obtained under a contingent fee agreement was to be 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." 213 F.3d at 1190. In those decisions, the Ninth Circuit had distinguished cases in other circuits that had reached the opposite conclusion. See 213 F.3d at 1190 (distinguishing *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000) (under Michigan law, attorney acquired ownership of portion of client's cause of action and attorney's fees portion of award was thus excluded from gross income), and *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959) (same under Alabama law).

In this case, however, the Ninth Circuit held that, under Oregon law, the contingent attorney's fee portion of the recovery was *not* to be included in respondent's gross income. The court distinguished its prior decisions in *Coady* and *Benci-Woodward* by stating that Oregon law with respect to contingent attorney's fees "is unlike the laws of California and Alaska." App., *infra*, 15a. The court stated that the statutory lien for attorney's fees under Oregon law "mirrors Alabama law [involved in *Cotnam* v. *Commissioner*, *supra*] in that it affords attorneys generous property interests in judgments and settlements." *Ibid*. The court gave the following explanation of its reasoning (*id*. at 15a-16a):

> Unlike California and Alaska law, an attorney's lien in Oregon is "superior to all other liens" except "tax liens." O.R.S. § 87.490. Under Oregon law, "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 claim of the attorney for fees based thereon, is satisfied in full." O.R.S. § 87.475. And Oregon law, like Alabama law, provides that attorneys shall

> have "the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount of judgment due thereon to them." O.R.S. § 87.480. Indeed, Alabama and Oregon law are almost identical in their treatment of the interest attorneys have in legal actions.
>
> In some respects, in fact, Oregon goes even further than does the Alabama law at issue in *Cotnam*. As the Oregon Supreme Court stated in *Potter* v. *Schlesser Co.*, 335 Or. 209, 63 P.3d 1172, 1174 (2003):
>
>> The lien is a charge on the action, and the parties to the action cannot extinguish or affect the attorney's lien by any means (such as settlement) other than by satisfying the underlying claim of the attorney for the fees incurred in connection with the action.
>
> The Oregon Supreme Court, thus, has recognized that an attorney has a right to sue a third party for attorneys fees that were left unsatisfied by a private settlement with the attorney's clients. *Id.* at 215, 63 P.3d 1172. * * * 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; as a result, Banaitis' claim under Oregon law is akin to—and even stronger than—the claim in *Cotnam*.

The court concluded that, "[b]ecause of the unique features of Oregon law," the contingent attorney's fees portion of respondent's settlement proceeds was not to be included in his gross income for federal income tax purposes. App., *infra*, 16a.

REASONS FOR GRANTING THE PETITION

This case presents the same question that is presented in *Commissioner* v. *Banks*, No. 03-892 (filed Dec. 19, 2003), which seeks review of the decision of the Sixth Circuit in that case. 345 F.3d 373 (2003). As is described in detail in the government's petition in *Banks*, the courts of appeals are in open and acknowledged conflict in their disposition of the issue that is presented in this case.* As is explained in the petition in *Banks*, the decision in that case conflicts with the decision of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001), and the decisions of the Fourth, Seventh and Tenth Circuits in *Young* v. *Commissioner*, 240 F.3d 369 (2001), *Kenseth* v. *Commissioner*, 259 F.3d 881 (2001), and *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312 (2001), cert. denied, 535 U.S. 1056 (2002).

In particular, the decision in this case conflicts with the holdings in *Young* v. *Commissioner* and *Hukkanen-Campbell* v. *Commissioner*, that sums paid as attorney's fees pursuant to contingent fee agreements are includible in the client's gross income regardless of the nature of the attorney's rights under state law. See *Young*, 240 F.3d at 378 (the inclusion of contingent fee payments in client's gross income is required "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"); *Hukkanen-Campbell*, 274 F.3d at 1314 (contingent fee payments are included in

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* A copy of the government's petition in *Banks* is provided herewith to respondent.

client's gross income, and "[t]he Tax Code mandates this result irrespective of a particular state's attorney lien statute's provisions"). Moreover, as we explain in the petition in *Banks*, the question presented in these cases recurs with significant frequency and has substantial importance in the administration of the revenue laws.

The disposition of the present case would properly be governed by the same principles that govern the disposition of the petition in *Banks*. The Court should therefore hold the present petition and dispose of it as appropriate in light of the disposition of the *Banks* case.

CONCLUSION

Th petition for a writ of certiorari should be granted or, in the alternative, the petition should be held and disposed of as appropriate in light of the Court's disposition of *Commissioner* v. *Banks*, No. 03-892.

Respectfully submitted.

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DECEMBER 2003

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT.

No. 02-70421

SIGITAS BANAITIS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[AUG. 27, 2003]

Before: BEEZER, THOMAS, and CLIFTON, Circuit Judges.

OPINION

THOMAS, Circuit Judge.

Sigitas Banaitis appeals the United States Tax Court's entry of judgment in favor of the Commissioner of Internal Revenue regarding a $1,708,216 deficiency in Banaitis' 1995 income tax. We affirm in part and reverse in part.

From 1980 until late 1987, Sigitas Banaitis, an Oregon resident, worked as a vice president and loan officer with the Bank of California. On behalf of the Bank of California, Banaitis developed grain-focused finance activity in Portland, Oregon, then the largest grain exporting port on the west coast. Banaitis had access to private information regarding the companies with which he worked. This private information included, among other things, data regarding these companies' comparative financial, inventory, and margin strengths, as well as information regarding their respective profitabilities. Much of this information was culled from confidential financial statements. To ensure the security of this information, Banaitis and the Bank of California executed confidentiality agreements.

Sometime in 1984, Mitsubishi Bank acquired a controlling interest in the Bank of California. Mitsubishi Group, Ltd., Mitsubishi Bank's parent company and then the largest company in the world, controlled and operated firms competing directly with a number of Banaitis' loan customers. Anticipating the potential conflict engendered by Mitsubishi Bank's acquisition of the Bank of California—namely, the potential exposure of sensitive financial information—many of Banaitis' customers contacted him, imploring Banaitis to keep the financial information with which he was entrusted confidential; indeed, some went so far as to request that their financial information be sequestered under lock and key.

Banaitis complied with his customers' wishes to keep this sensitive information confidential, refusing to disclose the data when asked to do so by employees of Mitsubishi Bank and the Bank of California. But Banaitis' refusal to disclose was apparently not well-received by Mitsubishi Bank or the Bank of California. Within months of Banaitis' action, Banaitis received an unfavorable performance review, a review that criticized Banaitis for inadequate business performance and accused him of dishonesty and improper employee conduct. Banaitis was placed on work probation.

Troubled by his employment situation, Banaitis apparently suffered a host of physical maladies; his symptoms included headaches, insomnia, gastrointestinal disorders, bleeding gums, and various orthopedic problems. By December 30, 1987, Banaitis' work situation had grown so intolerable that Banaitis left his job, a decision prompted by his employer's delivery of a letter stating that Banaitis had resigned and that he had only 30 minutes to clean out his desk. If Banaitis had been employed for one more day, his pension for 1987 would have vested for that year.

On November 15, 1989, Banaitis retained the law firm of Merten & Associates (hereinafter "Merten") to pursue legal action against Mitsubishi Bank and the Bank of California. To ratify his relationship with Merten, Banaitis signed a document titled "Contingent Fee Retainer Agreement (Statutory Attorneys Fees)." In general, the fee agreement provided for the payment of one-third of the gross settlement prior to commencement of a trial or arbitration and for forty percent of the gross recovery thereafter. Through this agreement, Merten was authorized to "accept a structured payment of the attorneys fee directly from the adverse party." Any award of statutory attorneys fees paid by the opposing parties would be credited toward the amount Banaitis owed Merten. The agreement also required Banaitis to approve the acceptance or rejection of any settlement offer, empowering Merten to terminate its representation of Banaitis if, generally stated, Banaitis behaved unreasonably as a client.

Less than a month after retaining Merten's services, Banaitis filed a lawsuit against Mitsubishi Bank and the

Bank of California in the Multnomah County Circuit Court for the State of Oregon. In his fourth amended complaint, Banaitis brought two claims for relief seeking general and punitive damages, one claim against Mitsubishi Bank and the other against the Bank of California. Banaitis alleged that Mitsubishi Bank intentionally and willfully interfered with Banaitis' employment agreement and economic expectations and caused the Bank of California to discharge Banaitis. Banaitis alleged that Bank of California wrongfully discharged him and improperly attempted to force him to breach his fiduciary duty to his customers by appropriating trade secrets and other confidential information.

On February 25, 1991, the state court empaneled a jury to try Banaitis' case. Approximately three weeks later, the jury retired for deliberations, returning a special verdict within four hours, finding that:

. Banaitis did not voluntarily resign his position;

. Mitsubishi Bank, through "improper means or . . . motive," caused the Bank of California to fire or to discharge Banaitis constructively;

. The Bank of California forced Banaitis to resign by making his working conditions unacceptable, doing so because Banaitis refused to give confidential information to Mitsubishi Bank;

. Banaitis' refusal to give confidential information reflected an "important public policy";

. As a result of the tortious acts, Banaitis suffered emotional distress and injury to reputation;

. Banaitis was entitled to a damage award of $196,389 for lost compensation, $450,000 for lost future compensation, "noneconomic" damages (*i.e.*, damages attributable to his "emotional distress and/or injury to reputation") of $500,000 against Mitsubishi Bank and $125,000 against the Bank of California, and punitive damages of $3 million against Mitsubishi Bank and $2 million against the Bank of California;

. Mitsubishi Bank was 80% at fault for the damages with the Bank of California 20% at fault, but the defendants were jointly and severally liable for the economic damage award and severally liable for the noneconomic and punitive damages awarded.

Soon after the jury returned its special verdict, Mitsubishi Bank and the Bank of California filed a motion with the trial court for judgment notwithstanding the verdict. The trial court granted this motion in part, setting aside the punitive damage award against each defendant. Both parties subsequently sought review with the Oregon Court of Appeals.

Before proceeding with this appeal, Banaitis and Merten entered a second fee agreement to confirm the terms of their arrangement for costs and fees incurred during the course of appellate litigation. In general terms, the new fee agreement provided that Merton would be entitled to 50% of all payable compensatory damages and 42.9127263% of all payable punitive damages.

The Oregon Court of Appeals decided entirely in Banaitis' favor, affirming the award of compensatory damages and reversing the trial court's judgment notwithstanding the verdict to the extent that it erased the jury's punitive damage award. *See Banaitis* v. *Mitsubishi Bank, Ltd.*, 129 Or. App. 371, 879 P.2d 1288 (1994). In response, Mitsubishi Bank and the Bank of California appealed to the Oregon Supreme Court. The Oregon Supreme Court initially granted review, *see Banaitis* v. *Mitsubishi Bank, Ltd.*, 320 Or. 407, 887 P.2d 791 (1994), but, on August 24, 1995, the court dismissed this review as improvidently granted. *See Banaitis* v. *Mitsubishi Bank, Ltd.*, 321 Or. 511, 900 P.2d 508 (1995) (noting that two justices voted against dismissal).

Shortly thereafter, the parties entered into a confidential settlement agreement to resolve all pending disputes. As a part of this settlement agreement, Mitsubishi Bank and the Bank of California issued checks totaling $8,728,559, $3,864,012 of which the Bank of California paid, pursuant to the terms of the agreement, directly to Merten. Mitsubishi remitted the remaining $4,864,547 directly to Banaitis.[1]

Banaitis submitted a timely 1995 Federal income tax return as a married person filing separately. In his 1995 return, Banaitis reported a total income of $1,473,685, most of which constituted what Banaitis deemed "taxable interest"; in his return, importantly, Banaitis excluded from his gross income the full predicate $8,728,599 settlement total. To justify this gross in-

[1] Oregon law requires recipients of punitive damage awards to contribute a portion of such awards to the State. *See* Or. Rev. Stat. § 18.540 (1991). In a letter dated March 7, 1996, Banaitis contested the applicability of the statute to his award, seeking "written confirmation . . . that the State of Oregon [would make] no claim under ORS 18.540 to any monies in this case." The State of Oregon refused to provide such "confirmation," and, sometime later, Banaitis agreed to pay $150,000 to the State. Merten paid none of his $3,864,012 to the State.

come amount, Banaitis appended to his return "a disclosure statement . . . explaining that the compensatory damages, the punitive damages, and the interest on the part of the award used to pay his attorney's fees were excludable from his gross income under Section 104(a)(2)" of the Internal Revenue Code.

The Internal Revenue Service (hereinafter "the IRS" or "the Commissioner") disagreed with both the return as filed and the justifications set forth in Banaitis' explanatory "disclosure statement," delivering to Banaitis on March 24, 2000, a notice of deficiency regarding Banaitis' 1995 income tax payment. In pertinent part, the notice explained that the taxable proceeds of Banaitis' 1995 settlement with Mitsubishi and the Bank totaled $8,103,559, not the $1,421,420 that Banaitis reported; thus, Banaitis' taxable income grew by a measure of $6,682,130. Based on this substantially larger taxable income total, the IRS recalculated Banaitis' allowable miscellaneous itemized deduction, permitting a deduction of $3,317,516 and shifting Banaitis' allowable itemized deduction from $3,325,379 to $3,105,811, thus increasing Banaitis' taxable income by $219,568. The IRS also recalculated Banaitis' alternative minimum tax exposure, raising Banaitis' alternative minimum tax liability from $0 to $288,798. Application of the alternative minimum tax resulted, in effect, taxing the portion of Banaitis's gross income that was paid to his lawyers, even though he was able to deduct the same amount as a miscellaneous itemized deduction and thereby reduce his taxable income by that amount. The effect of the alternative minimum tax, under such circumstances, is to reduce or eliminate the expense deduction. With deductions and additions then fully recalculated and incorporated, the deficiency notice concluded that Banaitis owed an additional $1,708,216 in 1995 income tax.

Banaitis promptly filed a petition with the United States Tax Court seeking a redetermination of the deficiency. *See* 26 U.S.C. § 6213(a) (1999). Banaitis claimed that the full amount of the settlement proceeds was properly excluded from gross income under 26 U.S.C. § 104(a)(2); that the amounts paid directly to Merten should similarly be excluded; and that his rights under the Fifth and Fourteenth Amendment had been violated.

The Tax Court found in favor of the IRS in all respects. It concluded that Banaitis was not entitled to exclude economic damages, punitive damages, or attorneys fees from his reported gross income and that his constitutional rights had not been infringed. Banaitis filed a timely notice of appeal.

We have jurisdiction under 26 U.S.C. § 7482(a)(1) (1999). We review the conclusions of the tax court *de novo*, *DHL Corp.* v. *Commissioner*, 285 F.3d 1210, 1216 (9th Cir. 2002), both with regard to that court's interpretation of the tax code and corresponding treasury regulations, id., and with regard to whether a particular tax burden violates the United States Constitution. *See Louis* v. *Commissioner*, 170 F.3d 1232, 1234 (9th Cir. 1999).

II

The Tax Court correctly held that the portions of the settlement representing economic and punitive damages were to be included in the taxpayer's gross income. Set forth in 26 U.S.C. § 61(a), the definition of "gross income" is broad: "Except as otherwise provided . . ., gross income means all income from whatever source derived." The Supreme Court has long reiterated the "sweeping scope" of § 61, *see Commissioner* v. *Schleier*, 515 U.S. 323, 327-28, 115 S. Ct. 2159, 132 L. Ed. 2d 294 (1995) (quoting *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429, 75 S. Ct. 473, 99 L.Ed. 483 (1955)); *see also United States* v. *Burke*, 504 U.S. 229, 233, 112 S. Ct. 1867, 119 L. Ed. 2d 34 (1992) ("The definition of gross income under the Internal Revenue Code sweeps broadly."), and, as a corollary to this liberal construction, the Supreme Court has repeatedly "emphasized" the "default rule of statutory interpretation that exclusions from income must be narrowly construed." *Schleier*, 515 U.S. at 328, 115 S. Ct. 2159 (internal quotation marks omitted) (citing *Burke*, 504 U.S. at 248, 112 S. Ct. 1867 (Souter, J., concurring) & 244 (Scalia, J., concurring)); *United States* v. *Centennial Sav. Bank FSB*, 499 U.S. 573, 583, 111 S. Ct. 1512, 113 L. Ed. 2d 608 (1991); *Commissioner* v. *Jacobson*, 336 U.S. 28, 49, 69 S. Ct. 358, 93 L. Ed. 477 (1949).

Under § 104(a)(2) of the revenue code, taxpayers may exclude from gross income "the amount of any damages received . . . on account of personal injuries or sickness." 26 U.S.C. § 104(a)(2). The general theory of this exclusion is that "the damage award amounts to a forced sale of the plaintiff's good health, and people who are not forced to sell their good health never have to pay tax on its value." B. Bittker, Fed. Inc. Tax'n of Indiv. ¶ 7.03[1], 2003 ed. Supp. 1(x).

Section 104(a)(2) erects a bipartite test for exclusion of damages from gross income. To merit § 104(a)(2)'s exclusion, (1) the underlying claim must be "based on tort or tort type rights," and (2) "the amount of any damages received . . . [must be granted] on account of personal injury or sickness." 26 C.F.R. § 1.104-1(c) (1999); *see also Schleier*, 515 U.S. at 336-37, 115 S. Ct. 2159. The test's two elements are "independent[ly]" considered and are not coextensive. *Id.* at 333-36, 115 S. Ct. 2159. "The regulatory requirement that the amount be received in a tort type action is not a substitute for the statutory requirement that the amount be received 'on account of personal injury or sickness'; it is an additional requirement." *Id.* at 333, 115 S. Ct. 2159. Neither the "economic" damage portion nor the punitive damage portion of Banaitis' settlement recovery satisfy both aspects of this conjunctive test. *See* 26 C.F.R. § 1.104-1(c) (1999); *Schleier*, 515 U.S. at 336-37, 115 S. Ct. 2159.

In the case at hand, there is no doubt that Banaitis' underlying claims were founded in tort theory. The Supreme Court has endorsed a broad construction of "tort," emphasizing the remedial principles inherent in the cause of action and looking to relevant state law for guidance. *Burke*, 504 U.S. at 234-36, 112 S. Ct. 1867. In this case, we need not speculate about the tort-like nature of the claims underpinning Banaitis' award, for the Oregon state courts construed Banaitis' claims as sounding in tort. *Banaitis* v. *Mitsubishi Bank, Ltd.*, 129 Or. App. 371, 879 P.2d 1288, 1299-1300 (1994). Banaitis thus satisfies the first prong of § 104(a)(2)'s conjunctive test.

But because economic and punitive damages were not awarded "on account of" his personal injuries, Banaitis fails to satisfy the second requirement of § 104(a)(2)'s conjunctive test. The Supreme Court has construed § 104(a)(2) to require that the damage award be more than only proximately caused by the tortious conduct; it must also be directly causally related to personal injuries. *See Schleier*, 515 U.S. at 329-30, 115 S. Ct. 2159. In the ordinary personal injury tort action, these damages are relatively easily discerned: The tortious act causes personal injuries which, in turn, cause further damages, such as economic loss due to physical inability to work. Thus, in the paradigmatic personal injury case, both non-pecuniary damages (such as pain and suffering) and economic damages (such as wage loss, diminished work capacity, etc.) may be excluded from gross income because the losses are "on account of" personal injury.

So-called economic or commercial tort actions present a different circumstance, however. In such economic or commercial tort cases, economic damages are often caused solely by the tortious action itself, rather than as a consequence of personal injury. For example, in the typical wrongful discharge lawsuit, wage loss is typically caused by the tortious employment termination, not by any physical injury that may also have been caused by the wrongful discharge.

Banaitis urges a different construction of § 104(a)(2). He contends that the section allows a taxpayer to exclude all damages suffered in a personal injury action, which in turn, he construes to mean a tort suit like his own. Banaitis' construction misconstrues and conflates the two independent prongs of § 104(a)(2), doing so in a manner inconsistent with the Supreme Court's analysis in *Schleier*. Had Congress intended for all tort damages to be excluded—or excludable—from gross income, it could have easily and plainly said so. But Congress chose to employ § 104(a)(2)'s conjunctive requirement instead, demanding that the action sound in tort *and* that the damages recovered be "on account of" personal injury. *See* 26 U.S.C. § 104(a)(2). As *Schleier* makes clear, the second part of the test can only be satisfied if there is "a direct causal link" between the damages and the personal injuries sustained. *See Fabry* v. *Commissioner*, 223 F.3d 1261, 1270 (11th Cir. 2000). Particularly in economic tort cases such as this, the "direct causal link" question requires a fact-specific analysis of the damage award.

In this case, it is clear that the economic and punitive damages were not causally related to Banaitis' alleged personal injuries. The personal injuries Banaitis alleges (*e.g.*, headaches, insomnia, gastrointestinal disorders, bleeding gums, and back aches) did not cause his wage loss. Rather, his wage loss was caused by Bank of California's improper termination of his employment and Mitsubishi Bank's interference with his employment relationship. Likewise, the punitive damage award was not causally related to his personal injuries; rather, it was predicated on the defendants' tortious conduct. Thus, the Tax Court properly concluded that Banatis' economic and punitive damage awards should have been included in his gross income in the relevant tax year.

III

The Tax Court erred in holding that the attorneys fees paid to Merten should be included in Banaitis' gross income total. The question of whether attorneys fees paid under a contingent fee contract with a plaintiff are includable in the plaintiff's gross income involves two related questions: (1) how state law defines the attorney's rights in the action, and (2) how federal tax law operates in light of this state law definition of interests. *See United States* v. *Mitchell*, 403 U.S. 190, 197, 91 S. Ct. 1763, 29 L. Ed. 2d 406 (1971) (noting that state law creates or defines the legal interests and property rights but that federal law defines when and how these interests and rights are taxed). The rationale of this two-part test is grounded on the long standing tax principle that one cannot escape tax liability through the assignment to another of income not yet received. *See Helvering* v. *Horst*, 311 U.S. 112, 114, 61 S. Ct. 144, 85 L. Ed. 75 (1940) (refusing to permit a taxpayer to escape tax liability through the anticipatory assignment of money due); *Lucas* v. *Earl*, 281 U.S. 111, 114-15, 50 S. Ct. 241, 74 L. Ed. 731 (1930) (refusing to allow a taxpayer to escape taxes through "anticipatory arrangements and contracts however skillfully devised to prevent the [income] . . . from vesting even for a second in the [one] who earned it"). As a rule, plaintiffs cannot avoid the tax consequences of a personal injury judgment or settlement through an anticipatory assignment of a portion of the proceeds to their attorneys in payment of a contingent fee.

In certain contexts, however, state law may operate to provide the plaintiff's attorney greater rights than the lawyer would have under a contingent fee contract. As a result, we must examine applicable state law to determine whether the plaintiff's attorneys have particular property interests arising as a matter of law in the judgment or settlement independent of the fee contract. Using this state-law-specific analysis, we have concluded that, under Alaska law, attorneys fees contingent upon recovery are to be included in the plaintiff's gross income. *See Coady* v. *Commissioner*, 213 F.3d 1187, 1190-91 (9th Cir. 2000). Significant to our decision in *Coady* was the fact that "under Alaska law, attorneys do not have a superior lien or ownership interest in the cause of action." *Id.* at 1190. The relevant Alaska statute, we noted, "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.* (citing *Hagans, Brown & Gibbs* v. *First Nat. Bank of Anchorage*, 783 P.2d 1164, 1168 (Alaska 1989)). Not long ago, we reached a similar conclusion about the operation of California law, holding contingent attorneys fees includable in the plaintiff's gross income. *Benci-Woodward* v. *Commissioner*, 219 F.3d 941, 943 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112, 121 S. Ct. 855, 148 L. Ed. 2d 770 (2001). Other circuits have reached similar conclusions in analyzing applicable law. *Young* v. *Commissioner*, 240 F.3d 369, 377-79 (4th Cir. 2001); *Kenseth* v. *Commissioner*, 259 F.3d 881, 884-85 (7th Cir. 2001); *Campbell* v. *Commissioner*, 274 F.3d 1312, 1313-14 (10th Cir. 2001); *Baylin* v. *United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995); *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963).

Some circuits, of course, have reached contrary conclusions based on the unique features of applicable state law. In *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), for example, the Fifth Circuit concluded that contingent fees paid directly to one party's attorney by a separate party did not, under Alabama law, constitute a part of the first party's gross income. Its rationale was that the germane portion of the Alabama Code: (1) invested attorneys with "a lien superior to all liens but tax liens" in suits, judgments, and decrees for money, (2) mandated that "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 (3) determined that "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 46 Al. Code § 64(2) (1940)). The Fifth Circuit has reached a similar conclusion about the operation of Texas law. *See Srivastava* v. *Commissioner*, 220 F.3d 353, 355-57, 364-65 (5th Cir. 2000) (relying on *Cotnam's* logic to conclude that "contingent fees paid according to Texas law are . . . excludable"); *see also Foster* v. *United States*, 249 F.3d 1275, 1278 (11th Cir. 2001) (extending *Cotnam's* Alabama-law-based holding into the law of the entire Eleventh circuit). And the Sixth Circuit has concluded that Michigan law vests attorneys with sufficient property interests in judgments such that contingent attorneys fees are properly excludable from the plaintiff's gross income. *See Estate of Clarks* v. *United States*, 202 F.3d 854, 856 (6th Cir. 2000) (following *Cotnam* because Michigan's common law lien "operates in more or less the same way as the Alabama lien in *Cotnam*").

In pertinent part, Oregon law is unlike the laws of California and Alaska. In pertinent part, in fact, Oregon law mirrors Alabama law in that it affords attorneys generous property interests in judgments and settlements. Unlike California and Alaska law, an attorney's lien in Oregon is "superior to all other liens" except "tax liens." O.R.S. § 87.490. Under Oregon law, "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 claim of the attorney for fees based thereon, is satisfied in full." O.R.S. § 87.475. And Oregon law, like Alabama law, provides that attorneys shall have "the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount of judgment due thereon to them." O.R.S. § 87.480. Indeed, Alabama and Oregon law are almost identical in their treatment of the interest attorneys have in legal actions.

In some respects, in fact, Oregon goes even further than does the Alabama law at issue in *Cotnam*. As the Oregon Supreme Court stated in *Potter* v. *Schlesser Co.*, 335 Or. 209, 63 P.3d 1172, 1174 (2003):

> The lien is a charge on the action, and the parties to the action cannot extinguish or affect the attorney's lien by any means (such as settlement) other than by satisfying the underlying claim of the attorney for the fees incurred in connection with the action.

The Oregon Supreme Court, thus, has recognized that an attorney has a right to sue a third party for attorneys fees that were left unsatisfied by a private settlement with the attorney's clients. *Id.* at 215, 63 P.3d 1172. In this sense, the case *sub judice* presents a different issue than the one we discussed in *Sinyard* v. *Commissioner*, 268 F.3d 756 (9th Cir. 2001), in which we held that a third party's discharge of a debt held by a particular plaintiff constituted income to the plaintiff. *Id.* at 758-59. 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; as a result, Banaitis' claim under Oregon law is akin to—and even stronger than—the claim in *Cotnam*.

Because of the unique features of Oregon law, we conclude that fees paid directly to Merten were not includable in Banaitis' gross income for the relevant year. Accordingly, we reverse the judgment of the Tax Court on this question.

IV

Banaitis also claims that the application of the alternative minimum tax in this case violates his right to due process because it operates to "nullify" the outcome of his jury trial. Banaitis' alternative minimum tax theory is not a novel one, and we have previously considered and rejected this legal argument. *See, e.g., Benci-Woodward*, 219 F.3d at 944; *Weiser* v. *United States*, 959 F.2d 146, 148-49 (9th Cir. 1992); *Okin* v. *Commissioner*, 808 F.2d 1338, 1342 (9th Cir. 1987). We likewise reject it here.

V

We affirm the judgment of the Tax Court that the economic and punitive damage awards are includable in gross income and that the alternative minimum tax was constitutionally applied in this case. We reverse the judgment of the Tax Court as to the inclusion of attorneys fees in the taxpayer's gross income.

AFFIRMED IN PART; REVERSED IN PART.

APPENDIX B

UNITED STATES TAX COURT

No. 4323-00

SIGITAS J. BANAITIS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Jan. 8, 2002

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, J.

Respondent determined a $1,708,216 deficiency in income tax for petitioner's 1995 taxable year. The issues for our consideration are: (1) Whether petitioner is entitled to exclude damages received in settlement of a lawsuit under section 104(a)(2);[1] (2) whether fees paid to petitioner's attorneys in accord with a contingent fee agreement are excludable from petitioner's gross income; and (3) whether respondent's determination violated petitioner's Fifth Amendment rights in the form of a Government taking without due process of law or just compensation.

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue.

FINDINGS OF FACT[2]

At all pertinent times, Sigitas J. Banaitis (petitioner) resided in Clackamas County, Oregon. From 1980 through December 30, 1987, petitioner was employed by the Portland branch of the Bank of California, N.A. (BCal), as a loan officer and vice president. As such, petitioner solicited and maintained customers, mostly businesses, to whom BCal made loans. In so doing, petitioner and BCal obtained sensitive and highly confidential information, including information contained in financial statements. Loan customers were assured by both petitioner and BCal of confidentiality through oral assurances and written contracts.

In 1984, Mitsubishi Bank, Ltd. (MBL), a member of the Mitsubishi Group (MG), acquired a controlling interest in BCal. Some of petitioner's loan customers competed directly with firms and enterprises of MG. During 1986 and 1987, MBL employees asked petitioner to provide confidential information about those specific loan customers. Adhering to his ethical and legal duties, confidentiality agreements and BCal policy, petitioner refused.

Subsequent to his refusal, MBL employees gave petitioner negative performance evaluations and attacked his integrity. This situation grew so intolerable for petitioner that on December 30, 1987, 1 day before his pension vested, petitioner was forced to leave his job at BCal.

Before and after petitioner left his job, he experienced insomnia, headaches, stomach problems, back and

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[2] The parties have stipulated some of the facts. The stipulation of facts and the attached exhibits are incorporated herein by this reference.

neck pain, and gum disease. Petitioner did not consider himself disabled, nor did he apply for disability insurance benefits. After he left BCal, petitioner actively searched for employment. He distributed resumes, went for job interviews, started businesses, and offered and performed consulting services.

On November 15, 1989, almost 2 years after petitioner was forced to leave BCal, petitioner retained the law firm of Merten & Associates to file a lawsuit against BCal and MBL. In so doing, petitioner signed an agreement entitled "Contingent Fee Retainer Agreement" (Fee Agreement I). Fee Agreement I provided that petitioner's attorneys would receive a percentage of petitioner's gross recovery. They were to receive one-third in the event that an agreement was reached before trial. If a trial commenced, the fee increased to 40 percent. Settlement offers had to be discussed with petitioner, and an offer could not be accepted or rejected without his approval. Merten & Associates had an attorney's statutory lien and a possessory lien on petitioner's property in its possession.

Additionally, Fee Agreement I provided that if petitioner (1) breached the agreement, (2) did not cooperate, (3) unreasonably rejected a settlement offer, or (4) insisted on pursuing a claim contrary to the attorney's advice, the law firm could terminate its services and would be entitled to payment at an hourly rate for services rendered to date, plus costs. Petitioner could fire Merten & Associates, at any time, which would entitle it to a minimum payment of an hourly rate for their services. Fee Agreement I did not provide legal fees for the pursuit or defense of an appeal.

Having hired attorneys, petitioner filed a complaint in the Multnomah County Circuit Court for the State of Oregon on December 12, 1989. Altogether, petitioner filed four amended complaints, the last of which was filed on March 11, 1991.

Petitioner's complaints, as amended, contained two claims for relief. The first was against MBL for intentional interference with contract and economic expectations. The second was against BCal for wrongful discharge from employment. In both claims, petitioner alleged that MBL and BCal acted maliciously "with the intent to harm the plaintiff * * * [which was] socially intolerable." Under this allegation, petitioner sought damages of $3 million from MBL and $2 million from BCal. Petitioner also prayed for economic and noneconomic damages, as follows: (1) Economic damages of $647,389—$196,889 for lost salary and benefits and $450,500 for lost future compensation; and (2) noneconomic damages for "stress, anger, worry, and loss of life enjoyment" in an amount to be determined by the jury after the trial.

On March 18, 1991, the jury returned a special verdict against BCal and MBL. The jury found that (1) petitioner did not voluntarily resign his position at BCal, (2) MBL caused BCal to constructively discharge petitioner, (3) BCal intended to make working conditions so unacceptable that petitioner would resign, (4) BCal forced petitioner to resign because petitioner refused to disclose confidential information to MBL, and (5) petitioner's refusal was in furtherance of important public policy. The jury allocated fault 80 percent to MBL and 20 percent to BCal.

The jury awarded petitioner the following damages: (1) $196,389 for his lost compensation to date, (2)

$450,000 for his lost future compensation, (3) $500,000 and $125,000 for emotional distress from MBL and BCal, respectively. Further, because they awarded petitioner compensatory damages, under Oregon law the jury was allowed to consider punitive damages. The jury found that the employees of both MBL and BCal were "guilty of wanton misconduct and acted within their employment." As such, the jury awarded punitive damages from MBL and BCal in the amounts of $3 million and $2 million, respectively.

In summary, the money judgment against MBL was $500,000 for noneconomic damages, $3 million for punitive damages and $646,389 for economic damages—$450,000 in lost future compensation and $196,389 in wages. The money judgment against BCal was $125,000 for noneconomic damages, $2 million for punitive damages, and $646,389 for economic damages. MBL and BCal were jointly and severally liable for the economic damages and severally liable for the noneconomic damages and the punitive damages. Petitioner was also entitled to postjudgment interest and costs of litigation.

Subsequently, MBL and BCal filed motions with the trial court for judgment notwithstanding the verdict. These motions were granted in part and the judgment set aside. At this point, petitioner was still entitled to compensatory damages, but no punitive damages. Petitioner and the banks, separately, appealed to the Oregon Court of Appeals.

For the legal fees occasioned by the appeal, petitioner and his attorney, Charles J. Merten (Merten), entered into a second contingent fee agreement on July 22, 1991 (Fee Agreement II). It provided for various scenarios under which legal fees would be payable.

Generally, Fee Agreement II provided that the fees would be computed as a percentage of petitioner's recovery.

Petitioner and Merten also entered into an agreement entitled "Letter Interpretation" (Letter) which was intended to govern the interpretation of Fee Agreement II. It provided that Merten's fee would be paid out of petitioner's punitive damages recovery. Again, it was clear that petitioner could fire his attorneys at any time, thereby entitling them to a prescribed amount of compensation.

On August 3, 1994, the Oregon Court of Appeals reinstated the jury verdict. Consequently, MBL and BCal filed an appeal with the Supreme Court of the State of Oregon. Before the appeal was completed, the parties reached a settlement.

On October 26, 1995, petitioner entered into a confidential settlement and a mutual release agreement with MBL and BCal. The total amount of the settlement was $8,728,559. Pursuant to the wording of the settlement agreement, MBL issued a cashier's check to petitioner for $4,864,547 and BCal issued a cashier's check to "[petitioner's] attorney, Charles J. Merten," for $3,864,012.

Under Oregon State law, Or.Rev.Stat. sec. 18.540 (1991), petitioner was required to pay a portion of his punitive damages award to the State. Petitioner initially disputed the applicability of this statute but later settled with the State for $150,000. The firm of Merten & Associates did not pay any part of its $3,864,012 to the State of Oregon for this statutorily imposed liability.

Respondent allowed, as a miscellaneous itemized deduction, $3,317,316 for attorney's fees paid to Merten & Associates.

OPINION

We consider three interrelated issues: (1) Whether any portion of damages received in settlement of petitioner's legal claim is excludable under section 104(a)(2); (2) whether the amount paid under the settlement directly to petitioner's attorney is excludable from petitioner's gross income; and (3) whether any portion of the tax burden placed on petitioner's settlement proceeds violates his constitutional rights as a taking without due process of law or just compensation within the meaning of the Fifth Amendment of the U.S. Constitution.

I. *Exclusion for Damages*

Section 61 defines gross income as "all income from whatever source derived". While this definition of gross income is broad in terms of what it includes, exclusions from gross income are narrowly construed. *United States* v. *Burke*, 504 U.S. 229, 248, 112 S. Ct. 1867, 119 L.Ed.2d 34 (1992). One such exclusion is provided for in section 104(a)(2): "damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness" are excluded from gross income.

Petitioner filed his 1995 Federal income tax return as married filing separately. He included a disclosure statement with his 1995 return explaining that the compensatory damages, the punitive damages, and the interest on the part of the award used to pay his attorney's fees were excludable from his gross income under section 104(a)(2). Accordingly, petitioner reported as income only the interest on the part of the award disbursed directly to him.

Respondent made the following determination concerning the litigation award:

Total amount of damages awarded:	$8,728,559
Less interest reported by the petitioner:	(1,421,420)
Less amount excluded, under I.R.C., sec. 104(a)(2) for emotional distress:	(625,000)
Increase to income reported by petitioner:	6,682,139

A. *Economic Damages*

Petitioner received $646,389 in economic damages. Petitioner contends that section 104(a)(2) applies to exclude these economic damages from gross income. In arguing that these proceeds are excludable, petitioner points out that under Oregon State law, his claims against BCal and MBL for wrongful discharge and intentional interference with economic expectations are torts. As such, petitioner claims that damages received in connection with these torts are excludable under section 104(a)(2). However, petitioner's argument assumes that the origin of the claim is the only relevant inquiry. A two-part test for the section 104(a)(2) exclusion was established in *Commissioner* v. *Schleier*, 515 U.S. 323, 333, 115 S. Ct. 2159, 132 L.Ed.2d 294 (1995). *Schleier* requires that, in addition to the law suit's being based upon a tort claim, the damages received must have been "on account of personal injuries or sickness". *Id.*

The factual circumstances in this case reflect that petitioner's economic damages were not "on account of personal injuries or sickness". Rather, petitioner's economic damages were intended to replace wages and other compensation lost when he was forced to leave his job. While in some circumstances economic damages measured by lost wages can satisfy the second prong of the *Schleier* test, petitioner's economic damages do not. For instance, if a taxpayer were unable to work as a direct result of his physical injuries, the economic damages he received to replace his lost wages would be excludable. *Id.*; Rev. Rul. 85-97, 1985-2 C.B. 50. In short, the taxpayer's physical injuries would have been the direct cause of his inability to work.

Although petitioner was forced to leave his job because of a tort and he had manifestations of emotional distress, he was not forced to leave his job because of those injuries. Rather, he was forced to leave because he refused to disclose confidential information. The damages were intended to replace salary and benefits wrongfully taken from him "on account of" his constructive discharge—not because of any personal injury. Moreover, petitioner's injuries did not prevent him from working at all—at BCal or elsewhere. We note that, after leaving BCal, petitioner actively searched for employment and was self-employed.

Accordingly, petitioner's economic damages are not "on account of personal injury or sickness" and as such, do not meet the *Schleier* test. Petitioner's economic damages are not excludable from his gross income.

Punitive Damages

Petitioner also received $5 million in punitive damages. As with his economic damages, petitioner claims that section 104(a)(2) applies to exclude this amount from his gross income.

Petitioner would have us accept his interpretation of the following legislation added to section 104(a)(2) in 1989: "Paragraph 2 [excluding from gross income any damages received on account of personal injuries or sickness] shall not apply to any punitive damages in connection with a case not involving physical injuries." Petitioner contends that the use of a double negative in this phrase creates a positive. In other words, petitioner believes that Congress intended for all punitive damages to be excludable from gross income in any case involving physical injuries or sickness. Petitioner's argument was addressed and rejected by the Supreme Court in *O'Gilvie* v. *United States*, 519 U.S. 79, 89-90, 117 S. Ct. 452, 136 L. Ed. 2d 454 (1996).

Petitioner has gone to great lengths in his attempt to support his interpretation, including citations and references to judicial commentary, syntax doctrines, and comparisons to other sections of the Internal Revenue Code. However, the Supreme Court has held that section 104(a)(2) does not exclude punitive damages from income even if awarded in a case involving physical injuries or sickness. *Id.*

Furthermore, petitioner's award of punitive damages was not intended to compensate for physical injuries. The punitive damages were intended to punish BCal and MBL and to deter them from future misconduct. When awarding petitioner punitive damages, the jury found that the employees of BCal and MBL were guilty of wanton misconduct and acted within the scope of their employment. Accordingly, we find petitioner's statutory interpretation is flawed.

To exclude his punitive damages from income, petitioner must satisfy section 104(a)(2) and the two-prong *Schleier* test. However, we have already held that while the damages arose from tort-based claims, they were not on account of physical injuries or sickness. Therefore, petitioner's punitive damages are not excludable from his gross income.

As such, we agree with respondent's position in that the noneconomic damages were the only damages excludable under section 104(a)(2). Petitioner must include his economic and punitive damages within his gross income for taxable year 1995.

II. *Attorney Contingent Fee Agreements*

Petitioner also seeks to exclude from his gross income $3,864,012, the portion of the settlement BCal paid directly to Merten, his attorney, pursuant to the two contingent fee agreements. Here again, we consider the broad reach of section 61 and whether, under some theory, the amount paid to petitioner's attorney should be excluded from gross income. Numerous taxpayers have attempted to find some approach for excluding from income the portion paid to their attorneys from judgment or settlement damages. This Court has not approved any such approach except where the case was appealable to a Court of Appeals with a contrary view.

This Court in *Kenseth* v. *Commissioner*, 114 T.C. 399, 2000 WL 669977 (2000), affd. 259 F.3d 881 (7th Cir. 2001), held that a contingent fee agreement did not result in an excludable assignment of income from the taxpayer. See *Helvering* v. *Horst*, 311 U.S. 112, 61

S. Ct. 144, 85 L. Ed. 75 (1940); *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930). In addition, we observed that the right created in an attorney pursuant to a contingent fee agreement was the right to be paid for services rendered—a right created in any creditor-debtor relationship. Under this holding, proceeds of a judgment or settlement which would be includable in the taxpayer's income if paid directly to the taxpayer, and which are instead paid to a taxpayer's attorney pursuant to an attorney contingent fee agreement are income to the taxpayer. *Kenseth* v. *Commissioner*, *supra*. The Court of Appeals for the Seventh Circuit recently affirmed this holding. *Kenseth* v. *Commissioner*, 259 F.3d 881 (7th Cir. 2001).

We recognize that there is a split among the Courts of Appeals on this question. The Court of Appeals for the Fifth Circuit, in *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), affg. in part and revg. in part 28 T.C. 947, 1957 WL 1117 (1957), held that an attorney's lien under Alabama law provided the attorney with a property right in the lawsuit. Therefore, the court held that the proceeds paid directly to the attorney pursuant to a contingent fee agreement constituted the attorney's property and were not income to the taxpayer. The Court of Appeals for the Sixth Circuit, on a somewhat different theory, held that fees paid to an attorney under a contingent fee agreement are not income to the taxpayer. *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, 202 F.3d 854 (6th Cir. 2000). On the other hand, the Courts of Appeals for the Third, Seventh, Ninth and Fourth Circuits have disagreed with the Fifth and Sixth Circuit's reasoning. *Kenseth* v. *Commissioner*, 259 F.3d 881 (7th Cir.2001); *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001), affg. 113

T.C. 152, 1999 WL 632706 (1994); *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), affg. T.C. Memo. 1998-291; *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963).

In a recent case, the Court of Appeals for the Ninth Circuit[3] held that a defendant's payment of a plaintiff's attorney's fees under a fee shifting statute results in income to the plaintiff. *Sinyard* v. *Commissioner*, 268 F.3d 756 (9th Cir. 2001), affg. T.C. Memo.1998-364. That same result pertains even though the attorney was hired under a contingent fee agreement. *Id.* In *Sinyard*, the court applied the discharge of indebtedness and constructive receipt doctrines as the rationale for its holding.

We find nothing in the case at bar to cause us to differ from our previous analyses in this regard. The fact that the attorney's fees were paid directly from petitioner's settlement proceeds does not alter the amount of petitioner's total settlement recovery. Petitioner settled the case for $8,728,559. The defendants wrote one check to petitioner for $4,864,547 and one check to petitioner's attorney, Charles J. Merten, for $3,864,012. The fact that two checks were written does not change the facts that (1) petitioner was owed $8,728,559 from the defendants for the settlement amount and (2) Merten was owed $3,864,012 from petitioner for services rendered. The payment structure is immaterial.

Petitioner has set forth an alternative argument. He argues that, in spite of *Sinyard* v. *Commissioner*, *supra*, the Court of Appeals for the Ninth Circuit would

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[3] Petitioner's case would be appealable to the Court of Appeals for the Ninth Circuit.

not apply Federal tax law in this case. Instead, petitioner contends that Oregon law would apply to determine whether a property right in the settlement proceeds had been created in the attorney under the contingent fee agreement. Petitioner contends that as Oregon law gives the attorney such a right, the Court of Appeals would disregard *Kenseth* and *Sinyard*.

In spite of petitioner's argument, we find nothing in Oregon law which provides an attorney hired under a contingent fee agreement with anything more than a right to compensation for services rendered. When BCal directly paid petitioner's attorneys, it merely paid the fees petitioner already owed to petitioner's attorney. Indeed, the settlement agreement explicitly stated that BCal would pay "defendant's attorney, Charles Merten".

In addition, the Court of Appeals for the Ninth Circuit explicitly rejected the reasoning in *Cotnam* v. *Commissioner*, *supra*. The court stated: "We do not see how the existence of a lien in favor of the taxpayer's creditor [taxpayer's attorney] makes the satisfaction of the debt any less income to the taxpayer whose obligation is satisfied." *Sinyard* v. *Commissioner*, *supra* at 760.

We also note that Merten did not pay any of his $3,864,012 to the State of Oregon under Or.Rev.Stat. sec. 18.540 (1991), which claims a percentage of all punitive damages awards. Under Fee Agreement II, Merten's fee was to come out of the punitive damages. The settlement proceeds replaced the jury verdict. Therefore, if Merten were a real party in interest with respect to that $3,864,012 settlement, and did not receive it instead to discharge petitioner's obligation to compensate him for services rendered, Merten should have paid the State of Oregon a portion of his proceeds.

Consequently, we hold that the portion of the damages, $3,864,012, paid directly to petitioner's attorney is includable within petitioner's gross income.

III. *Constitutionality*

Petitioner claims that respondent's determination violated his constitutional right against a Government taking without due process of law or just compensation. Petitioner points out, that after attorney's fees, the Federal alternative minimum tax, and the State of Oregon tax, he would be left with only $1,984,078. This amount is 22.7 percent of the total settlement of $8,728,559.[4] Petitioner claims that, as this is such a small percentage of the total settlement, the application of the alternative minimum tax is unconstitutional.

However, the Court of Appeals for the Ninth Circuit, to which petitioner's case is appealable, has spoken on this subject. In *Okin* v. *Commissioner*, 808 F.2d 1338, 1342 (9th Cir. 1987), affg. T.C. Memo. 1985-199, the Ninth Circuit stated that the Due Process Clause does not limit the congressional power to tax. Moreover, the Court specifically stated that the "alternative minimum tax is a rational means of * * * tax, and * * * is constitutional." See also *Sinyard* v. *Commissioner*, *supra* at 760.

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[4] We find it curious that petitioner claims his recovery was $8,728,559 for purposes of making his constitutional argument while he claims his recovery was only $4,864,547 for other arguments in his brief.

To the extent not herein discussed, we have considered all other arguments made by the parties and find them to be moot or without merit.

To reflect the foregoing,

Decision will be entered for respondent.