WILL THE NINTH CIRCUIT BE REVERSED IN *BANAITIS V. COMMISSIONER*?

Richard Mason*

I. INTRODUCTION

The question of whether successful litigants are required to include as income for federal tax purposes the portion of settlements or awards that go to their counsel for contingent attorney fees has been a thorny one for quite some time.[1] The Internal Revenue Code (IRC) §104(a)(2)[2] excludes from gross income the amount of any damages (other than punitive damages)[3] received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Accordingly, the contingent legal fee issue arises only for claims that are not for personal injury or sickness. The issue is relevant to all other claims that are handled by attorneys on a contingent fee basis, for example employment discrimination claims, wrongful termination claims, product liability claims, securities claims, most punitive damage claims, and interest paid on claims excluded under IRC §104(a)(2).

Seven of the Circuits consistently include contingency fees in a taxpayer's gross income,[4] while three Circuits[5] exclude contingent legal fees from gross

* Ph.D., JD; Assistant Professor, University of Nevada, Reno, mason@unr.edu. Editor's Note: In an effort to publish this article before the Supreme Court issues its decision in *Banaitis* and its companion case, *Banks v. Commissioner*, legislation, cases, and scholarship subsequent to October 1, 2004, have not been included. In particular, the Civil Rights Tax Relief Act, contained within the American Jobs Creation Act, enacted on October 22, 2004, has not been included. This new law provides an off-the-top deduction to taxpayers for the costs of litigation for federal civil rights claims. The deduction is limited to the amount of litigation for federal civil rights claims and to the amount of litigation income included in a given tax year. While the Act may lend persuasive support to the petitioner's position in *Banks*, it will not directly affect the outcome because the Act is not retroactive. The provisions of the Act would not apply to the facts of *Banaitis*.

1 *See* Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959).

2 Twenty-six United States Code sections are referred to in this note as the IRC sections.

3 IRC § 104(c) provides: The phrase "(other than punitive damages)" shall not apply to punitive damages awarded in a civil action - 104(c)(1) which is a wrongful death action, and 104(c)(2) with respect to which applicable State law (as in effect on September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action. This subsection shall cease to apply to any civil action filed on or after the first date on which the applicable State law ceases to provide (or is no longer construed to provide) the treatment described in paragraph (2).

4 Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995); Raymond v. United States, 355 F.3d 107 (2nd Cir. 2004), *petition for cert. filed,* 72 U.S.L.W. 3569; O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v.

income. The Ninth Circuit has ruled in two cases for inclusion and in a recent case *Banaitis v. Commissioner*[6] for exclusion. In *Banaitis,* the Ninth Circuit reversed the Tax Court[7] on the issue of requiring the inclusion in gross income of the amount of contingent legal fees paid to Banaitis' attorneys and held that an Oregon plaintiff may exclude the amount of contingent legal fees from gross income for federal tax purposes. On March 29, 2004 the United States Supreme Court granted certiorari at the government's request in *Banaitis* and consolidated *Banaitis* with *Banks v. Commissioner,*[8] a Sixth Circuit case presenting the same issue. The single question presented is: 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 his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.

Banaitis and *Banks* are representative of the minority approach in the Circuit Courts that the contingent legal fees may be excluded from gross income for federal tax purposes under IRC §61(a). Two other fairly recent cases,[9] earlier than *Banaitis,* that followed the majority approach were denied certiorari on taxpayer appeals; both *Hukkanen-Campbell* from the Tenth Circuit and *Benci-Woodward* from the Ninth Circuit followed the majority of Circuits' holding that the contingent legal fees were includable in a successful litigant's gross income.

The argument date for *Banaitis* and *Banks* has been set for November 1, 2004. These cases have engendered a significant amount of interest in the legal community that can be measured by the eleven *amici curiae* briefs filed to date in *Banaitis,* while *Banks* has had twelve *amici curiae* briefs filed.[10] The majority of these briefs are in support of the taxpayers and the organizations representing this support include the National Employment Lawyers Association, the NAACP Legal Defense and Education Fund, Inc., AARP, the Trial Lawyers for Public Justice, the Western Center on Law and Poverty,[11] and the Equal Employment Advisory Council.[12]

Comm'r, 259 F.3d 881 (7th Cir. 2001); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).

5 The Fifth Circuit excluded the contingent attorney's fees in *Cotnam v. Comm'r,* 263 F.2d 119 (5th Cir. 1959) under Alabama law and more recently under Texas law in *Srivastava v. Commissioner,* 220 F.3d 353 (5th Cir. 2000); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000), Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003) (relying on *Clarks*), *cert.granted*, 124 S.Ct. 1712 (2004); Foster v. United States, 249 F.3d 1275 (11th Cir. 2001) (same).

6 340 F.3d 1074 (9th Cir. 2003), *cert. granted* 124 S.Ct. 1712 (2004).

7 83 T.C.M. (CCH) 1053 (2002).

8 345 F. 3d 373 (6th Cir. 2003), *cert. granted* 124 S.Ct. 1712 (2004).

9 Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001) *cert. denied*, 535 U.S. 1056 (2002); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001).

10 Banaitis v. Comm'r, No. 03-907, *at* http://www.supremecourtus.gov/docket/03-907.htm (last visited Sept. 18, 2004); Banks v. Comm'r, *at* http://www.supremecourtus.gov/docket/03-892.htm (last visited Sept. 18, 2004).

11 2004 TNT 172-14 (Sept. 3, 2004).

12 2004 TNT 174-15 (Sept. 8, 2004).

This note is structured as follows: In Part II a hypothetical illustration of the two competing tax treatments to successful claimants is provided. Part III examines the specific facts and legal rationales employed in the minority approach in *Banaitis* (Ninth Circuit) and *Banks* (Sixth Circuit) and a brief review of the cases best illustrating the majority approach. In Part IV there is a review of the arguments and approaches that have been presented in briefs filed by the petitioner and the respondents with the Supreme Court in *Banaitis* and *Banks*. The conclusion is Part V.

II. Illustration of the Two Competing Tax Treatments

To best understand the issue it is important to look at the differing federal tax results for a successful litigant under the majority and minority positions. For illustration purposes, the following assumptions are made: there is a total $1 million settlement payment for employment discrimination, the litigant receives $650,000 and the lawyers receive contingent legal fees of $350,000, the litigant is single and would not normally itemize deductions, and the litigant has a $70,000 per year salary with no other income. These assumptions are purposefully simplistic, but keep the example tractable.[13] The legal fees are assumed at a 35 percent rate to approximate the general total cost of litigations of this type.

A. *Tax treatment under the majority approach*

Gross income	$1,070,000
Adjusted Gross Income (AGI)	1,070,000
Itemized deductions:	
(Attorney fees total $350,000)	
Amount allowed as itemized deductions:[14]	300,781
Personal exemption-phased out	-0-
Taxable income	769,219
Regular income tax[15]	250,134
Alternative minimum tax calculation:	
Taxable income	769,219
Add back itemized deductions	300,781
Alternative minimum taxable income	1,070,000
Exemption amount (fully phased out)	-0-
Alternative minimum tax base	1,070,000

[13] The illustration calculations were performed using 2004 tax rates tables, phaseout limitations, and standard deduction. Some writers have used an unrealistic example to illustrate the possibility that the a successful claimant may be obligated to pay more in federal tax than the amount she receives, see, for example, the amicus curiae brief of Kenneth Gideon, et al, using nominal damages of $1 and attorneys fees of $275,000. This note uses a legal fee level of 35% of the recovery to better illustrate a more realistic difference between the two treatments.

[14] The itemized deductions for attorneys fees is subject to a 2% of AGI floor, and there is an overall limitation of itemized deductions applicable to higher income taxpayers: The amount allowed is $350,000-((.02 × 1,070,000) + .03(1,070,000-142,700)) = $300,781.

[15] $92,592.50 + .35(769,219-319,100) = $250,134.15

Tentative minimum tax[16]	296,100
Minus regular income tax	250,134
Alternative minimum tax	45,966
Total Federal tax paid:	$ 296,100

B. Tax treatment under the minority approach

Gross income	$ 720,000
Adjusted Gross Income (AGI)	720,000
Less standard deduction	4,850
Personal exemption - phased out	-0-
Taxable income	715,150
Regular income tax[17]	231,213
Alternative minimum tax calculation:	
Taxable income	715,150
Add back standard deduction	4,850
Alternative minimum taxable income	720,000
Exemption amount (fully phased out)	-0-
Alternative minimum tax base	720,000
Tentative minimum tax[18]	208,100
Minus regular income tax	231,213
Alternative minimum tax	-0-
Total Federal tax paid	$ 231,213

C. Tax treatment without the settlement

Gross income	$ 70,000
Adjusted Gross Income (AGI)	70,000
Less standard deduction	4,850
Personal exemption	3,100
Taxable income	62,050
Regular income tax[19]	10,750
Alternative minimum tax calculation not applicable	
Total Federal tax paid	$ 10,750

D. Comparison of the tax treatments

The best measure of the difference in taxes due is the difference between the amount that would be due in federal taxes without the settlement and the amount that would be due in federal taxes with the settlement. Under the majority approach the taxpayer would owe $296,100 of federal tax incorporating the settlement as opposed to $10,750 of federal tax without the settlement. The

[16] Tentative minimum tax is 26% of the first $175,000 of income and 28% above $175,000, or $296,100

[17] $92,592.50 + .35(715,150-319,100) = $231,213.

[18] Tentative minimum tax is 26% of the first $175,000 of income and 28% above $175,000, or $208,100.

[19] $4000 + .25(62,050-29,050) = $10,750

difference in taxes owed would be $285,350. This difference accounts for about 44% of the net settlement amount received ($285,350/$650,000). Under the minority approach the difference is $220,463 ($231,213 - 10,750) or approximately 34% of the net settlement proceeds. For this hypothetical, the net amount of the proceeds remaining after legal fees and taxes is $353,900 (about 35% of the full settlement) under the majority view and $418,787 (about 42%) under the minority view. The difference in federal taxes payable under the two treatments incorporating the settlement is approximately $65,000. As the settlement amounts grow, the difference in federal taxes required to be paid also grows. The illustration used an individual earning a reasonable, but not overly high, salary by today's standards. For many of the plaintiffs in wrongful termination or discrimination suits the proceeds received from an award or settlement might represent a significant portion of their net worth and, consequently, be of critical importance to their overall financial picture. However, it should be recognized that a difference of 6.5%, although potentially important to the prevailing claimant, is not really a tremendous difference in the scheme of the federal tax laws.

The difference in federal income tax occurs due to the triggering of the alternative minimum tax by the inclusion of legal fees in gross income. In the minority view example an alternative minimum tax liability is not triggered. The illustration of the claimant's tax position without the settlement serves to provide the figures needed to show the effect of progressive tax rates and the alternative minimum tax on the claimant's salary income. Instead of paying federal taxes on his salary of approximately 15.4% ($10,750/$70,000), under the majority treatment the percentage escalates to 27.7% ($70,000/$1,070,000 x $296,100 = $19,371/$70,000), an increase due to the progressive nature of the tax rates. The illustration assumes that damages were received on account of an employment discrimination claim and would, consequently, represent lost wages. It is important to remember that even under the minority approach the after-tax damages retained by the plaintiff represent only about 42% of the wages lost.

The fact that the lost wages are realized in one period instead of over time as they would have been earned coupled with the progressive nature of the federal incomes rates results in the claimant being taxed at significantly higher rates than would be case if the lost wages were realized over a normal time frame. The tax situation of each successful claimant is different, but the fundamental result of the illustration that there is an additional federal tax burden triggered under the majority approach holds true across the vast range of taxpayers' individual situations.[20] In rare circumstances, where the legal fees sig-

[20] State tax implications have been excluded from the example, but as there is an income tax in the vast majority of states and an alternative minimum tax in some states, there would generally be a reduction in the amount of proceeds remaining to the taxpayer. The impact, if any, of state alternative minimum tax on this issue is beyond the scope of this analysis. For an excellent discussion of state alternative minimum taxes, *see* Yvonne L. Hinson & Ralph B. Tower, *State AMT for Individuals: An analysis and* Assessment, 32 STATE TAX NOTES 845 (June 14, 2004). Current tax laws generally treat each tax year as a separate economic unit with taxpayers paying the rates on a single period of income. On an historical note, there were at one time income-averaging provisions in IRC that would serve to tax a windfall in one period over the average tax rates for a greater period of time. These provisions, no

nificantly exceed the portion of the award retained by the claimant, the additional taxes owed under the majority approach can exceed the portion of the recovery that is retained by the claimant after taxes.[21] However, in the vast majority of cases the attorneys fees are at the traditional 30 to 40% of the recovery level and the level of additional taxes shown in the hypothetical illustration provided above are representative of the levels successful claimants would encounter.

III. *BANAITIS* AND THE NINTH CIRCUIT AND *BANKS* AND THE SIXTH CIRCUIT AND THE MAJORITY APPROACH

A. *Banaitis v. Commissioner*

In *Banaitis,* the plaintiff Banaitis was employed as a banker by the Bank of California specializing in export grain financing.[22] Mitsubishi Bank also was involved in the grain import/export financing business and then acquired the Bank of California. Banaitis refused to give certain information regarding his clients to Mitsubishi Bank officials at the request of his clients and in accord with various confidentiality agreements entered into by Banaitis and the Bank of California with these clients. Within months of his actions, Banaitis received poor performance evaluations, was placed on work probation, and began to have various physical maladies. His work situation became intolerable and, after receiving a letter from the bank stating he had resigned and giving him one-half hour to clear out his desk, Banaitis left his position with the Bank of California. He subsequently hired attorneys on a contingency fee arrangement to bring an action for wrongful termination, and the resulting physical and mental injuries. The action was successful, ultimately resulting in a settlement with Mitsubishi Bank and the Bank of California for in excess of $8 million with contingent legal fees in excess of $3.6 million.

Banaitis originally filed his tax return excluding the entire settlement from gross income. The Internal Revenue Service (IRS) disagreed and issued a notice of deficiency recalculating his liability including virtually the entire settlement in gross income. Commonly, taxpayers attempt to exclude, from gross income, the full settlements or awards as damages paid on account of personal injury. Such attempts when discovered by the IRS invariably result in a notice of deficiency. There is no way to know how many plaintiffs have incorrectly characterized these amounts as excludable from gross income where the exclusion is not discovered by the IRS. The contingent legal fee issue only arises in those cases where the IRS uncovers either a taxpayer attempt to erroneously exclude the settlement or a taxpayer attempt to exclude the legal fees where a claim amount is included in gross income. Accordingly, it is impossible to know how many taxpayers would be affected by the resolution of these cases.

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longer in place, would have served to mitigate the problem of pushing taxpayers into significantly higher rate brackets due to a windfall in a particular year.

[21] *See e.g.*, Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002 at 18.

[22] 340 F.3d 1074 (9th Cir. 2004) (the facts cited in Part III.A can be found in the opinion).

Banaitis filed a petition with the Tax Court seeking a review of the deficiency. The Tax Court ruled in favor of the IRS on all points, including requiring Banaitis to include the contingent legal fees in gross income under IRC §61 and requiring him to deduct the legal fees as expenses incurred for the production of income under IRC §212. The legal fees were treated as itemized deductions for the production of income subject to the 2% of adjusted gross income floor.[23] However, these large itemized deductions that relate to attorney fees are not allowable in calculating the taxpayer's alternative minimum taxable income, the consequence of which is to trigger a significant alternative minimum tax liability. The legal fees are treated under IRC §212 as are all other expenses in connection with the production of income, none of which are allowable as deductions in connection with the alternative minimum tax. On appeal to the Ninth Circuit, the court reversed the Tax Court on the issue of inclusion of the legal fees, but upheld the Tax Court on the inclusion of most of the remainder of the settlement.[24]

B. *Ninth Circuit Decisions*

Banaitis was the third case with respect to contingent legal fees that the Ninth Circuit has decided. The two prior cases, *Coady v. Commissioner*[25] required an Alaska plaintiff to include the total settlement in income and *Benci-Woodward v. Commissioner*[26] required a California plaintiff to do the same. In *Coady,* a wrongful termination claim was brought against Coady's employer and, after a bench trial, Coady was awarded approximately $373,000, contingent legal fees and court costs amounted to approximately $221,000.[27] In *Benci-Woodward,* the plaintiffs brought a series of claims arising out of an employer investigation against the parent corporation of Target Stores, including false imprisonment, defamation, and wrongful termination. A jury awarded the plaintiffs in excess of $3 million in punitive damages, as well as compensatory damages; the plaintiffs had entered into a 40% contingent fee agreement with counsel.[28]

The Ninth Circuit in ruling on the three cases analyzed the nature under state law of the attorneys' claim to the legal fees:

> 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 (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).[29]

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[23] Rev. Rul. 85-98, 1985-2 CB 51.

[24] A small portion of the settlement was attributable to personal injuries and excludable from income.

[25] 213 F.3d 1187 (9th Cir. 2000).

[26] 219 F.3d 941 (9th Cir. 2000), *cert. denied,* 531 U.S. 1112 (2001).

[27] *Coady*, 213 F.3d at 1188.

[28] T.C. Memo 1998-395.

[29] *Banaitis*, 340 F.3d at 1081.

The Ninth Circuit held in *Coady* and *Benci-Woodward* that there was no superior property interest acquired by the attorneys under either Alaska or California law and, consequently, the contingent legal fees represented gross income to the plaintiffs.

The court in distinguishing *Banaitis* from its two prior decisions found with respect to Oregon law:

> 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."[30]

In holding that the contingent fees in *Banaitis* were excluded from gross income the Ninth Circuit found that Oregon law vested the attorney with a sufficient property right in the settlement for the plaintiff not to be charged with the gross income.[31] The Ninth Circuit relied heavily on the reasoning in *Cotnam v. Commissioner*[32] and the Fifth Circuit's interpretation of Alabama law. The Ninth Circuit adopted the "property rights" approach in its three decisions. Essentially, the *Banaitis* holding relies strictly upon the interpretation that Oregon state law vests the attorney with a greater property right or interest in the legal fees than that of a mere service provider, or creditor of the plaintiff.

This property rights approach to exclude contingent legal fees from gross income was first taken by a divided Fifth Circuit in *Cotnam v. Commissioner*. That court decided that under Alabama laws an attorney has the same rights as the client to the fees,[33] and also that the granting of a interest in a contingent legal fee was not an assignment of income under *Lucas v. Earl*,[34] but rather the assignment of a claim that was valueless at the time the assignment was made.[35] This view that there is no value to the claim at the time of entering into the contingent fee arrangement becomes a critical component in the underlying rationale for the minority view cases in this area. It was not shared by the entire *Cotnam* court, as Judge Wisdom in his dissent noted that the underlying cause of action was for compensation for services rendered and the proceeds were earned, just not paid, at the time of the granting of an interest to the attorneys.[36]

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30 *Id.* at 1082.

31 *See* Karl K. Marschel, *It's a Property Issue: The Proper Treatment of Contingent Fees Under the Federal Tax Code*, 11 WASH. U. J. L. & POL'Y 323 (2003).

32 263 F.2d 119 (5th Cir. 1959).

33 *Id.* at 125.

34 281 U.S. 111 (1930).

35 *Cotnam*, 263 F.2d at 126. The court said "Mrs. Cotnam's tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit." *Id.*

36 *Id.* at 126 (stating "Mrs. Cotnam sued the Hunter Estate and recovered on the theory that she had a contract for compensation for services rendered. Thus, at the time of the assignment to the attorneys all of her services had been rendered and all of the income earned").

A more recent Fifth Circuit decision, *Srivastava v. Commissioner*,[37] examined the rationale of *Cotnam*, and, for a Texas plaintiff, a divided court held that the contingent legal fees were also excluded from gross income. The court noted that, were they ruling anew, they might well have applied the anticipatory assignment of income doctrine and included the contingent legal fees in the claimant's gross income,[38] but stated:

> Rightly or wrongly, this court in Cotnam decided not to apply the anticipatory assignment of income doctrine to contingent fee agreements . . . . In refusing the Commissioner's request to distinguish Cotnam (as the Tax Court has grudgingly done on occasion), we note that what the Commissioner truly seeks is a direct challenge to Cotnam, in the Eleventh Circuit as well as here. We decline that invitation and, instead, reverse the Tax Court's decision to include contingent fees within gross income . . . .[39]

Thus, the Fifth Circuit followed *Cotnam* while acknowledging the strength of the anticipatory assignment of income argument. More importantly, the court acknowledged the weakness of relying upon the state law attorney/client bundle of rights argument. On the latter point the court noted:

> We therefore agree with the Tax Court that, irrespective of whether it is proper to tax contingent attorney's fees under the anticipatory assignment doctrine, the answer does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state.

The Ninth Circuit's decisions in *Coady, Benci-Woodward* and *Banaitis* rely on the state law bundle of rights argument; an argument of which the Fifth Circuit currently is critical.[40] Unlike the Fifth and Sixth Circuits, the Ninth Circuit has not summarily rejected the property rights approach.[41] It remains the only Circuit with split case decisions relying strictly on the state property rights approach.

C. *Banks v. Commissioner*

The plaintiff in *Banks* was employed by the California Department of Education as an educational consultant for fourteen years and was terminated. Banks filed a federal employment discrimination claim, as well as state tort claims for slander and intentional infliction of emotional distress against his former employer.[42] Prior to trial, Banks abandoned his state tort claims and the case proceeded to trial on the federal employment discrimination claim. During trial, a settlement was reached and Banks received $464,000. Banks accepted a settlement that was lower than it otherwise would have been on his belief that the damages would be excluded from his gross income for tax pur-

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37 220 F.3d 353 (5th Cir. 2000).
38 *Id.* at 363.
39 *Id.* at 364-365.
40 Chris Staton Spicer, *Are Attorneys' Fees Income to the Taxpayer? The Inequitable and Inconsistent Result of the Ninth Circuit's State Attorney Lien Law Approach in Banaitis v. Commissioner*, 57 TAX LAW REV. 845 (2004) (criticized the Ninth Circuit for following the property rights approach and instead suggested that the Ninth Circuit should have used the approach taken by the Fifth and Sixth Circuits).
41 *Id.* at 845 (suggesting the approaches in the Fifth and Sixth Circuit provide a fairer and more consistent result).
42 *Banks*, 345 F.3d at 375.

poses as damages on account of personal injuries or sickness. He paid $150,000 of the settlement to his lawyers pursuant to a contingency fee agreement. Banks excluded the entire settlement from his 1990 tax return taking the position that all of the settlement proceeds related to personal injury damages for injuries suffered subsequent to his termination.[43] The Internal Revenue Service filed a notice of deficiency, and Banks filed a petition with the Tax Court. The Tax Court held that none of the settlement related to a personal injury and the contingent legal fee was not excludable from gross income.[44] Banks then appealed to the Sixth Circuit.

D. The Sixth Circuit's Decisions

In *Banks*, the Sixth Circuit affirmed the Tax Court on the issue of whether the settlement proceeds were excludable from gross income as damages relating to personal injury following *Commissioner v. Schlier*[45] noting "First, the taxpayer must have received the damages amount through the litigation of an action (or a settlement thereof) based on tort or tort-type rights. Second, the amount must be paid on account of personal injury or sickness."[46]

Since the claim that was settled related to legal injuries under Title VII and the sole remedy afforded was recovery of back wages, the Sixth Circuit concluded that the underlying claim was not sufficiently settled on account of his personal injuries.[47] Additionally, a divided Sixth Circuit panel reversed the Tax Court and held that the contingent fees may be excluded from income.[48] Banks sued under a California claim. In *Benci-Woodward*, discussed above, the Ninth Circuit had held that under California law an attorney did not receive a superior property right to the amount of contingent legal fees. Judge Moore in her dissent noted this and would have ruled for the inclusion of the contingent legal fee in income.[49] The majority of the court adopted a different standard from the underlying state property rights standard adopted by the Ninth Circuit. The court in *Banks* relied heavily on a prior Sixth Circuit decision *Estate of Clarks v. United States*[50] that had excluded contingent legal fees from gross income for a Michigan claimant.

Estate of Clarks is the most far-reaching of the cases adopting the minority view. In *Estate of Clarks* the underlying claim was a personal injury claim resulting from head injuries to Clark while he was unloading his truck at a K-Mart. The damage award was $5.6 million and was excludable from gross income as paid on account of personal injuries under IRC §104(a)(2). However, the interest on the award of approximately $5.7 million was not excludable from gross income. The attorneys received one-third of both the damages and the interest. The tax filing originally excluded the interest amount that was paid

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43 *Id.* at 376.
44 T.C. Memo 2001-48 (there was also an issue as to the deduction of alimony to Banks' former spouse, which is not relevant to this discussion).
45 515 U.S. 323 (1995).
46 *Id.* at 337.
47 *Banks*, 345 F.3d at 382.
48 *Id.* at 386.
49 *Id.* at 389.
50 202 F.3d 854 (6th Cir. 2000).

directly to the attorneys. The IRS issued a notice of deficiency and the estate subsequently paid the extra taxes due on the interest and then sued in district court for a refund. In the district court summary judgment was entered for the government.[51]

In *Estate of Clarks*, the Sixth Circuit advocated a more radical approach stating that the attorney-client relationship is akin to a joint venture:

> In the instant case, as in Cotnam, the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel. The claim simply amounted to an intangible, contingent expectancy. The only economic benefit Clarks 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. *Like an interest in a partnership agreement or joint venture, Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds.* Just as in Cotnam, the assignment Clarks' lawyer received operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney.[52]

The Sixth Circuit distinguished *Lucas v. Earl* and *Helvering v. Horst*[53] by noting that in those two cases the assignees were recipients of gifts with the effect of the gifts to split income off to lower taxed family members not to a person(s) who had to earn their share of the income. The court also noted that under the government's theory both the plaintiff and attorney are taxable on the income, but critically the attorney(s) must by his efforts earn his portion of the proceeds.[54] The Sixth Circuit reiterated this reasoning in *Banks.*

Estate of Clarks is particularly interesting because it introduces joint venture or partnership theory between the attorney and the client. This is a strong acknowledgment that the economics of the attorney/client relationship in contingent fee cases may be something more than the traditional service provider arrangements, due to the risks assumed by the attorney and the significant level of participation in the outcome that the attorney gains. Unlike the Ninth Circuit that has relied on the traditional state property rights analysis and rationale, the Sixth Circuit has introduced a more economically oriented and radical approach to the contingent fee question. If the court had not adopted the broader approach, then Banks, who was suing under a California claim and settled his claim during trial in the federal district court for the Eastern District of California[55] would have, as the dissent noted, been constrained by the Ninth Circuit's decision in *Benci-Woodward*. It is likely the Sixth Circuit's broader approach in these cases and the Ninth Circuit's apparent change of direction in *Banaitis* persuaded the Supreme Court that it is time to address the conflict on this split that currently exists among the circuit courts.

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51 *Id.* at 855.
52 *Id.* at 857 (emphasis added).
53 Lucas v. United States, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940).
54 *Estate of Clarks*, 202 F. 3d, at 857.
55 *Banks*, 345 F.3d, at 375.

E. *The Majority Approach*

Seven of the Circuits that have ruled favor inclusion: the First,[56] Second.[57] Third,[58] Fourth,[59] Seventh,[60] Tenth,[61] and Federal[62] Circuits include contingency fees in a taxpayer's gross income. The Circuits that have included contingent legal fees in gross income have generally relied on the anti-assignment logic of *Helvering v. Horst* and *Lucas v. Earl.* Strongly favoring inclusion, the Second Circuit reversed the Vermont district court in *Raymond v. United States*,[63] and included the contingent legal fees in the plaintiff's gross income and stated:

> In sum, although the relative interests that attorney and client have in the contingent fee portion of a judgment are relevant to the taxation of that fund, state-law concepts of those interests must be read in the context of federal tax policies. We do not read Vermont law as providing attorneys with a proprietary interest in their clients' claims. Further, determining to whom income flows depends in large part upon who controls the source of the income. When a taxpayer is in sufficient control of the source of income, federal principles of taxation deem him the recipient of gross income upon its disposition. This is such a case. *And at least in this case, we believe the result supports the primacy of substance over form. Raymond secured a judgment. He paid his attorney. The form that payment took is immaterial.*[64]

The Second Circuit attributed the income to the taxpayer and noted that the fact that the taxpayer would be prevented from deducting the attorneys' fees under the alternative minimum tax was unfortunate, but was not a sufficient motivation to create a contingent fee exception where the taxpayer controls the property, i.e., the claim. Its opinion is the most recent and contains perhaps the best articulations of the majority view on this issue. Accordingly, a discussion of *Raymond* and analysis of the issues can best provide a thorough understanding of the majority position in these cases.

In *Raymond*, Raymond was employed by IBM and brought a wrongful termination suit against IBM. He retained counsel on a one-third contingency fee basis. At trial, Raymond was awarded a \$900,000 judgment. IBM paid Raymond \$600,000, less \$243,000 in federal tax withholding, and directly paid his attorneys the remaining \$300,000. Raymond originally filed his tax return including the entire \$900,000 of the judgment as his gross income and deducted the legal fees as itemized deductions subject to the 2% of adjusted gross income floor. On an amended tax return for the year, Raymond excluded the \$300,000 from his gross income that IBM had paid directly to his attorneys and claimed a refund of approximately \$55,000.[65] The inclusion of the legal fees

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56 Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995).
57 Raymond v. United States, 355 F.3rd 107 (2nd Cir. 2004), *petition for cert. filed*, No. 03-1415.
58 O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963).
59 Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001).
60 Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001).
61 Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002)
62 Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995).
63 *Raymond*, 355 F.3d 107.
64 *Id.* at 117 (emphasis added).
65 *Id.* at 108-109.

on the original return as income and then deducted as itemized deductions triggered the alternative minimum tax, as discussed above, and resulted in the additional tax liability that he now claimed as a refund. The IRS denied Raymond's refund claim and he filed suit in district court to recover the refund claimed.[66] The district court granted Raymond's motion for summary judgment holding that under Vermont law the agreement between and his attorney gave rise to an equitable lien in favor of the attorney and that Raymond did not have a sufficient interest in the amount paid to the attorneys to give rise to income to Raymond.[67] The government appealed to the Second Circuit.

It is interesting to speculate whether this litigation would have occurred had Raymond not included the entire judgment on his initial tax filing. The document sent by IBM to Raymond and IRS likely included as gross income only the $600,000 that IBM paid to Raymond, as most corporate tax reporting systems are set to capture the payment amounts to payees rather than an inflated figure. IBM would have received, if allowable, a tax deduction of $900,000 in either scenario.[68] The opinion does not indicate how Raymond made the decision to include the entire judgment in the first instance. In any event, Raymond did choose to include the entire amount and the case proceeded up to the Second Circuit.

The Second Circuit reviewed the case, noting that the general approach taken by the various circuits has been to apply a state law analysis to determine the level of relative property interest between the attorneys and the litigant in the amount of the contingent legal fees.[69] The Court stated that courts that have found the attorney's interest to be sufficiently strong have excluded the contingent legal fees from the gross income of the litigant - a minority of courts -while the courts that have found the property interest of the attorney in the claim to be more in the nature of a security interest have included the amount of the contingent legal fees in the gross income of the litigant - a majority of the courts.[70] In this regard, the Second Circuit characterized the apparent "circuit split" as perhaps not a true split on the law.[71] The Court cited *Young* and *Banks* as cases that have taken a federal, rather than state law, approach to the issue, noting that the Fourth Circuit in *Young* indicated that the issue should be resolved as one of federal tax law and not by trying to ferret out the level of property interest the attorney and the claimant share in the underlying cause of action. The Second Circuit indicated that in *Banks* the contingent fee agreement was governed by California law and the Sixth Circuit departed from *Benci-Woodward* and that its departure was on federal grounds.[72] As discussed above, the Sixth Circuit in *Banks* may have decided on federal grounds, but it is also likely that its belief that there is more to the relationship of attorney-client, i.e., that the attorney client relationship is akin to a joint

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66 *Id.* at 109.
67 Raymond v. United States, 243 F. Supp. 2d 548 (D. Vt. 2002).
68 *See* Wood, Daher, and Wood, *Attorney's Fees: Maverick Circuit Says 'Oregon Good, Calif. Bad'*, 101 TAX NOTES 91, 92 (Oct. 6, 2003) (discussion of whether the attorneys fee are paid directly to the attorney by the defendant or paid by the claimant matters.)
69 *Raymond*, 355 F.3d at 110.
70 *Id.*
71 *Id.*
72 *Id.*

venture in contingency fee cases, as indicated in *Estate of Clarks* and reiterated in *Banks* likely played an important role in their decision.

The Second Circuit's analysis of the law started with the broad interpretation that has been given to IRC §61(a) that defines "gross income" as "all income from whatever source derived." The Court noted that the Supreme Court has given this provision a broad construction "to tax all gains except those specifically excluded."[73] However, a gain is not taxed until the benefit of it is realized. Additionally, the gain itself need not actually go to the taxpayer, it is only required that the taxpayer receives the benefit of a gain. Beyond the direct realization of the benefit, the anticipatory assignment of income doctrine prohibits a taxpayer from moving the realization of the benefit a gain from herself to another party.[74] The impact of this rule is that retaining control of property is retaining the income from the property. To effectively divest oneself of the income requires one to effectively divest the underlying property from which the income is derived.

This impact can be seen in *Helvering v. Horst*. In *Horst,* a father retained ownership of bonds while making a gift of the coupons to his son. The Supreme Court held that the income, i.e. the interest derived from the coupons, was properly taxed to the father.[75] Applying the logic of *Horst* in *Raymond*, the Second Circuit determined that although the attorney may have a lien on the proceeds of the claim it is not the same as having a proprietary interest in the claim itself.[76]

Commentators have also supported the Second Circuit's reasoning. Marschel[77] states:

> In reality, the client owns the entire claim; it is the client's property. While an attorney may have significant control over the prosecution of the claim, the claim is still the property of the client. The contingent fee contract simply provides a device by which the client pays for the attorney's labor with a portion of the client's future recovery. The client receives the benefit of the attorney's services and, therefore, the income represented by those services. To rule otherwise would be to create an artificial judicial exception to the statutory rules set forth by Congress in the Code.[78]

The Seventh Circuit in *Kenseth v. Commissioner*[79] also aptly articulated the argument and in criticizing *Cotnam* stated:

> Enough; for in any event it is not a feasible judicial undertaking to achieve global equity in taxation, *see* Benci-Woodward v. Commissioner, *supra*, 219 F.3d at 944, and cases cited there, especially when the means suggested for eliminating one inequity (that which Kenseth argues is created by the alternative minimum income tax) consists of creating another inequity (differential treatment for purposes of that tax of fixed and contingent legal fees). And if it were a feasible judicial undertaking, it still would not be a proper one, equity in taxation being a political rather than a jural

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73 Comm'r v. Glenshaw Glass, 348 U.S. 426, 430 (1955).

74 This doctrine comes from a pair of anti-assignment cases; *See* Lucas v. Earl 281 U.S. 111 (1930) and Helvering v. Horst, 311 U.S. 112 (1940).

75 *Horst*, 311 U.S. at 120.

76 *Raymond*, 355 F.3d at 115.

77 Karl L. Marschel, *It's a Property Issue: The Proper Treatment of Contingent Fees Under the Federal Tax Code*, 11 WASH. U. J.L. & POL'Y 323 (2003).

78 *Id.* at 349.

79 259 F.3d 881 (7th Cir. 2001).

> concept. Indeed the cases that reject the Tax Court's position seem based on little more than sympathy for taxpayers. The granddaddy of those cases, *Cotnam v. Commissioner*, *supra*, a 2-1 opinion (so far as relates to the issue in our case) with Judge Wisdom dissenting, states its rationale as follows: "The amount of the contingent fee was earned, and well earned, by the attorneys. True, in a remote rather than a proximate sense, the entire amount of the judgment had also been earned by Mrs. Cotnam, but she could never have collected anything or have enjoyed any economic benefit unless she had employed attorneys, and to do so, she had to part with forty per cent of her claim long before the realization of any income from it." 263 F.2d at 126. This rationale badly flunks the test of neutral principles. It is often the case that to obtain income from an asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion from income.[80]

The last thought in the above quote from the Seventh Circuit opinion in *Kenseth* seems a bit off the mark. One must frequently obtain skilled services, to obtain income from an asset, but whether the payment is up front or in arrears seems irrelevant to the question of whether contingent legal fees should be included the claimant's gross income. The facts in *Kenseth* involved an age-discrimination suit against an employer and a 40% contingency fee agreement. The Seventh Circuit's opinion noted that there is "nothing exotic about this analysis"[81] and rejected all of the taxpayer's arguments, holding there was no transfer of ownership of the claim, that the inability to fully deduct the legal fees against income is irrelevant, and that a contingency fee arrangement doesn't differ from an hourly fee arrangement in any material way.

The majority approach applies the existing legal precedents in a logical and straightforward manner. The crux of these applications is that it is the client who controls the claim from the onset to the disposition or dissipation of the claim. Only the client has the decisional authority to compromise or abandon the claim and at any time the client may dismiss counsel and retain another, albeit potentially at some cost. The attorney merely provides the services needed to facilitate the client's realization, if any, of value for the underlying claim. This precept coupled with the anti-assignment rulings and the very broad inclusion of income under IRC §61(a) provides a strong legal foundation for the majority view in these cases.

IV. The Arguments Included in Briefs to the Supreme Court

A. *The Government's Case*

The government's case is clearly the easier and more straightforward of the two presentations and is included in a joint brief that was filed for *Banaitis* and *Banks*.[82] The government's principal argument is that the taxation of these amounts is a question of federal law and that IRC §61(a) includes the entire award or settlement in gross income, since there is no specific statutory exclusion for the type of damages received by the taxpayers in either *Banaitis* or

[80] *Id.* at 885.
[81] *Id.* at 884.
[82] Brief for Petitoner, *Banaitis*, *at* http://www.lawmemo.com/emp/docs/us/banks_br_pet.pdf (last visited Oct. 10, 2004).

Banks.[83] The second argument made by the government is that, even if state law were to apply, that – under California law, as to *Banks,* or Oregon law, as to *Banaitis* – the law would still require the inclusion of the full settlement proceeds in federal income for tax purposes.[84]

Fundamentally, the government relies on the language of IRC §61(a) that provides "except as provided in this subtitle, gross income includes all income from whatever source derived," and past Supreme Court decisions giving a broad interpretation to the statute, including *Commissioner v. Glenshaw Glass,* where the Court held that it was the "the intention of Congress to tax all gains except those specifically excluded."[85] Thus, the first prong of the government's main argument is simply that the full amount of the settlements is income under IRC § 61(a).

The next prong to the government's inclusion argument is that the income is earned by the successful claimants and cannot through assignment be moved to another taxpayer. In this regard the government cites the cases giving rise to the judicial "assignment-of-income doctrine" that provides that a taxpayer is taxed on income attributable to him and cannot move the income to another through anticipatory assignment.[86] The government states that "[t]he assignment-of-income doctrine is a practical necessity in a system of graduated taxation; without it, a taxpayer in a high tax bracket could avoid heightened levels of taxation simply by shifting income to a lower-bracket taxpayer."[87] The government also includes a citation to *Lucas v. Earl*[88] to emphasize that the taxpayer's motives have been held to be irrelevant in the question of assignment, indicating that a motives test would be judicially intractable and subject to abuse.[89] The government then cites the various Circuit Court decisions that have held the contingent legal fees are included in the gross income of the taxpayer,[90] including excerpts from the decisions in *Raymond* and *Kenseth* that are discussed in Section III.E above.

In light of the Sixth Circuit's ruling in *Banks*, the government argues that the Sixth Circuit's conclusion that the assignment-of-income doctrine does not apply to contingent legal fee cases is erroneous. The government lists four factors that the Sixth Circuit used to justify its holding that the contingent legal fees are not income to the claimant: that the plaintiff's claim is a contingent expectancy at the time the contingent fee agreement is made; that the nature of the relationship of attorney client is like a partnership or joint venture; that there is no tax-avoidance purpose, or motive, for the transaction; and that there would be double taxation if the contingent legal fees are included in the claimant's income.[91]

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83 *Id.* at 14.

84 *Id*. at 35.

85 348 U.S. 426, 430 (1995). The government also relies on *Comm'r v. Schleier*, 515 U.S. 323 (1995) and *Helvering v. Clifford*, 309 U.S. 331 (1940).

86 Lucas v. Earl, 281 U.S. 111(1930); Helvering v. Horst 311 U.S. 112(1940).

87 Brief for Petitioner, *supra* note 82, at 20.

88 281 U.S. at 115.

89 Brief for Petitioner, *supra* note 82, at 20.

90 *See* cases cited *supra* note 4.

91 Brief for Petitioner, *supra* note 82, at 26.

With respect to the claim being a contingent expectancy, the government notes that *Earl* dealt with the anticipatory assignment of income, or income not yet earned. Regarding the partnership or joint venture factor, the government argues that there was no authority cited by the Sixth Circuit for this notion and that under state law there is only a secured claim at best for the attorney in the ultimate amount of any damages. The argument made here is that the control of the property right in the claim is never relinquished by the client and the attorney is, no matter how dependent on the outcome for his compensation, merely an instrument in effectuating the realization of income from property owned and controlled by another. Consequently, as the assignment-of-income cases have held the income simply belongs to the owner of the property. The third element of the Sixth Circuits' reasoning, that there is no tax-avoidance purpose, is countered with the argument that what the Sixth Circuit is doing is incorrectly attempting to introduce a motives inquiry in violation of the principles enunciated by the Supreme Court in *Earl*.[92] Finally, as to the double taxation notion the government argues that the Sixth Circuit is incorrect and that double taxation is a common occurrence under the tax code pointing out that any time a taxpayer purchases goods or services that are non-deductible there is tax on both parties to the transaction.[93]

The government's second argument addresses the decisions in the Fifth, Ninth and Eleventh Circuits that relied upon provisions in state law in deciding to exclude the contingent legal fees from the gross income of the successful claimant. Although the government contends these decisions are in error as the question is governed by federal law, they do argue that the respective state statutes, California for *Banks*, and Oregon for *Banaitis,* do not give the attorney an interest in the property but rather no more than a security interest in the proceeds in the claim. Consequently, the relationship is no more than that of a debtor-creditor and not joint owners of the property. In making this argument the government cites and discusses the respective state statutes and decisions, including the earlier Ninth Circuit decision in *Benci-Woodward* that concluded a California plaintiff should include the total damages in gross income. The government argues that the decision in *Banaitis* was incorrect as to the interpretation of Oregon law by the Ninth Circuit. With respect to *Banks*, the government argues that *Benci-Woodward's* interpretation of California law should control and that the decision in *Banks* was in error even on state law grounds. This is a restatement of the dissenting argument in *Banks.* Additionally, the government noted that the Sixth Circuit in *Banks* did not take issue with the Ninth Circuit's interpretation of California law.[94]

B. *The Taxpayer's Case in* Banks

There are five arguments made in the taxpayer's brief in *Banks.* These arguments are: there is no provision of the IRC that requires the taxpayer to recognize income properly allocable to his attorney; the contingent legal fee cannot be income to the taxpayer, as the taxpayer did not have the requisite

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[92] *Id.* at 33.
[93] *Id.* at 34.
[94] *Id.* at 35-41.

dominion or control over that portion of the recovery; the contingent fee part of the settlement could have been awarded under fee-shifting statutes and is therefore income only to the attorney; the government's position is unjust and can lead to the payment of more in taxes than the amount of a recovery; and the assignment-of-income doctrine does not apply to a contingent fee contract.[95] Each of these arguments presumes that federal law controls the disposition of the case. In *Banks* there is no argument made that it is a matter of state law that should control the case. The taxpayer's arguments are at times far more interrelated than the government's arguments.

The taxpayer's initial argument is that since IRC §61(a) does not specifically state that the contingent fee is income to the taxpayer that the decision as to whether it is income must come from a judicial interpretation of what is income. Without enumerating specific citations the taxpayer argues that "the Court's decisions have made clear that control or power of disposition of an item of receipt is a prerequisite to charging a taxpayer with income."[96] This essentially collapses the first argument into the second argument that the taxpayer lacked sufficient dominion, control, and beneficial ownership over the portion of the recovery that went to the attorneys.

In this regard the taxpayer relies on *Commissioner v. Sunnen* for the control test quoting "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."[97] The brief also cites *Carliss v. Bowers*,[98] stating that "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him . . . " The taxpayer's argument on this point is that the entering of a contingent fee arrangement is an action through which the taxpayer ceded sufficient control over the portion of any claim that was realized to his attorney so that it would be inappropriate to charge him with income for the portion of the damages retained by the attorney. This leads to the taxpayer embracing the joint venture or partnership theory that was enumerated by the Sixth Circuit in *Estate of Clarks,* discussed in Section III.D above, as this interpretation of the attorney-client relationship in contingent fee cases supports the lack of sufficient control argument for the charging of income to the taxpayer on the contingent legal fees.

The third and perhaps, the most interesting argument made for the taxpayer relates to the fact that the underlying causes of action that were ultimately settled in *Banks* related to discrimination claims under federal statutes. This is because the state tort claims initially alleged in the litigation were ultimately dropped. Under each of these federal statutes[99] there are fee-shifting provisions that enable a court to award attorneys' fees to successful litigants. The taxpayer's argument here is that there should be no difference between the tax treatment afforded those who settle claims including amounts that are for attorneys' fees and those who successfully prosecute their claims and the court

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95 Brief for Respondent, *Banks* (No. 03-892).
96 *Id.* at 10.
97 *Id.* (citing *Sunnen*, 331 U.S. 591, 604 (1948)).
98 *Id.* (citing *Carliss*, 281 U.S. 376, 378 (1930)).
99 42 U.S.C. § 2000(e) *et seq*. (2003); 42 U.S.C. §1981 (2003); 42 U.S.C. §1983 (2003).

awards attorneys' fees.[100] The thrust of this argument is that charging Banks with income relating to the portion of the settlement that went to his attorneys would punish him and future litigants under discrimination statutes, thus undermining the discrimination statutes.

The fourth argument made for the taxpayer is that the application of the anti-assignment rules to these legal fee cases can result in an unjust and unduly harsh result for claimants in that the taxes owed can exceed the net amount of the award received by the claimant. To illustrate this outcome the brief uses the case of Cynthia Spina[101] who received an award of $300,000, attorneys' fees of $850,000 and costs of $100,000. The ultimate tax bill, due to the inclusion of the attorneys' fees in her income, for the claimant was about $99,000 more than the $300,000 she received as her share of the award. This unusual outcome is only possible if the attorneys' fees are substantially in excess of the portion of the award that goes to the claimant. The illustration in section II above is more reflective of the actual outcomes for the claimant in these cases.

The final argument made by the taxpayers is that the assignment-of-income doctrine should not be applicable to the contingent legal fee situation. Here the taxpayer sets forth a series of reasons why this doctrine should not apply. Initially, the contingent legal fee situation as an arms-length arrangement differs from the intra-family assignments in *Earl* and *Horst* that are the foundation anti-assignment cases.[102] The taxpayer also argues that the motivation for entering the contingent fee contract was not to avoid taxes or to shift income to a lower bracket taxpayer.[103] The assignment-of-income doctrine does not apply to cases where the transfer of an interest is in a speculative litigation at the time of transfer. Here, the taxpayer, based on language in Private Letter Ruling 200427009, July 2, 2004, argues that where a claim is doubtful or contingent at the time of transfer no inclusion of income is required at the time.[104] The taxpayer also argues that absent clear Congressional intent that double taxation is to be avoided, and there is no authority for the IRS to tax this situation twice.[105] Finally, the taxpayer argues that there is a significant difference in the economic relationship between an hourly or fixed fee attorney-client relationship and a contingent attorney-client relationship. This last argument bolsters the joint endeavor theory expounded by the Sixth Circuit and the lack of sufficient control of the property argument discussed above.

C. *The Taxpayer's Case in Banaitis*

The respondent's brief in *Banaitis*[106] advances five main arguments on the taxpayer's behalf. The initial two arguments advance a partnership theory between the attorney and the client essentially adopting the Sixth Circuit's broad joint venture approach in *Estate of Clarks*. The third argument is that the assignment-of income doctrine is inapplicable. The fourth argument is that

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[100] Brief for Respondent, *supra* note 95, at 19.
[101] *Id.* at 21; Liptak, *supra* note 21.
[102] Brief for Respondent, *supra* note 95, at 23.
[103] *Id.* at 28.
[104] *Id.* at 32.
[105] *Id.* at 35.
[106] Brief for Respondent, *Banaitis* (No. 03-907).

under Oregon law the attorney owned a portion of the cause of action, while the final argument deals with the adverse consequences of a reversal of the Ninth Circuit's decision.

The taxpayer's partnership argument asserts that the case should be governed by Subchapter K of the IRC. This subchapter governs the tax treatment of numerous unincorporated entities, including partnerships and joint ventures.[107] The taxpayer's argument is that the relationship between Banaitis and his attorneys constituted an entity covered by Subchapter K and as such an entity each member should be taxed as provided for in the contingency fee agreement between the parties under IRC § 704(a). Essentially, the taxpayer is saying that the entire amount of damages constitutes gross income for the venture under IRC §61(a) and that each participant is appropriately taxed on his distributive share under IRC §61(a) (13). The argument asserts that the venture is created by the taxpayer contributing his claim, to cover the out-of-pocket costs, and to provide assistance in pressing the claim, while the attorney was obligated to do all the legal work and to absorb his overhead costs.[108] These contributions and efforts were directed to convert the cause of action against the taxpayer's former employer into a collectible judgment with the financial relationship between the parties governed by the contingency fee agreement.[109] The second part of this partnership argument is that the cause of action was contributed to the venture and that it is inappropriate to attribute all of the income realized to the taxpayer when the taxpayer and the attorney had an agreement specifying a differing distribution of the profits of the venture. A cause of action is like any other kind of property that may be contributed to a venture which would then be governed by the partnership rules under Subchapter K.[110]

The next argument made by the taxpayer is that the assignment-of-income doctrine is inapplicable in this case. Here the arguments against applying the doctrine are that there is no gratuitous assignment as in *Earl* and *Horst*. The assignments in those two cases were to family members lacking any business purpose, the income in those two cases was not speculative, but rather certain to be earned, the property was retained by the assignor in those cases rather than a portion of the property transferred, and finally, in those two cases the income was ultimately taxed to the assignors not to both the assignors and assignees.[111] Some of these arguments closely resemble those made by the taxpayer in *Banks* discussed above.

The taxpayer also argues that under Oregon law the attorney owned a portion of the cause of action and that since the attorney is a vested co-owner of the cause of action the total damages should not be taxed to the respondent.[112] Under Oregon's lien law, the lien not only attaches to the proceeds of the

[107] IRC §761(a) (2004) (provides in pertinent part that for purposes of this subtitle, the term "partnership" includes a syndicate, 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 trust or estate).

[108] Brief for Respondent, *supra* note 106, at 6.

[109] *Id.*

[110] *Id.* at 11-13.

[111] *Id.* at 13-18.

[112] *Id.* at 18-24.

action, but to the action itself. In support of this argument the taxpayer cites *Potter v. Schlesser*[113] a case in which a defendant was successfully sued by an attorney for fees after the client settled the case without paying or informing his attorney, even though the defendant had paid the full settlement to the client. The taxpayer's argument here differs from the joint venture, or Subchapter K argument, as this argument asserts that under Oregon law the taxpayer had effectively assigned a portion of the claim so he cannot be taxed on the whole of the damages.

The taxpayer's final argument includes a series of deleterious effects that might occur if the case is reversed. These effects include the double taxation of both the prevailing claimant and the attorney, the potential negative effect on fee-shifting agreements under both federal and state law, the potential for a prevailing defendant to have to pay tax on fees paid to his attorneys, the effect on class action attorney fees, and taxing the successful claimant on fees awarded to *pro bono* attorneys by the court where the claimant had no obligation to pay fees.[114]

V. Conclusion

Banaitis and *Banks* were consolidated at the Supreme Court because they present the sole question of whether the contingent legal fees of successful claimants should be included in the claimants' gross income under IRC §61(a) for federal income tax purposes. These cases may be joined by *Raymond,* the Second Circuit case following the majority approach, discussed in section III.E. This question of what is gross income continues to be a thorny one in our tax system. Further, the specific question of whether contingent legal fees are gross income has been addressed in many of the circuit courts. The overwhelming majority of the circuits have determined that the contingent legal fees are indeed gross income under IRC §61(a) to the winners of awards or settlements and that the legal fees are itemized deductions under IRC §212. This is true despite the fact that, for the alternative minimum tax, these deductions are disallowed and the tax bill escalates in a disproportionate manner, possibly eroding all of the benefit of having won an award or settlement.[115] There is no doubt that on paper the government has the stronger case to present; most of the precedents lean in their favor and the few that do not are, in some cases, weak split decisions. In *Srivastava*, after touting the majority opinion as more sound, the court followed the minority as a matter of stare decisis. There are, however, some novel arguments in the briefs filed by the taxpayers or *amici curiae* that require examination.

The argument that the statutes under which the claim arose provides for fee-shifting may be the most interesting. The taxpayer's reasoning is that a portion of any settlement must logically include some amount for legal fees and that if the legal fees were awarded by the court directly to the attorneys rather than included in the settlement the legal fees would only be taxed to the attorneys as the legal fees are separate from the cause of action at trial. This argu-

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113 *Id.* (citing Potter v. Schlesser, 63 P.3d 1172 (Or. 2003)).
114 *Id.* at 24-28.
115 *See* Liptak, *supra* note 21.

ment was adopted by *Porter v. United States Agency for International Development*.[116] If the award of attorneys' fees under discrimination statutes is a separate item from the cause of action, then it would appear to be unreasonable to attempt to tax those fees to the prevailing plaintiff.[117] This argument is limited to those claimants under federal discrimination statutes that contain fee-shifting provisions, such as the claimant in *Banks*, but it is a new argument in these contingent fee cases. The *amici curiae* briefs of The National Employment Lawyers Association, et al., and The Equal Employment Advisory Council strenuously support this argument. The claimant in *Banaitis* recovered under state claims rather then federal discrimination claims, so this argument would not be available to Banaitis, although it is included in the taxpayers brief in the list of potential adverse effects that would occur if the Ninth Circuit is reversed.

As noted in section IV.C, under subchapter K of the IRC, the arrangement between the attorney and the taxpayer qualifies as a partnership under the IRC. There is some question that even if this argument is accepted by the Supreme Court that the result would be in taxpayers favor. Professor Polsky has written a well reasoned analysis of this argument concluding that the result would go against the taxpayer,[118] and has also filed an *amicus curiae* brief to this effect.[119] Essentially, Polsky's argument is that under IRC §83 the attorneys interest is a capital interest with vesting held in abeyance until the resolution of the claim and that when the attorney's interest vests it is equivalent to an interest in exchange for past services triggering both a full gain and then a deduction of the legal fees for the taxpayer/partner. This result would leave the taxpayer in the same place as the majority approach, and not surprisingly, the amicus brief was filed in support of the government.

On the other side of the issue, Professor Davenport in his scholarship[120] and in his *amicus curiae* brief,[121] argues that all legal fees should be treated as transaction costs and recovered from the gross amount of the claim before the recognition of income under IRC §61 (a). This results in only the net amount of the damages, after attorneys' fees, being reported as gross income, i.e., the minority approach result, but achieves this result without embracing the reasoning to date in the minority approach cases. To adopt this view one must view the disposition of the legal claim as falling under IRC §61(a) (3) as a gain from the dealing in property. There has been only minor acceptance of this approach in the circuit courts[122] and neither of the respondents' briefs presents this argument. However, the argument provides an interesting possible alternative to the approaches taken to date.

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116 293 F. Supp. 2d 152 (D. D.C. 2003).

117 *See* White v. New Hampshire Dep't of Employment Security, 455 U.S. 445, 452 (1982).

118 Greg D. Polsky, *Contingent Fees: Why The Partnership Theory Doesn't Work*, 104 TAX NOTES 1089 (Sept. 6, 2004); Greg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent Attorney's Fees: Enough With the Fruit and The Trees*, 37 G.A. L. REV. 57 (2002).

119 Amicus Curiae Brief of Greg D. Polsky & Hellwig, *Banaitis* (No. 03-097).

120 Charles Davenport, *Why Tort Legal Fees Are Not Deductible*, 97 TAX NOTES 703 (Nov. 4, 2002).

121 Amicus Curiae Brief of Charles Davenport, *Banaitis* (No. 03-907).

122 Davenport, *supra* note 120, at 704.

Overall, despite the number of amici briefs supporting the taxpayer's position, the government's case is the clear favorite in this conflict. Nonetheless, for many of these claimants their awards or settlements might represent significant portions of their net worth. In *Banaitis,* the plaintiff was a successful banker fired for adhering to a confidentiality agreement he and his employer had signed before a corporate takeover by a Japanese bank. In *Banks*, the plaintiff was a fourteen year veteran employee in education that suffered employment discrimination and accepted a lower settlement on the erroneous belief that whole of the damages, not just the legal fees, would be excluded from gross income and, therefore, not subject to federal income tax.

As emphasized in the respondents' briefs, there is also a significant distinction between the tax consequences in these cases and the tax consequences in the anti-assignment cases. In those cases, there was an attempted shift from taxpayers in a higher tax bracket to taxpayers in a lower tax bracket and the government would not be getting the appropriate tax rate on the income.[123] Here, since for any sizable settlement, the alternative minimum tax effectively negates most of the value of the tax deduction of the legal fees, the government is collecting some additional income tax that is probably unwarranted. It is true that the itemized deductions are treated the same for all taxpayers and that it is within Congress' legislative prerogative to tax income twice.[124] In these cases, however, the double taxation is likely an unintended consequence of the alternative minimum tax scheme, rather than an intentional decision to assess additional tax to taxpayers in this situation. Contingent legal fees in their scope, amount and frequency are likely far more significant then most other items allowed as deductions under IRC §212 for the production of income.

If the Supreme Court takes a broader view of the situation than the government is advocating, it may be the tax treatment under the fee-shifting provisions associated with the federal discrimination statutes that may serve to persuade the Court that justice is better served by departing from the more traditional legal analysis. There is also the possibility that although the question presented in the two cases is the same that the court will find that contingent legal fees are generally includable in gross income, but that the fees in one of the respondent's situation is subject to a particular exemption. This could occur if the Supreme Court views the *Banks* federal discrimination fee-shifting argument favorably, while failing to see merit in the arguments advanced in *Banaitis.*

Finally, to look back at the question posed by the title of this note, will the Ninth Circuit be reversed in *Banaitis,* a careful reading of the IRC, the earlier decisions of the Supreme Court in the anti-assignment cases, and the majority of the circuit court opinions would indicate an answer in the affirmative. The difference in the taxes owed, illustrated in section II, also shows that the added tax burden, although real, may not be as significant in the vast majority of cases as proponents of the minority approach would have one believe. An inclusion-

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123 If one considers state and local income taxes that frequently are calculated starting from federal income, the problem in high-tax states would be even greater.

124 For example, the double taxation of dividend income to individuals and corporations that was somewhat mitigated by recent tax law changes reduces the maximum tax on dividends to the capital gain tax rates.

ary decision by the Supreme Court would provide the simplest way to ensure uniformity throughout the country in the tax treatment afforded contingent legal fees. Given the nature and prevalence of contingency fee arrangements in our legal system and the likelihood that contingency fees arrangements will continue to be utilized to provide access to the system to those who otherwise might be excluded from seeking justice, receiving a ruling from the Court that provides certainty and uniformity as to the tax treatment of contingent legal fees for claimants will be, irrespective of which side of the issue the Court comes down on, quite welcome. The arguments advanced by both sides of this controversy are interesting and well-reasoned and have engendered significant interest in the practice and academic arenas of the legal provision. Finally, the ultimate arbiter in tax cases is Congress and a ruling from the Court that proves unpopular may stir Congressional action on the issue.[125] In the meantime, the interest in the questions posed by *Banaitis* is likely to result in a significant number of comments and articles.

[125] *See* Richard E. Sympson, *Taxation of Contingent Legal Fees on Settlements or Awards*, 3 Hous. Bus. & Tax L.J. 170 (2003) (concluding the majority approach is unfair and suggesting the appropriate resolution is a change in the AMT rules).