WINNING PLAINTIFFS MAY BECOME LOSERS IN THE END: AWARD RECIPIENTS TAXED ON CONTINGENT FEES PAID TO ATTORNEYS

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INTRODUCTION

It is hard to imagine the total amount of litigation proceeds awarded by courts to plaintiffs across the United States in one day. Whether it be in the millions or the billions, these litigation proceeds are potentially subject to income tax liability. The prevalence of litigation in our judicial system raises three primary questions regarding the taxability of these proceeds: (1) is a settlement or judgment award subject to taxation; (2) may all or any portion of the award be excluded from gross income; and (3) must the plaintiff pay tax on the portion of the award representing the attorney's fees that must be paid to the plaintiff's attorney pursuant to a contingent fee agreement?

The answer to the first question is clear: the plaintiff must include in gross income all income received, regardless of the source, including any amounts received from a settlement or judgment award.[1] The second question, whether a settlement or judgment award may then be excluded from the plaintiff's gross income, is not always so clear.[2] As discussed below, the answer most often depends on whether the award is for physical personal injury or sickness.[3] The remaining question, whether the contingent fees paid to an attorney to pursue a cause of action on the plaintiff's behalf must be included in the plaintiff's gross income (as well as the attorney's gross income), has proved, until recently, the most difficult to answer. This uncertainty stemmed from the conflicting approaches of the circuit courts on this issue.[4] The Supreme Court, however, resolved the issue in January 2005 in two consolidated cases, *Commissioner v. Banks*

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1. I.R.C. § 61(a) (2000). Although § 61(a) does not specifically enumerate settlements or judgment awards as included in gross income, the provision defines gross income as "all income from whatever source derived." *Id.* More importantly, settlements and judgments are not generally listed in any of the sections in Part III of the Internal Revenue Code, titled "Items Specifically Excluded from Gross Income." *Id.* §§ 101–140. For further discussion, see *infra* notes 10–11 and accompanying text.

2. *See* I.R.C. § 104(a)(2) (2000 & Supp. III 2003) (excluding from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness"). For further discussion of § 104(a)(2) of the Code, see *infra* notes 10–15 and accompanying text.

3. *See infra* notes 10–15 and accompanying text.

4. *See infra* Part I.C.

and *Commissioner v. Banaitis.*[5]

The following hypothetical will help illustrate the issue. Mo brings a defamation suit against Larry. Mo hires an attorney, Curly, to bring the lawsuit against Larry. Mo enters into a contingent fee arrangement with Curly whereby Curly will receive forty percent of the recovery. After litigation and a high profile trial, the court awards Mo a judgment in the amount of $1,000,000. Pursuant to the contingent fee agreement with Curly, Mo must pay Curly $400,000 in fees.[6] Thus, he will net $600,000 after paying Curly his fees. Now the problem arises: is Mo subject to federal income tax liability on the $400,000 in fees?

Before answering the question (and discussing the Supreme Court's recent decision), it is necessary to discuss the existing statutory law and case law governing the tax treatment of contingent fees. Part I of this Article will provide a starting point for a discussion of the conflicting rationales justifying the inclusion and exclusion of attorney's contingent fees from an award recipient's gross income. Part I will also provide a description of the facts and analyses of the *Banks* and *Banaitis* cases. To illustrate the importance of the Court's recent decision, Part II will provide an analysis of the hypothetical set forth above under the conflicting approaches of the circuit courts prior to the Supreme Court's decision. Part III will then conclude with a discussion on the decision and the impact it will have in the future.

I. THE TAXATION OF CONTINGENT ATTORNEY'S FEES

It is clearly established in the realm of tax law that the entire amount of a settlement or judgment award must be included in the award recipient's gross income when the recipient is to pay the attorney on a flat-fee, non-contingent basis.[7] The taxability of an award portion attributable to contingent fees, however, has been a hot topic for tax practitioners for years.

Prior to discussing case law on the topic, it is necessary to consider the applicable provisions of the Internal Revenue Code of 1986, as amended (the Code), that deal with this issue. Part I.A sets forth a brief discussion of those key Code provisions. Part I.B then introduces the assignment-of-income doctrine, which is the primary justification for including contingent

5. Comm'r v. Banks, 543 U.S. 426 (2005).

6. For simplicity, costs are included in the $400,000 in fees.

7. *See, e.g.*, Srivastava v. Comm'r, 220 F.3d 353, 363 (5th Cir. 2000) ("[I]f there were no contingent fee arrangement, Srivastava presumably would have had to compensate counsel out of his own pocket, rather than rely wholly on the income stream arising from his claim.").

fees in the award recipient's gross income. Part I.C then examines the split in the circuit courts by outlining the main cases and the legal theories considered in those cases. Finally, Part I.D describes the facts and holdings of the *Banks* and *Banaitis* cases in the sixth and ninth circuits.

A. The Code

Section 61(a) of the Code requires that taxpayers include in their gross income "all income from whatever source derived" absent a contrary provision in the Code.[8] Quite simply, any accession to a taxpayer's wealth must be included in gross income.[9] That is the easy part. The more difficult question, and the next step in the analysis, is whether the entire settlement award may be excluded from the taxpayer's gross income.

1. Exclusion

A taxpayer must look to § 104(a)(2) when seeking to exclude amounts received from a settlement award.[10] Section 104(a)(2) is limited in scope, providing only a qualified exclusion from gross income for "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."[11] Thus, if the claim

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8. I.R.C. § 61(a) (2000).

9. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429–30 (1955) (noting that Congress intended then I.R.C. § 22(a), now I.R.C. § 61(a), to broadly "tax all gains except those specifically exempted").

10. I.R.C. § 104(a)(2) (2000 & Supp. III 2003).

11. *Id.* The accompanying Treasury Regulations provide that "'damages received (whether by suit or agreement)' means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." Treas. Reg. § 1.104-1(c) (as amended in 1970). Prior to its amendment in 1996, § 104(a)(2) provided that "damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness" were excludable from gross income. I.R.C. § 104(a)(2) (1994) (amended by I.R.C. § 104(a)(2) (Supp. V 1999)). There was no clear answer as to the type of personal injury awards that could qualify for the exclusion. H.R. Rep. No. 104-737, at 300 (1996) (Conf. Rep.), *reprinted in* 1996 U.S.C.C.A.N. 1677, 1792 (noting that some courts had extended the exclusion to cases of non-physical injuries, including employment discrimination and injuries to reputation). Consequently, three Supreme Court decisions helped clarify the extent to which settlement awards could be excluded under § 104(a)(2). In the first case, *United States v. Burke*, the Court examined the nature of the claim to determine if it involved "a tort-like personal injury." United States v. Burke, 504 U.S. 229, 237–40 (1992). The Court held that Title VII awards for back pay do not fit into the category of damages received from tort-like personal injuries, and thus are not excludable under § 104(a)(2). *Id.* at 241–42. In the second case, *Commissioner v. Schleier*, the Supreme Court enacted the following two-part test for determining whether a taxpayer may exclude a settlement or judgment award from gross income under § 104(a)(2): "First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is

flows from a physical personal injury or sickness, all compensatory damages that flow from that injury or sickness (including attorney's fees) are treated as payments received on account of the injury or sickness and are not taxable to the recipient.[12] On the other hand, if the claim is for anything other than a physical personal injury, such as an economic claim (e.g., breach of contract), then the exclusion does not apply.[13] To determine whether the underlying claim is for a physical personal injury, or some other injury, the origin and nature of the claim are considered.[14] The taxpayer must bear in mind, however, that this and other sections providing exclusions from gross income are narrowly construed;[15] in the absence of

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'based upon tort or tort type rights'; and second, the taxpayer must show that the damages were received 'on account of personal injuries or sickness.'" Comm'r v. Schleier, 515 U.S. 323, 337 (1995) (referring to the language set out in *Burke*, 504 U.S. at 237; and § 104(a)(2), respectively). This test is still used by courts in determining whether an award is excludable under § 104(a)(2). *See, e.g.*, Kidd v. Comm'r, 87 T.C.M. (CCH) 1396, 1398 (2004) (citing *Schleier* for the two-part test); Gantea v. Comm'r, No. 6222-02S, slip op. at 5 (T.C. filed May 19, 2003), *available at* http://digbig.com/4gswt (citing *Schleier* for the two-part test). Finally, in *O'Gilvie v. United States*, the Supreme Court determined that punitive damages are not excludable from gross income. O'Gilvie v. United States, 519 U.S. 79, 84 (1996) (explaining that punitive damages, like ADEA liquidated damages, are "not 'designed to compensate . . . victims'" but rather "are 'punitive in nature'" (alteration in original) (quoting *Schleier*, 515 U.S. at 332 n.5)).

In response to these decisions, Congress amended § 104(a)(2) by enacting the Small Business Job Protection Act of 1996. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (1996) (codified as amended at I.R.C. § 104 (2000 & Supp. III 2003)). This amendment had the effect of narrowing § 104(a)(2) by providing that: (1) punitive damages could not be excluded from gross income; and (2) in order to qualify for the exclusion, the personal injury or sickness must be physical. *Id.* Therefore, it is now clear that physical personal injuries (such as unwanted physical contacts resulting in bodily harm) are necessary for the exclusion, while nonphysical personal injuries (such as wrongful termination, discrimination, and loss of reputation) do not qualify for the exclusion.

12. *See* § 1605, 110 Stat. at 1838 (repealing the "exclusion for punitive damages and for damages not attributable to physical injuries or sickness"); *see also* H.R. REP. NO. 104-737, at 301 (narrowing I.R.C. § 104(a)(2) so that punitive damages must be included in gross income and requiring personal injuries to be physical rather than mental to qualify for the exclusion).

13. *Burke*, 504 U.S. at 234, 237.

14. *Id.* at 237; *see also Schleier*, 515 U.S. at 335–36 (interpreting *Burke*). Under the Supreme Court's decision in *Burke*, the claim must be based upon tort or tort-like rights in order for the exclusion to apply. *Burke*, 504 U.S. at 237. A tort is a "civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages." *Id.* at 234 (quoting W. KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 2 (5th ed. 1984)). In *Burke*, the Court examined the remedial scheme of the law providing the cause of action to determine whether the claim was tort like. *Id.* at 237–40. Once it is determined that the injury claimed was a personal injury, *Schleier* requires that any amount received by the taxpayer must be because of that personal injury. *Schleier*, 515 U.S. at 336. In other words, in order to be excludable, a cause-and-effect relationship must be established between the personal injury and the amount received, and each element of an award must be "on account of personal injuries or sickness." *Id.* at 336–37 (quoting I.R.C. § 104(a)(2) (1994) (amended by I.R.C. § 104(a)(2) (Supp. V 1999))).

15. *See* United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 583–84 (1991) ("[T]ax-exemption and -deferral provisions are to be construed narrowly."). Additionally, the taxpayer claiming

physical personal injury, it is unlikely that the exclusion will be available.

Therefore, if the taxpayer can successfully claim entitlement to the exclusion under § 104(a)(2), then the entire amount of the award, including the attorney's fees, is excluded from the taxpayer's gross income. However, even if the taxpayer is unable to obtain the exclusion, the taxpayer may be able to deduct the attorney's fees expended in pursuing the taxpayer's claim, but only to a limited extent, as discussed below.

2. Deductions for Attorney's Fees

The benefit of a deduction to a taxpayer is considered a "matter[] of legislative grace."[16] There are essentially two types of deductions: above-the-line deductions[17] and miscellaneous itemized deductions.[18] Above-the-line deductions, which are for the most part business-related,[19] are more favorable because they directly offset gross income dollar-for-dollar and result in adjusted gross income. Miscellaneous itemized deductions are less favorable because they are only available when their total exceeds two percent of the taxpayer's adjusted gross income.[20] In addition to this two-percent *floor*, a *ceiling* is imposed on the total amount of itemized deductions a taxpayer may claim.[21]

There is no provision in the Code that specifically allows a deduction for attorney's fees expended to pursue a cause of action. Deductions are not generally available for personal expenses.[22] Yet, attorney's fees may be deductible as either a trade or business expense under § 162 of the Code (an above-the-line deduction) or as an expense for the "production of income"

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the exclusion has the burden of establishing entitlement to the exclusion. *See* United States v. Wells Fargo Bank, 485 U.S. 351, 354 (1988) (recognizing "the settled principle that exemptions from taxation are not to be implied; they must be unambiguously proved").

16. Winters v. Comm'r, 468 F.2d 778, 781 (2d Cir. 1972) (citing First Nat'l Bank & Trust Co. in Macon, Ga. v. United States, 115 F.2d 194, 195 (5th Cir. 1940)).

17. *See* BLACK'S LAW DICTIONARY 6 (8th ed. 2004) (defining "above-the-line" as a deduction "taken after calculating gross income and before calculating adjusted gross income"); *see also* I.R.C. § 62(a) (LexisNexis 2006) (listing the types of deductions that do not count towards "adjusted gross income").

18. Miscellaneous itemized deductions are also known as "below-the-line" deductions. *See* BLACK'S LAW DICTIONARY 164 (8th ed. 2004) (defining "below-the-line" as a deduction "taken after calculating adjusted gross income and before calculating taxable income"); *see also* I.R.C. § 67(b) (2000) (listing the itemized deductions that do not count toward "miscellaneous itemized deductions").

19. *See* I.R.C. § 62(a)(1) (listing trade and business deductions).

20. I.R.C. § 67(a) (2000).

21. I.R.C. § 68(a). The ceiling applies only when the taxpayer's "adjusted gross income exceeds the applicable amount." *Id.*

22. *See* I.R.C. § 262(a) ("Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.").

under § 212 of the Code (a below-the-line deduction).[23]

The problem for many taxpayers in the context of settlement and judgment awards arises when they are unable to take the § 162 deduction. In that event, those taxpayers may claim only the limited itemized deduction for expenditures that qualify as production of income under § 212. As discussed above, this scenario is fraught with limitations. Although the ability to take a deduction for attorney's fees appears to compensate the taxpayer for inclusion of the fees in gross income, the limitations imposed upon individual taxpayers still result in inequities, as discussed further below.[24]

3. The Alternative Minimum Tax

A taxpayer who receives a large settlement award may be subject to the Alternative Minimum Tax (AMT).[25] The most basic explanation of the AMT regime is that a taxpayer must compute and pay the AMT if it yields a higher tax than the regular income tax.[26] With litigation proceeds, for example, a taxpayer who falls into the AMT scheme has a tentative tax liability equal to 26% of the proceeds up to $175,000 plus 28% of the amount that exceeds $175,000.[27]

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23. I.R.C. § 162 (West Supp. 2005); I.R.C. § 212 (2000). Attorney's fees paid to obtain income that is tax-exempt, such as an award that is excludable pursuant to § 104(a)(2), are not deductible. *See* I.R.C. § 265(a)(1) (stating that a taxpayer cannot deduct expenses relating to already excludable income). Typically, the "origin-of-the-claim" doctrine is used to evaluate whether a deduction may be taken and which type of deduction may be taken. *See* United States v. Gilmore, 372 U.S. 39, 49 (1963) (adopting an analysis based on "the origin and character of the claim" and rejecting the "consequences" view in order to determine whether a claimed deduction was "personal" or "business," which in turn affected the outcome of whether the claimed deduction was proper); Arthur H. DuGrenier, Inc. v. Comm'r, 58 T.C. 931, 937–38 (1972) (holding that application of the origin-of-the-claim doctrine determines whether legal fees are deductible).

24. Congress recently passed the "American Jobs Creation Act," which provides an above-the-line deduction for taxpayers who pay attorney's fees in pursuit of certain employment-related actions. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703(a), 118 Stat. 1418, 1546–47 (codified at I.R.C. § 62(a)(19) (LexisNexis 2006)). Under the Act, if the taxpayer receives an award in an employment discrimination suit, for example, the taxpayer will be able to take a dollar-for-dollar, above-the-line deduction for contingent attorney's fees paid during the year. *See id.* (providing an above-the-line deduction for *all* attorney's fees paid by the taxpayer in unlawful discrimination claims without distinguishing between contingent and flat-fee arrangements).

25. I.R.C. § 55 (LexisNexis 2006).

26. *See id.* §§ 55–59 (setting forth an elaborate scheme for computing the AMT). *See generally* Daniel S. Goldberg, *To Praise the AMT or to Bury It*, 24 VA. TAX REV. 835 (2005) (describing the complexity and the history of the AMT, as well as evaluating its effectiveness).

27. I.R.C. § 55(b)(1)(A)(i).

If the AMT applies, the biggest pitfall for the taxpayer is that it effectively eliminates the possibility of miscellaneous itemized deductions.[28] The taxpayer cannot deduct the attorney's fees and is still subject to the AMT on the award.[29] Consequently, the application of the AMT cuts deeply into the taxpayer's award.[30]

B. Assignment-of-Income Doctrine

Other than the broad language of § 61(a), no specific provision in the Code requires an award recipient to include in gross income that portion of the settlement or judgment award that is paid to the recipient's attorney as a contingent fee. In the absence of a Code provision, courts have used the assignment-of-income doctrine to justify requiring taxpayers to include contingent fees as gross income.[31]

Generally, the assignment-of-income doctrine is used to determine which taxpayer must include a certain item in gross income. The doctrine was introduced in the 1930 Supreme Court case *Lucas v. Earl*.[32] In that case, the husband entered into an agreement with his wife whereby all income that he and his wife received separately would be owned jointly by the two of them with a right of survivorship.[33] The question for the Court was whether the husband should be taxed on the entire amount of the salary and fees earned by him or only on one-half of that amount in light of the agreement with his wife.[34] The Court held that the husband must be taxed on the entire amount of the salary and fees earned because the anticipatory assignment of income to his wife was not sufficient to shift tax liability to her.[35]

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28. *Id.* § 56(b)(1)(A)(i).

29. *See id.* (barring deductions for the miscellaneous itemized deductions listed in I.R.C. § 67(b)).

30. *See* Brief of Nat'l Employment Lawyers Ass'n. et al. as Amici Curiae in Support of Respondents at 4, Comm'r v. Banks, 543 U.S. 426 (2005) (Nos. 03-892, 03-907), 2004 WL 1900508, *available at* TAX NOTES TODAY Doc. 2004-17396 (pointing out that if the case is a statutory fee case (where the statute dictates how fees are awarded), the AMT can result in a net loss for the plaintiff). In the event that the fee award is larger than the taxpayer's award, the plaintiff may be worse off financially if the plaintiff prevails rather than loses and the plaintiff is taxed on the amount of fees. *See id.* at 10 (citing Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, at 18, which describes how a woman, who won a sex-bias award of $3,000,000 only to have it reduced to $300,000 by the judge, lost $99,000 after paying taxes on both her award and $950,000 of jury-awarded attorney's fees and costs).

31. *E.g.*, Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001).

32. Comm'r v. Earl (Lucas v. Earl), 281 U.S. 111 (1930).

33. *Id.* at 113–14. The Court noted that the contract itself was valid under state law. *Id.* at 114.

34. *Id.* at 113.

35. *Id.* at 114–15. The Court stated that the husband "was the only party to the contracts by

In *Helvering v. Horst*, the Supreme Court applied the assignment-of-income doctrine to a father's gift to his son of interest coupons that were detached from bonds that the father continued to own.[36] The Court held that once interest payments were made, there was a realization of income to the father.[37] The Court cited *Lucas v. Earl* and explained that: "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it."[38] Here the Supreme Court laid the groundwork for the application of the assignment-of-income doctrine in situations involving attempted transfers of income-producing property, which is especially relevant in the context of attorney's fees. Pursuant to *Horst*, the question that courts consider when a taxpayer attempts to assign income-producing property to another is whether the taxpayer retained ownership and control of the property so that

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which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone." *Id.* at 114. The Court went on to find that "the tax could not be escaped by anticipatory arrangements and contracts however skil[l]fully devised to prevent the salary when paid from vesting even for a second in the man who earned it." *Id.* at 115. The Court concluded by saying that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Id.* *But cf.* Blair v. Comm'r, 300 U.S. 5, 7, 12–14 (1937) (reasoning that a beneficiary's assignment of trust income to his children was valid because the assignment shifted ownership of the income to the children and that "tax liability attaches to ownership").

36. Comm'r v. Horst (Helvering v. Horst), 311 U.S. 112, 114, 117–20 (1940). Specifically, in 1934 and 1935, the father detached negotiable-interest coupons from the negotiable bonds he owned "shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity." *Id.* at 114. The question for the Court, then, was whether this constituted a tax-realization event to the father. *Id.*

37. *Id.* at 117–18. The Court explained that the holder of a coupon bond owns both the right to demand and receive principal at maturity and the right to demand interest on the investment. *Id.* at 115. As such, the Court found that the father, as owner of the bonds, had "the legal right to demand payment at maturity of the interest . . . and the power to command its payment to others, which constituted an economic gain to him." *Id.* The Court acknowledged that not all economic gain is taxable income but nonetheless found "[w]here the taxpayer does not receive payment of income in money or property[,] realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." *Id.* (citing Corliss v. Bowers 281 U.S. 376, 378 (1930); Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929)). The Court reasoned that "income is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Id.* at 116–17. Put another way, the father procured payment of the interest to his son in the form of a gift, and this resulted in economic gain to the father because he received the money's worth (even though he never received the actual interest amount). *Id.* at 117.

38. *Id.* at 118. In *Horst*, the Court distinguished the facts at hand from the facts of *Blair v. Commissioner*. *Id.* In *Blair*, the beneficiary's gift of the right to receive income from the trust was sufficient to give away his ownership right to the donee because the beneficiary gave all the interest he had to the donee. *Id.* at 118–19. Whereas, in *Horst*, the father retained ownership of the property at issue. *Id.* at 114.

the taxpayer could control the disposition of the property *and the income produced from the property*.[39] If yes, the tax on the income should be borne by that taxpayer under the assignment-of-income doctrine.[40]

As stated above, the assignment-of-income doctrine is the primary justification used by the IRS and courts that have held that attorney's contingent fees should be included in the award recipient's gross income.[41] Accordingly, the next section provides a discussion of those cases, as well as cases that reject the assignment-of-income doctrine and hold that contingent fees should be excludable.

C. The Split in the Circuit Courts

Until recently, a split existed in the circuit courts on the issue of whether contingent attorney's fees must be included in an award recipient's gross income. A majority of circuit courts (the first, second, third, fourth, seventh, tenth, and federal circuits) held that the award recipient must include the amount of the settlement or judgment award attributable to the fees in his or her gross income.[42] The remaining circuits (the fifth, sixth, ninth, and eleventh circuits) held that the contingent fees are excludable from the recipient's gross income.[43]

In 1959 the Fifth Circuit was the first to address the issue, in *Cotnam v. Commissioner*.[44] In *Cotnam*, the plaintiff paid her attorneys a portion of her breach of contract-judgment award pursuant to a contingent fee agreement.[45] When she failed to include the fee portion of the award in her gross income, the Commissioner issued a deficiency for income tax on the basis that she must include the fees in her gross income.[46] The Tax Court upheld the Commissioner's assessment and the plaintiff appealed to the

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39. *Id.* at 116–17.

40. *See id.* at 119–20 (explaining that a donor is taxed on income earned by the donor despite the donor's transfer of the income to a donee).

41. *E.g.*, Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001).

42. *E.g.*, Raymond v. United States, 355 F.3d 107, 108 (2d Cir. 2004); Campbell v. Comm'r, 274 F.3d 1312, 1314 (10th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881, 882–83 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369, 379 (4th Cir. 2001); Alexander v. IRS, 72 F.3d 938, 944 (1st Cir. 1995); Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

43. *E.g.*, Banks v. Comm'r, 345 F.3d 373, 386 (6th Cir. 2003); Banaitis v. Comm'r, 340 F.3d 1074, 1083 (9th Cir. 2003); Foster v. United States, 249 F.3d 1275, 1279–80 (11th Cir. 2001); Srivastava v. Comm'r, 220 F.3d 353, 355 (5th Cir. 2000).

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

45. *Id.* at 120–21, 125. Specifically, the Alabama Supreme Court "awarded [the plaintiff] a judgment of $120,000" on her contract claim, of which the "[a]ttorneys' fees were $50,365.83." *Id.* at 121.

46. *Id.*

Fifth Circuit Court of Appeals.[47]

On appeal, the Fifth Circuit held that the portion of the taxpayer's award representing the fees was not taxable income to her.[48] The court examined the applicable state (Alabama) law on attorney's liens and found that the law provided attorneys with an equitable lien that effectively transferred a part of the plaintiff's claim to her attorneys.[49] In its rationale, the court favored this state-lien-law analysis over the assignment-of-income doctrine.[50] Also, the court reasoned that, because the plaintiff effectively transferred part of her claim to her attorneys prior to the claim having any worth and because the attorneys' services subsequently converted the claim into an item of value, the plaintiff had no income at the time she entered into the contingent fee agreement with the attorneys.[51] Therefore, the Fifth Circuit held that she did not have to include the amount of the fees in her gross income.[52]

The rationale applied in *Cotnam* set the basic arguments for future courts to consider. Some circuits have been critical of the rationale, holding that the attorney's lien law of the state is irrelevant and that the contingent attorney's fees are to be included in the award recipient's gross income under the assignment-of-income doctrine.[53] For example, in *O'Brien v. Commissioner*, the Tax Court considered the *Cotnam* analysis in its opinion (which was affirmed by the Third Circuit), but found "it doubtful that the

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47. *Id.*

48. *Id.*

49. *Id.* at 125. According to the court, the then-existing provision of the Alabama Code stated: "The 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.* (quoting ALA. CODE tit. 46, § 64 (1940) (current version at ALA. CODE § 34-3-61 (2005))). The court then determined that the plaintiff "could never have received" the amount of the fees ($50,365.83) under the lien law. *Id.* Instead, the court found that the lien was either an "'equitable assignment . . . [or] equitable lien' in the cause of action," and that "[a]n attorney 'holding such an interest has an equity in the cause of action and the recovery under it prior to that of the defendant in the judgment to exercise a right of set-off accruing to him after the attorney's interest had attached.'" *Id.* (omission and alteration in original) (quoting U.S. Fidelity & Guar. Co. v. Levy, 77 F.2d 972, 975 (5th Cir. 1935)).

50. *Id.* at 125–26. The court pointed out that the plaintiff's claim was worthless without the aid of her attorneys: "The services of her attorneys resulted in converting that claim into a judgment and the collection of the judgment. The amount of the contingent fee was earned, and well earned, by the attorneys." *Id.* at 126. As such, the court found that the attorneys, and not the plaintiff, were the proper parties to be taxed on the fees. *Id.* ("In a realistic sense the remaining $50,365.83 was income of the attorneys, not of Mrs. Cotnam.").

51. *Id.* at 125–26. The court found that the plaintiff'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.* at 126.

52. *Id.*

53. *E.g.*, Kenseth v. Comm'r, 259 F.3d 881, 884–85 (7th Cir. 2001); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

Internal Revenue Code was intended to turn upon such refinements."[54] In *Kenseth v. Commissioner*, the Seventh Circuit questioned the *Cotnam* analysis, disregarded the Wisconsin state law that provided an attorney's lien on the fees, and held that the assignment-of-income doctrine provided the proper framework for the analysis.[55]

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54. *O'Brien*, 38 T.C. at 712. In *O'Brien*, the plaintiff worked as a deputy collector of internal revenue before being wrongfully discharged in 1952. *Id.* at 708. He entered into an agreement with his attorney whereby the attorney would receive fifty percent of any award the plaintiff received. *Id.* In 1957, the United States District Court for the District of Columbia ordered that the plaintiff be restored to his position. *Id.* He also received an award of $16,173.05, from which he paid legal fees and costs of $8,243.10 to his attorney. *Id.* at 709. The plaintiff paid no tax on the award and the Commissioner subsequently issued a deficiency notice. *Id.* at 709–10. On the issue of whether the fees should be included in the plaintiff's gross income, the Tax Court held that the full amount should be included. *Id.* at 712. The court discussed the Fifth Circuit's rationale in *Cotnam*, and in doing so found that the applicable law would be that of Pennsylvania. *Id.* Nonetheless, the Tax Court determined that the state law was irrelevant to the issue, stating:

> [W]e think it doubtful that the Internal Revenue Code was intended to turn upon such refinements. For, even if the taxpayer had made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto even for a split second, it would still be gross income to him under the familiar principles of Lucas v. Earl . . . [and] Helvering v. Horst . . . .

Id. (citations omitted). On appeal, the Third Circuit affirmed the Tax Court's decision. *O'Brien*, 319 F.2d at 532.

55. *Kenseth*, 259 F.3d at 883–85. In *Kenseth*, the plaintiff filed an age-discrimination lawsuit against his former employer. *Id.* at 882. He had a contingent fee agreement with the law firm representing him under which the firm would first receive forty percent of the recovery and then remit the balance to the plaintiff. *Id.* The settlement proceeds that the plaintiff received (excluding lost wages) came to $197,024.76, of which the law firm deducted $91,800.54 as its fee. Kenseth v. Comm'r, 114 T.C. 399, 404–05 (2000). Due to the application of the AMT, the plaintiff was unable to deduct the firm's fee, and he also owed about $17,000 in AMT that he otherwise would not have owed had the fees not been included in his gross income. *Kenseth*, 259 F.3d at 882. Yet, the Seventh Circuit held that the fees must be included. *Id.* at 885. The court recognized that attorneys have liens under Wisconsin law but nevertheless concluded that the lien is a security interest and does not create ownership over the security. *Id.* at 883. Writing for the court, Judge Posner stated:

> It is true that if a contingent-fee lawyer expends effort on behalf of his client, who then terminates the contingent-fee contract, in effect confiscating the lawyer's work, the lawyer has a claim against the client; but he is no different in this respect from any other trade creditor stiffed by his debtor. In essence, Kenseth wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent-fee contract is not an assignment . . . and in Wisconsin the lawyer is prohibited from acquiring ownership of his client's claim. So what Kenseth really is asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.

Id. at 884 (citations omitted). Furthermore, the court criticized the Fifth Circuit's analysis in *Cotnam*, stating "[t]his rationale badly flunks the test of neutral principles." *Id.* at 885. Therefore, the Seventh Circuit cited the assignment-of-income doctrine as controlling the issue. *Id.* at 884.

Other courts followed the *Cotnam* rationale to a certain extent but nonetheless held that the fees should be included in the award recipient's gross income because the attorney's lien law of the state was weak or non-existent.[56] In a recent case, *Raymond v. United States*, the Second Circuit examined Vermont law and found that it did not provide attorneys with a proprietary interest in their clients' claims sufficiently to exclude the contingent fees from the clients' gross income.[57] The Second Circuit also expressed reluctance to cite state law as important to the issue, stating "[i]n any event, we should remember that we are interpreting federal tax law."[58] Yet, in spite of this reluctance, the Second Circuit based its holding on a combination of the assignment-of-income doctrine and the *Cotnam* rationale, in that: (1) the taxpayer retained a degree of control over the fee-portion of his award and thereby prohibited the shifting of tax on the fees to his attorneys; and (2) the attorney's lien law of Vermont did not provide the attorneys with a strong interest in the fees.[59]

Therefore, it appears that the circuit split hinged, in part, upon how a court would weigh state law against federal law. Generally, courts recognized that "state law determines the nature of legal interests in property, while federal law determines the tax consequences of the receipt or disposition of property."[60] Indeed, *Cotnam* paved the way for courts to examine state law to determine the strength of the attorney's interest in the

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56. *See, e.g.*, Raymond v. United States., 355 F.3d 107, 110, 114–18 (2d Cir. 2004) (describing the split in the caselaw, and basing its opinion on both the weakness of the attorney's interest under Vermont state law and the importance of federal principles of income taxation); Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (reasoning that California law does not confer any ownership of attorney's fees collected as punitive damage to an attorney).

57. *Raymond*, 355 F.3d at 114–15, 117. In *Raymond*, the taxpayer entered into a contingent fee agreement with a law firm pursuant to which it would receive one-third of any recovery. *Id.* at 108. He received an award of $900,000 and paid the law firm $300,000 in fees. *Id.* Initially, he included the entire amount of the award (including the fees) in his gross income on his federal income tax return for 1998. *Id.* at 108–09. He then tried to deduct the fees under I.R.C. § 212(1), but due to the large amount of his award, his gross income pushed him into the AMT (which barred the deductions). *Id.* at 109. He then filed an amended return, in which he excluded the fees from his gross income in an attempt to eliminate his AMT liability and to claim a refund for the extra amount of tax paid on the AMT. *Id.*

The Second Circuit reversed the district court's determination that the fees should be excluded from his gross income. *Id.* at 118. The court found that Vermont law did not provide the attorney with a proprietary interest in the fees to enable the taxpayer to exclude them. *Id.* at 115.

58. *Id.*

59. *Id.* at 117–18 (reasoning that when a client retains control of the award, "federal principles of taxation deem him the recipient of gross income upon its disposition"). The court pointed out that the taxpayer could have fired his attorney or dropped the case and that only the taxpayer had the power to settle the claim. *Id.* at 116. According to the Second Circuit, the taxpayer's "income was 'realized as completely as it would have been if he had collected the [judgment] in dollars' and then paid his attorney." *Id.* (alteration in original) (quoting Helvering v. Horst, 311 U.S. 112, 117 (1940)).

60. *Id.* at 110.

contingent fee.[61] Under *Cotnam*, where the attorney had a strong interest, the court held that the attorney had a property interest in the fee and therefore the fee was income to the attorney only.[62] On the other hand, courts in the majority either found that the attorney has a weak interest under state law, such as a security interest, or found that the state law analysis simply does not apply (and instead only federal law applies) in holding that the fees are income to the award recipient.[63] In other words, there was a sort of continuum among the circuits beginning with those that gave the most deference to state law, such as the Fifth Circuit in *Cotnam*, and those that gave less deference to state law and more to federal law, such as the Seventh Circuit in *Kenseth*, the Third Circuit in *O'Brien*, and the Fourth Circuit in *Young v. Commissioner*.[64]

Recently, however, some circuits have considered other theories to hold that the contingent fees should not be included in the award recipient's gross income. For example, in *Brisco-Whitter ex rel. Estate of Clarks v. United States*, the Sixth Circuit agreed with the *Cotnam* rationale but went further to explain that the attorney and client were like tenants in common with separate interests in real estate.[65] Also, the Sixth Circuit cited the following four reasons for excluding the fees: (1) the taxpayer's claim, at the time the contingent fee agreement was signed, was "an intangible, contingent expectancy" with a speculative value; (2) the claim was like a

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61. Cotnam v. Comm'r, 263 F.2d 119, 125 (5th Cir. 1959).

62. *Id.* at 125–26.

63. *E.g.*, Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001) (finding that attorneys in Wisconsin have only a security interest in the fee and that "ownership of a security interest is not ownership of the security"); O'Brien v. Comm'r, 38 T.C. 707, 712 (1962) (rejecting the applicability of state law), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

64. *See Cotnam*, 263 F.2d at 125; *Kenseth*, 259 F.3d at 883; *O'Brien*, 38 T.C. at 712; Young v. Comm'r, 240 F.3d 369, 378 (4th Cir. 2001) ("[W]hether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action."). In *Baylin v. United States*, the Federal Circuit held that the contingent fee portion of the settlement award from a condemnation proceeding paid directly to the attorney was income to the plaintiff. Baylin v. United States, 43 F.3d 1451, 1455 (Fed. Cir. 1995). The Federal Circuit pointed to the Supreme Court's liberal construction of "gross income" and found that even though the plaintiff never received the funds paid to the attorney (they were directly subtracted from the award), the plaintiff received an economic benefit because those funds discharged plaintiff's obligation to pay his attorney for the services. *Id.* at 1454.

65. Brisco-Whitter *ex rel.* Estate of Clarks v. United States, 202 F.3d 854, 857–58 (6th Cir. 2000). In *Estate of Clarks*, the issue was whether interest on a judgment that was paid to the attorney under the contingent fee agreement should be included in the taxpayer's gross income. *Id.* at 855. The Sixth Circuit examined Michigan state law on attorney's liens and found that it was similar to the Alabama state law in *Cotnam*. *Id.* at 856. The court distinguished the assignment-of-income doctrine cases and took the state-lien-law analysis a step further by setting forth additional reasons to exclude the interest from the client's gross income. *Id.* at 857–58.

partnership or joint venture where the taxpayer assigned away one-third in hope of recovering two-thirds; (3) there was no tax-avoidance purpose at work with the contingency fee arrangement; and (4) double taxation (of both the lawyer and the client) would otherwise result if the contingent fee were included in the taxpayer's gross income.[66]

Finally, in *Srivastava v. Commissioner*, the Fifth Circuit took a completely different approach from other circuits.[67] The court held that the fees would not be taxed to the client regardless of the attorney's rights under state law.[68] The Fifth Circuit followed *Cotnam* as a matter of *stare decisis* but found that the state-lien-law analysis was immaterial to the issue.[69]

In sum, although the state-lien-law rationale of *Cotnam* was a major deciding factor in the older cases, recent cases such as *Srivastava* indicate a reluctance to rely on that rationale. As set forth in *Estate of Clarks*, courts have found new justifications to uphold the exclusion of contingent fees from the client's gross income. Nonetheless, the assignment-of-income doctrine has remained a constant, as will be seen below in the discussion of the Supreme Court's recent decision in *Commissioner v. Banks*.[70]

Before discussing that decision, it is necessary to discuss the two cases that prompted the Supreme Court to grant certiorari. All of the theories discussed above were brought before the Supreme Court for consideration in those cases. Accordingly, Part I.D provides a lengthy discussion of the facts and rationales of the circuit court decisions, as well as the arguments that the parties then presented to the Court.

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66. *Id.* at 857. The court summarized the transaction as follows:

> The present transaction . . . is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. . . . The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant.

Id. at 857–58.

67. Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000).

68. *Id.* at 364. After citing Texas law as the applicable state law and noting that it did not provide a relatively strong interest to attorneys, the Fifth Circuit rejected the state-lien-law analysis, stating that it was not the deciding factor on the issue. *Id.* at 363–64.

69. *Id.* at 363–65. The Fifth Circuit refused to overrule *Cotnam*, and therefore it followed the *Cotnam* decision even though it appears not to have followed the analysis. *Id.* at 365.

70. Comm'r v. Banks, 543 U.S. 426 (2005). As set forth in Part III.A *infra*, assignment of income was the winning rationale for the Supreme Court's recent holding in *Banks* that the fees are to be included in the client's gross income. *Id.*

D. The Subject Cases: Banks & Banaitis[71]

Because of the conflict in the circuits (described in Part I.C), the Supreme Court granted certiorari for *Commissioner v. Banks* and *Banaitis v. Commissioner* as consolidated cases on appeal from the Sixth and Ninth Circuits respectively.[72] Oral argument was heard on the cases in November 2004.[73] As discussed more fully below, the two cases illustrate the problematic split in the circuits.

1. *Banks v. Commissioner*

Plaintiff John W. Banks II (Banks) was employed with the California Department of Education (CDOE) as an educational consultant from 1972 until he was terminated in 1986.[74] Banks responded to his termination with a lawsuit against the CDOE in the Eastern District of California alleging employment discrimination, as well as other statutory and common law tort claims.[75] He retained an attorney on a contingency basis.[76]

Shortly after trial commenced, the parties held a settlement conference where CDOE offered Banks $464,000 to settle.[77] Banks accepted the offer on the condition that the settlement amount be characterized as compensation for damages on account of personal injury,[78] presumably in an attempt to exclude the award from tax under I.R.C. § 104(a)(2).[79] Of the $464,000 settlement award, he paid his attorney $150,000 in contingent fees.[80] Later, on his 1990 federal income tax return, Banks did not include any of the settlement award in his gross income and later alleged that the

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71. Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003).

72. Comm'r v. Banks, 541 U.S. 958, 958 (2004).

73. Docket for Comm'r v. Banaitis, 543 U.S. 426 (2005) (No. 03-907), *available at* http://www.supremecourtus.gov/docket/03-907.htm; Docket for Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892), *available at* http://www.supremecourtus.gov/docket/03-892.htm.

74. *Banks*, 345 F.3d at 375.

75. *Id.* Banks filed employment discrimination claims under Title VII of the Civil Rights Act, specifically 42 U.S.C. §§ 1981, 1983, 2000e through 2000e-17 (2000); as well as California Act of Sept. 19, 1980, ch. 992, sec. 4, § 12965, 1980 Cal. Stat. 3156 (current version at CAL. GOV'T CODE § 12965 (West 2005)). *Id.* In addition, he alleged tort claims under state law including intentional infliction of emotional distress and slander; however, he later abandoned these claims. *Id.* According to the court, only the claims arising under §§ 1981 and 1983 survived a pre-trial order. *Id.* Banks "sought general damages, future medical and hospital expenses, punitive and exemplary damages, back pay and related employee benefits, various injunctions, and attorney's fees." *Id.*

76. *Id.*

77. *Id.* at 376.

78. *Id.*

79. I.R.C. § 104(a)(2) (2000).

80. *Banks*, 345 F.3d at 376.

§ 104(a)(2) exclusion applied.[81]

In 1997 the Commissioner issued a Notice of Deficiency to Banks for the 1990 tax year, to which Banks responded by filing a petition in the United States Tax Court requesting a re-determination of the deficiencies.[82] The Tax Court held that: (1) the settlement amount was not excludable from gross income because it was not on account of personal injuries as Banks contended;[83] and (2) the $150,000 that Banks paid to his attorney in fees was not deductible from Banks's gross income.[84] Banks then appealed the case to the Sixth Circuit.[85]

The Sixth Circuit affirmed in part and reversed in part the Tax Court's decision.[86] The Sixth Circuit agreed that the settlement proceeds that Banks received were not excludable from gross income under § 104(a)(2).[87] The court, however, disagreed with the Tax Court's holding that the contingent attorney's fees that Banks paid to his attorney constituted taxable income to Banks.[88]

The court first addressed the issue of whether § 104(a)(2) provided an exclusion for any portion of the settlement award Banks received.[89] The court used the test set forth by the Supreme Court in *Commissioner v. Schleier* and reasoned that certain claims brought by Banks were tort-like claims involving personal injuries that could potentially qualify for the § 104(a)(2) exclusion.[90] The court concluded, however, that Banks failed

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81. *Id.* at 376, 378.

82. *Id.* at 377. The amount of the deficiency was $101,168. *Id.*

83. Banks v. Comm'r, 81 T.C.M. (CCH) 1219, 1224 (2001). The court examined the nature of the underlying claim to make its determination, citing both *Commissioner v. Schleier*, 515 U.S. 323 (1995) and *United States v. Burke*, 504 U.S. 229 (1992). *Id.* at 1223–25.

84. *Banks*, 81 T.C.M. (CCH) at 1226. Despite acknowledging that it must follow the law of the Sixth Circuit (to which the case was later appealed), the Tax Court distinguished its opinion from the Sixth Circuit's opinion in *Brisco-Whitter ex rel. Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000) because *Estate of Clarks* rested on Michigan's attorney's lien law, whereas the instant case rested on California law that did not grant a strong attorney's lien. *Id.* at 1225.

85. *Banks*, 345 F.3d at 377.

86. *Id.* at 389.

87. *Id.*

88. *Id.* The court also reversed the tax court's ruling that Banks "could not deduct his alimony payments for the 1990 taxable year based on the 'duty of consistency' doctrine" and remanded the case. *Id.*

89. *Id.* at 378–82.

90. *Id.* at 378–79. The court set forth the following "disaggregated" form of the *Schleier* test:

> To satisfy *Schleier*, the taxpayer must show that (1) there was an underlying claim sounding in tort; (2) the claim existed at the time of the settlement; (3) the claim encompassed personal injuries; and (4) the agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" the personal injury.

Id. at 379 (quoting Greer v. United States, 207 F.3d 322, 327 (6th Cir. 2000)). Specifically, the court found that Banks's §§ 1981 and 1983 claims constituted claims sounding in tort to meet the first prong of the reformed *Schleier* test. *Id.* at 379–80. The court determined that the second prong of the test was to show that the settlement agreement compensated the plaintiff "on account of personal injuries or sickness."[91] Therefore, because none of the settlement amount could be excluded under § 104(a)(2), the court held that the Tax Court properly included it as income to Banks under § 61(a) of the Code.[92]

After determining that Banks's settlement amount was not excludable, the Sixth Circuit next addressed whether the contingent fee of $150,000 that Banks paid to his attorney was excludable.[93] The court noted the split among the circuits on the issue and began with a review of the assignment-of-income doctrine.[94] The court then examined the counterargument to the assignment-of-income doctrine through a discussion of *Cotnam* and *Estate of Clarks*.[95] The court acknowledged that the applicable lien law was the law of California (which did not provide a strong enforcement right to attorneys), but decided that it would not rest its decision on state lien law.[96] Instead, the court found that the state lien laws governing attorney's rights have nothing to do with whether the fees should be taxed to Banks.[97] In citing *Estate of Clarks*, the court noted that decision also did not rest on state lien law but instead relied on other factors to determine that the fees

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met because those claims existed at the time Banks executed the settlement with the CDOE, and he received the entire amount in settlement of those claims. *Id.* at 380. The court also found that prong three was met because the claims "potentially involved injuries that were personal." *Id.* at 380 (quoting *Greer*, 207 F.3d at 328).

91. *Id.* at 381 (quoting *Greer*, 207 F.3d at 334). According to the court, Banks failed to meet his burden to show that any portion of the settlement award could be characterized as payment for personal injury damages to meet § 104(a)(2). *Id.* The court noted that the settlement agreement did not assess and allocate the damages properly for the exclusion and that there was actually evidence in the record indicating that the damages were instead on account of non-personal injuries. *Id.* at 381–82.

92. *Id.* at 382.

93. *Id.* at 382–86.

94. *Id.* at 382–83.

95. *Id.* at 383–85.

96. *Id.* at 385. The court noted that California's lien law "confers no ownership interest on attorneys" and that contingent fee contracts only provide a lien to the attorney upon the client's recovery (i.e., the attorney "acquires no more than a professional interest"). *Id.* (quoting Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000)).

97. *Id.* at 385–86. The court found the Fifth Circuit's holding in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000), persuasive in its reasoning. *Id.* at 385. The court pointed to the reasoning in *Srivastava* that the application of *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), (and thus the exclusion of the fees) "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." *Id.* (quoting *Srivastava*, 220 F.3d at 364). The Sixth Circuit added:

> Given the various distinctions among attorney's lien laws among the fifty states, such a 'state-by-state' approach would not provide reliable precedent regarding our adherence to the *Cotnam* doctrine or provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards.

Id.

were excludable.[98] Accordingly, the Sixth Circuit reversed the Tax Court on this issue and held that the $150,000 in contingent fees that Banks paid to his attorney were excludable from his gross income.[99]

2. *Banaitis v. Commissioner*

Plaintiff Sigitas Banaitis served as a vice-president and loan officer for the Bank of California.[100] After he refused to disclose confidential client information to a successor of the Bank of California, he was forced to leave and, in response, brought a wrongful discharge suit against the Bank of California and its successors.[101] He entered into a contingent fee agreement with his attorneys where his attorneys would receive "one-third of [a] gross settlement prior to commencement of a trial . . . and . . . forty percent of [any] gross recovery thereafter."[102] In his complaint Banaitis sought general and punitive damages.[103] The parties eventually entered into a confidential settlement agreement, pursuant to which the defendants paid $3,864,012 directly to Banaitis's attorneys and $4,864,547 directly to

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98. *Id.* at 386. The court pointed to the following four factors (as mentioned above) as persuasive to the outcome of the cited case:

> (1) the fact that the claim, at the time the contingency fee agreement was signed, was "an intangible, contingent expectancy," (2) taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds; (3) no tax-avoidance purpose was at work with the contingency fee arrangement, as there ostensibly was in *Lucas* and *Horst*; and (4) double taxation would otherwise result by including the contingency fee in taxpayer's income.

Id. (citing Brisco-Whitter ex rel. Estate of Clarks v. United States, 202 F.3d 854, 857–58 (6th Cir. 2000)).

99. *Id.* at 386.

100. Banaitis v. Comm'r, 340 F.3d 1074, 1076 (9th Cir. 2003).

101. *Id.* at 1076–77. Through his position at the Bank of California, Banaitis had access to confidential financial information about the customers with whom he worked. *Id.* at 1076. In order "[t]o ensure the security" of the information, Banaitis entered into confidentiality agreements with the bank. *Id.* The bank was later acquired by Mitsubishi Bank, which was a subsidiary of the Mitsubishi Group, Ltd. *Id.* The Mitsubishi Group controlled and operated firms in direct competition with a number of Banaitis's clients. *Id.* Both the Mitsubishi Bank and the Bank of California requested that Banaitis turn over confidential information relating to some of the customers. *Id.* At the request of his customers Banaitis refused and he was then forced to leave. *Id.*

102. *Id.* The agreement authorized Banaitis's attorneys to "accept a structured payment of the attorneys [sic] fee directly from the adverse party." *Id.*

103. *Id.* at 1077.

> Banaitis alleged that Mitsubishi Bank intentionally and willfully interfered with Banaitis'[s] employment agreement and economic expectations and caused the Bank of California to discharge Banaitis. Banaitis alleged that the 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.

Id.

Banaitis.[104] Banaitis did not include any of the $8,728,559 in total settlement proceeds as part of his 1995 gross income, claiming that payments were excludable under § 104(a)(2).[105] The IRS disagreed and issued a notice of deficiency to Banaitis for his 1995 return, and Banaitis promptly filed a petition in the Tax Court.[106] The Tax Court found that the settlement proceeds were not excludable under § 104(a)(2) and that the amounts paid directly to Banaitis's attorneys must be included in his gross income.[107]

On appeal, the Ninth Circuit affirmed in part and reversed in part the Tax Court's decision.[108] The Ninth Circuit first addressed the issue of whether any of the settlement proceeds were excludable under § 104(a)(2).[109] The court cited the *Schleier* two-part test and found that although Banaitis's claims were founded in tort theory, the damages Banaitis received were not "'on account of' his personal injuries."[110] Like the Sixth Circuit in *Banks*, the Ninth Circuit determined that the two-part test was not met and that the economic and punitive damages comprising the settlement award were therefore not excludable under § 104(a)(2).[111]

Next, the court addressed the issue of whether the fees that were paid directly to Banaitis's attorneys pursuant to the settlement agreement should be included in his gross income.[112] The Ninth Circuit identified the dispositive factors as: "(1) how state law defines the attorney's rights in the

104. *Id.* at 1078.

105. *Id.*

106. *Id.* The IRS determined that the majority of the settlement proceeds should be included in Banaitis's gross income. *Id.* The IRS also found that Banaitis was subject to greater AMT liability, which had the effect of diminishing his miscellaneous itemized deductions. *Id.*

107. *Id.* at 1079. The Tax Court also disposed of Banaitis's argument that his Fifth and Fourteenth Amendment rights had been violated. *Id.*

108. *Id.* at 1083.

109. *Id.* at 1079–81.

110. *Id.* at 1079–80 (quoting I.R.C. § 104(a)(2) (2000 & Supp. III 2003)). The court explained that there must be a direct causal relation between the tortious conduct and the amount awarded to compensate for personal injuries; specifically, a plaintiff must have received the damages "on account of" the personal injuries in order to exclude the award. *Id.* at 1080 (citing Comm'r v. Schleier, 515 U.S. 323, 329–30 (1995)). "In the ordinary personal injury tort action, . . . [t]he tortious conduct causes personal injuries, which, in turn, cause further damages such as economic loss . . . . [A]nd [those] economic damages . . . may be excluded from gross income because the losses are 'on account of' personal injury." *Id.* The court distinguished these cases from pure economic or commercial tort cases, where the "economic damages are often caused solely by the tortious action itself, rather than as a consequence of personal injury." *Id.* The latter most accurately described Banaitis's case, the court concluded, because the personal injuries he received did not cause his economic loss, but instead the wrongful termination caused the economic loss. *Id.* at 1080–81. Accordingly, the court held that this was not sufficient to meet the "on account of" requirement. *Id.*

111. *Id.*

112. *Id.* at 1081–83.

action, and (2) how federal tax law operates in light of this state law definition of interests."[113] The court noted that sometimes "state law may operate to provide the plaintiff's attorney greater rights than the lawyer would have under a contingent fee contract."[114]

Accordingly, the court examined the applicable state law to determine whether the attorneys had property interests arising as a matter of law in the settlement or judgment, independent of the fee agreement.[115] The court found that Oregon law grants attorneys substantial property interests in their clients' awards.[116] "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'[s] claim under Oregon law is akin to—and even stronger than—the claim in *Cotnam*."[117] Consequently, the Ninth Circuit reversed the Tax Court on the fee issue and held that the fees were not includable in Banaitis's gross income for 1995.[118]

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113. *Id.* at 1081 (citing United States v. Mitchell, 403 U.S. 190, 197 (1971)). It is interesting to contrast the Ninth Circuit's rationale with that of the Sixth Circuit in *Commissioner v. Banks*, 345 F.3d 373 (6th Cir. 2003). In *Banks*, the Sixth Circuit found that the underlying state law governing attorneys' rights to enforce an interest in the fees had nothing to do with whether the fees should be taxed to the award recipient. *Banks*, 345 F.3d at 385–86. Here, the Ninth Circuit identified state law as controlling on the issue. *Banaitis*, 340 F.3d at 1081.

114. *Banaitis*, 340 F.3d at 1081, 1083.

115. *Id.* at 1081–82 (discussing, among other cases, Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), the Fifth Circuit's holding in Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959), the underlying Alabama state law in *Cotnam*, and the underlying state law in subsequent cases relying on state law).

116. *Id.* at 1082. The Ninth Circuit pointed out that Oregon state law mirrors Alabama law (as addressed in *Cotnam*), finding that an attorney's lien is "'superior to all other liens' except 'tax liens.'" *Id.* (quoting Oregon Act of June 7, 1975, ch. 648, § 68, 1975 Or. Laws 1659, 1681 (current version at OR. REV. STAT. § 87.490(1) (2003))). Furthermore, Oregon law also stated that:

> [A] party to the action, suit or proceeding, or any other person, does not have the right to satisfy the lien . . . or any judgment, decree, order or award entered in the action, suit or proceeding until the lien, and claim of the attorney for fees based thereon, is satisfied in full.

Id. (omission in original) (quoting Oregon Act of June 7, 1975, ch. 648, § 65, 1975 Or. Laws 1659, 1680–81 (current version at OR. REV. STAT. § 87.475(2) (2003))).

117. *Id.* at 1083. The court found that "Oregon [law] goes even further than does the Alabama law at issue in *Cotnam*," because the "Oregon Supreme Court . . . has recognized that an attorney has a right to sue a third party for attorneys [sic] fees that were left unsatisfied by a private settlement with the attorney's clients." *Id.* at 1082.

118. *Id.* at 1083.

3. The Consolidated Cases as Presented to the Supreme Court

The Supreme Court heard oral argument on the consolidated cases in November 2004.[119] The main question presented to the Court in both cases was "[w]hether . . . 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."[120]

As expected, the government advanced the same arguments in both *Banks* and *Banaitis*. It argued that the issue was "a matter of federal, not state, law."[121] The government relied on the broad reach of § 61(a) of the Code and the assignment-of-income doctrine, citing to the majority of circuit courts that have held that the portion of a settlement award representing the contingent attorney's fees is taxable because "income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else."[122] The government argued that, even if the Court were to determine that state law should apply, the lower court decisions should still be reversed because California law requires that the entire amount of Banks's litigation proceeds should be included in his gross income, and Oregon law requires that the entire amount of Banaitis's litigation proceeds should be included in his gross income.[123]

In Banks's brief, he set forth essentially five major arguments.[124] First, he argued that there is no provision in the Code requiring him to include in his gross income that income which is allocable to his attorney.[125] Second,

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119. Docket for Comm'r v. Banaitis, 543 U.S. 426 (2005) (No. 03-907), *available at* http://www.supremecourtus.gov/docket/03-907.htm; Docket for Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892), *available at* http://www.supremecourtus.gov/docket/03-892.htm.

120. Brief for Petitioner at I, Comm'r v. Banks, 543 U.S. 426 (2005) (Nos. 03-892, 03-907), *available at* 2004 WL 1330104. The question of whether the entire settlement awards were excludable pursuant to § 104(a)(2) was not presented to the Court. *Id.* at 15 n.3.

121. *Id.* at 16 (citing Raymond v. United States, 355 F.3d 107 (2d Cir. 2004); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Hukkanen-Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001)).

122. *Id.* at 11, 15–16 (citing Lucas v. Earl, 281 U.S. 111, 114–15 (1930)).

123. *Id.* at 35–41. With respect to Banks, the government argued that: "California law confirms that the relationship between respondent Banks and his attorney was simply that of debtor and creditor. They were not partners and the attorney acquired no proprietary interest in respondent Banks's cause of action by virtue of the contingent fee agreement." *Id.* at 37 (citing Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000)). With respect to Banaitis, the government argued that the attorney was not a co-owner of Banaitis's claim under Oregon law, but instead was nothing more than a lien holder. *Id.* at 39.

124. Brief for the Respondent at i, 9–39, Comm'r v. Banks, 543 U.S. 426 (2005) (No. 03-892), *available at* 2004 WL 1876293 [hereinafter Brief for Banks].

125. *Id.* at 9–10. Specifically, Banks argued that no provision in the Code requires a plaintiff in a federal employment discrimination action to include in his gross income the portion of his settlement award payable to his attorney as contingent fees. *Id.* at 10.

he argued that he lacked the "dominion, control, and beneficial ownership over that portion of the" settlement award attributable to the contingent fees, and it therefore could not be income to him.[126] Third, he contended that "[t]he attorney's fees portion of the settlement was in lieu of amounts that could have been awarded under fee-shifting statutes."[127] Fourth, he argued that the inclusion of fees in his gross income would lead to unjust and absurd results and cited one case where a taxpayer actually netted a loss from her lawsuit after she was taxed on fees and costs.[128] Fifth, Banks argued that "[t]he assignment of income doctrine is a court-created anti-abuse rule that does not apply to an attorney contingent fee contract."[129]

The arguments that Banaitis presented to the Court centered on the idea that Subchapter K of the Code[130] should apply to the matter because he and his attorney were joint venturers for the production of income.[131] Therefore, Banaitis argued, the assignment-of-income doctrine could not apply because he and his attorney, as joint venturers, should be separately taxed on their respective share of earned income pursuant to the terms of the contingent fee agreement.[132] Further, when Subchapter K rules apply, Banaitis argued that the Court should place no relevance on which joint venturer "'owned' the cause of action or other property involved."[133]

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126. *Id.* at 11–17.

127. *Id.* at 18. Banks concluded that he received the settlement in lieu of claims under 42 U.S.C. §§ 1981, 1983, and 2000e thru 2000e-17 (2000). *Id.* at 18. Because each of these statutes contains provisions allowing a court to award attorney's fees directly to the attorneys for prosecuting successful claims, Banks argued that the portion of the award attributable to fees could not be income to him if awarded by the court. *Id.* at 18–19. If the Court ruled that the fees were income to plaintiffs in discrimination cases, Banks contended that the result would punish those plaintiffs and thus contravene the purpose of the civil rights statutes. *Id.* at 20.

128. *Id.* at 20–22. Banks cited a case in which a law enforcement officer sued her employer for sex discrimination and harassment and, after recovering an award of $300,000 plus $850,000 in attorney's fees and $100,000 in costs, actually came out owing the IRS $99,000. *Id.* at 21 (citing Liptak, *supra* note 30, at 18).

129. *Id.* at 23. Banks argued that his attorney earned the fees. *Id.* at 25. "When he entered into the contingent fee contract, Mr. Banks effectively surrendered an undivided interest in his claim, the income-producing property." *Id.* at 27. Furthermore, Banks argued that no tax avoidance purpose was present, and therefore the fee award was income to his attorney only. *Id.*

130. I.R.C. §§ 701–777 (LexisNexis 2006). Subchapter K generally sets forth the taxation rules for partners and partnerships. *Id.*

131. Brief for Respondent at 5, Comm'r v. Banaitis, 543 U.S. 426 (2005) (No. 03-907), *available at* 2004 WL 1835368.

132. *Id.* at 5–6. Banaitis argued that he and his attorney "devoted their property and services to the pursuit of the cause of action, in a joint effort to convert it into a collectible judgment against the defendant, [Banaitis's] former employer." *Id.* at 9.

133. *Id.* at 18. Banaitis argued:

> Nothing in Subchapter K permits the Commissioner to treat participants differently according to whether their contribution to a joint venture was a chose in action (or some other property) or services. To the contrary, §704(a) provides

Banaitis continued by arguing that the assignment-of-income doctrine had no application in a case involving a joint venture[134] and because "[u]nder Oregon law, [his] attorney owned a portion of the cause of action."[135] He concluded by contending that reversing the case would produce "far-reaching and harmful" consequences.[136]

II. THE HYPOTHETICAL

Now that the arguments for and against inclusion of contingent fees have been set forth, the answer to Mo's situation is somewhat clearer. To recap,[137] Mo received a judgment award of $1,000,000. Pursuant to his contingent fee agreement with Curly, he paid Curly $400,000, leaving Mo with a net award of $600,000. The question is whether he should be taxed on what he nets after fees ($600,000) or what he grosses before fees ($1,000,000). Before discussing the Supreme Court's resolution of this question, it seems useful to examine the potential outcomes under the differing approaches taken by the circuit courts.

If Mo is situated in one of the circuits that follows the majority approach, he would be required to include the contingent attorney's fees in his gross income.[138] Accordingly, he would be taxed on the gross amount of $1,000,000. He might claim a miscellaneous itemized deduction for the

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> that the allocation of [a partner's] distributive share (and thus of taxable income) shall be determined solely by the agreement of the parties "except as otherwise provided in this Chapter." Nothing in Subchapter K provides for disregarding the terms of such an agreement because one party's contribution to a venture is a chose in action, because the other party provides only (or primarily) services, or because the profits which the parties have jointly generated, and agreed to divide, will come in the form of a check payable to only one of them.

Id. at 19 (quoting I.R.C. § 704(a) (West Supp. 2005)).

134. *Id.* at 21. Like Banks, Banaitis argued that the holdings of *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1940) were not applicable to his case. *Id.*; *see also* Brief for Banks, *supra* note 124, at 26 (distinguishing *Lucas* and *Horst*).

135. *Id.* at 31. Banaitis argued that Oregon statutory and case law give the attorney ownership rights over the portion of the judgment proceeds allotted to the attorney under the executed contingent fee agreement. *Id.* Therefore, he contended, "no assignment of income [took] place." *Id.* He cited the Ninth Circuit's analysis of the Oregon lien statutes and case law to support the theory that an ownership interest in the award proceeds had vested in his attorney. *Id.* at 33 (citing Banaitis v. Comm'r, 340 F.3d 1074, 1083 (9th Cir. 2003)).

136. *Id.* at 41–49 (listing the potential effects on contingent fee agreements, fee-shifting statutes, hourly fee agreements, contractual attorney's fees provisions, class-action attorney's fees, and pro bono attorneys).

137. *See supra* Introduction.

138. The First, Second, Third, Fourth, Seventh, Tenth and the Federal Circuit Courts of Appeals would likely hold that contingent attorney's fees must be included in Mo's individual gross income. *See supra* note 42 and accompanying text.

fees, but that would be limited by the two-percent floor.[139] Further, it is likely that the AMT would apply to this recovery, which may wipe out the ability for Mo to claim the deduction.[140]

On the other hand, if Mo is situated in one of the circuits in the minority, then he would exclude the amount of the fees from his gross income.[141] Thus, he would be taxed on the net amount of $600,000 instead. Put simply, the tax would be substantially less than it would be in the majority circuits, and there would be no "double taxation" issue.

The resolution to this difference in treatment has been provided by the Supreme Court's recent decision.

III. THE HIGH COURT RESOLVES THE ISSUE

On January 24, 2005, the Supreme Court decided the consolidated cases of *Banks* and *Banaitis*.[142] The Court sided with the Commissioner and held that contingent attorney's fees are taxable to a plaintiff–award recipient.[143]

A. The Court's Rationale

After discussing the facts of both *Banks* and *Banaitis*, the Court offered two preliminary observations regarding the importance of the issue.[144] The first concerned the limitation on the ability of a taxpayer to deduct the fees due to the operation of the AMT.[145] The second concerned the recent enactment of the American Jobs Creation Act of 2004.[146] The Act amended the Code by adding § 62(a)(19), which allows a taxpayer to take an above-the-line deduction for "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful

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139. *See* discussion *supra* Part I.A.2 (examining the effect of the two-percent floor of I.R.C. § 67 (2000)).

140. *See* discussion *supra* Part I.A.3 (explaining the applicability of the AMT).

141. The Fifth, Sixth, Ninth, and Eleventh Circuits would likely hold that contingent attorney's fees should be excluded from Mo's individual gross income. *See supra* note 43 and accompanying text.

142. Comm'r v. Banks, 543 U.S. 426 (2005).

143. *Id.* at 430.

144. *Id.* at 432–33.

145. *Id.* at 432. The Court summarized the effect the AMT has on the deductibility of the fees by noting that "[f]or noncorporate individual taxpayers, the AMT establishes a tax liability floor equal to 26 percent of the taxpayer's 'alternative minimum taxable income' (minus specified exemptions) up to $175,000, plus 28 percent of alternative minimum taxable income over $175,000." *Id.* (citing I.R.C. § 55(a), (b) (2000)). In addition, the Court observed that the AMT "does not allow any miscellaneous itemized deductions." *Id.* (citing I.R.C. § 56(b)(1)(A)(i)).

146. *Id.* at 433; American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) (codified as amended in scattered sections of 26 U.S.C.).

discrimination."[147] The Court stated that the Act may apply to future taxpayers in the position of Banks and Banaitis.[148] However, because the Act was not in force at the time of Banks's and Banaitis's transactions, and because the Act is not retroactive, it could not benefit Banks and Banaitis.[149]

The Court then commenced its analysis of the taxation of contingent fees and produced a general, but clear, holding. The Court first discussed the anticipatory-assignment-of-income doctrine through *Lucas*, *Horst*, and related cases.[150] The Court restated the taxpayers' argument that the assignment-of-income "doctrine is a judge-made antifraud rule with no relevance to contingent-fee contracts of the sort at issue" and the Commissioner's argument "that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery."[151] The Court, however, agreed with the Commissioner.[152]

Resolution of the issue depended upon whether the taxpayer retained dominion over the income (or the income-generating asset) in question.[153] With respect to litigation recoveries, "the income-generating asset is the

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147. *Banks*, 543 U.S. at 433 (quoting American Jobs Creation Act of 2004, § 703(a), 118 Stat. at 1546 (codified as amended at I.R.C. § 62(a)(19) (LexisNexis 2006)). According to the Court:

> The Act defines "unlawful discrimination" to include a number of specific federal statutes, . . . any federal whistle-blower statute, . . . and any federal, state, or local law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship . . . or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law," . . . .

Id. (citations omitted) (third omission in original) (quoting I.R.C. § 62(e) (2000)).

148. *Id.*

149. *Id.*

150. *Id.* at 433–38.

151. *Id.* at 434.

152. *Id.*

153. *Id.* The Court elaborated further:

> In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance the question becomes whether the assignor retains dominion over the income-generating asset, because the taxpayer "who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." . . . Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.

Id. at 434–35 (citations omitted) (quoting Helvering v. Horst, 311 U.S. 112, 116–17 (1940)). In other words, the Court is rehashing the principle that the fruit cannot be separated from the tree on which it grew—the person who controls the income-generating asset ultimately earns the income and should therefore be taxed on that income.

cause of action that derives from the plaintiff's legal injury."[154] The Court found that "[t]he plaintiff retains dominion over this asset throughout the litigation."[155] This point is important because the Court appears to have relied on it as a primary basis for its holding in the case.

The Court rejected Banks's and Banaitis's legal arguments. It began by summarizing Banks's and Banaitis's counterarguments as: (1) "the value of a legal claim is speculative at the moment of assignment, and may be worth nothing at all" for tax purposes; and (2) because the attorney contributes income-generating assets, the client's claim is not the only source of recovery.[156] In effect, the Court viewed Banks's and Banaitis's argument as asking the Court to create a rule that a contingent fee establishes a joint venture or partnership pursuant to which the resulting profits of the claim should be apportioned between the attorney and the client.[157] As to the first argument, the Court stated that the anticipatory-assignment-of-income doctrine "is not limited to instances when the precise dollar value of the assigned income is known in advance."[158]

In response to the second argument, the Court cited the Restatement of Agency and Judge Posner's opinion in *Kenseth*, finding that an "attorney is an agent who is duty bound to act only in the interests of the principal, [the client,] and so it is appropriate to treat the full amount of the recovery as income to the principal."[159] In light of this principal–agent rationale, the

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154. *Id.* at 435.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.* (citing Lucas v. Earl, 281 U.S. 111, 115 (1930); U.S. v. Basye, 410 U.S. 441, 445, 450–52 (1973)). The Court noted that:

> [T]he holding in [*Horst*] did not depend on ascertaining a liquidated amount at the time of assignment. In each of the cases before us, as in *Horst*, the taxpayer retained control over the income-generating asset, diverted some of the income produced to another party, and realized a benefit by doing so. . . . That the amount of income the asset would produce was uncertain at the moment of assignment is of no consequence.

Id. at 435–36.

159. *Id.* at 436. The Court stated that "[t]he relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship." *Id.* (citing RESTATEMENT (SECOND) OF AGENCY § 1 cmt. e (1958); MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 1, 1.7 cmt. 1 (2002)). The Court explained:

> The client may rely on the attorney's expertise and special skills to achieve a result the client could not achieve alone. That, however, is true of most principal-agent relationships, and it does not alter the fact that the client retains ultimate dominion and control over the underlying claim. . . . Even where the attorney exercises independent judgment without supervision by, or consultation with, the client, the attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney

Court then refuted the *Cotnam* state-law analysis: "[n]o state laws of which we are aware, . . . even those that purport to give attorneys an 'ownership' interest in their fees . . . convert the attorney from an agent to a partner."[160] The Court then briefly acknowledged, but refused to comment on, other arguments proposed by Banks, Banaitis, and their *amici*, such as: "(1) [t]he contingent-fee agreement establishes a Subchapter K partnership . . . ; (2) litigation recoveries are proceeds from disposition of property, so the attorney's fee should be subtracted as a capital expense . . . ; and (3) the fees are deductible reimbursed employee business expenses under § 62(a)(2)(A)" of the Code.[161]

The Court then concluded its opinion by addressing Banks's argument that, in his case, the policy behind the statutory fee-shifting provisions should prevent inclusion of the fees in his gross income.[162] The Court recognized that "when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court-awarded attorney's fees can exceed a plaintiff's monetary recovery."[163] According to the Court:

> Treating the fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit. . . . [T]reating statutory fee awards as income to plaintiffs would undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general.[164]

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or any other party.

Id. (citing RESTATEMENT (SECOND) OF AGENCY §§ 13, 39, 387). The Court then cited Judge Posner's observation in *Kenseth v. Comm'r* that "[t]he contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable." *Id.* at 436–37 (second alteration in original) (quoting Kenseth v. Comm'r, 259 F.3d 881, 883 (7th Cir. 2001)). The Court observed that although income "paid to the agent may be deductible, . . . it is not excludable from the principal's gross income." *Id.* at 437.

160. *Id.* (citations omitted). The Court explained that regardless of whether the attorney–client contract or state law gives special rights to the attorney, so long as the principal–agent relationship is not altered by the contract or the particular state law, the fees are not excludable by the client. *Id.* (citing RESTATEMENT (SECOND) OF AGENCY §§ 13 cmt. b, 14G cmt. a).

161. *Id.* (citations omitted).

162. *Id.* at 438 ("Banks brought his claims under federal statutes that authorize fee awards to prevailing plaintiffs' attorneys.").

163. *Id.* (citing City of Riverside v. Rivera, 477 U.S. 561, 564–65 (1986)).

164. *Id.* at 438–39.

The Court, however, sidestepped the argument, because in Banks's case the fees were paid to the attorney solely pursuant to the contingent fee agreement.[165] "There was no court-ordered fee award, nor was there any indication in Banks'[s] contract with his attorney, or in the settlement agreement . . . that the contingent fee paid to Banks'[s] attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover."[166] To conclude its analysis, the Court then shed some light on the situation for future taxpayers by pointing out that "the American Jobs Creation Act redresses the concern for many . . . claims governed by fee-shifting statutes."[167] Nonetheless, the Court held against the taxpayers, reversed the judgments of both the Sixth Circuit in *Banks* and the Ninth Circuit in *Banaitis*, and remanded the cases for further proceedings.[168]

B. Analysis and Impact

The Supreme Court's decision in *Banks* is certainly not favorable to taxpayers who must pay their attorney's fees pursuant to a contingent fee agreement. Reflecting on the possibility that current tax laws "so constrained" the Supreme Court to render its ruling as it did, Charles Davenport, the Rutgers law professor whose *amici* brief was mentioned in the Court's opinion,[169] remarked "I can't think of anything worse for the tax system."[170] Stephen Cohen, another law professor whose brief was mentioned in the opinion,[171] has asserted that "[t]he decision is going to result in some individuals being taxed at an effective rate of over 100 percent."[172] In Banaitis's case, "he will be taxed on $8 million of income when he received only $5 million."[173] Although this is one example of the potential inequities that fall on an award recipient, the Court's holding shows that the assignment-of-income doctrine remains the justification for

165. *Id.* at 439.

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.* at 437. Mr. Davenport's brief centered on the capitalization theory, which the "Justices were most interested in during oral argument." Brief for *Amicus Curiae* Professor Charles Davenport in Support of Respondents at 23–28, Comm'r v. Banks, 543 U.S. 426 (2005) (Nos. 03-892, 03-907), 2004 WL 1860016; Sheryl Stratton, *High Court Sides with Government in Contingent Attorney Fee Cases*, Jan. 25, 2005, TAX NOTES TODAY Doc. 2005-1428.

170. Stratton, *supra* note 169.

171. *Banks*, 543 U.S. at 437–38. Mr. Cohen's brief argued that fees should be deductible as employee business expenses. Brief for *Amicus Curiae* Prof. Stephen B. Cohen, *Pro Se*, in Support of Respondents at 4, 6, Comm'r v. Banks, 543 U.S. 426 (2005) (Nos. 03-892, 03-907), 2004 WL 1844489.

172. Stratton, *supra* note 169.

173. *Id.*

requiring inclusion of the fees in the taxpayer's gross income.

There are other potential drawbacks arising from the Court's decision. The Court seemingly left open the issue of contingent fee taxation in the statutory fee-shifting scenario (as in Banks's case).[174] This uncertainty might discourage future settlements because plaintiffs may be willing to proceed to trial rather than settle and take their chances that a fee award from a fee-shifting provision may be excludable in the future.[175] Therefore, because the Court left this question open, the uncertainty may cause protracted litigation that might have been avoided otherwise.

To avoid this scenario, there may be another avenue for plaintiffs and their attorneys to consider when dealing with this in the future. As attorney Robert W. Wood points out, because the Court left open the fee-shifting statute issue, it may be possible for practitioners to avoid these tax pitfalls by including language in the settlement agreement providing that the lawyer is receiving fees "directly from the defendant and in lieu of statutory fees that would be awarded" at trial.[176] According to Wood, it may also be possible to include partnership-like language in a contingent fee agreement to establish a partnership between the lawyer and client, as the Court did not address that rationale in its opinion.[177] Because the Court left these questions open, Wood's proposed drafting methods may, in the future, provide crafty ways of avoiding the inclusion of contingent fees in the client's income.

Another path for taxpayers to consider is to rehash the arguments that the Court left open in *Banks* and hope that future courts will agree. One argument that Banaitis propounded to the Court—that attorney's fees are capital expenditures and not deductible expenses, and therefore the fees should be subtracted from the amount of the settlement award subject to tax—may come up again.[178]

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174. *Id.*

175. *Id.*

176. Robert W. Wood, *Supreme Court Attorney Fees Decision Leaves Much Unresolved*, Feb. 7, 2005, TAX NOTES TODAY Doc. 2005-2351, *available at* http://digbig.com/4gtky.

177. *Id.*

178. *See* Appellant's Brief re Disposition of Case on Remand, Banaitis v. Comm'r, No. 02-70421 (9th Cir. May 2, 2005), *reprinted in* TAX NOTES TODAY Doc. 2005-12156 (reiterating the "transaction" or "capitalization" theory argued to the Supreme Court in amicus curiae briefs of Professor Charles Davenport and the Association of Trial Lawyers of America). The basic idea of the transaction theory, as articulated in the brief, is that: (1) a tort claim is classified as property for tax purposes; (2) the attorney's fees spent in prosecuting the claim are treated as nondeductible transaction costs which should be capitalized, and are to be added to the taxpayer's basis in the property (the cause of action); and (3) upon settling the taxpayer's claim, the taxpayer disposes of the property and the attorney's fees that have increased the taxpayer's basis are netted out of the taxable gain on the disposition. *Id.*

Another potential avenue for plaintiffs is the partnership theory mentioned above. However, at least one post-*Banks* court has already rejected that argument.[179] In *Allum v. Commissioner*, the taxpayer attempted to distinguish his case from *Banks* by citing the partnership theory (that the relationship between the taxpayer and his attorney amounted to a de facto subchapter K partnership).[180] Although the Tax Court noted that the Supreme Court declined to address this argument in *Banks*,[181] it went on to reject the argument because it did *not* find that "in light of all the facts, the parties in good faith and acting with a business purpose intended to join together in the present conduct of an enterprise."[182]

As stated above, some of the harshness of this result has now been partially remedied by the American Jobs Creation Act. The Act provides taxpayers with relief that Banks and Banaitis did not have at the time of their respective transactions.[183] Attorney's fees that are paid in many employment litigation claims specified in the Act may now be taken as an above-the-line deduction.[184] Thus, the limitations on the ability to take the deduction and the devastating effect of the AMT may no longer be a major issue for taxpayers in these actions.

Nonetheless, the Act does not cover all claims. There is still a possibility that a plaintiff may actually end up losing money after paying taxes on the attorney's fees. Indeed, with the Court's decision in *Banks*, it could be said that the Court has now closed the door on the issue, and the Act may be the only remedy left. As discussed above, however, some valid means may yet remain to provide taxpayers with a fighting chance against the inclusion of the fees. The door may be shut, but it is not yet locked.

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179. Allum v. Comm'r, No. 2424-03, slip op. at 28–29 (T.C. July 20, 2005), *available at* http://www.ustaxcourt.gov./InOpHistoric/Allum.TCM.WPD.pdf.

180. *Id.* at 20–21.

181. *Id.* at 24 n.14 (citing Comm'r v. Banks, 543 U.S. 426, 439 (2005)).

182. *Id.* at 27 (citing Comm'r v. Culbertson, 337 U.S. 733, 743 (1949)). The Tax Court examined the record and found "no evidence that [the taxpayer] intended to form a partnership with his attorney." *Id.* at 28. Instead, the Tax Court decided that the taxpayer's testimony suggested a principal–agent relationship rather than a partnership. *Id.* at 28–29.

183. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 703(a), 118 Stat. 1418, 1546–47 (codified at I.R.C. § 62(a)(19) (LexisNexis 2006)).

184. *Id.*