TO TAX OR NOT TO TAX: SHOULD CONTINGENT ATTORNEYS' FEES BE INCLUDED IN THE SUCCESSFUL LITIGANT'S GROSS INCOME?

ABSTRACT

The thrill of victory can quickly become the agony of defeat for the successful litigant, when the time comes to pay the income tax owed on his or her recovery. A majority of the circuits have held that contingent attorneys' fees must be included in the successful litigant's gross income.

The tax consequences of doing so can be devastating. The litigant, especially one whose award is statutorily capped and who has appreciable attorneys' fees, can end up owing more in taxes than was received in the judgment.

What causes this apparent anomaly is a judge-made rule known as the "anticipatory assignment-of-income" doctrine, which considers the portion of the judgment used to pay the attorneys' fees to be income first to the litigant. The rule was originally devised to prevent wealthier taxpayers from assigning income they had earned to someone else, typically a family member, in an effort to avoid paying tax on that income.

The rule has since been applied to non-family situations, such as the contingent fee arrangement between an attorney and client. The successful client is considered to have earned the entire recovery and then to have assigned a portion of it to the attorneys to pay their fee. The client can then deduct the fees paid as a miscellaneous itemized deduction. This was the position taken by both the Internal Revenue Service and the majority of the circuits.

The problem with this approach, however, was that under the tax code as it existed prior to October 22, 2004, the successful litigant could deduct only a portion of the fees paid, and if the taxpayer fell under the Alternative Minimum Tax, could not deduct them at all. Instead, he or she would pay tax on the entire recovery, including the portion used to pay the attorneys' fees. The taxpayer is therefore taxed on money he or she never saw, and the attorneys are also taxed on the fee, essentially resulting in double taxation.

A few circuits took a different approach and considered the attorneys' fees as being earned by the attorneys. Under the principle that income is taxed to the one who earns it, the successful litigant would therefore not include the fees in his or her gross income but would figure the tax owed on only the net recovery. At times, the strength of the state's attorney-lien law was the deciding factor, causing the court to determine

that the attorney had property rights in the judgment under state law and therefore owned the portion of the judgment that represented the attorney's fee.

Five times the Supreme Court refused to grant certiorari to resolve this circuit split, until two cases, one in the Sixth and one in the Ninth Circuit, were decided against the IRS and for the minority view, holding that the fees were earned by the attorneys and should not be included in the successful litigant's gross income. The two cases were Banks v. Commissioner of Internal Revenue *and* Banaitis v. Commissioner of Internal Revenue. *Both involved unlawful employment practices.*

The Internal Revenue Service petitioned the Supreme Court for certiorari, which was granted on March 29, 2004. Oral arguments were heard on November 1, 2004.

This note was originally written to advocate the minority circuit view, that contingent attorneys' fees should not be included in the successful litigant's gross income. It proposed that the Supreme Court should view the assignment-of-income doctrine in these cases as inapposite, and should instead adopt the position that contingent attorneys' fees are earned by the attorneys and should be taxable solely to them and not to the client.

After this note was written, however, two significant events occurred. First, Congress passed the American Jobs Creation Act of 2004 (Jobs Act) on October 7, 2004, which the president signed into law on October 22, 2004, about one week before oral arguments were scheduled to begin on Banks *and* Banaitis. *The Jobs Act amended the Internal Revenue Code and removed the limitations on deductibility of attorneys' fees in employment discrimination cases such as the* Banks *and* Banaitis *cases considered here. The two taxpayers consequently filed a supplemental brief on October 22, 2004, to have the Court consider their cases moot, but the Court opted to hear oral arguments and decide the case.*

Second, the Supreme Court decided the Banks/Banaitis *case on January 24, 2005, holding that, "as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits."*

While the Court's decision appears to decide the issue, it actually leaves the window open a bit. First of all, "as a general rule" suggests that there may be exceptions, such as those cases now covered by the Jobs Act, which include federal whistle-blower, civil rights cases and unlawful employment discrimination cases such as Banks *and* Banaitis.

Second, the Court also intimated that if Banks had included language either in his fee agreement or in the settlement agreement to the

effect that the contingent attorney fees were in lieu of statutory fees, there might have been a different outcome; that is, the attorneys' fees would not have to be included in the taxpayer's income. The same would hold true if the attorneys' fees were a court-ordered award.

This suggests a tax-planning strategy that attorneys and their clients would do well to consider, particularly in cases seeking injunctive relief where there is a statutory cap on the award and significant attorneys' fees, as in the Spina *case discussed herein. Having the appropriate language in the fee or settlement agreement with payment going directly to the attorneys, for example, may prevent a repeat of that debacle.*

Raising the window a little more, the Court also at first rejected the joint venture argument, but then later in its opinion said it was not considering that question. The Court also said it would not consider the amicus theory that the proceeds of the litigation are property and that attorneys' fees should be subtracted as a capital expense. Nor did the Court address treating the fees as a deductible reimbursed employee business expense.

In short, the opinion is as significant for what it does not address as for what it does. Defamation cases, false imprisonment cases, and emotional distress cases were not touched on. Cases with punitive damages were not addressed either.

Even employment cases that had a verdict before the Jobs Act but were appealed and resolved after October 22, 2004 may still pose tax problems for successful litigants because the judgment, not the resolution, has to occur after that date. The Jobs Act was held to be nonretroactive.

Why, then, this note? Its purpose is not to rehash the Supreme Court's January 24 opinion. Rather, its purpose is two-fold: (1) to discuss and analyze the arguments presented to the Court, including many of the amicus theories the Court chose not to address; and (2) to advocate the view that the Supreme Court should have ruled in favor of Banks/Banaitis *and declared that, in all cases involving contingent attorneys' fees, the fees should not be included in the successful litigant's gross income.*

Accordingly, the reader will still find this note extremely relevant and valuable in understanding the historical underpinnings of the issue of whether or not contingent attorneys' fees should be included in the gross income of the successful litigant. The explanations presented of the applicable tax law, the position of the various circuits, and the arguments raised on both sides of this issue can guide attorneys assisting clients whose cases fall outside the current Supreme Court ruling.

I. INTRODUCTION: A TAXPAYER'S TALE OF WOE

"The hardest thing in the world to understand is the Income Tax."
Albert Einstein[1]

If understanding income tax law was difficult for Einstein, pity the successful litigant when the time comes to pay her taxes. After typically spending years fighting alleged employment discrimination or some other civil rights violation, the taxpayer finds that the legal process that was supposed to make her whole has put her in a "hole," actually owing more to the Internal Revenue Service (IRS) in taxes than she was awarded in court.

Take, for example, the plight of Cynthia Spina, a Chicago police officer who, after nearly four years of litigation, won a sex discrimination and harassment lawsuit against her employer.[2] The court awarded her $300,000, plus attorneys' fees and costs of approximately $950,000.[3]

But it was a hollow victory, if it could, in fact, be considered a victory. "She loses every penny of the award," noted her attorney, Monica McFadden.[4] "[P]lus she will end up owing the Internal Revenue Service $99,000,"[5] money, the court observed, that she did not have.[6]

And so the police officer who, according to the court, "waged a courageous fight for what she believed was just," having endured years of being "berated, belittled and isolated because of her sex" and having her superiors "put pornography in her mailbox, spread sexual rumors about her" and slash her tires, had to suffer yet one more injustice: having to hand over everything she won plus $99,000 to the IRS.[7]

What made this "unfortunate"[8] result possible was the position of both the IRS and the Seventh Circuit (the jurisdiction in which this case was heard) that attorneys' fees must be included in a taxpayer's gross income.[9] Consequently, instead of being taxed on only the $300,000

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[1]BusinessTaxRecovery.com, *Humorous Tax Quotes*, at http://www.businesstaxrecovery.com/funny_quotes (last visited May, 20, 2005).

[2]Spina v. Forest Preserve Dist. of Cook County, 207 F. Supp. 2d 764 (N.D. Ill. 2002); Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Case*, N.Y. TIMES, Aug. 11, 2002, § 1, at 18.

[3]Liptak, *supra* note 3, at 18.

[4]*Id.*

[5]*Id.*

[6]*Spina*, 207 F. Supp. 2d at 777.

[7]*See* Liptak, *supra* note 3, at 18.

[8]*See* Alexander v. Commissioner, 72 F.3d 938, 946 (1st Cir. 1995) (recognizing that a similar outcome in its own case was "unfortunate" and "smacks of injustice").

[9]*Spina*, 207 F. Supp. 2d at 777.

award, Ms. Spina had to include the $950,000 or so of attorneys' fees in her gross income and pay tax on the combined total of approximately $1.25 million,[10] even though she never saw any of the nearly $1 million fee. Her attorneys also had to pay tax on the $950,000 fee, resulting in double taxation.[11]

The Seventh Circuit is not alone in adopting the IRS' position that contingent attorneys' fees must be included in the successful litigant's gross income. It is joined by the First, Second, Third, Fourth, Eighth, Ninth, Tenth, and Federal Circuits.[12] The Second Circuit refers to this, appropriately, as the "majority position,"[13] which the IRS is quick to point out.[14]

The "minority position," that contingent attorney fees are income to the attorneys and not the taxpayer, is held by the Fifth, Sixth, and Eleventh Circuits.[15] The Ninth Circuit, it should be pointed out, is itself split, having taken both positions, depending on how the state law involved treated the contingent-fee agreement.[16]

With such an obvious circuit split, many had wondered if and when the Supreme Court would weigh in and settle the issue.[17] No less than five times the Supreme Court had refused to grant certiorari to resolve this split.[18]

In 2004, however, the Supreme Court finally granted certiorari in two cases: *Banks* from the Ninth Circuit and *Banaitis* from the Sixth

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[10]*See* Liptak, *supra* note 3, at 18.

[11]*Id.*

[12]Robert W. Wood, *Everybody Loves Raymond? Second Circuit Further Fouls Tax Treatment of Attorney Fees*, 2004 TAX NOTES TODAY 54-30 (Mar. 19, 2004); *see, e.g.*, Raymond v. United States, 355 F.3d 107 (2d Cir. 2004); Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); Bagley v. Comm'r, 121 F.3d 393 (8th Cir. 1997); Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995); Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir.), *cert. denied*, 375 U.S. 930 (1963).

[13]*Raymond*, 355 F.3d at 109.

[14]Brief for the Petitioner at 22-23, Comm'r v. Banks, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907).

[15]*Raymond*, 355 F.3d at 110.

[16]*Id.*; *compare* Benci-Woodward v. Comm'r, 219 F.3d 941, 943 (9th Cir. 2000) (contingent attorney fees includable under California law) *with* Banaitis v. Comm'r, 340 F.3d 1074, 1081 (9th Cir. 2003), *cert. granted* 541 U.S. 958 (2004) (contingent attorney fees not includable under Oregon law).

[17]*See* Wood, *supra* note 12.

[18]*See, e.g.*, Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir.), *cert. denied*, 375 U.S. 931 (1963).

Circuit,[19] and considered them in its fall 2004 term.[20] Both cases had sided with the "minority" and ruled that contingent attorney fees were not includable in the successful litigant's gross income.[21]

It is of interest that the Supreme Court had denied certiorari in five cases that were decided in favor of the IRS,[22] but granted certiorari in two cases in which the IRS lost. One had to wonder if this was a signal that the Supreme Court wished to confirm the majority view and hold that contingent attorney fees should be included in the taxable income of the successful litigant. Or, as one writer suggested, perhaps the Supreme Court had denied certiorari in the past simply because it had "reasoned that these tax decisions could be based on the vagaries of how attorneys' liens are treated under applicable state law," and so did not see any federal issue.[23]

Whatever its reasons in the past, the Supreme Court had the opportunity to resolve the contingent attorney fee issue and bring consistency to the federal judiciary. As things stood then, litigants did not know how a case may turn out. Would a circuit court's decision depend on the choice of state law regarding attorney fee agreements as in the Ninth Circuit? Would a litigant try to find a way to have her case heard in one of the minority circuits so as to avoid the unjust result that Officer Spina endured, winding up worse off than if she had never filed suit in the first place?[24] The chilling effect this could have on individuals seeking justice through the courts could not be ignored.[25]

Although there were those who proposed a legislative solution

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[19]Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *cert. granted* 541 U.S. 958 (2004); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *cert. granted* 541 U.S. 958 (2004).

[20]*Hearings*, 2004 TAX NOTES TODAY 200-43 (Oct. 14, 2004). The taxpayer in *Raymond*, dissatisfied with the outcome in his Second Circuit trial, has petitioned for certiorari as well, but as of this writing, the Supreme Court has not granted it. Robert W. Wood, *Settlements and Judgments: Attorney Fees and Section 104 Cases*, 104 TAX NOTES 733, 734 (Aug. 16, 2004).

[21]*Banks*, 345 F.3d at 389; *Banaitis*, 340 F.3d at 1083.

[22]*See, e.g.*, Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); Benci-Woodward v. Comm'r, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); Coady v. Comm'r, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); O'Brien v. Comm'r, 319 F.2d 532 (3d Cir.), *cert. denied*, 375 U.S. 931 (1963).

[23]Robert W. Wood & Dominic L. Daher, *Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law*, 101 TAX NOTES 1427 (Dec. 22, 2003).

[24]*Id.*

[25]*See* Liptak, *supra* note 3, at 18 (noting Spina's attorney's belief that the tax laws will result in fewer civil rights cases).

through Congress,[26] this did not seem likely in the near term.[27] The Senate had passed the Jumpstart Our Business Strength (JOBS) bill in May of 2004 that would exclude attorneys' fees from gross income in cases involving employment disputes,[28] but no conferencing on the bills had occurred until late September 2004, with the Court scheduled to hear the case November 1.[29]

On October 11, however, less than two weeks afer conferencing began, Congress passed the American Jobs Creation Act, which the president signed into law on October 22, 2004.[30] The Act at § 703 amended the Internal Revenue Code by adding to it § 62(a)(19).[31] The new section allows a taxpayer to deduct "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination."[32] "Unlawful discrimination" includes 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."[33]

Since *Banks* involved a federal employment discrimination claim under Title VII of the Civil Rights Act of 1964, as amended, and *Banaitis* involved state claims for tortious interference with an employment contract and wrongful discharge, they would have been covered by the Act.[34] The Court noted, however, that the Act was not retroactive, which explains why

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[26]*See* Christopher W. Hesse, *CPA Suggests Resolution of Attorney Fees Issue for AMT Purposes Through Legislation*, 2004 TAX NOTES TODAY 1-32 (Jan. 2, 2004) (encouraging the IRS "to seek legislation if necessary, changes in regulations if possible").

[27]*See* Robert W. Wood, *Tax Treatment of Attorneys' Fees*, 2003 TAX NOTES TODAY 94-128 (May 15, 2003) (noting the "quagmire that might be expected on the legislative front" and that "any legislative remedy . . . would not evolve quickly"); Reply Brief for the Petitioner at 9, Comm'r v. Banks, 125 S. Ct. 826 (Mar. 11, 2004) (Nos. 03-892 & 03-907) (stating that "it is far from clear that [the Jobs Act] will ever be enacted into law, much less enacted soon enough tor educe the need for this Court's review").

[28]*See* Reply Brief for the Petitioner at 18, Comm'r v. Banks, 125 S. Ct. 826 (Sept. 22, 2004) (Nos. 03-892 & 03-907); *see also* S. 1637, 108th Cong. § 643 (May 11, 2004).

[29]*See* http://thomas.loc.gov/cgi-bin/bdquery/z?d108:HR04520:@@@x7 (last visited Oct. 6, 2005); *supra* note 20 and accompanying text.

[30]American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418; Joint Supplemental Brief for Respondents at 1, Comm'r v. Banks, 125 U.S. 826 (U.S. 2004) (Nos. 03-892 & 03-907).

[31]118 Stat. 1546 .

[32]*Id.*

[33]*Id.* at 1547-48.

[34]Comm'r v. Banks, 125 S. Ct. 826, 831 (2005) (stating that if the Jobs Act had been in effect "for the transactions now under review [*Banks* and *Banaitis*], these cases likely would not have arisen").

the Court heard oral arguments and decided the case.[35]

In its opinion, the Court held that, "as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits."[36] "As a general rule" suggests there are exceptions, such as employment discrimination cases like *Banks* and *Banaitis*, and federal whistle-blower and civil rights cases that are now covered by the Jobs Act.[37] In these cases, the attorneys' fees are not included in the income of the successful litigant.[38]

More important, however, there are those cases not reached by this decision because they fall outside the Jobs Act: defamation, false imprisonment, and emotional distress cases, not to mention those that involve punitive damages.[39] These cases would appear to be subject to the "old rules," including the assignment-of-income doctrine discussed *infra* Part II.[40]

The same is true for cases decided before the Jobs Act was passed but are as yet unresolved, the Act is not retroactive.[41] It applies to cases where judgment is rendered after October 24, 2004. Judicial uncertainty among the circuits in these cases as to whether to include contingent attorneys' fees in gross income will likely remain.

This note, therefore, takes the position that Banks and Banaitis should have won. Contingent attorneys' fees should be excluded from the successful litigant's gross income in *all* cases, not just those addressed by the Jobs Act. To that end, a consideration of the relevant tax code provisions, including the case law relied on by both the IRS and the majority and minority circuits, will follow. Next, an analysis of the arguments of Banks and Banaitis, both at the circuit level and before the Supreme court, as well as the IRS's argument before the Supreme Court,

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[35]*Banks*, 125 S. Ct. at 831. The IRS could have also provided administrative relief through issuance of a Notice that declared contingent attorneys' fees in such cases an "above-the-line" deduction, effectively removing the fees from the gross income of the successful claimant. Wood, *supra* note 27. Given the fact, though, that it was the IRS itself that was petitioning the Supreme Court to reverse *Banks* and *Banaitis*, it was unlikely that the IRS was going to issue such notice. *See* Petitioner's Brief, *Banks* (No. 03-892 & 03-907).

[36]*Banks*, 125 S. Ct. at 829.

[37]118 Stat. 1547-48.

[38]*Id.* at 1546.

[39]*Id.* at 1547-48; *see also* Robert W. Wood, *Supreme Court Attorney Fees Decision Leaves Much Unresolved*, 2005 TAX NOTES TODAY 24-67 (Feb. 7, 2005) (noting "it is unclear just how far the 'general rule' announced by the Court goes").

[40]*See infra* Part II and *infra* text accompanying notes 51-58.

[41]*Banks*, 125 S. Ct. at 832; *see* Wood, *supra* note 27.

will be considered. Finally, an evaluation of these arguments follows, including a discussion of some of the amicus legal theories, leading to the conclusion that contingent attorneys' fees should not be included in the successful litigant's gross income.

II. BACKGROUND: WHOSE INCOME IS IT?

"Gross income" is defined in section 61(a) of the Internal Revenue Code of 1986 (IRC) as "all income from whatever source derived."[42] The Supreme Court has broadly construed this equally broad definition as Congress' intent to exert "the full measure of its taxing power" through this statute[43] and "to tax all gains except those specifically exempted."[44]

The Court itself in *Glenshaw Glass* provided an oft-quoted definition of income: "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[45] Justice Holmes provided a similar definition: "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."[46]

As can be seen from the foregoing, what constitutes income is largely a matter of judicial interpretation as opposed to clear statutory definition. When, for example, is income "clearly realized" as in *Glenshaw Glass*?

According to the court in *Raymond*, "a gain is taxable not when the taxpayer acquires the right to receive it, but rather when the taxpayer receives the benefit of it."[47] So, when a corporation paid its president's income taxes, the Court held that this was taxable income to him, since he realized the benefit the same as if he had received the money himself and then paid his own taxes.[48] The money did not have to pass through his hands in order for him to benefit.[49]

This judicial interpretation has led to the important legal rule that income is taxed to the person who earns it.[50] This, in turn, forms the basis of what has been called the "anticipatory assignment-of-income doctrine,"[51]

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[42]26 U.S.C. § 61(a) (2004).

[43]Helvering v. Clifford, 309 U.S. 331, 334 (1940).

[44]Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955).

[45]*Id.* at 431.

[46]Corliss v. Bowers, 281 U.S. 376, 378 (1930).

[47]Raymond v. United States, 355 F.3d 107, 111 (2d Cir. 2004) (citing Helvering v. Horst, 311 U.S. 112, 115 (1940)).

[48]Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929).

[49]*See Horst*, 311 U.S. at 116.

[50]Lucas v. Earl, 281 U.S. 111, 114-15 (1930).

[51]Srivastava v. Comm'r, 220 F.3d 353, 363-64 (5th Cir. 2000).

or just the "assignment-of-income doctrine."[52]

The doctrine was derived from primarily two Supreme Court cases: *Earl* and *Horst*. In *Earl*, a husband and wife agreed by valid contract in 1901 (prior to the adoption of the federal income tax) to have all property, including salaries, received by them during their marriage to be owned as joint tenants, essentially assigning half of Mr. Earl's salary to his wife.[53]

The Court held that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."[54] The Court referred to the type of contract the Earls had as an "arrangement by which the fruits are attributed to a different tree from that on which they grew."[55]

In *Horst*, the taxpayer owned negotiable bonds and detached the interest coupons, making them a gift, or, in other words, assigning them, to his son.[56] The Court reversed the court of appeals decision that the interest was taxable to the son, holding that *Earl* applied, and that there was no "adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions."[57] The Court once again held that "the fruit is not to be attributed to a different tree from that on which it grew."[58]

III. ANALYSIS: GOVERNING STATE LAW, JOINT VENTURE, OR A "*HORST*-CASE" SCENARIO?

A. *The IRS and Majority View*

The assignment-of-income doctrine is a key argument of the IRS[59] and the majority circuits in holding that contingent attorneys' fees should be included in the successful litigant's gross income.[60] They reason, as in

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[52]Petitioner's Brief at 18, *Banks* (No. 03-892 & 03-907).

[53]*Earl*, 281 U.S. at 113-14. The agreement was still in effect in 1920 and 1921, the years in question in this case.

[54]*Id.* at 114-15.

[55]*Id.* at 115.

[56]*Horst*, 311 U.S. at 114.

[57]*Id.* at 120.

[58]*Id.*

[59]*See* Petitioner's Brief at 18, *Banks* (No. 03-892 & 03-907) (listing as heading B.1.: "The Assignment-of-Income Doctrine Ensures Taxation of Income To The Person Who Earns It Or Is The Source Of The Right To Receive And Enjoy It").

[60]*See, e.g.*, *Raymond*, 355 F.3d at 117 (holding that "determining to whom income flows depends in large part upon who controls the source of the income"); *Baylin*, 43 F.3d at 1455 (holding "[t]hat the partnership assigned a portion of its condemnation recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged

Horst, that even if the attorneys' portion of the judgment or settlement is paid directly to the attorneys, the money is part of the "fruit of the taxpayer's tree," having been "realized" by him and then paid to the attorney.[61]

As Justice Stone wrote in his majority opinion in *Horst*, "Even though [Horst] never receives the money he derives money's worth from the disposition of the [interest] coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth."[62] Or, as the IRS has put it: "It is axiomatic that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else."[63]

Consequently, the IRS and the majority circuits would have the taxpayer (not covered under the Jobs Act) include the attorneys' fees in gross income, but then deduct the legal expenses as a miscellaneous itemized deduction.[64] Although this seems reasonable on its face, in reality, there are limitations on how much of the attorneys' fees can be deducted. These limitations stem from three provisions of the IRC: (1) a two-percent "floor" for miscellaneous itemized deductions,[65] (2) a limitation on itemized deductions overall,[66] and (3) a provision of the much-maligned alternative minimum tax (AMT).[67]

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to the partnership"); *see also* Robert W. Wood, *More Confusion on Tax Treatment of Attorneys' Fees: Whose Law Applies?*, 2003 TAX NOTES TODAY 109-2 (June 6, 2003) (stating that "[a] primary rationale used (so far) in determining whether the attorneys' fees constitute income to the plaintiff is the assignment of income doctrine").

[61]*Horst*, 311 U.S. at 116-17.

[62]*Id.* at 117.

[63]Petitioner's Brief at 18, *Banks* (No. 03-892 & 03-907).

[64]*See* 26 U.S.C. § 67(b) (2004); see *also Benci-Woodward*, 219 F.3d at 944 (stating that "[m]iscellaneous itemized deductions are defined as those itemized deductions that are not specifically enumerated within section 67(b)" and that "[l]egal expenses are not so enumerated and thus are classified as miscellaneous itemized deductions.").

[65]Section 67(a) reads: "In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." 26 U.S.C. § 67(a) (2004).

[66]Section 68(a) states:

> In the case of an individual whose adjusted gross income exceeds the applicable amount, the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of—
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> (1) 3 percent of the excess of adjusted gross income over the applicable amount, or
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> (2) 80 percent of the amount of the itemized deductions otherwise allowable for such taxable year.

Id. § 68(a). The applicable amount for 2004 is $142,700 ($71,350 for a married taxpayer filing separately).

[67]Section § 56(b)(1) reads in part: "No deduction shall be allowed-(i) for any miscellaneous itemized deduction (as defined in section 67(b))." 26 U.S.C. § 56 (b)(1) (2004).

It is the application of these provisions, particularly the one attributed to the AMT, that has resulted in cases such as *Spina* mentioned above. National Taxpayer Advocate Nina Olson has stated that the exclusion of miscellaneous itemized deductions under the AMT "may result in the combined attorney fees and tax on the settlement or award consuming the majority, or possibly all, of the damages received by the taxpayer."[68]

In effect, then, the taxpayer must include attorneys' fees in gross income, but does not get to deduct from gross income the costs associated with the earning of that income to arrive at a correct picture of the taxpayer's true net gain. Instead, the taxpayer is taxed as if she had earned the entire amount as a settlement or award without any cost of doing so and is then forced to pay tax on that amount.

While some of the majority circuits have acknowledged the apparent unfairness of this outcome,[69] others have essentially said, "So, what?" As Judge Posner wrote in *Kenseth*, "[M]any of the expenses of producing [Kenseth's] income, such as the cost of commuting, would not have been deductible. So incomplete deductibility here is not surprising or anomalous or inappropriate."[70] He further stated with reference to the non-deductibility of attorneys' fees under the AMT: "[T]he idea behind the tax is of course to limit otherwise allowable deductions, so that, to put it crudely, everybody who has income pays some federal income tax."[71] Not surprisingly, the IRS has quoted Judge Posner's comments with approval.[72]

The IRS also rejects the claim that making both the taxpayer and the attorneys include the legal fees in gross income results in double taxation.[73] Instead, the IRS compares the situation to someone who earns salary income and then hires a plumber to perform plumbing services, paying the plumber with a portion of her salary.[74] The taxpayer paid tax on that portion of her salary used to pay the plumber, and the plumber rightly

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[68]National Taxpayer Advocate's FY 2002 Annual Report to Congress, *Section* 2, at 161; *see also* Robert W. Wood, *Tax Treatment of Attorneys' Fees*, 2003 TAX NOTES TODAY 94-128 (May 13, 2003) (noting the unfairness of the inability of many plaintiffs to deduct attorney fees); Porter v. U.S. Agency for Int'l Dev., 293 F. Supp. 2d 152, 155 (D.D.C. 2002) ("[T]he deduction [of attorneys' fees] will not be available if the Alternative Minimum Tax ('AMT') is triggered. The unhappy result is (or theoretically can be) that the tax consequences of an award of compensatory damages can seriously diminish or even exceed the award.").

[69]*See, e.g.*, *Alexander*, 72 F.3d at 946 (calling it "unfortunate" that "the outcome smacks of injustice because Taxpayer is effectively robbed of any benefit of the Legal Fee's below the line treatment").

[70]*Kenseth*, 259 F.3d at 884.

[71]*Id.*

[72]Petitioner's Brief at 34-35, *Banks* (No. 03-892 & 03-907).

[73]*Id.* at 34.

[74]*Id.*

includes in his gross income the fee for services rendered and is taxed on it. The resulting tax to both the taxpayer and the plumber is "neither anomalous or harsh," the IRS has said, "but is instead a commonplace result inherent in the very nature of an income tax."[75]

B. *The Minority View*

The minority courts have taken a different view of the contingent-attorney-fee issue. They have held that attorneys' fees are not income to the plaintiff, determined largely by how state law governing the case treats the attorney's fee agreement with the plaintiff.[76] As the court in *Raymond* held, "state law determines the nature of legal interests in property, while federal law determines the tax consequences of the receipt or disposition of property."[77]

The minority courts have typically examined the state law governing the case to determine if the attorney has a strong enough interest in the contingency fee to consider it a property interest "exclusive of the client's interest."[78] If so, then "these courts conclude that the fee was never income to the client, but only to the attorney."[79]

The leading case among the minority circuits is *Cotnam*, a 1959 Fifth Circuit decision,[80] and the first case to rule on the inclusion or exclusion of contingent attorneys' fees in the successful litigant's gross income.[81] Edna Cotnam had been promised one-fifth of the estate of T. Shannon Hunter "if she would serve him as an attendant or friend for the rest of his life."[82] She did so, and after winning her suit against his estate (Hunter died without a will), she was awarded $120,000 and had attorneys' fees of approximately $50,000.[83]

The court determined that the $120,000 was taxable income and not a bequest, since she had to carry out services under a contractual arrangement with Mr. Hunter in order to receive it.[84] The majority of the court, however, held that attorneys' fees should not be included in her gross income, finding that "[t]his sum was income to the attorneys but not to Mrs.

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[75] *Id.*
[76] *See, e.g.*, *Raymond*, 355 F.3d at 110.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959).
[81] *Banks*, 345 F.3d at 383.
[82] *Cotnam*, 263 F.2d at 120.
[83] *Id.* a 120-21.
[84] *Id.* at 125.

Cotnam."[85]

The court's decision was based on the Alabama Code, which stated in part that "attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them."[86] In short, the court said, "[a]ttorneys have the same rights as their clients."[87] The attorney therefore has an "equitable lien" against the recovery, giving him a "right of set-off" for his fees once that lien attached.[88] Consequently, in the court's view, Mrs. Cotnam "did not realize income as to her attorneys' interests of 40% in her cause of action and judgment."[89] Interestingly, the court distinguished *Cotnam* from *Horst*, holding that Mrs. Cotnam had not "'fully enjoyed the benefit of his (her) economic gain represented by his (her) right to receive income' within the doctrine" of *Horst*.[90] The court went on to state that the *Horst* doctrine "can have no just or realistic application to a case like this, where the only economic benefit to the taxpayer was an aid to the collection of a part of an otherwise worthless claim."[91]

Instead, the court credited the services of her attorneys in bringing the claim to fruition, stating that "she could never have collected anything or have enjoyed any economic benefit unless she had employed attorneys, and to do so, she had to part with forty per cent of her claim long before the realization of any income from it."[92] The court stated that it would be both "illegal" and "unjust" to tax her on her attorneys' fees, "which did not pass through her hands and of which she never had control."[93]

The *Cotnam* court also rejected the Commissioner of Internal Revenue's argument based on *Old Colony*[94] that "payment of the attorneys' fees was a legal obligation," and that discharge of that obligation by the judgment proceeds was equivalent to the receipt of the attorneys' fees.[95] In the court's view, Mrs. Cotnam had not obligated herself to pay the attorneys' fees, and that

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[85] *Id.*

[86] *Cotnam*, 263 F.2d at 125 (citing 46 ALA. CODE § 64(2) (1940)). The full statute also included the following: "Upon suits, judgments and decrees for money, they shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied."

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Cotnam*, 263 F.2d at 126.

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] *See Old Colony*, 279 U.S. at 729.

[95] *Cotnam*, 263 F.2d at 126.

> [t]heir fee was contingent upon success, and was fully paid by the assignment of a portion of a doubtful claim. Mrs. Cotnam's tree had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit.[96]

Cotnam is an important case for at least three reasons: (1) its treatment of attorneys' fees as the assignment of a property right,[97] as opposed to the IRS' position that fees are a debt, and that an attorney is a lienholder[98] who is paid by an assignment of income;[99] (2) its holding that contingent fees are an uncertainty, and that without the services of skillful attorneys, the plaintiff would not have recovered anything;[100] and (3) its reliance on the strength of the governing state's attorney lien laws.[101] The now-familiar tree/fruit analogy was also used in *Cotnam*, only it was "part interest in that tree" that was being transferred as opposed to the fruit.[102]

Courts that have decided the fee-inclusion issue in favor of the taxpayer have generally included one or more of these lines of reasoning from *Cotnam* as the basis for their decision.[103] The court in *Estate of Clarks*, for instance, the next big case in favor of the exclusion of contingent attorneys' fees, determined that the contingency fee is "more like a division of property than an assignment of income."[104] It also held that "the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel."[105] Both of these holdings were similar to *Cotnam* as noted above.

The *Clarks* court also found the fact that there was no tax avoidance

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[96]*Id.* (citation omitted).

[97]*Id.* at 125; *see also* Wood, *supra* note 60 (observing that "the Minority tends to view a contingent fee agreement as an assignment of a property right").

[98]Petitioner's Brief at 13, *Banks* (No. 03-892 & 03-907).

[99]*See* Wood, *supra* note 60 (stating that "the Majority tends to view the [contingent fee] arrangement as an assignment of income").

[100]*Cotnam*, 263 F.2d at 126.

[101]*Id.* at 125.

[102]*Id.* at 126.

[103]*See, e.g.*, Foster v. United States, 249 F.3d 1275, 1280 (11th Cir. 2001) (noting the uncertainty of the collection of the contingent attorney fee, and holding that it was "due to the hard work and expertise of the attorney that he is paid, and the attorney accordingly pays income taxes on the fees collected"); Davis v. Comm'r, 210 F.3d 1346, 1348 (11th Cir. 2000) (holding that "Cotnam v. Commissioner is controlling" in deciding that contingent attorneys' fees should be excluded from the taxpayer's gross income).

[104]Estate of Arthur L. Clarks v. United States, 202 F.3d 854, 857-58 (6th Cir. 2000).

[105]*Id.* at 857.

purpose involved in the case persuasive.[106] This would distinguish *Clarks* from *Earl* and *Horst* where there was a shifting of tax liability to a family member, thus reducing the shifter's tax liability.[107] Additionally, in *Earl* and *Horst*, the recipients of the income were not taxed, but only the donor was.[108] The court was therefore concerned that including the attorneys' fees in the taxpayer's income would result in double taxation.[109]

Clarks introduced another line of reasoning, however, that has also influenced subsequent cases, including *Banks* and *Banaitis*, the two cases granted certiorari by the Supreme Court.[110] The *Clarks* court analogized the contingent fee agreement between attorney and client to "an interest in a partnership agreement or joint venture."[111] The court reasoned that, like a joint venture, "Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds."[112] Clarks' assignment therefore "operated as a lien on a portion of the judgment sought to be recovered transferring ownership of that portion of the judgment to the attorney."[113]

So, instead of transferring only a part interest in the tree as in *Cotnam*,[114] "here the client as assignor has transferred *some of the trees* in his orchard, not merely the fruit from the trees."[115] The attorney was likened by the court to "a tenant in common of the orchard owner [who] must cultivate and care for and harvest the fruit of the entire tract."[116] By way of further analogy, the court compared the situation to a "transfer of a one-third interest in real estate that is thereafter leased to a tenant," finding there was no difference between the two.[117] Consequently, the court said, the income is charged to the one who earns it and "not as under the government's theory of the case, to one who neither received it nor earned it."[118]

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[106] *Id.* at 858.

[107] *Id.* at 857.

[108] *Clarks*, 202 F.3d at 857 (noting that the recipients were donees and therefore not taxed on their gifts).

[109] *Id.*

[110] Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003), *cert. granted* 541 U.S. 958 (2004); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003), *cert. granted* 541 U.S. 958 (2004).

[111] *Clarks*, 202 F.3d at 857.

[112] *Id.*

[113] *Id.*

[114] *Cotnam*, 263 F.2d at 127.

[115] *Clarks*, 202 F.3d at 858 (emphasis added).

[116] *Id.*

[117] *Id.*

[118] *Id.*

C. Banks/Banaitis v. IRS: *Arguments Before the Supreme Court*

Although the Supreme Court consolidated the *Banks* and *Banaitis* cases, the respondents in each case presented different arguments, the Court having granted a motion for divided argument.[119] A consideration of these arguments will follow, along with the IRS response.

1. *Banks*: Assignment-of-Income Doctrine Does Not Apply

Employee John Banks brought suit against his former employer, the California Department of Education, for employment discrimination under Title VII of the Civil Rights Act of 1964 as a result of his termination in 1986.[120] The suit was settled out of court for $464,000.[121] Banks had entered into a contingent attorney's fee agreement with his attorney prior to the lawsuit, and $150,000 of the settlement proceeds was paid to the attorney.[122]

The Commissioner of Internal Revenue sent Banks a deficiency notice in 1997, which asserted that the contingent fee paid out of proceeds was taxable income to Banks, and that he owed an additional $101,168.[123] Banks appealed to the U.S. Tax Court, which held that the contingent fee "was not excludable from income" and adjusted the deficiency in tax down to $99,068.[124]

Banks then appealed to the Sixth Circuit, which sided with *Cotnam* and *Estate of Clarks*, holding that (1) the anticipatory assignment-of-income doctrine did not apply,[125] (2) the claim was "an intangible, contingent expectancy" brought to fruition by the attorney's "own skill and judgment," (3) the claim was "like a partnership or joint venture" in which Banks transferred a third of his "trees from the orchard, rather than simply transferring some of the orchard's fruit," in order to recover two-thirds of his claim, (4) there was "no tax avoidance purpose," and (5) "double taxation would otherwise result" if the fees were included in Banks' gross income.[126] In a surprising move, the *Banks* court also held that "the *Estate of Clarks* holding does not primarily rest on the rationale that separate state lien laws governing attorneys' rights determine the correct characterization

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[119] *See* Comm'r v. Banks, 125 S. Ct. 28 (2004).
[120] Brief for the Respondent at 2, Comm'r v. Banks, 125 S. Ct. 826 (2004) (No. 03-892).
[121] *Id.*
[122] *Id.*
[123] *Banks*, 345 F.3d at 377.
[124] *Id.*
[125] *Id.* at 383-84.
[126] *Id.* at 386.

of an attorney contingency fee."[127] Consequently, although California's attorney lien law was different from Michigan's and Alabama's, the court was going to follow its own precedent "without protracted inquiries into 'the intricacies of an attorney's bundle of rights.'"[128] The court therefore agreed with the court in *O'Brien*, which held that it doubted "that the Internal Revenue Code was intended to turn upon such refinements."[129]

This decision effectively decoupled governing state law from the issue of whether attorneys' fees should be included in a taxpayer's gross income, thus allowing the issue to turn on federal law. Consequently, in Banks' brief before the Supreme Court, no argument was made regarding California's attorney lien law.[130]

Instead, he made essentially nine arguments against the inclusion of attorneys' fees in the gross income of the successful litigant. First, he noted that nowhere in the Internal Revenue Code is it required that a federal employment discrimination plaintiff include in his income "the portion of his settlement earned by, retained by, and taxed to his attorney as a contingent fee."[131] Thus, whether the contingent attorneys' fees are income to Banks "must be based on judicial interpretation of the term 'income'."[132]

Second, Banks argued that he lacked both control and beneficial ownership of the contingent fee, quoting the Court in *Sunnen* that the "crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes."[133] Banks claimed that, by virtue of the contingent fee contract with his attorney, he "ceded substantial control over his lawsuit, and *all* control over the portion attributable to the contingent fee earned and retained by his attorney."[134]

Thus, Banks asserted that his case was distinguishable from *Earl* and *Horst*. In *Earl*, the taxpayer retained "total control over the income flow at the time of assignment [of income]."[135] In *Horst*, the assignment of interest coupons to his son demonstrated Horst's control over them and "the power to command its payment to others, which constituted an economic

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[127]*Banks*, 345 F.3d at 386.

[128]*Id.* (citing *Srivastava*, 220 F.3d at 64).

[129]*Id.* at 385 (citing O'Brien v. Comm'r, 38 T.C. 707, 712 (T.C. 1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963)).

[130]Respondent's Brief at 3-9, *Banks*, (No. 03-892).

[131]*Id.* at 4.

[132]*Id.* at 9.

[133]Respondent's Brief at 11, *Banks* (No. 03-892) (quoting Comm'r v. Sunnen, 333 U.S. 591, 604 (1948)).

[134]Respondent's Brief at 17, *Banks* (No. 03-892).

[135]*Id.* at 12.

gain to him."[136] Unlike Banks, however, Horst's interest payments were a virtual certainty, and he retained the right to all future income.[137]

His third argument reasoned that the contingent nature of the agreement rendered the relationship of Banks and his attorney as "effectively that of joint venturers."[138] Banks stated four elements of a joint venture that applied in this case: (1) the "client contribute[d] the inchoate claim," and the attorney contributed his skill and effort; (2) the attorney, not the client, earned the contingent fee, unlike *Earl*, "where it was the *assignor*, not the assignee, who earned the income subject to assignment;" (3) the attorney also faced the substantial risk that, if he lost, he would recover nothing; and 4) "the attorney ha[d] a *bona fide* property interest in the contingent fee portion of the recovery."[139]

Fourth, Banks referred to the "fee-shifting" provisions of his Title VII discrimination claims as a basis for not including the fees in his income.[140] Had he won his federal district court suit instead of settling, Banks could have had his attorney's fees awarded as part of the judgment. He argued that since fees awarded under these statutes are not income to the successful litigant, his attorneys' fees should not be included in his gross income simply because his employer chose to settle rather than face potential liability for these fees at trial.[141]

In his fifth argument, which was essentially policy based, Banks referred to the "absurd and grievously unjust" result under *Spina*.[142] He argued that the IRS' position would have the "chilling effect of discouraging federal civil rights plaintiffs from bringing meritorious claims."[143]

Sixth, Banks then characterized the assignment-of-income doctrine as a "court-created anti-abuse rule that does not apply to an attorney contingent fee contract."[144] He claimed that the rule was "designed to prevent high bracket taxpayers from shifting income to lower bracket

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[136]*Id.* at 12-13 (quoting *Horst*, 311 U.S. at 115).

[137]*Id.* at 12.

[138]Respondent's Brief at 16, *Banks* (No. 03-892).

[139]*Id.*

[140]*See* 42 U.S.C. §§ 1988, 2000e-5(k) (West 2002). In this country, litigants generally pay their own attorneys' fees, the so-called "American rule." Fee-shifting statutes allow the courts to award attorneys' fees to the successful litigant, to be paid by the losing party. *See* Sierra Club v. City of Little Rock, 351 F.3d 840, 844-45 (8th Cir. 2003) (observing that "[u]nder the American Rule, parties to a lawsuit generally foot their own attorney fees 'absent explicit statutory authority' to the contrary") (quoting Buckhannon Bd. & Care Home, Inc. v. W.V. Dep't of Health & Human Res., 532 U.S. 598, 602 (2001)).

[141]Respondent's Brief at 5, *Banks* (No. 03-892).

[142]*Id.* at 20.

[143]*Id.* at 22.

[144]*Id.* at 23.

family members to avoid paying income tax at a higher marginal rate."[145] Because there was no "tax avoidance purpose," the assignment-of-income doctrine did not apply here.[146]

An additional argument against the assignment-of-income doctrine, Banks maintained, was that the IRS issued a private letter ruling in July of 2004, which stated:

> [I]n general, a transferor who makes an effective transfer of a claim in litigation to a third person prior to the time of the expiration of appeals in the case is not required to include the proceeds of the judgment in income under the assignment-of-income doctrine because such claims are contingent and doubtful in nature.[147]

Banks cited the private letter ruling not as precedent, but merely to show the IRS' inconsistent position on this issue.[148] Interestingly, the ruling also agreed with the Fifth Circuit's decision in *Cotnam*, which held: "It was doubtful and uncertain as to whether [the claim] had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder."[149]

For his seventh argument before the Court, Banks maintained that he and his attorney never had a debtor-creditor relationship, there was no discharge of a debt involved when the attorney received his fee, and therefore *Old Colony*[150] should not apply.[151] The absence of debt was further corroborated by the fact that, if the attorney lost the case, no fee was owed.[152]

Banks argued next that accepting double taxation as "neither anomalous nor harsh" or as a "commonplace result inherent in the very nature of an income tax," as the Commissioner contended, was mistaken.[153] Rather, Banks asserted that the Court itself "has long taught that double taxation will not be presumed absent a clear expression of congressional

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[145]Respondent's Brief at 24, *Banks* (No. 03-892).

[146]*Id.*

[147]I.R.S. Priv. Ltr. Rul. 200427009, at 6 (July 2, 2004).

[148]Respondent's Brief at 30, *Banks* (No. 03-892).

[149]*Id.* at 33 (quoting *Cotnam*, 263 F.2d at 125).

[150]*Old Colony*, 279 U.S. at 729 (holding that money paid by corporation by its president's income taxes was taxable income to the president).

[151]Respondent's Brief at 34-35, *Banks* (No. 03-892).

[152]*Id.* at 35.

[153]*Id.* (quoting Petitioner's Brief at 34, Banks (No. 03-892)).

intent to the contrary."[154] For example, Banks cited the double taxation of corporate dividends as having been explicitly sanctioned by Congress.[155]

Finally, Banks took issue with the *Kenseth* court's view, upon which the Commissioner relied, that contingent fees and hourly fees should be treated the same for tax purposes.[156] He argued that economic reality undercuts that line of reasoning in that the fixed-fee attorney "gets paid regardless of recovery" and "does not incur anything close to the same level of risk as a contingent fee arrangement."[157] If the contingent-fee attorney loses his case, he will not be paid.[158]

Additionally, the client "loses all practical control over that portion of any potential recovery," Banks maintained. As a result, he argued, the client should not be taxed on it.[159]

2. *Banaitis*: A *Cotnam*-Like Decision Based on Oregon State Attorney Lien Law

Banaitis was a wrongful termination suit filed as a result of Banaitis leaving his job with the Bank of California after a forced resignation. The resignation stemmed from his refusal to disclose confidential information to Mitsubishi Bank, which had acquired the Bank of California.[160] Prior to suit, Mr. Banaitis had signed a contingent fee agreement with Merten & Associates for one-third of the payment, if the case was settled prior to trial or arbitration, or for forty percent of the recovery, if the case was litigated.[161]

The case reached the Oregon Court of Appeals, which awarded Banaitis $6,271,389. The Oregon Supreme Court initially granted review, but then dismissed the review as "improvidently granted."[162] Shortly thereafter, Banaitis settled for $8,728,559, with $3,864,012 being paid directly to Merten & Associates as their contingent fee.[163]

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[154] *Id.* at 36; *see, e.g.*, United States v. Hemme, 476 U.S. 558, 572 (1986) (holding that double taxation requires the clear expression of congressional intent); United States v. Supplee-Biddle Hardware Co., 265 U.S. 189, 196 (1924) (averring that double taxation "is to be avoided, unless required by express words"); *see also* Neptune Mut. Ass'n v. United States, 862 F.2d 1546, 1549 (Fed. Cir. 1988) (noting that "[d]ouble taxation is never to be presumed").

[155] Respondent's Brief at 37, *Banks* (No. 03-892).

[156] *Id.* at 38; *see Kenseth*, 259 F.3d at 883.

[157] Respondent's Brief at 39, *Banks* (No. 03-892).

[158] *Id.* at 38-39.

[159] *Id.* at 39.

[160] *Banaitis*, 340 F.3d at 1076.

[161] *Id.* This agreement was later modified to fifty percent of compensatory damages and approximately forty-three percent of any punitive damages.

[162] *Id.* at 1077-78.

[163] *Id.* at 1078.

The IRS sent Banaitis a notice of deficiency disagreeing with both the return as filed and his attached explanation and stating that he owed an additional $1,708,216. The IRS had included in Banaitis' income the attorneys' fees, recalculated his tax allowing for a miscellaneous itemized deduction of $3,105,811 (resulting in $219,568 more in taxable income) and added $288,798 from the AMT calculation.[164]

Banaitis appealed to the Tax Court, which found in favor of the IRS, holding that the attorneys' fees had to be included in his gross income and that he had to pay the tax as calculated by the IRS.[165] Banaitis then appealed to the Ninth Circuit.

The Court of Appeals for the Ninth Circuit applied a basic two-part test: (1) how does state law define the attorney's interests in the action, and (2) how does federal law tax those interests as defined by the state.[166] Under this test, the court held that Oregon's attorney lien law mirrored Alabama's law, being "superior to all other liens" except tax liens.[167] In fact, the court held that "[p]ut simply, Oregon law vests attorneys with property interests that cannot be extinguished or discharged by the parties to the action except by payment to the attorney; as a result, Banaitis' claim under Oregon law is akin to—and even stronger than—the claim in *Cotnam*."[168]

Banaitis' attorneys retained this holding as their secondary argument in their brief before the Supreme Court.[169] Banaitis' principal argument, however, was that the attorney/client fee agreement and subsequent law suit established a joint venture subject to the tax provisions of subchapter K of the IRC, and that the assignment-of-income doctrine did not apply.[170]

As stated in Banaitis' brief, a joint venture involves three elements: "(a) each participant agrees to contribute to the joint effort to generate income, (b) the participants' right to any income depends on the success of the venture, and (c) the amount of each share depends, at least in part, on the total income generated by the venture."[171] When an attorney and his client enter into a contingent fee arrangement, therefore, they have what the court in *Estate of Clarks* referred to as "an intangible, contingent expectancy."[172] A creditor/debtor relationship has not been created.

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[164]*Banaitis*, 340 F.3d at 1078.
[165]*Id.* at 1079.
[166]*Id.* at 1081.
[167]*Id.* at 1082 (citing OR. REV. STAT. § 87.490 (2003)).
[168]*Banaitis*, 340 F.3d at 1083.
[169]Respondent's Brief at 4, *Banaitis* (No. 03-907).
[170]*Id.* at 1-3.
[171]*Id.* at 1.
[172]*Clarks*, 202 F.3d at 857.

Instead, whether the attorney gets paid or not depends on the outcome of the joint venture: the trial and/or negotiations resulting in a settlement.

If the venture is successful, then, under subchapter K, the proceeds are allocated according to the terms of the agreement.[173] Since the proceeds are distributed in this manner, it is irrelevant what the respective state attorney lien law is. The income allocation "is not affected by whether the contribution to the joint venture from one of the parties consisted of a cause of action or any other type of property,"[174] such as a property interest created under the governing state's attorney lien law as in *Cotnam*.

The assignment-of-income doctrine would therefore not apply in this case, Banaitis argued, as the assignment of a joint venturer's respective share is governed under subchapter K, which distributes the income to the attorney and client according to their agreement.[175] It also would not matter which one, the attorney or the client, received the check for the proceeds, as these proceeds would be income to the joint venture, to the partnership, as it were, and not to either participant.[176] Banaitis further distinguished *Earl* and *Horst* in that those cases involved gratuitous transfers to family members and not arm's-length commercial transactions where each party contributed to the production of income.[177] Banaitis did not first earn the income individually and then assign it to a third party.[178]

Instead, the income in this case was "contingent and speculative."[179] In *Earl* and *Horst* the income was either already earned or virtually certain to be earned, as in the case of Horst's bond interest.[180]

Banaitis then argued that the IRS itself has already twice taken the position that the assignment-of-income doctrine does not apply in cases such as this one.[181] He referred first to the recent IRS private letter ruling noted in Banks' brief, where the IRS reasoned that the doctrine did not apply to claims: (1) that are contingent and doubtful, (2) that are non-gratuitous, (3) that were assigned before the tax year in which the income was received, and (4) that had a legitimate business purpose.[182]

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[173]*See* Respondent's Brief at 2-3, *Banaitis* (No. 03-907) (referring to subchapter K, 26 U.S.C. § 702(a) (2004)); *see also* 26 U.S.C. § 704(a) (2004) (partner's distributive share determined by partnership agreement); *id.* § 761(a) (partnership includes joint venture).

[174]Respondent's Brief at 2, *Banaitis* (No. 03-907).

[175]*Id.* at 3, 19.

[176]*Id.* at 18.

[177]*Id.* at 22.

[178]*See* Respondent's Brief at 24-25, *Banaitis* (No. 03-907).

[179]*Id.* at 24.

[180]*Id.* (observing that "[i]n Earl and Horst, the income assigned to the assignee was already earned, vested and relatively certain to be paid") (citing *Clarks*, 202 F.3d at 857).

[181]*Id.* at 25.

[182]Respondent's Brief at 25-26, *Banaitis* (No. 03-907).

Second, Banaitis cited to a another letter ruling, where the IRS maintained that the assignment-of-income doctrine applied "where recovery on the transferred claim is certain at the time of transfer, *but not where recovery on such claim is doubtful or contingent at the time of transfer*."[183] Interestingly, in the case to which this letter ruling applied, the assignment-of-income occurred *after* the awarding of damages to the taxpayer, making Banaitis' position even stronger, since he assigned his income prior to his settlement.[184]

3. The IRS' Position Before the Court

In its brief petitioning certiorari, the IRS trotted out the "usual suspects": *Horst*, *Earl* and the assignment-of-income doctrine already analyzed above.[185] The IRS also found "unavailing" the argument that respondents only had "an 'intangible contingent expectancy' at the time they entered into their contingent fee agreements."[186] It cited *Earl*, stating that "*Earl* itself involved an intangible, contingent interest,"[187] and yet the assignment-of-income doctrine applied in that case.

The IRS called the joint venture argument "equally misguided," characterizing the contingent fee agreement as "merely a promise by the client to pay his attorney a portion of the proceeds as compensation for services rendered; the relationship between the client and his attorney is simply that of debtor and creditor."[188] According to the IRS, the respondents "at all times exercised sufficient power and control over both the underlying causes of action and the receipt of the income."[189] Therefore, in the IRS' view, the proceeds should be treated as the taxpayer's gross income.[190]

Finally, the IRS maintained that Oregon's attorney lien law did not "confer on the attorney any ownership interest in his client's cause of action

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[183]*Id.* at 26-27.

[184]*Id.* at 27. As in Banks' respondent brief, Banaitis also raised the issues of double taxation, hourly fees v. contingency fees (including contractual fees, class-action fees and pro bono cases), and fee shifting statutes. *See id.* at 30, 41-49. Interestingly, Banaitis referred to an appendix to Justice Brennan's dissenting opinion in *Marek v. Chesney*, 473 U.S. 1 (1985), where he listed 119 fee-shifting statutes involving such issues as racial and gender discrimination, fair housing and civil rights. Banaitis maintained that reversal of his case would negatively impact these causes of action, producing a Spina-like result.

[185]Petitioner's Brief at 11-12, *Banks* (No. 03-892 & 03-907).

[186]*Id.* at 12.

[187]*Id.*

[188]*Id.* at 12-13

[189]Petitioner's Brief at 13, *Banks* (No. 03-892 & 03-907).

[190]*Id.*

or otherwise give the attorney control over the action."[191] Instead, Oregon law "defines the attorney's interest in his fees as nothing more than that of a lienholder, not that of a part-owner or co-venturer."[192] The IRS reasoned that, if the attorney is a lienholder, then he cannot be a property owner, as those terms are "mutually exclusive."[193]

In its reply brief, the IRS reiterated these arguments and addressed arguments raised by the respondents and their amici briefs filed subsequent to the IRS' initial brief. The IRS questioned the joint venture argument on the basis that an attorney/client relationship is a principal/agent relationship, not a co-proprietor relationship, citing various authorities to support its view.[194] It also maintained that neither California's nor Oregon's attorney lien laws conveyed any ownership interest in the client's cause of action, and, as stated above, the client and attorney were in a debtor/creditor, principal/agent relationship.[195]

The IRS also claimed that the "theory advanced by respondents and many of the amici" of attorneys being "'true earners' of the litigation proceeds" was without merit.[196] First, the respondents were the ones injured, not their attorneys, the IRS argued, and "it is the injury that gives rise to the cause of action and provides the measure of the damages recovery."[197]

Second, the IRS rejected the premise that the respondents could not have won their suit without the efforts of their attorneys, stating that "[m]any litigants successfully represent themselves."[198] Third, the respondents' inability to obtain their recoveries on their own did not make the contingent-fee portion of the proceeds excludable from their gross income. Had they paid their attorneys an hourly fee, they would have had to use a portion of the recovery to pay their fee.[199] The IRS also argued that the respondents maintained "sufficient control over the contingent-fee portion of the proceeds," and that it was not necessary that they have "unfettered control" after transferring control over the contingent-fee portion to their attorneys.[200] Quoting the Court in *Sunnen*, the IRS stated that "[a]s long as the assignor actually earns the income or is otherwise the

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[191] *Id.*

[192] *Id.*

[193] Petitioner's Brief at 13, *Banks* (Nos. 03-892 & 03-907).

[194] Reply Brief for the Petitioner at 3, *Banks*, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907).

[195] *Id.* at 4-6.

[196] *Id.* at 6.

[197] *Id.* at 7.

[198] Reply Brief for the Petitioner at 7, *Banks* (Nos. 03-892 & 03-907).

[199] *Id.*

[200] *Id.* at 9-10.

source of the right to receive and enjoy the income, he remains taxable."[201]

The IRS also took exception to *Banks*' argument that the assignment-of-income is a "judicially-created, anti-abuse rule."[202] Instead, the IRS stated that the doctrine is based upon section 61(a) of the IRC, that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived."[203] Since contingent attorneys' fees are not "excepted," they should be included in the gross income of the litigant.[204] The IRS further maintained that the payment of the fees to the attorneys by third parties (the unsuccessful litigant) constituted the discharge of a debt, and under *Old Colony*, should be income to the respondents.[205]

There was no "'double taxation' in any meaningful sense" in the government's view,[206] and any inequity that may result from the AMT was a matter for Congress to remedy.[207] The government's position was that any "harshness" that results from the AMT "is mandated by the plain language of the statute."[208]

IV. EVALUATION: *BANKS/BANAITIS* SHOULD HAVE WON (WITH A LITTLE HELP FROM THEIR "FRIENDS")

As previously noted, the Supreme Court held for the IRS and against Banks and Banaitis. But the Supreme Court should have decided this case in their favor and held that, as a matter of subtantive law and policy, contingent attorneys' fees should not be included in the successful litigant's gross income.

A. *Substantive Law:* Banks/Banaitis *and* Blair *Should Control*

The IRC is of little help in determining if contingent fees are includable in gross income to both litigant and attorney.[209] In fact, it is of little help in even determining what gross income is.[210] Thus, as Banks

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[201] *Id.* at 10 (citing Commissioner v. Sunnen, 333 U.S. 591, 604 (1948)).

[202] Reply Brief for the Petitioner at 11, *Banks* (Nos. 03-892 & 03-907); *see* Respondent's Brief at 23, *Banks* (No. 03-892).

[203] Reply Brief for the Petitioner at 11, *Banks* (Nos. 03-892 & 03-907) (quoting 26 U.S.C. § 61(a) (2000)).

[204] *Id.*

[205] *Id.* at 12.

[206] *Id.* at 15; *see supra* text accompanying notes 73-75.

[207] Reply Brief for the Petitioner at 14-15, 17, *Banks* (Nos. 03-892 & 03-907).

[208] *Id.* at 17.

[209] *See supra* Part II.

[210] *Id.*

argued, whether the contingent attorneys' fees are income to the taxpayer "must be based on judicial interpretation of the term 'income'."[211]

More than 200 years ago, the Supreme Court held in *Marbury v. Madison* that "[i]t is emphatically the province and duty of the judicial department to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule. If two laws conflict with each other, the courts must decide on the operation of each."[212]

The Court, as is its province, should therefore have interpreted both the statutes and case law to determine "what the law is" with regard to the inclusion of attorneys' fees in the taxpayer's gross income. Even as the assignment-of-income doctrine was judicially created,[213] the court could have created another doctrine, a "contingent-attorney-fee doctrine," as it were, to resolve this issue.

As a model, the Court should have adopted the holdings of *Banks*, along with the reasoning of both respondents' briefs, and *Clarks*, that contingent agreements create a joint venture between attorney and client.[214] Additionally, *Blair*, a Supreme Court case decided between *Earl* and *Horst* that will be considered below, could also serve as a useful model.[215]

The joint-venture model, as argued by respondents and *Clarks*, presents a more realistic picture of the economic reality of the contingent-fee agreement.[216] The assignment-of-income doctrine, on the other hand, is inapposite, in that it attempts to expand what is essentially an intra-family rule that prevents income-shifting and tax avoidance to include what is an arm's-length business arrangement between attorney and client.[217]

Indeed, not only is this arrangement a commercial transaction, but at the time the contingent fee agreement is entered into there is only, as *Clarks* held, "an intangible, contingent expectancy" of income.[218] No

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[211]*See supra* text accompanying note 132.

[212]5 U.S. 137, 177 (1803).

[213]Respondent's Brief at 23, *Banks* (No. 03-892).

[214]*See supra* text accompanying notes 126, 138 & 170.

[215]Blair v. Comm'r, 300 U.S. 5 (1937).

[216]*See* Respondent's Brief at 38-39, *Banks* (No. 03-892) (citing Michael P. Coyne et al., *Contingent Legal Fees on Settlements and Awards and the Calculation of Gross Income by Individuals for United States Federal Income Tax Purposes*, 2 J. LEGAL TAX RES. 1, 6-7 (2004) (concluding that the Sixth Circuit's view was "more enlightened and more in line with true economic aspects" of the contingent-fee arrangement)).

[217]*See* Respondent's Brief at 21, *Banaitis* (No. 03-907) (stating that *Earl* and *Horst* do not apply to *Banaitis* because "neither of those cases came even close to a relationship in the nature of a partnership or joint venture, where the two taxpayers *jointly* produced income").

[218]*Clarks*, 202 F.3d at 857.

income has as yet been earned and, in fact, may never be.[219]

In contrast, the income at issue in *Earl* and *Horst* was either earned or virtually certain of being earned.[220] The joint-venture model therefore more accurately reflects the "contingent" aspect of contingent-fee agreements than does the assignment-of-income doctrine.

As noted, the IRS itself in at least two Private Letter Rulings has stated that when the amount of a settlement is uncertain at the time the attorney fee agreement is entered into, the taxpayer does not have to include the attorneys' fees in her gross income.[221] In other words, the assignment-of-income doctrine does not apply in instances where there is only an intangible expectancy of income as there was here.[222] These letter rulings clearly demonstrate that the IRS was speaking out of both sides of its mouth, and that its position in respondents' cases was inconsistent and untenable by its own determination.

It should be mentioned, too, that *Horst* has long since been overturned by statute and is no longer the law as to the disposition of unmatured interest coupons (the issue in *Horst*) or the bond itself.[223] Instead, "the basis of the bond is allocated between the retained portion and the portion sold."[224] Although the total income reported remains the same as it would have been in *Horst*, the income "is allocated between the transferor and transferee," rather than "being taxed solely to the transferor."[225]

Evidently, Congress did not like the result in *Horst* and changed the law to more accurately reflect the true economic situation in these cases. This suggests that Congress must have felt that taxing the transferor on what he has transferred was not equitable. The same situation obtains here. The joint-venture model is also more appropriate than the assignment-of-income doctrine in that there is no tax avoidance motive in the contingent fee agreement.[226] The motive is generally economic. The taxpayer cannot afford to pay for his legal defense, upfront or otherwise, so he contracts with the attorney to transfer away a percentage of the proceeds as the

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[219] *Id.* (stating that Clarks only had "a chance to recover the remaining two-thirds" of the suit's proceeds after assigning a one-third interest to his attorney); *see also Cotnam*, 263 F.2d at 125 (referring to her claim as "worthless without the aid of skillful attorneys," and noting that she transferred "a part so that she might have some hope of ultimately enjoying the remainder").

[220] *See supra* note 180.

[221] *See supra* text accompanying notes 181-84.

[222] *See supra* text accompanying note 147.

[223] 26 U.S.C. § 1286 (2000).

[224] MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAX, PRINCIPLES AND POLICIES 504 (rev. 4th ed. 2002).

[225] *Id.*

[226] *Banks*, 345 F.3d at 386.

attorney's share in lieu of receiving hourly fees.[227]

But, in anticipatory arrangements, a husband's transferring half his salary to his wife or some other family member in a lower tax bracket often has a tax avoidance motive.[228] One could potentially assign away income to several family members and seriously reduce one's tax liability. The Commissioner, in fact, advanced that argument as one reason to reverse *Banks* and *Banaitis*.[229] However, since the joint-venture model would be taxed under partnership statutes, as proposed by respondents,[230] the result would be entirely in keeping with the theory that each partner is taxed on his share of the proceeds according to the partnership agreement. In this case, it would be the percentage agreed on in the contingent fee agreement.[231]

Certainly the Commissioner would not argue that partnerships should be disallowed different tax treatment than individuals solely because they can split the tax liability among the partners. Allowing contingent fee agreements to be viewed as joint ventures and taxed as partnerships would have no effect at all on individual taxpayers and would not impact the assignment-of-income doctrine in those cases where it is appropriate.

Petitioner countered, however, that the taxpayer retains control over the suit and the proceeds and is simply paying a debt to his attorney for the fees owed.[232] This is where the holding in *Blair* serves as the appropriate model for characterizing the income under a contingent-fee contract.

In *Blair*, the taxpayer was the beneficiary of income from a trust.[233] He transferred an interest to his children "in the net income which the petitioner [Blair] was then or might thereafter be entitled to receive during his life."[234] The trustees, consequently, "distributed the income directly to the assignees."[235]

The IRS ruled that the income should be taxed to Blair and not his children.[236] The Seventh Circuit found for the IRS and held that the income

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[227]Brief Amici Curiae of the Lawyers' Committee for Civil Rights Under Law, et al., in Support of Respondents at *13-14, Comm'r v. Banks, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907), 2004 WL 1856001 (stating that in amici's experience, civil rights plaintiffs "often enter into fee agreements with private attorneys because they do not have the funds to pay a fixed fee").

[228]Respondent's Brief at 24, *Banks* (No. 03-892).

[229]Petitioner's Brief at 18-20, *Banks* (No. 03-892 & 03-907).

[230]Respondent's Brief at 16, *Banks* (No. 03-892); Respondent's Brief at 2-3, *Banaitis* (No. 03-907).

[231]Respondent's Brief at 1-3, *Banaitis* (No. 03-907).

[232]*See supra* text accompanying notes 188-90.

[233]*Blair*, 300 U.S. at 7.

[234]*Id.*

[235]*Id.*

[236]*Id.*

had to be received by Blair before he could distribute it, and therefore it should be taxed to him.[237] This is essentially an assignment-of-income argument.

The Supreme Court, however, reversed and held that "[t]he tax here is not upon earnings which are taxed to the one who earns them," and that it was not "a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation."[238] There was also "no question of [tax] evasion."[239] Instead, the Court stated that "the tax is upon income as to which, in the general application of the revenue acts, the tax liability attaches to ownership."[240]

Although provisions of the revenue acts tax the beneficiary of trust income, the Court held that these provisions do not "preclude valid assignments of the beneficial interest."[241] If the interests were "assigned without reservation, the assignee thus becomes the beneficiary and is entitled to rights and remedies accordingly."[242]

The government's argument that Blair only transferred the right to receive the income, but not "any equitable right, title or interest in the trust itself" was, according to the Court, "strained."[243] The Court held that the assignment was nothing less than "a complete transfer of the specified interest."[244] Consequently, "the assignees thereby became the owners of the specified beneficial interests in the income," and "they . . . not the petitioner [Blair] were taxable" on the income.[245]

Blair therefore addressed the concerns of the IRS as to who owns the income. The Court determined that, if the transfer was "complete," the assignee was now the owner of the income.[246] The holding, in fact, was that the transferee has an equitable right, title and interest in the income thus transferred.[247] As a result, the transferee or assignee, *not the transferor*, owns the income and is taxed on it.[248] The transferor does not have control as the IRS maintained, but, according to the Court, has relinquished it.

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[237] *Blair*, 300 U.S. at 8.
[238] *Id.* at 11.
[239] *Id.* at 12.
[240] *Id.*
[241] *Blair*, 300 U.S. at 12.
[242] *Id.*
[243] *Id.* at 13.
[244] *Id.*
[245] *Blair*, 300 U.S. at 14.
[246] *Id.* at 13.
[247] *Id.* (holding that what was assigned was the "'right, title and estate in and to property'") (quoting Brown v. Fletcher, 235 U.S. 589, 599 (1915)).
[248] *Id.* at 14.

The income would also not be income to the transferor by virtue of the discharge of a debt, the Court held.[249] This effectively negated the IRS' position that the attorneys' fee portion of the settlement was income to the taxpayer under *Old Colony*. In fact, the *Blair* Court cited *Old Colony* as supporting its position that the income-by-reason-of-a-discharge-of-a-debt theory did not apply in that case.[250]

Consequently, *Blair* stands for the proposition that income is taxed to the one who *owns* it.[251] Therefore, under *Blair*, when a taxpayer transfers completely a portion of her lawsuit to an attorney, the attorney as an assignee now owns an interest in that lawsuit, according to the terms of the fee agreement, as Blair's children owned part of the income from his trust.[252]

This is why the question of taxability does not turn on state attorney lien laws, as seen in *Banks*.[253] The property interest arises from the joint venture as a partnership, with each member having a property interest in partnership property.[254]

Moreover, income is also taxed to the one who *earns* it.[255] As seen in *Cotnam*, *Clarks*, and *Banks*, the courts held that the attorneys earned their portion of the proceeds.[256] There was no gratuitous transfer as in *Earl* or *Horst*.[257] There was a true joint venture, with the client providing the case, and the attorney providing the skill and expertise in order to bring the suit to fruition.[258]

The attorneys in those cases would also pay taxes on their portion of the proceeds, and the client would pay taxes on his or her portion.[259] Therefore, characterizing contingent attorneys' fee agreements as joint ventures eliminates double taxation, whereas application of the assignment-

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[249]*Blair*, 300 U.S. at 11.

[250]*Id.*

[251]*Id.* at 12.

[252]*Id.* at 14 (holding that "the assignees thereby became the owners of the specified beneficial interests in the income, and that as to these interests they and not the petitioner were taxable").

[253]*See supra* text accompanying notes 127-29.

[254]*See* Uniform Partnership Act § 8(1): "All property originally brought into the partnership stock or subsequently acquired by purchase or otherwise, on account of the partnership, is partnership property;" *quoted in* CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, STATUTES, RULES, MATERIALS, AND FORMS 93 (Melvin Aron Eisenberg ed., 2003); 26 U.S.C. § 761(a) (2004) (stating that "the term 'partnership' includes . . . joint venture").

[255]*See* Lucas v. Earl, 281 U.S. 111, 114-15 (1930).

[256]*See supra* text accompanying notes 100, 105 & 139.

[257]Respondent's Brief at 22, *Banaitis* (No. 03-907).

[258]*Clarks*, 202 F.3d at 857.

[259]Brief Amici Curiae of the Lawyers' Committee for Civil Rights Under Law, et al., in Support of Respondents at *9-11, *Banks* (Nos. 03-892 & 03-907), 2004 WL 1856001.

of-income doctrine results in unnecessary double taxation.[260]

Even though the IRS insisted that the assignment-of-income doctrine is "well-established,"[261] equally well established is the principle that one should be allowed to deduct the costs of producing income.[262] The assignment-of-income doctrine actually contravenes this principle, disallowing the successful plaintiff from deducting his costs to arrive at the true economic gain.[263] In all other areas of tax law, be it investing,[264] business,[265] or even employee business expenses,[266] there is a provision for deducting the costs of doing business or producing income so as to be taxed only on the *net* gain. The IRS is therefore attempting to tax gross income as opposed to net gain.[267] Even on the standard IRS Form 1040 for filing an individual's income tax return there are lines to report gross income and adjusted gross income.[268] The IRS, then, is tacitly acknowledging right on its own form that individuals should not be taxed on income that is properly excluded as the cost of producing gross income.

Professor Charles Davenport similarly reasoned in his amicus brief that to arrive at taxable income, attorneys' fees are properly considered transaction costs and should be excluded from gross income.[269] He argued that cases such as *Banks* and *Banaitis* are tort claims as opposed to breaches of contract,[270] and as such are "intangible property."[271]

Under the IRC, transaction costs are not deductible.[272] Rather, they are costs relating to the acquisition or disposition of property and are

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[260]*Id.*

[261]Petitioner's Brief at 2, *Banks* (No. 03-892 & 03-907).

[262]Hantzis v. Comm'r, 638 F.2d 248, 249 (1st Cir. 1981).

[263]*See supra* notes 64-67.

[264]*See* 26 U.S.C. § 212(1) (2004) (allowing individuals to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income").

[265]*See id.* § 162(a) (allowing a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business").

[266]For an argument in favor of subtracting attorneys' fees in employment cases as an above-the-line, reimbursed employee business expense under 26 U.S.C. §§ 62(a)(2)(A), 162(a) (2004), see generally Professor Stephen B. Cohen's Brief for Amicus Curiae, Professor Stephen B. Cohen, Pro Se, in Support of Respondents, Comm'r v. Banks, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907).

[267]Reply Brief for the Petitioner at 7, *Banks* (Nos. 03-892 & 03-907).

[268]*See* IRS Form 1040 (2004), lines 22, 36 and Instructions (calling the amount on line 22 "total income" and the amount on line 36 "adjusted gross income").

[269]Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents at 1, Comm'r v. Banks, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907).

[270]*Id.* at 3.

[271]*Id.* at 1.

[272]*See* 26 U.S.C. § 263 (2004); Treas. Reg. §§ 1.263(a)-1(b), 1.263(a)-2(e) (1987).

"offset against the recovery they produce."[273] After subtracting transaction costs, the remainder is the net income upon which the taxpayer is taxed.

The advantage of this view is that it takes the whole issue of miscellaneous itemized deductions and the disallowance of these deductions under the AMT off the table.[274] It is a non-issue because the costs of producing the income are subtracted "above the line," or, in other words, before line 34 of Form 1040.[275] They are not included in the taxpayer's gross income, having already been subtracted from the proceeds to arrive at the net gain.

In *Baylin*, used by Professor Davenport as an example, a partnership owned 137 acres of land that was condemned by the state of Maryland.[276] The partnership disagreed with the amount the state estimated was the fair market value of the partnership's land and sued in state court, winning $3,899,000 plus interest and costs.[277]

Still not satisfied, the partnership "entered into a contingent fee arrangement with its attorney," and "agreed to pay him a percentage of any amount recovered above the previous award."[278] The state appeals court remanded the case "for a new valuation," and the state offered just over $10 million to the partnership for the land.[279] Further negotiations resulted in a settlement of $16,319,522.91 to the partnership.[280]

What is truly amazing in this case, is that in arriving at the tax on the settlement, the "IRS classified all of the legal fees as a capital expenditure and calculated a capital gain of $5,274,964 *by adding all of the legal fees to the basis of the condemned property*."[281] The IRS, therefore, treated the attorneys' fees as a transaction cost, reducing the capital gain by increasing the basis of the property by the attorneys' fees. The fees were not classified as miscellaneous itemized deductions to the partners, but as costs to the partnership. The court held that "[c]osts related to property disposition are capital expenditures."[282]

Viewing *Banks* and *Banaitis* as tort claims that are intangible property, and the attorney-client relationship as a partnership that has

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[273]Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents at 5-6, *Banks* (Nos. 03-892 & 03-907).

[274]*See supra* notes 64-68 and accompanying text.

[275]*See supra* note 269.

[276]Baylin v. United States, 43 F.3d 1451, 1452 (Fed. Cir. 1995); Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents at 9-10, *Banks* (Nos. 03-892 & 03-907).

[277]*Baylin*, 43 F.3d at 1452.

[278]*Id.*

[279]*Id.* at 1453.

[280]*Id.*

[281]*Baylin*, 43 F.3d at 1453 (emphasis added).

[282]*Id.* at 1454.

produced income, using the IRS' own reasoning, the partnership would subtract its transaction costs to arrive at net income to the partners according to their fee agreement. The result under Professor Davenport's amicus brief is therefore in keeping with the joint-venture model. Banks and Banaitis should have been allowed to subtract the costs associated with producing the income in question and be taxed on their respective net incomes.[283]

The Association of Trial Lawyers of America (ATLA) in its amicus brief analogized the attorney contingent-fee arrangement to a taxpayer who retains a real estate agent on a contingency basis to help sell her house.[284] Only if the house sells does the agent receive his commission. The taxpayer does not include the commission in her gain, if any, on the sale of the property. Instead, the commission is subtracted from the proceeds as "selling expenses" to arrive at the net gain on the sale.[285]

The attorney contingent-fee arrangement should be taxed in the same manner. A taxpayer has a property interest, in this case "intangible personal property," which the Internal Revenue Manual says includes "choses in action" or *causes of action*, and retains an attorney on a contingent-fee basis to help her "liquidate" the asset.[286]

The liquidation in this case would be the settling of the case, and would fall under the IRC as "other disposition" of property.[287] The IRS in its brief appears to agree with this characterization, by stating that "the settlement proceeds represent the value given in exchange for the dismissal

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[283]Professor Davenport argues that viewing attorneys' fees as transaction costs also refutes the amici brief of Professors Polsky and Hellwig, which classifies attorney-fee expenses as a deduction under § 83(h) of the IRC, which would then become a miscellaneous itemized deduction. *See* Brief for Amici Curiae Professor Gregg D. Polsky and Professor Brant J. Hellwig in Support of Petitioner at 12-13, Comm'r v. Banks, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907). According to Professor Davenport, § 83(h) deductions are still subject to capitalization (added to or subtracted from basis) even as § 162 business expenses are, and Reg. § 1.83-6(a)(4) "prohibits a deduction for a capital expenditure." *See* Brief for Amicus Curiae Professor Charles Davenport in Support of Respondents at 17, *Banks* (Nos. 03-892 & 03-907).

[284]Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 24, Comm'r v. Banks, 125 S. Ct. 826 (2004) (Nos. 03-892 & 03-907).

[285]*See* IRS Pub. 523, at 3, 4 (2003) (instructing taxpayers to subtract selling expenses (including agent fees) from the sales price to arrive at the gain on the sale).

[286]Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 24-26, *Banks* (Nos. 03-892 & 03-907) (citing I.R.M. 5.17.2.4.3.4-Intangible Property (2000)); *see also* 26 U.S.C. § 1221 (2000) (stating that intangible personal property is a capital asset unless it is property used in taxpayer's trade or business that is subject to depreciation).

[287]Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 26, *Banks* (Nos. 03-892 & 03-907); *see also* 26 U.S.C. § 1001(b) (2000) ("amount realized from the sale or other disposition of property").

of respondents' claims."[288]

The taxpayer should then subtract the attorneys' fees as an "offset" against the selling price, even as she would do in the case of attorneys' fees paid in connection with the sale of stock, for example, which is itself an intangible asset, or the sale of her house as noted above.[289] The attorneys' fees should be viewed as a capital expenditure to be offset against the total recovery of the taxpayer to arrive at net income.[290]

Based on the foregoing, then, the Court should have adopted the joint-venture model as the correct tax treatment of contingent attorneys' fees as a matter of substantive law. Both the IRC and relevant case law support this conclusion, as seen from both the respondents' briefs and their amici. But there are also strong policy reasons for doing so.

B. *Policy Concerns: More Friendly Persuasion*

As has been shown, there are many provisions of the IRC that, when taken together, can lead intelligent people to form different conclusions as to whether contingent attorneys' fees should be included in a taxpayer's gross income. This strongly indicates that the Court should have also considered long-standing tax policies in resolving this matter. There are four policies in particular that should have been considered.

First, the law should never be interpreted so as to produce an absurd or unjust result.[291] The *Spina* case perhaps more than any other highlights the absurdity and injustice of applying the time-worn assignment-of-income doctrine to force successful litigants to include contingent attorneys' fees in their gross income under section 61(a).[292] Having someone fight long and hard to preserve her rights, only to give up everything she gains plus owe nearly $100,000 in additional taxes is not just "unfortunate,"[293] as the *Alexander* court held. As observed at the beginning of this discussion, such an unjust result has the chilling effect of discouraging victims of injustice from seeking relief through the courts.[294]

Although the Jobs Act did address the injustice of the tax treatment

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[288]Petitioner's Brief at 12, *Banks* (No. 03-892 & 03-907)

[289]*See* Treas. Reg. § 1.263(a)-2(e) (1987) (commissions paid in connection with selling securities "are an offset against the selling price").

[290]Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 28, *Banks* (Nos. 03-892 & 03-907).

[291]*See In re* Chapman, 166 U.S. 661, 667 (1897) (stating that "[n]othing is better settled, than that statutes should receive a sensible construction, such as will effectuate the legislative intention, and, if possible, so as to avoid an unjust or an absurd conclusion").

[292]*See* discussion *supra* Part I.

[293]*Alexander*, 72 F.3d at 946; Liptak, *supra* note 3, at 18.

[294]Liptak, *supra* note 3, at 18.

of attorneys' fees in discrimination and civil rights cases,[295] there are still those cases that fall outside the Act or the Court's opinion or those that are primarily seeking an injunction. They are exposed to the same type of absurd and unjust result seen in *Spina*.[296]

Second, discouraging victims of discrimination and other civil rights violations from filing suit undermines "the central statutory purposes of eradicating discrimination throughout the economy."[297] As the Supreme Court held in *Christiansburg Garment*, an employment discrimination case, individual lawsuits are "the chosen instrument of Congress to vindicate 'a policy that Congress considered of the highest priority.'"[298] If individuals acting as their own "private attorney general" must pay their own litigation costs, the Court has stated that, "few aggrieved parties would be in a position to advance the public interest."[299]

Again, although the Jobs Act eliminated many of such cases, any case decided before the passage of the Act and still not resolved is not covered under the Act because the Act is not retroactive.[300] Neither are cases that involve invasion of privacy, defamation, and the like.[301] Should these cases be subject to *Spina*-like outcomes? Would that not discourage "aggrieved parties" from "advancing the public interest" by filing suit? The answer is obvious, and the Court, had it considered this important policy interest, might likely have decided the instant case differently.

For example, as in *Spina*, courts can award attorneys' fees far in excess of the monetary damages awarded to the victim.[302] In fact, as noted above, some cases are brought to obtain primarily injunctive relief with very little, if any, monetary award. Under the Commissioner's theory, the attorneys' fees would be taxable to the successful litigant in these cases either as a result of the assignment-of-income doctrine or as a debt satisfied by a third party.[303] The Court said it would not address the injunctive relief issue, but until it does, more *Spina*-like cases could result.[304]

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[295] 118 Stat. 1547-48.

[296] *Banks*, 125 S. Ct. at 834.

[297] Albemarle Paper Co. v. Moody, 422 U.S. 405, 421 (1975).

[298] Christiansburg Garment Co. v. EEOC, 434 U.S. 412, 418 (1978) (quoting Newman v. Piggie Park Enters., Inc., 390 U.S. 400, 402 (1968)).

[299] *Piggie Park*, 390 U.S. at 402.

[300] *Banks*, 125 S. Ct. at 832.

[301] 118 Stat. 1547-48; *see also* Wood, *supra* note 27.

[302] Liptak, *supra* note 3, at 18 (noting that Spina was awarded $300,000 and $850,000 in legal fees).

[303] Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 14, *Banks* (Nos. 03-892 & 03-907).

[304] *See Banks*, 125 S. Ct. at 834 (stating that the court would not address the claim that "treating 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").

No wonder that Justice McKeown in his dissenting opinion in *Sinyard* stated: "[T]his Draconian result under the Tax Code can only undermine our civil rights laws."[305] As ALTA pointed out in their amicus, if the Supreme Court adopted the Commissioner's position it "would likely extend such draconian results far beyond employment discrimination cases."[306] ALTA noted that there are an estimated 150 fee-shifting statutes enacted by Congress to enable victims who have been harmed by the violation of federal laws to seek redress.[307] It further stated: "Few aggrieved persons are likely to pursue their claims if this Court announces that they thereby obligate themselves to report as income an unknown sum of money they will never see and which could leave them owing the IRS more than they recover."[308]

Not only are federal objectives undermined by the Court's decision, but so are many state objectives. "[M]ost tort law is state law," ALTA noted.[309] Plaintiffs bringing suit under state tort actions such as invasion of privacy, false imprisonment and intentional infliction of emotional distress are also affected by the Court's holding that they must include contingent attorneys' fees in their gross income. The same "Draconian result" that would dissuade victims of federal law violations from pursuing justice would similarly discourage victims of these state violations.[310]

It would not, of course, discourage those who commit the tort violations. And yet one of the purposes of state tort law is "to deter misconduct and prevent such harms in the first place."[311] The Court in *International Paper* stated that the "States have 'a significant interest in redressing injuries that actually occur within the State.'"[312] Consequently, the Court held that the "[s]tate's interest in applying its own tort laws cannot be superseded by a federal act unless that was the clear and manifest purpose of Congress."[313]

As already noted, the manifest purpose of Congress is not to discourage victims of federal civil rights violations from bringing suit,

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[305]Sinyard v. Comm'r, 268 F.3d 756, 763 (9th Cir. 2001) (McKeown, J., dissenting).

[306]Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 15, *Banks* (Nos. 03-892 & 03-907).

[307]*Id.* at 15.

[308]*Id.* at 14-15.

[309]*Id.* at 11.

[310]Amicus Curiae Brief of the Association of Trial Lawyers of America in Support of Respondents at 11, *Banks* (Nos. 03-892 & 03-907).

[311]*Id.*

[312]Int'l Paper Co. v. Ouellette, 479 U.S. 481, 502 (1987) (quoting Keeton v. Hustler Magazine, Inc., 465 U.S. 770, 776 (1984)).

[313]*Id.* at 503.

acting, as it were, as their own "private attorney general."[314] It would therefore seem apparent that Congress would never intend the same result in State cases involving violations of tort law such as invasion of privacy and the like.

Third, the Court's decision affects the policy of "making the victim whole." As the Court in *Albemarle* noted: "The 'make whole' purpose of Title VII is made evident by the legislative history . . . Congress' purpose in vesting a variety of 'discretionary' powers in the courts was . . . to make possible the 'fashioning [of] the most complete relief possible.'"[315] Additionally, the Court in *Milliken* stated that the purpose of the "make-whole" policy is to "restore the victims of discriminatory conduct to the position they would have occupied in the absence of such conduct."[316]

It is enough that successful litigants are taxed on the proceeds from their non-personal-injury recovery. But now they would have to come up with the money to pay the tax on their legal expenses that is considered income to them—an impossible task for many victims of civil rights violations.[317] Consequently, as stated at the outset, this winds up putting the taxpayer in a hole, rather than making them whole.[318] As the Lawyers' Committee for Civil Rights Under Law put it: "Surely Congress did not intend that the Internal Revenue Code would be construed so as to produce a result that undercuts the very objectives of its civil rights legislation."[319]

Even though the Jobs Act has addressed most, if not all, employment and civil rights discrimination cases, the "make-whole" policy should still apply to other cases that fall outside the Act or the Court's decision, particularly those seeking injunctive relief. Certainly Congress would not want the tax code to undercut a victim's being made whole in these situations either, and the Court should have considered such situations.

There is also a fourth policy: no judicial uncertainty among the various circuits. This is no doubt one reason the Supreme Court finally agreed to hear this issue. Litigants were forced to file suit, not knowing how the court would ultimately decide the issue of attorneys' fees.[320]

The Ninth Circuit, for example, had decided the contingent fee issue

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[314] *See supra* text accompanying notes 298-300.

[315] *Albemarle*, 422 U.S. at 419, 421 (quoting 118 CONG. REC. 7168 (1972)).

[316] Milliken v. Bradley, 418 U.S. 717, 746 (1974).

[317] *See supra* note 227.

[318] *See supra* Part I.

[319] Amicus Curiae Brief of the Lawyers' Committee for Civil Rights Under Law in Support of Respondents at *15, *Banks* (Nos. 03-892 & 03-907), 2004 WL 1856001.

[320] *See Banks*, 345 F.3d at 385 (opining that "such a 'state-by-state' approach would not provide reliable precedent . . . or provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards").

both ways, depending on the applicable state law.[321] Whose state law would apply? The plaintiff's? The attorneys'? Litigants were forced to file suit, if at all possible, in one of the "good" states, such as Alabama, Texas or, Michigan, whose attorney lien laws have resulted in contingent fees being excluded from the taxpayer's gross income.[322] This, too, was an unacceptable situation. To restate what was noted above in *O'Brien*, "we think it doubtful that the Internal Revenue Code was intended to turn upon such refinements."[323]

While one can understand the court in *Kenseth* saying that "everybody who has income pays *some* federal income tax,"[324] the result of an interpretation of tax law that winds up taking away everything one obtains in a lawsuit and more is an egregious result that no one could reasonably argue was the intent of Congress or the courts. While it is true that congressional action has now eliminated this result in many cases, it has not done so in many others. Judicial uncertainty still remains for many litigators.

What is clear and is of "serious concern" is that litigants will continue to be exposed to potentially devastating results simply by "winning" their lawsuit.[325] This result could have been eliminated entirely if the Court had ruled that contingent attorneys' fees should not be included in the gross income of successful litigants in all cases.

The Court therefore still needs to intervene and adopt the "joint venture" approach to the taxation of contingent attorneys' fees, holding that the assignment-of-income doctrine does not apply in these cases. Alternatively, even as the Court created the assignment-of-income doctrine, it could just as easily create an "exclusion-of-contingency-fees" doctrine in cases not addressed by the Jobs Act on the basis of the substantive law and policy discussed here. Contingent attorneys' fees would be excluded from the gross income of the plaintiff and included in the gross income of the attorney. Attorneys would then pay tax on their share of the proceeds and the litigant would pay taxes only on the net proceeds, thus avoiding future *Spina*-like or *Horst*-case scenarios.

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[321] *See supra* note 16.

[322] *See* Wood & Daher, *supra* note 23, at 1427 (observing that "[i]t doesn't seem fair that just because you live in one of the 'good circuits' you end up paying substantially less federal income tax than the poor slobs who live in one of the 'bad circuits'"); *see also* Wood, *supra* note 60 (referring to IRS audit directives that do not require residents of Alabama, Michigan, and Texas to include attorneys' fees in their gross income because of their state's attorney lien laws).

[323] O'Brien v. Comm'r, 38 T.C. 707, 712 (T.C. 1962).

[324] *Kenseth*, 259 F.3d at 884 (emphasis added).

[325] Porter v. United States Agency for Int'l Dev., 293 F. Supp. 2d 152, 156 (D.D.C. 2003) (noting that "the possibility that an attorney's fee award could place a Title VII plaintiff like Porter in a worse position than if he had never filed suit is a matter of serious concern").

V. CONCLUSION

The Supreme Court was in a position in its fall 2004 term to finally put to rest the issue of whether contingent attorneys' fees are includable in a taxpayer's gross income, and bring an end to the judicial uncertainty, the egregious results as seen in *Spina*, and the unnecessarily high tax burden on successful litigants such as Banks and Banaitis. The Court should have adopted the taxpayers' argument that a contingent attorney-fee agreement sets forth a joint venture between the attorney and his client—an intangible uncertainty that the attorney through skill and hard work brings to fruition—and declared that attorneys' fees should be excluded from the successful litigant's gross income. Instead, the Court chose to adopt the position of the IRS that these fees are includable in gross income, thus leaving many successful litigants exposed to potentially devastating *Spina*-like outcomes.

As Einstein said, the tax law is indeed hard to understand. And at times, so is the Court's interpretation of it. The Court must therefore determine what the law is and interpret it fairly. The interests of justice and uniform equity under the law demand it.

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