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No. 03-892

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II, RESPONDENT

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. § 61(a), a discrimination plaintiff's gross income from the proceeds of litigation includes the portion of a damages recovery that is paid to his attorney pursuant to a contingent fee agreement.

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V.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a–33a) is reported at 345 F.3d 373. The opinion of the Tax Court (Pet. App. 34a-57a) is a memorandum decision, T.C. Memo. 2001-48 (Feb. 28, 2001), unofficially reported at 81 T.C.M. (CCH) 1219.

JURISDICTION

The judgment of the court of appeals was filed on September 30, 2003. The petition for certiorari was filed on December 19, 2003. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATEMENT

1. In 1984, Respondent John W. Banks, II, filed a federal civil rights employment discrimination lawsuit against his former employer, the California Department of Education ("CDOE"). Mr. Banks, through his attorney, filed two amended complaints and a second lawsuit. Mr. Banks's second amended complaint alleged, *inter alia,* violations by the CDOE of: (1) Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.*; (2) 42 U.S.C. § 1981; and (3) 42 U.S.C. § 1983. Pet. App. 2a. The two lawsuits were consolidated. Shortly after trial began in 1990, the parties settled all of the claims for $464,000. Pursuant to a contingent fee contract Mr. Banks entered into with his attorney before the commencement of the lawsuit, $150,000 of the settlement amount was retained by Mr. Banks's attorney. Pet. App. 1a-5a.

2. In 1997, the Commissioner issued a Notice of Deficiency to Mr. Banks for the 1990 tax year. In the Notice, the Commissioner asserted that the portion of the settlement proceeds retained by Mr. Banks's attorney under the contingent fee contract also constituted taxable income to Mr. Banks. Mr. Banks filed a timely petition with the United States Tax Court challenging the Commissioner's determination. Pet. App. 6a.

3. The Tax Court upheld the Commissioner's determination that the portion of the settlement proceeds retained by Mr. Banks's attorney as a contingent fee also constituted taxable income to Mr. Banks. Pet. App. 52a.

4. Mr. Banks appealed the Tax Court's decision. Relying on its previous decision in *Estate of Clarks v. Commissioner*, 202 F.3d 854 (6th Cir. 2000), the court of appeals reversed the Tax Court with respect to the

contingent fee issue. Pet. App. 17a-25a.[1] In *Estate of Clarks*, the court of appeals held that the assignment of income doctrine does not require that a taxpayer include in his gross income the attorney's contingent fee portion of a litigation recovery. Consistent with *Estate of Clarks*, the court of appeals held that the portion of the settlement retained by Mr. Banks's attorney as a contingent fee was not income to Mr. Banks. Pet. App. 25a.

SUMMARY OF ARGUMENT

1. This Court has long taught that "[c]ommon understanding and experience are the touchstones for interpretation of the revenue laws." *Helvering v. Horst*, 311 U.S. 112, 118 (1940). The Commissioner's position in this case violates that principle. He asserts that a contingent fee plaintiff in a federal discrimination case must include in income not only his net recovery, but the contingent fee paid to his attorney. While conceding that this rule produces harsh results, the Commissioner concludes that the assignment of income doctrine, a court-made anti-abuse rule, requires such a result. However, to compel the plaintiff to pay taxes on income earned and enjoyed by his attorney and on which his attorney also pays taxes contravenes any notion of "common understanding and experience," and is fundamentally in conflict with the decisions of this Court that created the assignment of income doctrine.

2. No provision in the Internal Revenue Code requires that a federal employment discrimination plaintiff such as Mr. Banks include in his gross income

[1] The court of appeals below also relied upon the Fifth Circuit's decision in favor of the taxpayer in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). Pet. App. 23a; *accord Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001).

the portion of his settlement earned by, retained by, and taxed to his attorney as a contingent fee. Section 61(a) defines "gross income" as "all income from whatever source derived." What constitutes "income" for purposes of Section 61(a) is the subject of a long line of judicial decisions, many from this Court, none of which support the Commissioner's position here.

In those cases, the courts have established the dominion and control test, *i.e.*, that income is charged to a taxpayer where the taxpayer receives, controls or has power of disposition over an item of receipt. Prior to retaining counsel, Mr. Banks, as a practical matter, had no hope of recovering anything from his speculative claim. To obtain competent counsel who would share the risk that the claim would fail, Mr. Banks retained an attorney by entering into a contingent fee contract. As the court of appeals below correctly determined, Mr. Banks, by engaging an attorney to pursue his claims, and by entering into a contingent fee contract with that attorney, ceded control over that portion of his recovery. Pet. App. 24a-25a. Mr. Banks's attorney, through his own skill and effort, made the recovery possible. Mr. Banks had no right to divest his attorney of the portion of the recovery rightfully retained by the attorney as a contingent fee. Thus, under the proper application of the dominion and control test, that portion of the recovery is not income to Mr. Banks.

3. The court of appeals below determined, and the parties do not dispute, that the amount paid by Mr. Banks's former employer in settlement of his lawsuit was attributable to Mr. Banks's Title VII federal employment discrimination claims and his federal civil rights claims he had plead under 42 U.S.C. § 1981 and 42 U.S.C. § 1983. Pet. App. 17a-25a. Amounts received in settlement of a lawsuit are taxed the same as a successful judgment would have been taxed. The federal statutes

under which Mr. Banks brought his claims contained "fee-shifting" provisions, under which the federal district court could have awarded attorney's fees had Mr. Banks obtained a judgment. 42 U.S.C. § 2000e-5(k); 42 U.S.C. § 1988. A portion of the settlement paid by the CDOE to Mr. Banks was therefore necessarily paid in lieu of any potential recovery and award for fees under these fee-shifting provisions. Because attorney's fees awarded under the fee-shifting statutes should not give rise to income for a prevailing plaintiff, Mr. Banks should not be charged with income on the amounts paid to him and his attorney by the CDOE to avoid potential liability under the fee-shifting statutes.

This Court has made clear that Congress' purpose in enacting fee-shifting statutes was to encourage a litigant such as Mr. Banks, acting in his capacity as a "private attorney general," to vindicate public policy with respect to the federal civil rights or other laws. However, the Commissioner's position in this case has the effect of deterring federal civil rights claimants and other federal and state claimants from bringing meritorious claims.

Even more unsettling about the Commissioner's position in this case is that it has actually led, in at least one instance, to a federal employment discrimination plaintiff owing more in tax than her net recovery in litigation. Such an absurd and patently unjust result cannot be accepted, particularly since no provision in the Internal Revenue Code requires it.

The Commissioner does not confront this issue square-on in his brief, but hints that such a result is mandated by the Alternative Minimum Tax (AMT). Pet. Br. 25. The AMT disallows certain deductions, such as legal expenses, in arriving at alternative minimum taxable income. As applied to a contingent fee contract, however, the AMT, which operates to allow certain *deductions*, is a moot issue unless it is first determined that the contingent fee portion of a litigation recovery is gross *income* to the plaintiff.

The attorney's portion of a recovery should not be treated as income. A contingent fee arrangement is the economic equivalent of a joint venture between the plaintiff and his attorney. A successful plaintiff thus should not be charged with the income earned by and paid to his effective joint venturer, his attorney.

4a. The Commissioner's position that the contingent fee portion of a litigation recovery is includible in a plaintiff's gross income rests exclusively on the misapplication of a court-made anti-abuse rule, *i.e.*, the assignment of income doctrine. That doctrine has no application to a contingent fee contract, which is an arm's length transaction not involving any tax avoidance purpose. Pet. App. 24a. The assignment of income doctrine originated as a judicial anti-abuse rule, and was designed to prevent high bracket taxpayers from shifting income to lower bracket family members. Two main lines of assignment of income cases developed, both of which actually support the taxpayer here.

Lucas v. Earl, 281 U.S. 111 (1930) is the landmark case of this Court dealing with the assignment of income from services. In that case, this Court held that the taxpayer could not escape the bite of the marginal tax structure by assigning half of his income to his lower bracket taxpayer wife. Justice Holmes, writing for this Court, made it clear that income is properly taxed to the person who earns it, *i.e.*, under the facts in that case, the husband. In this case, it is clear that Mr. Banks did not earn the attorney's fee portion of the settlement; his attorney did. As a layperson, Mr. Banks's entire discrimination claim was practically worthless without his employing the services of a skillful attorney. The price he paid for that attorney was, effectively, a portion of that otherwise worthless claim. The attorney's personal services converted Mr. Banks's claim into money and Mr. Banks received the settlement proceeds less the contingent fee. At no time did Mr. Banks have the ability to receive or to exercise power of disposition over the contingent fee. That portion of the settlement was worthless before retention of counsel and irrevocably forsaken by Mr. Banks after signing the contingent fee contract. In sum, Mr. Banks's attorney, not Mr. Banks, earned and properly retained the contingent fee.

The second main line of cases dealing with the assignment of income involves transfers of income from property. The principle emerging from these cases is plain: the price that must be paid by the transferor of income from property in order to effectively assign the income from property is that he must transfer the income-producing property itself, not just the income. *Blair v. Commissioner*, 300 U.S. 5 (1937); *Helvering v. Horst*, 311 U.S. 112 (1940). The taxpayer has done just that in this case. The income-producing property is Mr. Banks's discrimination claim. Pursuant to the contingent fee contract, Mr. Banks, in effect, surrendered the contingent fee portion of the claim to his attorney. He no longer had the right to assign it to anyone else or, for that matter, control its disposition in any way.

Application of the assignment of income doctrine in Mr. Banks's case is inconsistent with the rationale of the case law which engendered that doctrine. Mr. Banks's attorney, not Mr. Banks, earned the contingent fee. When he entered into the contingent fee contract, Mr. Banks effectively surrendered an undivided interest in his claim, the income-producing property. No tax avoidance purpose was afoot. Under either line of assignment of income cases, Mr. Banks must prevail and the decision of the court of appeals below should be affirmed.

4b. The Commissioner defends his position by relying on *Old Colony Trust v. Commissioner*, 279 U.S. 716, 729 (1929), where this Court held that the satisfaction of a taxpayer's debt by a payment made by a third party directly to the taxpayer's creditor is income to the taxpayer. That case, however, is inapposite here. A contingent fee plaintiff owes no "debt" to his attorney that is "discharged" by the defendant. *Cotnam v. Commissioner*, 263 F.2d 119, 126 (5th Cir. 1959). Instead, a contingent fee plaintiff, in hope of recovering on his claim, surrenders a portion of it to his attorney. In the event the attorney's efforts result in a recovery, through either judgment or settlement, the attorney receives his fee from the defendant, and no debtor-creditor relationship between the attorney and his client ever arises. If there is no recovery, then the attorney is not entitled to a fee; *a fortiori*, no debtor-creditor relationship exists.

4c. This Court has admonished that double taxation is not to be presumed with respect to a transaction absent a clear expression of congressional intent to the contrary. Yet, the Commissioner's position, if followed, results in double taxation. A contingent fee client and his attorney will both be taxed on the same item. No provision of the Internal Revenue Code requires this result. Moreover, under the classic intra-family assignment of income cases upon which the Commissioner relies (*Earl* and *Horst*), the only question before the court was *which* taxpayer was liable, the high tax bracket assignor, or the lower tax bracket assignee. Those cases thus do not stand, as the Commissioner suggests, for the principle that *both* the assignor and assignee can be taxed on the same funds.

In sum, this Court created the assignment of income doctrine to prevent the shifting of income from high bracket taxpayers to lower bracket taxpayers. It never contemplated the misapplication of that doctrine to produce the results pursued here by the Commissioner. Moreover, the assignment of income doctrine is a *judicial* doctrine, not a constitutional construct, nor a statutory command of Congress, nor an immutable law. This doctrine should be applied in such a manner that it accomplishes its original purpose, and not produce unjust results, results which undermine other federal laws.

ARGUMENT

I. NO PROVISION OF THE INTERNAL REVENUE CODE REQUIRES MR. BANKS TO RECOGNIZE INCOME PROPERLY ALLOCABLE TO HIS ATTORNEY.

The dispute in this case is over whether the portion of the settlement in Mr. Banks's federal civil rights lawsuit against the California Department of Education that was earned by, retained by, and taxed to Mr. Banks's attorney as a contingent fee constitutes gross income to Mr. Banks pursuant to section 61(a)[2] of the Internal Revenue Code. Importantly, section 61(a) itself does not supply an answer to this question.

Section 63(a) defines "taxable income" as "gross income" less certain enumerated deductions. Section 61(a) defines "gross income" as "all income from whatever source derived." Because of the circular and self-referential nature of section 61(a), whether the portion of Mr. Banks's settlement earned and retained by Mr. Banks's attorney as a contingent fee is income to Mr. Banks must be based on a judicial interpretation of the term "income."

[2] Unless otherwise indicated. all section references are to the Internal Revenue Code of 1986. 26 U.S.C. § 1 *et seq.*. as amended and in effect during the relevant period.

This Court's decisions have made clear that control or power of disposition of an item of receipt is a prerequisite to charging a taxpayer with income. As explained in the following section, Mr. Banks *never* had control or power of disposition over the contingent fee portion of the settlement.

In addition, as explained in Section III, the Commissioner's position has the effect of deterring plaintiffs from prosecuting meritorious claims under Title VII and other various federal and state laws which contain fee-shifting provisions. Moreover, as explained in Section IV, the Commissioner's position leads to grievously unjust results, such as an employment discrimination plaintiff actually owing more money in federal income tax than her net recovery in litigation. Finally, as explained in Section V, *infra*, contrary to the Commissioner's assertions, the assignment of income doctrine, a judicial anti-abuse rule, does not apply to an attorney contingent fee contract, which is an arm's length transaction, akin to a joint venture, not involving any tax avoidance purpose.

The absence of statutory language indicating that a successful federal discrimination plaintiff such as Mr. Banks must include his attorney's fees in his own income, combined with the plentiful reasons for *not* including those fees in Mr. Banks's income, present a compelling case for affirming the court of appeals' decision in favor of Mr. Banks.

II. THE PORTION OF THE SETTLEMENT EARNED BY, RETAINED BY, AND TAXED TO MR. BANKS'S ATTORNEY—THE CONTINGENT FEE—CANNOT BE INCOME TO MR. BANKS BECAUSE MR. BANKS LACKED THE REQUISITE DOMINION, CONTROL, AND BENEFICIAL OWNERSHIP OVER THAT PORTION OF THE RECOVERY.

In determining what constitutes "income" for purposes of section 61(a), this Court has long established that unfettered control is the hallmark of income:

> It is not enough to trace income to the property which is its true source, a matter which may become more metaphysical than legal. Nor is the tax problem with which we are concerned necessarily answered by the fact that such property, if it can be properly identified, has been assigned. 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.

Commissioner v. Sunnen, 331 U.S. 591, 604 (1948).[3] This Court has also summarized the control test as follows:

> [T]axation is not so much concerned with the refinements of title as it is with *actual command over the property taxed*—the actual benefit for which the tax is paid. * * * 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.

[3] As a preliminary matter, it is worth noting that the Commissioner now agrees with Mr. Banks that federal, not state law controls this issue. *See* Pet. Br. 15-18.

Corliss v. Bowers, 281 U.S. 376, 378 (1930) (Holmes, J.) (emphasis added). Put another way, in order to qualify as "income", the payments received must be "undeniable accessions to wealth, clearly realized, and over which the taxpayers have *complete dominion.*" *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 209 (1990) (quoting *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)) (emphasis added). The "key" to determining whether a taxpayer enjoys "complete dominion" is "whether the taxpayer has some guarantee he will be allowed to keep the money." *Indianapolis Power & Light Co.*, 493 U.S. at 210.

The primary authorities relied upon by the Commissioner actually support the taxpayer in this case. In *Lucas v. Earl,* 281 U.S. 111 (1930), involving the assignment of income from personal services, the taxpayer, unlike here, had control over the flow of income, both before and after the assignment of a portion of that income to his wife, by regulating the amount of services he performed. And while the taxpayer lost the ability to receive a portion of the income after assignment, he had total control over the income flow at the time of assignment.

Likewise, in *Helvering v. Horst,* 311 U.S. 112 (1940), involving the assignment of income from property, the taxpayer, unlike here, had total control over the future income from interest coupons attached to negotiable bonds. It is true that, after the taxpayer gave the coupons to his son, the taxpayer no longer had a right to receive interest payments. However, after the taxpayer purchased the bonds, the interest payments were virtually *certain* to be paid. *Id.* at 119-20 ("[H]ere the right of the assignor to receive the income antedated the assignment which transferred the right."). Thus, it was the taxpayer's very act of giving the interest coupons away that constituted the exercise of the power of disposition of that income that caused him to realize income. *Id.* at 115 ("Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him.")

The facts in this case are dramatically different from the facts in the cases relied on by the Commissioner. By entering into a contingent fee contract, Mr. Banks ceded all practical control over the disposition of the contingent fee portion of any potential future recovery earned by his attorney. In addition, Mr. Banks never had any *de facto* ability to obtain *any* recovery without the assistance of counsel. Mr. Banks was not an attorney, and no authority need be cited for the fact that it is unlikely that he could have successfully prosecuted his claims in federal district court.[4] This is in marked contrast to *Horst, supra,* where the bond interest payments that were the subject of the transfer were virtually certain to be paid out. This also is in marked contrast to *Earl, supra,* where it was the *assignor* who earned the income that was the subject of assignment. In a contingent fee arrangement, it is the *assignee*—the attorney—whose skill and efforts produce a recovery from a speculative claim. *Estate of Clarks v. United States,* 202 F.3d 854, 857 (6th Cir. 2000) (distinguishing *Earl* and explaining that, in a contingent fee arrangement "the lawyer's income is the result of his *own* personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation") (emphasis added).

The contingent fee contract Mr. Banks entered into with his attorney operated to shift practical and legal

[4] A decision in favor of the Commissioner in this case will require many discrimination plaintiffs to do just that in order to avoid incurring a net loss upon a "successful" prosecution of their claims. *See* Sections III and IV, *infra*.

control of the contingent fee portion of the settlement proceeds from Mr. Banks to his attorney. Under California law, the assignment to Mr. Banks's attorney operated as a lien on the contingent fee portion of any potential recovery. *Isrin v. Super. Ct.*, 403 P.2d 728 (Cal. 1965). Mr. Banks thus did not have uncontrolled discretion over the portion of the settlement proceeds earned and rightfully retained by his attorney; he had no right to divest his attorney of the contingent fee portion of the settlement proceeds. Accordingly, that portion of the settlement proceeds cannot be income to Mr. Banks.

Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), was the first case to address the applicability of the assignment of income doctrine to attorney contingent fee contracts. The Fifth Circuit in that case concluded that, unlike the typical assignment of income situation, such as *Earl*, *supra*, where the assignor needs only to perform services to generate the income to be transferred, a plaintiff in a contingent fee situation, as a practical matter, can obtain a judgment or settlement only by ceding control of a portion of any potential recovery to his attorney:

> [The contingent fee plaintiff's] claim had no fair market value, and it was doubtful and uncertain as to whether it 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. Accordingly she, in effect, assigned to her attorneys forty per cent of the claim in order that she might collect the remaining sixty per cent. That was not the assignment of income of Mrs. Cotnam within the doctrine of *Lucas v. Earl*.

Id. at 125.

Similarly, the Sixth Circuit also considered the contingent fee plaintiff's lack of effective control over the fee portion of a settlement or judgment to be significant and likened the contingent fee arrangement to a joint venture. The Sixth Circuit concluded that a contingent fee arrangement is akin to a joint venture, correctly determining that only the attorney should include the fee in income. *Estate of Clarks*, 202 F.3d at 857; *see also* Pet. App. 24a (stating "taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds"). The Sixth Circuit's analysis is supported by the Internal Revenue Code. Sections 761(a) and 7701(a)(2) both provide that the term "partnership" includes, *inter alia*, a joint venture through or by means of which any business, financial operation, or venture is carried on. "The tax definition of a 'partnership' is broad and imprecise, embracing every jointly owned, profit-oriented arrangement that is not a corporation, trust, or estate, whether or not the arrangement constitutes a state law partnership." William S. McKee, *et al.*, FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS, vol. 1, ¶ 3.02 (3d ed., Warren, Gorham & Lamont of RIA, 1997 & Supp. 2004) [citing sections 761(a) and 7701(a)(2)].

The Sixth Circuit's holdings are consistent with the statutory provisions governing the taxation of partners. Section 61(a)(13) provides that gross income includes an individual's distributive share of partnership gross income. Section 704(a) provides, in general, that a partner's distributive share of income shall be determined by the partnership agreement subject to the requirement in section 704(b) that the agreement has substantial economic effect. The contingent fee agreement between Mr. Banks and his attorney reflected the economic reality that Mr. Banks's claim was not recoverable without a skilled attorney who would expend substantial efforts, and incur the risk that his efforts would go unremunerated if the claim failed.

Indeed, the economic substance of a contingent fee arrangement has all the essential elements of a joint venture. First, the client contributes the inchoate claim, and under the contingent fee arrangement, the attorney, through his skill and effort, adds value to the asset (*i.e.*, by prosecuting the lawsuit). Second, it is the attorney and attorney alone who earns the contingent fee portion of any recovery. This is in fundamental contrast to *Earl, supra,* where it was the *assignor,* not the assignee, who earned the income subject to assignment. Third, the attorney incurs a substantial risk in the venture, namely, that, absent recovery, he will not be paid. Fourth, the attorney has a *bona fide* property interest in the contingent fee portion of the recovery. Neither the plaintiff, nor anyone else, has a right to divest the attorney of the portion of the recovery earned and retained as a contingent fee. The attorney, in effect, has a right to exclude others from that portion of the recovery, and it is that very right to exclude which this Court has recognized is the hallmark of a property interest. *College Savings Bank v. Florida Prepaid Postsecondary Education Expense Bd.*, 527 U.S. 666, 673 (1999) (stating "The hallmark of a protected property interest is the right to exclude others. That is 'one of the most essential sticks in the bundle of rights that are commonly characterized as property.'") (quoting *Kaiser Aetna v. United States*, 444 U.S. 164, 176 (1979)).

In sum, the relationship between Mr. Banks and his attorney was effectively that of joint venturers. Like joint venturers, each should be taxed only on the amount he received.

The Commissioner contends that a plaintiff who pledges a portion of a potential recovery to his attorney as a contingent fee still has sufficient control to be charged with income on that portion because he retains the right to dismiss the lawsuit and to authorize settlement. Pet. Br. 32. This argument misses the point. The critical question is not whether a contingent fee plaintiff like Mr. Banks transferred title to *all* of his rights as a plaintiff to his attorney. Rather, the critical question is whether Mr. Banks had "complete dominion" (*Glenshaw Glass*, 348 U.S. at 431) or "unfettered command" (*Corliss*, 281 U.S. at 378) over the assigned property. It is plain that he did not. Hypothetically, Mr. Banks could have obstreperously refused to accept his attorney's recommendation to settle, thereby preventing (at least temporarily) his attorney from receiving his contingent fee. At no time, however, was Mr. Banks in a position to receive the fee himself or direct that it be paid to anyone else.

Mr. Banks cannot be charged with income from an item that he neither received nor could have received. *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 403 (1972) ("We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. * * * The underlying assumption always has been that in order to be taxed for income, a taxpayer must have *complete dominion* over it.") (emphasis added). By entering into the contingent fee contract with his attorney, Mr. Banks ceded substantial control over his lawsuit, and *all* control over the portion attributable to the contingent fee earned and retained by his attorney. Accordingly, under this Court's precedents, Mr. Banks lacked the necessary dominion and control over the contingent fee portion of the settlement, *both before and after* entering into the contingent fee contract, to be charged with income on that portion.

III. THE ATTORNEY'S FEES PORTION OF THE SETTLEMENT WAS IN LIEU OF AMOUNTS THAT COULD HAVE BEEN AWARDED UNDER FEE-SHIFTING STATUTES AND IS THEREFORE INCOME ONLY TO MR. BANKS'S ATTORNEY.

Amounts received in settlement of a legal claim are taxed the same as a judgment under that claim would have been taxed. The question is "in lieu of what" was the settlement paid. *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997); *see also Woodward v. Commissioner*, 397 U.S. 572, 578 (1970); *United States v. Gilmore*, 372 U.S. 39, 48 (1963); Treas. Reg. § 1.104-1(c) (section 104(a)(2) exclusion for amounts received on account of personal injuries or sickness applies to amounts received through a settlement agreement entered into in lieu of such prosecution).

The court of appeals below determined that the settlement received by Mr. Banks and his attorney was in lieu of claims under (1) Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.*; (2) 42 U.S.C. § 1981; and (3) 42 U.S.C. § 1983. Pet. App. 2a-3a, 10a-17a. This holding has not been challenged by the parties. Accordingly, the taxation of the settlement payment received by Mr. Banks and his attorney is controlled by the tax treatment of recoveries under those statutes.

Each of the statutes under which Mr. Banks could have recovered contains a "fee-shifting" provision which enables a court to award attorneys fees to those who successfully prosecute claims. *See* 42 U.S.C. § 2000e-5(k), 42 U.S.C. § 1988. A portion of the settlement paid to Mr. Banks and his attorney was therefore necessarily paid in lieu of any potential recovery under those fee-shifting statutes.[5]

An amount awarded by a court under a fee-shifting statute is properly income only to the attorney who receives the awarded fees from the defendant. *Cf. Porter v. United States Agency for Int'l Dev.*, 293 F. Supp. 2d 152 (D.D.C. 2003). The court-awarded attorney's fees are separate and distinct from any award intended to compensate the prevailing plaintiff. The fee-shifting statutes simply put the burden of some of the costs of litigation on the defendant by requiring the defendant to pay the plaintiff's attorney's reasonable fees. The defendant's payment to the plaintiff's attorney does not represent an accession to the plaintiff's wealth, and should not be treated as income to the plaintiff under section 61(a).

As a civil rights plaintiff, Mr. Banks was acting as a "private attorney general," vindicating public policy, when he pursued his claims against the CDOE. *See Newman v. Piggie Park Enterprises*, 390 U.S. 400, 402 (1968). Congress chose to encourage suits like Mr. Banks's by enacting fee-shifting statutes under which a court could require the CDOE to pay Mr. Banks's attorney's reasonable fees. *See Venegas v. Mitchell*, 495 U.S. 82, 86 (1990). Partly to eliminate the possibility of a court requiring it to pay Mr. Banks's attorney, the CDOE settled the case.

[5] There is no reason that a litigant who opts to settle his case, such as Mr. Banks, and whose attorney is paid pursuant to a contingent fee contract, should be treated any differently for tax purposes than a litigant who recovers attorney's fees pursuant to a federal fee-shifting statute. Such a position, if adopted by this Court, would contravene previous decisions of this Court recognizing that Congress intended to encourage settlement of employment discrimination disputes. *Burlington Industries, Inc. v. Ellerth*, 524 U.S. 742, 764 (1998); *EEOC v. Shell Oil, Inc.*, 466 U.S. 54, 57 (1984).

The approach advocated by the Commissioner in this case would punish civil rights litigants who answer Congress's call and assume the role of "private attorneys general." Charging Mr. Banks with income on the portion of the settlement attributable to CDOE's extinguishment of its potential obligation to pay Mr. Banks's attorney undermines the civil rights statutes.[6] Mr. Banks should properly only recognize income on the portion of the settlement that he actually received and of which he enjoyed the economic benefit.

IV. THE COMMISSIONER'S POSITION LEADS TO ABSURD AND GRIEVOUSLY UNJUST RESULTS, AND HAS CAUSED A CONTINGENT FEE PLAINTIFF TO OWE MORE IN TAX THAN HER ENTIRE NET RECOVERY.

As explained above, the Commissioner's position in this case is neither supported by any provision of the Internal Revenue Code, nor by any of the cases of this Court interpreting the term "income" for purposes of

[6] Mr. Banks's contingent fee contract was controlled by California law. A decision in favor of the Commissioner by this Court would have the consequence of undermining the California Supreme Court's determination that attorney's fees awarded pursuant to a California fee-shifting provision. Cal. Gov't Code § 12965 (part of the California Fair Employment and Housing Act (FEHA). Cal. Gov't Code § 12900 *et seq.*). belong *exclusively* to a FEHA claimant's attorney. absent an enforceable contract to the contrary. *See Flannery v. Prentice*. 28 P.3d 860 (Cal. 2001). Under *Flannery*. there is no basis for contending that a FEHA claimant has *any* control. for federal tax purposes. over an attorney's fee awarded pursuant to the FEHA fee-shifting statute to be charged with federal income tax. Such claimants should not be charged with federal income tax on those amounts that they do not control. However. should the Court rule against Mr. Banks in this case. it would have collateral consequences for FEHA claimants pursuing their discrimination claims under state law. FEHA claimants. due to federal income tax considerations. would have less incentive to settle their state claims.

section 61(a). But perhaps most striking of all about the Commissioner's position, which is based entirely on a judicial anti-abuse rule, is the harsh and absurd results it foists upon certain federal and state litigants in discrimination and other actions. There is no reason to accept these results, especially in light of the fact that they are not compelled by any provision in the text of the Internal Revenue Code.

As chronicled in the *New York Times*, Cynthia Spina, a law enforcement officer employed by the Forest Preserve District of Cook County, Illinois, sued her employer for sex discrimination and harassment. Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Suit," NEW YORK TIMES, August 11, 2002, at section 1, column 5, p. 18; *see also Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002). Ms. Spina recovered an award of $300,000, in addition to about $850,000 in attorney's fees and $100,000 in costs. After all was said and done, Ms. Spina's tax bill consumed her *entire* $300,000 recovery, and she actually wound up *owing* the Commissioner $99,000.

In his carefully-reasoned and lengthy (38-page) dissent in *Kenseth v. Commissioner*, 114 T.C. 399, 421-58 (2000), Judge Beghe, *inter alia*, forewarned that the Commissioner's untenable position would lead to the absurd result in Ms. Spina's case: "[I]n cases in which the aggregate fees exceed 72-73 percent of the recovery, the tax can exceed the net recovery, resulting in an overall effective rate of tax that exceeds 100 percent of the net recovery." *Id.* at 425-26. Such a result, however, can occur only if, as a threshold matter, it is determined that the attorney's fee portion of Ms. Spina's award is "income" to her under section 61(a). Once that determination is reached, the Alternative Minimum Tax (AMT) provisions of the Internal Revenue Code, 26 U.S.C. §§ 55-59, operate to disallow her any deduction of her attorney's fees.

The Commissioner cannot seriously maintain that the result in Ms. Spina's case is merely the unfortunate result of a mechanical application of the tax laws enacted by Congress, specifically the AMT. Nothing in the text of the Internal Revenue Code mandates the result in Ms. Spina's case. The AMT, *inter alia,* operates to impose a statutory limit or bar on certain types of *deductions* claimed by a taxpayer. Application of the AMT provisions, however, is a moot issue unless it is initially determined that the attorney's fee portion of her recovery is gross income to her under section 61(a). As explained more fully in Section V, *infra,* the Commissioner bases his determination that the attorney's fee portion of a recovery is includible in a plaintiff's gross income entirely on the assignment of income doctrine—a court-made anti-abuse rule. The result in Ms. Spina's case thus rests entirely on the erroneous application of a judicial doctrine. This is why Mr. Banks plainly is *not* asking this Court to disregard, for equitable reasons, any of the statutory requirements or computational steps mandated by the AMT.

The Commissioner's position ultimately has the chilling effect of discouraging federal civil rights plaintiffs from bringing meritorious claims. The assignment of income doctrine, a court-created anti-abuse rule, should not be used to reach such results. It is revealing that the Commissioner's brief does not address the manifestly unjust results in cases such as Ms. Spina's, results compelled by the Commissioner's position in this case.

V. THE ASSIGNMENT OF INCOME DOCTRINE IS A COURT-CREATED ANTI-ABUSE RULE THAT DOES NOT APPLY TO AN ATTORNEY CONTINGENT FEE CONTRACT.

A. A Contingent Fee Contract Is Fundamentally Distinguishable From The Classic Intra-Family Assignments Of Income Present in Such Cases As *Earl* And *Horst*.

The Commissioner does not identify *any* provision of the Internal Revenue Code that expressly provides that a discrimination claimant like Mr. Banks must include in his gross income the portion of the recovery earned and retained by his attorney as a contingent fee. Instead, the Commissioner relies exclusively upon a judicially-created anti-abuse rule known as the assignment of income doctrine.

Because the federal income tax is progressive, taxpayers have sometimes attempted to shift income to lower bracket taxpayers. Section 61 defines income but, notably, does not indicate how to determine who is the appropriate taxpayer. Nevertheless, the courts, and, in particular, this Court, have filled the breach by adopting certain principles to determine who should report an item of income that is transferred from one taxpayer to another. The term "assignment of income doctrine" was the label affixed to these principles.

In this case, the Commissioner has turned the assignment of income doctrine inside-out by asserting that it requires Mr. Banks to report his attorney's contingent fee as income of his own. The assignment of income doctrine originated in cases such as *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940), and has developed as a judicial anti-abuse rule designed to prevent high bracket taxpayers from shifting income to lower bracket family members to avoid paying income tax at a higher marginal rate. *See United States v. Basye*, 410 U.S. 441, 450 (1973) (stating "[t]he principle of *Lucas v. Earl*, that he who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle, has been repeatedly invoked by this Court and stands today as a cornerstone of our graduated income tax system").

A contingent fee contract, however, is an arm's length transaction not involving any tax avoidance purpose. The assignment of income doctrine thus does not apply to such an arrangement. Pet. App. 24a; *Estate of Clarks, supra*, 202 F.3d at 857; *Cotnam, supra*, 263 F.2d at 126. There is no reason to apply this anti-abuse rule to tax Mr. Banks on income earned by the skill and efforts of his attorney, that Mr. Banks never received, and which Mr. Banks never was legally entitled to receive.

Two main lines of assignment of income cases have developed, one dealing with the assignment of income from services and the other with the assignment of income from property. Under either line of cases, Mr. Banks should prevail. With respect to the assignment of income from services, this Court held in *Earl*, *supra*, that a taxpayer could not escape the bite of the progressive tax structure by splitting income he earned with his lower income bracket wife. Writing for the Court, Justice Holmes explained that a taxpayer could not avoid taxation through such clever diversions:

> [T]he tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who *earned* it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives

> leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

281 U.S. at 115 (emphasis added).[7] The fundamental principle from *Earl* is clear: income is taxed to the person who *earns* it. The facts of this case are equally clear: Mr. Banks's attorney earned the contingent fee and the income from that portion of the recovery is Mr. Banks's attorney's alone to report. Pet. App. 22a ("unlike the *Earl* * * * assignee[ ] who performed no services to earn [her] income, the attorney earned his income because the income resulted from his own skill and judgment"); *Estate of Clarks*, 202 F.3d at 858 ("The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it").

In sum, if this case is viewed as an attempted assignment of income from services, then the taxpayer must prevail. Mr. Banks performed no services to earn the contingent fee. Those services were provided solely by his attorney.

This Court has also held that income from *property* can be effectively assigned for federal income tax purposes but only at a price: control of the income-producing property must be relinquished as well. *Blair v. Commissioner*, 300 U.S. 5 (1937). In *Horst, supra*, a taxpayer attempted to avoid paying income tax on interest earned from negotiable bonds by assigning the detachable periodic interest coupons as a gift to his son

[7] It may be true, as the Commissioner contends (Pet. Br. 33-34), that since the contract between Mr. Earl and his wife antedated the advent of the federal income tax, no tax avoidance motive was afoot. However, Mr. Earl's assignment had the effect of tax avoidance because of the progressivity of the income tax. As explained in detail in Section V(B), *infra*, the assignment of income doctrine is widely understood as a judicial anti-abuse rule.

prior to their maturity date. The Court rejected the taxpayer's reliance on *Blair* because Mr. Horst, unlike Mr. Blair, had retained ownership over the income-producing property (the bonds). 311 U.S. at 118-119.

If this case is to be viewed as an assignment of income from property, what is the property? It would have to be Mr. Banks's discrimination claim against his employer. By entering into the contingent fee contract, Mr. Banks effectively transferred an undivided interest in the attorney's fees portion of the income-producing property. Under *Blair*, the income from that property is charged to the transferee, his attorney. 300 U.S. at 12; *see also*, Daniel Q. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 5.02 at 340 (5th ed., West 2000) (explaining that, in *Blair*, "The father, in effect, chopped down some of his fruit and some of his tree and *gave some of his fruit and some of his tree to his children*. Such a 'vertical cut' was effective to shift the tax liability on the assigned income to the children.") (emphasis in original).

A contingent fee arrangement thus differs significantly from the transactions considered in the classic assignment of income cases. Unlike the situations in *Earl* and *Horst*, the value of the contingent fee portion of the claim assigned by Mr. Banks was (1) speculative and unaccrued at the time of transfer, (2) entirely dependent upon the efforts and skill of the assignee rather than the assignor, and (3) motivated by practical, non-tax considerations, not tax avoidance. These factors influenced the Sixth Circuit's decision to refuse to apply the assignment of income doctrine. *Estate of Clarks*, 202 F.3d at 857.

In *Earl*, this Court employed a tree-fruit metaphor to explain why a taxpayer could not shift income from services to his lower bracket wife: "no distinction can be made according to the arrangement by which fruits are attributed to a different tree on which they grew." 281 U.S. at 115. The tree-fruit metaphor simply provides another way of stating that income must be attributed to the person who *earns* it. In *Earl* it was the husband (the tree) who earned the income (the fruit), and he could not escape taxation by assigning the fruit to his wife.

The tree-fruit metaphor is more descriptive of the circumstances where the assignment is one of property. A rental building (tree) generates rent (fruit); corporate stock (tree) generates dividends (fruit); and, as in *Horst*, a bond (tree) generates interest income (fruit). As noted earlier, the income (fruit) from income-producing property (tree) can be effectively transferred for federal income tax purposes if the transferor is willing to transfer the tree along with the fruit. Here, Mr. Banks effectively transferred an undivided interest in his discrimination claim (tree). Pet. App. 24a-25a ("[b]y signing the contingency fee agreement, [Mr. Banks] transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit.") (citing *Estate of Clarks*, 202 F.3d at 858); *accord Cotnam, supra*, 263 F.2d at 126. As a result, the contingent fee (fruit) is solely the income of Mr. Banks's attorney.

In sum, the Commissioner's position in this case is at odds with the rationale of the relevant case law establishing the assignment of income doctrine. Mr. Banks's attorney, not Mr. Banks, earned the contingent fee. When he entered into the contingent fee contract, Mr. Banks effectively surrendered an undivided interest in his claim, the income-producing property. At the time of transfer, Mr. Banks's claims were speculative and unaccrued, and could be turned into recovery only through the effort of a skilled attorney. No tax avoidance purpose was afoot. Accordingly, the contingent fee portion of Mr. Banks's settlement is not income to him.

B. The Assignment Of Income Doctrine Is A Judicial Anti-Abuse Rule And Should Not Be Applied Here Because Mr. Banks's Motivation For Signing The Contingent Fee Contract Was Not To Avoid Taxes.

The Commissioner contends that the judicial assignment of income doctrine is not an anti-abuse rule. Pet. Br. 33-34. The Commissioner rests his assertion in part on the fact that in *Earl,* the husband and wife entered into the contract to split income prior to the advent of the federal income tax. Pet. Br. 33. While Mr. Earl himself might not have had a tax avoidance motive at the time he entered into the agreement, his assignment certainly *resulted* in tax avoidance after the establishment of the income tax. The facts in that case constitute the quintessential tax avoidance situation for post-income tax agreements and this Court treated it as such: "There is no doubt 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 skilfully devised *to prevent* the salary when paid from vesting even for a second in the man who earned it." 281 U.S. at 114 (emphasis added). In addition, the failure to rescind the agreement after the imposition of the income tax must have been motivated in whole or in part by tax avoidance.

The assignment of income doctrine developed as, and is universally understood to be, a judicial doctrine crafted for the purpose of preventing taxpayers from planning ploys designed to defeat the progressive tax system. *See* Daniel Q. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 5.02 (5th ed., West 2000); *see also Lehman v. Commissioner,* 25 T.C. 629, 633 (1955) ("The anticipatory assignment of income doctrine *presupposes* the ability of the assignor to earn the income at issue and *an intent to escape the tax burden thereon* by transferring the right to such income prior to its actual receipt.") (emphasis added).

This Court, in a very early assignment of income case, *Blair v. Commissioner*, 300 U.S. 5 (1937), expressly considered whether a tax avoidance purpose was afoot in determining not to apply the assignment of income doctrine. In that case, this Court ruled that the assignment by a father to his children of fixed annual dollar amounts of income to be paid from the life interest in a trust was effective for tax purposes. In so ruling, this Court noted that "[t]here is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion." *Id.* at 12. In addition, this Court has explained further in another case, many years later, that:

> The principle of *Lucas v. Earl,* that he who earns income may not *avoid taxation* through anticipatory arrangements *no matter how clever or subtle,* has been repeatedly invoked by this Court and stands today as a cornerstone of our graduated income tax system.

Basye, supra, 410 U.S. at 450 (emphasis added).

The Commissioner's assertion that the presence or absence of a tax avoidance purpose is not relevant is also inconsistent with his position taken in a recent private letter ruling. Priv. Ltr. Rul. 200427009 (July 2, 2004) (available at 2004 PRL LEXIS 342).[8] There, the Commissioner, citing, *inter alia, Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957), and *Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962), determined that where a taxpayer transfers a portion of a claim in litigation to a third party prior to the expiration of appeals, the taxpayer is "not required to include the proceeds of the judgment in income under the assignment of income doctrine." 2004 PRL LEXIS 342, at *11. The Commissioner based his ruling in part on the fact that the taxpayer's assignments in question "appear[ed] to have been motivated by genuine business purposes." 2004 PRL LEXIS 342, at **10, 12 (citing *Jones, supra*). The facts here are slightly different, but the principles cited by the Commissioner have general applicability. As the Commissioner recognized in his own ruling, the taxpayer's motivation is a significant factor in determining whether a transfer is an assignment of income. His position to the contrary in this case is incorrect.

[8] The private letter ruling is cited for the limited purpose of demonstrating the Commissioner's inconsistent position. not as precedent. *See* 26 U.S.C. § 6110(k)(3): *see also Hanover Bank v. Commissioner*. 369 U.S. 672. 686 (1962) (stating "[A]lthough the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them. such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."): *see also Harco Holdings, Inc. v. United States*. 977 F.2d 1027. 1035 n.13 (7th Cir. 1992) (citing private letter ruling as evidence of erroneous or inconsistent IRS position). In addition. the private letter ruling is a valuable resource to the extent of the strength of Commissioner's analysis therein and the cases relied on by the Commissioner.