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Misassigning Income: The Supreme Court and Attorneys' Fees

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MISASSIGNING INCOME: THE SUPREME COURT AND ATTORNEYS' FEES

*Stephen B. Cohen**

This past term's Supreme Court decision in Commissioner v. Banks and Commissioner v. Banaitis distorts foundational principles, known as assignment of income law, which help identify the person who must report income for federal tax purposes. The Court holds that assignment of income principles require a plaintiff to report as income the portion of a recovery paid to the plaintiff's attorney as a contingent fee. As a result, the plaintiff is taxed at excessively high rates, which may in some cases equal or exceed a confiscatory 100%. Taxing the plaintiff on the attorney-fee portion of a recovery also undermines the objective of federal fee-shifting statutes, which is to enable a prevailing plaintiff to act as a private attorney general by employing an attorney without cost. Although recent legislation changes the result in the future for specified categories of litigation, including a wide variety of civil rights and employment claims, there remain significant classes of cases, including nonphysical torts, physical torts with punitive damages, and environmental statutes with fee-shifting provisions, to which this recent legislation does not apply and in which plaintiffs will continue to be taxed unfairly under the Court's decision.

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I. INTRODUCTION

Over thirty years have passed since the Supreme Court last considered foundational principles, known as assignment of income law, which help identify the person who must report income for federal tax purposes.¹ Tax lawyers therefore expectantly awaited the

¹ See generally 4 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 75.1 (3d ed. 1999). The Supreme Court last considered assignment of income law principles in *United States v. Basye*, 410 U.S. 441 (1973) (applying assignment of income principles to hold that payments for services deflected to a retirement fund were presently taxable to individual partners of a partnership). In the three decades since the *Basye* decision, the Court typically has decided only a handful of tax cases each term. Moreover, those cases have usually concerned technical interpretation of the Internal Revenue Code (Code) rather than foundational principles. See, e.g., *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) (referring to the plain language of I.R.C. § 108 to resolve a conflict over the

Supreme Court's decision this past term in *Commissioner v. Banks*² and *Commissioner v. Banaitis*,³ which applies these principles to contingent attorneys' fees.

Unfortunately, the Court's decision, which requires a plaintiff to report as income the portion of a recovery paid to the plaintiff's attorney as a contingent fee,⁴ distorts assignment of income principles by treating the recovery as the product *solely* of the plaintiff's claim rather than the product *jointly* of the plaintiff's claim and the attorney's labor. The Court also fails to provide convincing reasons for refusing to apportion the recovery between the plaintiff and the attorney according to their proportionate shares so that the plaintiff is not taxed on the entire recovery, including the contingent fee. As a result, the plaintiff is taxed at excessively high rates, which may in some cases equal or exceed a confiscatory 100%.⁵

In addition, the Court unreasonably declines to consider the conflict between its holding and the fee-shifting provisions of federal statutes, under which the defendant must pay the attorneys' fees of a prevailing plaintiff.⁶ These fee-shifting provisions enable the plaintiff who cannot pay an attorney to act as a "private attorney general"⁷

sequencing of pass-through and attribute reduction); *United Dominion Indus., Inc. v. United States*, 532 U.S. 822 (2001) (holding that in calculating consolidated product liability loss, a "single-entity" approach should be utilized, as opposed to a "separate-member" approach).

² *Commissioner v. Banks*, 125 S. Ct. 826 (2005).

³ *Id.* The Supreme Court's order granting certiorari consolidated the two cases for oral argument and decision. 541 U.S. 958 (2004).

⁴ *Banks*, 125 S. Ct. at 829.

⁵ The decision was unanimous, except for Justice Rehnquist who did not participate. *Id.* at 826.

⁶ *See, e.g.*, Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988 (2000) (providing for fee shifting in § 1988(b)); Civil Rights Act of 1964 § 204, 42 U.S.C. § 2000a-3 (2000) (providing for fee shifting in § 2000a-3(b)); Civil Rights Act of 1964 § 706, 42 U.S.C. § 2000e-5 (2000) (providing for fee shifting in § 2000e-5(k)); Fair Housing Act of 1968, 42 U.S.C. § 3601 *et seq.* (2000) (providing for fee shifting in § 3612 (p)); Americans with Disabilities Act of 1990, 42 U.S.C. § 12101 *et seq.* (2000) (providing for fee shifting in § 12205). The Supreme Court has interpreted these statutes, which state that the court may award reasonable attorneys' fees to the "prevailing party," as requiring an award of fees to a prevailing plaintiff, unless special circumstances would make an award unjust. *See Hensley v. Eckerhart*, 461 U.S. 424, 429 (1983); *N.Y. Gaslight Club, Inc. v. Carey*, 447 U.S. 54, 68 (1980); *Newman v. Piggie Park Enters., Inc.*, 390 U.S. 400, 401-03 (1968).

⁷ *See Blum v. Stenson*, 465 U.S. 886, 894 n.10 (1984); *Christiansburg Garment*

vindicating national policy. Taxing the plaintiff on the attorney-fee portion of a recovery, however, eviscerates the objective of the fee-shifting statutes, which is to enable plaintiffs “to employ . . . lawyers without cost to themselves if they prevail.”⁸

If the attorneys’ fees had been fully deductible by the plaintiffs, these cases would never have arisen.⁹ For the tax years in question, however, the Internal Revenue Code (Code) restricted deduction of the attorneys’ fees incurred by the plaintiffs in *Banks* and *Banaitis*.¹⁰ The American Jobs Creation Act of 2004 (Jobs Act), enacted after the Court had granted certiorari in these cases, makes attorneys’ fees fully deductible in the future for specified categories of litigation, including a wide variety of civil rights and employment cases.¹¹ Nevertheless,

Co. v. EEOC, 434 U.S. 412, 416 (1978); *Newman*, 390 U.S. at 402.

⁸ *Venegas v. Mitchell*, 495 U.S. 82, 86 (1990).

⁹ *Banks*, 125 S. Ct. at 830–31.

¹⁰ *Id.* The attorneys’ fees were classified as miscellaneous itemized deductions, for which the deduction is limited under the regular tax and not available at all under the Alternative Minimum Tax (AMT). See I.R.C. §§ 56(b)(1)(A)(i), 67(b), 68(a).

¹¹ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. Section 703 of the Jobs Act amended the Code by adding sections 62(a)(19) and 62(e). *Id.* at 1546–47. Section 62(a)(19) applies to attorneys’ fees “in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of [31 U.S.C. § 3721 *et seq.*] or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)).” *Id.* Section 62(e) further defines “unlawful discrimination” to mean,

an act that is unlawful under any of the following:

- (1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).
- (2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).
- (3) The National Labor Relations Act (29 U.S.C. 151 *et seq.*).
- (4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 *et seq.*).
- (5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).
- (6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).
- (7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).
- (8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 *et seq.*).
- (9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 *et seq.*).
- (10) The Worker Adjustment and Retraining Notification Act (29 U.S.C.

because the Jobs Act applies only prospectively, it provided no relief for Mr. Banks and Mr. Banaitis.¹² More importantly, the Jobs Act does not apply to significant classes of cases, including nonphysical torts such as defamation,¹³ physical torts in which punitive damages are awarded,¹⁴ and environmental statutes with fee-shifting

2102 et seq.).

- (11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).
- (12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).
- (13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).
- (14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).
- (15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
- (16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
- (17) Any provision of Federal law (popularly known as whistleblower protection provisions) 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 under Federal law.
- (18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law—
 - (i) providing for the enforcement of civil rights, or
 - (ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

Id. at 1547.

¹² The Jobs Act states that the new provision “shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date.” *Id.* at 1548. The date of enactment was October 22, 2004, while the settlements in *Banks* occurred on May 30, 1990 and October 26, 1995, respectively. *Id.* at 1418; *Commissioner v. Banks*, Nos. 03-892, 03-907, 2004 WL 1562987 at *23, *108 (June 14, 2004) (joint appendix to filings for writ of certiorari in U.S. Supreme Court).

¹³ See generally Robert W. Wood, *Supreme Court Attorney Fees Decision Leaves Much Unresolved*, 106 TAX NOTES 792, 795 (Feb. 14, 2005).

¹⁴ If litigation involves a claim for physical injury, then the compensatory damages, including any portion paid as an attorney’s fee, are excluded from income under section 104(a)(2). However, section 104(a)(2) does not apply to punitive damages. Therefore, under *Banks* a plaintiff must report as income any and all

provisions.¹⁵ In these cases, the Court's holding in *Banks* and *Banaitis* will continue to cause the taxation of plaintiffs at excessively high rates and will undermine fee-shifting provisions of federal law.

This article discusses how and why the Court went wrong, noting not only the Court's written opinion but also issues raised during oral argument and in the briefs that are not mentioned in the opinion but may have affected the outcome. Part II details the background of *Banks* and *Banaitis*. Part III describes the evolution of foundational principles of assignment of income law and explains why these principles do not support the Court's decision. Part IV criticizes the reasons given by the Court for refusing to apportion the income between the plaintiff and lawyer as joint producers of the recovery. Part V shows that the Court's decision to disregard the conflict between the federal income tax and fee-shifting statutes is based on an untenable distinction between judgments and settlements that undermines the objective of fee-shifting and is inconsistent with settled tax law principles and practices. Readers who are already familiar with the background of the litigation and the evolution of foundational principles of assignment of income law may wish to skip directly from this Introduction to Part III, Section B.

II. BACKGROUND OF THE LITIGATION

Banks and *Banaitis* involved plaintiffs who settled claims against their employers for unlawful termination of employment and who paid their attorneys a contingent fee. John W. Banks sued his former employer, the California Department of Education, for employment discrimination under federal civil rights statutes and the civil rights provisions of the California Code.¹⁶ The employer paid Mr. Banks

punitive damages arising under a claim for physical injury, including the portion of such damages paid as an attorney's fee.

¹⁵ Since amending the Clean Air Act in 1970 to include a citizen suit provision, Congress has provided for fee-shifting in most major federal environmental legislation. See, e.g., Clean Air Act, 42 U.S.C. § 7401 *et seq.* (2000) (providing for fee-shifting in section 7604(d)); Federal Water Pollution Control Act, 33 U.S.C. § 1251 *et seq.* (2000) (providing for fee-shifting in section 1365(d)); Resource Conservation and Recovery Act of 1976, 42 U.S.C. § 6901 *et seq.* (2000) (providing for fee-shifting in section 6972(e)); Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. § 9601 *et seq.* (2000) (providing for fee-shifting in section 9659(f)).

¹⁶ Mr. Banks filed federal claims under 42 U.S.C. §§ 1981 and 1983 and Title VII

\$464,000 to settle the litigation.¹⁷ Mr. Banks in turn paid \$150,000 of this settlement amount to his attorneys pursuant to a contingent-fee agreement.¹⁸

Sigitas J. Banaitis sued his former employer, the Bank of California, under Oregon state law, alleging willful interference with his employment contract.¹⁹ The parties settled the case for a total of \$8,728,559, of which the employer paid \$4,864,547 directly to Mr. Banaitis and \$3,864,012 directly to the attorneys representing Mr. Banaitis.²⁰ The contingent-fee agreement between Mr. Banaitis and his attorneys determined the division of the settlement payments between them.²¹

The issue in both cases was the same: whether the plaintiff's income includes the amount of the recovery paid to his attorneys as a contingent fee.²² The Supreme Court granted certiorari at the request of the Solicitor General to resolve a conflict among the Courts of Appeals.²³ The Court decided for the government, holding that "the

of the 1964 Civil Rights Act, as amended, 42 U.S.C. § 2000e. *Commissioner v. Banks*, 125 S. Ct. 826, 829 (2005). He also filed state claims under section 12965 of the California Code. *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* at 830.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 828.

²³ See *Commissioner v. Banks*, 541 U.S. 958 (2004); Petition for Writ of Certiorari, *Banks*, 125 S. Ct. 826 (2005) (No. 03-892), 2003 WL 23010681 at *7-8 (for certiorari of *Commissioner v. Banks*, 345 F.3d 373 (6th Cir. 2003)); Petition for Writ of Certiorari, *Banks*, 125 S. Ct. 826 (No. 03-907), 2003 WL 23055055 at *10 (for certiorari of *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003)). Three circuits had held that such amounts are not income to the plaintiff. *Banks*, 345 F.3d at 382-86; *Foster v. United States*, 249 F.3d 1275, 1279-80 (11th Cir. 2001); *Srivastava v. Commissioner*, 220 F.3d 353, 362-65 (5th Cir. 2000). Conversely, three circuits had held that such amounts are income to the plaintiff. *Campbell v. Commissioner*, 274 F.3d 1312, 1313-14 (10th Cir. 2001); *Young v. Commissioner*, 240 F.3d 369, 376-79 (4th Cir. 2001); *O'Brien v. Commissioner*, 38 T.C. 707, 712 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963). One circuit had held that whether such amounts are income or not depends on the nature of the interest in the plaintiff's cause of action (if any) granted to the plaintiff's attorney under state law. *Banaitis*, 340 F.3d at 1081. Three circuits had held that such amounts are income without making clear whether their decisions depended on the nature of the interest in the plaintiff's cause of action granted to the plaintiff's attorney under state law. *Raymond v. United States*, 355 F.3d 107, 113-17 (2d Cir. 2004); *Kenseth v. Commissioner*, 259 F.3d 881, 883-84 (7th

litigant's income includes the portion of the recovery paid to the attorney as a contingent fee."²⁴

Even if the attorney-fee portion of the settlement is income to the plaintiffs, these cases would not have arisen if the attorneys' fees had been fully deductible by the plaintiffs.²⁵ In that event, inclusion of the contingent-fee amount would have been offset by deduction of the same amount. Because of the offsetting inclusion and deduction of the same item, the amount of the plaintiffs' taxable income (that is, net income subject to taxation) would not have increased, nor would their tax liability.

The Code, however, limits or denies the deduction of so-called "miscellaneous itemized deductions,"²⁶ a category interpreted to include the attorneys' fees of the plaintiffs in *Banks* and *Banaitis*.²⁷ Under the regular tax, miscellaneous itemized deductions are available only to the extent that they exceed 2% of the taxpayer's adjusted gross income,²⁸ and even deduction of that excess amount may be phased out if the taxpayer's adjusted gross income exceeds a certain amount.²⁹ Most important, miscellaneous itemized deductions are not deductible at all under the Alternative Minimum Tax (AMT),³⁰ to which both Mr. Banks and Mr. Banaitis were subject.³¹

There is general agreement that Congress never contemplated that the miscellaneous itemized deduction category might encompass the attorneys' fees of individuals like Mr. Banks and Mr. Banaitis.³² Congress intended the category to include expenses that have

Cir. 2001); *Baylin v. United States*, 43 F.3d 1451, 1454–55 (Fed. Cir. 1995).

²⁴ *Banks*, 125 S. Ct. at 829.

²⁵ *Id.* at 830–31.

²⁶ Expenses that are not deductible in computing adjusted gross income under section 62 are "itemized deductions." I.R.C. § 63(d). Itemized deductions are classified as "miscellaneous itemized deductions" unless specially exempted, and the attorneys' fees in these cases are not among the exempted items. I.R.C. § 67(b).

²⁷ *Banks*, 125 S. Ct. at 830. For the tax years in question, the attorneys' fees in *Banks* and *Banaitis* were treated as not deductible in computing adjusted gross income under section 62, and as a result, they were classified as "miscellaneous itemized deductions." I.R.C. §§ 63(d), 67(b).

²⁸ I.R.C. § 67(a).

²⁹ I.R.C. § 68.

³⁰ I.R.C. § 56(b)(1)(A)(i).

³¹ *Banks*, 125 S. Ct. at 830.

³² See, e.g., Kenneth W. Gideon, *An Interesting Time to Be a Tax Lawyer*, 107 TAX NOTES 779, 780 (May 9, 2005).

“characteristics of voluntary personal consumption expenditures.”³³ Nevertheless, miscellaneous itemized deductions were defined in such general terms that the attorneys’ fees in *Banks* and *Banaitis*, although lacking any personal consumption element whatsoever, appear to have been inadvertently swept in with other items that Congress clearly intended to count as miscellaneous itemized deductions.

There is also consensus that the result of the Supreme Court’s decision in *Banks* and *Banaitis* is manifestly unfair.³⁴ The plaintiffs are taxed under the AMT on the entire recovery, including the attorneys’ fees. The overstatement of the plaintiffs’ income leads to taxation at excessively high rates. Although the highest marginal tax rate under the AMT is 28%,³⁵ Mr. Banks appears to be taxed on his actual share of the settlement at an effective rate in excess of 40%,³⁶ and Mr.

³³ STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78 (Joint Comm. Print 1987). The quoted passage explains the justification for section 67(a), which limits the deduction under the regular tax for miscellaneous itemized deductions. Neither the Joint Committee on Taxation nor the House and Senate reports explained the justification for section 56(b)(1)(A)(i), which disallows a deduction entirely under the AMT for such expenses. *Id.* at 78–79; H.R. REP. No. 99-841, pt. 2, at 259–60 (1986); S. REP. No. 99-313, at 535 (1986). It is, however, reasonable to assume that the justification for section 67(a) applies to section 56(b)(1)(A)(i) as well, since both provisions were enacted at the same time as part of the same legislation. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2114, 2323–24.

³⁴ See, e.g., *Banks v. Commissioner*, 345 F.3d 373, 385 (6th Cir. 2003) (application of the assignment of income doctrine to attorneys’ fees results in double taxation); *Sinyard v. Commissioner*, 268 F.3d 756, 762–63 (9th Cir. 2001) (McKeown, J., dissenting) (application of the assignment of income doctrine to attorneys’ fees could leave a victorious civil rights plaintiff with a net after-tax loss). The National Taxpayer Advocate, an independent office established by Congress within the Internal Revenue Service (Service), has listed the unfair treatment of attorneys’ fees as one of six major problem areas in the federal income tax. NAT’L TAXPAYER ADVOCATE, FY 2002 ANNUAL REPORT TO CONGRESS, 156, 160–62 (2002).

³⁵ I.R.C. § 55(b)(1)(A)(i)(II).

³⁶ Assuming that Mr. Banks is married and has no other income or deductions, his AMT income is the full \$464,000 settlement amount since any exemptions are phased out. *Banks*, 125 S. Ct. at 829; I.R.C. § 55(d)(1)(B), (d)(3)(B). The first \$175,000 of AMT income above the exemption amount is taxed at a rate of 26%, and any additional AMT income is taxed at a rate of 28%. I.R.C. § 55(b)(1)(A)(i). The tax due on the first \$175,000 of AMT income is \$45,500. The tax due on the \$289,000 of additional AMT income is \$80,920, and the total tax due under the AMT is \$126,420. The effective tax rate on the plaintiff’s share (\$314,000) is consequently over 40%. *Banks*, 125 S. Ct. at 829.

Banaitis appears to be taxed at an effective rate in excess of 50%.³⁷

The plaintiff's effective tax rate depends on the ratio of the attorneys' fees to the total recovery. As the ratio increases, so does the plaintiff's effective tax rate.³⁸ The ratio is 32% in *Banks*³⁹ and 44% in *Banaitis*,⁴⁰ but in cases involving fee-shifting statutes, the ratio of attorneys' fees to the total recovery may be much higher.⁴¹ If the ratio is 72%, the Court's decision permits a confiscatory tax at an effective rate of nearly 100%.⁴² If the ratio exceeds 72%, which is not only possible in fee-shifting cases but also likely whenever the primary

³⁷ Assuming that Mr. Banaitis is married and has no other income or deductions, his AMT income is the entire \$8,728,559 settlement amount since any exemptions are phased out. *Banks*, 125 S. Ct. at 830; I.R.C. § 55(d)(1)(B), (d)(3)(B). The first \$175,000 of AMT income above the exemption amount is taxed at a rate of 26%, and any additional AMT income is taxed at a rate of 28%. I.R.C. § 55(b)(1)(A)(i). The tax due on the first \$175,000 of AMT income is \$45,500. The tax due on the additional \$8,553,559 of AMT income is \$2,394,997, and the total tax due under the AMT is \$2,440,497. The effective tax rate on the plaintiff's share (\$4,864,547) is consequently over 50%. *Banks*, 125 S. Ct. at 830.

³⁸ Even if the proportion of the recovery going to attorneys' fees increases and the plaintiff's share consequently falls, the plaintiff's tax liability under the AMT remains constant because the entire attorney-fee portion is includible in the plaintiff's AMT income without any off-setting deduction. *See supra* notes 36 and 37. If the plaintiff's tax liability remains constant but the plaintiff's share of the recovery falls, then the effective rate of tax on the plaintiff increases.

³⁹ Mr. Banks paid his attorneys \$150,000 of the \$464,000 recovered. *Banks*, 125 S. Ct. at 829.

⁴⁰ Mr. Banaitis paid his attorneys \$3,864,012 of the \$8,728,559 recovered. *Id.* at 830.

⁴¹ In ordinary contingent-fee litigation, the attorney's fee is a percentage of the total recovery. In fee-shifting cases, however, the fee does not come from the plaintiff's recovery; rather, responsibility for payment of the fee is shifted to the defendant, and the amount is determined by the court in a separate proceeding in which the fee is calculated on the basis of what is a reasonable fee given the time and effort involved. What constitutes a reasonable fee does not depend on the amount of damages. Instead, "a reasonable attorney's fee is properly calculated by multiplying the number of hours reasonably expended on the litigation times a reasonable hourly rate." *Blum v. Stenson*, 465 U.S. 886, 888 (1984); *see also City of Riverside v. Rivera*, 477 U.S. 561, 576-79 (1986); *Hensley v. Eckerhart*, 461 U.S. 424, 433 (1983); *Quartino v. Tiffany & Co.*, 166 F.3d 422, 426 (2d Cir. 1999).

⁴² Assume that the total recovery is \$1 million, of which the attorney receives \$720,000 and the plaintiff receives \$280,000. The tax due on the first \$175,000 of AMT income is \$45,500. The tax due on the additional \$825,000 of AMT income is \$231,000. I.R.C. § 55(b)(1)(A)(i). Thus, under the AMT, the plaintiff's tax liability is \$276,500, nearly equal to the plaintiff's entire \$280,000 share.

remedy in a fee-shifting case is injunctive relief, the Court's decision may cause the "successful" plaintiff to suffer an after-tax loss.

Shortly before oral argument in these cases, Congress enacted the American Jobs Creation Act of 2004 (Jobs Act), which amended the Code to permit plaintiffs to deduct fully the attorneys' fees in specified categories of litigation, including a wide variety of civil rights and employment cases.⁴³ Because the Jobs Act amendment only has prospective effect, however, it did not apply to Mr. Banks and Mr. Banaitis.⁴⁴ Moreover, the new provision effectively moots the Court's decision in the future only for the kinds of litigation specified in the legislation.⁴⁵ The new provision therefore does not apply to other categories of litigation, including nonphysical torts such as defamation, physical torts involving punitive damages, and environmental statutes with fee-shifting provisions.⁴⁶ For these categories of cases, the Court's decision in *Banks* and *Banaitis* will continue to have a harmful impact, causing plaintiffs to be taxed at excessively high rates and undermining the objectives of other fee-shifting provisions.

III. THE COURT DISTORTS FOUNDATIONAL PRINCIPLES

A. Foundational Cases

Between 1930 and 1940, the Supreme Court articulated foundational principles known as assignment of income law that help determine the person to whom income is taxed.⁴⁷ Assignment of income law originally evolved along two more or less distinct lines: one concerned with income from labor and the other with income

⁴³ Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in 26 U.S.C.). Section 703 of the Act amended the Code by adding sections 62(a)(19) and (e). *Id.* at 1546-47.

⁴⁴ See discussion *supra* note 12 and accompanying text.

⁴⁵ See discussion *supra* note 11 and accompanying text.

⁴⁶ See *supra* notes 13-15. The nonapplication of the Jobs Act will, of course, not pose a problem in the unlikely event that attorneys' fees qualify as fully deductible under one of the other categories listed in section 62, such as the trade or business expenses of a self-employed taxpayer, the reimbursed trade or business expenses of an employee, or the expenses of producing rent or royalty income. I.R.C. § 62(a)(1), (a)(2)(A), (a)(4).

⁴⁷ See generally BITTKER & LOKKEN, *supra* note 1, ¶ 75.2.1.

from property.⁴⁸ The Court's first encounter with an assignment of income question arose in 1930 in the case of *Lucas v. Earl*,⁴⁹ which involved labor income. Mr. Lucas, who worked as an attorney, made a binding assignment by contract to his spouse, a housewife, of one-half of all his future earnings. The issue was whether the assigned labor income should be attributed and taxed to Mr. Lucas, the assignor, who earned the assigned income. The Court held that labor income is always taxable to the person who earns it, even if the income is assigned to another.⁵⁰

When *Lucas* was decided, all taxpayers filed income tax returns as individuals and there was no provision for married couples to file jointly.⁵¹ Today, by filing a joint return, a taxpayer is able to cause one-half of his or her income to be taxed to a spouse.⁵² Thus, the availability of joint income tax filing for married couples produces the result unsuccessfully sought by Mr. Lucas. Nevertheless, the *Lucas* principle remains critical to preventing tax avoidance by individuals with high marginal tax rates, who might otherwise assign their labor income to related parties other than a spouse (such as minor children) in order to take advantage of the assignees' lower marginal tax rates. Even after the institution of joint returns, the Court continued to refer to the *Lucas* principle, that labor income is taxed to the person who performs services and earns such income, as "the first principle of income taxation"⁵³ and as "the cornerstone of our graduated income tax system."⁵⁴ The leading treatise on federal income taxation describes the continuing influence and importance of *Lucas*:

Rarely has a judicial decision shaped an entire area of tax practice as conclusively as *Lucas v. Earl*. It prevents ordinary wage earners and salaried employees from assigning portions of their earned income to members of their families, and it is almost equally effective against similar assignments of self-employed persons and partners engaged in

⁴⁸ *Id.* at 75-6 to -7.

⁴⁹ 281 U.S. 111 (1930).

⁵⁰ *Id.* at 114-15.

⁵¹ Congress did not provide for joint filing until 1948. See BITTKER & LOKKEN, *supra* note 1, ¶ 111.3.2.

⁵² I.R.C. § 6013. See generally BITTKER & LOKKEN, *supra* note 1.

⁵³ Commissioner v. Culbertson, 337 U.S. 733, 739-40 (1949).

⁵⁴ United States v. Basye, 410 U.S. 441, 450 (1973).

occupations . . . such as the practice of law and medicine.⁵⁵

During the decade after its decision in *Lucas*, the Court also developed principles for determining the person to whom property income should be attributed and taxed.⁵⁶ The Court had two competing objectives to balance: on the one hand, as in *Lucas*, preventing a high marginal rate taxpayer from assigning income for tax purposes to a party in a lower tax bracket; on the other hand, avoiding the imposition of unreasonable impediments to the free transfer of property, as would exist if an assignor of property were taxable on the property income even after a bona fide assignment of the property to another.

While adopting the perhaps obvious answer that property income should be taxed to the owner, the Court was careful to require that ownership be determined on the basis of economic realities rather than legal formalities. Thus, for example, in 1930 in *Corliss v. Bowers*,⁵⁷ the Court held that an individual who transfers property to a trust but retains the legal power to revoke the trust is treated as owner of the property for tax purposes and is therefore taxed on the property income even though he has relinquished formal legal title.

Similarly, in a landmark 1940 case, *Helvering v. Horst*,⁵⁸ the Court reiterated the principle that property income is to be taxed to the person who controls the property, even if the right to the income is assigned to another person. Mr. Horst owned a bond with the right to receive periodic interest. Shortly before an interest payment date, he transferred to his son the right to receive that period's interest payment. The question was whether Mr. Horst should report the interest income that was assigned and paid to his son. In holding that the interest income should be taxed to Mr. Horst, the Court emphasized that he retained control over the property (the bond) that was the source of the interest income. Therefore, under the principle that the person controlling an asset is taxable on the income produced by the asset, Mr. Horst had to treat the interest as his income.

⁵⁵ BITTKER & LOKKEN, *supra* note 1, at 75-10.

⁵⁶ See *Harrison v. Schaffner*, 312 U.S. 579 (1941); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940); *Blair v. Commissioner*, 300 U.S. 5 (1937); *Corliss v. Bowers*, 281 U.S. 376 (1930).

⁵⁷ 281 U.S. 376, 377-78 (1930).

⁵⁸ 311 U.S. 112, 116-17 (1940).

B. The Court Misapplies Lucas and Horst

In *Banks* and *Banaitis*, the Court concludes that the assignment of income law principles of *Lucas* and *Horst* require a litigant to report as income the portion of a settlement paid to an attorney as a contingent fee. The issue, the Court states, is:

[W]hether the assignor retains dominion over the income-generating *asset*, because the taxpayer “who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants.” [citing *Horst* and *Lucas*] . . .

In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff’s legal injury. The plaintiff retains dominion over this asset throughout the litigation.⁵⁹

It may be helpful to restate the Court’s reasoning as a syllogism:

- (1) The income in these cases, consisting of the settlement, was the product of an asset, namely the cause of action.
- (2) Income from an asset is taxed to the person who controls the asset under the assignment of income principles of *Lucas* and *Horst*.
- (3) The plaintiff retained control over the asset.
- (4) Therefore, the plaintiff must report all the income from the asset under the assignment of income principles of *Lucas* and *Horst*.

The Court treats the recovery in each case as entirely the product of an asset, the cause of action, and ignores the contribution of services made by the plaintiff’s attorney. As a matter of economics, however, the settlement in these cases is obviously the product of two separate factors of production. One factor is labor, consisting of legal services, contributed by the plaintiff’s attorney. The other factor is an asset, consisting of the cause of action, contributed by the plaintiff.

⁵⁹ *Commissioner v. Banks*, 125 S. Ct. 826, 831–32 (2005) (emphasis added).

The attorney-fee portion of the settlement compensates the attorney for the contribution of his legal services and therefore is the economic return to (that is, the amount earned by) the attorney's services. The plaintiff's portion of the settlement compensates the plaintiff for the contribution of his asset (the cause of action) and therefore is the economic return to (that is, the amount earned by) the asset.

Once the settlement is characterized as the product of two factors, with the attorney-fee portion constituting the economic return to the attorney's labor and the plaintiff's portion of the settlement constituting the economic return to the cause of action, neither *Lucas* nor *Horst* can justify taxing the attorney-fee portion to the plaintiff. Assignment of income principles are irrelevant since the attorney's fee is compensation neither for labor provided by the plaintiff in connection with the litigation (so that *Lucas* applies), nor for an asset provided by the plaintiff in connection with the litigation (so that *Horst* applies). If the Court's holding — that the attorney's fee is income to the plaintiff — is to be justified, it must be under some other theory.

The following examples may help distinguish instances in which assignment of income principles do apply to contingent fees from cases like *Banks* and *Banaitis* and in which the assignment of income principles of *Lucas* and *Horst* are irrelevant.

Example #1 — A contingent-fee agreement provides that the attorney, who is the plaintiff's child, will receive 70% of any recovery. If the contingent-fee agreement was negotiated between two unrelated parties dealing at arms' length, it would provide for the attorney to receive only 40% of any recovery. Because the parent and child are related parties and because the contingent fee exceeds what would be paid under an arms' length deal, the fees in excess of 40% of the recovery presumably do not represent compensation for the services of the attorney and are income attributable to the cause of action, which is the property of the plaintiff. Therefore, the plaintiff must report the excess fees as income from the asset.

Example #2 — A plaintiff signs an agreement assigning 20% of any recovery to a hospital to which the plaintiff owes a debt for medical care. Because the hospital has not contributed property or services to the conduct of the litigation, the amount paid to the hospital cannot represent

compensation for either property or labor contributed to the litigation activity. The payment to the hospital liquidates a debt owed by the plaintiff and presumably represents an assignment by the plaintiff of income attributable to the cause of action, which is the property of the plaintiff. Therefore, the plaintiff must report that amount as income.

Example #3 — A contingent-fee agreement provides that the attorney will receive 40% and that the plaintiff will receive 60% of any recovery. The attorney and the plaintiff are unrelated parties, dealing at arms' length. If there is a recovery, the 40% paid to the attorney represents compensation for the attorney's labor and the 60% paid to the plaintiff represents income attributable to the cause of action, which is the property of the plaintiff. Therefore, assignment of income principles should not require the plaintiff to report the amount paid to the attorney.

C. *Why and How Did the Court Go Wrong?*

Why does the Court insist on characterizing the settlement as the product solely of an asset consisting of the cause of action and refuse to view the settlement as the product jointly of that asset and the personal services of the attorney, particularly when the briefs for the respondents forcefully pressed that view?⁶⁰

The Solicitor General's Reply Brief made two arguments against the characterization of the settlement as the joint product of an asset (consisting of the plaintiff's cause of action) and the services of the attorney:

First, respondents ignore the fact that the legal right to recover damages arises at the time of the actionable *injury*, not when that right is subsequently reduced to judgment with (or without) the assistance of an attorney. Under the law, a plaintiff's right to income is complete when an actionable injury is suffered, because it is the injury that gives rise to the cause of action and provides the measure of the damages recovery to which the plaintiff is entitled. To be sure, an

⁶⁰ Brief of Respondent Banks at *10, *15, 2004 WL 1876293; Brief of Respondent Banaitis at *5-9, 2004 WL 1835368.

attorney's services may help enforce that income entitlement, but the attorney does not *earn* the damages award; the plaintiff had already "earned" his or her entitlement to that award by suffering injury before the attorney even appeared on the scene. What the attorney "earns" is merely the right to be paid for services rendered.

Second, the factual premise of respondents' argument—that they could not have recovered on their causes of action absent the services of their attorneys—is pure speculation. Many litigants successfully represent themselves, and there is no basis to determine from the record in these cases whether respondents could have achieved the same or similar recoveries had they represented themselves.⁶¹

The Court does not mention these arguments in its opinion, and it is difficult to believe that the Court took either argument seriously. The government's first argument is irrelevant. The critical question is not when the right to sue arises but rather what factors of production produce the recovery. Clearly, there are two factors involved: the plaintiff's cause of action and the attorney's services.

The government's second argument defies belief and common sense. As the brief for Mr. Banaitis noted:

After years of intensive litigation, with repeated motions, extensive discovery, a lengthy trial, and two appeals, the defendants agreed to settle the case for \$8,728,559. It defies reality to assert, as the government does, that only respondent earned that money. The Commissioner does not suggest that the defendants in this case, from the day they dismissed respondent in 1987, wanted to pay him more than \$8 million in back pay and damages, were somehow unable to find him for eight years, and then spontaneously produced the check in 1995 when they happened to encounter him in an Oregon courthouse.... If the attorney representing respondent had not invested hundreds or thousands of hours of his time working on this case, respondent would have received nothing.⁶²

⁶¹ Reply Brief of Petitioner at *7, 2004 WL 2190372.

⁶² Brief of Respondent Banaitis, *supra* note 60, at *10–11.

Moreover, during oral argument, at least Justice Souter indicated that he understood the flaw in the government's position that the entire recovery had already been earned at the time when the right to sue arose:

JUSTICE SOUTER [addressing the government's attorney]: Mr. Salmons, doesn't the plausibility of your argument here rest on the assumption that what the—that the cause of action at the time the—that the plaintiff made the agreement with the lawyer is a cause of action which has the same value as the ultimate recovery that the lawyer gets? Whereas, in fact, the cause of action at the time of the agreement with the lawyer has an inchoate value. The—the value that is actually realized is going to depend in part on the—on the skill and—and the—the gumption of the lawyer. . . .

. . . [I]t seems to me that the value realized as opposed to the right to sue are two different figures. And I don't see realistically how the client has complete control over the value realized, which we don't even know until the lawyer has done his work and gotten the check.⁶³

It is possible that the Court may have doubted whether characterizing the recovery as a joint product distinguishes *Banks* and *Banaitis* from *Lucas*. During oral argument, Justice Ginsburg asked why, if the settlements in *Banks* and *Banaitis* were joint products (of the plaintiff's cause of action and the attorney's services), the earnings of the attorney in *Lucas* were not also the joint product of the husband (who worked as an attorney) and his wife (who provided the husband with household services).

MR. CARTY [counsel for Banks]: [I]n *Lucas v. Earl*, it was the assignor who earned the income that was subject to disposition. Here —

JUSTICE GINSBURG: I'm not so sure about that because why doesn't the theory that—that applies to the lawyer [in *Banks* and *Banaitis*] equally apply to the wife [in *Lucas*]? I mean, she took care of everything going on at home, and that enabled him to go out there and make all that money. So

⁶³ Transcript of Oral Argument at *18, 2004 WL 2513558.

without her services, just like without the lawyer's services —

MR. CARTY: That is an excellent point, Your Honor.⁶⁴

Rather than conceding the point, Mr. Carty might have distinguished *Lucas* from *Banks* and *Banaitis*. Even if Mrs. Lucas contributed to her husband's well-being, she did not contribute either assets or services to the activity of the practice of law for which he was compensated. The compensation that Mr. Lucas received for his legal services is still the economic return to (the amount earned by) his labor. Therefore, when he assigned a portion of that compensation to his wife, he was assigning income that he would earn. On the other hand, in *Banks* and *Banaitis*, the portion of the settlement retained by the plaintiff is the entire economic return to (that is, the entire amount earned by) the asset consisting of the cause of action. The attorney-fee portion is not earned either by the asset or by services contributed by the plaintiff, but by the attorneys who performed litigation services, whereas Mr. Lucas actually earned the compensation that he sought to assign to his wife.

The attorneys for Mr. Banks and Mr. Banaitis may also have weakened their position by attempting to distinguish *Lucas* and *Horst* on grounds that are clearly wrong. Briefs for the respondents emphasized that in their cases, unlike *Lucas* and *Horst*, (1) there was no tax avoidance purpose,⁶⁵ (2) the contingent-fee agreement was an arms' length transaction between independent parties who were not family members,⁶⁶ and (3) the contingent-fee agreement conveyed no more than a mere expectancy of future income.⁶⁷

The Supreme Court had previously declared that the assignment of income doctrine could be applied notwithstanding these three factors. In *Lucas*, for example, the Court flatly stated that the presence or absence of a tax avoidance motive was irrelevant since it was too difficult to ascertain.⁶⁸ Moreover, *Lucas* involved a mere

⁶⁴ *Id.* at *52–53.

⁶⁵ Brief of Respondent Banks, *supra* note 60, at *24; Brief of Respondent Banaitis, *supra* note 60, at *23.

⁶⁶ Brief of Respondent Banks, *supra* note 60, at *24; Brief of Respondent Banaitis, *supra* note 60, at *22–23.

⁶⁷ Brief of Respondent Banks, *supra* note 60, at *13; Brief of Respondent Banaitis, *supra* note 60, at *24.

⁶⁸ 281 U.S. 111, 115 (1930). It was in 1901 that Mr. Lucas signed the contract providing his wife with the right to one-half of his earnings. In its opinion in *Banks*

expectancy, since the assignment was made two decades before Mr. Lucas earned the income in question. In addition, while the assignments in both *Lucas* and *Horst* were to family members, the Court clearly contemplated that the assignment of income doctrine could apply to an arms' length assignment to a third party. The opinion in *Horst*, for example, stated that the owner of the bond would be taxable on the interest if he assigned it to a grocer in satisfaction of a debt for groceries.⁶⁹

In its opinion in *Banks* and *Banaitis*, the Court explicitly rejects the respondents' arguments that either the absence of a tax avoidance purpose or the conveyance of a mere expectancy distinguished their cases from *Lucas* and *Horst*.⁷⁰ Thus, the respondents may have lessened their chances for success by attempting to distinguish *Banks* and *Banaitis* on invalid grounds. The respondents' clearly incorrect arguments may have distracted the Court from focusing on the valid distinction: that the income was the joint product of the asset contributed by the plaintiff and the services contributed by the attorney, whereas in *Lucas*, the income was entirely earned by Mr. Lucas, and in *Horst*, the interest income was entirely the return on the father's bond.

In rejecting the characterization of the recovery in each case as the joint product of the plaintiff's asset and the attorney's services and focusing instead on the question of who controlled the cause of action, the Court may also be mistakenly responding to a theory articulated

and *Banaitis*, the Court assumes that Mr. Lucas could not have had a tax avoidance purpose at that time, since the federal income tax only became law in 1913 after enactment of the Sixteenth Amendment to the Constitution. During oral argument, Justice Scalia pressed the attorney for Mr. Banaitis on this point:

JUSTICE SCALIA: There was no avoidance motive in the —

MR. JONES: Yes.

JUSTICE SCALIA:—granddaddy of all cases. The assignment there, although it was between family members, had been made before there was an income tax.

MR. JONES: But we must —

JUSTICE SCALIA: The income tax didn't exist. There—there couldn't conceivably have been an avoidance motive. So—so our holding could hardly be based upon—upon the existence of an avoidance motive.

Transcript of Oral Argument, *supra* note 63, at *35–36.

⁶⁹ 311 U.S. 112, 117 (1940).

⁷⁰ *Commissioner v. Banks*, 125 S. Ct. 826, 831–32 (2005).

by the Courts of Appeals in *Banks*⁷¹ and *Banaitis*,⁷² which was repeated in the briefs for the respondents. Both Courts of Appeals construed the contingent-fee agreements as transferring ownership of part of the cause of action to the attorney.⁷³ Under this reasoning, for example, a contingent-fee agreement guaranteeing the attorney the right to one-third of any recovery transfers ownership to the attorney of a one-third interest in the asset in question, the cause of action, with the plaintiff retaining two-thirds of the asset. Consequently, assignment of income principles do not require the plaintiff to report the attorney-fee portion of the settlement. That portion, according to the Courts of Appeals in *Banks* and *Banaitis*, was income earned by an asset that the plaintiff no longer owned and which, at the time of the settlement, was owned by the plaintiff's attorney. The Supreme Court reaches the contrary conclusion that the plaintiff should be treated as owning the entire asset consisting of the cause of action because "[t]he plaintiff retains dominion over this asset throughout the litigation."⁷⁴ Therefore, under the *Horst* principle — that the person who controls an asset is taxed on the asset's income — the Court holds that the plaintiff must report the entire recovery, including the portion devoted to attorney's fee.⁷⁵ The Court, however, fails to consider that even if the plaintiff effectively retained the entire asset, the plaintiff's return on (the amount earned by) the asset consisted of the plaintiff's share of the settlement and no more. Thus, whether the contingent fee is characterized as the economic return on a portion of the asset transferred to the attorneys under the contingent-fee agreement (as the Courts of Appeals held in *Banks* and *Banaitis*) or as the economic return to the attorneys' services, it is not the economic return for either the plaintiff's services or an asset owned by the plaintiff.

IV. ATTRIBUTING INCOME FROM JOINT PRODUCTION

As the preceding section indicates, foundational principles of assignment of income law, as articulated in *Lucas* and *Horst*, do not justify the Supreme Court's holding that "the litigant's income

⁷¹ *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003).

⁷² *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003).

⁷³ *Banks*, 345 F.3d at 383–86; *Banaitis*, 340 F.3d at 1081–83.

⁷⁴ *Banks*, 125 S. Ct. at 832.

⁷⁵ *Id.* at 832–33.

includes the portion of the recovery paid to the attorney as a contingent fee.”⁷⁶ Instead of applying assignment of income law principles, the Court should have analyzed the cases of Mr. Banks and Mr. Banaitis as involving the question of how income should be reported when it is the joint product of assets and/or services contributed by two or more parties to a common venture with a view to sharing the profits.

A. Does the Contingent Fee Create a Partnership?

If joint producers create a partnership to conduct a common venture under Subchapter K of the Code, then each joint producer will be taxed only on that producer’s proportionate share of the income.⁷⁷ Consequently, the brief for Mr. Banaitis argued that the contingent-fee agreement should be treated as creating a partnership for federal income tax purposes so that Mr. Banaitis would be taxed on his share of the recovery but no more.⁷⁸ In its opinion, however, the Court cites the principal-agent character of the attorney-client relationship as the reason for not treating the contingent-fee arrangement as a partnership:

We . . . reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes. The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. The client may rely on the attorney’s expertise and special skills to achieve a result the client could not achieve alone. That, however, is true of most principal-agent relationships

The attorney is an agent who is duty bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal.⁷⁹

⁷⁶ *Id.* at 829.

⁷⁷ I.R.C. § 701 *et seq.*

⁷⁸ Brief of Respondent Banaitis, *supra* note 60, at *5-13.

⁷⁹ *Banks*, 125 S. Ct. at 832-33 (internal citations omitted). After explicitly rejecting the respondents’ suggestion that the contingent-fee agreement be treated as

The opinion does not explain why the nature of the duties owed by the attorney to the client under state law should affect whether the contingent-fee agreement should be treated as creating a partnership for federal tax purposes. The Court simply asserts that such duties matter, referring to the fact that the law of every state prohibits a lawyer from entering an actual partnership with a client whom the lawyer represents.⁸⁰ The reference to actual partnerships under state law nevertheless implies an explanation: since virtually every state law prohibits such partnerships, the contingent-fee agreement should not be treated as creating a partnership for federal income tax purposes.

This explanation, however, contradicts long-established law and practice. The Court has previously stated that whether a partnership exists for purposes of state law does not determine whether a partnership exists for purposes of federal taxation.⁸¹ As the leading treatise on partnership taxation notes:

Whether a joint enterprise is a partnership at common law or under state partnership statutes is not determinative of its status for income tax purposes. Therefore, an enterprise may be classified as a partnership for tax purposes even though it is not, or could not be, a partnership under a state partnership statute. Conversely, the fact that a joint enterprise is a

a partnership, the Court bizarrely claims that it is in fact not deciding the partnership issue:

Respondents and their *amici* propose other theories to exclude fees from income or permit deductibility. These suggestions include: (1) The contingent-fee agreement establishes a Subchapter K partnership These arguments, it appears, are being presented for the first time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories.

Id. at 833.

⁸⁰ *Id.*

⁸¹ *Commissioner v. Tower*, 327 U.S. 280, 288 (1946) (holding Michigan law cannot determine partnership status for purposes of federal income tax law); *see also Nichols v. Commissioner*, 32 T.C. 1322, 1330 (1959) (acq.) (holding partnership for federal income tax purposes existed between physician and his nonphysician wife, even though prohibited under state law); Rev. Rul. 77-332, 1977-2 C.B. 484 (holding partnership for federal income tax purposes existed between CPA and non-CPAs, even though prohibited by state law).

partnership under state law is not dispositive of its classification for federal income tax purposes.⁸²

A more substantial reason for not treating a contingent-fee agreement as creating a partnership for federal tax purposes is that the venture would then be subject to the extremely detailed and complex rules and requirements of Subchapter K of the Code.⁸³ As one commentator has noted, “contingent-fee contracts are quite common, and to convert every contingent-fee contract in the economy into the equivalent of a tax partnership would be to severely complicate common economic arrangements.”⁸⁴

In any event, a decision not to classify the contingent-fee agreement as a partnership, for whatever reason, does not by itself resolve the question before the Court in these cases. True, a decision to classify the agreement as a partnership would have meant that Mr. Banks and Mr. Banaitis should report as income only their shares of the recovery, exclusive of the contingent fee. The converse, however, is not true. A decision not to classify the agreement as a partnership still leaves the question before the Court unanswered. Such a decision does not tell us whether the plaintiff should report as income the contingent-fee portion of the recovery.

B. Distinctions Among Informal Profit-Sharing Activities

During oral argument, the Justices made no mention whatsoever of the principal-agent character of the attorney-client relationship as the reason for not treating the contingent-fee arrangement as a partnership.⁸⁵ The Justices, however, repeatedly suggested that the result sought by Mr. Banks and Mr. Banaitis — taxing the plaintiff on his share of the recovery but no more — would create arbitrary differences among similarly situated taxpayers.⁸⁶

Taxpayers often contribute property and/or services to a common venture with a view to sharing profits but without creating a

⁸² 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 3-5 (3d ed. 2005) (emphasis added).

⁸³ I.R.C. § 701 *et seq.*

⁸⁴ Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531, 539 (July 24, 2000).

⁸⁵ Transcript of Oral Argument, *supra* note 63.

⁸⁶ *Id.* at *30-32, *36-37.

partnership for federal tax purposes.⁸⁷ Such arrangements can be described as informal profit-sharing activities. They are informal because the parties are not treated as creating a partnership (or other separate entity) for federal tax purposes. They involve profit-sharing because the parties pool property and services and agree to share profits. Consider three examples of such informal profit-sharing activities:

Example #4 — A, an owner of farmland, and B, a tenant farmer, agree that B may grow crops on the land and sell them, with 30% of the proceeds going to A and 70% going to B.

Example #5 — C, a plaintiff with a cause of action, and D, an attorney, sign a contingent-fee agreement under which D will litigate C's cause of action, with two-thirds of any recovery going to C, and one-third going to D.

Example #6 — E, an author, and F, a literary agent, agree that F will sell the rights to E's books to a publisher, with 80% of the proceeds going to E and 20% going to F.

In Example #4 (landowner and tenant farmer), the Internal Revenue Service (Service) takes the position that each profit-sharing joint producer reports as income his or her respective share of the proceeds. Neither joint producer must report the entire amount of the proceeds as income.⁸⁸ In Examples #5 and #6, however, the Service takes the position that the plaintiff and the author respectively must report the entire proceeds as income and then deduct payments to the attorney and literary agent to the extent permitted.⁸⁹

What are the criteria used by the Service to determine how to treat these three examples of informal profit-sharing activities? There is no Code rule, Treasury regulation, or other official pronouncement

⁸⁷ See generally MCKEE ET AL., *supra* note 82, at 3-24 ("There is, however, a wide variety of economic arrangements that are not partnerships, but that involve the cooperative commitment of capital and services with a view to making a profit or achieving some gainful economic objective.").

⁸⁸ INTERNAL REVENUE SERVICE PUBLICATION 225, FARMER'S TAX GUIDE 78 (2005).

⁸⁹ Brief of Petitioner at *24, 2004 WL 1330104; Reply Brief of Petitioner, *supra* note 61, at *8-9.

on point. The statute — the Internal Revenue Code — is entirely silent on this question. The Treasury has not issued regulations providing guidance. Nor has the Service issued a ruling explaining when it is likely to allow each joint producer to report his or her contractual share of the proceeds and when it will require one of the joint producers to report the entire amount and then deduct payments to the other producer to the extent permitted. The Service appears to make judgments about how to treat such activities on a purely ad hoc basis.

Much of the time, the decision how to treat such informal profit-sharing activities will not matter, because even if one party is required to report all the proceeds of the joint production activity as income, the party will be entitled to fully offsetting deductions for payments that compensate other parties for their contributions. Thus, for example, assuming that the author in Example #6 is self-employed, he will be able to deduct the literary agent's fee without limit because the miscellaneous itemized deduction category does not include the business expenses of self-employed persons.⁹⁰ The issue becomes important, however, in cases like *Banks* and *Banaitis*, in which the expense is classified as a miscellaneous itemized deduction so that the deduction is limited under the regular tax and not available at all under the AMT.

For this reason, Mr. Banks and Mr. Banaitis argued that they should be treated like the landowner in Example #4 rather than like the author in Example #6.⁹¹ In making this argument, they followed Tax Court Judge Renato Beghe, who had earlier argued in an emphatic dissent in *Kenseth v. Commissioner*⁹² that the plaintiff and attorney with a contingent-fee agreement in Example #5 are like the landowner and the tenant farmer in Example #4:

One way to think of the contingent fee agreement . . . is to analogize it to a cropsharing arrangement. Cropsharing is strikingly similar to the contingent fee agreement. The attorney is in the position of the tenant farmer, who bears all his direct and overhead expenses incurred in earning the contingent fee (and the contingent fees under all such

⁹⁰ I.R.C. § 62(a)(1).

⁹¹ See generally Brief of Respondent Banks, *supra* note 60; Brief of Respondent Banaitis, *supra* note 60.

⁹² 114 T.C. 399 (2000).

arrangements to which he is a party with other clients). The client is in the position of the landowner . . . who bears none of the operating expenses, but is responsible for paying the carrying charges on his land, such as mortgage interest and real estate taxes. These charges are analogous to court costs, which the client under a contingent fee agreement is usually responsible for, and which the attorney can only advance to or on behalf of the client

. . . [C]ropsharing arrangements result in a division of the crops and the total gross revenue from their sale in the agreed-upon percentages. This income is characterized as rental income to the owner or lessee of the land and farm income to the tenant-farmer.

The analogy of contingent fee agreements to cropsharing arrangements is suggestive and helpful. It solves the problem under the attorney's ethics rule that says the attorney is not supposed to acquire an ownership interest in the cause of action that is the subject of such an agreement. The client, like the owner or lessee of farmland who rents it to the tenant-farmer, transfers to the attorney an interest in the recovery that is analogous to the tenant-farmer's share of the crop generated by his farming activities on the land leased or made available to him by the nonactive owner. . . .⁹³

During oral argument, the Justices incorrectly suggested that the position of the respondents would draw arbitrary lines in the treatment of informal profit-sharing activities, while the position of the government would not. The Justices repeatedly pressed the attorneys for Mr. Banks and Mr. Banaitis to defend the arbitrary difference in treatment, which a decision for the respondents would create, between the contingent-fee plaintiff in Example #5 and the author in Example #6.⁹⁴ The Justices did not mention, however, that the government's position would cause an arbitrary difference in treatment between the landowner in Example #4 and the contingent-

⁹³ *Id.* at 454–55 (Beghe, J., dissenting) (citations omitted).

⁹⁴ Transcript of Oral Argument, *supra* note 63, at *31–32. When both Justices Kennedy and Breyer pushed the attorney for Mr. Banaitis to articulate a principled basis for distinguishing between the contingent-fee plaintiff in Example #5 and the author in Example #6, the attorney tried to change the subject. *Id.* at *31–33.

fee plaintiff and author in Examples #5 and #6. The Justices thus failed to acknowledge that the position of the government, no less than the position of the respondents, draws arbitrary lines.

In fact, under ordinary and usual principles of taxation, the landowner, plaintiff, and author in Examples #4, #5, and #6 should all be treated the same, with each having to report only his or her share of the proceeds as gross income under section 61(a). Under these principles, it is either legal entitlement or economic benefit that usually triggers income taxation.⁹⁵ A taxpayer must report amounts to which the taxpayer is legally entitled or from which the taxpayer benefits economically. Conversely, a taxpayer ordinarily need not report as income an amount to which the taxpayer is not legally entitled and from which the taxpayer does not benefit economically.⁹⁶

In Example #5, by virtue of the contingent-fee agreement, the plaintiff is not legally entitled to and does not benefit economically from the attorney's share of the proceeds. Therefore, the plaintiff should have to report only his or her share of the proceeds as gross income under section 61(a) and should not have to report the attorney's share. Similarly, the landowner in Example #4 and the author in Example #6 are neither legally entitled to nor economically benefited from the share of the proceeds going to the farmer and agent respectively and therefore should not have to report those amounts as gross income under section 61(a).⁹⁷

There are, of course, exceptions to these principles, under which a taxpayer may have to report income to which the taxpayer is not

⁹⁵ See, e.g., *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 423–24 (1932) (holding that taxpayer should not report income from property in 1916 when taxpayer's right to the income was contested and the income was paid to a receiver instead of the taxpayer but that taxpayer should report the income in 1917 when a court terminated the receivership and the taxpayer became entitled to the income); *United States v. Drescher*, 179 F.2d 863, 865–66 (2d Cir. 1950) (holding that a taxpayer must report as gross income the economic benefit of a nontransferable annuity purchased for the taxpayer by his employer).

⁹⁶ *N. Am. Oil Consol.*, 286 U.S. at 423–24; *Drescher*, 179 F.2d at 865–66.

⁹⁷ It is true that in these examples, each co-producer benefits from the contribution of the other co-producer. Nevertheless, the benefit conferred by co-producers on each other in joint production activities does not and should not constitute a separate item of gross income, in addition to each co-producer's contractual share. To illustrate, in example #4, the tenant farmer benefits from the use of the land, and the landowner benefits from the tenant's labor. Yet neither reports such benefit as a separate additional item of income.

entitled and from which the taxpayer does not benefit economically. In *Lucas*,⁹⁸ for example, despite the lack of entitlement or benefit, the husband is taxed because the income is earned by him. In *Horst*,⁹⁹ despite the lack of entitlement or benefit when the interest is paid, the father is taxed because the income is earned by property that he controls. For reasons explained in Part II above, however, neither of those exceptions applies to Examples #4, #5, and #6 (or to the facts of *Banks* or *Banaitis*).

C. *Contingent Versus Hourly Fees*

Questioning the attorney for Mr. Banaitis during oral argument, the Justices also seemed troubled by another distinction — between the plaintiff who enters a contingent-fee agreement and the plaintiff who pays the attorney an hourly rate.

JUSTICE STEVENS: Yes, but what if you had the same result but—in terms of the sharing of the expense and the recovery, but it was computed on an hourly basis rather than a percentage basis? Would that produce a different result?¹⁰⁰

As the questioning implies, had Mr. Banks or Mr. Banaitis paid the attorneys an hourly rate, the portion of the settlement paid to the plaintiffs' attorneys would presumably have to be reported as income by the plaintiffs. Therefore, the Court was asking, wouldn't the position of respondents create a second arbitrary difference between plaintiffs paying their attorneys a contingent fee (who would only report as income their recovery net of attorneys' fees) and plaintiffs paying their attorneys by the hour (who would be obligated to report their entire recovery as income)?

Although a distinction between profit-sharing payments that bear the risk of a venture and fixed payments would result, this distinction is already embedded in current tax law and practice. Return to Example #4 above — if the tenant pays the landowner a fixed rent (analogous to the plaintiff paying the attorney by the hour), then the tenant presumably must report the entire proceeds of selling the crops as income and take a deduction for the rent paid.

⁹⁸ 281 U.S. 111 (1930).

⁹⁹ 311 U.S. 112 (1940).

¹⁰⁰ Transcript of Oral Argument, *supra* note 63, at *36.

An *Amicus* brief proposed an alternative theory that would have permitted a decision for Mr. Banks and Mr. Banaitis while at the same time treating alike both contingent-fee and hourly fee plaintiffs.¹⁰¹ The brief argued that the attorneys' fees should be capitalized, that is, treated as the cost of acquiring and disposing of an asset consisting of the cause of action.¹⁰² In that event, under longstanding provisions of the Code, the taxpayer would report as income only the difference between the amount realized from the asset (which is the recovery) and the asset's cost consisting of the attorneys' fees.¹⁰³ Whether the plaintiff pays a contingent fee or by the hour, the capitalization argument treats the payment as a cost of an asset so that the plaintiff reports as income only the difference between the total recovery from the asset and the asset's cost. During oral argument, the Justices repeatedly asked questions regarding the capitalization rationale, giving the impression that the Court might adopt this theory as a basis for decision.¹⁰⁴ The Court's opinion, however, states simply that it was not reaching the merits of the capitalization argument since it had not been considered by the courts below.¹⁰⁵ Of course, had the Court adopted the capitalization approach, it could have eliminated any differences in the treatment of contingent and hourly fees.¹⁰⁶

To sum up, the difficulty of drawing principled distinctions (either between different kinds of informal profit-sharing activities or between payment according to a profit percentage and a fixed rate) cannot justify the Court's holding in *Banks* and *Banaitis*. Although during oral argument, the Justices repeatedly expressed concern that a

¹⁰¹ Brief for Prof. Charles Davenport as Amicus Curiae Supporting Respondents, 2004 WL 1860016.

¹⁰² *Id.* at *5-10.

¹⁰³ I.R.C. §§ 61(a)(3), 1001(a).

¹⁰⁴ Transcript of Oral Argument, *supra* note 63, at *12-13, *21-22, *27, *41-42.

¹⁰⁵ *Commissioner v. Banks*, 125 S. Ct. 826, 833 (2005).

¹⁰⁶ The proposed capitalization treatment of legal fees as the cost of a recovery parallels the actual treatment of the manufacturer or merchandiser of inventory under Treas. Reg. § 1.61-3(a), in conjunction with the capitalization rule of section 263A. The regulation provides that "[i]n a manufacturing [and] merchandising . . . business, 'gross income' means the total sales, less the cost of goods sold . . ." Under section 263A, the salary and raw material costs of manufacturing or merchandising inventory are capitalized as part of the cost of inventory. Thus, the manufacturer or merchandiser would include in gross income under section 61(a) only the receipts from selling inventory less their cost. I am grateful to Professor Bernard Wolfman for suggesting this analogy.

decision for the respondents would create arbitrary distinctions, the Court's opinion does not mention this problem as a reason for its holding. Perhaps, on reflection, the Justices recognized that arbitrary lines would persist even if they decided for the government and therefore omitted that consideration in their published opinion.

V. THE RELEVANCE OF FEE-SHIFTING STATUTES

A. *Conflict Between Tax Law and Fee-Shifting Statutes*

Even if the Court's holding — that the plaintiff must report as income the portion of a recovery paid as a contingent fee — is correct *purely as a matter of tax law standing alone*, the decision nevertheless undermines the fee-shifting provisions of federal statutes, which permit a prevailing plaintiff to recover attorneys' fees from the defendant. The purpose of the fee-shifting statutes is to enable the plaintiff who cannot pay an attorney to act as a “private attorney general”¹⁰⁷ vindicating national policy. Therefore, Congress has provided for the prevailing plaintiff in specified categories of litigation to recover not only damages, but also a reasonable amount to pay for the services of an attorney.¹⁰⁸

Taxing the plaintiff on the attorney-fee portion of a recovery, however, negates the objective of the fee-shifting statutes, which is to permit plaintiffs “to employ . . . lawyers without cost to themselves if they prevail.”¹⁰⁹ When the damages are modest compared to the attorneys' fees, the Court's decision will result in the plaintiff retaining little or none of the damages after paying taxes on the gross recovery, which includes the attorneys' fees as well as the damages. In some cases, the “successful” plaintiff may even suffer a net loss because the tax liability will exceed the damages received.

A New York Times article provides a striking example of such a case.¹¹⁰ The article discusses *Spina v. Forest Pres. Dist. of Cook County*.¹¹¹ In *Spina*, a police officer who sued her employer for sex

¹⁰⁷ *Blum v. Stenson*, 465 U.S. 886, 894 n.10 (1984); *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412, 416 (1978); *Newman v. Piggie Park Enters.*, 390 U.S. 400, 402 (1968).

¹⁰⁸ See *supra* notes 6 and 15.

¹⁰⁹ *Venegas v. Mitchell*, 495 U.S. 82, 86 (1990).

¹¹⁰ Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. TIMES, Aug. 11, 2002, at 18.

¹¹¹ 207 F. Supp. 2d 764 (N.D. Ill. 2002).

discrimination, including sexual harassment, in violation of Title VII of the 1964 Civil Rights Act, was awarded \$300,000 in compensatory damages,¹¹² plus \$950,000 for her attorneys' fees.¹¹³ The fee award was especially large because of the extraordinary dilatory and obstructionist tactics of the defendant.¹¹⁴ If the plaintiff must report as income the entire \$1,250,000 recovery, including the attorneys' fees as well as her compensatory damages, her AMT liability will be approximately \$345,000, or \$45,000 more than her compensatory damage award.¹¹⁵

B. The Spurious Distinction: Settlements Versus Judgments

During oral argument, several Justices indicated that they were well aware of the conflict with fee-shifting statutes,¹¹⁶ and the Court's opinion refers to the problem:

Treating the [attorney] fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit . . . [and] would undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general.¹¹⁷

A neutral observer therefore might reasonably have expected the Court to address and attempt to resolve the conflict, particularly since Mr. Banks' employment discrimination claim was brought under federal and state laws that provide for fee-shifting and the Court had previously observed that, when possible, courts should construe a

¹¹² *Id.* at 779.

¹¹³ *Spina v. Forest Pres. Dist. of Cook County*, No. 98-C-1393, 2002 WL 1770010, at *9 (N.D. Ill. Jul. 31, 2002).

¹¹⁴ *Id.* at *4.

¹¹⁵ Assuming that the taxpayer is married and has no other income or deductions, her AMT income is the entire \$1,250,000 amount. I.R.C. § 55(d)(1)(B), (d)(3)(B). The first \$175,000 of AMT income is taxed at a rate of 26%, and any additional AMT income is taxed at a rate of 28%. I.R.C. § 55(b)(1)(A)(i). The tax due on the first \$175,000 of AMT income is \$45,500, the tax due on the \$1,075,000 of additional AMT income is \$301,000, and the total tax due under the AMT is \$346,500. The net loss to the prevailing plaintiff is nearly \$46,500.

¹¹⁶ Transcript of Oral Argument, *supra* note 63, at *24, *26–28, 2004 WL 2513558.

¹¹⁷ *Commissioner v. Banks*, 125 S. Ct. 826, 834 (2005).

statute to “foster harmony” with other statutory law.¹¹⁸ Yet the Court makes no attempt to harmonize the Code and federal and state statutes with fee-shifting provisions, asserting that it need not address the conflict because in *Banks* there was no court-ordered fee award, “nor was there any indication . . . that the contingent fee paid to Banks’ attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover.”¹¹⁹

The Court’s statement that there was no indication that the contingent fee was in lieu of statutory fees is simply wrong. Mr. Banks’ complaint recited that one of his claims was for attorneys’ fees under the fee-shifting provisions of the 1964 Civil Rights Act,¹²⁰ and the settlement agreement recited that Mr. Banks was to receive \$464,000 in satisfaction of *all* his claims.¹²¹ Thus, the settlement necessarily included the settlement value of his claim for attorneys’ fees as well as the settlement value of his other claims.

The Court’s additional statement that it was unnecessary to address the significance of fee-shifting in Mr. Banks’ case because there had been no court-ordered fee award is inconsistent with settled tax law principles and practices. The Service and the courts routinely determine the tax treatment of an amount received in settlement of a claim by how the amount would have been taxed if received in a judgment.¹²² The leading treatise on the taxation of recoveries states: “For federal income tax purposes, it is irrelevant whether proceeds are received as a result of settlement or judgment; i.e., there is no difference whether litigation (or the threat of litigation) is concluded through court adjudication or by agreement of the parties.”¹²³

For example, a settlement of a claim for lost wages is taxed in the

¹¹⁸ See *Digital Equip. Corp. v. Desktop Direct, Inc.*, 511 U.S. 863, 879 (1994); *Bhd. of R.R. Trainmen v. Chi. River & Ind. R.R. Co.*, 353 U.S. 30, 40–42 (1957).

¹¹⁹ *Banks*, 125 S. Ct. at 834.

¹²⁰ *Commissioner v. Banks*, Nos. 03-892, 03-907, 2004 WL 1562987 at *49–51 (June 14, 2004) (joint appendix to filings for writ of certiorari in U.S. Supreme Court).

¹²¹ The settlement agreement recited that “[t]he parties desire to compromise and settle all claims which are, have been, or could have been asserted by plaintiff against defendants” and characterized the settlement payment as “full and complete satisfaction” of Mr. Banks’ claims. *Id.* at *23–24.

¹²² See *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff’d*, 121 F.3d 393 (8th Cir. 1997); *Sager Glove Corp. v. Commissioner*, 36 T.C. 1173, 1180 (1961), *aff’d*, 311 F.2d 210 (7th Cir. 1962); *Estate of Longino v. Commissioner*, 32 T.C. 904, 905 (1959).

¹²³ ROBERT W. WOOD, *TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS* ¶ 1.2 (3d ed. 2005).

same way as a judgment that awards damages for a claim of lost wages.¹²⁴ Similarly, the settlement of a claim for attorneys' fees under a fee-shifting statute should be taxed in the same way as a judgment that awards the fees under a fee-shifting statute. How else could the tax treatment of the settlement possibly be determined other than by reference to what would have been the tax treatment of a judgment? Amounts received in settlement are in place of what might otherwise have been received by way of judgment and should be taxed accordingly. Thus, the absence of a court-ordered fee award does not justify the Court's decision not to address the conflict with fee-shifting statutes.

C. Should the Writ of Certiorari Have Been Dismissed?

In a supplementary brief filed a few days before oral argument, Mr. Banks and Mr. Banaitis suggested that, in light of the Jobs Act amendment to the Code that made attorneys' fees fully deductible in the future in all civil rights and employment cases, the Court should dismiss the writ of certiorari as improvidently granted.¹²⁵ Given the Jobs Act, the Court could well have concluded that the issues raised in *Banks* and *Banaitis* were no longer of such pressing national importance and that it would be a waste of judicial resources to hear the cases.

The Court was certainly aware of the legislation, noting that the Jobs Act offered an additional reason for not addressing the conflict between the tax law and fee-shifting statutes.¹²⁶ Having proceeded to decide the case on the merits, however, it was unprincipled to disregard the conflict on the basis of a spurious distinction between settlements and judgments and because of legislation resolving the issue for future cases. The Court should either have dismissed the writ as improvidently granted or should have confronted the conflict between the tax law and the fee-shifting provisions of federal statutes.

¹²⁴ *Hodge v. Commissioner*, 64 T.C. 616 (1975).

¹²⁵ Joint Supplemental Brief of Respondents, 2004 WL 2407555.

¹²⁶ *Commissioner v. Banks*, 125 S. Ct. 826, 834 (2005) ("Also, the amendment added by the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.").

VI. CONCLUSION

The Court's opinion sustaining the position of the government in *Banks* and *Banaitis* is poorly reasoned and unpersuasive. Assignment of income principles are irrelevant once the settlement is characterized as the joint product of the plaintiff's asset and the attorneys' services. There is no explanation why the duties owed by the attorney to a client under state law preclude taxing the plaintiff on his proportionate share of a recovery but no more. The disregard of the conflict with fee-shifting provisions of federal statutes depends on an untenable distinction between settlements and judgments.

Additional concerns expressed by the Justices during oral argument are equally groundless. There is no merit to the suggestion that joint production does not distinguish *Banks* and *Banaitis* from *Lucas*. The notion that the plaintiff's position, but not the government's, would create arbitrary differences among similarly situated taxpayers is also incorrect.

Although the Jobs Act undoes the damage in the future for specified categories of litigation, including a wide array of civil rights and employment cases, there remain significant instances, including nonphysical torts such as defamation, ordinary tort litigation involving punitive damages, environmental statutes with fee-shifting provisions, and any judgment or settlement reached before October 22, 2004, to which the new law does not apply.¹²⁷ Under *Banks* and *Banaitis*, plaintiffs in such cases must report as gross income the contingent-fee portion of a recovery. The result will be to overstate the plaintiff's actual income, overtax the plaintiff, and undermine the objectives of the fee-shifting provisions of federal statutes.

¹²⁷ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

