Nos. 03-892/03-907

In The
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Sixth And Ninth Circuits

BRIEF FOR *AMICI CURIAE* PROFESSOR GREGG D. POLSKY AND PROFESSOR BRANT J. HELLWIG IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

This brief for *amici curiae* will address the following question presented in the petition for a writ of certiorari:

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

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INTEREST OF THE *AMICI CURIAE*

Amici curiae are teachers and scholars of the tax law. The issue in these cases involves a subject in which they have a special academic interest and about which they have written. Except for their academic interest, *amici* have no interest in the outcome of these cases.[1]

SUMMARY OF ARGUMENT

Various Circuit Courts of Appeal have reached opposing conclusions on the issue of whether a plaintiff must include in gross income the portion of a recovery that is paid to her attorney pursuant to a contingency fee agreement. The root of the disagreement between those courts holding that the plaintiff's gross income includes the entire recovery and those holding that the plaintiff's gross income is limited to the net recovery that remains after payment of the attorney's fee is the characterization of the contingency fee arrangement.

The courts that have concluded that the contingent attorney's fee is excluded from the plaintiff's gross income view the plaintiff as having transferred, for federal tax purposes, a portion of the underlying cause of action to the

[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief have been filed with the Clerk. Pursuant to this Court's Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party. *Amici* received no monetary contribution for the preparation or submission of this brief apart from the financial support of their respective academic institutions to defray the costs of printing the brief. The opinions expressed in this brief are those of the individual *amici*, and do not necessarily reflect the views of the institutions at which they teach.

attorney upon the execution of the fee agreement. In this manner, the plaintiff and attorney emerge from the agreement as co-owners of the claim. The courts concluding that the plaintiff must include the entire recovery in gross income (including the portion paid to the attorney as a contingent fee) treat the plaintiff as the sole owner of the claim at all times. As it turns out, the characterization of the contingency fee arrangement is of no particular moment. If the tax laws are properly applied, the resulting tax consequences are the same under either description. Regardless of the characterization of the contingent fee arrangement, the plaintiff must include the entire amount of the recovery in gross income, and any portion of the recovery paid to the attorney as a contingency fee gives rise to a deduction.

The courts that have allowed the plaintiff to exclude the attorney fee portion of the recovery failed to apply the tax law correctly. If, in fact, the plaintiff is properly viewed as having transferred a portion of the underlying cause of action to the attorney upon execution of the contingent fee agreement, the transfer of that portion of the claim carries its own tax consequences. In particular, because the transfer of the portion of the claim to the attorney is made in connection with the provision of services by the attorney, the tax consequences of the transfer are governed by § 83 of the Internal Revenue Code. Had these courts properly applied § 83, they would have concluded that the plaintiff's gross income includes the entire recovery–including the portion of the claim proceeds paid to the attorney under the contingency fee agreement. Rather than being excluded from the plaintiff's gross income, the

amounts paid to the attorney as a contingent fee would have given rise to a deduction.

ARGUMENT

The Circuit Courts of Appeals are split on the issue of whether a plaintiff who hires an attorney to prosecute a cause of action for taxable damages on a contingency basis must include in gross income the portion of the recovery paid to the attorney. A majority of circuits to address the issue have concluded that the entire recovery is included in the plaintiff's gross income, leaving the plaintiff with a deduction for the amount of the attorney's contingent fee. *See Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963). On the other hand, a minority of circuits have held that the plaintiff's gross income includes only the net amount retained by the plaintiff; that is, the total recovery reduced by the contingent fee paid to the attorney. *See Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003); *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003); *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *see also Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2003) (following *Cotnam* on *stare decisis* grounds, albeit reluctantly[2]); *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir.

[2] After undertaking a lengthy analysis of the potential applicability of the assignment-of-income doctrine, the Fifth Circuit in *Srivastava* remarked that "were we to decide this case as an original matter, we

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2000) (following *Cotnam* as binding precedent from the former Fifth Circuit).

At the heart of the circuit split is the characterization of the contingency fee agreement. The majority of circuits view the contract as a mere promise on the part of the plaintiff to pay a portion of the recovery to the attorney if and when the recovery is obtained. On the other hand, the circuits in the minority treat the execution of the contract as a present transfer to the attorney of a portion of the underlying cause of action.[3] These latter courts conclude that the contingent fee paid to the attorney represents a liquidation of the attorney's portion of the claim. Consequently, under this view, the contingent fee does not "flow through" the plaintiff and, as a result, the plaintiff's gross income is limited to the portion of the total recovery that remains after the contingent fee is paid.

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might apply the anticipatory assignment doctrine to hold that contingent fees are gross income to the client." *Srivastava v. Commissioner*, 220 F.3d 353, 363 (5th Cir. 2003).

[3] Some courts in the minority base this characterization on the specifics of the applicable attorney's lien statute. *See*, *e.g.*, *Banaitis v. Commissioner*, 340 F.3d 1074, 1083 (9th Cir. 2003) (relying on "the unique features of Oregon law" governing attorney liens); *Cotnam v. Commissioner*, 263 F.2d 119, 125 (5th Cir. 1959) (basing holding on Alabama attorney lien statute). However, other courts–including the Ninth Circuit itself–have determined that the nuances of state attorney lien law are not important in resolving the question of whether a present transfer occurs. *See, e.g.*, *Banks v. Commissioner*, 345 F.3d 373, 385 (6th Cir. 2003) (quoting *Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000) for the proposition that its holding does not depend upon "the intricacies of an attorney's bundle of rights"); *Sinyard v. Commissioner*, 268 F.3d 756, 760 (9th Cir. 2001) (stating that "we do not see how the existence of a lien in favor of the taxpayer's creditor makes the satisfaction of the debt any less income to the taxpayer whose obligation is satisfied").

The purpose of this brief is to illustrate that regardless of the characterization accorded the contingency fee arrangement, the tax results are the same. That is, once a recovery is secured, the plaintiff must include the entire recovery in gross income–including the portion paid to the attorney. The plaintiff is left with a deduction for the amount of the attorney's fee. Accordingly, the debate undertaken by the lower courts concerning whether the plaintiff has assigned to her attorney future income from the claim or a portion of the underlying claim itself ultimately proves to be a wasted exercise.

I. CONTINGENCY FEE AGREEMENT AS A MERE PROMISE TO PAY

One view of the contingency fee arrangement is that the fee agreement constitutes an executory contract under which the plaintiff promises to pay the attorney a percentage of any amounts recovered on the claim in exchange for the attorney's agreement to provide services in connection with the prosecution of the claim. If and when the claim is reduced to a recovery, state law generally provides the attorney with an equitable lien on the recovered amounts to secure the plaintiff's payment obligation. However, under this view of the contingency fee arrangement, the attorney's potential future security interest in the recovered fund does not alter the characterization of what occurs upon the execution of the fee agreement. Rather, the fee agreement remains nothing more than the plaintiff's promise to pay a contingent amount of money in the future.

The income tax treatment of the contingency fee arrangement under this characterization is relatively

straightforward. As the fee agreement evidences only the plaintiff's promise to pay money to the attorney in the future, the execution of the fee agreement carries no immediate tax consequences. Rather, the tax consequences of the arrangement are deferred until the cause of action is prosecuted to a recovery. At that point, barring the application of an exclusion under § 104(a), the plaintiff includes the entire recovery in gross income. The portion of the recovery that the plaintiff pays to the attorney gives rise to a deduction. *See* IRC §§ 162(a), 212(1).[4]

The analysis described above does not change if the parties arrange for the defendant to pay the contingent fee directly to the attorney. Under the venerable case of *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), the defendant's satisfaction of the plaintiff's obligation to pay the attorney is equivalent to the defendant's payment of the contingent fee directly to the plaintiff.[5] In other words,

[4] If the expense relates to the taxpayer's trade or business, including a trade or business of providing services as an employee, the deduction is governed by § 162(a). *See McKay v. Commissioner*, 102 T.C. 465, 488-89 (1994) (holding that costs of suing former employer for wrongful discharge were deductible under § 162), *vacated and remanded on another issue*, 84 F.3d 433 (5th Cir. 1996). If the expense does not relate to the taxpayer's trade or business, the deduction is governed by § 212(1).

[5] The Fifth Circuit in *Cotnam* concluded that the holding from *Old Colony Trust* was inapplicable in the context of a contingency fee arrangement. Specifically, the court reasoned that the taxpayer had previously discharged her obligation to her attorneys by assigning to them a portion of her claim by executing the fee agreement. *See Cotnam v. Commissioner*, 263 F.2d 119, 126 (5th Cir. 1959). Thus, the only way to avoid the application of *Old Colony Trust* is to view the execution of the contingency fee agreement as effecting a present transfer of a portion of the underlying cause of action. The tax consequences of this characterization of the contingency fee arrangement are addressed in section II below.

the plaintiff cannot escape taxation by procuring a direct payment of a portion of a taxable recovery to her creditor. *See Helvering v. Horst*, 311 U.S. 112, 116 (1940). Thus, as one would expect, the tax consequences of the transaction do not turn on something as trivial as the number of checks written by the defendant.

II. CONTINGENCY FEE AGREEMENT AS MORE THAN A MERE PROMISE TO PAY

Under an alternate view of the contingency fee agreement, the fee agreement represents more than the plaintiff's mere promise to pay the attorney a contingent amount of money. Instead, the plaintiff is considered to have presently transferred "something" to the attorney upon execution of the fee agreement. On one hand, the thing presently transferred could be described as a right to a percentage of the future proceeds of the claim. However, most courts adopting the present-transfer characterization of the contingency fee arrangement attempt to avoid application of the assignment-of-income doctrine by describing plaintiff as presently transferring to the attorney a portion of the underlying cause of action. Under this latter characterization, the plaintiff and the attorney emerge from the execution of the fee agreement as co-owners of the claim, with the relative ownership of the claim determined by the percentage contingency fee charged by the attorney. *See Estate of Clarks v. Commissioner*, 202 F.3d 854, 858 (6th Cir. 2000) (concluding that the contingency fee arrangement is "no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant"). Yet if the plaintiff indeed is properly viewed as making a present transfer to the attorney upon execution of the contingency fee agreement, whether the object of the

transfer is described as a portion of the future proceeds of the claim or a portion of the claim itself ultimately proves irrelevant. In either case, the tax consequences of the transaction would be governed by § 83.

A. Applicability of Section 83

Section 83 applies in any case where property is transferred in connection with the performance of services. In this regard, the concept of "property" for purposes of § 83 is rather broad. As provided in § 1.83-3(e) of the Treasury Regulations, the term includes all "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Courts interpreting the scope of property under § 83 have affirmed the broad definition afforded by the regulation. *See, e.g., Theopolis v. Commissioner*, 85 F.3d 440, 445 (9th Cir. 1996) (contract to purchase stock is property under § 83); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991) (profits interest in a partnership is property under § 83); *Montelepre Systemed, Inc. v. Commissioner*, 61 T.C.M. (CCH) 1782, 1786, *aff'd*, 956 F.2d 496 (5th Cir. 1992) (right of first refusal is property under § 83). Accordingly, if the contingency fee agreement constitutes not merely the plaintiff's promise to pay money in the future but rather a present transfer of something from the plaintiff to the attorney, the fee agreement implicates § 83.[6]

[6] For a rebuttal of the possible taxpayer argument that the portion of the claim purportedly transferred to the attorney by way of the contingency fee agreement is not "property" for purposes of § 83, see Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent*

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The general rule under § 83(a) provides that the excess of the fair market value of the transferred property over the amount paid for the property constitutes gross income to the service provider. However, if the transferred property is subject to a "substantial risk of forfeiture," the tax consequences of the transaction are held in abeyance until the risk of forfeiture lapses. Specifically, the service provider does not recognize gross income until the first time the service provider's rights in the property are not subject to a substantial risk of forfeiture. IRC § 83(a). For purposes of measuring the service provider's gross income, the value of the transferred property is its fair market value when the risk of forfeiture lapses. *Id*. On the other side of the transaction, the transferor realizes a gain on the transfer to the extent the fair market value of the property–determined when the risk of forfeiture lapses–exceeds the transferor's basis. Treas. Reg. § 1.83-6(b).[7] Finally, the transferor is entitled to deduct the amount included in the service provider's gross income when the transferred property is no longer subject to a substantial risk of forfeiture. IRC § 83(h). In short, the specific tax consequences of a transfer of property to which § 83 relates cannot be determined until the substantial risk of forfeiture, if any, lapses. At that point, the transfer is given full tax effect.

Attorney's Fee Arrangements: Enough with the Fruits and the Trees, 37 Ga. L. Rev. 57, 96-101 (2002).

[7] This regulation simply restates the well-established tax rule that when property is transferred in exchange for services, the transferor realizes gain or loss as if the property were sold for fair market value. *See International Freighting Corp. v. Commissioner*, 135 F.2d 310, 313 (2d Cir. 1943); *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); *Riley v. Commissioner*, 328 F.2d 428 (5th Cir. 1964).

B. Substantial Risk of Forfeiture

As evident from the framework described above, the concept of a "substantial risk of forfeiture" occupies a central role in the § 83 analysis. The statute provides that the service provider's rights in property are subject to a substantial risk of forfeiture "if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual." IRC § 83(c). The Treasury Regulations elaborate on the statutory definition by providing that a substantial risk of forfeiture exists:

> where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance . . . of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Treas. Reg. § 1.83-3(c)(1). Considering this definition in the context of a typical contingency fee arrangement, it is clear that the attorney's interest in the portion of the claim that would be assigned to her by operation of the fee agreement (under the present-transfer characterization) is subject to a substantial risk of forfeiture. It goes without saying that an attorney's work is not completed once the contingency fee agreement is executed. Quite to the contrary, the attorney's work has just begun. In order for the attorney to realize full enjoyment of her portion of the claim–by obtaining her full contingent fee–the attorney must provide considerable future services on behalf of her client.

While the exact moment at which the attorney's right to payment of the contingent fee under the contract vests

depends on state law, the prevailing view among the jurisdictions to address the issue is that the attorney must prosecute the claim to the point of the occurrence of the contingency specified in the contract. *See, e.g., Potts v. Mitchell*, 410 F. Supp. 1278, 1282 (W.D.N.C. 1976) (holding that an attorney's equitable interest "could not become 'vested' in a contingent fee situation until the case was prosecuted to a favorable judgment or settled by the contracting attorney"). Short of that, the attorney generally is entitled only to the reasonable value of her services rendered on a *quantum meruit* basis.[8] *See, e.g., Ellerin & Assoc. v. Brawley*, 589 S.E.2d 626 (Ga. App. 2003); *Fracasse v. Brent*, 494 P.2d 9 (Cal. 1972); *Ambrose v. Detroit Edison Co.*, 237 N.W.2d 520 (Mich. Ct. App. 1975).[9] Thus, an attorney cannot execute a contingency fee agreement and then simply walk away with the right to a specified percentage of any eventual recovery. Rather, in order for the attorney to receive full enjoyment of the transferred portion of the claim, she generally must provide legal services until the claim is resolved.[10] At that point, the

[8] Furthermore, if the attorney quits the case or is discharged for cause (*e.g.*, for failure to provide adequate representation) prior to final resolution of the claim, the attorney generally is entitled to no fee whatsoever. *See*, *e.g.*, *Hardison v. Weinshel*, 450 F. Supp. 721, 723 (E.D. Wis. 1978); *Gary v. Cohen*, 231 N.Y.S.2d 394, 398 (N.Y. Sup. Ct. 1962); *Royden v. Ardoin*, 331 S.W.2d 206, 209 (Tex. 1960).

[9] For a survey of cases addressing this issue, see George L. Blum, Annotation, *Limitation to Quantum Meruit Recovery, Where Attorney Employed Under Contingent-Fee Contract is Discharged Without Cause*, 56 ALR 5th 1 (1998).

[10] In a minority of jurisdictions, an attorney terminated without cause is entitled to the contract fee. *See*, *e.g.*, *Mandell & Wright v. Thomas*, 441 S.W.2d 841 (Tex. 1969) (holding that law firm discharged without cause entitled to contractual contingency fee when settlement was later obtained); *Jones v. Kubalek*, 334 P.2d 490 (Or. 1959) (holding

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substantial risk of forfeiture lapses and the attorney's rights in the portion of the claim transferred by way of the fee agreement become vested.

C. Tax Consequences Under Section 83

When the cause of action is prosecuted to a resolution and the attorney's substantial risk of forfeiture lapses, the tax consequences of the transaction finally take hold. Only at that point is the property transfer that occurred upon execution of the fee agreement taken into account for tax purposes.

Upon this lapse of the risk of forfeiture, the attorney has gross income for services rendered equal to the then fair market value of the portion of the claim previously transferred to the attorney. IRC § 83(a). Because the settlement of the claim liquidates the entire claim, the fair market value of the portion of the claim previously transferred from the plaintiff to the attorney will exactly equal

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that attorney discharged without cause after filing complaint on behalf of client entitled to full contingency fee). Yet even in these jurisdictions, the plaintiff's entitlement to the contingent fee is subject to a substantial risk of forfeiture following the execution of the fee agreement. The attorney must continue to provide adequate services in connection with the plaintiff's claim to avoid being terminated for cause. In fact, the only instance in which an attorney's interest in the cause of action would vest sooner in these jurisdictions than in the majority of jurisdictions is if the attorney were in fact terminated without cause. In that event, an argument could be made that the difficulties inherent in valuing the portion of the claim transferred to the attorney should be deferred until the claim is later resolved pursuant to the open-transaction doctrine articulated in *Burnet v. Logan*, 283 U.S. 404 (1931).

the amount of the attorney's contingent fee.[11] At that point the plaintiff, who has transferred appreciated property with a zero basis to the attorney, recognizes a gain in the same amount.[12] Treas. Reg. § 1.83-6(b). This amount, when combined with the recovery on the portion of the claim retained by the plaintiff, leaves the plaintiff with gross income equal to the entire recovery. Finally, the plaintiff is entitled to a deduction for the amount of the contingent fee in the year such fee is included in the attorney's gross income. IRC § 83(h).[13] In this manner, the final tax consequences determined under § 83 where the plaintiff is viewed as making a present transfer to the attorney upon execution of the contingency fee agreement are the same as those under general tax principles where the contingency fee agreement is viewed as evidencing nothing more than the plaintiff's mere promise to pay money in the future. Under each scenario, the entire amount of the recovery constitutes gross income to the plaintiff, and the plaintiff is left with a deduction for the contingent fee paid to the attorney.

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[11] As a technical matter, under the present-transfer characterization, the attorney gets paid cash in respect of his ownership interest in a portion of the claim. Therefore, when the attorney is paid, she is treated as receiving the payment in satisfaction of the attorney fee portion of the claim. However, because the attorney will take a fair market value basis in that portion of the claim, *see* Treas. Reg. § 1.61-2(d)(2)(i), she will have no further gain realization.

[12] This gain will be taxed as ordinary income under the substitution of ordinary income doctrine articulated in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 264-65 (1958).

[13] For an example demonstrating how § 83 applies under the present-transfer characterization, see Polsky, *supra* note 6, at 108-11.

III. FLAW IN ANALYSIS SUPPORTING EXCLUSION OF ATTORNEY'S FEE FROM GROSS INCOME

Those circuits that have determined that the plaintiff's gross income does not include the portion of the recovery paid to the attorney have grounded their analysis in the determination that the plaintiff transferred a portion of the underlying cause of action to the attorney upon executing the contingency fee agreement. Beyond failing to recognize the applicability of § 83 to the purported transfer of the claim, the ultimate flaw in the analysis employed by these courts is the failure to treat the transfer of the claim as a taxable transaction–ever. To the extent these courts address the tax ramifications of the transfer of the portion of the claim deemed to occur upon the execution of the contingency fee agreement, they do not treat the transfer as presently taxable. Rather, these courts cite the speculative or even worthless value of the claim as justification for deferring the tax consequences of the transaction. *See Estate of Clarks v. Commissioner*, 202 F.3d at 857 (describing the value of the taxpayer's lawsuit as "entirely speculative and dependent upon the services of counsel"); *Cotnam v. Commissioner*, 263 F.2d at 125 (stating that the taxpayer's claim was "worthless without the aid of skilled attorneys").[14] Yet once the claim is liquidated, the tax consequences resulting from the transfer of the portion of the claim from the plaintiff to the attorney continue to be ignored. At this point, the courts simply

[14] It is doubtful that the cause of action in the plaintiff's hands prior to the plaintiff retaining an attorney can properly be described as devoid of value. In any event, it is worth noting that § 83 applies to transfers of property made in connection with the performance of services even if the transfer lacks a compensatory element. *See Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984).

conclude that the plaintiff and the attorney each have gross income to the extent of their proportional interest in the recovery. *See Cotnam v. Commissioner*, 263 F.2d at 125 (concluding that the contingent fee "was income to the attorneys but not [the taxpayer]"). Under the proper application of § 83 to this transaction, the transfer of the portion of the claim from the plaintiff to the attorney is not forever ignored from a tax perspective. Rather, the transfer is fully taxable to both parties at the time a recovery is obtained, which also happens to be the point at which the value of the transferred portion of the claim can be determined with certainty.

IV. THE RESULTING INEQUITY AND THE APPROPRIATE RESPONSE

Nothing concerning the conclusion that a plaintiff must include the entire recovery in gross income while taking a deduction for the contingent attorney's fee is particularly remarkable. Rather, the scenario fits squarely within the long-standing framework of the Internal Revenue Code under which expenses incurred by a taxpayer in generating gross income are recovered by way of a deduction.[15] If plaintiffs were entitled to the full benefit of the

[15] Some fellow academics recently have argued that the payment to the attorney should not be treated as a deduction; rather, the attorney's fee should be treated as a cost that is capitalized into the basis of the cause of action. When the cause of action is liquidated, they argue that the recovery is offset by such basis in determining the plaintiff's gross income. *See* Charles Davenport, *Why Legal Fees Are Not Deductible*, 97 Tax Notes 703 (Nov. 4, 2002); Charles Davenport, *Capitalization of Legal Fees: Professor Davenport Responds*, 97 Tax Notes 1237 (Dec. 2, 2002); *see also* Deborah A. Geier, *Davenport Has the Right Idea*, 97 Tax Notes 1627 (Dec. 23, 2002). This argument (the "capitalization argument") is inconsistent with the origin-of-the-claim

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deduction for their attorney's fees in computing their tax liability, it is doubtful that the inclusion-deduction treatment of the transaction would raise any eyebrows.

Of course, taxpayers in many cases do not enjoy the full benefit of their deductions for attorneys' fees. Rather, in those situations where the deduction is relegated to the status of a miscellaneous itemized deduction,[16] the deduction is subject to a number of limitations. *See* IRC §§ 56(b)(1)(A), 67(a), 68(a). Generally, the most significant of these limitations is the complete disallowance of the deduction in determining the taxpayer's liability under the

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doctrine, which provides that costs of litigating entitlement to a payment of income are deductible whereas legal costs relating to the acquisition of property must be capitalized. *See*, *e.g.*, *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Southland Royalty Co. v. United States*, 582 F.2d 604 (Ct. Cl. 1978); *see also* Treas. Reg. § 1.212-1(k). Thus, under the origin-of-the claim doctrine, the cause of action itself is disregarded as a separate asset and the tax treatment (*i.e.*, deduct immediately or capitalize) of the legal costs incurred in prosecuting the cause of action are determined by the nature of the underlying claim. If the case were otherwise–that is, if the legal right to a payment of income were treated as a separate item of property for tax purposes–then the established distinction between income and property under the Internal Revenue Code, the Treasury Regulations, and caselaw would be effectively eliminated. *See* Brant J. Hellwig, *Davenport's Capitalization Argument Fails to Convince*, 98 Tax Notes 433 (Jan. 20, 2003). The only court to consider an argument similar if not identical to the capitalization argument rejected it. *See Alexander v. I.R.S.*, 72 F.3d 938, 941-44 (1st Cir. 1995).

[16] If the underlying cause of action does not relate to the taxpayer's trade or business, the deduction afforded under § 212(1) is treated as a miscellaneous itemized deduction. *See* IRC §§ 62(a), 63(d), 67(b). Even if the cause of action relates to the taxpayer's trade or business, the deduction under § 162(a) is a miscellaneous itemized deduction if the taxpayer's trade or business consists of the performance of services as an employee. *See* IRC § 62(a)(1), (a)(2)(A); *see also Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003).

alternative minimum tax (AMT). *See Alexander v. I.R.S.*, 72 F.3d 938, 946 (1st Cir. 1995) (noting that the disallowance of the deduction under the AMT "smacks of injustice"). Because these limitations on miscellaneous itemized deductions tend to produce unfair or even draconian results in certain contexts, it is understandable that taxpayers would attempt to circumvent these limitations by arguing that the attorney's fee should be regarded as an exclusion from gross income. For that matter, it is understandable that courts would be sympathetic to the plight of these taxpayers and, consequently, to their argument. Indeed, with regard to the cases presently before the Court, no justifiable reason exists why Mr. Banks or Mr. Banaitis should be taxed on anything more than the amount of the recovery they retained after making payment to their attorneys.[17]

Nonetheless, fundamental principles of taxation should not be ignored in order to reach the equitable result in these and similar cases. As this Court has noted:

> It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd, or otherwise objectionable. But in such case

[17] *See* Polsky, *supra* note 6, at 73; Robert J. Peroni, *Reform in the Use of Phaseouts and Floors in the Individual Income Tax System*, 91 Tax Notes 1415, 1425 (2001) (each concluding that the deduction limitations should not, as a policy matter, apply to these sorts of payments).

> the remedy lies with the law making authority, and not with the courts.

Crooks v. Harrelson, 282 U.S. 55, 60 (1930) (citations omitted). Equity in taxation is a political concept, one that should and must be resolved by the legislative body. *See Kenseth v. Commissioner*, 259 F.3d 881, 885 (7th Cir. 2001). Congress created the legislative defect that results in the unfortunate and unjustified overtaxation of certain plaintiffs. One would hope that Congress eventually will heed the repeated calls to correct it.[18]

CONCLUSION

In a broad sense, the effect of the execution of a contingency fee agreement is susceptible to two interpretations. The fee agreement constitutes the plaintiff's executory promise to pay a portion of the claim proceeds to the attorney in the future, or, alternatively, the execution of the fee agreement transfers a portion of the underlying cause of action from the plaintiff to her attorney. While the latter interpretation appears to be driven by a desire to achieve a more favorable and equitable tax result for the plaintiff, it ultimately fails to achieve this goal. The proper

[18] In that regard, we offer a simple legislative solution. Section 62(a) should be amended to include among those deductions allowed in computing adjusted gross income "deductions allowed under sections 162 or 212 which consist of expenses paid or incurred in connection with the prosecution of a cause of action." As of the filing of this brief, Congress is considering a more complicated and under-inclusive legislative solution than the one proposed above. *See* Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 643(a) (2004) (proposing a new § 62(a)(19) to afford above-the-line status to deductions for legal fees and court costs in certain discrimination cases).

application of § 83 to the transferred portion of the claim leads to the same result achieved under general tax principles if the contingent fee contract is viewed as the plaintiff's mere promise to pay money in the future–the plaintiff must include the entire recovery in gross income. For this reason, the judgments of the United States Courts of Appeals for the Sixth Circuit and the Ninth Circuit should be reversed.

Respectfully submitted,

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