No. 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIGITAS J. BANAITIS

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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TABLE OF AUTHORITIES

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Respondent does not deny the existence of a widening circuit conflict over the recurring and important question presented in the petition, nor does he deny that the decision of the court of appeals in this case is irreconcilable with the decisions of other courts of appeals. Other than providing a wealth of irrelevant factual detail, respondent's brief in opposition essentially offers multiple variations on a single theme, namely, respondent's theory that state law considerations should govern the federal tax treatment of contingent fees paid to attorneys out of the proceeds of litigation brought by a taxpayer. As demonstrated below, respondent's theory is both incorrect and inconsistent with the decisions of several courts of appeals. This Court's review is therefore warranted,

and this petition should be held pending the disposition of the petition for a writ of certiorari in *Commissioner* v. *Banks*, No. 03-892, which provides a better vehicle for the Court's consideration of all aspects of the question presented.

1. Respondent errs in contending (Br. in Opp. 1) that the petition contains a "serious" misstatement of fact. The petition states (Pet. 6) that respondent "did not include any part of the $8,728,559 settlement proceeds on his 1995 income tax return," a statement that reflects the court of appeals' description of the facts. See Pet. App. 6a ("in his return, * * * [respondent] excluded from his gross income the full predicate $8,728,599 settlement total"). Respondent contends that this description is incorrect because he reported $1,427,397 of the settlement proceeds on his 1995 federal income tax return. Br. in Opp. 1.

Respondent did in fact report $1,421,420 of the proceeds on that return, described as "Interest on settlement of tort litigation." Def.'s Exh. 2, Schedule B. That fact, however, is irrelevant to this petition, because the tax treatment of the interest element of the settlement proceeds is not at issue here. This petition instead concerns the tax treatment of the portion of the settlement proceeds that was paid to respondent's attorney as a contingent fee, and it is undisputed that respondent excluded that entire contingent fee payment from his gross income as reported on his return. The factual issue identified by respondent is thus of no consequence here.

2. Respondent asserts (Br. in Opp. 1, 6) that the settlement agreement entered into by himself, his lawyer and the two defendant banks constitutes a "novation" by which the contingent fee agreement was terminated and by which the banks assumed the

obligation to pay the attorney's fees. In respondent's view, the alleged assumption by the banks of the payment obligation supports his position that the attorney's fees portion of the recovery was not part of his gross income.

There was no holding, however, by the court of appeals below that the settlement agreement constituted a novation, or anything other than what it purported to be. On the contrary, the Ninth Circuit simply held that respondent was entitled to exclude from his gross income the portion of the settlement proceeds paid to his attorney. Even if there had been a novation, moreover, it would not provide support for the exclusion allowed by the Ninth Circuit. The critical fact remains that the entire amount of the settlement, including the portion paid directly to respondent's attorney, represents the proceeds from respondent's cause of action. It therefore follows under fundamental principles of federal tax law that the entire amount of the settlement is includible in respondent's gross income. See *Kenseth* v. *Commissioner*, 259 F.3d 881, 884-885 (7th Cir. 2001); *Young* v. *Commissioner*, 240 F.3d 369, 378 (4th Cir. 2001); *Campbell* v. *Commissioner*, 274 F.3d 1312, 1313-1314 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002); see generally Pet. at 9-11 in *Commissioner* v. *Banks*, No. 03-892. It is of no moment that payment to respondent's attorney went directly to the attorney from the defendant banks without passing through his hands. See *ibid.*; *Helvering* v. *Horst*, 311 U.S. 112, 114 (1940); *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930); *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929).

3. Respondent errs in his assertion (Br. in Opp. 7) that certiorari is not appropriate because state law is determinative of the issue presented here. Although

state law determines the nature of legal interests in property, federal law determines the tax consequences of the receipt or disposition of property. See *United States* v. *National Bank of Commerce*, 472 U.S. 713, 722 (1985); *Aquilino* v. *United States*, 363 U.S. 509, 513-514 (1960). As the Government pointed out in the petition (at 10) in *Commissioner* v. *Banks*, No. 03-892, the relationship between a client and his attorney is one of debtor and creditor, and it is a well-established principle of federal tax law that, when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives income in the amount of the discharged debt. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. at 729. Moreover, to the extent a client makes an actual assignment of a portion of the proceeds of his cause of action to his attorney under state law, such an assignment of a right to receive income, for services rendered, would not shift the incidence of tax away from the client. A taxpayer cannot avoid tax on the income he has earned by the simple artifice of having it paid, by a third party, to someone else. See, *e.g.*, *Helvering* v. *Horst*, 311 U.S. at 114; *Lucas* v. *Earl*, 281 U.S. at 114-115.

These fundamental federal tax principles have led other courts of appeals to hold that the portion of a taxable damages award that is paid directly to the client's attorney by a third party is nevertheless includible in the client's gross income, regardless of the nature of the attorney's rights under state law. See *Young* v. *Commissioner*, 240 F.3d at 378 (the inclusion of contingent fee payments in client's gross income is required "by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action"); *Campbell* v.

Commissioner, 274 F.3d at 1314. As stated in the petition in this case (Pet. 10), and as respondent appears to concede (Br. in Opp. 9), the decision in this case conflicts with those holdings. Respondent's contention that the question presented is not worthy of review by this Court because it is solely a matter of state law is incorrect.

After the petitions for certiorari were filed in this case and in *Banks*, the Second Circuit decided another case presenting this same issue, *Raymond* v. *United States*, No 03-6037, 2004 WL 51836 (Jan. 13, 2004). The Second Circuit held that principles of federal tax law require that the portion of a damages recovery paid to a Vermont attorney under a contingent fee agreement be included in the client's gross income. Discussing the taxpayer's contingent attorney's fees, the court of appeals stated that:

> Raymond "control[led] the source of the income [and] . . . divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants." [*Helvering* v. *Horst*, 311 U.S.] at 116-17, 61 S. Ct. 144. He diverted a portion of his judgment to his attorney in the service of receiving the remainder of that judgment—certainly a result "procurable only by the expenditure of money or money's worth." *Id.* at 117, 61 S. Ct. 144. Accordingly, the judgment flowing to Raymond is income to him . . . , and the expense of producing that income—his attorney's fee—is a deductible expense. *See* [26 U.S.C.] § 212(1). That the Alternative Minimum Tax precludes Raymond from taking advantage of that deduction is unfortunate, * * * but it is not a reason to create an artificial contingent-fee exception to the rule that one is

> taxable on income from a source over which one retains control.

Id. at *7.

Thus, the Second Circuit has now joined the Fourth, Seventh and Tenth Circuits in holding that federal tax law requires successful litigants to include in gross income the portion of a damages recovery paid to the litigant's attorney without regard to the rights of the attorney under state law to protect the attorney's claim for fees. As stated in the Government's petitions for writs of certiorari here and in *Banks*, this widespread conflict among the courts of appeals on a frequently recurring issue requires resolution by this Court to eliminate the disparity that now exists among similarly situated taxpayers.

4. Respondent is also mistaken in his assertion (Br. in Opp. 12-13) that the Rules of Decision Act requires that the issue presented here be resolved solely by reference to state law. That Act, 28 U.S.C. 1652, provides that "[t]he laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply." Respondent's assertion that the Act controls this case merely begs the question, because the Act mandates recourse to state laws only "in cases where they apply." This is not a diversity case and, as noted above, several courts of appeals have correctly held that federal law is determinative of the issue. The Rules of Decision Act therefore does not render this question one of state law.

5. In a similar vein, respondent errs in asserting (Br. in Opp. 14) that "[t]his is a parochial and narrow question of Oregon law." To the contrary, as demonstrated

above, the question presented is governed by fundamental principles of federal tax law. Regardless of the correctness *vel non* of the court of appeals' appraisal of Oregon law,[1] the decision below conflicts with the decisions of those courts that have decided the question presented as a matter of federal tax law.

6. Although the question presented in this case is worthy of review, the petition in *Commissioner* v. *Banks*, No. 03-892, provides the best vehicle for this Court's consideration of the full range of issues involved in determining the federal tax treatment of litigation proceeds paid to a taxpayer's attorney pursuant to a contingent fee agreement. In *Banks*, the Sixth Circuit held that such proceeds are not includible in the successful litigant's gross income, *regardless* of how state law defines the attorney's interest in the proceeds. *Banks* v. *Commissioner*, 345 F.3d 373, 385-386 (6th Cir. 2003). That holding is obviously inconsistent with the decisions of the Second, Fourth, Seventh, and Tenth Circuits discussed above. Moreover, it conflicts with numerous other court of appeals decisions which hold that litigation proceeds paid to a taxpayer's attorney as contingent fees are includible in the taxpayer's gross income where state law defines the interest conferred on the attorney by the contingent-fee agreement as a security interest rather than an ownership interest. See 03-892 Pet. at 7-8, 13, 17 (citing decisions of the Third, Ninth, and Federal Circuits).

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[1] Respondent's suggestion (Br. in Opp. 2) that, in essence, he and his attorney had formed a partnership is farfetched and unsupported by the record in this case. Indeed, Oregon law makes it unethical for an attorney to acquire a proprietary interest in his client's cause of action. See Oregon Code of Prof'l Resp., DR 5-103 (West 2003).

Thus, *Banks* would provide the Court an opportunity to address and resolve the full array of circuit conflicts that have arisen over the question presented in these cases. Accordingly, the petition in *Banks* is a better vehicle for this Court's review, and it would be appropriate to hold the petition in this case pending the Court's disposition of *Banks*.[2]

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For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be held and disposed of as appropriate in light of the Court's disposition of *Commissioner* v. *Banks*, No. 03-892, or, in the alternative, the petition should be granted.

Respectfully submitted.

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[2] On January 30, 2004, the Court requested the respondent in *Banks* to file a response to the petition for certiorari filed in that case.