No. 00-592

In the Supreme Court of the United States

IVOR F. BENCI-WOODWARD, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

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

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioners may exclude from their gross income the portion of a punitive damages award that was retained by their attorney pursuant to a contingent fee agreement.

2. Whether attorney's fees incurred by petitioners are a deduction in computing their alternative minimum tax liability.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is reported at 219 F.3d 941. The opinion of the Tax Court (Pet. App. 9a-21a) is reported at 76 T.C.M. (CCH) 787.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. The petition for certiorari was filed on October 13, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners filed a lawsuit against their employer that sought damages for false imprisonment, defamation, intentional infliction of emotional distress, wrongful discharge in violation of public policy, breach of an implied-in-fact employment contract, breach of an implied covenant of good faith and fair dealing, constructive discharge and intentional misrepresentation. Pet. App. 5a. In connection with that litigation, petitioners entered into a contingent fee agreement with their attorney that authorized and directed him to "handle any and all legal proceedings arising out of said incidents." *Id.* at 12a. The agreement further provided that (*ibid.*):

> Client agrees to pay Attorney for services a sum equal to forty percent (40%) of any amounts received or recovered in this matter on behalf of Client. Attorney may retain his share out of the amount finally collected by settlement or judgment, herein termed "recovery", in full for the services and any advanced costs.
>
> Attorney is given a first lien and assignment on any recovery however procured to the extent of this contract and such amounts may be retained therefrom. Attorney is given a further lien and assignment on any sums recovered herein for fees incurred for all legal work performed for client whatsoever and such amounts shall be in addition to the contingent fee and costs provided for in this agreement.

In 1990, a jury returned a verdict for petitioners that included both compensatory and punitive damages. Pet. App. 5a, 13a. In 1992, the damages awarded,

including interest and costs, were remitted to petitioners' attorney. *Id.* at 13a. Their attorney deducted his fees pursuant to the contingent fee agreement and paid the remainder to petitioners. *Ibid.* Petitioner Ivor F. Benci-Woodward received $915,097, and petitioner Jose Ragatz received $881,226. *Ibid.*[1]

2. On their federal income tax returns, petitioners did not include in gross income any portion of the damages award. The Internal Revenue Service determined on audit that petitioners were required to include in their gross income the portion of the award that represented punitive damages. The Service further determined that, although petitioners' attorney's fees are deductible as "miscellaneous itemized deductions" in computing their regular tax liability, those fees are not deductible in computing their alternative minimum tax. See 26 U.S.C. 55, 56.

Petitioners challenged the Service's determination in Tax Court. While petitioners conceded that, under *O'Gilvie* v. *United States*, 519 U.S. 79 (1996), punitive damages are generally to be included in gross income, petitioners contended that the portion of that award retained by their attorney should *not* be included in their gross income. The Tax Court disagreed, holding that the entire amount of the punitive damages is to be included in gross income. Pet. App. 18a-21a. The court also rejected petitioners' claim that their attorney's fees are deductible in computing the alternative minimum tax. The court held that such fees are deductible only as "miscellaneous itemized deductions," which are specifically disallowed in determining the alternative minimum tax under 26 U.S.C. 56(b)(2). Pet. App. 16a-

[1] The amount received by petitioner Laurentz J. Mangum is not in the record.

18a. The court therefore upheld the Service's determination that taxes in the amounts of $85,009, $73,787, and $75,694 were due from the Benci-Woodwards, the Mangums and the Ragatzes, respectively. *Id.* at 14a, 21a.

3. The court of appeals affirmed. Pet. App. 1a-12a. The court concluded that, "[u]nder California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 5a-6a. Since petitioners retained full ownership of their claim, and their attorney possessed only a lien on the award to secure the payment of his fees, the entire amount of the award necessarily was income to petitioners. *Id.* at 5a-7a. The court concluded that this case was controlled by its recent decision in *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), which presented the same issue with respect to contingent attorney fees incurred by residents of Alaska. The court in *Coady* held that the entire award of damages obtained pursuant to a contingent fee arrangement is to be included in the taxpayers' gross income because Alaska law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 1190. The court in *Coady* had noted that, in *Lucas* v. *Earl*, 281 U.S. 111 (1930), this Court "explicitly rejected the notion that taxation can be escaped by procuring payment directly to creditors or by making anticipatory arrangements to prevent earnings from 'vesting even for a second' in the person who earned it." 213 F.3d at 1191 (quoting 281 U.S. at 114-115).

The court of appeals also rejected the assertion of petitioners that the portion of the recovery paid to their

attorney should be allowed as a deduction in computing the alternative minimum tax (AMT). The court explained (Pet. App. 7a) that the statutory definition of "miscellaneous itemized deductions," which are not deductible for AMT purposes, includes all itemized deductions *except* those enumerated in 26 U.S.C. 67(b) (1994 & Supp. IV 1998). See 26 U.S.C. 56(b)(1)(A)(i), 212(1). Because attorney fees incurred in obtaining a taxable litigation recovery are *not* included in 26 U.S.C. 67(b) (1994 & Supp. IV 1998), such fees are not deductible in determining the AMT. Pet. App. 8a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. The court below correctly held that, under California law, a contingent fee agreement provides the attorney with only a security interest in the proceeds of the litigation and does not confer upon the attorney any ownership interest in the client's cause of action. Pet. App. 5a-7a.[2] Indeed, in this Court, petitioners do not challenge that interpretation of California law. Because petitioners thus retained full ownership of their cause of action, it necessarily follows that the entire amount of the punitive damages awarded to them must be included in their gross income under 26 U.S.C. 61(a). Pet. App. 5a-7a; see *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

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[2] As the court of appeals noted, numerous California decisions have made this conclusion quite clear. Pet. App. 6a (citing, *e.g.*, *Isrin* v. *Superior Court*, 403 P.2d 728, 733 (Cal. 1965)).

2. Petitioners err in contending (Pet. 11-15) that the decision in this case conflicts with decisions in other circuits. The cases on which petitioners rely differ from the present case in the precise manner explained by the court of appeals. The court of appeals noted that in *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), and *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000), the Fifth and Sixth Circuits determined that the plaintiffs had assigned an ownership interest in their causes of action prior to obtaining any recovery. Pet. App. 7a.[3] By contrast, under the state law that applies here, no such assignment of an ownership interest in the cause of action had occurred. *Id.* at 6a-7a. In none of the cases on which petitioner relies did a court hold that a plaintiff who merely gives a contractual lien to an attorney—and who does not assign to the attorney ownership rights in the cause of action—need not

[3] In *Cotnam* v. *Commissioner*, 263 F.2d at 125, the court held that, under Alabama law, the execution of a contingent fee agreement effects an assignment to the attorney of an undivided portion of the client's cause of action. Based on that interpretation of state law, the court concluded that the portion of a jury award that was paid to the plaintiff's attorneys pursuant to the contingent fee agreement was not includable in the plaintiff's gross income. As the court of appeals noted in this case (Pet. App. 7a), the state law that governs the contingent fee contract involved here differs from that involved in the *Cotnam* case for, under California law, only a lien is created by a contingent fee contract. In *Estate of Clarks* v. *United States*, 202 F.3d 854, 857-858 (6th Cir. 2000), the court concluded that the applicable Michigan law is similar to that of Alabama and gives an attorney with a contingent fee agreement an ownership interest in the client's cause of action. The decision in *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000), on which petitioner relies (Pet. 12), also involved an Alabama award of damages and thus differs from the present case for precisely this same reason.

include the entire award in his gross income.[4] The decisions cited by petitioners thus do not directly conflict with the decision in this case.

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[4] For example, *Srivastava* v. *Commissioner*, 220 F.3d 353 (5th Cir. 2000), on which petitioners rely (Pet. 12), involved the tax treatment of the proceeds of the settlement of a Texas lawsuit for which a contingent fee agreement had been made. The Fifth Circuit concluded that "the taxpayer who transfers, sells, or otherwise relinquishes an asset or income source to another" is not to be taxed upon the subsequent realization of the item that he "no longer owns." 220 F.3d at 359. The court concluded that it was bound to follow its prior decision in *Cotnam*, *supra*, which, the court said, was "indistinguishable from the present case." 220 F.3d at 364 n.33. Since the *Cotnam* decision was squarely based on that court's interpretation of Alabama law (see note 3, *supra*), the court in *Srivastava* was bound to follow *Cotnam* only if Texas law was not materially different from the Alabama law applied in *Cotnam*. The Fifth Circuit did not determine precisely what rights the plaintiff had transferred to his attorney in *Srivastava*; the court did, however, note its view that, under Texas law, the "attorney retainer agreements accompanied by contingent fee provisions assign more than just the fruit" even though they may have divested the taxpayers of "something less than the entire tree." 220 F.3d at 360.

By contrast, *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1999), addresses facts that are indistinguishable from the present case and reaches precisely the same conclusion reached by the Ninth Circuit in this case. In *Baylin*, a Maryland partnership assigned a portion of its recovery in a condemnation lawsuit to its attorney under a contingent fee agreement. The court held that, under Maryland law, the contingent fee agreement served only to give the attorney a lien on the proceeds of the litigation and, "[l]ike any other lien, this lien does not create an ownership interest in the attorney * * * ." *Id.* at 1455 (quoting *Chanticleer Skyline Room, Inc.* v. *Greer*, 319 A.2d 802, 806 (Md. 1974)). The court therefore concluded that "the entire condemnation award was properly considered gross income to the partnership." 43 F.3d at 1455.

3. Petitioners' alternative argument (Pet. 18-20) that the amount of fees they paid to their attorney should be deductible in computing their alternative minimum tax liability is unsupported by any authority and foreclosed by the plain language of the controlling statutes. As the court of appeals explained (Pet. App. 7a-8a), petitioners' legal expenses constitute "miscellaneous itemized deductions" under 26 U.S.C. 67, and 26 U.S.C. 56(b)(1)(A) expressly provides that, in computing the alternative minimum tax, "[n]o deduction shall be allowed * * * for any miscellaneous itemized deduction." There is no valid basis for disregarding the plain language of these directly applicable statutory provisions. See *Alexander* v. *IRS*, 72 F.3d 938, 946-947 (1st Cir. 1995).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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