

1 IN THE SUPREME COURT OF THE UNITED STATES

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3 COMMISSIONER OF INTERNAL :

4 REVENUE, :

5 Petitioner :

6 v. : No. 03-892

7 JOHN W. BANKS, II; :

8 and :

9 COMMISSIONER OF INTERNAL :

10 REVENUE, :

11 Petitioner :

12 v. : No. 03-907

13 SIGITAS J. BANAITIS. :

14 - - - - -X

 Washington, D.C.

 Monday, November 1, 2004

17 The above-entitled matter came on for oral
18 argument before the Supreme Court of the United States at
19 10:03 a.m.

20 APPEARANCES:

21 DAVID B. SALMONS, ESQ., Assistant to the Solicitor
22 General, Department of Justice, Washington, D.C.; on
23 behalf of the Petitioner.

24 PHILIP N. JONES, ESQ., Portland, Oregon; on behalf of
25 Respondent Banaitis.

1 JAMES R. CARTY, ESQ., Los Angeles, California; on behalf
2 of Respondent Banks.

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3 JUSTICE STEVENS: We'll hear argument in two
4 cases, the Commissioner of Revenue -- Internal Revenue
5 against Banks and the Commissioner against Banaitis.

6 Mr. Salmons.

7 ORAL ARGUMENT OF DAVID B. SALMONS

8 ON BEHALF OF THE PETITIONER

9 MR. SALMONS: Thank you, Justice Stevens, and
10 may it please the Court:

11 Section 61(a) of the Internal Revenue Code
12 defines gross income to include all income from whatever
13 source derived. As this Court has held, that definition
14 is sweeping and represents an intent by Congress to exert
15 the full measure of its taxing power.

16 The court of appeals decisions below, by
17 excluding from respondent's gross income the portion of
18 litigation proceeds paid to their attorneys under
19 contingent fee agreements, is inconsistent with two
20 longstanding Federal tax law principles for defining gross
21 income.

22 JUSTICE O'CONNOR: Now, if -- if this didn't
23 involve the alternative minimum tax, would the amount be
24 deductible?

25 MR. SALMONS: Your Honor, but for the

1 alternative minimum tax, there would be an -- a
2 miscellaneous itemized deduction --

3 MR. SALMONS: -- under section 212 of the
4 code --

5 MR. SALMONS: -- that would be subject to the
6 limit of the 2 percent of adjusted gross income that
7 applies to itemized deductions. But section
8 56(b) (1) (A) --

9 JUSTICE SCALIA: That's of annual income.
10 Right? 2 percent of -- of the person's annual income?

11 MR. SALMONS: Of the adjusted gross income.

12 JUSTICE SCALIA: For the year.

13 MR. SALMONS: For the year. That's correct,
14 Your Honor.

15 JUSTICE SCALIA: But, gee, in the case of a --
16 of a major award, that 2 percent is very likely to be
17 exceeded, isn't it?

18 MR. SALMONS: It -- it certainly may, Your
19 Honor.

20 JUSTICE SCALIA: So this is a problem that's
21 going to exist even -- even after the alternate minimum
22 tax is abolished. Right?

23 (Laughter.)

24 MR. SALMONS: I'm not sure entirely what you're
25 referring to as the problem, but it is the case that --

1 that --

2 JUSTICE SCALIA: Well, you don't think -- the
3 Government doesn't think it's a problem. I'm talking
4 about taking a huge percentage of the -- of the person's
5 recovery. That -- that will happen even -- even in the
6 case where there's no minimum tax -- alternative.

7 MR. SALMONS: That is correct. That -- that is
8 correct, Your Honor. Now, I mean -- and let me make two
9 points about that.

10 The first is that as a -- as a general matter,
11 the tax code defines gross income expansively, and there's
12 a number of this Court's cases that make that clear. Then
13 -- then the question becomes are there deductions provided
14 that allow for certain expenses to be deducted.

15 JUSTICE O'CONNOR: Don't some States such as
16 Oregon require a plaintiff to remit a portion of punitive
17 damages recovered to the State so they don't even go to
18 the taxpayer? But is the taxpayer saddled with that too?

19 MR. SALMONS: Your Honor, I would think the
20 answer to that question is no. It's not a question that I
21 have examined in depth in -- in this case because it's not
22 presented, but as a general matter --

23 JUSTICE O'CONNOR: Well, what about attorney's
24 fees in class actions? As I understand it, those are not
25 regarded by the Government as attributable all to the

1 taxpayer.

2 MR. SALMONS: Your Honor --

3 JUSTICE O'CONNOR: A plaintiff who's part of a
4 class in a class action suit where attorney's fees are
5 paid.

6 MR. SALMONS: Your Honor, we believe that the
7 same principles would apply to class action lawsuits as to
8 other lawsuits in terms of the taxation of litigation
9 proceeds. It may very well be the case in a number of
10 class action contexts that when applying those principles,
11 the proper -- the proper analysis leads to the conclusion
12 that the taxpayer doesn't exert sufficient control and
13 that the payment of attorney's fees is not in response to
14 a debt owed by the taxpayer. And so there might be a
15 different result.

16 JUSTICE O'CONNOR: Well, I -- I thought we were
17 -- our attention was pointed to a number of instances
18 where the Internal Revenue Service did not require the
19 taxpayer to show all the attorney's fees as income in
20 those class action situations.

21 MR. SALMONS: Your Honor, that is correct.

22 JUSTICE O'CONNOR: Yes.

23 MR. SALMONS: I want to be clear. We think the
24 same principles apply across the board to defining gross
25 income. In applying that in a number of class action

1 contexts, the proper answer may be that it's not included
2 in gross income because there wasn't sufficient control
3 and because it wasn't paid in -- in lieu of a debt owed by
4 the taxpayer. But here --

5 JUSTICE SOUTER: Why -- why isn't there as much
6 control in each case? I mean, the -- somebody goes to a
7 lawyer with a claim and says, press the claim for me,
8 recover if you can. What's the difference in -- in terms
9 of control? So that if you win this case, why doesn't it
10 apply to class action?

11 MR. SALMONS: Again, the principles would apply
12 and there may very well be class actions --

13 JUSTICE SOUTER: Yes, and I -- I want to know
14 why the result would be different.

15 MR. SALMONS: Again, I'm -- I'm trying to be as
16 specific as I can. There may be situations in which, even
17 in the class action context, there's a fee agreement
18 between the -- the class member and the lawyer so that the
19 payment of attorney's fees is in satisfaction of a debt
20 owed by the class member, and in that situation we think
21 that it would be --

22 JUSTICE SOUTER: Why -- why would -- why would
23 that analysis appear? Certainly there's -- there's not
24 going to be any fee paid in the -- in the paradigm example
25 of the class action without a recovery.

1 MR. SALMONS: That's correct, Your Honor. There
2 -- there are situations --

3 JUSTICE SOUTER: So we're in the -- so we're in
4 the situation we're in right now, aren't we?

5 MR. SALMONS: We are in the situation in which
6 there's a need to apply the general principles for
7 defining gross income.

8 JUSTICE SOUTER: All right. But let me just --
9 I'll just press the point one more time. I don't
10 understand, based on what you've said, why the class
11 action result would be different from the result that
12 you're arguing for here if you win this case.

13 MR. SALMONS: And -- and what I'm trying to
14 point out, Your Honor, is that there may very well be
15 class actions where it's not different. There may be some
16 when -- where it is if it's the case that there's no
17 contractual obligations to pay the fee -- pay the fee
18 between the class member and the attorney, and if it's the
19 case that the class member really exerts no meaningful
20 control over the -- over the attorney's fees portion --

21 JUSTICE BREYER: I thought the class action
22 distinction that the commissioner had was between opt in
23 and opt out.

24 MR. SALMONS: That is certainly one of the
25 factors that -- that the commissioner has looked to in

1 those class --

2 JUSTICE BREYER: So if you opt in, then you did
3 exercise control. So all the money is yours. But if you
4 opt out, you didn't have control over the suit because you
5 didn't opt out. I mean, you just were lethargic.

6 MR. SALMONS: Again, those are all facts --

7 JUSTICE BREYER: That's the basic thing. I
8 mean, I'm trying to understand what the principle is for
9 the reason that it's pretty hard for me to reconcile the
10 commissioner's view in the class action case with the
11 punitive damage case because there the person has control
12 over the lawsuit. So why doesn't all the punitive damage,
13 attorney's fees that come out of that, and so forth belong
14 to -- in other words, it sounds to me, as I read this,
15 something of a mess, and I'd like to know what the clear
16 principle is.

17 MR. SALMONS: Yes, Your Honor. And -- and just
18 to be clear, I -- I don't think the commissioner has ever
19 taken the position that all class actions don't present
20 the -- the possibility of the attorney's fees portion of
21 the award being included in -- in the class member's gross
22 income.

23 Now, there are real enforcement issues, as a
24 practical matter, to trying to -- to trying to implement
25 that. You can imagine a number of class actions --

1 JUSTICE GINSBURG: When you say the class
2 member, do you -- you mean the named representative. The
3 class may include thousands of people, but it would be
4 income to the named representative? Is that --

5 MR. SALMONS: Well, presumably, Your Honor, that
6 -- only the portion of the attorney's fees that would be
7 attributable to the -- the named representative's recovery
8 would be included in the named representative's gross
9 income. I don't think that the named representative would
10 be on the hook, if you will, for all of the attorney's
11 fees that would relate to other class members' recoveries.

12 But I think what all this points out is that --

13 JUSTICE GINSBURG: Well, then -- then would it
14 be -- would the income then go to each class -- would each
15 class member have a share of the income?

16 MR. SALMONS: In a number of instances, yes,
17 Your Honor. Again, the -- the way that we think that
18 class action cases should be resolved is the same way that
19 -- that these issues are approached in all cases, which is
20 to look at the type of relationship that exists between
21 the -- the client and the attorney to see whether the
22 payment is made in -- in response to a debt owed by the
23 client and also to look to the degree of control that the
24 client has over the -- the underlying source of income.
25 And in this context, it is --

1 JUSTICE SCALIA: Suppose -- suppose the same
2 amount were paid, as was paid here, to the attorney, but
3 it was not by way of a contingent fee, that the -- the
4 client had committed to pay this dollar amount in a dollar
5 amount.

6 MR. SALMONS: As a flat fee?

7 JUSTICE SCALIA: As a flat fee. What -- what
8 would the tax treatment of that be?

9 MR. SALMONS: Your Honor, I think in fact it is
10 undisputed in -- in the -- in these cases that if the
11 payment of attorney's fees had either been under an hourly
12 rate arrangement or a flat fee arrangement, that the
13 entire amount of the litigation proceeds would be included
14 in the -- in the respondent's gross income and nothing
15 about the contingent fee arrangements here should --
16 should alter that result. The respondents --

17 JUSTICE O'CONNOR: Well, let -- let me ask you
18 about Professor Davenport's theory. He filed a -- an
19 amicus brief here saying that the contingency fee or the
20 attorney's fees should be capitalized as a transaction
21 cost increasing the basis of the property which was the
22 claim in the lawsuit.

23 MR. SALMONS: Your Honor, I'm trying to recall
24 that amicus brief. I believe that -- was that an
25 argument, I believe, about the application of section 83

1 of the tax code when you have a transaction --

2 JUSTICE O'CONNOR: Yes.

3 MR. SALMONS: -- in exchange for services and
4 you provide property?

5 JUSTICE O'CONNOR: Yes.

6 MR. SALMONS: We think that the better way to
7 analyze this is that in fact there was no transfer of the
8 underlying cause of action, and so we think that -- that
9 we -- that gets into a very complicated area as to how you
10 value the attorney's fees at the time.

11 JUSTICE SCALIA: Well, you -- you don't need a
12 transfer of the -- I don't understand what you mean --

13 JUSTICE O'CONNOR: No, I don't either.

14 JUSTICE SCALIA: -- a transfer of the -- the
15 cause of action. Certainly if you buy a piece of real
16 estate and -- and there's lawyer's business connected with
17 it, you -- you don't -- you don't take an ordinary
18 deduction which is subject to the alternative minimum tax
19 for those lawyer's fees. You just say that's part of the
20 transaction, and it goes onto the basis of your property.
21 Right?

22 MR. SALMONS: I believe that's correct, Your
23 Honor. But the point I was making --

24 JUSTICE SCALIA: Why isn't -- why isn't that
25 very similar to this? I mean, what difference does it

1 make whether there's a -- there's a transaction here,
2 isn't there? Isn't there a transaction?

3 MR. SALMONS: Well, there is an agreement to pay
4 a fee for a service, and in that sense there is a
5 transaction, yes.

6 JUSTICE SCALIA: Yes, but a -- the service is
7 connected to a transaction, namely the conversion of the
8 chosen action into a money payment. You have this --

9 MR. SALMONS: That -- that is correct.

10 JUSTICE SCALIA: -- this unformed chosen action.
11 You're entitled to it, but there's a transaction
12 converting it into a money payment. Now, why shouldn't
13 you attribute to that transaction all -- which is
14 profitable to you, all of the costs that go along with the
15 transaction?

16 MR. SALMONS: Well, again, Your Honor, we think
17 that transaction is essentially identical to numerous
18 transactions that take place every day out in the real
19 world where -- where taxpayers retain professional
20 services in exchange for a commission or a percentage of
21 the income that's generated.

22 JUSTICE SCALIA: That is a problem that occurs
23 to me. I don't know where you draw the line. And you say
24 you can't draw a line.

25 MR. SALMONS: That is absolutely correct. I

1 don't see any basis for distinguishing between --

2 JUSTICE GINSBURG: How does it work?

3 MR. SALMONS: -- the attorneys here and -- and a
4 -- and an agent negotiating a book contract for an author
5 or a financial analyst.

6 JUSTICE GINSBURG: You -- on that, that example,
7 you gave the book contract with the author and you gave, I
8 think, the investor. Would this problem arise in those
9 cases or would the author get an above-the-line deduction?

10 MR. SALMONS: No, Your Honor. I believe that
11 the author in those -- in that situation would receive the
12 same deduction that prior to the enactment of section 703
13 of the American Jobs Creation Act where Congress just
14 addressed in part the -- the issue raised in these
15 cases --

16 JUSTICE GINSBURG: So you say the author -- that
17 these people are all in the same --

18 MR. SALMONS: They would have an itemized --
19 excuse me -- a miscellaneous itemized deduction for the
20 cost incurred in -- in producing income that under the
21 alternative minimum tax would not be allowed.

22 JUSTICE KENNEDY: Is there any argument -- you
23 -- you said at the outset that it has to be an itemized
24 deduction subject to the two percent rule even if we set
25 aside the alternative minimum tax. Is that conceded by

1 everyone, or does somebody -- do some people say this is
2 an ordinary and necessary expense? I know it's not your
3 business, but it seems to me an ordinary and necessary
4 expense to recover the -- the -- for employment
5 discrimination, which is really part of your work. I
6 don't know why -- is it -- does everybody agree that this
7 is subject to the 2 percent rule?

8 MR. SALMONS: I will -- I will have to allow
9 respondents to speak for themselves to that question, but
10 as far as I'm aware, that is not in dispute in these cases
11 or in any of the cases that have been litigated that --
12 that but -- that but for the alternative minimum tax, the
13 way this would have been handled is that there would have
14 been a miscellaneous itemized deduction under section 212
15 of the code for the cost incurred in producing income, and
16 that the alternative minimum tax, along with, by the way,
17 a large number of other perfectly valid deductions, get
18 disallowed under the alternative minimum tax.

19 JUSTICE KENNEDY: I -- I can't get out of my
20 mind in this case that the mechanics of the particular
21 case may control. I know we need a national rule and so
22 forth. My recollection is that in some States when there
23 is a settlement or a judgment paid under a case where
24 there's a contingency fee contract, the check is made out
25 both to the attorney and to the client and is put in the

1 attorney's client's trust account. So the client never
2 has control over it.

3 MR. SALMONS: Well --

4 JUSTICE KENNEDY: Let's assume that that's true
5 in most of the States.

6 MR. SALMONS: That -- that -- I know that were
7 -- that was the facts, Your Honor, in the -- in the Banks
8 case, that there was a check made out to both. In fact --
9 in fact, there was --

10 JUSTICE KENNEDY: So in a very real -- in -- in
11 a very real sense, in a -- in the legal sense, the client
12 just doesn't have control.

13 MR. SALMONS: Well, Your Honor, we disagree with
14 that for, it seems to me, at least three reasons. The
15 first is that at the time the client entered into the fee
16 agreement, he certainly had control then. He had complete
17 control over his cause of action. He was --

18 JUSTICE KENNEDY: Well, he -- he did or he
19 didn't, but there was no money there. There was nothing
20 there.

21 MR. SALMONS: Well, there was an entitlement to
22 recover. Now, there might have been a dispute as to the
23 proper amount or whether that claim was valid, but he was
24 entitled to recover based on the injury he suffered that
25 was cognizable at law and that gave raise to a cause of

1 action.

2 Now, in exchange for legal services, he promised
3 to pay a portion of the recovery to the lawyer. That is a
4 promise to pay a fee. That is not an assignment or any
5 other transfer of the underlying cause of action. And it
6 is undisputed, I think --

7 JUSTICE SOUTER: Mr. Salmons, doesn't the
8 plausibility of your argument here rest on the assumption
9 that what the -- that the cause of action at the time the
10 -- that the plaintiff made the agreement with the lawyer
11 is a cause of action which has the same value as the
12 ultimate recovery that the lawyer gets? Whereas, in fact,
13 the cause of action at the time of the agreement with the
14 lawyer has an inchoate value. The -- the value that is
15 actually realized is going to depend in part on the -- on
16 the skill and -- and the -- the gumption of the lawyer.

17 So that the -- what I'm getting at -- and -- and
18 going to Justice Kennedy's question, it seems to me that
19 the value realized as opposed to the right to sue are two
20 different figures. And I don't see realistically how the
21 client has complete control over the value realized, which
22 we don't even know until the lawyer has done his work and
23 gotten the check.

24 MR. SALMONS: Your Honor, two responses to that
25 question, if I may. The first is that, as a matter of

1 law, it is the client that controls the cause of action
2 and throughout the time period, even after they -- they
3 enter into an -- a contingent fee agreement, it is the
4 client that owns and controls the cause of action and he
5 decides whether to settle. He decides whether to press
6 forward or withdraw the case. He decides whether to fire
7 the lawyer or not. He is a -- he controls the source of
8 the income. Therefore --

9 JUSTICE GINSBURG: Even -- even the potential
10 lawyer's fee. I mean, suppose this client has a major
11 dental repair and he's got a risk-taking dentist, and he
12 says, dentist, I'm going to give you a deal. I know you
13 like to take risks. I may win big in my lawsuit, in which
14 case you get everything; and I may lose, in which case you
15 get nothing. The dentist says, fine, I'll take it. Can
16 the client in that agreement with his dentist give what
17 will be the lawyer's fee, the part that will go to the
18 lawyer under the contingency fee agreement?

19 MR. SALMONS: Well, presumably, Your Honor, if
20 he's already -- he's already promised that to the
21 attorney, he would be in violation of his agreement with
22 the attorney if he did so, and his attorney could sue him
23 to recover or the dentist could sue him to recover.

24 JUSTICE GINSBURG: Then he doesn't have -- then
25 he doesn't have dominion over that portion.

1 MR. SALMONS: Well, because he's -- he's given
2 it away. In that sense I think -- and -- and in answering
3 this, if I may just go back to one point that Justice
4 Souter made and that is that I don't think it's the case
5 that our analysis turns at all on how you value the claim,
6 either at the time of the fee agreement or afterwards.
7 Our analysis says at all relevant times, regardless of
8 whether the value changed or not, the client was at all
9 times in control of the underlying source of income, and
10 it's just as if in *Helvering v. Horst* the father assigns
11 the -- the bond coupon to his son, but he controls the
12 underlying source of income.

13 JUSTICE SOUTER: No, but the bond coupon has a
14 certain value at the time the father assigns it.

15 MR. SALMONS: That's true.

16 JUSTICE SOUTER: The only thing that has to be
17 realized after the assignment of the coupon is the passage
18 of time at which it will be payable. Here we do not have
19 a definite value. We don't know -- there's no way to know
20 for sure what that value will be until the lawsuit is over
21 with. The -- the two are not comparable.

22 MR. SALMONS: Your Honor, that would be equally
23 true of an assignment of a stock dividend while I retain
24 the stock. I may not know what the dividend payment is
25 going to be, but if I control the underlying source of

1 income, i.e., the stock, then the transfer to someone else
2 of the dividend doesn't alter the incident of tax, even if
3 it's unknown.

4 And I would point out that in *Lucas v. Earl*, the
5 husband and wife in that case entered into agreement to
6 assign to each other 50 percent of their income in 1901,
7 long before the income tax was even instituted, and the
8 tax years at issue in that case were 1920 and 1921. If
9 anything, it was much more speculative and uncertain what
10 income would have been earned 20 years later in that case,
11 and that did not stop the Court from --

12 JUSTICE BREYER: So you're -- you're --

13 MR. SALMONS: -- applying this principle that --

14 JUSTICE SCALIA: Can I -- can I ask you a
15 question relating to the *Davenport* -- what's been referred
16 to as the *Davenport* theory? I had thought that -- that
17 the service has used the -- the transaction theory with
18 regard to legal fees payable for a lawsuit seeking
19 increased compensation for the condemnation of real estate
20 where the taxpayer had objected to the amount that the
21 condemning entity was offering and brought suit in court
22 and with a contingent fee to the lawyer and that the
23 service treated that as -- as part of the transaction
24 cost. Am I wrong about that?

25 MR. SALMONS: Your Honor, to my knowledge, the

1 -- the IRS has had a consistent position that the entire
2 amount of litigation proceeds, including the amount that
3 may be paid to a lawyer under a contingent fee agreement,
4 even in the condemnation context, is tax -- is included in
5 the gross income of -- of the taxpayer.

6 And I would point Your Honor to the case out of
7 the Federal Circuit, *Baylin v. United States*. That case
8 involved a condemnation action, and the court of appeals
9 in that case addressed the issue that's presented in these
10 cases and concluded that it was includable in gross
11 income.

12 JUSTICE SCALIA: Maybe my recollection is wrong.
13 I'll look again.

14 MR. SALMONS: And -- and I would point out, Your
15 Honor -- and this has to do, I think, with the impact of
16 the new legislation that's been pointed to in the
17 supplemental briefs -- that at least six of the court of
18 appeals cases addressing the issue presented in these
19 cases involved claims that would not be covered under the
20 new section 703 because they -- they don't involve claims
21 for unlawful discrimination or -- or FCA claims or certain
22 Medicare claims --

23 JUSTICE BREYER: But can -- can I ask you to go
24 back for a minute? I guess the IRS -- you're seeing the
25 lawsuit as the income-generating asset.

1 MR. SALMONS: That's correct, Your Honor.

2 JUSTICE BREYER: And you're looking at the
3 control of the plaintiff, for example, over the lawsuit as
4 something that determines whether it's his income. And
5 he, of course, can't give away his income. But on that
6 theory, to go back to Justice O'Connor's original
7 question, then the punitive damages also must be his
8 income because he has equal control over them and they
9 grow out of the income-producing asset. And that, of
10 course, is what's bothering me because it seems to me that
11 your theory, which is a well-established theory, coupled
12 with a Congress that seems to be willing to take away
13 deductions for expenses that lead to the income, could
14 produce an income tax that in many cases, not just a few,
15 exceeds the income that an individual has. And I would
16 like to know what in the law is there to guard against
17 that result.

18 MR. SALMONS: Well, Your Honor, I guess my
19 response to that is that, first --

20 JUSTICE KENNEDY: Other -- other than the mercy
21 of the Internal Revenue Service.

22 (Laughter.)

23 MR. SALMONS: Your Honor, the fact of the matter
24 is, is that Congress has looked at -- at this issue, and
25 in the new section that I just referred to, section 703 --

1 JUSTICE O'CONNOR: Well, but does that happen?
2 You haven't answered the question. Are there instances
3 where plaintiffs in lawsuits end up receiving tax bills,
4 as a result of this scheme, for more money than they
5 received in the lawsuit?

6 MR. SALMONS: That has occurred, Your Honor.

7 JUSTICE O'CONNOR: Yes.

8 MR. SALMONS: And -- and Congress responded to
9 concerns about that very result --

10 JUSTICE KENNEDY: Well, but doesn't -- doesn't
11 that indicate --

12 MR. SALMONS: -- in the new section.

13 JUSTICE KENNEDY: -- something basically flawed
14 about your whole theory?

15 MR. SALMONS: No, Your Honor. It is --

16 JUSTICE KENNEDY: This is not income in any --
17 in any real sense.

18 JUSTICE BREYER: Is there any constitutional
19 protection? The Sixteenth Amendment refers to an income
20 tax, and perhaps that doesn't include a tax that grossly
21 exceeds in many cases a person's income. That would be
22 quite a far-out theory at the moment.

23 MR. SALMONS: I think it would be, Your Honor.

24 JUSTICE BREYER: But I -- that's why I ask you.
25 Is there any protection in the law whatsoever? Or if

1 Congress decides to tax a set of people who, let's see --
2 say, earn \$10,000 a year and because they're small
3 business people, they happen to have \$20,000 expenses. So
4 it taxes them on \$20,000, and the tax exceeds the income.
5 There's no protection in your view against that result.
6 And you just said, well, Congress decided to do it, it
7 decided to do it.

8 MR. SALMONS: But we do think, Your Honor, that
9 the only limit on Congress' taxing authority would be the
10 Constitution, and I don't see a constitutional violation
11 in disallowing a deduction, but --

12 JUSTICE BREYER: What about an assumption, for
13 example, that when we read the code, we read it with a
14 view towards thinking Congress did not want to produce
15 such unfair results?

16 MR. SALMONS: Your Honor, if I may. The way I
17 would respond to that concern is that the proper way to
18 address it is not as the courts below did and as
19 respondents urge, to alter or distort the general
20 definition for gross income under the -- under the tax
21 code which may have broad ramifications in a number of
22 areas outside of this one, but to go to Congress, as in
23 fact people have done, and to get them to make -- make
24 additional deductions or otherwise alter the alternative
25 minimum tax, which generates the primary concern I think

1 at issue in these cases.

2 JUSTICE GINSBURG: What happened in the cases --

3 MR. SALMONS: That's the proper way to handle
4 that.

5 JUSTICE GINSBURG: There were cases -- we don't
6 have to deal in hypotheticals. There were cases where
7 this happened, where people ended up liable for a tax
8 greater than what they took in. What happened in those
9 cases?

10 MR. SALMONS: They were -- they were liable for
11 a tax greater than what they took in. Those were pointed
12 to Congress --

13 JUSTICE GINSBURG: I mean, there was one that
14 was \$99,000, if I remember right.

15 MR. SALMONS: I believe that's correct. Those
16 were pointed out to Congress and that was part of what
17 motivated Congress --

18 JUSTICE GINSBURG: Was there a private bill?

19 MR. SALMONS: -- to enact section 703 to
20 protect --

21 JUSTICE GINSBURG: Or what happened? What
22 actually happened in that case, do you know?

23 MR. SALMONS: I do not know, Your Honor. My --
24 my understanding is that the tax was assessed and I don't
25 know whether --

1 JUSTICE SCALIA: Mr. Salmons, I -- I -- you've
2 cited the -- the Baylin case to me and I -- I've looked at
3 the description of it in the brief, which I had recalled,
4 and what it says is that it did, indeed, involve a taking
5 by the State, and when the State didn't offer what Baylin
6 thought was -- was enough, he went to court, he prevailed,
7 and recovered a much larger sum than the State had offered
8 him. His legal fees were, by the IRS, subtracted from the
9 award, and he was taxed only upon the proceeds reduced by
10 the legal fees. Now, how do you explain that situation
11 there?

12 MR. SALMONS: Your Honor, if I --

13 JUSTICE SCALIA: And how does that --

14 MR. SALMONS: -- misremembered that case, I
15 apologize. My -- my recollection was that -- was that the
16 court in that case had included the attorney's fees in
17 gross income. But -- but --

18 JUSTICE SCALIA: I doubt -- I doubt whether
19 Professor Davenport has misdescribed the case in -- in his
20 brief, but I --

21 MR. SALMONS: But -- but again, Your Honor, if I
22 may. I think the -- the basic point to recall here is
23 that the definition of gross income cuts across the tax
24 code. If there are concerns about application, then the
25 proper result is to go to Congress, as has been done.

1 Congress has addressed the very concerns cited by
2 respondents and the amici in this case, and that
3 specifically is the -- the application on civil rights
4 plaintiffs.

5 JUSTICE O'CONNOR: Does the Fifth Amendment
6 Takings Clause apply to a Government tax scheme that taxes
7 something beyond the income received?

8 MR. SALMONS: Your Honor, it -- there may be --
9 there may be a takings issue at some point. Again, there
10 may be constitutional limitations.

11 JUSTICE O'CONNOR: Well, at the point where the
12 Government charges more than the taxpayer received --

13 MR. SALMONS: But I think, Your --

14 JUSTICE O'CONNOR: -- in income?

15 MR. SALMONS: Your Honor, I think when -- when
16 what you're talking about is how to define --

17 JUSTICE O'CONNOR: I mean, this is an appalling
18 situation.

19 MR. SALMONS: Again, Your Honor, I -- I think as
20 a general matter, the -- the proper definition of gross
21 income would include the attorney's fees portion of
22 litigation awards. It's important to note that the when
23 Congress --

24 JUSTICE SOUTER: What -- what do you we make of
25 the fact that two Senators apparently don't agree with

1 that position? I mean, I -- I'm referring to the colloquy
2 that was quoted in -- in one of the -- the briefs about
3 the recent legislation, and the -- the substance of the
4 colloquy was we're not making any change in the law, we're
5 just clarifying it. Well, in fact, if there is no textual
6 difference for tax purposes between the law, so far as it
7 concerns these -- these so-called discrimination
8 recoveries and non-discrimination recoveries that have the
9 same problem that Justice O'Connor is talking about,
10 shouldn't we infer that at least the Senate of the United
11 States assumes that this does not get into gross?

12 MR. SALMONS: No, Your Honor. In fact, what I
13 would say is that the thing to focus on is what Congress
14 actually enacted and it makes clear that all the
15 litigation proceeds --

16 JUSTICE SOUTER: I'm -- I'm talking about the
17 colloquy. I'm talking about the colloquy.

18 MR. SALMONS: I -- I understand that, Your
19 Honor, and what I'm trying to answer is that the -- the
20 legislation itself makes clear that it's included in gross
21 income and an above-the-line deduction is provided, and
22 that the colloquy was referring to a prior version of the
23 bill that would have been retroactive in part. The new
24 bill is not retroactive, and we think it's clear that it
25 does work a change because from, among other reasons, it's

1 undisputed that if these fees had been paid on an hourly
2 fee basis, they would have been included in gross income
3 and -- and the alternative minimum tax would apply.

4 JUSTICE SCALIA: We don't really know who
5 prepared that colloquy anyway, do we?

6 MR. SALMONS: We do not.

7 JUSTICE SCALIA: It might have been prepared by
8 the respondents here.

9 MR. SALMONS: We do not.

10 (Laughter.)

11 MR. SALMONS: If I may reserve the remainder of
12 my time.

13 JUSTICE STEVENS: Mr. Jones.

14 ORAL ARGUMENT OF PHILIP N. JONES

15 ON BEHALF OF RESPONDENT BANAITIS

16 MR. JONES: Thank you, Justice Stevens, and may
17 it please the Court:

18 My client and I are asking the Court to rule
19 that the assignment of income doctrine does not apply when
20 unrelated persons combine their resources to jointly
21 generate income. And we --

22 JUSTICE KENNEDY: What -- so what -- what about
23 the talent scout who tells the celebrity that he'll take
24 10 percent of the celebrity's movie proceeds or the
25 management search person that's going to take a -- a third

1 of the executive's pay for the first 6 months? Where --
2 are all -- all these cases ones in which there -- there's
3 no income to the -- to the principal, we'll call them?

4 MR. JONES: You mentioned the -- the management
5 agent and the -- I think you mentioned the talent agent,
6 and there was also mentioned the literary agent. The --
7 the author is in the trade or business and gets to deduct
8 all this off the top. There's no problem there.

9 JUSTICE GINSBURG: That's the -- that's the
10 question I asked Mr. Salmons --

11 MR. JONES: Yes. The literary agent --

12 JUSTICE GINSBURG: -- and he gave me the
13 opposite answer.

14 MR. JONES: Yes. The literary agent is in a
15 trade or business. That's off the top. That's an
16 ordinary and necessary business deduction on Schedule C.

17 JUSTICE BREYER: And that isn't the question.

18 MR. JONES: Yes.

19 JUSTICE BREYER: The -- the problem is you're --
20 you're trying to get a theory in response to him that I
21 think Justice Kennedy is asking about.

22 MR. JONES: Yes.

23 JUSTICE BREYER: And that theory, which is the
24 problem for your side of the case -- that theory has all
25 kinds of implications. I go out and I help the painter

1 paint my office. We have a joint venture. I -- so
2 there's no problem. I don't take it in -- you know, I get
3 a -- this is great. And so that I think, if I'm right,
4 was the thrust of Justice Kennedy's question.

5 MR. JONES: Our first choice, our preference for
6 this Court to rule is -- is not the partnership or joint
7 venture theory. Our first choice is for this Court to
8 simply look at the application of the assignment of income
9 doctrine and ask it -- if it is being misapplied. The --
10 the petitioner has not cited to the Court a single,
11 solitary case in which unrelated persons combine their
12 resources to jointly produce income, and that is the rule
13 of law I'm suggesting to the Court today. That is apart
14 and separate from the partnership theory, that two
15 unrelated persons who join together to produce income --

16 JUSTICE SCALIA: It's a partnership theory when
17 you talk about two persons joining together. I don't like
18 this -- this gold mine view of litigation, that it's, you
19 know, like two prospectors. You know, there's money to be
20 obtained.

21 (Laughter.)

22 MR. JONES: I --

23 JUSTICE SCALIA: That's -- that's not what I
24 view of a chosen action as. I view it as a legal right --

25 MR. JONES: Yes.

1 JUSTICE SCALIA: -- that the person is entitled
2 to money, and ultimately the amount he's entitled to is
3 determined by the litigation. And I'm not about to adopt
4 a -- a legal theory that -- that views this as a -- as a
5 search for buried treasure --

6 JUSTICE SCALIA: -- in -- in which the -- the
7 lawyer and the person who has been wronged are -- are
8 simply co-prospectors. I -- I just think that that's --

9 MR. JONES: Well, the --

10 JUSTICE SCALIA: Maybe that's how you view the
11 -- the enterprise --

12 MR. JONES: I would like to --

13 JUSTICE SCALIA: -- but I don't think the law
14 does.

15 MR. JONES: I would like to suggest to the Court
16 three avenues to reach this result that I have just
17 suggested and the partnership/joint venture theory is only
18 one of those.

19 JUSTICE O'CONNOR: Well, let's move on to
20 something else because I have a couple --

21 (Laughter.)

22 MR. JONES: Okay. I will move on to that, and I
23 will not mention that again.

24 (Laughter.)

25 MR. JONES: This Court created the assignment of

1 income doctrine. Congress did not create it. This Court
2 has every right and power to limit its -- its definition,
3 to limit its scope to keep it from being misapplied. In
4 every case cited by the petitioner, we have a -- a family
5 situation, related people making gifts to each other with
6 no commercial purpose. Apart from the partnership and
7 joint venture theory, if we simply say that this case is
8 dramatically outside of the scope of that doctrine, of
9 good doctrine that has been applied properly in an inter-
10 family situation, but when you have two unrelated persons
11 joining forces to produce income --

12 JUSTICE STEVENS: Would you have a different
13 result if they were related? Supposing the lawyer is a
14 cousin of the client.

15 MR. JONES: This Court has a long history of
16 recognizing --

17 JUSTICE STEVENS: Or a good friend.

18 MR. JONES: -- of recognizing sham transactions.

19 JUSTICE STEVENS: Well, it's not a sham
20 transaction. You just happen to be related.

21 MR. JONES: All right.

22 JUSTICE STEVENS: And I'm just wondering if
23 that --

24 MR. JONES: I would like to focus on the
25 gratuitous nature of the cases relied upon by the

1 petitioner and the non-gratuitous aspects of our case.
2 Let's talk about a personal injury case where this problem
3 does not arise because there's no tax involved. This
4 relationship of a contingent fee is entered into thousands
5 of times every week by people injured in automobile
6 accidents. They are not entering into this contingent fee
7 agreement for tax purposes. They're not trying to avoid
8 tax -- taxes. The commissioner is confusing intent
9 with --

10 JUSTICE SOUTER: All right. On -- on that
11 theory, that there is a non-tax economic purpose, do you
12 still maintain that your theory should have as an element
13 unrelated people?

14 MR. JONES: I --

15 JUSTICE SOUTER: Why do we need the question of
16 the relationship, which Justice Stevens's questions
17 raised, even to arise if -- if the principal criterion is
18 going to be economic non-tax purpose?

19 MR. JONES: I agree completely. I was trying to
20 emphasize the -- the intrafamily gratuitous nature of
21 those cases, but I agree --

22 JUSTICE SCALIA: There was no avoidance motive
23 in the --

24 MR. JONES: Yes.

25 JUSTICE SCALIA: -- granddaddy of all cases.

1 The assignment there, although it was between family
2 members, had been made before there was an income tax.

3 MR. JONES: But we must --

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

8 MR. JONES: I'm asking the Court to skip over
9 motive and look at result. The Court in that case was
10 attacking a result because that arrangement stayed in
11 place after the income tax was -- was enacted. The
12 Solicitor General is confusing intent with result. In
13 every case, in every single case, without exception, this
14 doctrine has been applied to the result.

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

20 MR. JONES: It would produce a different result.
21 The commissioner's case is based on could have's. They say
22 they could have tried the case himself. He couldn't. But
23 -- but the main thing he --

24 JUSTICE STEVENS: No, but he could have made --
25 I'm saying he could have said to the lawyer, I'll pay you

1 30 -- a -- a third of the recovery or I'll pay you \$100 an
2 hour.

3 MR. JONES: Well, he --

4 JUSTICE STEVENS: And they come out exactly the
5 same result, but you -- but do you treat them differently
6 or the same?

7 MR. JONES: We treat them differently simply
8 because he didn't. I practice law in a partnership. I'm
9 taxed accordingly. I could -- I could be -- set up my
10 arrangement different ways and the tax results would be
11 different. We must honor these relationships --

12 JUSTICE SCALIA: What is different?

13 JUSTICE STEVENS: Well, may I ask one --

14 JUSTICE SCALIA: What is different?

15 JUSTICE STEVENS: May I ask one other
16 hypothetical? Supposing that the agreement on the
17 contingency is postponed until the middle of the
18 preparation, not made at the outset, but along the line,
19 they say we'll figure out what a fair percentage will be,
20 and when the recovery comes in, they then decide, okay,
21 you take a third. What -- what result do you do in that
22 case?

23 MR. JONES: I -- I have difficulty with that
24 question.

25 JUSTICE STEVENS: But I'm sure it arises fairly

1 often.

2 MR. JONES: My -- I believe that attorneys don't
3 allow themselves to be placed in that position. They get
4 the contingent fee agreement signed when the -- the --

5 JUSTICE STEVENS: Well, I did very often.

6 MR. JONES: But I don't know the answer to your
7 question. I -- I don't know that.

8 But an -- we -- the Internal Revenue Code
9 respects people who enter into corporations, who enter
10 into joint ventures, who enter into sole proprietorships,
11 who hire employees or allow themselves to be hired by
12 others. Those relationships are all respected and honored
13 by the Internal Revenue Code, and the commissioner is
14 asking you to dishonor this relationship because Mr.
15 Banaitis could have handled the case himself or could --

16 JUSTICE KENNEDY: I think probably what's --
17 what's one of the problems here is that the reason this is
18 income is it relates to employment. And I don't see why
19 hiring the attorney to get that income is not an ordinary
20 and necessary business expense under what used to be
21 section 162. That may be part of the problem. Do you
22 agree that it's not an ordinary and necessary business
23 expense?

24 MR. JONES: I believe the problem is that a
25 plaintiff has -- I wish I could say this plaintiff is in

1 -- engaged in a trade or business and can deduct it or
2 trade or -- as a trade or business expense.

3 JUSTICE KENNEDY: I mean, I suppose that's the
4 reason -- that's the reason why it's taxable to begin
5 with, is it relates to employment. If I hire an attorney
6 because I'm wrongfully discharged and I get -- I get my
7 job back, it seems to me that's an ordinary and necessary
8 business expense. That -- that's why -- one of the
9 reasons I have problems with this.

10 MR. JONES: I understand. But one of the -- the
11 odd result here of a person having to pay more in taxes
12 than they recover -- this actually comes up under a fee
13 shifting statute that applies to the Internal Revenue
14 Service where a person could be in litigation with the
15 Internal Revenue Service, the Internal Revenue Service
16 becomes obligated to pay fees because they acted
17 unreasonably. They pay those fees, and then they
18 simultaneously hand the taxpayer a bill for taxes on those
19 fees.

20 JUSTICE KENNEDY: Well, let me get -- get to a
21 different point. It -- it does seem to me that we -- we
22 have to be very careful in this case not to distort the
23 revenue law for other transactions that are not before the
24 Court. And the -- the natural extension of your
25 position is that anytime when the taxpayer enters into an

1 agreement with an agent to pay the agents an amount
2 contingent on the success of the venture, that it's not
3 income, that -- that the -- that the payment is not income
4 to the principal. And I just can't accept it.

5 MR. JONES: No. That is not my position. My
6 position is that the assignment of income doctrine does
7 not apply. Those relationships are all governed by
8 existing law and there is a large body of law dealing with
9 those cases and they can be found in a cite that is
10 offered by the petitioner at page 3 of his reply brief.
11 It talks about the literary agents. It talks about the --
12 the management agents.

13 JUSTICE KENNEDY: But what's the difference in
14 principle. I don't understand the difference in principle
15 when we're talking about who has the income. It's the
16 first thing you ask in -- in a first-year -- in -- in your
17 -- in your first class in tax. Where is the income? Who
18 gets the income?

19 MR. JONES: I -- I am not trying to avoid your
20 question, but I'm trying to clarify that I am not asking
21 this Court to determine who has the income in those cases
22 because there is a large body of law and a large body of
23 statutory law that answers the questions for each of those
24 examples. All I'm suggesting is that we do not get to
25 those answers. We should not get to those answers through

1 the assignment of income doctrine.

2 JUSTICE BREYER: What's your third? I just
3 don't want you to miss your third. You have the joint
4 venture theory, an exception to an assignment in income,
5 and you said you had a third.

6 MR. JONES: The Oregon question, Your Honor,
7 which I don't think the Court is likely interested in --

8 JUSTICE SCALIA: The who?

9 MR. JONES: The -- the Oregon question.

10 JUSTICE SCALIA: The Oregon question.

11 MR. JONES: The Oregon question. That is --

12 JUSTICE SCALIA: What is the Oregon question?

13 MR. JONES: The Oregon question is part IV of
14 our brief beginning on page 31 which would not be a
15 national uniform rule. But what we're asking this Court
16 to do is simply, as narrowly as possible, to limit the
17 assignment of income doctrine and do nothing more than
18 that.

19 JUSTICE O'CONNOR: Well, what do you make of
20 Professor Davenport's proposal to capitalize the
21 contingency fee as a transaction?

22 MR. JONES: I believe Professor Davenport is
23 completely correct. I support his theory wholeheartedly.
24 We didn't make that argument because we believe the
25 limitation on the assignment of income doctrine is the

1 real issue and we believe that is the narrower issue.

2 JUSTICE BREYER: Well, if you took a settlement
3 -- his theory, I take it, was seeing the lawsuit as a
4 capital asset. Is that right?

5 MR. JONES: Yes. Well, I -- I think so.

6 JUSTICE BREYER: Well, then whenever you settled
7 a lawsuit, it would be -- you'd have to pay capital gains
8 instead of ordinary income.

9 MR. JONES: I -- I'm sorry. I think I misspoke.
10 I'm not sure that's his theory. I'm not certain, and
11 I'm --

12 JUSTICE SCALIA: I'm sure it's not his theory.
13 He -- he thinks it's -- it's attached to transactions, and
14 -- and much of his argument is devoted to showing that
15 capital transactions are no different from other
16 transactions as far as the Internal Revenue Code's desire
17 to match the -- the gain with the expenses concerned. And
18 that's the part of his theory that I'm not so sure about
19 because aside from the -- aside from the condemnation case
20 that I mentioned, I -- I don't know of any other cases in
21 which the Internal Revenue Service has treated transaction
22 costs the way he would have it done. Maybe it makes
23 sense, but I --

24 MR. JONES: I would like to make one additional
25 point in the few seconds I have left. The -- the

1 Solicitor General is arguing that the language, the
2 statutory language, of the new statute implies a
3 particular result. This Court decided as early as 1940 in
4 the Higgins v. Smith case when the commissioner made the
5 exact same argument, and this Court said -- and I quote --
6 that does not follow. The statutory language says that to
7 the extent this income is -- this -- this money is
8 included in income, to the extent it is included in income
9 -- it doesn't say whether it is or not -- then a deduction
10 will be allowed. And that as neutral a statement as I can
11 think of. There is nothing in the statutory language that
12 implies one answer or the other.

13 But I emphasize to the Court that the -- the
14 commissioner is confusing intent with result when he
15 discusses the cases upon which he is relying. Those cases
16 reached a result and they corrected that result. We don't
17 have an abuse in this situation. And the assignment of
18 income doctrine should not be stretched beyond its bounds
19 by this Court. It should be limited to its historical
20 use. This is a misuse.

21 Thank you very much.

22 JUSTICE STEVENS: Thank you, Mr. Jones.

23 Mr. Carty.

24 ORAL ARGUMENT OF JAMES R. CARTY

25 ON BEHALF OF RESPONDENT BANKS

1 MR. CARTY: Thank you, Justice Stevens.

2 Neither section 61(a) nor any other provision of
3 the Internal Revenue Code expressly requires that a
4 Federal civil rights litigant, such as Mr. Banks, include
5 in his gross income the portion of a litigation recovery
6 that was earned by, retained by, and already taxed to his
7 attorney as a contingent fee.

8 The commissioner's position in this case relies
9 exclusively on the misapplication of a judicial doctrine
10 known as the assignment of income doctrine. That doctrine
11 originated and developed as a judicial anti-abuse rule,
12 designed to prevent high-bracket taxpayers --

13 JUSTICE SCALIA: No, it didn't.

14 MR. CARTY: I respectfully --

15 JUSTICE SCALIA: It -- it originated in a case
16 where there could not possibly have been an intent -- an
17 intent to abuse because the -- the transfer had occurred
18 before there was any income tax.

19 MR. CARTY: Justice --

20 JUSTICE SCALIA: I mean, just -- just don't --
21 maybe you think that that's what it ought to be, but --
22 but please don't tell us that that is how it originated.
23 It plainly did not originate that way.

24 MR. CARTY: Justice Scalia, I respectfully
25 disagree. It is true, as the commissioner and you point

1 out, that at the time of the agreement between the husband
2 and wife, the income tax was not in existence. However,
3 the agreement certainly was in existence after the income
4 tax was passed. So that could have been a reason why the
5 agreement was never rescinded.

6 In addition, in another landmark case from 1937,
7 Blair, this Court expressly looked to whether there was a
8 tax avoidance motive. And this is how this principle is
9 taught in first-year tax class. That's the whole purpose
10 behind this. As a matter of fact, the commissioner in a
11 -- in a different context actually looked to the fact,
12 with respect to a particular transaction, whether there
13 was a tax avoidance purpose.

14 JUSTICE SCALIA: That's a different argument.
15 I'm -- I'm just quarreling over whether it originated that
16 way. If you want to say --

17 JUSTICE KENNEDY: Under -- under your view --

18 JUSTICE SCALIA: -- that's fine.

19 JUSTICE KENNEDY: -- suppose that the attorney
20 is -- is waiting for payment of -- of his, say, one-third
21 contingent fee, and the client just absconds with the money.
22 How is -- what -- what happens from a tax standpoint under
23 your theory? I take it the attorney has to declare the
24 income on his return and then declare a loss?

25 MR. CARTY: Well, certainly the attorney has a

1 legal right to those funds. He has a contractual right
2 and under most --

3 JUSTICE KENNEDY: I'm asking you about the tax
4 consequences.

5 MR. CARTY: Well, at -- at that point the income
6 wouldn't have inured to the benefit of the attorney.

7 JUSTICE KENNEDY: Well, but I -- I thought under
8 your view the moment the client gets the check for the
9 full amount, one-third of it is taxable to the attorney.

10 And I have some problems, incidentally, with
11 respect to tax years if it -- if you -- if the client
12 receives the check December 30 and is on vacation and
13 doesn't get around to remitting to the attorney until
14 January 5th, I'm -- I'm not quite sure how your theory
15 works, but --

16 MR. CARTY: Justice Kennedy, I -- I think the --

17 JUSTICE KENNEDY: But on the absconding theory,
18 how -- how is it handled from a tax standpoint?

19 MR. CARTY: I believe that for tax purposes the
20 attorney's right to the funds -- that's at the moment he
21 receives it. So if he doesn't have the funds in hand, he
22 wouldn't be liable for Federal tax. It would be at the
23 point he either receives the funds --

24 JUSTICE SOUTER: Aren't -- aren't you --

25 JUSTICE GINSBURG: This is an academic question

1 because he would have an offsetting theft loss.

2 MR. CARTY: I -- I think that is an alternative
3 way to -- to view it. There would be a --

4 JUSTICE SOUTER: If -- if you view it as the
5 theft loss, you -- you maintain your theory. If you
6 argue, as you were arguing a second ago, I think what, in
7 fact, you're doing is adopting the mere lien theory.

8 MR. CARTY: Justice Souter, I -- I --

9 JUSTICE SOUTER: I think you better go with
10 Justice Ginsburg.

11 (Laughter.)

12 JUSTICE BREYER: Like somebody stealing a check
13 out of my mailbox from my employer. Right? Okay.

14 MR. CARTY: Yes.

15 JUSTICE BREYER: So what is your theory, I mean,
16 precisely? A, an assignment of income, what would
17 otherwise count of A giving an assignment of income to B,
18 and therefore still be A's income because the asset
19 remains with A, the work, or whatever. Now, your theory
20 is but not in the case that. Now fill in the blank for
21 me.

22 MR. CARTY: Justice --

23 JUSTICE BREYER: Precisely, please.

24 MR. CARTY: It would not be in the case that the
25 funds are not under the control of the attorney.

1 JUSTICE BREYER: Not in the case -- it is an
2 assignment of income to B, but not in the case where the
3 funds are not in -- when B -- when B get -- when B, the
4 attorney, gets the funds, he controls them. What's --
5 what do you mean? I don't get it.

6 MR. CARTY: I thought your hypothetical --

7 JUSTICE BREYER: I want to know. You have three
8 -- your problem on your side for me is that maybe all the
9 equities are there, but I'd like to know the proposition
10 of law that you want us to write in this opinion. And now
11 we had three theories, and one, the one that you seem to
12 be adopting, is this exception to the assignment of income
13 doctrine. If that is what you're adopting, I'd like to
14 know the precise form of words that create the exception.
15 If that's not the theory you're adopting, I would like to
16 know what the theory you're adopting is.

17 MR. CARTY: I would state, Your Honor, that the
18 assignment of income doctrine simply does not apply when
19 the -- the client has no control or power of disposition
20 over the income that was subject to the assignment. There
21 are at least five reasons why this type of contract --

22 JUSTICE BREYER: But he did have control. He
23 could have settled the lawsuit or not settled the lawsuit.
24 He controlled when the income was generated, and moreover,
25 he could have stopped it from being generated by settling the

1 suit or dismissing it. Moreover, if he had not entered
2 into this assignment of income, it would have been paid
3 right into his bank account at the end. It sounds an
4 awful lot like the Lucases or like the Horsts or whoever,
5 Old Colony Trust. It sounds an awful lot like those
6 cases.

7 MR. CARTY: Justice Breyer, I -- I think it's
8 helpful to make a conceptual distinction between the
9 claim, the underlying litigation claim, and the right to
10 receive the funds. Now, certainly Mr. Banks in this case
11 had a right to enter into settlement or not. He had a
12 right to fire his attorney. But once he assigned the
13 contingent fee portion of the recovery, he, as a practical
14 matter, had no ability, he had no control over that
15 portion of the recovery.

16 Another fundamental difference between --

17 JUSTICE KENNEDY: That -- that would be the same
18 with the theater agent or the commission agent.

19 MR. CARTY: We submit, Justice Kennedy, that the
20 nature of the attorney-client relationship is
21 fundamentally different from the types of relationships
22 you cited, and that's because an attorney here is the one
23 who's earning the income. It's the attorney who is making
24 the critical decisions.

25 JUSTICE KENNEDY: Well, you could say the same

1 thing for the talent scout.

2 MR. CARTY: I would respectfully disagree. I --
3 I think there's a -- there's a fundamental difference.
4 Presumably a -- a actor or an entertainer -- their --
5 their market value is -- already has some type of tangible
6 value. The -- the agent might --

7 JUSTICE KENNEDY: Your client, in effect, earned
8 the money by having this -- undergo this -- this
9 discrimination. That -- that's --

10 MR. CARTY: Well, Your Honor --

11 JUSTICE KENNEDY: This is not the plumber
12 hypothetical, which is I think quite misleading. No. No,
13 I don't think that even the Government will defend that.

14 MR. CARTY: Again, Your Honor, I think with
15 respect to an entertainer, an entertainer necessarily
16 doesn't need an agent. Neither does an athlete.

17 JUSTICE GINSBURG: Take an investment advisor
18 and the client is not at all -- doesn't know anything
19 about the market, and he's got this whiz-bang advisor who
20 makes millions for him that he never could have made on
21 his own.

22 MR. CARTY: I -- I think that might be more
23 similar to the attorney-client relationship. But Mr.
24 Banks, unlike the athlete or unlike the entertainer, had
25 no -- no ability to -- to recover these funds himself. He

1 essentially had two options. He could have either done
2 nothing and collected nothing --

3 JUSTICE BREYER: Your -- your -- you want to
4 fill in the blank, in other words, and say where the
5 assignment of income is such, such that B was in effect
6 the person who really earned the income, unlike Mrs.
7 Lucas' -- what Mr. Lucas' or maybe Mr. Earl -- I don't
8 know --

9 MR. CARTY: That's correct.

10 JUSTICE BREYER: -- husband -- the wife didn't
11 earn the income.

12 MR. CARTY: Right.

13 JUSTICE BREYER: The husband did. So you want
14 to say where the -- and then your answer, I guess -- don't
15 say I'm right if I'm not right, please, because I'll just
16 find out later.

17 (Laughter.)

18 JUSTICE BREYER: The -- the answer to the
19 hypothetical about the agent and so forth is, well, so be
20 it. If a person wants to go to the trouble of carving out
21 some of his income and assigning that over to the agent,
22 let him. Except for perhaps provisions of the code which
23 we cannot now envisage -- I can't because I'm not an
24 expert -- it doesn't matter since, after all, it would be
25 deductible anyway. Is that -- is that what you're saying?

1 MR. CARTY: Well, Your Honor --

2 JUSTICE BREYER: Tell me if I'm wrong, please,
3 on this.

4 MR. CARTY: Again, I -- what we're saying is the
5 unique situation of an attorney and a client, it is the
6 attorney who's taking the laboring, or unlike the
7 entertainer example where the -- where -- or the athlete
8 example --

9 JUSTICE BREYER: Okay, I see. You say double.
10 Both the income is earned by the attorney, and at that
11 stage the client does virtually nothing. So it's the
12 reverse of the Earls or the Lucases where the husband was
13 doing the work and the wife is getting the income. It
14 would be as if the wife was doing all the work and the
15 husband just sat there and clipped coupons or whatever.

16 MR. CARTY: That's correct, Your Honor, and in
17 Lucas v. Earl, it was the assignor who earned the income
18 that was subject to disposition. Here --

19 JUSTICE GINSBURG: I'm not so sure about that
20 because why doesn't the theory that -- that applies to the
21 lawyer equally apply to the wife? I mean, she took care
22 of everything going on at home, and that enabled him to go
23 out there and make all that money. So without her
24 services, just like without the lawyer's services --

25 MR. CARTY: That is an excellent point, Your

1 Honor.

2 JUSTICE SCALIA: You should agree with that.

3 You should --

4 (Laughter.)

5 JUSTICE BREYER: Those were less enlightened
6 times.

7 MR. CARTY: Nevertheless -- nevertheless, I -- I
8 think there may be some -- some difference in degree that
9 you might even recognize between the two cases.

10 Another issue I'd like to address is the impact
11 of the fee shifting statutes, if I could get to that
12 quickly. It is a bedrock principle of taxation that
13 settlements of a claim are taxed the same as a judgment
14 would have been taxed. Mr. Banks' settlement was achieved
15 in lieu of his claims under title VII and 42 U.S.C.,
16 sections 1981 and 1983.

17 Now, each of these statutes contains a fee
18 shifting provision which enables a court to award
19 attorney's fees to a prevailing plaintiff. The defendant
20 in Mr. Banks' case, the California Department of Education
21 -- they therefore settled Mr. Banks' claim in lieu of
22 their exposure under these fee shifting statutes.

23 An award pursuant to these fee shifting statutes
24 is separate and distinct from a damages recovery and
25 therefore should not be taxable to a plaintiff. And the

1 Federal tax consequences to Mr. Banks, the litigant who
2 settles, shouldn't be any different as well. Otherwise,
3 this Court would be discouraging settlement. Therefore, a
4 judicial anti-abuse rule should not be misused to
5 undermine the statutory scheme devised by Congress to
6 encourage civil rights litigants to bring meritorious
7 claims and vindicate national policy.

8 Unless the Court has any further questions?

9 JUSTICE GINSBURG: The Government says on that
10 branch of it, well, the fees -- the lodestar fee, that's
11 one thing. A court awards it, but that's quite different
12 from the one-third/one-half even contingent fee. The
13 court has control over the fee shifting, but we're not
14 dealing with any court award here.

15 MR. CARTY: That's correct, Justice Ginsburg.
16 Mr. Banks settled his claims. Yet, we are pressing the
17 point that Mr. Banks shouldn't be treated any differently
18 for tax purposes than a litigant who recovers pursuant to
19 a fee shifting statute. Otherwise, the Court would be
20 discouraging settlement.

21 If there's any other questions.

22 JUSTICE STEVENS: Thank you, Mr. Carty.

23 MR. CARTY: Thank you.

24 JUSTICE STEVENS: Mr. Salmons, you have a little
25 over 2 minutes.

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REBUTTAL ARGUMENT OF DAVID B. SALMONS
ON BEHALF OF THE PETITIONER

MR. SALMONS: Thank you, Your Honor.

It is clear that the only thing that respondents' attorneys earned under the fee agreements was the right to be paid a fee for their services. In petitioner's view, those agreements don't even give rise to an assignment of income in the ordinary sense. If you look at the text of the fee agreement in the Banaitis case -- the Banks' fee agreement is not in the record -- among other things, it makes clear that if there is a termination -- and it provides lots of grounds on which the attorney-client relationship can be terminated -- that the attorney will be paid a reasonable fee, calculated at the sum of \$175 per hour. That doesn't sound like an assignment of any income or even an assignment of the underlying cause of action. Even if it did, it is clear that in every assignment of income case, the assignor loses control over that income that he assigned. That doesn't stop the application of the proper tax principles, however.

The -- the respondents in these cases suffered a legally cognizable injury. They had a claim. That claim entitled them to a recovery. They retained services to pursue that claim. If they had paid their lawyers on an

1 hourly basis, those lawyers may have been just as
2 necessary to the actual outcome of the case as their
3 contingent fee attorneys. Both the -- an hourly fee
4 attorney and a contingent fee attorney in both of the
5 States at issue here -- and in fact, in all States of
6 which I'm aware -- received precisely the same attorney's
7 lien. That lien makes clear that the relationship between
8 attorney and client starts out as that between a master
9 and an agent and then is converted through the fee
10 agreement to that between a creditor and a debtor, and the
11 lien secures the debt and ensures its payment. When the
12 proceeds from the litigation are paid to the attorney, it
13 satisfies the respondent's debt and is therefore income to
14 the attorney. Under the separate and alternative ground
15 of this Court's Old Colony decision, it goes far and
16 beyond even the holding with regard to an assignment of
17 income.

18 To address just a couple of questions that came
19 up, I would point out that in the class action context,
20 again, as I indicated, there are a number of differences.
21 And just to be a little more specific about some of them,
22 generally speaking there's no unilateral right to settle a
23 -- a case by class members. There's no unilateral right
24 to dismiss the case, and there's no right to a determined
25 fee.

1 JUSTICE STEVENS: Thank you, Mr. Salmons.

2 MR. SALMONS: Thank you.

3 JUSTICE STEVENS: The case is submitted.

4 (Whereupon, at 11:00 a.m., the case in the
5 above-entitled matter was submitted.)

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