viewpoints

Even Tax Court Itself Divided On Attorneys' Fees Issue!

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Tax practitioners know, as do many litigators, that the Circuit Courts of Appeal are split over the tax treatment of attorneys' fees paid to contingent fee lawyers. Maybe the U.S. Supreme Court will have to resolve the matter. In the meantime, yet another important case has been decided by the Tax Court dealing with the tax treatment of contingent attorneys' fees. In *Elden R. Kenseth, et ux. v. Commissioner,* 114 T.C. No. 26, *Doc 2000-14845 (98 original pages), 2000 TNT 102-6* (May 24, 2000), the Tax Court held that attorneys' fees paid out of an age discrimination settlement were includable in the income of the plaintiff.

This may not sound like an important case, since a number of other Tax Court cases (and Circuit Court of Appeal cases) have reached the same holding. Yet it *is* significant, and two things are notable about the case. First, the Tax Court was divided about this matter, the judges disagreeing fairly significantly (an eight to five vote). More about the dissenting opinions later.

Second, the majority of the Tax Court used the assignment of income doctrine as a way of finding that the plaintiff had received for tax purposes the money that was sent directly to the lawyer. The assignment of income doctrine is probably not the most effective or applicable basis for the IRS or the courts to use here. The assignment of income doctrine dates back to the 1930s, and generally has been restricted to situations involving related parties. All these factors may signal a change in what many thought was a tax injustice that would require a legislative fix.

The basic problem is this. If Pauline Plaintiff sues for gender discrimination and receives a settlement of $500,000, and her contingent fee attorney is entitled to 40 percent of it, what is Pauline's income? Common sense dictates that Pauline has $300,000 of income, the lawyer $200,000.

But common sense aside, regardless of how the payments to the attorney are handled, the IRS takes the position that Pauline has $500,000 in income, and must claim a miscellaneous itemized deduction for the $200,000 the attorney receives. All this would be well and good if the $200,000 deduction meant that Pauline pays tax on only $300,000. In fact, because of the limitations on itemized deductions (the 2 percent rule), the phaseout of deductions and exemptions, and most importantly, because of a complex creature called the alternative minimum tax (AMT), Pauline will end up paying tax on a good portion of the money the attorney received. This is the stuff that Supreme Court cases are made of.

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There have been legislative efforts to try to ameliorate the alternative minimum tax problem that results from the treatment of attorneys' fees as miscellaneous itemized deductions. So far, none of this legislation has been successful in eradicating the problem. As a result, taxpayers are forced to try an end run around the deduction problem by requiring that the defendant pay the plaintiff's lawyer directly. The idea is to try to avoid income to the plaintiff, even though the contractual relationship between plaintiff's lawyer and plaintiff is obviously between those two parties and no one else. Often, the question is how effectively this is done, how the often ancient attorneys' lien law works in the particular state, and so on.

Root of the Problem

The attorneys' fee dilemma has become more and more of a problem over the past few years. In the early 1990s, there were many cases in which plaintiffs received amounts in a variety of contexts outside the scope of traditional personal injury actions, yet in which the recoveries were wholly or partially tax-free. If one receives a recovery that is tax-free under section 104 of the Internal Revenue Code, the attorneys' fees are not a problem. Attorneys' fees to recover an excludable amount are not deductible. Yet, since the

recovery is not income, the plaintiff does not *need* the deduction for the attorneys' fees.

In the mid-1990s, the case law began to turn against the widening scope of section 104 as applied to a variety of types of employment actions. The U.S. Supreme Court weighed in several times on the topic. Then, Congress took action in 1996 to require that there be "physical" injury or "physical" illness for section 104's exclusion to apply. The attorneys' fee problem then became critical, and significant controversy is now brewing in the circuit courts.

Although most taxpayers never make it to the circuit courts of appeal (indeed, most tax cases are resolved long before Tax Court), the law on the tax treatment of attorneys' fees depends on the particular jurisdiction in which the taxpayer finds himself. The Tax Court is bound to follow the law in the particular circuit in which the Tax Court is sitting at the time, so there is inconsistent treatment even in the Tax Court. The tax authorities are supposed to look to state law too, which varies.

Even apart from all of this, it now appears there is a fairly vigorous disagreement among the Tax Court judges themselves. If you go to Tax Court, you get only one judge (and no jury). The one judge who conducts your trial determines how your case will come out. Since the Tax Court judges are now lining up on different sides of this legal fee question, and since you can't pick *which* judge is assigned to your case, how you come out on this important legal fee question is in the laps of the gods.

The recent *Kenseth* case is important, both because it was yet another case in this confusing area, and because it sheds a little light on what is going on in the minds of the Tax Court judges that are required to decide this important issue.

Kenseth Case

The underlying facts are fairly commonplace. Mr. Kenseth recovered $229,501 for a claim brought under the Age Discrimination in Employment Act (ADEA). The portion for back pay and lost wages was paid directly to Kenseth, after withholding tax. The remainder of the settlement was paid into the trust fund of his attorney, who subtracted his retainer under the contingent fee agreement, and paid the remainder to Kenseth. Admittedly, this was *not* the best set of facts. In my opinion, the attorney should have been separately paid for *only* the attorneys' fees, and that amount should have gone into the attorney's general account, not into his trust account. These actions would be more consistent with the notion that the attorney and client were co-venturers, and that the attorney was entitled to his share.

Mr. Kenseth filed his return, excluding the settlement proceeds as personal injury damages and only including the portion allocated to wages. The IRS audited, determining that the entire $229,501 was gross income. The Service allowed the attorneys' fees as a miscellaneous itemized deduction. After the deficiency notice (which not surprisingly included a liability for alternative minimum tax), the matter went to Tax Court.

Assignment of Income Resurrected

The majority of the Tax Court (the opinion is written by Judge Robert P. Ruwe) found that the attorneys' fees were includable in Mr. Kenseth's income under the assignment of income doctrine. Little used today, the assignment of income doctrine is raised like a long-forgotten religion and becomes the deciding principle of the case. The Tax Court majority specifically declined to follow the reasoning recently set forth in *Estate of Clarks v. United States,* 202 F.3d 854, *Doc 2000-1776 (7 original pages), 2000 TNT 10-21* (6th Cir. 2000) and the venerable case of *Cotnam v. Commissioner,* 263 F.2d 119, (5th Cir. 1959). Instead, the Tax Court chose to follow its own decision in *O'Brien v. Commissioner,* 38 T.C. 707 (1962), *aff'd per curiam* 319 F.2d 532 (3rd Cir. 1963).

Mr. Kenseth made all the arguments one would expect a taxpayer to make against the assignment of income doctrine. He argued that he had insufficient control over his own cause of action to be taxable on a recovery of a portion of the settlement proceeds diverted to or paid to the attorneys under the contingent fee agreement. The attorneys had control of the case, he argued, as they do in most cases of this nature. The Tax Court found this unpersuasive.

The Tax Court opinion is quite long, and full of explanations of other decisions in this embattled area. The court cites with approval the First Circuit's decision in *Alexander v. Commissioner,* 72 F.3d 938 (1st Cir. 1935). The Tax Court acknowledges that there is a split in the circuits, noting that the Fifth and Eleventh Circuits, and recently the Sixth Circuit, have sided with the taxpayer. The hallmark Fifth Circuit decision is *Cotnam.* For authority in the Eleventh Circuit, see *Davis v. Commissioner,* T.C. Memo. 1998-248, *aff'd per curiam* 85 AFTR2d Par. 2000-620; No. 98-7026, *Doc 2000-12246 (5 original pages), 2000 TNT 86-7* (11th Cir., April 27, 2000).

The most recent victory for the taxpayer on this issue deserves special mention. In *Estate of Clarks,* the taxpayer carried the day. Although the government was awarded summary judgment by the district court, the Sixth Circuit reversed, employing reasoning similar to that used in *Cotnam.* The court of appeals for the Sixth Circuit held that under Michigan law (which applied to the underlying lawsuit), the taxpayer's contingent fee agreement with the lawyer operated as a lien on the portion of the judgment to be recovered. Thus, ownership of that portion of the judgment was transferred to the lawyer. The court placed great emphasis on the fact that the taxpayer's claim was speculative and depended on the services of the lawyer when it was assigned. In effect, the court found that the relationship between lawyer and client was similar to a joint venture between the taxpayer and the lawyer.

The *Estate of Clarks* case was widely heralded as a break in the stream of cases going against taxpayers. Still, the Tax Court in *Kenseth* was not impressed with the Sixth Circuit's view in *Estate of Clarks.* Indeed, the Tax Court goes on at some length about all the state laws on the attorneys' lien question that have been examined. These include *Estate of Gadlow v. Commissioner,* 50 T.C. 975 (1968) (Pennsylvania law); *O'Brien v. Commissioner, supra* (Pennsylvania law); *Petersen v.*

Commissioner, 38 T.C. 137 (1962) (Nebraska and South Dakota law); *Srivastava v. Commissioner,* T.C. Memo. 1998-362, *Doc 98-29917 (39 pages), 98 TNT 194-6 on appeal* (5th Cir., June 14, 1998) (Texas law); and *Coady v. Commissioner,* T.C. Memo. 1998-291, *Doc 98-25202 (8 page), 98 TNT 152-5, aff'd* 85 AFTR2d Par. 2000-723, *Doc 2000-16766 (7 original pages), 2000 TNT 117-9* (9th Cir., June 14, 2000) (Alaska law). We are still awaiting the decision of the Ninth Circuit Court of Appeals in *Benci-Woodward v. Commissioner,* T.C. Memo. 1998-395, *Doc 98-32917 (13 pages), 98 TNT 217-9* (9th Cir. Feb. 2, 1999) (California law). Then there is *Sinyard v. Commissioner,* T.C. Memo. 1998-364, *Doc 98-29997 (14 pages), 98 TNT 195-10,* (9th Cir., Oct. 15, 1999) (Arizona law).

Even more recently than all of these, and more recently than *Kenseth,* is *Coady v. Commissioner,* Dkt. No. 98-71358 (9th Cir. June 14, 2000). The Ninth Circuit sided with the IRS, citing *Alexander* and *Baylin* with approval (and *Estate of Clarks* with disapproval). Interestingly, the taxpayer argued the joint venture theory in the Ninth Circuit, but because this argument had not been made in the Tax Court, the Ninth Circuit refused to consider it.

Review by the Court

The decision by the Tax Court in *Kenseth* adds to the list of states whose law about attorneys' liens has now been considered for tax purposes. Wisconsin law was applied to reach the unfortunate result in *Kenseth.* Yet as I noted above, the case has special significance for a couple of reasons.

First, it was "reviewed by the court." This designation means that the opinion prepared by the trial judge was examined by the entire Tax Court, in this case by 13 judges. See Taylor, Simonson, Winter & Seery, *Tax Court Practice,* section 12.01(d) (7th Ed. 1990). Only the Chief Judge of the Tax Court can decide whether an opinion will be reviewed by the full court. Section 6470(b). In fact, very few Tax Court cases actually receive this treatment. In the majority of cases, a single Tax Court judge decides the case. According to the Tax Court's fiscal year statistical information, a tiny percentage of cases are reviewed by the court. In 1982-1991, only 1.5 percent of the cases were reviewed by the court. See *United States Tax Court Fiscal Year 1991 Statistical Information,* at p. 5 (1992).

Two Important Dissents

There were two dissents filed, and they are important, both for what they say and for the support they marshaled. One of the dissenters was Judge Herbert L. Chabot, long a respected jurist. Rejecting the majority view, he noted that the assignment of income doctrine was not created by a statute. Judge Chabot found that the assignment of income doctrine was created by the courts, and therefore that courts could correct errors based on it.

Pragmatically, Judge Chabot noted that the majority of the court taxed Mr. and Mrs. Kenseth on *money they never received,* and were never entitled to receive. It was money they never turned their backs on, so the assignment of income doctrine was not applicable. Judge Chabot found that the court was simply doing an injustice and disagreed with the result.

Judge Chabot is well-respected, and his dissent carries particular weight. Moreover, Judges Carolyn Miller Parr, Thomas B. Wells, John L. Colvin, and Renato Beghe agreed with Judge Chabot's dissent. This means the Tax Court itself is highly divided on this issue.

Judge Beghe decided to file his own separate dissent, even though he also joined with Judge Chabot's dissent. Interestingly, Judge Beghe was the presiding judge at the trial of the case. He dissented, finding that the facts did not call for an application of the assignment of income doctrine. His opinion is detailed. Indeed, Judge Beghe's dissent is extremely long, longer than the majority opinion and Judge Chabot's dissent put together. Like Judge Chabot and all of the other dissenters, he would have held that the control over prosecution of the claims made by the attorneys made it reasonable to include in Mr. Kenseth's gross income only his *net* share of the settlement proceeds. The attorneys, after all, control these things.

Judge Beghe also noted that the majority of the assignment of income cases that were decided by the Supreme Court primarily arose in intrafamily donative transfers. The touchstone of these cases, said dissenting Judge Beghe, was retained control over the subject matter. Mr. Kenseth's retained control (if any), was so small as to make it unreasonable to charge him with the full amount of his share of the settlement, without offset of the attorneys' fees.

The Road Ahead

Clearly, we have not heard the last from these attorney fee cases. The *Kenseth* case may be just another victory for the government on this nettlesome attorneys' fee problem that most (even some people in the government!) admit is a trap for the unwary. On the other hand, *Kenseth* does not have the best facts for the taxpayer. And of all things, the case ends up carrying the long mothballed assignment of income doctrine as the new herald of the attorney fee problem. I didn't like the problem before, and I like it even less now.

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Still, the most illuminating aspect of the *Kenseth* case is that there were two important judges dissenting who voiced the pragmatic, realistic, and downright sympathetic view (and sympathy in the Tax Court comes in small measures) that there was *no reason* to apply the assignment of income doctrine here, and that the taxpayer was in fact not in control of the prosecution of the case to begin with. Besides, the dissenters cried, it was simply unjust to tax someone on something they never saw.

The judges line up eight to five on the case, eight on the side of the assignment of income doctrine (yuck!), and five concluding that enough is just enough. Indeed, Judge Chabot, in a statement of both wisdom and courage, states that the continued application of "court-made rules in this era of minimum tax can raise

effective tax rates to hardship levels in some real-world instances." It was the courts, Judge Chabot correctly pointed out, that made the assignment of income doctrine, not Congress. The naysayers who argue that Congress has to fix this terribly unjust problem, at least as far as Judge Chabot is concerned (and the other Tax Court judges who agreed with him), are simply wrong.

Just go back and reread (if you can stand it) those old assignment of income doctrine cases from the 1930s. Remember *Lucas v. Earl,* 281 U.S. 111 (1930)? Look also at the other ancient assignment of income cases, and ask yourself if these ought to have any application in the tax scheme today and to the lawyer/client relationship. The plaintiff and the plaintiff's lawyer may be on the same side *viz.* the defendant, but they are decidedly not related (and often don't cooperate well at all).

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Judge Chabot took a real world view of the ancient assignment of income doctrine, the relationship between the parties in litigation, and the practical effect of the alternative minimum tax. Judge Chabot stated that the court "chose to follow a wrong path decades ago." Amen!

Judge Beghe is not to be slighted either. His very long and thoughtful dissent deserves particular emphasis because he was the trial judge in the case. Note that if this case had not been designated to be reviewed by the court, the decision would have come out differently. Judge Beghe would have simply ruled for the taxpayer.

Judge Beghe's dissent even takes into account the various tax laws enacted over the years. Judge Beghe stated that he did not believe "Congress expected or intended that the interplay of the newly-enacted itemized deduction and AMT provisions could result in effective rates of tax substantially exceeding 50 percent up to more than 100 percent of a net recovery." Like Judge Chabot, Judge Beghe found the contingent fee agreement between lawyer and client to be peculiar, and far removed from intrafamily and other related-party transfers that generate concern over the assignment of income doctrine.

Conclusion

Litigants who are trying to determine exactly how to settle their cases, and tax advisors who are trying to help them, are certainly in a quandary now. It is hardly open season on the government. *Kenseth* was yet another decision *favoring* the government and *against* taxpayers. Yet, *Kenseth* gives a rare glimmer of hope in a dispute that it seemed inevitable would either have to be resolved by Congress or by the U.S. Supreme Court.

Certainly given the split in the circuits, a U.S. Supreme Court decision would be nice. Unfortunately, it also may be years away. And the Supreme Court does not have the best record with tax cases. Tax Court Judges are all trained as tax lawyers. The fact that the Tax Court is now deeply divided on this issue, with five judges reflecting sentiments of "enough's enough" about the impact of the alternative minimum tax, is hopeful.

Thus, I think the winds of change are starting to blow. I also think taxpayers should not be dissuaded by the bulk of the adverse authority on this issue, and should still attempt where appropriate to structure a settlement to avoid paying tax on something they will never get — their lawyer's share. Sooner or later, I hope Judge Chabot's and Judge Beghe's view will carry the day.

Much to my chagrin, it was the majority opinion that cited an article I wrote, one that I thought had a particularly demonstrative title. See Wood, "The Plight of the Plaintiff: The Tax Treatment of Legal Fees," *Tax Notes*, Nov. 16, 1998, p. 907. Buried in a footnote, I'm not sure the majority opinion took into account what I was trying to get across in that and other articles, and how plaintiffs truly do suffer under the weight of the AMT, taxing them on monies their lawyer gets. Fortunately, the dissenters in *Kenseth* — all five judges who participated — are now taking this stuff seriously. Hallelujah!