PROFESSIONAL LIABILITY FUND

IN BRIEF

MALPRACTICE AVOIDANCE NEWSLETTER FOR OREGON LAWYERS

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WAGE/INCOME AWARDS: TAX CONSEQUENCES

You and your client have just signed a $500,000 settlement for wages under the *Federal Age Discrimination in Employment Act of 1967,* Pub. L. 90-202, sec 2, 81 Stat. 602. The Court transfers the settlement proceeds directly to you for deposit into your trust account. In distributing the settlement, you retain $200,000 in attorney's fees pursuant to your contingent fee agreement. You distribute $300,000 to your client.

At first glance it may seem that the taxpayer should claim $300,000 as gross income. Unfortunately, the court in *Kenseth v. Commissioner, 114 TC 399 (2000),* recently held that attorney's fees, contingent or otherwise, must be included in the income of the taxpayer who earned the settlement. This means that your client should include the full $500,000 in gross income and take a $200,000 deduction. Although you may expect that these scenarios come out the same, they don't because of the way the law treats itemized deductions and because of the impact of the alternative minimum tax.

What is the difference to this taxpayer between including $300,000 in gross income and including $500,000 in gross income with a $200,000 itemized deduction? Assume that your client is a typical American taxpayer: married with two children less than eighteen years of age. Your client and her husband will incur $15,000 in mortgage interest, $3,000 in property taxes, and $2,000 in charitable contributions during the year of settlement. Their adjusted gross income before the settlement would have been $150,000. The difference is caused substantially by the federal alternative minimum tax as demonstrated by the chart at the bottom of this page.

From a pure fairness point of view, the client's displeasure is justified. Although the economics of the distribution of the settlement between you and the client are identical, the client will have to pay $43,751 more, of which $35,259 is attributed to the alternative minimum tax. In short, scenario #2 listed below is the correct tax treatment.

CLIENT RECEIVED BENEFIT OF FEES

According to the IRS and the majority opinion in *Kenseth v. Commissioner*, Mr. Kenseth received the benefit of the fees even though they were paid directly to the attorney for services rendered. In the words of the majority, attorney's fees paid under a

	Before Settlement	Scenario No. 1: *$300,000* added to AGI	Scenario No. 2: *$500,000* added to AGI; $200k in itemized deductions
Taxable Income	$108,831	$401,768	$418,719
Federal Income Tax	24,859	131,768	138,481
Federal Alternative Minimum Tax	0	0	35,259
State Income Tax	10,601	37,864	39,913
Total Tax	35,460	169,632	213,653
Total Tax Caused by Settlement	0	134,442	178,193
Amount Paid to Attorney	N/A	200,000	200,000
Settlement Available to Client	N/A	**165,558**	**121,807**

settlement "come with the ambit of the assignment of income doctrine and do not serve, for purposes of Federal taxation, to exclude the fee from the assignor's gross income." Under the assignment of income doctrine, income is distributed to the person who is entitled to receive the income whether through (1) the performance of personal services or (2) ownership of property that produces the income. A person is entitled to receive the income if the person has control or dominion over the income, has the use of the income, or directs the receipt of the income. *The Internal Revenue Service treats assigned income as if the taxpayer had first received the income, included it in gross income, and then transferred an equivalent sum to the assignee*. The assignment of income doctrine specifies which taxpayer must include certain items in gross income. In short, Mr. Kenseth effectively received the attorney fee portion of the award, and then paid the fees over to his attorney pursuant to their binding contingent fee contract.

The attorneys representing Mr. Kenseth before the Tax Court refused to yield to the assignment of income doctrine and advanced several arguments, all of which the court rejected. They included:

- **The taxpayer's claim was not "perfected;" the *attorney's* efforts perfected the claim into a judgment.** The *Kenseth* majority held that even if perfection of the claim is a prerequisite to application of the doctrine, the claim was perfected at the moment of inquiry. At that point, the client was entitled to the award that must be included in income. What was in doubt *after* the injury was only the *amount* of the award. The lawyers merely carried out their fiduciary duties to the plaintiff and the entire award still belongs to the client.

- **The cause of action had no value when the client and lawyer signed the contingent fee agreement.** The taxpayer argued that if the assigned income has no "value," then the assignment of income doctrine should not apply. The court rejected this rather clever argument on two grounds. First, they were unable to find a requirement of "value" in the doctrine itself. Second, even if the assignment of income doctrine required a finding that the assigned income had value, the cause of action generating the income must have been valuable. If the case had no value, then the lawyer and the client would not have agreed to pursue the matter on a contingent fee basis.

- **The taxpayer had "no vested interest in the claim, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury."**

- **The taxpayer could not, under applicable state law, receive the attorney's fees.**

- **Both the client and the attorney earned the right to the damages, and income should be taxed to the persons who earn it.**

- **Based upon the attorney fee statute, the client and the attorney are essentially joint venturers or tenants in common in the cause of action.**

- **This is not a case where the client wants to split income to avoid taxation.**

- **Even if the fees are taxable to the client, the application of the AMT makes application of the assignment of income rule in this area too harsh.**

The Ninth Circuit in *Brewer v. Commissioner*, 127 F. 3d 875 (9th Cir. 1999), has already held that a taxpayer must include, in income, attorney fees paid directly to the attorney. The opinions by the 9th Circuit and the Tax Court in that case, however, did not address all of the possible arguments against application of the assignment of income doctrine discussed by the *Kenseth* court. The Kenseth opinion is a scholarly, well-reasoned opinion and, in my opinion, states the correct application of the assignment of income doctrine in this area. Therefore, this case should be reviewed by counsel carefully before giving any advice in this area. There is a split of authority in this area (the 5th and 6th Circuits are "pro" taxpayers; the 9th and Federal circuits are "pro" IRS), so this issue is probably destined for the Supreme Court. Attorneys should use extreme caution in issuing any advice that causes clients to exclude from income any portion of a taxable award representing attorney fees.

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