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# Income Tax: *Kenseth v. Commissioner*: The Assignment of Income Doctrine and Its Misapplication to Contingent Attorneys' Fees

## Introduction

In *Kenseth v. Commissioner*,<sup>1</sup> a taxpayer received \$229,501 as a settlement award under the federal Age Discrimination in Employment Act (ADEA) of 1967.<sup>2</sup> Of the total settlement, the taxpayer paid \$91,800 to his attorney pursuant to a contingent fee agreement. How much of the settlement award must the taxpayer claim as income when filing his federal income tax return? There are two alternative solutions to the problem. First, the taxpayer could exclude from gross income the portion of the settlement award paid as attorneys' fees.<sup>3</sup> Second, the taxpayer could report the entire settlement, including the portion paid for attorneys' fees, as gross income while claiming an itemized deduction for the portion paid as attorneys' fees.<sup>4</sup> The latter option imposes the greater tax burden upon taxpayers.<sup>5</sup> In *Kenseth*, the Tax Court had the opportunity to resolve this issue.<sup>6</sup> To taxpayers' dismay, the majority of the Tax Court chose the latter option.<sup>7</sup> The result is not necessarily surprising because the Tax Court has consistently followed this rule.<sup>8</sup> However, some circuit courts disagree with the Tax Court's position,<sup>9</sup> and some circuits have not yet had the opportunity to decide the issue.<sup>10</sup> Hopefully, the

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1. 114 T.C. 399 (2000).

2. 29 U.S.C. §§ 621-633a (1994).

3. See Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 16, 531, 532 (2000).

4. See *id.*

5. Application of §§ 56, 67, and 68 of the Internal Revenue Code often interact to allow a taxpayer an itemized deduction for only a portion of the total expense incurred. See *infra* notes 12-17 and accompanying text; see also I.R.C. §§ 56, 67, 68 (2000).

6. See *Kenseth*, 114 T.C. at 407; see also *Coady v. Comm'r*, 213 F.3d 1187, 1190 (9th Cir. 2000); *Baylin v. United States*, 30 Fed. Cl. 248 (1993). But see *Estate of Clarks ex rel Brisco-Whitter v. United States*, 202 F.3d 854, 856 (6th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119, 121 (5th Cir. 1959).

7. *Kenseth*, 114 T.C. at 407, 417. The majority was only an eight-to-five majority. Robert W. Wood, *Leave Section 83 Out of This Mess*, 89 TAX NOTES 1187, 1187 (2000).

8. See *Bagley v. Comm'r*, 105 T.C. 396, 419 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997); *O'Brien v. Comm'r*, 38 T.C. 707, 712 (1962), *aff'd per curiam*, 319 F.2d 532 (3d Cir. 1963).

9. See *Clarks*, 202 F.3d at 857; *Cotnam*, 263 F.2d at 121.

10. A taxpayer can either bring suit in the United States Tax Court, the United States District Court, or the United States Court of Federal Claims. See JAMES J. FREELAND ET AL., *FUNDAMENTALS OF FEDERAL INCOME TAXATION* 971-72 [hereinafter *FUNDAMENTALS*] (11th ed. 2000); see also I.R.C. §§ 7441, 7443 (2000). Lawsuits filed in Tax Court or Federal Claims Court are tried without a jury. See *FUNDAMENTALS*, *supra*, at 971-72. In cases tried before a United States district court, a jury determines the factual issues. See *id.* If a tax issue is decided in Tax Court or a United States district court, all appeals are made to the appropriate circuit court of appeals. See *id.* at 975-76; see also I.R.C. § 7482 (2000). However, taxpayers must appeal decisions of the United States Court of Federal Claims to the

United States Supreme Court will decide the issue in the near future and resolve the current state of confusion resulting from the conflicting decisions of courts across the country.<sup>11</sup>

The reason for the existing controversy is that the two alternatives have significantly different consequences to the taxpayer.<sup>12</sup> For example, assume a taxpayer enters into a contingent fee agreement with his attorney whereby the attorney will receive 30% of any lawsuit proceeds. If the taxpayer wins a \$100,000 settlement award, the attorney automatically receives \$30,000 and the taxpayer receives the remaining \$70,000. Under the first alternative, the taxpayer would simply include \$70,000 in his gross income. Thus, he would pay tax on the amount that he actually received and no more. However, under the approach adopted by the Tax Court in *Kenseth*, the taxpayer would have to include the entire \$100,000 in his gross income even though he only received \$70,000. Although the taxpayer could claim as an itemized deduction the \$30,000 paid in attorneys' fees, several sections of the Internal Revenue Code interact to reduce the amount allowed as itemized deductions.<sup>13</sup> The relevant sections are § 56,<sup>14</sup> which governs adjustments in computing the alternative minimum tax (AMT); § 67,<sup>15</sup> which imposes a 2% floor on itemized deductions; and § 68,<sup>16</sup> which imposes the overall limitation on itemized deductions. The application of these provisions lies at the heart of the controversy because if contingent fees exceed 50% of the total recovery, the taxpayer could incur a tax liability exceeding 100% of the amount received from settlement proceeds.<sup>17</sup>

United States Court of Appeals for the Federal Circuit. See FUNDAMENTALS, *supra*, at 975-76.

11. Article 1, Section 8, Clause 1 of the United States Constitution requires that the federal taxing power be uniform in application throughout the United States. See FUNDAMENTALS, *supra* note 10, at 15; see also *Lawrence v. Comm'r*, 27 T.C. 713, 716 (1957) (holding that the Tax Court did not have to follow appellate court decisions on law in later cases involving the same issue). *But see* *Golsen v. Comm'r*, 54 T.C. 742, 756-57 (1970) (reversing the Tax Court's position as described in *Lawrence* and stating that the Tax Court would start deciding future cases based on the applicable appellate court decisions).

12. See *Geier*, *supra* note 3, at 532 (noting that § 68 of the Internal Revenue Code can reduce a taxpayer's itemized deductions by up to 80% under the regular tax system). However, the biggest threat to taxpayers comes from the alternative minimum tax system, not the regular tax system. *Id.*; see also *Kenseth*, 114 T.C. at 407; Jon Forman, *Tax Treatment of Contingent Legal Fees*, J. REC. (Okla. City), Sept. 5, 2000, at 19.

13. See I.R.C. §§ 56, 67, 68 (2000); see also *Kenseth*, 114 T.C. at 425-26 (Beghe, J., dissenting).

14. I.R.C. § 56 (2000).

15. *Id.* § 67.

16. *Id.* § 68.

17. *Kenseth*, 114 T.C. at 425-26 (Beghe, J., dissenting); see also Robert W. Wood, *The Plight of the Plaintiff: The Tax Treatment of Legal Fees*, 98 TAX NOTES TODAY 220-101, ¶¶ 4-6, Nov. 16, 1998, available at LEXIS, 98 TNT 220-101 (commenting on the interaction of revenue laws and the deductibility of legal fees). See generally Burgess J.W. Raby & William L. Raby, *Deducting Legal Fees — Before-Tax and After-Tax*, 79 TAX NOTES 1295, 1298 (1998) (discussing the application of the AMT to contingent attorneys' fees arising out of business litigation). Tax scholars state:

If the contingent fee is not deductible in arriving at AGI, and the AMT applies to the total amounts involved, nondeductibility at the 28 percent AMT rate means that what appears to be a 33-1/3 percent contingent fee is actually a 46.3 percent after-tax

Due to the limitations on deductions, the result of including the entire amount as gross income can be extremely unfair to the taxpayers.<sup>18</sup> The Tax Court stated that the unfair result can only be corrected if Congress reforms the Internal Revenue Code.<sup>19</sup> However, the Tax Court based its reasoning upon a judge-made doctrine — the assignment of income doctrine. Some courts believe the assignment of income doctrine should not apply to cases like *Kenseth*. This note identifies why the Tax Court erred in its conclusion and why the assignment of income doctrine should not apply to cases with factual circumstances like *Kenseth*. Part I of this note outlines the applicable provisions of the Internal Revenue Code, while Part II explains the assignment of income doctrine. Part III reviews previous case law, and Part IV explains the holding and reasoning of the *Kenseth* decision. Finally, Part V of this note sets forth a counterargument to the *Kenseth* decision and explains possible solutions to the issue.

### I. Applicable Internal Revenue Code Provisions

#### A. Section 61(a) of the Internal Revenue Code

The starting point in any income tax issue turns on how much and what items the taxpayer must include in gross income. Section 61<sup>20</sup> of the Internal Revenue Code is the section that answers this question. Section 61(a) specifically states, "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived."<sup>21</sup> The section then goes on to give a list of certain items that represent gross income. This list includes compensation for services, commissions, and fringe benefits.<sup>22</sup> Courts have interpreted § 61 broadly. If an item of income falls under § 61(a), it will be included in gross income unless a separate section of the Internal Revenue Code specifically exempts the item from inclusion in gross

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contingent fee. In other words, a \$1 million recovery will cost \$280,000 in tax. Thus, the after-tax amount is \$720,000. The nondeductible \$333,333 fee that was withheld from the \$1 million is 46.3 percent of the net recovery, after tax. If the fee is based on the gross recovery and expenses are charged against the client's portion of the recovery, the effective contingent fee rate is even greater. Thus, if the lawyer were reimbursed, expenses of \$100,000 in addition to the \$333,333, the recovery still costs \$280,000 in tax, but the after-tax net to the taxpayer turns out to be only \$620,000 before reflecting the attorney's fee. That fee is then 53.76 percent after tax. If the lawyer's third is calculated after the \$100,000, then the fee is only \$300,000 (1/3 of \$900,000) and is 48.4 percent of the after-tax recovery.

*Id.* at 1298.

18. The plaintiffs most affected by these tax consequences are employees who receive awards from their employers in employment litigation. *See Geier, supra* note 3, at 533. Other affected individuals include those recovering awards that are not excludable under § 104(a)(2), including punitive damages and postjudgment interest from which attorneys' fees are paid. *See id.*

19. *Kenseth v. Comm'r*, 114 T.C. 399, 407 (2000).

20. I.R.C. § 61 (2000).

21. *Id.* "Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services." Treas. Reg. § 1.61-1(a) (1957).

22. I.R.C. § 61(a)(1) (2000).

income.<sup>23</sup> In *Kenseth*, the Tax Court decided that § 61(a) includes the entire settlement award the taxpayer received whether or not the taxpayer pays a portion of the settlement as an attorney's fee.

*B. Sections 67 and 68 of the Internal Revenue Code*

The next issue becomes whether and how much of a deduction the taxpayer can claim for attorneys' fees. The Tax Court ruled that Mr. Kenseth could claim an itemized deduction for the amount of his attorneys' fees. The Internal Revenue Code provides that taxpayers can claim the greater of their itemized deductions or the standard deduction allowed by the Internal Revenue Code.<sup>24</sup> Absent application of either § 67 or § 68, allowance of an itemized deduction for attorneys' fees would have the same result as simply excluding the amount from gross income. However, the Internal Revenue Code does not operate this way, and the application of §§ 67 and 68 to itemized deductions caused the unfair result in *Kenseth*.<sup>25</sup> Section 67 imposes a 2% floor on a taxpayer's miscellaneous itemized deductions for the year.<sup>26</sup> Thus, a taxpayer can only take a deduction from gross income for that portion of the contingent attorneys' fees (in addition to any other miscellaneous itemized deductions) that exceeds 2% of the taxpayer's adjusted gross income for the year.<sup>27</sup> In addition, § 68 imposes a further limitation on the amount of itemized deductions allowed for individuals with income above a specified amount.<sup>28</sup> Under § 68, the total amount of itemized deductions otherwise allowed is reduced by a certain percentage,<sup>29</sup> which shall not exceed 80% of the total itemized deductions for the year.<sup>30</sup> After application of §§ 67 and 68, taxpayers certainly will not be left with a deduction for the total amount of attorneys' fees. Unfortunately, the limitations do not end there.

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23. *Id.* § 61(a); see also *Comm'r v. Glenshaw Glass*, 348 U.S. 427, 430 (1955); *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929).

24. See I.R.C. § 63 (2000).

25. See *Kenseth v. Commissioner*, 114 T.C. 399, 407 (2000); see also 3 FED. TAX BULL. 12 (2000), available at LEXIS, 2000 Fed. Tax Bull. 140 ("While the taxpayer was entitled to a miscellaneous itemized deduction for the fees, the application of the 2-percent limitation, the overall itemized deduction limitations, and the alternative minimum tax resulted in the taxpayer going home with very little of the settlement award in the end.")

26. See I.R.C. § 67 (2000).

27. See *id.*

28. *Id.* § 68.

29. *Id.* § 68(a). Section 68(a) states:

In the case of an individual whose adjusted gross income exceeds the applicable amount, the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of —

3 percent of the excess of adjusted gross income over the applicable amount, or

80 percent of the amount of the itemized deductions otherwise allowable for such taxable year.

*Id.* Section 68(b) sets forth the applicable amount described in § 68(a) and it is adjusted for inflation.

*Id.* § 68(b).

30. *Id.* § 68(a)(2).

### C. Section 56 of the Internal Revenue Code

Another part of the Internal Revenue Code, the alternative minimum tax (AMT),<sup>31</sup> actually adds additional tax liability on top of the regular tax liability.<sup>32</sup> When the alternative minimum tax exceeds the taxpayer's regular tax liability, the taxpayer must pay both the regular tax plus the portion of the alternative minimum tax in excess thereof.<sup>33</sup> Section 56 governs the adjustments required in computing the alternative minimum tax.<sup>34</sup> However, § 56 does not allow deductions for any miscellaneous itemized deductions.<sup>35</sup> Because attorneys' fees are classified as miscellaneous itemized deductions, they are not deducted in the AMT computation. Thus, § 56 increases the tax burden of those subject to the AMT by including the entire settlement award in gross income and not allowing any deduction for the attorneys' fees.<sup>36</sup> These Internal Revenue Code sections help demonstrate the negative effect of the *Kenseth* decision. However, the *Kenseth* court premised its decision upon the assignment of income doctrine.

### II. Assignment of Income Doctrine

The U.S. Supreme Court created the assignment of income doctrine over sixty years ago in *Lucas v. Earl*<sup>37</sup> to prevent taxpayers from engaging in tax avoidance schemes.<sup>38</sup> Tax avoidance most often occurs in intrafamily transfers whereby a family member in a high tax bracket assigns income to a family member who falls into a lower tax bracket.<sup>39</sup> In *Lucas*, a husband and wife entered an agreement that

31. See *id.* § 55.

32. See *id.*

33. *Id.*

34. *Id.* § 56. Section 56 is not the only section of the Internal Revenue Code that governs computation of the alternative minimum tax. Section 58 sets forth additional adjustments to a taxpayer's regular taxable income required in determining the alternative minimum tax. *Id.* § 58. Section 57 lists "tax preference" items that are added before calculating the alternative minimum tax. *Id.* § 57.

35. *Id.* § 56(b)(1)(A)(i).

36. See Laura Sager & Stephen Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. CAL. L. REV. 1075, 1077 (2000) (noting that a plaintiff "must report her entire recovery as income. However, the attorney's fees — the cost of producing the income — are not fully deductible under the regular tax and are *not deductible at all* under the alternative minimum tax.") (emphasis added). The following illustration clarifies the problem:

If the ratio of attorney's fees to the entire recovery is high enough, a before-tax gain may metamorphose into an after-tax loss . . . for example, the plaintiff settled a state law employment claim for \$250,000 but incurred \$245,000 in attorney's fees, for a pre-tax profit of \$5,000. Under the AMT, the entire \$250,000 recovery was taxable but none of the \$245,000 in attorney's fees was deductible. If we assume that the taxpayer files jointly and has no other income, his AMT liability would be \$53,900. Under these assumptions, the nondeductibility of the employee's attorney's fees under the AMT would convert a \$5,000 before-tax gain into a \$48,900 after-tax loss.

*Id.* at 1078 (footnotes omitted).

37. 281 U.S. 111 (1930); see also Ronald H. Jensen, *Schneer v. Commissioner: Continuing Confusion over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 624 (1993).

38. See *Lucas*, 281 U.S. at 114-15.

39. See Jensen, *supra* note 37, at 631-32; see also *Kenseth v. Comm'r*, 114 T.C. 399, 441 (2000)

granted to each spouse one-half of the income earned from the other spouse.<sup>40</sup> On his tax return for the year in question, the husband claimed only one-half of the income he earned.<sup>41</sup> The Supreme Court held that an individual cannot avoid paying tax on income he earned by making an anticipatory assignment of that income to another person.<sup>42</sup> Therefore, the husband was responsible for paying the entire tax liability on all of his earned income regardless of any separate agreement limiting his access to or use of the money. The assignment of income doctrine means that a person cannot avoid paying tax through an "arrangement, by which fruits are attributed to a different tree from that on which they grew."<sup>43</sup>

The facts of *Lucas* involved a gratuitous assignment of personal service income. In *Helvering v. Horst*,<sup>44</sup> the Supreme Court applied the assignment of income doctrine to gratuitous assignments of investment income. In *Horst*, the taxpayer, an owner of negotiable bonds, detached from them the interest coupons and gave them to his son shortly before their due date.<sup>45</sup> Although the interest on the bonds was thereafter paid to the son, the Court required the taxpayer to include the interest in his gross income.<sup>46</sup> The Court viewed the taxpayer, not the recipient of the gift, as realizing the income: "[H]e, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants."<sup>47</sup> The taxpayer did realize the income for tax purposes because he enjoyed a benefit from it; he gave a gift to his son. "Such a use of his economic gain . . . to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods . . . or gifts to his son."<sup>48</sup> Case law that developed after *Horst* intimates that the assignor can avoid paying taxes on the assigned income as long as the assignor also assigns the property producing such income.<sup>49</sup> Thus, the taxpayer in *Horst* could have avoided tax liability for the interest by assigning both

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(Beghe, J., dissenting).

40. *Lucas*, 281 U.S. at 114.

41. *Id.*

42. *Id.* "A gratuitous anticipatory assignment of income does not shift the burden of taxation and the donor is taxable when the income is received by the donee." Tax Analysts, *Amounts Not Received from Employer Are Income*, 8 INS. TAX REV. 728 (1994), available at LEXIS, 8 Ins. Tax Rev. 728 (discussing the application of the assignment of income doctrine to certain employment health benefit options); see also Tax Analysts, *Payments to Former Wife from Husband's Nonqualified Deferred Compensation Account Are Taxable to Husband*, Tax Analysts, 61 TAX NOTES 311, 319 (1993) (discussing Priv. Ltr. Rul. 93-40-032 (Oct. 18, 1993)).

43. *Lucas*, 281 U.S. at 115.

44. 311 U.S. 112 (1940); see also 5 MERTENS LAW OF FEDERAL INCOME TAXATION § 24A:42.15 (Kenneth G. Zaleski rev., 2001), WL 5 Mertens 24A:42.15 [hereinafter MERTENS] (noting that *Horst* is the second Supreme Court case that "shaped the assignment-of-income doctrine").

45. *Horst*, 311 U.S. at 114.

46. *Id.* at 114-16, 120.

47. *Id.* at 116-17.

48. *Id.* at 117.

49. See Jenson, *supra* note 37, at 631. However, even if the taxpayer assigns the income-producing property, the taxpayer will be taxed on income accrued prior to the assignment. *Id.*

the negotiable bonds and the interest coupons to his son. Case law prior to *Kenseth* is divided on the issue of how and when the assignment of income doctrine should apply to various factual situations.

### III. Prior Case Law

#### A. Circuit Courts Finding That the Assignment of Income Doctrine Does Not Apply to Payment of Attorneys' Fees

##### 1. Fifth Circuit

In *Cotnam v. Commissioner*,<sup>50</sup> the Fifth Circuit adopted the position that the portion of a judgment used to pay attorneys' fees should not be included in the gross income of the taxpayer.<sup>51</sup> In *Cotnam*, a man offered to give Mrs. Cotnam one-fifth of his estate if she would provide care and friendship to him until his death.<sup>52</sup> Mrs. Cotnam agreed and served the man until his death, four and one-half years later.<sup>53</sup> The man died without a will, and Mrs. Cotnam sued the estate for the amount he promised her. The court awarded Mrs. Cotnam \$120,000.<sup>54</sup> Pursuant to a contingency agreement, Mrs. Cotnam paid \$50,365 to her attorneys.<sup>55</sup> She did not include the attorneys' fees in her gross income, and the Commissioner issued a deficiency.<sup>56</sup>

The *Cotnam* court held that the taxpayer did not have to include in gross income the portion of her settlement paid as attorneys' fees.<sup>57</sup> The Alabama Code provided that "attorneys . . . have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them."<sup>58</sup> The court reasoned that this gave attorneys a lien on any judgment, prohibiting Cotnam from ever having an entitlement to that portion of the settlement.<sup>59</sup> Thus, she never realized any income attributable to the contingency fee arrangement.<sup>60</sup> Cotnam's agreement to pay 40% of any judgment to her

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50. 263 F.2d 119 (5th Cir. 1959).

51. *Id.* at 121; *see also* Thad Austin Davis, *Cotnam v. Commissioner and the Income Tax Treatment of Contingency-Based Attorneys' Fees — The Alabama Attorney's Charging Lien Meets Lucas v. Earl Head-on*, 51 ALA. L. REV. 1683, 1700 (2000).

52. *Cotnam*, 263 F.2d at 120.

53. *Id.*

54. *Id.* at 121.

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.* at 125; *see also* Davis, *supra* note 51, at 1716-20 (discussing the attorney lien laws of other states and how they compare to the Alabama statute analyzed in *Cotnam*); Robert W. Wood, *Even Tax Court Itself Divided on Attorney's Fees Issue!*, 88 TAX NOTES 573 (2000) (stating the various cases that have evaluated state law on attorney liens).

59. *Cotnam*, 263 F.2d at 125; *see also* Davis, *supra* note 51, at 1705 ("[O]ther courts addressing the issue have neglected two lines of cases that support *Cotnam* . . . The Supreme Court's decision in *Poe v. Seaborn* endorsed the position that state property law can trump general income tax principles when examining who has the right to earned income.").

60. *Cotnam*, 263 F.2d at 125.



attorneys did not amount to an assignment of income for several reasons. First, although Cotnam did have a right to be paid for the services she rendered, without assistance of counsel, her claim was worthless.<sup>61</sup> Cotnam had not received any income or even a right to income at the time she hired her attorneys.<sup>62</sup> In fact, she relinquished 40% long before she was ever awarded any income.<sup>63</sup> The only benefit she could enjoy from the income was the ability to hire attorneys so that she might have a chance to recover a part of it.<sup>64</sup>

## 2. Sixth Circuit

The Sixth Circuit also adheres to the view that attorneys' fees are not included in the gross income of a taxpayer. The court reinforced this view in January 2000 when it heard the case of *Estate of Clarks v. United States*.<sup>65</sup> Arthur Clarks instituted a personal injury suit against K-Mart and was awarded \$5,600,000 in damages plus \$5,707,837 interest.<sup>66</sup> Clarks paid a portion of the contingent attorneys' fees from the interest and excluded this amount from gross income on his tax return.<sup>67</sup> The Commissioner issued a deficiency, and the taxpayer took the issue to court. For the following reasons, the court determined that the taxpayer did not have to include the attorneys' fees in gross income. First, Michigan had a common law attorneys' lien, and the court found it operated like the Alabama lien in *Cotnam*.<sup>68</sup> Clarks did own and control the claim of personal injury; however, Clarks relinquished his right to any payment from the lawyer's portion of the judgment.<sup>69</sup> The value of Clarks' claim, if any, could not be determined at the time Clarks reached the contingent fee agreement with the attorney.<sup>70</sup> Furthermore, the taxpayer could not realize any value without the assistance of counsel.<sup>71</sup> The court reasoned that the only economic benefit that Clarks enjoyed from the contingent portion of the settlement award was to hire an attorney to retrieve the remaining

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61. *Id.*; see also MERTENS, *supra* note 44, § 24A:42.16.

62. *Cotnam*, 263 F.2d at 125.

63. See *id.*

64. See *id.* at 126; see also MERTENS, *supra* note 44, § 24A:42.15 (stating that the assignment of income doctrine "can have no just or realistic application to a case like this, where the only economic benefit to the taxpayer was as an aid to the collection of a part of an otherwise worthless claim").

65. 202 F.3d 854 (6th Cir. 2000). *But see* *Srivastava v. Comm'r*, 220 F.3d 353 (5th Cir. 2000); *Coady v. Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Johnston v. Comm'r*, 80 T.C.M. (CCH) 477 (2000).

66. *Clarks*, 202 F.3d at 855.

67. *Id.* According to the contingent fee agreement, Clarks owed his attorneys one-third of the total recovery. *Id.* Clarks paid \$1,865,156 from the original damages and \$1,901,314 from the interest. *Id.* The issue in the case only concerned the attorneys' fees paid from the interest because personal injury damages are excluded from gross income under § 104(a)(2) of the Internal Revenue Code. *Id.*; see also I.R.C. § 104(a)(2) (2000).

68. *Clarks*, 202 F.3d at 856; see also *Cotnam*, 263 F.2d at 124.

69. *Clarks*, 202 F.3d at 856.

70. *Id.* at 857.

71. *Id.* "When attorney and client enter a contingent fee agreement, the amount of the ultimate recovery is unknown; the recovery is determined . . . [by] the experience and skill of the attorney [which] results both in some recovery and in an increase in the value of that recovery." *Kenseth v. Comm'r*, 114 T.C. 399, 447 (2000) (Beghe, J., dissenting).

settlement.<sup>72</sup> The court held that a contingent agreement bears more similarity to a joint venture or partnership than to an assignment: "Clarks contracted for services and assigned his lawyer a one-third interest in the venture in order that he might have a chance to recover the remaining two-thirds."<sup>73</sup> Thus, the contingent agreement created a lien in favor of Clarks' lawyer for one-third of any judgment recovered, and the court determined that this lien transferred ownership of that portion of the judgment to Clarks' lawyer.<sup>74</sup> Because Clarks did not own the portion subject to the lien, he did not have to include it in his gross income.

Next, the court determined that the assignment of income doctrine did not apply.<sup>75</sup> In reaching this conclusion, the court compared the facts in *Lucas v. Earl* to the instant facts. In *Lucas*, the assignor of the income had already earned the income and was "relatively certain"<sup>76</sup> to be paid. The assignor gave the income to a family member as a gift to enable the assignor to avoid a higher tax bracket.<sup>77</sup> The assignor knew the value of the income, and the assignee did not perform any services in exchange for the income.<sup>78</sup> Finally, the underlying purpose in *Lucas* was tax avoidance.<sup>79</sup> The court viewed the facts in *Clarks* entirely different from the facts in *Lucas*. Clarks had no vested interest in the income and did not even know the value of the potential award.<sup>80</sup> Also, Clarks did not know if he would receive any money from the litigation.<sup>81</sup> Therefore, Clarks did not try to shift income or avoid paying tax. In fact, whereas the donee of a gift does not have to pay any tax, the lawyer in *Clarks* did have to pay tax on the "assigned" income.<sup>82</sup> Both the client and the attorney paid tax on the same amount of money. Upon reaching the conclusion that the payment of attorneys' fees did not constitute an assignment of income, the court reasoned that it was instead a joint venture or a division of property.<sup>83</sup> The lawyer owned the income and would not have received his portion if he had not completed his professional duties.<sup>84</sup>

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72. *Clarks*, 202 F.3d at 857.

73. *Id.*

74. *Id.* Judge Beghe noted in his *Kenseth* dissent that the view followed in cases like *Cotnam* and *Clarks* does not help alleviate tax burdens on litigants who chose to pay their attorneys by the hour rather than through a contingent agreement. *Kenseth*, 114 T.C. at 425 n.15 (Beghe, J., dissenting).

75. *See Clarks*, 202 F.3d at 857.

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*; *see also* 3 KLEINROCK'S FED. TAX BULL. 12, available at LEXIS, 2000 Fed. Tax Bull. LEXIS 140, at \*8 (2000).

82. *Clarks*, 202 F.3d at 857.

83. *Id.*

84. *Id.* at 858. "The attorney creates and adds value; the efforts of the attorney contribute to — indeed he may be solely responsible for — both the recovery and its augmentation." *Kenseth v. Comm'r*, 114 T.C. 399, 447 (2000) (Beghe, J., dissenting).

*B. Circuit Courts Finding That the Assignment of Income Doctrine Does Apply to Payment of Attorneys' Fees*

*1. Ninth Circuit*

In *Coady v. Commissioner*,<sup>85</sup> the Coadys received a judgment totaling \$373,307.<sup>86</sup> This amount consisted of \$89,225 of back pay, \$76,980 of future lost earnings, and \$207,102 of lost fringe and pension benefits.<sup>87</sup> The Coadys paid \$124,435 of the judgment as attorneys' fees pursuant to a contingent fee agreement.<sup>88</sup> Also, the Coadys paid \$96,902 to their attorneys for litigation expenses.<sup>89</sup> The Coadys reported the \$284,082, which did not represent past wages, on Schedule C as self-employment income and deducted a proportionate amount of the attorneys' fees and litigation expenses as self-employment expenses.<sup>90</sup> Of the remaining attorneys' expenses, the Coadys claimed \$53,121 as miscellaneous itemized deductions.<sup>91</sup> The Ninth Circuit disagreed with this treatment and held that the Coadys were required to include the entire award in gross income. Therefore, the Coadys could only claim the attorneys' fees as miscellaneous itemized deductions.<sup>92</sup> The court noted that Alaska did not give attorneys a superior lien or ownership interest in the cause of action.<sup>93</sup> The court focused its analysis on the assignment of income doctrine, holding that the payment of contingent fees constitutes an assignment of income.<sup>94</sup>

In determining whether a taxpayer must include the entire amount of litigation proceeds in gross income, the *Coady* court held that courts must first examine the "nature of the underlying action."<sup>95</sup> Courts should accomplish this by examining what the payments are compensating.<sup>96</sup> The court reasoned that the Coadys' award compensated them for lost wages and compensation.<sup>97</sup> Because wages and

85. 213 F.3d 1187 (9th Cir. 2000).

86. *Id.* at 1187-88.

87. *Id.*

88. *Id.* at 1188.

89. *Id.*

90. *Id.*

91. *Id.* The \$53,121 represents the portion of the attorneys' fees and expenses that is proportionate to the \$89,225 of the judgment that the Coadys reported as income from wages. *Id.*

92. *Id.* at 1191. An important difference exists between claiming a deduction on Schedule C and claiming one as an itemized deduction. When taxpayers take deductions on a Schedule C, the entire amount is allowed and no limitations apply. However, when taxpayers take deductions as miscellaneous itemized deductions, the limitations imposed by §§ 67 and 68 of the Internal Revenue Code apply to disallow a portion of the deduction. *See supra* text accompanying notes 24-30.

93. *Coady*, 213 F.3d at 1190 (noting that the Alaska statute on attorney liens does not grant attorneys any ownership interest in the claim or bestow the attorneys with any "power over the suits, judgments, or decrees of their clients"). To compare with the Wisconsin statute analyzed in *Kenseth* and the Alabama statute referred to in *Cotnam*, *see infra* note 150.

94. *Coady*, 213 F.3d at 1190.

95. *See id.*

96. *Id.*

97. *Id.* The issue of the litigant's control over the claim and any resulting judgment may be immaterial when the proceeds from the litigation represent personal-service income such as lost wages.

compensation are included in gross income, the litigation award must also be included in gross income.<sup>98</sup> The fact that the Coadys decided to spend a portion of that award on attorneys' fees does not change the nature of the underlying purpose of the award.<sup>99</sup> The court stressed that income is taxed to the persons who earn it and that an anticipatory assignment to another does not change the character of the income.<sup>100</sup> Furthermore, the court reasoned, any contingent or speculative nature of the claim does not change the analysis.<sup>101</sup>

## 2. Federal Circuit

In *Baylin v. United States*,<sup>102</sup> a partnership argued that it should not have to include its contingent attorneys' fees in gross income because (1) the attorney received the fee directly from the circuit court, and (2) the attorney had a statutory lien on the proceeds under Maryland state law.<sup>103</sup> The United States Court of Appeals for the Federal Circuit disagreed and required the taxpayer to include the entire amount of the condemnation award in gross income.<sup>104</sup> First, the court found it irrelevant that the partnership never received the portion of the condemnation award paid directly to its attorneys.<sup>105</sup> The partnership benefitted from the condemnation award by choosing to use a portion of it to pay its attorneys' fees.<sup>106</sup> That the partnership decided to compute the attorneys' fees in reference to the ultimate recovery does not mean the partnership never "received" that amount as income.<sup>107</sup> The court also found that the attorney lien statute in Maryland did not grant attorneys an ownership interest.<sup>108</sup> The state's lien statute "merely places a charge upon the fund as security for the debt which is owed to the attorney by his client."<sup>109</sup>

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*See* *Kenseth v. Comm'r*, 114 T.C. 399, 443 (2000) (Beghe, J., dissenting); *see also infra* text accompanying notes 186-188 and accompanying text.

98. *Coady*, 213 F.3d at 1190.

99. *Id.* at 1191.

100. *Id.*

101. *Id.*

102. 43 F.3d 1451 (Fed. Cir. 1995).

103. *Id.* at 1454-55.

104. *Id.*

105. *Id.* at 1454 (noting that if this argument were given validity it "would elevate form over substance and allow the partnership to escape taxation on a portion of its income through a 'skillfully devised' fee arrangement") (quoting *Lucas v. Earl*, 281 U.S. 111, 115 (1930)); *see also supra* text accompanying notes 42-43.

106. *Id.*

107. *Id.* at 1455. If the taxpayer paid the attorney on an hourly basis, the taxpayer would have to include the entire amount in gross income. *See Baylin v. United States*, 30 Fed. Cl. 248, 258 (1993). Under either form of payment, the taxpayer benefitted from the condemnation award by enjoying the ability to pay its legal fees. *Id.*

108. *Baylin*, 43 F.3d at 1455.

109. *Chanticleer Skyline Room, Inc. v. Greer*, 319 A.2d 802, 806 (Md. 1974).

*IV. Statement of the Case: Kenseth v. Commissioner**A. Facts*

Mr. Kenseth's confrontation with the Internal Revenue Service began when he contacted a law firm, seeking legal representation against his employer, APV Crepaco, Inc. (APV), for alleged employment discrimination. Kenseth entered into a contingent fee agreement with Fox & Fox, S.C., the law firm that served as his legal representative in the suit against APV.<sup>110</sup>

After Fox & Fox filed a complaint against APV in the U.S. District Court for the Western District of Wisconsin, Kenseth entered into a settlement agreement with APV and received a total amount of \$229,501.<sup>111</sup> Pursuant to the settlement, \$32,476 was designated as lost wages.<sup>112</sup> From this amount, APV withheld federal and state employment taxes, leaving a net amount of \$21,246.<sup>113</sup> The settlement agreement described the remaining \$197,024 as "personal injury damages which the parties intend as those types of damages excludable from income under section 104(a)(2)<sup>114</sup> of the Internal Revenue Code . . . and the corresponding provisions of the Tax Code of the State of Wisconsin."<sup>115</sup> APV wrote the check to the Fox & Fox trust account.<sup>116</sup> According to the contingent fee agreement, Fox & Fox was entitled to 40%, or \$91,800.54, of the gross amount, \$229,501.37.<sup>117</sup> After deducting the fee, Fox & Fox wrote a check to Kenseth for the net amount of \$105,724.22.<sup>118</sup>

On his 1993 federal income tax return, Kenseth only reported as income the portion of the total settlement designated as wages (\$32,476.61).<sup>119</sup> Kenseth did not report as income the sum designated as personal injury damages, and he did not claim a deduction for any portion of the attorneys' fees associated with the litigation.<sup>120</sup> The Commissioner issued a notice of deficiency to Kenseth, which increased his gross income by \$197,024 — the portion of the settlement award that Kenseth did not report as income.<sup>121</sup> Also, the notice permitted Kenseth to claim the \$91,800 of attorneys' fees as an itemized deduction.<sup>122</sup> However, that amount allowed as an itemized deduction was reduced by \$5298 pursuant to the 2% floor on miscellaneous itemized deductions required by § 67 of the Internal Revenue

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110. *Kenseth v. Comm'r*, 114 T.C. 399, 400 (2000).

111. *Id.* at 404.

112. *Id.*

113. *Id.*

114. I.R.C. § 104(a)(2) (2000).

115. *Kenseth*, 114 T.C. at 404-05.

116. *Id.* at 405.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

Code.<sup>123</sup> The deduction was further reduced by \$4694 for the overall limitation on itemized deductions under § 68.<sup>124</sup> The total tax deficiency of \$55,037 included \$17,198 of alternative minimum tax. Application of § 56 of the Internal Revenue Code created the additional \$17,198 in tax liability by disallowing a miscellaneous itemized deduction for attorneys' fees.<sup>125</sup>

Kenseth brought suit in the United States Tax Court, conceding that the settlement proceeds were not excludable in their entirety.<sup>126</sup> However, he argued that he should not have to include in gross income that portion of the settlement paid to Fox & Fox pursuant to the contingent fee agreement.<sup>127</sup> Kenseth believed that he "exercised insufficient control over the settlement proceeds used to pay Fox & Fox" and that he "should . . . not be taxed on amounts to which [he] had no 'legal' right and could not, and did not, receive."<sup>128</sup> The issue before the Tax Court was whether the portion of the settlement agreement used to pay the attorneys' contingent fee must be included in the taxpayer's gross income.

### *B. Holding*

The Tax Court rejected petitioner's arguments and agreed with the Commissioner that the entire settlement proceeds, including the portion paid as contingent attorneys' fees, must be included in Kenseth's gross income.<sup>129</sup> The court further held that Kenseth could claim the cost of his legal fees as a miscellaneous itemized deduction.<sup>130</sup> However, the deduction would be reduced by the limitations imposed under §§ 56, 67, and 68 of the Internal Revenue Code.<sup>131</sup>

### *C. Reasoning*

The *Kenseth* court first looked to statutory requirements. Section 61(a)<sup>132</sup> states that "gross income means all income from whatever source derived."<sup>133</sup> The court reasoned that no Internal Revenue Code provision specifically excludes from gross income those portions of settlement proceeds used to pay contingent attorneys' fees.<sup>134</sup> Therefore, the entire settlement amount must be included in Kenseth's gross income.<sup>135</sup> The court viewed it as irrelevant that Kenseth did not actually receive that portion of the settlement before paying Fox & Fox because Kenseth

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123. *Id.* at 405-06.

124. *Id.* at 406.

125. *Id.*; see also I.R.C. § 56(b)(1)(A)(i) (2000).

126. *Kenseth*, 114 T.C. at 406.

127. *Id.*

128. *Id.* at 406-07.

129. *Id.* at 407, 412.

130. *Id.* at 411.

131. *Id.* at 407, 417.

132. *Id.*; see also I.R.C. § 61(a) (2000).

133. *Kenseth*, 114 T.C. at 413.

134. *Id.*

135. *Id.*

received "the full benefit of those funds in the form of payment for the services required to obtain the settlement."<sup>136</sup>

Further, the court reasoned, the assignment of income doctrine prohibits a taxpayer from avoiding taxation through an anticipatory assignment of such income.<sup>137</sup> Accordingly, the court required Kenseth to pay taxes on the amount of the settlement anticipatorily assigned to Fox & Fox.<sup>138</sup> The Tax Court declined to find any importance in the speculative nature of the claim or the necessity of hiring attorneys to pursue the lawsuit and obtain the judgment.<sup>139</sup> The court reasoned that Kenseth had been discriminated against before hiring Fox & Fox and, therefore, had already earned the damages.<sup>140</sup> Kenseth was entitled to the settlement award long before he ever hired Fox & Fox to represent him.<sup>141</sup> Fox & Fox merely enabled Kenseth to retrieve the damages owed.<sup>142</sup> Because Kenseth was the only person discriminated against, there could not have been a joint venture between Kenseth and Fox & Fox.<sup>143</sup>

Kenseth argued that when he entered the contingent agreement, he lost sufficient control over those funds so that the assignment of income doctrine did not apply.<sup>144</sup> The Court rejected this argument,<sup>145</sup> reasoning that the client, not the attorney, retains control over the settlement and disposition of the lawsuit.<sup>146</sup> In fact, it is unethical for lawyers to pursue a course of action against the consent of their clients.<sup>147</sup>

136. *Id.*

137. *See id.* But see *Shrivastava v. Comm'r*, 220 F.3d 353, 362-63 (5th Cir. 2000) (noting that most clients do not enter contingent fee agreements to avoid taxation, but to retain an attorney without incurring current costs).

138. *Kenseth*, 114 T.C. at 413. But see *Deborah A. Geier, Letters to the Editor, Attorney's Fees Debate Continues*, 88 TAX NOTES 827, 827-28 (2000) (noting that "it is not all clear that a contingent-fee agreement operates to 'assign' a portion of assignable 'property' income. It is just as reasonable . . . to argue that the relationship between the parties is that of service recipient to service provider").

139. *Kenseth*, 114 T.C. at 413 (noting that if Kenseth's claim had no value, then Fox & Fox probably would have declined to provide representation on a contingent basis).

140. *Id.*; see also *Geier, supra* note 138, at 828 (stating that the burden of proof is on the taxpayer to show that the "contingent-fee contract operated to assign income for tax purposes").

141. *See Kenseth*, 114 T.C. at 413.

142. *See id.*

143. *See id.*

144. *Id.* at 414; see also *Shrivastava v. Comm'r*, 220 F.3d 353, 364 (5th Cir. 2000) ("[A] taxpayer who enters into a contingent fee contract divests some measure of control over a claim but retains the rest, and how much control is sufficient to trigger taxation under the anticipatory assignment of income doctrine is not easily answerable.").

145. *Kenseth*, 114 T.C. at 414.

146. *Id.*

147. *Id.* However, clause VI of the contingent fee agreement with Fox & Fox stated:

**CLIENT WILL NOT SETTLE WITHOUT ATTORNEYS' CONSENT**

The client will not compromise or settle the case without the written consent of the attorneys. The client agrees not to waive the right to attorneys' fees as part of a settlement unless the client has reached an agreement with the attorney for an alternative method of payment that would compensate the attorneys in accordance with Section III of this agreement.

Finally, the court refused to base its decision on the attorney lien rationale.<sup>148</sup> The Wisconsin statute would not result in an exclusion of the fees from gross income.<sup>149</sup> Unlike the Alabama statute in *Cotnam*, the Wisconsin statute did not give the attorney the same rights as their clients to the cause of action.<sup>150</sup> Thus, the Tax Court stands strong behind its prior holdings that contingent fees represent taxable income under the assignment of income doctrine. The Tax Court has the power, however, to render a more equitable decision for taxpayers.

### V. Analysis

#### A. Courts Have the Power to Remedy the Inequity of Judge-Made Law

The Tax Court's decision in *Kenseth* is extremely unfavorable to taxpayers. Under *Kenseth*, taxpayers may have to pay tax on money they never receive.<sup>151</sup> For instance, after application of the itemized deduction rules in conjunction with the alternative minimum tax, the overall effective tax rate ends up exceeding 50% of the net recovery when the contingent attorneys' fees amount to more than 50% of the recovery.<sup>152</sup> When the total attorneys' fees exceed 72-73% of the total recovery, the total tax liability can exceed the total net recovery.<sup>153</sup> In rendering its decision, the Tax Court did acknowledge the degree of inequity to taxpayers.<sup>154</sup> However, the majority blamed the resulting unfairness on Congress and the application of §§ 56, 67, and 68 of the Internal Revenue Code.<sup>155</sup> The Tax Court stated that because Congress enacted these provisions, Congress, not the courts,

*Id.* at 401.

148. *Id.* at 415; cf. *Srivastava*, 220 F.3d at 364 ("[T]he answer does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state.").

149. See *Kenseth*, 114 T.C. at 415.

150. *Id.* The court stated:

[The Wisconsin] statute provides for an attorney's lien upon the cause of action or upon the proceeds or damages from such cause of action to secure compensation, but it does not give attorneys the same rights as their clients over the proceeds of suits, judgments, and decrees. Accordingly, the Wisconsin statute contains obvious differences and is distinguishable from the Alabama statute.

*Id.* (emphasis omitted). The Alabama attorney lien statute examined in *Cotnam* provided as follows:

2. Upon suits, judgments, and decrees for money, they shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.

*Cotnam v. Comm'r*, 263 F.2d 119, 125 n.5 (5th Cir. 1959) (quoting ALA. CODE § 64 (1940)).

151. See Jeffrey S. Dible, *Income Tax Reporting of Attorney Fees (and Damages)*, 43 RES GESTAE, Aug. 1999, at 11; see also Wood, *supra* note 58, at 575 (stating that a taxpayer might end up paying tax on the portion of the award the attorney received); I.R.C. § 63(c) (2000).

152. See *Kenseth*, 114 T.C. at 425 (Beghe, J., dissenting); see also Wood, *supra* note 58, at 576.

153. See *Kenseth*, 114 T.C. at 415.

154. *Id.* at 415.

155. *Id.* at 407, 415; see also *supra* text accompanying notes 12-17, 25, 28, 36 (discussing the effects of §§ 56, 67, and 68 of the Internal Revenue Code upon the tax liability of litigants deducting attorneys' fees).



must rectify such harshness.<sup>156</sup> The majority indicated that it had no option to render a different decision because courts should not engage in "ad hoc modification of established tax law principles . . . to counteract hardship in specific cases."<sup>157</sup>

To prevent this unfairness, one must first determine the source of the inequity and who has the authority to remedy it. Obviously, Congress determines the ultimate tax liability imposed by the Internal Revenue Code, and courts are bound to apply the Tax Code. Congress established the rules for itemized deductions and the alternative minimum tax, and therefore Congress should take action to change the disparaging effects.<sup>158</sup> However, the Tax Court did not specifically rely upon the Internal Revenue Code when it ruled upon the facts of *Kenseth*. Rather, the Tax Court looked to the assignment of income doctrine. The Supreme Court, not Congress, created the assignment of income doctrine.<sup>159</sup> Consequently, the Tax Court could have prevented the harsh result by examining its application of this judge-made doctrine.<sup>160</sup>

Five of the thirteen judges dissented from the decision; thus, close to half of the court felt that it did have the power to render a more equitable decision. Judge Beghe's dissent "deserves particular emphasis because he was the trial judge in the case . . . if this case had not been designated to be reviewed by the court, the decision would have come out differently. Judge Beghe simply would have ruled for the taxpayer."<sup>161</sup>

Judge Beghe disagreed that the courts do not have the power to remedy the injustice arising from decisions like *Kenseth*.<sup>162</sup> "What the courts have created and applied, courts can interpret, refine, and distinguish to determine whether in changed circumstances the conditions for application of the doctrine have been satisfied."<sup>163</sup>

156. *Kenseth*, 114 T.C. at 415. *But see* Robert W. Wood, *Letters to the Editor: The Energizer Bunny Has Nothing on the Attorneys' Fee Debate*, 88 TAX NOTES 1059, 1059 (2000). One commentator has stated:

Congress could resolve it . . . . But there are at least two other possibilities. One is that it will be resolved by the appellate courts (the U.S. Supreme Court resolving the split among the circuits). The other possibility . . . is that the five Tax Court judges who dissented in *Kenseth* may convince the rest of the Tax Court to start deciding all of these cases on a consistent basis — consistently in favor of the taxpayer.

*Id.* (emphasis omitted).

157. *Kenseth*, 114 T.C. at 407.

158. *See Geier, supra* note 138, at 828 (arguing that attorneys' fees should be fully deductible and not subject to the limitations of § 67, § 68, and the alternative minimum tax, and that Congress, not the courts, is responsible for this change). *But see Kenseth*, 114 T.C. at 427 (Beghe, J., dissenting).

159. *See Kenseth*, 114 T.C. at 427 (Beghe, J., dissenting).

160. *See id.*

161. *See Wood, supra* note 58, at 576. When the court reviews a case, as in *Kenseth*, it means that the entire Tax Court examined it. *See id.* at 575. Very few cases ever get this type of treatment. *See id.*

162. *See Kenseth*, 114 T.C. at 442 (Beghe, J., dissenting); *see also Wood, supra* note 58, at 573 (noting that the assignment of income doctrine is "probably not the most effective or applicable basis for the IRS or the courts to use" in these cases); Wood, *supra* note 156, at 1059 (noting that the discharge of indebtedness doctrine is more applicable than the assignment of income doctrine).

163. *See Kenseth*, 114 T.C. at 427 (Beghe, J., dissenting); *see also Wood, supra* note 58, at 575.

*B. The Assignment of Income Doctrine Was Inappropriately Applied to Kenseth*

Because the Tax Court based its decision upon a judicially created doctrine, it had the latitude to decide whether the doctrine was created for factual circumstances similar to those in *Kenseth*. The Tax Court erred in holding that the assignment of income doctrine applies to the transaction in *Kenseth*. In *Lucas v. Earl*, the Supreme Court created the assignment of income doctrine to prevent tax avoidance through assignments of income from a person in a higher tax bracket to those in lower tax brackets. The primary reason the assignment of income doctrine should not have been applied is that *Kenseth* did not engage in a tax avoidance scheme. *Kenseth* involved a *nongratuious* transfer rather than a gratuitous assignment. In nongratuious assignments, the taxpayer assigns the income in exchange for adequate consideration rather than making a gratuitous gift.<sup>164</sup> *Kenseth* did not give the money to his attorney as a gratuity. Rather, *Kenseth* transferred a percentage of his claim in the litigation in exchange for legal representation. Because *Kenseth's* motive resembles something other than tax avoidance, application of the assignment of income doctrine would not further the stated purpose of "preserv[ing] the integrity of the graduated tax rate schedule."<sup>165</sup> If anything, reliance on the doctrine results in double taxation of the portion paid for the contingent fee.

Gratuitous assignments of income pose no threat of double taxation because the assignee excludes the assigned income from his gross income under § 102<sup>166</sup> of the Internal Revenue Code.<sup>167</sup> For instance, in *Lucas*, the husband was liable for paying the tax liability for his total earned income for the year. Under § 102, the wife was exempted from any tax liability even though she was assigned half of the income. Similarly, the father in *Horst* was responsible for paying the tax on the interest and the son owed nothing. In these gratuitous assignments, the total income is taxed only once. However, § 102 does not apply to nongratuious assignments.<sup>168</sup> If the assignor is not exempted from paying tax on the assigned income, both the assignor and the assignee will pay tax on the same income.<sup>169</sup> Under this theory, double taxation occurs in *Kenseth* because *Kenseth* must include the entire settlement award in his gross income, but he is not allowed a full deduction for the entire amount of attorneys' fees. Simultaneously, *Kenseth's* attorney must also report the contingent fee as income under § 61(a)(1). As long

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[T]he 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.

*Id.* at 574; see also *supra* note 11.

164. See *Jensen, supra* note 37, at 633.

165. *Id.*

166. I.R.C. § 102 (2000).

167. See *Jensen, supra* note 37, at 635.

168. Section 102 applies only to gifts. I.R.C. § 102 (2000).

169. See *Jensen, supra* note 37, at 635.

as nongratiuitous transactions are negotiated at arm's length, the assignor should only be taxed on that portion of the income not assigned.<sup>170</sup>

Application of the doctrine to the facts of *Kenseth* did not uphold the original, intended purpose of the doctrine — elimination of tax avoidance. Because the majority opinion admits that its decision had an unfair result, it should reconsider why it continues to apply the judicially created doctrine to any assignment regardless of the underlying motive. However, even if the court wanted to extend application of the doctrine to situations other than tax avoidance, the facts of *Kenseth* do not demonstrate an assignment of income.

The doctrine has traditionally been applied to intrafamily donative transfers like *Lucas* and *Horst*, rather than commercial transactions in which the parties have no preexisting mutual interest.<sup>171</sup> Intrafamily cases principally focused on how much control the assignor retained over the assigned income.<sup>172</sup> In many intrafamily transfers the transferred income never really left the family, and therefore the transferor retained some control over the income after it had been transferred.<sup>173</sup> Consequently, the transferor continued to enjoy benefits from the income.<sup>174</sup> To determine whether an assignment of income has occurred, courts must consider whether the assignor maintained the requisite degree of control over the income so that the assignor should be treated as the payee of the income for tax purposes.<sup>175</sup> The assignment of income cases focus on control in order to identify those intrafamily transfers designed to avoid tax liability.

In contrast, *Kenseth* relinquished considerable control over the award, and he should be entitled to a complete exclusion from gross income for that portion for several reasons.<sup>176</sup> First, Fox & Fox refused to represent *Kenseth* unless he entered the fee agreement and agreed to the attorney lien.<sup>177</sup> Second, *Kenseth* could not settle the case without the approval of the law firm.<sup>178</sup> This diminished the amount of control that *Kenseth* had over the final amount awarded.<sup>179</sup> APV might have offered *Kenseth* a sum that *Kenseth* wanted. Under their agreement, *Kenseth* had no control to accept the settlement if Fox & Fox refused. Third, *Kenseth* decided to fire Fox & Fox, the firm would still have a lien for the fees agreed to and for any accrued expenses.<sup>180</sup> Finally, the contingent fee portion of the settlement award was paid directly to Fox & Fox, and therefore *Kenseth*

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170. *See id.*

171. *See* *Kenseth v. Comm'r*, 114 T.C. 399, 441 (2000) (Beghe, J., dissenting); *see also* Wood, *supra* note 58, at 575; MERTENS, *supra* note 44, § 24A:42.15 (noting that the early Supreme Court cases that created the assignment of income doctrine all "involved intra-family or related-party transfer[s]").

172. *Kenseth*, 114 T.C. at 441-42 (Beghe, J., dissenting).

173. *Id.* at 441 (Beghe, J., dissenting).

174. *Id.*

175. *Id.*

176. *See id.* at 442 (Beghe, J., dissenting); *see also* Geier, *supra* note 138, at 827 n.4.

177. *Kenseth*, 114 T.C. at 422 (Beghe, J., dissenting).

178. *Id.* at 444 (Beghe, J., dissenting).

179. *See id.*

180. *Id.* at 403.

never even had possession of the amount paid as attorneys' fees.<sup>181</sup> In support of his position, Judge Beghe cited a 1964 American Bar Foundation study of contingent fees. The study found that under contingent agreements, attorneys have a very high degree of control over "prosecution, settlement, and recovery of plaintiff's claims."<sup>182</sup>

Judge Beghe's opinion states that contingent fee agreements are comparable to contracts of adhesion.<sup>183</sup> He did not argue that the contingent fee agreement should be unenforceable or that the agreement was so unfair as to make it unenforceable.<sup>184</sup> Rather, he claimed the similarity of the agreement to a contract of adhesion supports the contention that Kenseth lacked control over the claim.<sup>185</sup> An assignor's lack of control may be irrelevant when the assigned income is personal-service income, as in *Lucas*.<sup>186</sup> Both the *Coady* court and the *Kenseth* court argued that the income was personal-service income, that the taxpayer earned it before he assigned it away through the contingency agreement. However, Kenseth's settlement did not represent personal-service income.<sup>187</sup> Although the settlement did take into account loss of past earnings and future income, Kenseth's claim originated from constitutional rights of a protected status, rather than a bargain over a personal-service contract.<sup>188</sup>

[W]here a claim based on status, such as an ADEA claim, is the subject of a contingent fee agreement, the amount paid the attorney as a result of his successful prosecution of the claim is much more personal service income of the attorney than personal service income of the claimant, however the claimant's share of the income might be characterized for tax purposes.<sup>189</sup>

The tax liability imposed upon Kenseth resulted from the provisions of the Internal Revenue Code. However, Kenseth only came within the purview of § 61(a) after the Tax Court applied the assignment of income doctrine and ruled that the portion of the settlement paid to Fox & Fox was Kenseth's income "assigned" away. Courts can avoid the inequity of the Tax Code by seeking to apply the assignment of income doctrine in a manner that upholds the doctrine's original purpose.

181. *Id.* at 405.

182. *See id.* at 445 (Beghe, J., dissenting).

183. There are seven characteristics that define a contract of adhesion; all these characteristics are present in the contingent fee agreement between Kenseth and Fox & Fox. *Id.* at 444 n.49 (Beghe, J., dissenting).

184. *See id.* at 444-45 (Beghe, J., dissenting). "[C]ontracts of adhesion are prima facie enforceable as written." *Id.*

185. *Id.* at 445 (Beghe, J., dissenting).

186. *See id.* at 442 (Beghe, J., dissenting).

187. *Id.* at 443 (Beghe, J., dissenting).

188. *Id.*

189. *Id.*

### VI. Current State of the Law and Proposed Changes

In those circuits that have not yet reviewed this tax issue, the Tax Court's decision serves as the guideline. Thus, attorneys will now have to factor these tax consequences into the structuring of settlements. Any client who wins a judgment must include the entire amount of the award in his gross income and is allowed to claim an itemized deduction for the cost of attorneys' fees.<sup>190</sup> One possible planning device that might help alleviate the financial burden of *Kenseth* is to spread out payment of the proceeds in order to reduce the amount of alternative minimum tax owed.<sup>191</sup> By spreading out the recovery over several years, clients will not have as much additional income as if they received the entire amount in one year. Therefore, the taxpayer increases his chances of having an alternative minimum tax that is less than his regular tax liability. Additional proposals for alleviating the tax burden of *Kenseth* include encouraging Congress to change the tax laws to allow for a "meaningful deduction of the attorneys' fees."<sup>192</sup>

Plaintiffs would no longer have to deal with the limitations placed on deducting attorneys' fees such as the two percent floor on miscellaneous itemized deductions, the AMT, and the phaseout of itemized deductions. The exclusion approach would foster uniformity in the application of the Code to attorneys' fees. . . . An exclusion of the attorneys' fees from income would also eliminate the application of the AMT to this nonabusive area.<sup>193</sup>

Also, Congress could eliminate the portion of the AMT that does not allow a deduction for attorneys' fees.<sup>194</sup> This option is a compromise because while it eliminates the AMT problem, it does not eliminate the 2% floor or the phaseout of the miscellaneous itemized deduction.<sup>195</sup> A congressional revision of the Tax Code would be the optimal resolution to the inequities of cases like *Kenseth*. However, the courts do not have to stand idly by waiting for such congressional action. There would have been no assignment of income issue if the Supreme Court had not created the doctrine in *Lucas v. Earl*. The courts addressed the issue when it first arose, and courts have the responsibility of examining and defining the scope of its continued application.

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190. The Tax Court has shown that in those jurisdictions where the appellate courts have not yet ruled on the issue, the Tax Court will follow the rule set forth in *Kenseth*. See *supra* note 11.

191. See Forman, *supra* note 12.

192. Davis, *supra* note 51, at 1723 (noting that this could be accomplished by "amending § 104 to exclude contingency-based attorneys' fees paid as a result of a taxable damage award").

193. *Id.*; see also Sager & Cohen, *supra* note 36.

194. Davis, *supra* note 51, at 1724.

195. See *id.* (noting that elimination of the AMT would offer some relief to taxpayers, but that changing the AMT would further complicate the Tax Code).

*Conclusion*

The assignment of income doctrine is intended to prevent tax avoidance schemes whereby an individual in a higher tax bracket assigns some of his income to an individual in a lower tax bracket. This normally occurs in an intrafamily situation. In *Kenseth*, the taxpayer "assigned" income to a law firm. Most large law firms will not be in a lower tax bracket than their clients. Therefore, the Internal Revenue Service will not lose tax revenues by allowing taxpayers to exclude the amount of a settlement paid as a contingent fee. Contrary to the majority's pronouncement in *Kenseth*, courts do have the power to reverse the burdensome effects of decisions like *Kenseth* by reexamining the purpose of the assignment of income doctrine and modifying when and where it should apply.

*Aubree Helvey*

