Kenseth v. Commissioner, T. C. Memo. 2000-178

Settlement proceeds paid directly to an attorney under a contingent fee agreement must be included in the client's gross income, with attorney's fees deductible subject to statutory limitations.

Summary

In Kenseth v. Commissioner, the Tax Court ruled that the full amount of a settlement from an age discrimination lawsuit, including the portion paid directly to the attorney under a contingent fee agreement, must be included in the client's gross income. Eldon Kenseth received a settlement from his former employer, APV Crepaco, Inc. , for age discrimination, with a portion of the proceeds paid directly to his attorneys, Fox & Fox, as per their contingent fee agreement. The court held that Kenseth must report the entire settlement amount as income, with the attorney's fees deductible as a miscellaneous itemized deduction, subject to the 2% adjusted gross income floor and the overall limitation on itemized deductions. The decision reaffirms the assignment of income doctrine and distinguishes the case from others where different state attorney lien statutes might affect the outcome.

Facts

Eldon Kenseth, a former employee of APV Crepaco, Inc. , filed a complaint with the Wisconsin Department of Industry, Labor, and Human Relations in October 1991, alleging age discrimination. Kenseth and other former employees retained Fox & Fox, S. C. , under a contingent fee agreement that provided for a 40% fee on any recovery before appeal and 46% after appeal. In February 1993, Kenseth settled his claim against APV for $229,501. 37. APV issued a check for $32,476. 61 directly to Kenseth for lost wages and another check for $197,024. 76 to Fox & Fox for the remainder of the settlement, which included the attorney's fees. Kenseth reported only the lost wages portion on his 1993 tax return, leading to a dispute with the IRS over the tax treatment of the attorney's fees.

Procedural History

The IRS issued a notice of deficiency to Kenseth, asserting that the full settlement amount should be included in his gross income, with the attorney's fees deductible as a miscellaneous itemized deduction. Kenseth petitioned the Tax Court, arguing that the portion paid directly to Fox & Fox should be excluded from his gross income. The Tax Court heard the case and issued its opinion, affirming the IRS's position and ruling against Kenseth.

Issue(s)

1. Whether the portion of the settlement proceeds paid directly to Fox & Fox under the contingent fee agreement is includable in Kenseth's gross income.
2. Whether the attorney's fees paid to Fox & Fox are deductible as a miscellaneous

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itemized deduction subject to statutory limitations.

Holding

1. Yes, because the full settlement amount, including the portion paid to Fox & Fox, is considered income to Kenseth under the assignment of income doctrine.
2. Yes, because the attorney's fees are deductible as a miscellaneous itemized deduction, subject to the 2% adjusted gross income floor and the overall limitation on itemized deductions.

Court's Reasoning

The Tax Court relied on the assignment of income doctrine, established by Lucas v. Earl, to hold that Kenseth must include the entire settlement amount in his gross income. The court rejected Kenseth's argument that he lacked control over the settlement proceeds paid to Fox & Fox, noting that he retained ultimate control over the litigation and could have settled or changed attorneys at any time. The court distinguished the case from Cotnam v. Commissioner, where the Fifth Circuit had excluded attorney's fees from gross income based on Alabama's attorney lien statute, stating that Wisconsin's attorney lien statute did not confer the same rights to attorneys. The court also addressed the potential inequities of the alternative minimum tax (AMT) on the deductibility of attorney's fees but emphasized that such policy considerations are for Congress to address.

Practical Implications

This decision reinforces the principle that clients must include the full amount of settlement proceeds in their gross income, even if a portion is paid directly to attorneys under a contingent fee agreement. Attorneys and clients should be aware that such fees are deductible only as miscellaneous itemized deductions, subject to statutory limitations, which can significantly impact the client's net recovery. The ruling may influence how attorneys structure fee agreements and advise clients on the tax implications of settlements. It also highlights the ongoing debate over the fairness of the AMT's treatment of legal fees, potentially spurring further legislative action. Subsequent cases, such as those in the Fifth and Eleventh Circuits, may continue to grapple with the tax treatment of attorney's fees based on different state lien statutes, but the assignment of income doctrine remains a key consideration in federal tax law.

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