

Contingent Attorney Fees

Abstract:

Court cases determining whether contingent attorney fees are includible in gross income differ in various jurisdictions. The inclusion can add substantial taxes to the taxpayer. This material discusses the tax consequences and lists which jurisdictions have ruled in favor of inclusion and which for exclusion.

ISSUE 6: CONTINGENT ATTORNEY FEES

GENERAL INFORMATION

With the continuing flood of age discrimination, sexual harassment, racial discrimination and other similar lawsuits, tax preparers may encounter clients who receive significant court awarded judgments. Since the 1995 Supreme Court decision in *Commissioner v. Schleier*, 515 U.S. 323 (1995), these types of judgments awarded are generally **not** excludable from gross income.

I.R.C. §104(a)(2), as amended in 1996, states: Gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

The tax result is that judgments received after August 20, 1996, for **nonphysical personal injury or sickness** are includible in gross income. Examples of these (not all inclusive) are:

- Employment discrimination (age, racial, gender)
- Wrongful termination of employment
- Defamation of character (libel/slander)
- Alienation of affections
- Wrongful prosecution
- Breach of contract (including business disputes)

CONTINGENT ATTORNEY FEES PAID BY CLIENTS

General Information

The tax issue is whether contingent attorney fees are includible in the client's gross income. The courts are split on this issue. Following is a combined judicial/IRS "scoreboard" of the decisions/positions as of May 2001 (see the introduction to the Rulings and Cases chapter for the jurisdictions of the various courts).

Includable in Gross Income	Excludable from Gross Income
Internal Revenue Service	5th Circuit Ct. of Appeals
Tax Court	6th Circuit Ct. of Appeals
Federal Circuit Ct. of Appeals	11th Circuit Ct. of Appeals
9th Circuit Ct. of Appeals	
1st Circuit Ct. of Appeals	
4th Circuit Ct. of Appeals	
7th Circuit Ct. of Appeals	

Two lines of reasoning in the conflicting court decisions are:

1. The **assignment-of-income doctrine** results in the inclusion of income to the client. This doctrine, established by the Supreme Court in 1930, holds that taxpayers can't assign income, to which they are legally entitled, to a third party without first paying tax on it. The Tax Court applied this doctrine to contingent attorneys fees in *Kenseth v. Commissioner*, 114 T.C. 399 (2000). See pages 630–31 in the *2000 Farm Income Tax School Workbook* for an analysis of this important decision. The 7th Circuit court of Appeals affirmed the Tax Court's decision in 2001.

Practitioner Caution. The nine majority Tax Court judges in the *Kenseth* decision held that state lien statutes are irrelevant. The "shotgun" approach of I.R.C. §61 controls and the assignment-of-income doctrine must be applied. Gross income means all income from whatever source derived [I.R.C. §61(a)].

2. **State law** must be examined to determine if attorneys have a superior lien or ownership right in judgments of their clients. If **not**, the contingent fee must be **included** in the client's gross income. See *Coady v. Commissioner*, 213 F. 3d 1187 (9th Cir. 2000) discussed on pages 629–30 in the *2000 Farm Income Tax School Workbook*. In the *Coady* case, Alaskan state law did **not** grant a superior lien. Thus the contingent fee was **includable** in gross income of the taxpayer/client.

Practitioner Caution. From an analysis of the numerous court cases in this highly litigated area, it appears that the courts have decided that **only** the statutes of the following states **do grant attorneys a superior**

lien or ownership right in judgments awarded to clients (based on cases decided as of August 2001):

Texas
Michigan
Alabama

Tax Complications Caused by Inclusion in Gross Income of Contingent Attorney Fees Paid by Clients

1. These legal fees are a miscellaneous itemized deduction, subject to the 2% of AGI floor.
2. The legal fees also are subject to the 3% of AGI reduction rules for itemized deductions claimed by high-income taxpayers. In most cases, successful litigants are high-income taxpayers in the year the
3. judgment is paid.
4. Miscellaneous itemized deductions are not deductible for alternative minimum (AMT) purposes. This can cause a significant AMT liability for the taxpayer/client in the year the judgment is received and the legal fee is paid.

Example from facts in the *Kenseth* case (amounts listed are after the IRS exam results as affirmed by the Tax Court):

- Total judgment received by taxpayer in 1993 \$229,000
- Contingent fee paid directly to taxpayers' attorney (40%)
by the defendant/employer 92,000
- Net amount retained by taxpayer
\$137,000
- Amount of contingent fee deductible on Schedule A
after the 2% of AGI floor and the 3% of AGI reduction
for high-income taxpayers 82,000
- AMT liability created by the \$82,000 Schedule A
deduction (not deductible for AMT purposes) 17,000
- Additional regular tax owed to IRS 38,000
- Total additional tax owed on the 1993 Form 1040 \$55,000
- After-tax settlement retained by taxpayer \$82,000

- Legal fees paid by taxpayer in disputing the IRS exam result in Appeals and in Tax Court ?
- Interest paid to IRS on the \$55,000 deficiency ?

Summary for Example. All of the facts and numbers aren't shown, but it is clear that the taxpayers kept less than \$82,000 of the court awarded judgment in the age discrimination suit against the husband's former employer.

Conclusion. This is a difficult issue for preparers. Since IRS is entering a more vigorous enforcement mode, this area is a logical one for selected IRS exam projects. Both the IRS and the Tax Court agree on the **inclusion** of contingent fees in gross income of clients. Taxpayers who reside in the Fifth, Sixth, and Eleventh Circuits can assert "substantial authority" for **exclusion** of contingent fees. It is expected that the Supreme Court will eventually resolve the conflict that now exists among the various appellate courts.