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Assigning Litigation Claims for Charity

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Plaintiffs in lawsuits usually expect an eventual recovery. Some plaintiffs today want to borrow against or sell all or some of their rights, or give them to charity. Wood suggests that those gifts to charity can be particularly tax efficient.

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If a plaintiff expects a litigation recovery, can he assign the expectation of the settlement or verdict? That is done frequently, in whole or in part. Assignments are often made as part of gift and estate planning and in commercial transactions.

However, the tax effects of such an assignment, both immediately and in the future, might not be considered. In the charitable contribution arena, the more nuanced question is whether the plaintiff can assign the proceeds without adverse tax effects and achieve a better long-term tax result than the charitable contribution rules might afford.

Assume that a plaintiff in a lawsuit wishes to donate the money to charity if the litigation is successful. Rather than waiting to win or settle the case and then donate the proceeds, can the plaintiff shortcut the entire series of events and assign his interest in the case to charity now?

Is there any income to the plaintiff on that assignment? Is there any income to the plaintiff when the case is later resolved? Does a contingent attorney fee agreement complicate or prejudice the result?

The answers to those questions vary depending on the facts and procedural posture of the litigation. It is important that when the assignment is made to the charity, the result in the litigation is uncertain. It is also important for the assignment to be complete. Done properly, while the outcome of the case is uncertain, neither the assignment by the plaintiff nor the subsequent disposition of the case by the charity should have any adverse income tax effects on the plaintiff.

Case Study

Long-running litigation between a plaintiff and a financial institution concerns the latter acting as trustee and failing to diversify the trust's concentrated holdings of stock. In this case, the plaintiff asserted claims against the trustee for breach of fiduciary duty, failure to diversify, and so forth.

The trial court found for the plaintiff and called for a substantial surcharge against the trustee, plus interest. The case was appealed, and by then was strictly a contingent fee case, with lawyers to be paid a share of the proceeds. However, the plaintiff had paid (or in the language of contingent fee lawyers had "advanced") significant costs in the case over the years.

The plaintiff did not need or want any eventual recovery. In fact, the plaintiff said that if he eventually recovered in the case, he would give the proceeds to charity after taxes. That "after taxes" phrase suggested that because the plaintiff would be reporting and paying tax on the recovery, he would give only the net difference to the charity.

Of course, there are statutory annual limits on charitable contributions. In general, contributions are limited to 50 percent of the taxpayer's adjusted gross income for the year. That was another reason the charity would lose out on part of any ultimate litigation proceeds.

As a result, the plaintiff and the charity agreed that the plaintiff would assign the case and all that went with it to the charity. The charity would step into the shoes of the plaintiff with the contingent fee lawyer, too. Although the plaintiff had funded many costs in the case over the years, he would not be reimbursed for any of them.

After the assignment, the charity would begin funding any subsequent costs and would have full

control over the case and the lawyer. The assignment was completed, and the contingent fee firm agreed and commenced working for its new client, the charity. It was clear that the assignment was effective under state law. Many states, including New York and California, have recognized those assignments as transfers of the property rights of legal claims.[1]

In addition to the assignment, the plaintiff, the charity, and the contingent fee lawyer executed a release and novation agreement. Under the novation, the attorney released the plaintiff from all obligations under the prior fee agreement. The charity was officially responsible for all costs thereafter.

The plaintiff wanted assurances that any judgment or settlement proceeds (whether a net recovery after attorney fees or any portion of the recovery paid directly to the contingent fee lawyers) would not be taxed as income to him. Moreover, he wanted assurances that the act assigning his interest in the case would not be income to him.

Assignment of Income Doctrine

Tax lawyers are used to worrying about the assignment of income doctrine. When income is too close to being actually earned, we know that it cannot be transferred to someone else without tax effect. In some cases, the act of assigning the item actually accelerates the income, making a bad situation worse.

Under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from it.[2] If the taxpayer has the right to receive the income, or if, based on the circumstances, the receipt of the income is practically certain to occur, it is too late to avoid the income. If the right has effectively become a fixed right, even if the taxpayer transfers the right before receiving the income, it remains the transferor's income.[3]

In contrast, a transferor of a mere anticipation or expectation of the receipt of income, rather than a fixed right to it, is not subject to tax on post-transfer income.[4] A review of the case law shows that anticipatory assignment of income principles requires the transferee to include the proceeds of the claim in gross income when recovery on the transferred claim is *certain* at the time of transfer. Conversely, that is plainly not required when recovery on a claim is doubtful or contingent at the time of transfer.[5]

Accordingly, one who transfers a claim in litigation to a third person before the expiration of appeals in the case is not required to include the proceeds of the judgment in income. Here, the plaintiff assigned his entire interest in the case while it was on appeal and before any settlement or final judgment. Because the plaintiff's assignment occurred while his claims in the action were contingent and doubtful in nature, none of the proceeds should be included in his income.

Attorney Fees

The tax treatment of the contingent attorney fees are often a hot-button item for plaintiffs. Fees are generally seen as paid to the plaintiff and then paid thereafter to the contingent fee lawyer. However, under the assignment and novation, the charity was solely responsible for the payment of attorney fees and costs. The plaintiff was no longer a party to the case and no longer obligated under the attorney fee agreement.

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[1]*See, e.g.*, *Essex Insurance Co. v. Five Star Dye House Inc.*, 137 P.3d 192 (Cal. 2006) (approving an assignment of claims for economic losses, noting that California policy favors transferability of all causes of action except for purely personal claims such as for slander or emotional distress); N.Y. Gen. Oblig. section 13-101; *DiLallo v. Fidelity & Casualty Co.*, 355 F. Supp. 519, 522-523 (S.D.N.Y. 1973) (citing New York cases permitting assignment of claims for conversion, fraud, and deceit); *In re Public Administrator of Kings County*, 206 Misc. 768 (N.Y. Sur. Ct. 1954) (holding that there is no statutory or public policy prohibition against a widow assigning all of her claim, right, title, and interest in her husband's estate); D.C. Code sections 28-2301 and 28-2304.

[2]*See, e.g.*, *Wilkinson v. Commissioner*, 304 F.2d 469 (Ct. Cl. 1962) (assignment of contract right to ordinary services income to charity treated as ordinary income).

[3]*See, e.g.*, *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *Doc 1999-13049*, *1999 TNT 67-4*; *Jones v. United States*, 531 F.2d 1343, 1346 (6th Cir. 1976); *Kinsey v. Commissioner*, 447 F.2d 1058, 1063 (2d Cir. 1973); *Hudspeth v. United States*, 471 F.2d 275, 280 (8th Cir. 1972); *Estate of Applestein v. Commissioner*, 80 T.C. 331, 345 (1983); *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930).

[4]*Johnson & Son Inc. v. Commissioner*, 63 T.C. 778, 787-788 (1975).

[5]*See, e.g.*, *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945) (taxpayer who assigned judgment award after it was affirmed on appeal was required to include the proceeds in income); *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957), *rev'g* 25 T.C. 1333 (1956) (taxpayer's right to income on a judgment is not earned or does not ripen until all appeals on the judgment have been exhausted); *Wellhouse v. Tomlinson*, 197 F. Supp. 739 (S.D. Fla. 1961) (transferor not taxable on the interest portion of a note when there were legal doubts about the collectability of the note at the time of the assignment); *Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962), *rev'g* T.C. Memo. 1960-115 (taxpayer not taxable on award assigned to related corporation when the claim was contingent when assigned); *Schulze v. Commissioner*, T.C.M. 1983-263 (taxpayer not required to include in gross income the portion of a litigation claim paid to his former spouse under a divorce property settlement).

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In *Commissioner v. Banks*,[6] the Supreme Court held that as a general rule, when a litigation recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. The Court reasoned that an attorney is the agent of the client. Consequently, the full recovery is income to the client, as principal.[7]

Here, the assignment to the charity had no effect on the income tax treatment of the settlement or judgment. By the express terms of the assignment, the plaintiff turned over all his rights in the case and his control to the charity. Under *Banks*, the charity became the client/principal to whom any recovery will be attributed for tax purposes. That would include the portion due for attorney fees. The Supreme Court in *Banks* emphasized that a client who retains ultimate dominion and control over the underlying claim is properly considered the principal to whom the recovery is attributed.[8]

Release of Contingent Attorney Fee Obligation

Despite that, could the novation somehow trigger income to the plaintiff? A review of case law indicates that the release by the attorney of the plaintiff's contingent fee obligation does not result in income to the plaintiff. The plaintiff's agreement to pay attorney fees from a future recovery is not debt but is entirely contingent. The courts have held that the cancellation of a contingent obligation to pay a third party amounts from future profits does not result in income.

In *Terminal Investment Co. v. Commissioner*,[9] a corporation issued bonds that provided for contingent interest payments. Payments would be made on the bonds only if the corporation had sufficient net earnings. That contingency never occurred. With borrowed funds, the corporation purchased and retired all the bonds for less than their par value. The corporation did not report as income any amount attributable to the contingent interest obligation.

The Tax Court agreed, reasoning that the corporation was not required to include in income ''amounts which it was not then obligated to pay and which it might never be required to pay, even if the scrip certificates [providing for the contingent interest payments] remained outstanding.''[10] Further, *United States v. Kirby Lumber Co.*[11] is distinguishable because that case involved a fixed, rather than a contingent, obligation.[12]

Similarly, in *Corporacion de Ventas v. Commissioner*,[13] a foreign corporation was the issuer of bonds under which its liability was strictly limited by law. The obligation to pay either interest or principal arose only if the corporation had net earnings sufficient for that purpose. When the corporation later purchased its bonds at a discount from their face value, the IRS argued that the difference was taxable income.

The Second Circuit disagreed, noting that the obligation to make payments was wholly contingent on future earnings. The court reasoned that ''if the cancellation of indebtedness results in income on the theory that thereby assets are freed for the debtor's general use, it appears self-evident that the obligation to be retired must be one which *unconditionally* subjects the obligor's assets to liability for the payment of a *fixed* amount'' (emphasis added).

One possible justification for the Second Circuit's decision was simply that the contingent obligation in question was not debt for tax purposes. After all, an obligation that is entirely contingent on future earnings has strong equity characteristics, and under section 1032 a corporation generally does not recognize income when receiving money or other property in exchange for an equity interest in itself. However, the decision refers to the obligation as indebtedness, and the quasi-equity characteristic of the instrument does not appear to have been the decisive factor.

Would the result be different now that Treasury has recognized that debt instruments may provide for contingent payments under regulations finalized in 1996?[14] Arguably, there should be no difference. Those regulations state that the contingent payment debt instrument regulations and the examples should not give rise to any inference regarding whether the instrument is a debt instrument for tax purposes or not.[15]

A recent letter ruling supports that.[16] In LTR 201027035, the taxpayer discharged an obligation under a tax indemnity agreement by paying the obligee a lump sum payment. Even though the taxpayer deemed the obligation to be indebtedness within the meaning of section 61(a)(12), which the IRS seemed to have accepted, the ruling states that the discharge of the obligation did not give rise to cancellation of indebtedness income.

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[6]543 U.S. 426 (2005), *Doc 2005-1418*, *2005 TNT 15-10*.
[7]*Id.* at 436.
[8]*Id.*
[9]2 T.C. 1004 (1943), *acq. Corporacion de Ventas v. Commissioner*, 130 F.2d 141 (2d Cir. 1942).
[10]*Id.* at 1013.
[11]284 U.S. 1 (1931).
[12]*Id.* at 1013-1014.
[13]130 F.2d 141 (2d Cir. 1942).
[14]Reg. section 1.1275-4.
[15]*See, e.g.*, reg. section 1.1275-4(b)(4)(vi).
[16]LTR 201027035, *Doc 2010-15268*, *2010 TNT 132-34*.

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Instead, the IRS reasoned that — just like the obligation in *Corporacion de Ventas* — the obligation under the tax indemnity agreement was contingent upon the taxpayer's future earnings. Therefore, the discharge of the obligation did not result in cancellation of indebtedness income.

In this case, the plaintiff's obligation to pay attorney fees depends entirely on whether he obtains a recovery on his claims. Because his recovery from the lengthy and contentious litigation remained speculative at the time of the assignment, the plaintiff did not at that time owe any fees to his attorneys.

Moreover, because the fee agreement called only for contingent fees payable upon a recovery in the case, it was uncertain whether the plaintiff would ever owe any fees. The assignment was effected during that uncertainty so there could be no income to the plaintiff. Accordingly, a discharge of the plaintiff's contingent fee obligation, before it became fixed and payable, should not result in income to him.

The plaintiff's contingent obligation to pay fees also bears an analogy to the types of liabilities that are excluded from treatment as consideration in a tax-free exchange under section 357(c)(3). In general, under section 357(a), a taxpayer must reduce its basis in property received in a section 351 tax-free exchange to the extent of any liabilities that are assumed. However, there is an exception for liabilities that would give rise to a deduction.

After a liability is assumed by the controlled corporation in a section 351 transaction, the payment of the liabilities would no longer generate a deduction for the transferor. Thus, section 357(c)(3) was intended to prevent that taxation of phantom gain because the liability would have given rise to a deduction had the liability not been assumed. Similarly, to treat the discharge of the plaintiff's contingent fee obligation as income would have resulted in phantom gain to the plaintiff, because he would have been entitled to deduct the fees had the charity not assumed the fee obligation.

Conclusion

The plaintiff assigned his entire interest in the case to the charity while it was on appeal and before the date of any final judgment or settlement. Thus, the plaintiff's assignment occurred when his claims were contingent and doubtful in nature. Accordingly, no portion of any judgment or settlement proceeds would be includable in the plaintiff's income.

Also, because the plaintiff's agreement with his attorneys to pay fees remained contingent at the time of the assignment, the charity's agreement to pay those fees should not result in income to the plaintiff. Indeed, to treat the assumption of the fee obligation as resulting in income would charge the plaintiff with phantom income. Following the assumption, the plaintiff was no longer entitled to claim a deduction for the attorney fees.

Is that a surprising or difficult result? Hardly. It follows from clear assignment of income principles and established state law concepts of the assignment and transfer of pending litigation claims. However, in this particular instance, the plaintiff was extremely risk averse and wanted an IRS ruling.[17] Because the ruling was required by the plaintiff, the assignment was conditioned on the receipt of a favorable IRS ruling. At that point, the assignment became effective. An alternative would have been an unconditional assignment based on a legal opinion, which would not have been difficult to write.

Despite what seems to be the sensible nature of that result, is it possible to say that a case on appeal must have some value so that an assignment of the case (and the attorney fee agreement) must trigger something? Perhaps, but if the Service wanted to pursue that, it would seem to depend a great deal on the nature and status of the appeal.

Consider this closing example:

Paul sues Dan for fraud and wins a $40 million verdict at trial. The verdict comprises $20 million of compensatory damages for investment losses and $20 million of punitive damages. Paul's contingent fee lawyer is to receive 40 percent.

The case is appealed but Dan does not appeal the $20 million compensatory damages. He appeals only the punitive damages, although his appeal prevents the entire verdict from becoming final. If Paul assigns his entire interest in the case to charity and his lawyer signs up the charity as his sole client, is there income to Paul?

Does it influence the result if settlement discussions ensue during the pendency of the appeal and there is never a question about Dan's liability for the $20 million in compensatory damages? There may be arguments for applying a different result in that case. After all, the IRS has had success attributing punitive damages or interest character to amounts settling on appeal based to some extent on the trial court's verdict. Yet those issues are about the character of income, not timing.

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[17]LTR 201232024, *Doc 2012-17104*, *2012 TNT 156-16*.

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Indeed, under accounting and constructive receipt rules, if no part of a case is final until the last appeal is concluded or a settlement agreement is fully executed, even this kind of case may come out the same way. In any event, an industry seems to be growing up around the idea of investing in lawsuits, so we can expect more assignments of interests in cases to be made and the inevitable tax questions to be asked.

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