PUNITIVE DAMAGES: CAN THEY BE ASSIGNED TO AVOID INCOME?[1]

By Robert W. Wood

Can litigation damages awarded to a plaintiff (punitive or compensatory) be assigned to a third party without creating income to the assignor? This question — to a tax lawyer anyhow — would seem to answer itself. The assignment of income doctrine has long plagued taxpayers, in part because its timing has always been confusing. A taxpayer certainly cannot perform all duties for an employer, and then at the last minute before his check is delivered avoid the income by telling his employer to pay someone else. But the exact bounds of this notion are often confused.

The IRS has recently enjoyed reinvoking the assignment of income doctrine in cases dealing with attorneys' fees paid to contingent fee lawyers. For an excellent recent example of assignment of income discussion, see Elden R. Kenseth, et ux. v. Commissioner, 114 T.C. No. 26, Tax Analysts Doc. No. 2000-14845, 2000 TNT 102-6 (May 24, 2000), on appeal, 7th Cir. Dkt. No. 00-3705 (filed Dec. 15, 2000). The problem of attorneys' fees paid to contingent fee lawyers is addressed toward the end of this article.

Despite what might seem to be common sense about how the assignment of income doctrine works, an important recent letter ruling, No. 200107019, Tax Analysts Doc. No. 2001-4799, 2001 TNT 34-19, takes a look at an assignment by a plaintiff of rights to litigation proceeds. Although private letter rulings are issued to one particular taxpayer only, and technically cannot be cited as precedent, they are widely looked upon by tax professionals as showing the position of the IRS on similar situations. In fact, although the IRS was not pleased about it, the U.S. Supreme Court has even cited private letter rulings. See Rowan Companies v. U.S., 452 U.S. 247 (1981). This doesn't exactly make letter rulings binding legal precedent, but it does underscore the importance of reviewing them to learn what the IRS is thinking.

In Letter Ruling 200107019, the IRS ruled that a portion of the punitive damages that a couple was awarded (but which they transferred to a charitable trust before receipt) was not includable in the couple's income. Interestingly, the same ruling concludes that the damages awarded to their attorney are includable in the couple's income.

Does an Assignment Work?

The facts in Letter Ruling 200107019 arose out of the death of the couple's son in a car accident. The husband and wife entered into a contingent fee agreement with an attorney to prosecute their claims for the wrongful death of their son. During the course of the litigation, the plaintiffs created a charitable trust exempt under Section 501(a). They assigned to the trust any and all punitive damages in an amount exceeding the attorneys' fees. Notably, this assignment was made when it was unclear whether there would be any punitive damages. After the trial and appeals ensued, the defendant eventually issued a check to the couple and their attorney (as co-endorsers) for the punitive damages and the interest.

One of the issues addressed in the letter ruling is a fundamental one: the assignability or transferability of judgments. The letter ruling includes a reference to the taxpayer's representation that under applicable state law, judgments are assignable, and that an assignment transfers the

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same right, title and interest of the assignor to the assignee. The ruling indicates that the prevailing state law recognizes and enforces gratuitous assignments as well, and generally will enforce assignments to charities.

State law is unlikely to be controversial on assignments of this nature, but it is worth looking into the matter to ensure that there is no problem with such an assignment under the law of the state in question. In Letter Ruling 200107019, the IRS simply relies on the taxpayer's representations that under applicable local law, the punitive damage award was considered transferred to the trust on (or after) the date that the trust was created.

This particular date (referred to as "Date 7" in the ruling) was long before "Date 10," the date the supreme court of the state dismissed the defendant's appeal.

Of course, the ruling implicitly recognizes that as of Date 7 (the date that the punitive damage award was transferred to the charitable trust), it was unclear whether any portion of the punitive damage award would be paid, or whether the case would be settled.

Is the Plaintiff/Assignor Taxable?

Interestingly, the letter ruling not only refers to general principles regarding assignment of income, but also considers situations in which a transferred claim is required to be taken into income by the transferor. According to the ruling, although anticipatory assignment of income principles require a transferee to include the proceeds of a claim in gross income where the recovery on a transferred claim is certain at the date of transfer, this does not apply where the recovery is doubtful. If, as of the date of the transfer of the claim, the recovery is doubtful or contingent, the assignment of income doctrine does not require the transferor to pick up the income.

In Doyle v. Commissioner, 147 F.2d 769 (4th Cir. 1945), a taxpayer assigned 60% of a claim he owned to his wife and children. This assignment was made after the Court of Claims denied an application for a new trial and the Supreme Court of the United States denied the taxpayer's petition for certiorari. The IRS argued that, after the denial of certiorari and before the transfer to the wife and children, the gain the taxpayer expected to receive was "practically assured." Thus, argued the IRS, the transfer resulted in an anticipatory assignment of income. The court agreed with the government's argument, holding that the taxpayer was in receipt of the profits on his purchase of the interest in the lawsuit. The court reasoned that at the time he made the gifts of his interest in the suit, the profits had already been rendered certain by the judgment of the Court of Claims, and the denial of certiorari by the Supreme Court.

Another case following the same approach (but under considerably more favorable facts) is Cold Metal Process Co. v. Commissioner, 247 F.2d 864 (6th Cir. 1957). This case repeats the phrase that a taxpayer's right to income on a judgment is not earned until all appeals with respect to the judgment have been exhausted. The underlying case in Cold Metal Process Co. was a patent infringement suit with multiple defendants. The district court had rendered a judgment, but there was a pending appeal to the court of appeals. During the pendency of the appeal, several defendants settled. Some of the settlement monies were transferred through an impound to a charitable trust. Later, the court of appeals affirmed the district court judgment and the Supreme Court of the United States denied certiorari.

In contrast to the conclusion in Doyle, the court in Cold Metal Process found that the matter was a continuing controversy when a portion of the judgment was assigned to the charitable trust. Indeed, the court found that the rights to the impounded funds could not be established while the government was strenuously contesting those rights (by virtue of the appeal and the later petition for certiorari). Thus, the Cold Metal Process case demonstrates the doubtful and contingent nature of any lower court judgment during the time an opposing party is prosecuting appeals. The court's decision in Cold Metal Process sensibly turned on those uncertainties.

Another case considered by the IRS in Letter Ruling 200107019 is Wellhouse v. Tomlinson, 197 F.Supp. 739 (S.Dist. Fla. 1961). There, the court found that a transferor was not taxable on the interest portion of a note because there were doubts whether there would ever be payment by the debtor. Furthermore, the creditor had divested himself of all rights to the note in the year prior to the year of payment. The court noted the legal defenses available to the debtor's estate.

The IRS also considers Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962). Jones involved a claim assigned to third parties. The taxpayer/assignor was held not to be taxable on the award. The reasoning of the court was that: (a) the claim was contingent and doubtful when it was assigned; (b) no gift was involved triggering the potential imposition of the gift tax; (c) the assignment was made prior to the year in which income could be treated as received; and (d) the assignment arose out of the exercise of a legitimate business purpose.

In Schulze v. Commissioner, T.C. Memo 1983-263 (1983), the tax dispute arose out of an underlying dispute between the taxpayer (a lawyer) and his law partnership. The taxpayer sued his former law partnership for damages. The taxpayer and his wife divorced during the pendency of this suit and the taxpayer's claim against the law firm was divided between the former partner and his spouse in the divorce. The value of the claim was indeterminate at the time of division of property.

Eventually, the taxpayer recovered on the claim as a result of an arbitration decision, and he paid a portion to his former spouse. The IRS asserted that he was taxable on all of it, including his former wife's share. The Tax Court held that the assignor/taxpayer was not required to include in his gross income the portion of the award that he paid to his former spouse because: (a) at the time of the assignment, the recovery was uncertain; (b) the recovery did not occur for more than a year after the assignment of the claim was made; (c) the assignment did not involve a gift or gratuity; and (d) the assignment was made for a legitimate nontax purpose.

Interestingly, the court in Schulze noted that the outcome of a lawsuit is rarely (if ever) certain or free from doubt. In Schulze, since the assignment was made before a decision of the arbitrator was rendered, the court found the assignment of income doctrine inapplicable. The arbitrator's decision apparently was final (and there was no right to appeal and no appeal taken) but the assignment to the former spouse was made before the arbitration decision was rendered.

Avoiding AMT and Charitable Contribution Limitations

The impact of an assignment that works should be fairly obvious. In Letter Ruling 200107019, a charity was created and the assignment was made to charity. Because the assignment was held to be effective, the couple did not have to take the settlement (in this case, punitive damages) into income first and then claim a deduction for a charitable contribution.

The difference in tax result can be huge. There can be a dramatic difference between not taking something into income at all and taking it into income and then deducting it. Common sense might dictate that taking $5 into income and then deducting $5 ought to put one back to zero. But that is not the way the rules work.

To begin with, deductions for charitable contributions are only available as miscellaneous itemized deductions. That means that right away one loses 2%, since deductions for miscellaneous itemized deductions are deductible only in excess of 2% of adjusted gross income. Second, for high-income taxpayers, there is a phase-out of itemized deductions and exemptions, which can make the deduction of even less value. Charitable contribution deductions are also subject to specific percentage contribution limits, which were avoided by this assignment.

Finally, and most insidiously, the alternative minimum tax (which applies to virtually any deduction today), can eliminate (or at least greatly restrict) the scope of a deduction. Although the alternative minimum tax (AMT) doesn't apply to charitable contributions (which have their own set of percentage restrictions), all of the above-listed restrictions, including the AMT, apply to attorneys' fees and many other items. The presence of these problems makes an assignment of the type that was successfully employed in Letter Ruling 200107019 terribly interesting. It should make litigants sit up and take notice about what they intend to do with their funds, assuming that their suit is successful.

No Luck on Attorneys' Fees

What is unfortunate about the IRS' conclusion in Letter Ruling 200107019 is that the IRS (quite predictably) refused to give effect to the attempted assignment of monies to the attorney. It was (as is so often the case) a contingent fee lawyer that was employed to bring the wrongful death suit. The same problem of miscellaneous itemized deductions and alternative minimum tax exists in the case of payments to lawyers. Again, logic might dictate that taking $5 into income and then deducting $5 (a payment to an attorney, let's say) should bring the amount down to zero. Once again, that is not the way the rules work, for all three reasons noted above.

There has been a great deal of litigation about the tax treatment of payments to contingent fee lawyers. There is currently a split in the circuit courts around the country over the efficacy of direct payments to attorneys. Some circuit courts have held that there is no need for the plaintiff to take the attorney's money into income and then deduct it. These (to my mind, forward-thinking) circuits include the Fifth (Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959)), Eleventh (Willie Mae Barlow Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000)), and the Sixth (Estate of Arthur L. Clarks v. U.S., 202 F.3d 854 (6th Cir. 2000)).

In the other camp are the courts that hold that the taxpayer/plaintiff must take into income the payment to the lawyer, even if the payment to the lawyer is made directly. These courts require the plaintiff to then deduct the attorneys' fees — even if the phase-out and the alternative minimum tax make that deduction vacuous. These circuits include the First (Alexander v. Commissioner, 72 F.3d 938 (1st Cir. 1995)), Federal (Baylin v. U.S., 43 F.3d 1451 (Fed. Cir. 1995)), and Ninth (Benci-Woodward, et ux., et al. v. Commissioner, 219 F.3d 941 (9th Cir. 2000) and Coady v. Commissioner, 213 F.2d 1187 (9th Cir. 2000)).

Solution to Attorneys' Fee Dilemma?

There may be a ray of light here, however. In Kenseth v. Commissioner, 114 T.C. No. 26 (2000), the Tax Court thoroughly examined this issue, and thirteen Tax Court judges participated in the decision (unlike the normal Tax Court case where only one Tax Court judge decides). This "reviewed by the Court" status makes Kenseth an important case. Unfortunately, eight out of thirteen judges felt that the plaintiff/taxpayer had to include the amount in income and then claim a deduction for it. These judges felt that it was up to Congress to change the rules about deductions and their value, even if the alternative minimum tax basically eviscerates the deduction.

It is significant, though, that five Tax Court judges felt that this was simply wrong, and that Congress did not need to do anything to fix it. These five Tax Court judges felt that the assignment of income doctrine (originally created by judges, not by statute), could simply be changed by judges. These five Tax Court judges (in dissent) argued that it was simply unfair and unwarranted to have the plaintiff take into income the lawyer's share of the proceeds from a lawsuit payable under a contingent fee agreement.

The fact that five Tax Court judges are taking this view makes it at least possible that the law will develop more favorably in the future. In the alternative, the fact that there is a split in the circuits makes it likely that the Supreme Court will be required to face this issue in the not too distant future. Hopefully, the Supreme Court will agree with the five dissenting Tax Court judges in Kenseth.

Finally, since the most draconian problem is the alternative minimum tax, it is possible that the alternative minimum tax will be either significantly modified or entirely repealed. In 2000, the repeal of the alternative minimum tax was passed by both the House and the Senate, but President Clinton vetoed the bill. (He has received far less adverse press from this stroke of the pen than for his pardon of Marc Rich!) In this year of tax legislation, a repeal of the AMT might be the quickest fix of all.

Last Word

Whatever occurs with respect to the deductibility of legal fees, Letter Ruling 200107019 should be considered by plaintiffs who anticipate a significant recovery. Not only does it offer the possibility of a gift to charity in advance of the recovery (that would thereby escape the normal limitations on charitable contributions), but this letter ruling may also offer the possibility of transfers to family members and others before a judgment becomes final.