Assigning Pending Litigation: Tax Savings or Tax Disaster

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There has long been discussion about plaintiffs assigning all or part of their claims against a defendant. Mechanically, of course, that assignment is possible. A claim (sometimes referred to by the antiquated legal term ''chose in action'') can be transferred from a plaintiff to a third party who, in effect, can then pursue the claims. The assignee stands in the shoes of the original claimant. Sometimes it's done piecemeal, with creditors or other assignees receiving fractions of the case.

The tax issues those assignments raise can be interesting. Taxpayers have long been hesitant to assign claims because ''assigning income'' was almost universally regarded as a bad thing. A related issue arises in the context of many contingent attorney fee cases, in which plaintiffs understandably do not want to pay taxes on attorney fees paid to their lawyers that they (the clients) never receive. After a split in the circuit courts that went on for a decade, the Supreme Court finally held in *Commissioner v. Banks*[1] that a plaintiff generally cannot ''assign'' a portion of his claim to a contingent fee lawyer.

Basically, that means the plaintiff will in each case have gross income measured by the full amount of the settlement or judgment and thereafter must claim a tax deduction for the fees paid to the lawyer. There are decided tax disadvantages to that because the tax deduction rules rarely result in a perfect wash. Consequently, plaintiffs have long tried to avoid that result. Now the mechanics of payment to the plaintiff's lawyer don't seem to matter, says the Supreme Court.

Most of the IRS success in those attorney fee cases is attributable to the age-old assignment of income doctrine, which says a taxpayer cannot transfer the right to receive income to someone else after that right has already accrued. So if you perform services and are owed money, you can't avoid the income by telling the recipient of the services to pay someone else. Nor can you assign your income away before performing the services. Taxpayers have tried every variation of that, and the IRS has responded.

The earliest attempts by taxpayers to avoid income involved contracting away rights to receive income. For example, a husband and wife contracted to share income, gains, gifts, and so forth received during their marriage. Even though the contract may have been valid under state law, it was not respected for tax purposes for

[1] 125 Sup. Ct. 826, *Doc 2005-1418*, *2005 TNT 15-10* (2005).

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services performed by the husband. See *Lucas v. Earl*, 281 U.S. 111 (1930). Another infamous case of attempted income shifting occurred when a taxpayer gave his son an interest coupon from a bond that entitled the son to receive an interest payment in the current year. Notably, the taxpayer retained the bond. Again, the income shifting was not respected. See *Helvering v. Horst*, 311 U.S. 112 (1940).

Timing of Assignment

One of the important questions, of course, is the timing of the assignment and the degree to which the assignment is irrevocable and unconditional. It's more likely to be effective the more final it is. There is also a distinction drawn between income payable for the performance of services and income arising from property. If you fully and irrevocably transfer a piece of rental property to a charity or child, all income accruing on that property after the assignment will unquestionably belong to the transferee. Personal services are obviously more dicey.

The most disastrous assignment of income would be when a transfer actually accelerates the income event. In *Hurwitz v. Commissioner*, T.C. Memo. 1964-326, the taxpayer did just that. On December 2, 1959, Hurwitz executed a settlement with his former employer, receiving $11,500 on that date and a promise to receive $6,500 within 90 days. Later in December, as part of an unrelated divorce proceeding, Hurwitz assigned the $6,500 to his wife. Even though Hurwitz did not receive the payment until 1960, the Tax Court found the payment to be taxable to Hurwitz in 1959, because he completely divested himself of any interest in the $6,500 and vested the interest in his former wife.

The assignment of income doctrine has long plagued taxpayers, in part because its timing has always been confusing. A taxpayer cannot perform all duties for an employer and then at the last minute before the check is delivered avoid the income by telling the employer to pay someone else. But the exact bounds of that notion are often confused.

In contrast, a successful assignment involves the plaintiff transferring the claim (or a portion thereof) while it is still inchoate, with no income tax consequence to the transferor or the transferee. On the successful conclusion of the case, the transferee would receive and pay tax on the proceeds. Recently, the IRS addressed one facet of that situation in LTR 200534015, *Doc 2005-17865*, *2005 TNT 166-38* (May 13, 2005). The ruling involved a wrongful death claim filed by a woman after the death of her husband.

During the pendency of the suit, the woman created an irrevocable trust for the benefit of her children and more remote descendants. The question in the ruling was whether the taxpayer could, without tax consequences, irrevocably assign part of the potential proceeds of the wrongful death action to the trust. Interestingly, the issue raised in the ruling was not income tax but gift tax.

The taxpayer wanted the transfer to the trust to be a completed gift so that any proceeds to which that (gifted) share of the case was entitled would be unquestionably received by, and taxable to, the trust. The IRS first noted that the potential proceeds of a judgment or settlement are recognized property under applicable state law and can be equitably assigned by one party to another. One interesting point is valuation. The ruling, however, expresses no opinion on the value of the potential proceeds for gift tax purposes as of the date of the assignment. More about valuation below.

Does an Assignment Work?

Assigning portions of claims in litigation during their inchoate stage can be effective tax planning. One interesting private letter ruling — LTR 200107019, *Doc 2001-4799*, *2001 TNT 34-19* — looks at an assignment of a portion of the punitive damages to be awarded in a case. The IRS ruled that the punitive damages the couple was awarded (but which they transferred to a charitable trust before receipt) were not includable in the couple's income. The same ruling concludes that the damages awarded to the couple's attorney are includable in their income.

LTR 200107019 arose out of a boy's death in a car accident. The mother and father entered into a contingent fee agreement with an attorney to prosecute claims for the wrongful death of their son. During 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 attorney fees. That 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 coendorsers) for the punitive damages and the interest.

One issue addressed in the ruling is fundamental — the assignability or transferability of judgments. The ruling indicates that the prevailing state law recognizes and enforces assignments. State law is unlikely to be controversial on assignments of that nature, but it is worth verifying under your own state law.

Of course, the ruling implicitly recognizes that as of the date 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?

The letter ruling considers situations in which a transferred claim must be taken into income by the transferor. Assignment of income principles require a transferee to include the proceeds of a claim in income when the recovery on a transferred claim is certain at the date of transfer. When the recovery is doubtful or contingent as of the date of transfer, the assignment of income doctrine does not require the transferor to pick up the income.

A few cases prove helpful, at least in setting some boundaries. In *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945), a taxpayer assigned 60 percent of a claim he owned to his wife and children. The assignment was made after the Court of Claims denied an application for a new trial, and after the Supreme Court 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.''

The court agreed with the IRS, holding that the taxpayer was in receipt of the profits on all of his interest

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in the lawsuit. At the time the taxpayer 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). That case repeats the phrase that a taxpayer's right to income on a judgment is not earned until all appeals have been exhausted. *Cold Metal Process* grew out of a patent infringement suit with multiple defendants. The district court rendered a judgment, but several defendants settled pending appeal. Some of the settlement monies were transferred through an impound to a charitable trust. Later the court of appeals affirmed, and the Supreme Court denied certiorari.

In contrast to *Doyle*, the court in *Cold Metal Process* found that the matter remained a continuing controversy when a portion of the judgment was assigned to the charitable trust. The court found that the rights to the impounded funds could not be established while the government was contesting the case. Thus, *Cold Metal Process* demonstrates the doubtful and contingent nature of any lower court judgment while an opposing party is prosecuting appeals.

Another success story is evident in *Wellhouse v. Tomlinson*, 197 F. Supp. 739 (S.D. Fla. 1961). There the court found a transferor not to be taxable on the interest portion of a note because there were doubts whether there would ever be payment by the debtor. The creditor divested himself of all rights to the note the year before the year of payment.

Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962), involved a claim assigned to third parties. The assignor was held not to be taxable on the award when: (1) the claim was contingent and doubtful when it was assigned; (2) no gift was involved triggering the potential imposition of the gift tax; (3) the assignment was made before the year in which income could be treated as received; and (4) the assignment arose out of the exercise of a legitimate business purpose. It's not clear if all of those elements must be present to have an assignment respected for tax purposes.

In *Schulze v. Commissioner*, T.C. Memo. 1983-263, the case arose out of a 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 the suit, and his claim against the law firm was divided between him and his spouse in the divorce. The value of the claim was indeterminate when the marital property was divided.

The taxpayer eventually recovered on the claim in arbitration and 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 he was not required to include in his gross income the portion of the award he paid to his former spouse because: (1) at the time of the assignment, the recovery was uncertain; (2) the recovery did not occur for more than a year after he assigned the claim; (3) the assignment did not involve a gift or gratuity; and (4) 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*, the assignment was made before a decision of the arbitrator was rendered, so the court found the assignment of income doctrine inapplicable. Although the arbitrator's decision was final (there was no right to appeal and no appeal taken), the assignment to the former spouse was made before the arbitration decision was rendered.

AMT and Charitable Contribution Limitations

The effect of an assignment that works should be fairly obvious. In LTR 200107019, a charity was created and the assignment was made to charity. Because the assignment was held to be effective, the assignor did not have to take the settlement (in that 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 isn't how the rules work.

To begin with, many itemized deductions, including deductions for attorney fees (but, notably, not deductions for charitable contributions), are available only as miscellaneous itemized deductions. That means that right away one loses because deductions for miscellaneous itemized deductions are deductible only in excess of 2 percent of adjusted gross income. Second, for high-income taxpayers, there is a phaseout of itemized deductions and exemptions that can make the deduction even less valuable. Charitable contribution deductions are, however, subject to percentage contribution limits, which were avoided by this assignment.

Most insidiously, the alternative minimum tax can eliminate, or at least restrict, the scope of a deduction. Although the 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 attorney fees and many other items. Those problems make assignments of claims in litigation very interesting. It should make litigants sit up and take notice about what they intend to do with their funds, assuming their suit is successful.

No Luck on Attorney Fees

In light of the Supreme Court's conclusion in *Banks*, it may not be surprising that in LTR 200107019, the IRS refused to give effect to the attempted assignment of monies to the attorney. A contingent fee lawyer was employed to bring the wrongful death suit. The same problem of miscellaneous itemized deductions and the AMT exists in the case of payments to lawyers.

The Supreme Court in *Banks* tried to lay to rest the attorney fee controversy, holding that as a general rule, the plaintiff will have gross income on 100 percent of the case, even if the plaintiff's lawyer directly receives a contingent fee for the lawyer's percentage. The Supreme Court agreed with the government's arguments about assignments of income, but the Court left open some questions — for example, whether a real partnership between lawyer and client that observes partnership

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formalities and documentation might make a difference. Creative tax lawyers may try to structure attorney/client agreements as partnerships in at least some states, though occasionally the objection is raised that state bar ethics rules may prevent those partnerships.

The Supreme Court also left open whether statutory fee awards might change the general result (for example, when counsel in a case is awarded fees by the court). Still, there are indications that the IRS and the courts may be fairly strict in interpreting arguments designed to get around the unfortunate result in *Banks*. For example, in *Allum v. Commissioner*,[2] the Tax Court seemed to set a high benchmark for what a partnership between lawyer and client must be to avoid the plaintiff being taxable on the attorney fees paid to the plaintiff's counsel.

All of those cases suggest that an assignment of a part of a claim to an attorney who uses his or her personal services to prosecute the case is very different from the kind of assignment that occurred in LTR 200107019. After all, when a claim is transferred and the transferee will not render personal services on the claim, the situation (for tax and other purposes) is different. Much more like a transfer of income-producing property such as an apartment house, a transfer of a claim (or chose in action) may — or may not — throw off income in the future.

As long as the assignment is made irrevocably and before the claim has any certainty of value (in other words, when the claim is still inchoate), the transfer should be respected. The fact that it will be respected, and that the value of the claim as of the date of the transfer is likely to be small, does offer some planning opportunities to careful and creative litigants.

Valuation

It is difficult to discuss assignments of claims without addressing valuation. Usually, claims in litigation won't be sold, but will be transferred either as a gift or a contribution. If the transfer is a contribution (to charity, for example), the claim must be valued for income tax purposes. If the claim is transferred by gift to a family member, the claim must be valued for gift tax purposes.

Traditionally, there is much tension between valuation dynamics in charitable contribution situations (when you want a high valuation) versus gift tax valuation (when you want it to be low). My suspicion is that plaintiffs are more likely to need to value their claims for gift tax purposes since they are more likely to give a piece of the claim to a family member than to charity. Ultimately, of course, valuation principles are pretty much the same, even if the incentives for a high or low valuation come out differently.

As common sense dictates, the value of property is its fair market value — the price at which a willing buyer and willing seller would exchange the property. Unfortunately, there's often confusion because that term of art can mean different things to different people, and the tax code has subtle and complex variations on what constitutes fair market value in different circumstances.

[2] T.C. Memo. 2005-177, *Doc 2005-15466*, *2005 TNT 139-9*.

Often there is no market from which to judge market value. Without a willing buyer and a willing seller, most valuations are limited to a defensible range of acceptable values that seems to allow taxpayers to choose a precise value. It is easy to see why it can be difficult to value intangible property like a legal claim.

Judicial precedent is of little value in that area. Cases tend to be fact-specific and frequently involve dueling specialists. Courts are often left to just pick values, rather than provide guidance. Usually, cases settle on the courthouse steps because parties are reluctant to let courts decide. Nonetheless, even though it may seem that the valuation of an inchoate claim could be more than a small hassle, in the right circumstances, it could produce significant tax savings.

Conclusion

Plaintiffs who anticipate a significant recovery should consider possible assignments of claims to family members and to charity. The Service has issued some private letter rulings, and that means at least some of that is occurring. The rulings show that the Service isn't even hostile to the idea. Settled principles of law seem to govern assignments.

As most of the above authorities make clear, the real key to that area is first verifying that an assignment is permissible under applicable state law. Usually it will be. However, there may be some niceties of local law to be observed, and it is important to ensure the documents are signed and delivered to effect whatever kind of transfer is intended.

Next, ensure all of that occurs at a time well before some enterprising taxing authority could argue that the value of the case is certain. Also consider maintaining an evidence file of whatever you can to show that speculative state as of the date of the transfer. Although a formal appraisal of the case is not always necessary, it can be a good idea. In any event, there is often a lot of material that can be gathered that falls far short of a formal appraisal but still will evidence the speculative nature of the case. Letters from attorneys are a good place to start. Another good piece of evidence to maintain is the current posture with the defendant. If the defendant is writing to the plaintiff saying the claim is spurious and threatening malicious prosecution, that would be a good piece of correspondence to retain.

The settled case law suggests that as long as the claim (or a portion thereof) is fully and unequivocally transferred, and that transfer occurs before the claim has any fixed or ascertainable value, the assignment should be given effect. That opens up myriad planning opportunities. For example, a plaintiff may wish to transfer a percentage of his claim (say 30 percent) to a family limited liability company or limited partnership that, in effect, may (if the claim is ultimately successful) benefit his children. Not only can that be good estate planning and good tax planning, but there can be a double benefit because of the concept of minority discount. Put simply, that concept puts more value in the hands of the children at a lower tax cost.

Of course, that is only a private letter ruling. Although private letter rulings are issued to only one taxpayer and technically cannot be cited as precedent, they are widely

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regarded by tax professionals as showing the IRS's position on similar situations. In fact, although the IRS was not pleased about it, the Supreme Court has even cited private letter rulings.[3] That 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.

LTR 200107019 is notable, not only because it offers the possibility of a gift to charity in advance of the recovery (which would thereby escape the normal limitations on charitable contributions), but because it may also offer the possibility of transfers to family members and others before a settlement or judgment becomes final.

[3] *See Rowan Companies v. United States*, 452 U.S. 247 (1981).

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