CHARITABLE CONTRIBUTIONS OF PENDING LITIGATION CLAIMS

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Tax lawyers, accountants, financial planners, and planned giving officials are aware of the horsepower of non-cash charitable giving. Most large donors are, too. In general, it is simply not as desirable to write a check to charity as it is to give the charity property with an equivalent value that has a low tax basis. The reason is obvious. When properly planned, both donations yield the same charitable contribution tax deduction. But in the case of the gift of appreciated property in kind, the donor gets the benefit of making the gift and claiming the tax deduction, while simultaneously avoiding recognition of the gain on the appreciation.

The donor could either make the donation in kind or sell the appreciated property and then donate the sales proceeds. The income tax triggered on the sale will invariably favor the donation in kind. Of course, donations in kind come with additional requirements and compliance hurdles. Moreover, in the case of some in-kind donations, the valuation of those gifts is highly subjective. That may cause some donors to steer clear of them. These valuation issues can be particularly challenging when the property at issue is a claim in litigation.

A plaintiff can assign his, her, or its position in a litigation as part of a commercial transaction, family gift, or donation to charity. If a plaintiff in a lawsuit wishes to donate the money to charity if the litigation is successful, collecting the money and donating the cash is certainly possible. While any non-cash asset can involve valuation challenges, valuing litigation claims is often harder than valuing real estate, stock in privately held companies, and many other types of assets. Litigation claims almost by definition involve contests of lawyers and clients. Often, each side is bristling over the tactics and substance of the dispute. Particularly in that adversarial environment, views about the value of the case can be notoriously polarized. Nevertheless, as with other types of property, the plaintiff may be better off donating the claim in kind rather than waiting to collect the judgment and donating the proceeds. It is worth comparing the figures and the likely outcomes to determine the optimal tax result.

In the charitable contribution arena, there is an additional question. In assessing the relative benefits of in-kind and cash contributions, there may be a significant barrier to making an in-kind gift- the assignment of income doctrine. If it applies, this doctrine could attribute income on the assignment or on the later success of the case to the donor/plaintiff. Of course, the result of the litigation must not be certain at the time the assignment is made to charity. Moreover, when properly documented and timed, neither the assignment by the plaintiff nor the subsequent disposition of the case by the charity should have an adverse income tax impact on the plaintiff.

Non-cash contribution rules

Any gift of property in kind triggers special charitable contribution rules. If a donor contributes property with a fair market value that is more than its basis, the donor may have to reduce the fair market value by the amount of appreciation in value to compute the available deduction. Different rules apply to figuring a deduction, depending on whether the property is ordinary income or capital gain property.

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Property is ordinary income property if the taxpayer would have recognized ordinary income or short-term capital gain had it been sold at its fair market value on the date it was contributed.

Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held for one year or less. Property used in a trade or business is considered ordinary income property to the extent of any gain that would have been treated as ordinary income because of depreciation if the property had been sold at its fair market value at the time of contribution.

The deduction for a contribution of ordinary income property is its fair market value minus the amount that would be ordinary income or short-term capital gain if the property was sold for its fair market value. Generally, this rule limits the deduction to the donor's basis in the property. This reduction need not be made, however, if the donor includes the ordinary income or capital gain in gross income in the same year as the contribution.

Capital gain property

Property is capital gain property if the donor would have recognized long-term capital gain had the property been sold at its fair market value on the date of the contribution. Capital gain property includes capital assets held more than one year. Capital assets include most items of property owned and used for personal purposes or investment. Examples are stocks, bonds, jewelry, coin or stamp collections, and cars or furniture used for personal purposes. Capital assets also include certain real property and depreciable property used in a trade or business and generally held more than one year. The deduction for a contribution of long-term capital gain property is usually the property's fair market value.

In certain situations, the fair market value of the donated property must be reduced by any amount that would have been long-term capital gain if the property was sold for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis. This rule applies if the property (other than qualified appreciated stock) is contributed to certain private non-operating foundations, or if the donor chooses the 50% statutory annual deduction limit instead of the 30% limit that generally applies to capital gain property. It also applies if the contributed property is tangible personal property that either: (1) is put to an unrelated use by the charity or (2) has a claimed value of more than $5,000 and is sold, traded, or disposed of by the qualified organization during the year in which it was contributed and the qualified organization has not made the required certification of exempt use.

Donating litigation?

Donating a litigation claim can be surprisingly easy. Many states, including New York and California, have recognized such assignments as transfers of the property rights of legal claims.[1]

A plaintiff wishing to benefit a charity with the proceeds of litigation could wait until the case is resolved and then donate the cash. For example, a recovery of $1 million followed by a $1 million charitable contribution deduction might seem to be a wash. The donor, however, may want to benefit the charity but not want either to pay tax on any portion of the recovery or to be limited by percentage limits on annual charitable contributions.

That suggests that the charity would lose out on part of any ultimate litigation proceeds if the case was resolved before the donation. As a result, the plaintiff and the charity could agree that the plaintiff would assign his or her interest in the case to the charity. The charity would step into the shoes of the plaintiff with the lawyer, too. After the assignment, the charity would fund any subsequent costs and would have full control over the case and the lawyer.

Assignment of income?

The donor/plaintiff may want the assurance that any judgment or settlement proceeds will go directly to the charity and not be income to him or her. There is a hurdle to this goal—the assignment of income doctrine. That rule requires that a taxpayer who earns a right to receive income will

[1] See, e.g., Essex Insurance Co. v. Five Star Dye House, Inc., 137 P3d 192 (Cal. 2006) (approving assignment of claims for economic losses, noting that California policy favors transferability of all causes of action except for purely personal claims such as slander or emotional distress); N.Y. Gen. Oblig. §13-101; DiLallo v. Fidelity & Casualty Co., 355 F Supp 519 522-23 (DC 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, 134 NYS2d 903 (N.Y. Sur. Ct., 1954) (holding there is no statutory prohibition, nor is it against public policy, for a widow to assign all of her claim, right, title, and interest in her husband's estate); D.C. Code §§28-2301, 28-2304.

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be taxed on any gain realized from that right.[2] If the receipt of the income is practically certain, tax liability for that income is unavoidable. If the right has effectively become fixed, even if the taxpayer transfers the right before receiving the income, it remains that taxpayer's income.[3]

By contrast, a transferor who has the only expectation of receiving the right is not subject to tax on post-transfer income.[4] The assignment of income doctrine requires the transferee to include the proceeds of a claim in gross income if recovery on the transferred claim is *certain* at the time of transfer. Conversely, this is not required if recovery is doubtful or contingent at the time of transfer.[5]

If a plaintiff's assignment occurs while his or her claim in the lawsuit is contingent and doubtful in nature, none of the litigation proceeds should be included in income. Put simply, a plaintiff who transfers a claim in litigation to a third person before a trial, or even after a trial but before the expiration of appeals in the case, is not required to include the proceeds of the judgment in income.

[2] See, e.g., Wilkinson, 9 AFTR 2d 1717, 157 Ct Cl 847, 304 F2d 469, 62-2 USTC ¶9529 (Ct. Cl., 1962) (assignment of contract right to ordinary services income to charity treated as ordinary income).

[3] Ferguson, 83 AFTR 2d 99-1775, 174 F3d 997, 99-1 USTC ¶50412 (CA-9, 1999); Jones, 37 AFTR 2d 76-885, 531 F2d 1343, 76-1 USTC ¶9247 (CA-6, 1976); Kinsey, 447 F.2d 1058 , 1063 (CA-2, 1973); Hudspeth, 31 AFTR 2d 73-488, 471 F2d 275, 73-1 USTC ¶9136 (CA-8, 1972); Estate of Applestein, 80 TC 331 , 345 (1983); Lucas v. Earl, 8 AFTR 10287, 281 US 111, 74 L Ed 731, 2 USTC ¶496 (1930).

[4] Johnson & Son, Inc., 63 TC 778, 787-88 (1975).

[5] See, e.g., Doyle, 147 F2d 769, 45-1 USTC ¶9190 (CA-4, 1945) (taxpayer who assigned judgment award after it was affirmed on appeal was required to include the proceeds in income); Cold Metal Process Co., 52 AFTR 160, 247 F2d 864, 57-2 USTC ¶9921 (CA-6, 1957), *rev'g*25 TC 1333 (1956) (taxpayer's right to income on judgment is not earned or does not ripen until all appeals with respect to the judgment have been exhausted); Wellhouse v. Tomlinson, 8 AFTR 2d 5216, 197 F Supp 739, 61-2 USTC ¶9597 (DC Fla., 1961) (transferor not taxable on the interest portion of a note where there were legal doubts about the collectability of the note at the time of the assignment); Jones, 10 AFTR 2d 5261, 306 F2d 292, 62-2 USTC ¶9629 (CA-5, 1962), *rev'g*TC Memo 1960-115, PH TCM ¶60115, 19 CCH TCM 611 (taxpayer not taxable on award assigned to related corporation where the claim was contingent when assigned); Schulze, TC Memo 1983-263, PH TCM ¶83263, 46 CCH TCM 143 (taxpayer not required to include in gross income the portion of a litigation claim paid to his former spouse pursuant to divorce property settlement).

Contingent attorney fee obligation

The assignment of income problem for a pending litigation claim is fairly easy to dispose of. The key is to transfer the full measure of control, and to do so early enough in the case so that the IRS cannot later say the result in the case was certain. With those simple steps, the risk of assignment of income assertions seems low.

But an often nettlesome question concerns the interaction of charitable contributions and contingent legal fees. If the donor/plaintiff has liability for attorney fees and is relieved of them as part of the process of assigning the case to charity, is there income to the donor? It is not a silly question.

Indeed, the case may involve contingent legal fees. Discharge of indebtedness or assignment of income principles can apply to attribute income to plaintiffs by reason of having a lawyer working on a contingent fee basis. A donor who is assigning an interest in a pending case to charity will want to step away from his or her lawyer, too, and the lawyer is usually likely to continue the case thereafter representing the charity.

Fortunately, case law indicates that the attorney's release of the plaintiff from the contingent fee obligation does not result in income to the plaintiff. The agreement to pay attorney fees from a future recovery is not considered a debt. It is entirely contingent upon future events that have not yet occurred. The courts have held that cancelling a contingent obligation to pay a third party a portion of future profits does not result in income.

At issue in *Terminal Investment Co.,* 2 TC 1004 (1943), *acq.,*[6] were corporate bonds that provided for contingent interest payments. Interest payments would be made only if the corporation had sufficient net earnings, which never happened. The corporation borrowed money to purchase and retire all of the bonds for less than their par value. It did not report any amount attributable to the contingent interest obligation as income. The Tax Court held 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."[7] The court found that *Kirby Lumber*

[6] See also Corporacion de Ventas, 29 AFTR 1074, 130 F2d 141, 42-2 USTC ¶9599 (CA-2, 1942).

[7] Terminal Investment Co., 2 TC 1004 (1943) at 1013.

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*Co.,*10 AFTR 458, 284 US 1, 76 L Ed 131, 2 USTC ¶814, 1931-2 CB 356 (1931), was distinguishable because it involved a fixed, rather than a contingent, obligation.[8]

The taxpayer in *Corporacion de Ventas,*29 AFTR 1074, 130 F2d 141, 42-2 USTC ¶9599 (CA-2, 1942), was a foreign corporation that issued bonds under which its liability was strictly limited by law. As in *Terminal Investment Co.,* 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. It reasoned that "[i]f 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."[9]

Evidently, the contingent obligation at issue simply was not a 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. The decision, however, refers to the obligation as "indebtedness," and the quasi-equity characteristic of the instrument does not appear to have been the decisive factor.

Debt instruments may provide for contingent payments, of course.[10] The regulations state that the contingent payment debt instrument provisions and the examples should not give rise to any inference regarding whether the instrument is a debt instrument for federal income tax purposes.[11] A 2010 private ruling supports this view.

The taxpayer in Ltr. Rul. 201027035 discharged an obligation under a tax indemnity agreement by making a lump-sum payment to the obligee. The taxpayer considered the obligation to be indebtedness within the meaning of Section 61(a)(12), and the IRS apparently accepted this classification. Nevertheless, the discharge of the obligation did not give rise to cancellation of indebtedness income. The ruling reasoned that 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. The same should be true if a donor/plaintiff assigns a lawsuit claim to charity. As long as the result of the litigation remains speculative at the time of the assignment, the plaintiff should not owe *any* fees to his or her attorneys.

If the plaintiff would owe contingent fees only upon a recovery in the case, it would not be certain that the plaintiff would ever owe any such fees. The assignment was effected during such uncertainty, so there could be no income to the plaintiff. Accordingly, a discharge of the contingent fee obligation, before it became fixed and payable, should not result in income to the plaintiff.

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). Under Section 357(a), a taxpayer generally must reduce its basis in property received in a Section 351 tax-free exchange to the extent of any liabilities that are assumed. There is an exception, however, 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.

Conclusion

A plaintiff who wishes to benefit a charity in a tax-efficient manner may wish to timely assign his or her entire interest in a pending case to the charity. This must be done either prior to trial or, if a trial has already been concluded, while the case remains on appeal and before the date of any final judgment or settlement. Specifically, the plaintiff's assignment must occur when his or her claim is contingent and doubtful in nature.

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[8] *Id.* at 1013-1014.

[9] Corporacion de Ventas, *supra* note 6 at 29 AFTR 1076 (emphasis added).

[10] Reg. 1.1275-4.

[11] See, e.g., Reg. 1.1275-4(b)(4)(vi).

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On those facts, no portion of any judgment or settlement proceeds should be includable in the plaintiff's income. In addition, concerning contingent attorney fees, the charity's agreement to pay those fees should not result in income to the donor/plaintiff.

This result follows from the assignment of income doctrine and from established state law concepts of the assignment and transfer of pending litigation claims. There is also a helpful IRS ruling.[12] Particularly given the increasing practice of assigning litigation claims in both commercial and estate planning contexts, one can expect more such assignments to effect charitable contribution goals and income tax planning.

Indeed, it is not foolish to suggest that charities start being sensitive to such donations, especially where they have established relationships with large donors, and may even know that such donors are engaged in litigation. In some cases, it may be appropriate for charities to offer to facilitate contribution planning where the charity either knows or can reasonably assume that once the litigation is concluded, the charity will benefit.

The charity and the donor may be better off by not waiting. ■

[12] Ltr. Rul. 201232024.

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