Don't Assign Litigation Claims in a Waffle House

By Robert W. Wood

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Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (4th ed. with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Since the earliest assignment of income cases, taxpayers have wanted to make transfers in ways that avoid income to the transferror. As expectancies, litigation claims seem ideal, but timing and details clearly matter. Wood examines assignment techniques and effects in light of the lottery ticket case of *Dickerson v. Commissioner*.

Working frequently with litigants who anticipate receiving settlements or judgments, I often hear discussions about transferring a portion of those claims before they mature. The plaintiff may want to make gifts to family members, transfers into family limited liability companies or partnerships, or even transfers for consideration. Some plaintiffs may want to borrow against their recoveries or sell all or a portion outright.

Most of these discussions are just talk. Sometimes, however, people follow through. Their plans may be timely, cautious, and well executed, or they may be late, aggressive, and sloppy. I was reminded of these common circumstances while reading *Dickerson v. Commissioner*,[1] which does not involve a claim in litigation but rather a lottery ticket.

Even so, the case did involve competing claims to the ticket that resulted in litigation. Although lottery tickets have been a source of interesting but usually academic tax questions, this lottery tax mess was real. I would like to use it as an illustration of what not to do with litigation claims.

Let's start with some background. There has long been discussion about plaintiffs assigning all or part of their claims. Mechanically, a claim (sometimes called a chose in action) can be transferred from a plaintiff to a third party. The third-party assignee can then pursue it. The assignee stands in the shoes of the original claimant.

Sometimes this is done piecemeal, with creditors or other assignees receiving fractions of the case. Often the assignment is partial, and the assignee appears to be along for the ride with the assignor continuing to function as the plaintiff. Even in wholesale assignments (when the plaintiff ought to be out of the picture), the plaintiff is likely to be required to stay active both in name and in deed to make sure the case is prosecuted fully.

Despite the attractiveness of this concept, taxpayers have long been hesitant to assign claims. This is partly because assigning income is almost universally regarded as a bad (or ineffective) thing. The earliest attempts by taxpayers to avoid income involved contracting away rights to receive income.

For example, in *Lucas v. Earl*,[2] 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 services performed by the husband. Need another infamous case of attempted income shifting?

In *Helvering v. Horst*,[3] a taxpayer gave his son an interest coupon from a bond. The coupon 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 for federal income tax purposes.

Timing and Mechanical Aspects

Two important factors affecting tax effects are the timing of the assignment and the degree to which the assignment is effective to transfer the claim. An

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[1]T.C. Memo. 2012-60, *Doc 2012-4775*, *2012 TNT 45-11*.

[2]281 U.S. 111 (1930).

[3]311 U.S. 112 (1940).

assignment is more likely to be effective if it transfers the claim itself, rather than just the *proceeds* of the claim. An assignment is more likely to be effective if it occurs while the outcome of the claim is still in doubt.

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 should belong to the transferee. How income from personal services should be attributed is more debatable.

Assignments can provide significant tax benefits or can be a disaster. Disaster can occur when the assignment actually accelerates the income event. In *Hurwitz v. Commissioner*,[4] the taxpayer did just that. On December 2, 1959, Hurwitz executed a settlement with his former employer, receiving $11,500 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 receivable to his wife. Even though Hurwitz did not receive the payment until 1960, the Tax Court found it taxable to Hurwitz in 1959. As this case shows, timing under the assignment of income doctrine can be confusing.

Will the Plaintiff Be Taxed?

A successful assignment involves the plaintiff transferring a claim (or a portion) while it is still inchoate. On the successful conclusion of the case, the transferee should receive and pay tax on the proceeds. A few cases prove helpful in setting some boundaries.

In *Doyle v. Commissioner*,[5] a taxpayer assigned 60 percent of his claim to his wife and children. The assignment was made after the Court of Claims denied the request 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, the taxpayer's gain was "practically assured."

The Fourth Circuit agreed, holding that the taxpayer received the income from the lawsuit despite the assignment. Another case following the same approach (but under considerably more favorable facts) is *Cold Metal Process Co. v. Commissioner*.[6]

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 Sixth Circuit affirmed, and the Supreme Court denied certiorari. The case repeats the phrase that a taxpayer's right to income on a judgment is not earned until all appeals have been exhausted.

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 assignment success story is evident in *Wellhouse v. Tomlinson*,[7] in which a federal district court found a transferor not to be taxable on the interest portion of a note because there were doubts that the note would ever be repaid. The creditor divested himself of all rights to the note the year before the payment was due.

Jones v. Commissioner[8] involved a claim assigned to third parties. The assignor was held not to be taxable on the award because: (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 is not clear if all these four elements must be present to have an assignment respected for tax purposes.

In *Schulze v. Commissioner*,[9] the tax 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 while the suit was pending, and his claim against the law firm was divided in the divorce. The value of the claim was indeterminate when the marital property was divided.

The taxpayer eventually recovered on the claim and paid a portion to his former spouse. The IRS claimed he was taxable on all of it, including his former wife's share. The Tax Court held he was not required to include in his gross income the portion of the award paid to his former spouse because: (1) at the time of the assignment, recovery was uncertain; (2) recovery did not occur for more than a year after he assigned the claim; (3) the assignment did

[4]T.C. Memo. 1964-326.
[5]147 F.2d 769 (4th Cir. 1945).
[6]247 F.2d 864 (6th Cir. 1957).
[7]197 F. Supp. 739 (S.D. Fla. 1961).
[8]306 F.2d 292 (5th Cir. 1962).
[9]T.C. Memo. 1983-263.

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) free from doubt. In *Schulze*, the assignment was made before the arbitrator rendered a decision, 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.

IRS Letter Rulings and Other Guidance

The IRS addressed one aspect of this situation in LTR 200534015,[10] which involved a wrongful death claim filed by a widow. While the suit was pending, she created an irrevocable trust for the benefit of her children and more remote descendants. The question was whether she could (without tax consequences) irrevocably assign part of the potential proceeds of her wrongful death action to the trust.

The issue was gift tax, not income tax. The taxpayer wanted the transfer to be a completed gift so any proceeds accruing to the gifted share of the wrongful death case would be received by and taxable to the trust. The IRS noted that the potential proceeds of a settlement or judgment are recognized as property under state law and can be assigned by one party to another. The ruling expresses no opinion on the value of the potential proceeds for gift tax purposes as of the date of the assignment.

LTR 200107019[11] examines the assignment of a share of the punitive damages to be awarded in a case. The facts 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 tax-exempt charitable trust and assigned to it any punitive damages that might be awarded in excess of attorney fees.

That assignment was made when it was unclear whether there would be *any* punitive damages. After the trial and appeals, the defendant eventually issued a check to the couple and their attorney (as co-endorsers) for the punitive damages and interest. The IRS ruled that the punitive damages the couple was awarded (and had promptly transferred to the charitable trust) were not includable in the couple's income. The ruling also concludes that the damages awarded to the couple's attorney were includable in their income.

One issue addressed in LTR 200107019 is fundamental — the transferability of judgments. The ruling indicates that the prevailing state law recognized and enforced assignments. It is unlikely to be controversial on many assignments, but it is worth verifying the law in your own state. Claims for personal injury, for example, may not be assignable.[12]

The ruling implicitly recognizes that the punitive damage award was transferred to the charitable trust when it was unclear whether *any* punitive damages would be paid or whether the case would be settled. What if a transfer is attempted later than that? The letter ruling considers situations in which a transferred claim must be taken into income by the transferor.

If a recovery is certain, it is too late. Assignment of income principles require a transferor to include the proceeds of a claim in income if the recovery is certain on the date of transfer. Conversely, if the recovery is doubtful or contingent on the date of transfer, the assignment of income doctrine does not require the transferor to pick up the income.

ILM 200335034[13] considers that the plaintiff's claims contributed to a corporation or partnership. Although several fact patterns are reviewed, the Service's overarching theory appears to be a kind of trump card. Sections 351 and 721 both trump the assignment of income doctrine, as long as the transfer is not primarily tax motivated.

The lynchpin for this favorable treatment appears to be that the contribution of legal claims to a corporation (under section 351) or partnership (under section 721) escapes assignment of income principles as long as it occurs in the context of ''an arm's-length transaction for valid consideration'' under section 351 or section 721.

A useful summary of many of the pertinent cases appears in LTR 200427009,[14] a ruling involving the twists and turns of lengthy litigation. The essence of the ruling is that an assignment of all or part of a claim often can be made safely and without income tax consequences. The key is whether at the time of the assignment the claims remain doubtful and contingent. Notably, the ruling shows that much can happen, including a jury verdict, as long as significant hurdles to the conclusion of the case remain.

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[10] *Doc 2005-17865*, *2005 TNT 166-38*.

[11] *Doc 2001-4799*, *2001 TNT 34-19*.

[12] *See* N.Y. Gen. Oblig. Law section 13-101; *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).

[13] *Doc 2003-19474*, *2003 TNT 169-45*.

[14] *Doc 2004-13609*, *2004 TNT 129-20*.

Similarly, LTR 200445002[15] reiterates the rule that an assignment, in this case to charity, is treated in the same fashion. Key to a plaintiff-transferor not having to pay tax on the transfer or collection of proceeds is that the transfer occurs while the claim is still inchoate.

Finally, in ILM 200246003,[16] the IRS confirmed the sensible proposition that a plaintiff forced by operation of law to transfer a share of a recovery or damages to the government is not first taxed on them. The Service considers a now common provision in state law requiring successful plaintiffs to transfer a share of any punitive damages to the state. In such a case, the plaintiff will not be taxed on the portion that must be transferred.

In the statute considered in ILM 200246003, the state law required that a 50 percent share be remitted to the state. However, the share was calculated after the reduction of attorney fees and costs. The ruling concludes that the net portion payable to the government was not income to the plaintiff-taxpayer.

No Luck on Attorney Fees

The Supreme Court in *Commissioner v. Banks*[17] tried to resolve the attorney fee controversy, holding that as a general rule, the plaintiff will recognize gross income on the entire recovery in his case, including any contingent fee paid to his attorney as a contingent fee. This is so even if the plaintiff's lawyer directly receives a contingent fee for his percentage. The Supreme Court agreed with the government's arguments about assignments of income, but the Court left open some important questions, for example, whether a partnership between lawyer and client that observes partnership formalities and documentation might make a difference.

Creative tax lawyers may try to get around the result in *Banks*. Yet it should not be surprising that in LTR 200107019 (pre-*Banks*), the IRS refused to give effect to the attempted assignment of monies to the attorney. The assignment of income authorities involving attorney fees are complex and voluminous.

Consider the following possibilities, all premised on the notion that Plaintiff P wants to transfer 50 percent of his claim to Charity C. P has a contingent fee agreement with Larry Lawyer calling for a 40 percent fee. The possibilities would seem to be:

1. P assigns a 50 percent interest to C with all fees coming out of P's share;
2. P assigns a 50 percent interest to C with 50 percent of Larry's fees borne by C; and
3. P assigns a 50 percent interest to C with 50 percent of Larry's fees borne by C. Larry and C enter into a parallel fee agreement that amends and supersedes P's fee agreement with Larry as to the transferred half.

There may be other possibilities, but if it is desirable for the transferor to assign a 50 percent interest in the case net of lawyer fees and costs, it should be possible to do so without adverse tax consequences owing to the legal fees.

Valuation

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

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

As common sense dictates, the value of property is its fair market value — the price at which a willing buyer and willing seller transact business at arm's length. With litigation claims, there is often no market from which to assess market value. Without a willing buyer and willing seller, many valuations may be limited to a defensible range of acceptable values.

Judicial precedent is of little value as cases tend to be fact-specific and frequently involve dueling specialists. Courts may be forced to pick values, interpolating between the extremes of expert opinion and not providing useful valuation methods. Often, cases settle on the proverbial courthouse steps because the parties are reluctant to let the courts decide. Even though it may seem that obtaining a valuation of an inchoate claim involves expense, inconvenience, and uncertainty, in the right circumstances, it can produce significant tax savings.

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[15] *Doc 2004-21422*, *2004 TNT 216-16*.

[16] *Doc 2002-25553*, *2002 TNT 222-42*.

[17] 543 U.S. 426 (2005), *Doc 2005-1418*, *2005 TNT 15-10*, *rev'g and remanding* 345 F.3d 373 (6th Cir. 2003), *Doc 2003-21492*, *2003 TNT 190-11*; and 340 F.3d 1074 (9th Cir. 2003), *Doc 2003-19359*, *2003 TNT 167-5*.

Don't Waffle

Finally, I return to the waffle house. The Tax Court in *Dickerson v. Commissioner*[18] considered an Alabama Waffle House waitress, Tonda Dickerson, who won a $10 million lottery jackpot on a ticket given to her by a customer. The Tax Court held she was liable for gift tax when she transferred the winning ticket to a family S corporation (formed for this purpose) of which she owned 49 percent.

Dickerson's restaurant was frequented by a customer who often made gifts of Florida lottery tickets to restaurant workers. On March 7, 1999, the customer gave Dickerson a lottery ticket that she later learned had a cash payout of $5 million (which would total more than $10 million if paid over 30 years). Dickerson had a sharing, close-knit family and she wanted to benefit them in a tax-efficient way.

In fact, the family had a tradition of buying lottery tickets and often talked about sharing a jackpot. However, there was no written sharing agreement or documentation to support one.

One day after receiving the winning ticket, Dickerson's lawyer prepared incorporation papers for an S corporation called 9 Mill. Dickerson would own 49 percent and her mother and two siblings would each hold 17 percent. The percentages were determined by Dickerson's father. The articles of incorporation for 9 Mill were signed three days later.

On March 9 (two days after getting the winning ticket), Dickerson learned employees were staking a claim to 80 percent of the total prize. On March 12, Dickerson and her family went to Florida to collect on the ticket. Signing on 9 Mill's behalf, Dickerson elected to receive the money over 30 years.

However, lottery officials wouldn't pay out the prize because of the competing claim made by Dickerson's co-workers. On April 30, 1999, a state court found for the co-workers. On February 28, 2000, the Alabama Supreme Court reversed and held for Dickerson.

In 2007 Dickerson filed a gift tax return for 1999 but reported that she had made no taxable gifts. The IRS claimed she had made a gift of $2,412,388 resulting in a tax deficiency of $771,570. The IRS's argument was that Dickerson's transfer of the lottery ticket to 9 Mill was an indirect gift because 51 percent of the shares were owned by her mother, brother, and sister.

The Tax Court agreed. Dickerson would have been saved if there had been an enforceable, preexisting contract to share the lottery prize among the members of her family. There wasn't. There also were insufficient facts to indicate that a legal partnership existed among family members and that it owned the gifted lottery ticket.

Finally, of course — and most pertinent to assignments of litigation claims — the lottery ticket here was already a guaranteed winner when it was transferred to the S corporation! One silver lining? The Tax Court agreed with Dickerson that the value of her gift should be discounted for the claim that was asserted by her co-workers. On March 9 (and certainly by March 11 or 12) of 1999, a hypothetical buyer would have known of the potential cloud on title.

Indeed, any buyer would have investigated it before buying the lottery ticket. In that investigation, the Tax Court said it had no doubt this hypothetical buyer would have determined a lawsuit was likely and would not have paid full value for the disputed portion of the lottery ticket. Based on the testimony of a litigation attorney who had experience evaluating which cases to take on a contingency basis and which claims to settle, the Tax Court determined that an appropriate discount for the 80 percent of the lottery ticket disputed by Dickerson's co-workers was 67 percent.

Thus, 80 percent of the $4,730,172 present value of the ticket is $3,784,137.60. Applying a 67 percent discount resulted in a $1,248,765.41 value for the 80 percent disputed portion of the lottery ticket. Fifty-one percent of this amount is $636,870.36; 51 percent of the undisputed 20 percent is $482,477.54. As a result, the court determined that the total gift Dickerson made was $1,119,347.90, considerably lower than the $2,412,388 the IRS had claimed.

Conclusion

Plaintiffs who anticipate a significant litigation recovery should consider possible assignments of claims. The Service has issued some private letter rulings and other guidance showing that the IRS isn't hostile to the idea. Pertinent court opinions agree.

Settled principles of law seem to govern assignments. As most of the authorities make clear, one key is verifying that an assignment is permissible under applicable state law. As long as the assignment is made irrevocably and before the claim has any certainty of value, the transfers should be respected. If the transfer is likely to be respected and the value of the claim is likely to be small, planning opportunities can be available to careful and creative litigants. However, there may be some niceties of local law to be observed.

It is important to ensure that documents are signed and delivered to effect whatever kind of transfer is intended. Make sure it occurs well before some enterprising taxing authority could argue that

[18]T.C. Memo. 2012-60.

the value of the case is certain. Consider maintaining an evidence file to document the speculative nature of the claim as of the date of the transfer.

Although a formal appraisal may not always be necessary, it is almost always a good idea. In any event, there is generally considerable material that can be gathered that falls far short of a formal appraisal but still could be helpful evidence in showing the speculative nature of the case. Letters from attorneys are a good place to start.

Another good piece of evidence is a record of the defendant's current posture. 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 case law suggests that as long as the claim (or a portion of it) is fully and unequivocally transferred, and as long as the 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 LLC or limited partnership. Not only can that be good estate and income tax planning, but there can be a double benefit because of minority discount. That concept can put more value in the hands of his children at a lower tax cost.

However you approach this issue, consider it early and carefully. If you do, it can pay dividends.