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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:BR05 – PLR-143637-03
Date:
March 19, 2004

In Re:

Att'n: , Personal Representative

LEGEND:

Individuals:
A =

B

M&N =
O =
P =
Company C =
Estate of A =

State Y =
Dates:
1 =
2 =
3 =
4 =
5 =
6 =
7 =
8 =
9 =
10 =

11 =
12 =
Law Firm --

Amounts:
$n =
$o =
$p =
$q =
$r =
$s =
$t =
$u =
$v =
$w =
$x =
$y =
$z =

Dear

This is in response to your authorized representative's letter and submissions of July 21, 2003, and other correspondence and submissions, in which he requested on your behalf, as personal representative of the Estate of A, rulings regarding the proper federal income tax treatment under section 61 of the Internal Revenue Code of 1986 attendant payment to the Estate of a certain judgment for compensatory and related damages, as further discussed below. We are pleased to address your concerns.

The information submitted indicates that A died on Date 11. B is the surviving spouse of A, and claims an interest in the Estate under A's last will and testament.

The primary asset of the Estate is the decedent's interest in an action against Company C ("C"), now pending against C in the State Y Supreme Court. That case arose out of C's bad-faith defense of an earlier lawsuit (the "personal injury action") brought against A by P and M&N. The personal injury action was filed following an automobile accident on Date 1 in State Y in which P was disabled and O, M&N's son, was killed.

At the trial of the personal injury action in Date 2, A was found 100% at fault, and judgments against him were entered in the amount of $o. C refused to pay the judgments on his behalf, which left his personal assets exposed to execution by P and M&N. C had rejected offers to settle the case before trial for policy limits of $50,000.

In consequence of C's bad-faith handling of the defense, parties A, P, and M&N executed an agreement on Date 3 (the Date 3 Agreement) wherein A agreed to pursue a bad-faith action against C on behalf of himself, P, and M&N; in exchange P and M&N agreed to forego execution on their judgments against A. The Date 3 Agreement provided that A would be represented by Law Firm, also P and M&N's attorneys, that P and M&N would have the right to participate in all major decisions respecting the litigation, and that any recovery would be allocable to and divided among the participating parties 45% to P, 45% to M&N, and 10% to A.

A and B commenced litigation against C on Date 9 alleging, among other things, fraud and intentional infliction of emotional distress. The State Y trial court granted summary judgment to C on the grounds that there was no bad-faith as a matter of law. A&B appealed, and the State Y Court of Appeals reversed and remanded, permitting A&B to pursue a claim for bad faith in C's previous dealings.

Following remand, a bifurcated trial was conducted in Dates 5. Before trial, the parties renegotiated some of the terms of the Date 3 Agreement because B was not a party to the earlier agreement, failure of the earlier Agreement to address her claim was proving an impediment to negotiating an overall settlement of the dispute, and because in the intervening period C had paid certain amounts to P and M&N. Under the revised Agreement (the Date 6 Agreement), the parties agreed that the balance of any recovery from C in the action would, after payment of the costs and expenses of litigation, including attorney's fees, be disbursed 1/3 to A&B, 1/3 to M&N, and 1/3 to P. (On Date 10, terms of the earlier agreements were memorialized into a single document, for clarity of reference.)

On Date 8, following trial, judgment was entered against C for general compensatory damages in the amount of $q (which the trial court later remitted to $r (60% for A and 40% for B)) and special compensatory damages of $y. In a subsequent judgment entered on Date 9, the trial court also awarded attorneys fees and expenses/costs to the plaintiffs, A&B, totaling $s. The total compensatory award of $t thereafter accrued interest until paid. (The jury also awarded punitive damages against C in the amount of $p; however, that action has been remanded for further re-determination, and is still pending. Issues respecting the tax treatment of punitive damages, if any, are not a part of this ruling request.) The compensatory damages award became final and payable, and was paid by C to the Clerk of the State Y Supreme Court on Date 12. Shortly thereafter (Date 12), that amount plus certain additional amounts (the "Proceeds") was paid to Law Firm and placed in interest bearing trust accounts. No amounts have yet been distributed to the concerned parties, pending a determination of the Estate's potential federal income tax liabilities in connection with such Proceeds.

You, as personal representative of the Estate of A, believe that no portion of the amounts that M&N and P are entitled to receive under the Date 6 Agreement is required to be included in the Estate's gross income for federal income tax purposes, and that only a portion (A's portion) of the total amounts that A&B have been awarded in the subject personal injury litigation is properly includible in the Estate's gross income for such purposes; you have requested a ruling confirming the correctness of this position. (Since the Date 6 Agreement does not address how amounts received for attorney fees, costs, and expenses of litigation are to be allocated as between A and B, you have requested additional guidance on this matter as well.) We are pleased to assist you in addressing the federal income tax obligations of the Estate in this matter.

Section 61 of the Internal Revenue Code provides that, except as otherwise provided in subtitle A (relating to income taxes), gross income means all income from whatever source derived.

In general, 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, if the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is practically certain to occur (i.e., whether the right basically had become a fixed right), even if the taxpayer transfers the right before receiving the income. Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999); 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); Est. of Applestein v. Commissioner, 80 T.C.331,345 (1983); Lucas v. Earl, 281 U.S.111,114-115 (1930). In contrast, a mere anticipation or expectation of the receipt of income is insufficient to conclude that a fixed right to income exists. Johnson & Son, Inc. v. Commissioner, 63 T.C.778,787-88 (1975).

With respect to the assignment of claims in litigation, a review of the case law shows that anticipatory assignment of income principles require the transferee to include the proceeds of the claim in gross income where recovery on the transferred claim is certain at the time of transfer, but not where recovery on such claim is doubtful or contingent at the time of transfer. In Doyle v. Commissioner, 147 F. 2d 769 (4th Cir.1945), a taxpayer assigned 60 percent of a claim that he owned to his wife and children after the Court of Claims denied application for a new trial and the Supreme Court of the United States denied taxpayer's petition for a writ of certiorari. The government argued that, after the denial of certiorari and before the transfer to the wife and children, the gain that the taxpayer expected to receive was "practically assured" and thus its transfer resulted in an anticipatory assignment of income. Doyle, 147 F. 2d at 772. The court, agreeing with the government's argument, held that the taxpayer was in receipt of the profits on his purchase of the interest in the lawsuit because, at the time he made the gifts of his interest in the lawsuit, such profits "had already been rendered certain by the judgment of the Court of Claims and denial of certiorari by the Supreme Court." Doyle, 147 F. 2d at 773. (Emphasis added.)

Like Doyle, Cold Metal Process Co. v. Commissioner, 247 F.2d 864 (6th Cir.1957), revg 25 T.C.1333 (1956), follows the view that a taxpayer's right to income on a judgment is not earned or does not ripen until all appeals with respect to the judgment have been exhausted. Cold Metal demonstrates the doubtful and contingent nature of a lower court judgment during the time an opposing party is prosecuting appeals. Citing to Harrison v. Schaffner, 312 U.S.579 (1941), the court stated that "the rule applicable to an assignment of income applies when the assignor is entitled at the time of the assignment to receive the income at a future date and is vested with such a right." Cold Metal, 247 F.2d at 873. In Cold Metal, the court held that, notwithstanding a district court's opinion for the taxpayer in a cancellation suit, as of the end of that year it had only a "continent right to income . . . . payable, if at all, at some indefinite time in the future in an indeterminate amount, with respect to which the assignor had no voice or control whatsoever. . . ." Cold Metal, 247 F.2d at 873. Thus, Cold Metal's assignment did not result in an assignment of income.

Similarly, in Wellhouse v. Tomlinson, 197 F. Supp.739 (S.D.Fla. 1961), the court found that a transferor was not taxable on the interest portion of a note because there were doubts as to whether there ever would be payment by the debtor, and because the creditor divested himself of all rights to the note in a year prior to the year of payment.

Likewise, *see* Jones v. Commissioner, 306 F.2d 292 (5th Cir. 1962) and Schulze v. Commissioner, T.C. Memo 1983-263. In Jones, an insolvent taxpayer-subcontractor made a claim in 1944 through the general contractor against the United States for additional compensation for work done. In February 1953, the taxpayer assigned the claim to a related corporation for $ 10,000 and the corporation's agreement to pay the taxpayer's 1948-1950 tax deficiencies. Thereafter, the corporation assumed the costs of the action. In July 1953, the Court of Claims decided the claim favorably to Jones, which decision became final in October 1953. In April 1954, the taxpayer received an award of $ 259,936 (net of attorneys' fees of $ 79,741) which he endorsed over to the corporation pursuant to the assignment. The court concluded that the taxpayer was NOT taxable on the award. In so holding the court noted that (1) the claim was contingent and doubtful when it was assigned, (2) no gift was involved, (3) the assignment was made prior to the year the income was received, and (4) the assignment arose out of the exercise of a legitimate business purpose.

In Schulze v. Commissioner, T.C. Memo.1983-263, a taxpayer sued his former law partnership for damages. Subsequently, taxpayer and his wife divorced and agreed to divide their assets equally, including taxpayer's claim against the partnership. The value of the claim was indeterminate at the time of the property division. Subsequently, taxpayer recovered on his claim as a result of an arbitrator's decision and paid a portion to his former spouse. Following, Jones, supra, the Tax Court held that taxpayer 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 on the claim was uncertain;

(2) the recovery did not occur for more than a year after the assignment of the claim; (3) the assignment did not involve a gift or gratuity, and (4) the assignment was made for a legitimate non-tax purpose. The court noted also that the outcome of a lawsuit is rarely, if ever, certain or free of doubt. Since the assignment was made before the arbitrator's decision, and the arbitrator's decision appears to have been final, this opinion is not inconsistent with the principle that income arising from a judgment is contingent until the final decision in a suit is rendered.

The above-cited line of cases support the proposition that, in general, a transferor who makes an effective transfer of a claim in litigation to a third person prior to the time of the expiration of appeals in the case is not required to include the proceeds of the judgment in income under the assignment of income doctrine because such claims are contingent and doubtful in nature.

In the instant circumstances, the Dates 3 and 6 Agreements gave each of the relevant parties at issue herein an irrevocable interest in a claim in litigation, or chose-in-action, even before the beginning of the trial in the action that generated the subject recovery, at a time when no recovery was certain, or even foreseeable. (For purposes of this letter ruling, it is assumed that the transfers or assignments of the interests in the bad-faith action against Company C at issue herein are valid, effective, and binding under the laws of State Y.) The initial summary judgment action granting C dismissal of A&B's claim, and the lapse of over 19 years between the initial Date 3 transfers and the date that the award of the compensatory damages at issue herein became final and payable, tend to further confirm the uncertainty of any recovery at the time of the conveyances. Further, A&B's assignments appear to have been motivated by genuine business purposes, i.e., the forbearance of judicial remedies, including immediate execution of judgments against their personal assets, and M&N and P provided valuable consideration for the rights and interests assigned to them by agreeing to forego execution of their judgments against A&B.

Thus, we conclude that the assignment of income doctrine is not applicable in the subject circumstances, and that those portions of the $u judgment proceeds received by Law Firm that are payable to M&N and P under the Dates 3 and 6 transfer Agreements relevant herein, are not properly includible in the Estate of A's gross income for federal income tax purposes.

The Dates 3 and 6 Agreements are silent as to how the general compensatory award to A&B, and other amounts received for attorney fees, costs, and expenses of litigation are to be allocated as between A and B, and you have requested guidance as to the sums properly includible in the Estate of A's gross income. We believe that the amounts of general compensatory damages properly allocable to A and to B must follow the apportionment as determined in the State Y litigation judgments of Dates 8 and 9, i.e., 60% of $r, or $v, being allocable to A, and 40% of $r, or $w, allocable to B. The amount of $x received for attorneys fees, being determined by and based upon the general damages award, may properly be apportioned in the same ratio, i.e., 60% to A and 40% to B. The jointly awarded amounts of $y and $z (for special damages and general costs of litigation) may properly be allocated equally between A and B.

Final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by adoption of final regulations, to the extent the regulations are inconsistent with any conclusions in this ruling. See section 12.04 of Rev. Proc. 2004-1, 2004-1 I.R.B. 1. However, when the criteria in section 12.06 of Rev. Proc. 2004-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

This letter ruling is based on facts and representations provided by the Taxpayer and its authorized representatives, and is limited to the matters specifically addressed. No opinion is expressed as to the tax treatment of the transactions considered herein under the provisions of any other sections of the Code or regulations which may be applicable thereto, or the tax treatment of any conditions existing at the time of, or effects resulting from, such transactions which are not specifically addressed herein.

Because it could help resolve federal tax issues, a copy of this letter should be maintained with the Estate of A's permanent records.

Pursuant to a power of attorney on file with this office, copies of this letter ruling are being sent to the Estate of A's authorized representatives.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Associate Chief Counsel
(Income Tax & Accounting)

/s/ William A. Jackson

By _________________________
William A. Jackson
Chief, Branch 5

Enclosures:
Copy of this letter
Copy for section 6110 purposes