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Taxability of Gain Upon a Contingent Fee Contract Assigned to Charity

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CASES NOTED

TAXABILITY OF GAIN UPON A CONTINGENT FEE CONTRACT ASSIGNED TO CHARITY

Captain Bonnin, not an attorney, contracted in 1932 to represent the Ute Indians in their claims against the United States. In 1935, he assigned his contract to a New York law firm, retaining an interest as to contingent compensation while continuing to work on the claims. In 1937, the law firm dissolved, but the taxpayer, who was a member of the firm, continued to represent the Ute Indians. In 1938, the taxpayer purchased from Bonnin 44.79 per cent of Bonnin's remaining contingent fee for 12,092 dollars. At this time there was much uncertainty as to the extent of the Indian claims and even greater uncertainty as to whether the claims could ever be collected. In 1950, almost 32 million dollars was awarded to the Indians. In 1951, the 44.79 per cent portion of Bonnin's contingent fee was assigned by the taxpayer to charities. In the same tax year, the fees were awarded; 1,266,625 dollars was paid to the taxpayer for his personal services and 191,000 dollars was paid directly to the charities as a result of the assigned claim. On the issue of whether the assignment to charity rendered taxpayer liable for income taxes on the appreciation in value of the claim, *held:* the increment in value is taxable income to the taxpayer, and is taxable at ordinary income rates. *Wilkinson v. United States*, 304 F.2d 469 (Ct. Cl. 1962).[1]

Ordinarily, the making of a gift does not result in the realization of income. In other words, the donor is not regarded as having sold the property for its then fair market value. It has become almost axiomatic that the donation to a charitable organization of property that has appreciated in value does not render the donor taxable on the appreciation, although he is granted a charitable deduction for the property's fair market value at the time of the donation.[2] It has been recognized that

1. Another issue in the case involved the fees Wilkinson received for his *own* services rendered in prosecuting the claims of the Utes. Since these fees were the result of services rendered over a period of seventeen years, he elected to have them taxed as if they had been earned ratably over the seventeen years (under Section 107(a) of the Internal Revenue Code of 1939). Section 23 of the 1939 Code allowed a maximum of 15 per cent of adjusted gross income to be deducted for charitable contributions purposes. On the issue of whether the amount used for computing the maximum 15 per cent limitation was the adjusted gross income *before* the spread-back provisions were applied, or *after* they were applied, *held:* taxpayer was allowed to compute the allowable charitable deduction on gross income *before* the spread-back for purposes of computation of tax liability. This holding has been substantially codified by Section 1307(e) of the Internal Revenue Code of 1954, which was added by the Revenue Act of 1962.

2. Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954). Rev. Rul. 55-410, 1955-1 CUM. BULL. 297 states that satisfaction of a pledge by means of a donation of a gift of property which has appreciated in value does not give rise to a taxable gain. The event which gives rise to the deduction is the actual payment of money or the transfer of property.

this result was within the contemplation of Congress at the time it enacted the charitable contributions section.[3] Usually only "capital assets" are the subject of gifts to charity, and no question arises as to the non-realization of income upon the making of the gift.[4]

In general, amounts realized from the sale or exchange of capital assets held for more than six months are taxed at capital gains rates.[5] "Capital asset" has been defined by the Internal Revenue Code as "property held by the taxpayer,"[6] with certain exceptions.[7] It would seem to follow, then, that any "property" not included in the enumerated exceptions would qualify as a "capital asset." However, courts have been giving a restricted meaning to the term "property."[8] Therefore, if the item cannot be classified as "property" it cannot qualify for capital gains treatment.

Generally, amounts received from a personal service contract do not qualify for capital gain treatment.[9] Most courts have excluded these contracts on the rationale that no "sale or exchange" was involved upon realization of the profit, rather than basing their decision on whether the asset is "property" or a "capital asset."[10] Since a "sale or exchange" is

3. L.O. 1118, II-2 CUM. BULL. 148 (1923); Rev. Rul. 55-410, 1955-1 CUM. BULL. 297, 298 recites: "It would be inconsistent to treat such payment or transfer as a 'contribution or gift,' and at the same time as a satisfaction of a debt with the tax consequences which would ordinarily follow from the use of appreciated property . . . to pay a debt."

4. Rev. Rul. 55-138, 1955-1 CUM. BULL. 223.

5. INT. REV. CODE OF 1954, § 1201. All further references to sections will be sections of the Internal Revenue Code of 1954 unless otherwise indicated.

6. Section 1221.

7. Section 1221 lists the following as specific exceptions to the general rule that the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business):

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

8. Corn Prods. Ref. Co. v. Comm'r, 350 U.S. 46 (1955); Hort v. Comm'r, 313 U.S. 28 (1941); Arnfeld v. United States, 143 Ct. Cl. 277, 287, 163 F. Supp. 865 (1958), *cert. denied*, 359 U.S. 943 (1959); Martin Charles Ansorge, 1 T.C. 1160 (1943).

9. Cotlow v. Comm'r, 228 F.2d 186 (2d Cir. 1955).

10. Helvering v. Oak, 313 U.S. 247 (1941); Fairbanks v. United States, 306 U.S. 436

required for capital gain treatment, courts have excluded these contracts from this tax benefit.

Anticipatory assignments of income (as opposed to assignments of capital assets) have been consistently held taxable to the assignor, under the "fruit-tree" doctrine of *Helvering v. Horst.*[11] In that case (which concerned a gratuitous intra-family assignment), Justice Stone stated that "fruit is not to be attributed to a different tree from that on which it grew,"[12] and that therefore, if one earns income and assigns it to another before it is collected, the assignor will still be taxed on the proceeds. In an arms-length transaction, the assignor of a personal service contract is taxed on the consideration received, and the assignee is taxed on any amount ultimately collected under the assignment in excess of his cost.[13]

The novelty of the *Wilkinson* case is that the court found realization of income resulting from assignment of an asset to a charity. It based its decision on the premise that only a capital asset qualifies for the benefits of non-recognition of appreciation in value.[14] It held that since the asset involved (the right to legal fees) was not "property," and since only "property" can be a capital asset, Wilkinson could not disregard the appreciation in value in computing his taxable income.[15]

The government tried to apply the "fruit-tree" doctrine, claiming that even though the charities ultimately collected the legal fees, Wilkinson should be taxed with them. The court rejected that argument, holding that all of the cases construing that doctrine arose in the context of gratuitous, intra-family assignments, rather than from arms-length bargaining transactions.[16] Here, the court said, the income to be earned

(1939); Jones v. Comm'r, 306 F.2d 295 (5th Cir. 1962); Cotlow v. Comm'r, 228 F.2d 186 (2d Cir. 1955); Ogilvie v. Comm'r, 216 F.2d 748 (6th Cir. 1954); United States v. Burrows, 133 F.2d 772 (6th Cir. 1943); Hale v. Helvering, 85 F.2d 819 (D.C. Cir. 1936); Galvin Hudson, 20 T.C. 734 (1953); Pat N. Fahey, 16 T.C. 105 (1951); Mary E. Wenger, 42 B.T.A. 225, *aff'd* 127 F.2d 523 (6th Cir.), *cert. denied*, 317 U.S. 646 (1942).

11. 311 U.S. 112 (1940). This case involved the gift to taxpayer's son of negotiable interest coupons which were detached from the bonds. In holding the interest derived from the coupons to be taxable to the taxpayer, Justice Stone made the observation quoted in text accompanying note 12 *infra*. This has become known as the "fruit-tree" doctrine, and has precluded capital gains treatment of anticipatory assignment of earnings. The doctrine has been applied in most cases where income-shifting through gratuitous assignments was attempted.

12. *Id.* at 120.

13. Harrison v. Schaffner, 312 U.S. 579 (1941); Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Eubank, 311 U.S. 122 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

14. Wilkinson v. United States, 304 F.2d 469, 473 (Ct. Cl. 1962).

15. *Ibid.*

16. The attempt of the government and the courts to extend the application of the "fruit-tree" doctrine has been criticized by at least one writer: "[T]he metaphor has been substituted for rational analysis to the point where a critic in this area frequently cannot see the forest for the fruit trees." Rice, *Judicial Trends in Gratuitous Assignment to Avoid Federal Income Taxes*, 64 YALE L.J. 991 (1955).

was attributable to Bonnin rather than to Wilkinson. "Taxpayer, in a bona fide sale, purchased the right to receive this income if and when it became due."[17]

Was the court correct in determining that Wilkinson should have been taxed on the appreciation in value of his gift? To analyze the decision logically, we must examine the nature of the "property" involved. Wilkinson purchased someone else's right to a contingent fee in a claim. According to the evidence, at the time Wilkinson bought Bonnin's interest for 12,092 dollars, there was much uncertainty as to the extent of the Indian claims and even greater uncertainty as to whether the claims could ever be collected.[18] As the years passed, and the claims were perfected, the uncertainties diminished. However, not until some *twelve years* later did Wilkinson see his patience rewarded. The court seemed to believe that income, rather than capital appreciation, was being realized through the passage of time.[19] It looked to the nature of the "property" in *Bonnin's* hands, rather than in the taxpayer's. Judge Whittaker in his dissenting opinion questioned the validity of this approach when he said:

> This was not a gift of income that had been earned by the plaintiff; it was never plaintiff's income; it was Bonnin's income. Plaintiff became entitled to it by purchase, and not as compensation for his services.[20]

It seems more logical to analyze the nature of the property as it stands in the hands of the taxpayer, rather than in someone else's hands, and this approach is used in other areas of taxation.[21]

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17. Wilkinson v. United States, 304 F.2d 469, 472 (Ct. Cl. 1962).

18. *Ibid.*

19. In looking at the "actual and practical occurrences of this particular instance" the court stated: "[T]he accretion in value of the contract right was due mainly as the result of taxpayer's own efforts and performance of his personal services." Wilkinson v. United States, 304 F.2d 469, 474 (Ct. Cl. 1962). The validity of this conclusion is questionable because taxpayer was fully compensated (1,266,625 dollars) for his own services. The 191,000 dollars in question arose solely out of his purchase. True, if the legal services had not been performed, the purchased claim would have remained valueless. But what difference does it make that *he* was the lawyer in the case? As far as the purchased claim was concerned, he had to do nothing further. Someone else could have done the legal work. If he had not been fully compensated for his legal services, there would be room for the argument that the increase in value of the claim constituted payment for his services, but this was not the case here. A good analogy would be the situation of a fully-compensated officer of a corporation buying a few shares of his company's stock. It might be easy to show that the subsequent increase in value of the stock was due to the officer's diligent efforts, but no one has gone so far as to claim that the subsequent sale of the stock should result in ordinary income.

20. *Id.* at 479.

21. In determining whether taxpayer is a dealer or an investor, the courts look to the activities of the taxpayer. Curtis Co. v. Comm'r, 232 F.2d 167 (3d Cir. 1956); Di Lisio v. Vidal, 233 F.2d 909 (10th Cir. 1956). In computing "amount realized" in year of sale for purposes of installment reporting of realty sales, the purchaser's mortgage is not con-

The court seemed to base its decision on practical grounds rather than legal principles, and cited an example of a loophole which would be opened were the case to be decided otherwise.[22] The decision hinges on whether the claim would have qualified for capital gains treatment upon sale, and this in turn upon whether the claim qualified as "property." *Corn Prod. Ref. Co. v. Commissioner*[23] was a landmark case restricting the definition of "property" for income tax purposes. That case involved the purchase of "futures" by a manufacturing concern in order to protect its competitive position. The court held that while "futures" were ordinarily "capital assets," in the hands of *this* taxpayer they were not.[24] The application of this approach to the *Wilkinson* case is illogical, since the "property" in the *Corn Products* case was examined from its nature in the hands of the *taxpayer*, while in *Wilkinson*, the "property" was analyzed from its nature in the hands of someone who owned it twelve years earlier.

Section 1221 and the regulations thereunder[25] define the term "capital asset" to include "all classes of property not specifically excluded." The language is clear and unambiguous. The word "property" has a fixed meaning in general law. Are the courts doing a service to the law by an approach which turns property from a fixed into an elastic concept, contracting or expanding according to what, in the court's judgment, a capital gain should be?[26] The courts' desire to be vigilant guardians of the nation's purse-strings is commendable. In the interest of certainty, however, a better approach might be to have Congress amend section 1221 to enumerate additional exceptions to the general rule that "capital asset means property held by the taxpayer."

The *Wilkinson* case may have a profound effect on future gifts to charities. Nonrealization of income upon a gift of appreciated property has been a settled principle of tax jurisprudence since the early days of

sidered as such, while someone else's mortgage given by the purchaser in payment would be included. Nina J. Ennis, 17 T.C. 465 (1951).

22. "[T]wo lawyers, each working on a contingent fee contract, might sell to the other the right to receive payment under their contract for a nominal sum. They would then aver that the gain realized was a capital gain because it represented gain on the sale or exchange of property." Wilkinson v. United States, 304 F.2d 469, 472 (Ct. Cl. 1962). What might at first blush appear to be an appalling loophole under the logical definition of "property" yields to attack on several fronts under closer scrutiny. First of all, it might be found that this was a "sham" transaction—that the sale was not a bona fide one. Second, there does not appear to be a provision made for the lawyer who works on the case to receive full compensation for his services. It would be quite valid to make a distinction between payment for services performed and payment resulting from an investment.

23. 350 U.S. 46 (1955).

24. *Id.* at 47.

25. Treas. Reg. § 1.1221-1(a): "The term capital asset includes all classes of property not specifically excluded by Section 1221."

26. As stated by Justice Stone in Harrison v. Schaffner, 312 U.S. 579 (1941): "'Drawing the line' is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind."

the income tax laws.[27] The tendency of the courts (starting with *Corn Products*) to give the word "property" a narrow construction[28] should cause the prudent attorney to take a close look at the nature of the "property" being assigned to a charity before advising his client that the assignment will result in no realization of income to him.

CLAUDE L. EICHEL

THE INAPPLICABILITY OF A STATUTE OF LIMITATIONS TO A VOID CONVEYANCE OF HOMESTEAD

A sister sued her brother in equity in 1957 to obtain cancellation of two deeds executed in 1930. The first deed, which was executed jointly by the parents, conveyed homestead property held singularly by the father to the brother. The second deed was a reconveyance of the homestead by the brother to the parents to create an estate by the entirety. Both conveyances were without consideration. The brother contended that his sister's action was barred by section 95.23 of the Florida Statutes,[1] since the deed reconveying the homestead to the parents had been of record without adverse claim for more than twenty years. However, the trial court held the conveyance void as an ineffective attempt to alienate homestead property without consideration and allowed the sister's action.[2] On rehearing,[3] the Florida Supreme Court *held*, affirmed: section 95.23 is not applicable to a void deed or to a deed transferring homestead property in violation of the constitutional provisions[4] regu-

27. L.O. 1118, II-2 CUM. BULL. 148 (1923): "On account of the clear purpose of Congress in enacting the charitable contributions section and the express language used permitting a taxpayer to deduct charitable gifts . . . , it is not considered that Congress intended to tax indirectly any unrealized appreciation in the value of property given to charitable organizations . . . ."

28. Kaltreider v. Comm'r, 255 F.2d 833 (3d Cir. 1958) (subdivision case); Pennroad Corp. v. Comm'r, 228 F.2d 329 (3d Cir. 1958) (sales of land acquired in 1828); Simonsen Indus., Inc. v. Comm'r, 243 F.2d 407 (7th Cir. 1957) (sales of purchased war surplus wire); Charlie Hilliard, 31 T.C. 961 (1959) (sale of cars used in car rental business); Rev. Rul. 58-77, 1958-1 CUM. BULL. 118 (deposits retained on containers used by manufacturer in shipping its products and not returned by customers).

1. FLA. STAT. § 95.23 (1961) provides:

Limitations where deed or will of record for twenty years or more.—After the lapse of twenty years from the record of any deed or the probate of any will purporting to convey lands no person shall assert any claims to such lands as against the claimants under such deed or will, or their successors in title.

After the lapse of twenty years all such deeds or wills shall be deemed valid and effectual for conveying the lands therein described, as against all persons who have not asserted by competent record title an adverse claim.

2. The decision of the trial court was affirmed by the Second District Court of Appeal. Reed v. Fain, 122 So.2d 322 (Fla. 2d Dist. 1960).

3. In its original adjudication of the *Reed* case, the supreme court reversed the decision of the district court, but on rehearing the decision of the district court was affirmed.

4. FLA. CONST. art. X, §§ 1, 2, 4.