5-4-2015

The Agency Exception to the Anticipatory Assignment Doctrine

Jeffrey H. Kahn
Florida State University College of Law

Douglas A. Kahn
University of Michigan Law School

The Agency Exception to the Anticipatory Assignment Doctrine

By Douglas A. Kahn and Jeffrey H. Kahn

Douglas A. Kahn

Jeffrey H. Kahn

Douglas A. Kahn is the Paul G. Kauper Professor of Law at the University of Michigan, and Jeffrey H. Kahn is the Harry W. Walborsky Professor of Law at Florida State University.

In this article, the authors discuss the agency exception to the anticipatory assignment of income doctrine and explain the policy justification for the exception.

One consequence of having graduated income tax rates is that it becomes advantageous to shift income from a high-bracket taxpayer to a person in a lower tax bracket. Taxpayers have tried several different vehicles to shift the incidence of the income tax to another person, and the courts and Congress have adopted rules to prevent that from occurring.[1]

As early as 1930, the Supreme Court adopted the anticipatory assignment of income doctrine to prevent a person who anticipates earning income from his services from shifting that income to another person in a lower tax bracket. In the landmark case of *Lucas v. Earl*,[2] a lawyer executed a contract with his wife making one-half of all the income earned by either spouse the property of the other spouse. The Supreme Court held that the contract was ineffective for changing the incidence of the tax on the income that the lawyer earned from providing his services to clients.[3] The Court held that an anticipatory assignment of the right to income does not prevent that income from being taxed to the person whose services generated it. Income is taxed to the person whose services produced it rather than to the person who has the beneficial right to possess the income once it is earned. The Court applied this doctrine in the *Earl* case notwithstanding that, in executing the contract, the spouses clearly were not motivated by federal income tax considerations.[4] While the *Earl* case involved income earned from performing services, the same doctrine has been applied to prevent the anticipatory assignment of income from property that the assignor retains, regardless of whether the income was earned before or after the assignment was made.[5] Efforts to use a family partnership or an S corporation to split income earned from services among family members have been rebuffed by statutory restrictions.[6]

What then is the treatment of an employee whose services create income for his employer? For example, Hilda is an associate of the Milborne law firm. She obtains a client because of family connections to him. She performs all the legal work for the client who pays a fee of $350,000 to the law firm. Clearly, Hilda is not taxed on that fee even though it was her services and her relationship to the client that earned the income.[7] Instead, the fee is taxed to the Milborne law firm. Why did the anticipatory assignment of income not apply to cause her to be taxed on the income produced by her services?

[1]In some circumstances, Congress has allowed the shifting of income to another. For example, when alimony is payable to a divorced spouse, the code expressly allows income shifting. *See* sections 71 and 215. But in most circumstances, Congress seeks to prevent it.

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

[3]*But see Poe v. Seaborn*, 282 U.S. 101 (1930), allowing income of a married couple to be split when the division was the product of a state's community property laws. *Earl* arose long before the special treatment of the joint income of spouses was added to the tax law.

[4]The spouses executed the contract in 1901, when no federal income tax existed. Indeed, a federal income tax was not enacted until 1913 shortly after the adoption of the 16th Amendment to the Constitution.

[5]*See Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Eubank*, 311 U.S. 122 (1940).

[6]Sections 704(e) and 1366(e).

[7]Reg. section 1.61-2(c). *See also* Rev. Rul. 58-515, 1958-2 C.B. 28; O.D. 119, 1 C.B. 82 (1919).

Treating the fee as income of Hilda's employer is sometimes referred to as the agency exception to the anticipatory assignment doctrine.[8] There is no indication that the IRS has ever attempted to tax an agent in that circumstance. Indeed, the exclusion from an agent's income of amounts received for services performed for clients was acknowledged before the Supreme Court's decision in *Lucas v. Earl*.[9]

The anticipatory assignment doctrine can arise in connection with an assignment to a qualified charity, and the agency exception operates there as well. For example, Patricia, a prominent actress, wished to make a gift to the Beth El Temple, a qualified charity. She was offered a position to perform on a television production for a fee of $250,000. She required as a condition to her accepting the position that the fee be paid to the Beth El Temple, and the producer did so. Because Patricia's services were the source of the payment, Patricia must include it in her income under the anticipatory assignment doctrine.[10]

Let us change the facts of that illustration. The Beth El Temple decided to produce a television show and asked Patricia to perform in the production. While her usual fee is $250,000, she agreed to perform for no compensation. The tax law does not treat that transaction as a constructive payment to her, and so she will report no income from the transaction.[11]

Take another example. Roger volunteered to serve as the supervisory attorney for students engaged in a clinical course at the Piedmont Law School. In that capacity, Roger worked on a legal issue for a client of the clinic's, and the client paid him a fee for his services and for the services of the law students who worked with him on the matter. Under his arrangement with the law school, Roger turned the fee over to Piedmont. Because Roger and the law students were serving as agents of the law school in earning the fee, the fee is not taxable to him or to the students, but rather is the income of the law school.[12] If Roger and the students had not qualified as agents of the law school, the fee would have been taxable to them under the anticipatory assignment doctrine.

The IRS and the courts have placed a heavy burden on a taxpayer to prove that he was acting as the agent of a charity; therefore, strong evidence of an agency relationship will be required.[13] The question whether an agency relationship exists frequently arises in the context of a member of a religious organization who has taken a vow of poverty and turns over any fees he earns to the religious organization. If the fees were for services provided to an unrelated entity, the fees would be taxable to the member unless it can be shown that the religious organization itself was engaged to provide the services so that the member was acting on its behalf.[14]

While the existence of an agency exception is indisputable, there has been no explanation of why it exists and what tax principle justifies it. Without knowledge of the justification for the exception, it is difficult to understand why it is not applied more broadly. For example, why was the husband in *Lucas v. Earl* not acting as an agent of his wife and why is the priest who made a vow of poverty not an agent of his order when he performs services for an unrelated entity? The answer is found by determining the principle on which the agency exception is grounded.

To determine that underlying principle, it is necessary first to consider the operation of a different doctrine: the anticipation of income doctrine. This doctrine possesses some of the same elements as the anticipatory assignment doctrine and shares a somewhat similar designation. Unfortunately, the courts sometimes conflate the two doctrines and cite cases dealing with one of the doctrines in a case involving the other. However, the two doctrines do operate together in one important respect. Before considering that interaction, let us examine the anticipation of income doctrine and distinguish it from the anticipatory assignment doctrine.

An anticipatory assignment is a transfer of the right to future income for which no consideration is received in exchange. An anticipation of income is a transfer of the right to future income in exchange for which consideration is received. A transaction

[8] *See* the dissenting opinion of Judge James Halpern in *Schneer v. Commissioner*, 97 T.C. 643 (1981).

[9] O.D. 119, 1 C.B. 82 (1919). *See also Maryland Casualty Co. v. United States*, 251 U.S. 342 (1920).

[10] Reg. section 1.61-2(c). Patricia will be allowed to claim a deduction for the amount paid to the temple as a contribution to a qualified charity subject to the limitations on deductibility under section 170.

[11] Reg. section 1.61-2(c).

[12] Rev. Rul. 74-581, 1974-2 C.B. 25. Of course, the law school likely is a tax-exempt entity.

[13] *See, e.g.*, *Schuster v. Commissioner*, 800 F.2d 672 (7th Cir. 1986); Rev. Rul. 77-290, 1977-2 C.B. 26. *See also* Douglas A. Kahn and Jeffrey H. Kahn, *Federal Income Tax*, para. 14.2380 (2011).

[14] Rev. Rul. 77-290, 1977-2 C.B. 26; *McEneany v. Commissioner*, T.C. Memo. 1986-413.

can be part anticipatory assignment and part anticipation of income if consideration that is received is less than the value of the income interest that was transferred.

One consequence of an anticipation of income transaction is that the consideration that the transferor receives is treated as ordinary income.[15] A second consequence is that when the future income that was the subject of the transfer is recognized, it will be income to the transferee, who purchased it, and not to the transferor.[16] Because the transferor sold the right to that income in an arm's-length transaction, he will not be taxed on its subsequent recognition.

For example, in year 1, Paula was the income beneficiary of a trust, which provides that she is to receive the income from the trust for 20 years. In year 1, Paula needed a large amount of cash, and so she sold to Mark, an unrelated party, the right to income from the trust for the next five years. The amount that Mark paid Paula was equal to the present value of the right to the trust's income for the next five years. The amount that Paula received from Mark is ordinary income to her in year 1. The trust income that is payable to Mark in each of the five years is included in Mark's taxable income and not in Paula's. Mark can amortize his cost over the five-year period. Because Paula sold her right to the five years of income, the anticipatory assignment doctrine does not cause her to be taxed on that income when it is earned. In other words, the application of the anticipation of income doctrine negates the application of the anticipatory assignment doctrine to that transaction.

The same treatment should apply to the sale of the right to income from services when the sale is made at arm's length. The amount realized will be treated as ordinary income in the year of receipt, and the subsequent income produced by the seller and purchased by the buyer will be taxable to the buyer and not to the seller. The seller received the present value of the income stream that he anticipates producing, and so is not taxed again when that income is earned.

That treatment explains the justification for the agency exception. The principal purchased the right to use the services of the agent to produce income for the principal. Any amount paid to the agent by the principal for the right to use the agent's services (that is, wages) is ordinary income to the agent in the year received or accrued. Any income earned from the agent's services is included in the principal's taxable income. The principal can deduct whatever it paid to the agent to purchase the use of his services.

Concededly, the anticipation of income doctrine is not expressly applicable to the case of hiring an agent. However, the circumstances are similar to those to which the doctrine does apply, and the principles underlying that doctrine apply with equal force to the circumstances of the agency relationship.

How does this help distinguish those circumstances when persons who took a vow of poverty are not taxed on the income they produced from those that are taxed? If the principal uses the agent to perform services for a business or activity conducted by the principal, it is using the services whose use it purchased. Consequently, the income produced by the agent is not taxable to the agent. But if the agent performs services that are not under a service that the principal is required to provide to that entity, the agent is merely assigning the income he earns to his religious organization and is not acting as their agent. In other words, the services performed by the agent are not services the use of which had been purchased by the principal.

In most of the cases involving a member of a religious organization who took a vow of poverty, the religious organization pays a stipend to the member, and so the situation is similar to that of an ordinary employee. What if, instead, someone chooses to volunteer to act as an agent for an organization without receiving any compensation? Can the organization be deemed to have "purchased" the right to the services of that volunteer? If the volunteer donates his services to an organization in which the volunteer owns no interest and has no personal relationship, the organization can be seen as having constructively purchased the volunteer's services and having received a constructive gift of an amount equal to the value of those services. If there is a personal relationship between the volunteer and the purported principal (such as the relationship between a husband and a wife, a parent and a child, or a corporation and a shareholder), there is reason to doubt that there is a true agency relationship, and not just a facade that disguises an anticipatory assignment. While there could be situations in which a true agency relationship is intended, those would be rare, and the difficulty in establishing their existence warrants

[15]*E.g.*, *Hort v. Commissioner*, 313 U.S. 28 (1941); *Commissioner v. P.G. Lake Inc.*, 356 U.S. 260 (1958).

[16]*Estate of Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973). The transferee can amortize the amount paid for the right to the income to offset some of its receipt.

adopting a bright-line rule rejecting it.[17] Moreover, in personal relationship situations, such as in *Lucas v. Earl*, the taxpayer typically does not act in connection with the business of his purported principal, and so the agency exception is inapplicable.

Conclusion

The justification for the agency exception to the anticipatory assignment rule lies in the treatment of income earned after the right to it was sold to another person. While the anticipation of income doctrine is not explicitly applicable to an agency relationship, the circumstances are sufficiently similar that the principles underlying the doctrine should be applied to the latter relationship. The agent who has sold to his principal the right to use the agent's services to produce income should not be taxed on the subsequent production of that income. The agent's sale of the right to his services negates an application of the anticipatory assignment of income doctrine.

---

[17] An example of such a bright-line rule is the provision in section 102(c) barring gift treatment for a transfer from an employer to an employee.