

Nonqualified Settlement Ruling Spurs Damage Structures

By Robert W. Wood

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Four years ago, I wrote that nonqualified structured settlements — that is, legal settlements in nonphysical injury or sickness cases — could be structured so plaintiffs could be paid — and taxed — over a number of years.¹ I also wrote that this stepchild of the structured settlement industry (an industry that is primarily focused on qualified assignments and personal physical injury structures) could potentially blossom into a huge industry of its own, providing tax savings, tax deferral, and wealth preservation for litigants.

At the least, my timing was off. Although there has been some growth, it has not been exponential. One problem may have been the situs of the assignment companies that are key participants in nonqualified structured settlements, since those assignment companies are usually non-U.S. corporations.² That fact may scare away some plaintiffs. However, I believe the absence of unequivocal tax authority confirming the staged taxation coinciding with staged payments has had a more

pronounced chilling effect. With the release of a recent private letter ruling,³ I think that will change.

Flexibility and Mechanics

The underlying litigation may involve claims for racial discrimination, age discrimination, sexual harassment (without any observable physical injury or physical sickness), wrongful termination, or violations of the Americans with Disabilities Act or ERISA. Alternatively, the litigation may arise entirely outside the employment arena, involving a contract dispute, defamation, invasion of privacy, negligent or intentional infliction of emotional distress, etc. The types of litigation suitable for the techniques explored in the letter ruling are numerous.

The mechanics are also straightforward. The plaintiff wants to receive periodic payments over time, but does not want to rely on the defendant (someone with whom the plaintiff has been litigating) to honor a commitment to make each payment when due. Moreover, the defendant is often anxious to make a lump sum payment, and to have no further dealings with the plaintiff after the settlement.

Consequently, the plaintiff is asked to consent to the defendant assigning its payment obligation to a third-party assignment company, which will thereafter become the sole obligor to the plaintiff. The assignment company then has the opportunity to purchase an annuity from a life insurance company to fund the periodic payments to the plaintiff. The annuity will name the plaintiff as beneficiary but not as owner. All documents will be clear that the plaintiff cannot accelerate, delay, assign, pledge, or otherwise alienate any right to any portion of the payments.

The defendant will make a single payment to settle the case, but the settlement agreement will specify that the defendant will not pay the plaintiff, but instead will pay the third-party assignment company. The assignment company receives the cash in exchange for its commitment to make every periodic payment to the plaintiff. In virtually every case, this third-party assignment company will be a separate-purpose affiliate of a major U.S. life insurance company engaged in writing annuities.

The assignment company will use the cash it receives from the defendant to buy an annuity issued by the assignment company's parent life insurance company. Thereafter, the annuity payments will track the periodic payments to the plaintiff that are required by the terms of the settlement agreement.

The defendant has paid all cash to settle the legal dispute. Yet, the plaintiff arguably has income only on the

¹See Robert W. Wood, "Structured Settlements in Non-Physical-Injury Cases: Tax Risks?" *Tax Notes*, Aug. 2, 2004, p. 511, *Doc 2004-15135*, or *2005 TNT 142-59*. See also Wood, "Structured Settlements and Nonqualified Assignments," *The Tax Adviser* (Jan. 2005), p. 26.

²Without the tax benefit of a section 130 qualified assignment, non-U.S. assignment companies are used so that the assignment company will not have to pay U.S. tax on its receipt of the defendant's money with which the assignment company then buys the annuity.

³The ruling is as yet unnumbered, and is referred to in this article as the letter ruling. An advance copy is available at *Doc 2008-15237* or *2008 TNT 134-9*.

periodic payments when actually received. I say arguably because until now, it has not been crystal clear whether the plaintiff in those cases recognized gross income for federal income tax purposes in the year in which the settlement agreement was signed (a devastating tax result), or when he actually received the periodic payments spread over multiple tax years. Some tax lawyers (including me) had argued that the periodic payments were likely to be income to the plaintiff only on receipt, but there was no authority squarely and unequivocally on point.

New Day

That is, until now. While letter rulings do not technically constitute authority other taxpayers can rely on, we all know that we frequently place a kind of informal reliance on them.⁴ Thus, the issuance of a letter ruling in this area is very important.

The letter ruling involves a relatively simple fact pattern that should be familiar to anyone involved in the structured settlement business. Unlike a qualified assignment, in which the damages will be tax free under section 104 of the code (with an assignment that is thus qualified under section 130), the case considered in the letter ruling involved *taxable* damages. The plaintiff was an employee who sued her employer for being subjected to hostile employment practices.

The plaintiff made claims for wages as well as for nonwage injuries. Significantly, however, there was no claim for physical injury or physical sickness damages that could have been excludable under section 104. Consequently, the sole allocation question on the settlement proceeds was between wage and nonwage damages.

The plaintiff and the employer agreed to settle her claims for a monetary settlement in two forms. First was a cash payment of wages, subject to customary withholding. The remainder of the settlement payment (of the nonwage damages) was to be paid to the taxpayer according to a schedule of periodic payments.

The settlement agreement specified that the taxpayer could not change the timing or the amount of these periodic payments (no acceleration, no deferral, no increase, no decrease, etc.). Likewise, the taxpayer agreed that she could not sell, mortgage, encumber, or anticipate all or any portion of the periodic payments she was destined to receive.

Following standard protocol for the documentation of nonqualified cases, the settlement agreement reserved to the employer the right to enter into a nonqualified assignment, under which an assignment company (as assignee) would actually make the periodic payments directly to the taxpayer. Thus, the employer would obligate itself to make periodic payments, but under a prearranged plan would pay the assignment company to assume its periodic payment obligations. On the assignment company's acceptance of the nonqualified assign-

ment, the assignment company would become the sole obligor with respect to all periodic payments to be made to the plaintiff.

The assignment company's obligation to make those periodic payments was no greater than that of the employer. Notably, however, the assignment company's obligation to make the periodic payments would continue unabated, even if the employer later went bankrupt or became insolvent. The nonqualified assignment is an irrevocable contract requiring the assignee to make the periodic payments to the taxpayer. Under no circumstances can the taxpayer elect to receive the commuted value of the periodic payments.

Again, the nonqualified assignment prohibits changes to the timing or amount of the periodic payments, and prohibits the taxpayer from accelerating, deferring, increasing, or decreasing the scheduled periodic payments. Also, the taxpayer may not sell, assign, encumber, or anticipate any portion of the payments by assignment.

As for the taxpayer's rights against the assignment company, the nonqualified assignment specifies that the taxpayer's rights are limited to those of an unsecured general creditor. All rights of ownership for any annuity contract purchased by the assignment company belong exclusively to the assignment company, not to the plaintiff. The taxpayer is not a third-party beneficiary of that annuity contract. The nonqualified assignment document even states that no assets have been set aside to secure the periodic payments.

Reasoning of Ruling

The IRS does a creditable job of addressing the issues raised by this fact pattern. The Service starts with a discussion of section 451, noting that it requires an item to be included in the taxpayer's gross income when it is received by the taxpayer, unless the taxpayer has another method of accounting that will include it in income before receipt. Examining the regulations under section 451 as well as various revenue rulings and cases, the Service focuses on the point in time at which income may not yet be reduced to a taxpayer's possession, but is constructively received because it is credited to his account, set apart for him, or otherwise made available to him.

Thus, first and foremost, the Service views this fact pattern as raising issues about constructive receipt. In framing the issue, the Service cites some situations in which constructive receipt has been triggered and some situations in which there is no constructive receipt. For example, the Service notes that in *Williams v. United States*,⁵ a seller was held to be in constructive receipt of sales proceeds when the buyer agreed to pay the full purchase price, but the seller added self-imposed limitations on the payments in an escrow. Such self-imposed limits did not prevent constructive receipt.

In contrast, the Service cites Rev. Rul. 2003-115,⁶ dealing with the September 11 Victims Compensation Fund, as illustrative of the other end of the spectrum. The

⁴Indeed, even the U.S. Supreme Court has cited letter rulings. See *Rowan Cos., Inc. v. United States*, 452 U.S. 247 (1981).

⁵219 F.2d 523 (5th Cir. 1955).

⁶2003-2 C.B. 1052, *Doc 2003-23359, 2003 TNT 209-15*.

Service there allowed claimants to irrevocably elect to receive their payments over time (and the parties made qualified assignments under section 130).⁷ The Service reasoned that the claimants' control of the receipt of payment was subject to substantial restrictions because they had to sign releases to get the money. Among other cases and rulings cited in the letter ruling are Rev. Rul. 66-45,⁸ Rev. Rul. 67-203,⁹ and *Commissioner v. Brooklyn Gas Co.*¹⁰

In one of the most telling discussions in the letter ruling, the Service describes and cites *Childs v. Commissioner*.¹¹ The *Childs* case is still the seminal (and only) case upholding the tax treatment of structured attorney fees.¹² Axiomatically, a structured attorney fee also involves a nonqualified assignment, since the attorney is receiving legal fees (either in a lump sum or via periodic payments) that are certainly not excludable under section 104.

Thus, the same documentation that was present under the facts in the letter ruling is present in an attorney fee structure such as the one considered in *Childs*. The *Childs* court (famously) held there to be no constructive receipt.¹³

Cash Equivalency

The cash equivalency doctrine holds that a cash-basis taxpayer may be treated as receiving income for tax purposes when the taxpayer receives a promise or other contractual obligation that the taxpayer can readily convert into cash.¹⁴ The doctrine of cash equivalency is used far less frequently than its economic benefit and constructive receipt cousins, yet it should always be discussed in this context. On the facts of the letter ruling, the question was whether the assignment company's promise to pay was unconditional, readily convertible into cash, and the type of obligation that is frequently discounted or factored.

The answer was no. Indeed, under the facts of the letter ruling, the plaintiffs' rights cannot be assigned, sold, transferred, pledged, or encumbered, making any application of the cash equivalency doctrine improbable.¹⁵ The nonqualified assignment documents actually

made void any attempt to sell, transfer, or assign any portion of (or rights to) the periodic payments.

Drawing a contrast between the facts in *Cowden* and the facts before it in the letter ruling, the IRS made clear that the taxpayer/plaintiff in the letter ruling would not be able to assign, encumber, or otherwise transfer her right to receive periodic payments. Although the IRS acknowledged that the documents contemplated an annuity contract to fund the assignment company's obligation to pay the periodic payments, the taxpayer will have no rights in the annuity contract. Thus, the Service found, the plaintiff will continue to possess only an unsecured (and unfunded) promise to pay.

Constructive Receipt

Of course, cash equivalency is not the only game in town. Constructive receipt concerns can arise in the structured settlement arena in several different circumstances. Most commonly, the specter of constructive receipt may be raised when several different options for a settlement are discussed. Yet, merely discussing and considering different payment options does not trigger constructive receipt. As long as the plaintiff has not signed a settlement agreement, discussions can continue about myriad payment options without fear of constructive receipt.

Most individuals are cash-basis taxpayers, so their income is generally taxed when it is actually or constructively received.¹⁶ At its root, the constructive receipt doctrine prohibits a taxpayer from deliberately turning his back on income, thereby attempting to select the year in which he is taxed. But a taxpayer is free to condition his relinquishment of legal rights on his receipt of payment however he chooses to demand it, and constructive receipt does not enter into the equation.

To that end, income is considered constructively received by a taxpayer when it is set aside, may be drawn on, or is otherwise made available to the taxpayer.¹⁷ When a taxpayer has an unrestricted right to receive funds immediately, the taxpayer must recognize those funds as gross income.¹⁸ However, income is not constructively received when the taxpayer's control over its receipt is subject to substantial limitations or restrictions, or, even if the taxpayer has released all conditions and restrictions, when the taxpayer receives only an unsecured promise to pay.¹⁹ This is nothing new.

Under traditional principles, if the assignment of settlement proceeds to an assignment company is not credited to a claimant's account, set apart, or otherwise made available to him so he can draw on the settlement monies at any time, there should be no constructive

⁷The assignments in Rev. Rul. 2003-115 were qualified because the proceeds were excludable under section 104.

⁸1966-1 C.B. 95.

⁹1967-1 C.B. 105.

¹⁰62 F.2d 505 (2d Cir. 1933).

¹¹103 T.C. 634, *Doc 94-10228*, 94 TNT 223-15 (1994), *aff'd without opinion*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-17279*, 96 TNT 115-16.

¹²For further discussion of *Childs*, see Wood, "Structuring Attorneys' Fees: Kingdom of Heaven?" *Tax Notes*, Aug. 1, 2005, p. 539, *Doc 2005-15920*, or *2005 TNT 142-28*; and Wood, "Top 10 Practice Points to Observe With Legal Fee Structures," *BNA Daily Tax Report* (Feb. 14, 2008), p. J-1.

¹³See also *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952) (taxpayer realized an economic benefit in which money was placed in trust for the taxpayer without restricting the taxpayer's right to assign or otherwise dispose of it). See also *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961).

¹⁴See *Cowden*, *id.*

¹⁵See *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983); *Johnston v. Commissioner*, 14 T.C. 560 (1950).

¹⁶Section 451; reg. sections 1.446-1(c)(1)(I), 1.451-1(a), and 1.451-2(a).

¹⁷*Id.*

¹⁸*Martin v. Commissioner*, 96 T.C. 814, 823 (1991); *Williams v. Commissioner*, 219 F.2d 523 (5th Cir. 1955).

¹⁹See reg. section 1.451-2(a); *Ames v. Commissioner*, 112 T.C. 304 (1999); Rev. Rul. 79-313, 1979-2 C.B. 75. See also LTR 8527050 (income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions).

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receipt. The parties involved in structuring these transactions should be careful to ensure that the plaintiffs have no right to demand any payments from the assignment company (which becomes the sole obligor), other than those promised under the terms of the settlement agreement.²⁰

The letter ruling makes a measured recitation of the key elements of constructive receipt, and discusses some constructive receipt authorities. Under the nonqualified assignment described in the letter ruling, the taxpayer has no right to draw on (or otherwise accelerate) her receipt of the periodic payments. The amounts to be paid by the assignment company will come from its general assets, which are subject to the claims of its creditors.

The Service quotes key phrases from the nonqualified assignment, including the rigid rule that:

none of the periodic payments may be accelerated, deferred, increased or decreased and may not be anticipated, sold, assigned or encumbered. Any attempt to do so will be void.

The Service takes considerable pains to recite the various places within the governing documents where these concepts are repeatedly brought home. It is crystal clear that the taxpayer can do nothing to receive the payments any faster (or slower, for that matter) than scheduled. Significantly, the Service expressly states that the assignment company's purchase of an annuity contract to fund its obligations under the nonqualified assignment "does not amount to a setting apart or crediting of funds for the taxpayer's benefit given that she will possess no rights under the annuity contract."

For this proposition, the Service favorably cites the *Childs* case (again). As in *Childs*, the plaintiff considered in the letter ruling has no unilateral right to accelerate, defer, increase, or decrease the amount of payments she will receive from the assignment company. In fact, the plaintiff does not have the right to demand *anything* from the assignment company, other than the promised periodic payments as they become due. The letter ruling is clear that these structures are subject to substantial restrictions and limitations. After all, the annuity will at all times be owned by the assignment company. It is issued in the name of the assignment company, and is fully subject to the claims of the assignment company's general creditors.²¹

In Rev. Rul. 2003-115,²² the IRS considered the assignment of nontaxable periodic payments to an assignment company. Although the periodic payments were qualified settlement payments in that situation, and although the settlement payments were otherwise nontaxable under section 104(a)(2), the IRS analyzed the assignment of the qualified periodic settlement payments to an assign-

ment company in light of the constructive receipt and economic benefit doctrines. Rev. Rul. 2003-115 obviates constructive receipt concerns, as long as the claimants have made irrevocable elections relating to their periodic payments at a time when their control of the receipt of the payments was still subject to substantial limitations or restrictions.

In other words, you must commit to a particular (and thereafter immutable) stream of periodic payments *before* you sign a settlement agreement.

Economic Benefit

The economic benefit doctrine is another part of the IRS playbook, and it certainly merits discussion in the letter ruling. The theory of the economic benefit doctrine may be harder to articulate than its constructive receipt and cash equivalency brethren. It finds income in which a taxpayer is assured of the benefit of future payments, even though those payments will not be made until subsequent tax years.

Perhaps the Service could have tried to argue in the revenue ruling that the stream of payments the assignment company must make to the plaintiff confers an economic benefit on the plaintiff (perhaps the discounted present value of the stream of payments?) at the time of settlement. Yet plainly, there is no economic benefit under the facts of the letter ruling, and the IRS readily and sensibly agrees.

Of course, the plaintiff ultimately winds up with a different obligor (that is, one other than the defendant). Yet, a different obligor hardly spells an economic benefit that could by any stretch of the imagination accelerate the entire stream of periodic payments into the current year. Indeed, for the Service to win an attack based on the economic benefit doctrine, it would have to prove that the amount is funded and secured, and that the plaintiff need only wait for unconditional payments to arrive at a later time.²³

In the letter ruling, as the IRS repeatedly notes, the payments promised to plaintiffs are far from secured or unconditional. They are subject to creditors' claims (in the hands of the assignment company). The economic benefit doctrine is inapplicable, as long as the annuity is purchased by the assignment company, the assignment company is the owner of the annuity, and it is clear that no assignment, pledge, or acceleration by the plaintiff is allowed.²⁴

In Rev. Rul. 72-25,²⁵ no economic benefit was found to have been conveyed when an employer purchased an annuity to fund payments to an employee. The employer (not the employee) was the named beneficiary under the annuity contract. Under *Sproull v. Commissioner*,²⁶ a taxpayer is considered to have received the current economic benefit of future payments when a payor

²⁰See LTR 8435154 (insurance company requested a ruling on the assignability of periodic payments outside the scope of section 130 assignments; IRS ruled that as long as the payments were "unfunded" and "unsecured" and the plaintiff had no right to demand payment from the assignee, there was no constructive receipt).

²¹See reg. section 1.451-1(a) and 2(a).

²²2003-2 C.B. 1052.

²³See *Commissioner v. Smith*, 324 U.S. 177 (1945); *Drysdale v. Commissioner*, 277 F.2d 413 (6th Cir. 1960) *rev'g* 32 T.C. 378 (1959).

²⁴See *Brodie v. Commissioner*, 1 T.C. 275 (1942); *Oberwinder v. Commissioner*, 35 T.C. 429 (1960), *aff'd*, 304 F.2d 16 (8th Cir. 1962).

²⁵1972-1 C.B. 127

²⁶16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

unconditionally and irrevocably establishes a separate trust or fund of assets exclusively for the taxpayer's benefit.²⁷ Could one say that situation was present under the facts in the letter ruling? Hardly.

Against those cases that affirmatively find economic benefit, the Service parsed the language of the nonqualified assignment in the letter ruling. The IRS found nothing suggesting that there was a current economic benefit to this taxpayer. The settling litigant in the ruling will possess only an unsecured promise to be paid. The Service does note that the identity of the promissor will have changed by the time the smoke clears from the assignment transaction and the annuity purchase.

Nevertheless, no amount will be set aside from which to make the scheduled payments, nor will a separate fund be irrevocably and unconditionally created or set aside for the taxpayer's benefit. The annuity, issued by the life insurance company and owned by the assignment company, simply does not do that, though of course, it does informally serve as a source of funds to pay the periodic payments. Significantly, however, it does not cross the line. The taxpayer has no rights against the assignment company other than those of a general creditor.

The Ruling

After its analysis, the Service rules that the taxpayer will not be in actual or constructive receipt of the periodic payments until she actually receives each cash payment. Furthermore, the taxpayer will include each of these periodic payments in her income in the respective tax years in which she actually receives those payments.

Tax practitioners should not be surprised by this letter ruling. It makes perfect sense, it is well reasoned, and it sensibly allows plaintiffs — before they release their legal rights — to agree to a chain of periodic payments that will be taxed exactly as they should be taxed. There is no surprise here.

At the same time, there is relief, both that there is now this nearly unequivocal authority, and that (sensibly and appropriately) the Service has made clear that it sees no abuse here. The fact that I or some other tax lawyer see no abuse is never as comforting as when the IRS reaches that same conclusion.

²⁷*Id.* *Pulsipher v. Commissioner*, 64 T.C. 245 (1975) is to the same effect (*Pulsipher* involved Irish sweepstakes winnings irrevocably deposited with an Irish court for the benefit of a minor sweepstakes winner).

If there is a surprise, it is probably in the extent to which the letter ruling cites, discusses, and relies on *Childs*. To my mind, that too is quite appropriate. Yet, the Service has long been silent about *Childs* and attorneys' fee structures in general. The letter ruling's apparent blessing of the *Childs* case is significant.

Conclusions

Apart from giving attorneys' fee structures a shot in the arm (itself a noteworthy development), I believe the letter ruling will trigger much discussion of periodic payments across a wide variety of litigation types. Indeed, the letter ruling may even be useful authority entirely outside the context of dispute resolution.

Since the assignment company can (and always will) purchase an annuity to make the periodic payments, it is worth noting the almost infinite flexibility plaintiffs have in arranging payment timetables. As in the case of a (qualified) structure in a personal physical injury or sickness case, nonqualified structures can call for level payments over a term of years, level payments over the plaintiff's lifetime, or level payments over joint lifetime with his spouse. Payments can be increasing or decreasing. They may build in greater or smaller payments in years when the plaintiff may expect to have larger or smaller needs (to take into account college education expenses, for example).

Moreover, the schedule of periodic payments may call for no payments at all for a stated number of years after the settlement, allowing enhanced tax-free buildup of funds. The structure can thus serve a kind of retirement income function once the periodic payments commence. In short, there is almost infinite flexibility in designing a periodic payment structure that suits the plaintiff. Of course, once the periodic payment structure is in place, it cannot be changed. That means considerable thought should go into designing the payment structure.

All this rosy news aside, it is appropriate to end on a cautionary note. Thoughtful practitioners should be mindful that:

- the documents are really important;
- form is really important; and
- adding bells and whistles that may step outside of what the Service has just (nicely and fairly and clearly) blessed in this letter ruling is probably a bad idea.

At the very least, be cautious, be respectful, and don't look a gift horse in the mouth.

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