Using Non-Physical Injury Structured Settlements—Any Tax Risks?

by Robert W. Wood *

In today's increasingly litigious society, recoveries for tort actions stemming from physical injuries frequently eclipse seven-figure dollar amounts. Structured settlements are being used to settle tort actions in increasing numbers. Of course, most traditional structured settlement payments involve excludable periodic payments made "on account of personal physical injuries". These traditional structured settlements are frequently paired with Section 130 qualified assignments.

Even so, emerging practice suggests the use of structured settlement payments and non-qualified assignments outside of the physical injury context. It is this important new area that is my focus, but to get there, I want to begin with background.

Recent Section 104 Authority

The Section 104 exclusion was winnowed down considerably with the enactment of the Small Business Job Protection Act of 1996. If I am right that there is growing interest in (and a growing need for) structures *outside* of Section 104 cases, one of the reasons is tautological: Section 104 does not go far enough.

Indeed, in a slew of recent decisions, the Tax Court has time and again found sex discrimination recoveries to not be excludable under Section 104(a)(2).[1]

Although the facts in the underlying cases vary from case to case, the ultimate result (and the underlying rationale) have become almost boilerplate. Courts generally cite *Commissioner v. Schleier*,[2] for the proposition that for a recovery to be excludable under Section 104(a)(2): (i) the underlying cause of action must be based upon tort or tort type rights; and (ii) that the resulting damages must be recovered on account of personal injuries or sickness. For recoveries after August 20, 1996 (the effective date of the Small Business Job Protection Act), the second prong of *Schleier* has been held to require that the personal injuries or sickness be *physical* in nature.[3]

In each of these sex discrimination cases, the Tax Court essentially determines that even if the cause of action was based upon tort or tort type rights, the resulting recovery was not paid on account of personal physical injuries. Accordingly, the recovery is often found not to be excludable from gross income under Section 104(a)(2), because sex discrimination *alone* does not constitute a personal physical injury.

The tax consequence of a racial discrimination recovery is not much different in this respect. For example, in *Oyelola v. Commissioner,*[4] the Tax Court held that a taxpayer was not entitled to exclude a racial discrimination recovery because the taxpayer failed to prove that the recovery was received on account of personal physical injuries or sickness. In *Cates v. Commissioner*,[5] the Tax Court reached a similar conclusion.

Wrongful termination recoveries in recent years have followed a similar path. For example, in *Tamberella v. Commisssioner*,[6] the Tax Court held that an individual may not exclude the proceeds of a wrongful termination recovery under Section 104(a)(2), because the taxpayer failed to show that any portion of the recovery was received on account of personal physical injuries or sickness.

Current Trends in Structured Settlements

One current possibility in the structured settlement arena is for a defendant to fund its obligation to make periodic payments in non-physical injury cases by purchasing an annuity and employing a non-qualified assignment to a third-party obligor. These non-physical injury cases may involve any number of tort claims which do not involve physical injuries, such as claims for racial discrimination, sexual harassment (without any overt and observable physical harm), wrongful termination, or violations of the ADA or ERISA.

One question is whether the plaintiffs in such cases recognize gross income for federal income tax purposes in the year in which the settlement agreement is signed (a *devastating tax result*), or whether they recognize gross income in the years in which the payments are actually received. If a plaintiff utilizes a structured settlement in a non-physical injury case, proper matching and general fairness suggest that the plaintiff should be taxed on the stream of payments only as they are actually received (absent constructive receipt or economic benefit concerns, topics addressed below).

Regrettably, this is an emerging area, and neither the IRS nor the courts have addressed the use of structured settlements in this context. With this as our backdrop, let's examine a brief history of structured settlements and Section 130 qualified assignments.

Background on Structured Settlements

In its purest form, a structured settlement merely calls for periodic payments, payments over time. The use of periodic payments to compensate victims of personal injuries was not widespread until the late 1970s. The idea that a tort victim would receive a stream of payments payable over his or her lifetime (as opposed to a lump-sum) raised a variety of issues, one of which was the appropriate tax treatment for such

a stream of payments.

The future of structured settlements was more certain after the IRS issued several Revenue Rulings establishing the tax treatment of structures. The IRS made clear that the plaintiff would receive all amounts from a periodic payment settlement free from federal income tax. These three Revenue Rulings were later codified in amendments to the Internal Revenue Code enacted by the Periodic Payment Settlement Act of 1982, providing a further impetus for the widespread utilization of structured settlements. These three fundamentally important Revenue Rulings involved different factual situations, but all considered settlement situations that are of continuing interest.[7]

Funding Periodic Payments with Qualified Assignments

Several common types of periodic payments result in favorable tax treatment to the recipient and the payor. Perhaps the most common model involves the purchase of an annuity by a "qualified assignee" of the defendant. If the insurer purchases the annuity and retains its exclusive ownership, the plaintiff in the physical injury action (who was designated to receive the annuity payments) may exclude from gross income the full amount of these payments, not merely their discounted present value.[8] The plaintiff in this situation does not have constructive receipt of the full amount, nor has he received an "economic benefit" resulting in taxation. He has only an unfunded, unsecured promise to pay regularly scheduled payments in the future.

Once a structured settlement is in place, it does not necessarily follow that the *defendant* will make each payment. A "qualified assignment" of the defendant's obligation to make periodic payments is possible, so that the plaintiff thereafter looks to a third party obligor for payment rather than to the defendant.

Under Section 130, if a defendant pays a qualified assignee for assuming its liability to make periodic payments to an injured plaintiff, the amount received will not be taxable to the assignee, except to the extent that it exceeds the aggregate cost of the "qualified funding asset." The basic model of a qualified assignment is that the defendant (or its liability insurer) first gives the plaintiff a promise to pay money in the future. Then, the defendant (or its liability insurer) transfers that obligation to its substituted obligor, who thereafter remains liable on the payment obligations.

For all of this to work properly, a number of technical requirements must be met. A qualified assignment is defined as any assignment of a liability to make periodic payments as damages on account of *physical* injury or sickness if all of the following requirements are met:

> The assignee assumes the liability from a person who was a party to the suit or agreement;
>
> The periodic payments are fixed and determinable as to amount and time of payment;
>
> The periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of the payments;
>
> The assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability;
>
> The periodic payments are excludable from the gross income of the recipient under Section 104(a)(2); and
>
> The amount received by the assignee for assuming a periodic payment obligation must be used to purchase a "qualified funding asset."

A "qualified funding asset" is defined as any annuity contract issued by a company licensed to do business as an insurance company under the laws of any state, or any obligation of the United States, if all of the following conditions are met:

> The annuity contract or obligation must be used by the assignee to fund periodic payments under any qualified assignment;
>
> The periods of the payments under the annuity contract or obligation must be reasonably related to the periodic payments under the qualified assignment, and the amount of any such payment under the contract or obligation must not exceed the periodic payment to which it relates;
>
> The annuity contract or obligation must be designated by the taxpayer as being taken into account under Section 130(d) with respect to the qualified assignment; and
>
> The annuity contract or obligation must be purchased by the taxpayer not more than sixty days before the date of the qualified assignment or not later than sixty days after the date of that assignment.[9]

In determining whether there has been a qualified assignment, any provision in the assignment which grants the recipient rights as a creditor greater than those of a general creditor will be disregarded.[10] Thus, the plaintiff may hold a security interest in the entity or qualified funding asset. This can make qualified assignments more attractive to a settling plaintiff, who may achieve security by virtue of the qualified assignment that would otherwise be prohibited, without risking constructive receipt on the entire stream of periodic payments.

Section 104(a)(2) provides the exclusion for recoveries received on account of physical injuries or sickness, but Section 130 provides for a type of assignment so that payments by a third party payor of the periodic payments will not alter the tax-free nature of the stream of periodic payments.

The Basic Transaction

Now, let's turn *outside* the Section 104 area, but without turning away from structures. Some savvy insurance companies have created an innovative system for discharging settlement

liabilities. The plaintiff is asked to consent to the insurance company assigning its payment obligation to an assignee who will become the sole obligor. The assignee then has the opportunity to purchase an annuity from the assignor insurance company to fund the periodic payments to the plaintiff.

There may be various entrants into what I believe will be a growing field. At least one blueblood insurance company starting to market the nonqualified structure is Allstate, generally a conservative company. It uses NABCO, an assignment company based in Barbados, to affect the transfer. There seems no reason I can discern why this arrangement would not work perfectly, achieving the desired deferral to the plaintiff and the security of payment to the plaintiff.

However, I'm getting ahead of myself. Unfortunately, there does not appear to be any published guidance from the Service (or the courts) discussing structured settlements in non-physical injury cases (let alone, structured settlements, which are paired with non-qualified assignments). Obviously, this can make the tax consequences to the plaintiff uncertain. There is a chance the Service could argue that the total value of the entire stream of payments represents gross income to the plaintiff in the year of settlement. The Service could potentially invoke the constructive receipt, economic benefit, or cash equivalency doctrines. Nonetheless, there are strong arguments that the plaintiff should recognize these periodic payments as gross income *only* when the payments are actually received from the assignee.

<u>Constructive Receipt</u>

Constructive receipt concerns can arise in the structured settlement area in several different circumstances. Most commonly, constructive receipt concerns are raised when several different options for a settlement are discussed.

> ***Example:*** Paula Plaintiff is offered $1 million in settlement of her racial discrimination claim against Atrocious Automobiles, Inc. After some discussion, Atrocious also offers $50,000 in cash per year for the rest of her life. Atrocious even indicates that Paula can have $50,000 per year for ten years, with a lump sum of $200,000 now and an additional $200,000 at the end of ten years. Is Paula in constructive receipt of the $1 million for tax purposes? As long as no legal document releasing her claim is executed calling for the lump sum payment, there should be no constructive receipt on the facts of this example. All that has occurred is bargaining in which the taxpayer has said she does not wish to receive a lump sum settlement. Admittedly, the events which would allow the receipt of the lump-sum settlement—the taxpayer's execution of the release—are within the control of the taxpayer; nevertheless there should be no constructive receipt here.[11]

This common misconception aside, a closer look at the constructive receipt doctrine must begin with acknowledging that most individuals are cash basis taxpayers. Hence, their income is generally taxed when it is actually or constructively received.[12] At its root, the constructive receipt doctrine prohibits a taxpayer from deliberately turning his or her back on income, thereby attempting to select the year in which he or she is taxed.[13]

Income is considered constructively received by a taxpayer when it is set aside, may be drawn upon, or is otherwise made available to the taxpayer.[14] Thus, where a taxpayer has an unrestricted right to receive funds immediately, the taxpayer must recognize the funds as gross income.[15]

Even so, income is not constructively received where the taxpayer's control over its receipt is subject to substantial limitations or restrictions, or when it is a mere unsecured promise to pay.[16] If an insurance company assigns its obligations to pay non-qualified periodic settlement payments to an assignment company, a claimant should not have to recognize gross income for federal income tax purposes until the payments are actually made by the assignment company. Under traditional assignment of income principles, if the assignment of insurance payments to an assignment company is not credited to a claimant's account, set apart for him or otherwise made available so he may draw upon the settlement at any time, there should be no constructive receipt.

Insurance companies involved in structuring these transactions are careful to make sure the plaintiffs have no right or ability to demand any payments from the assignee (who becomes the sole obligor), other than those promised under the terms of the settlement agreement.[17] (where an insurance company requested a ruling on the assignability of periodic payments outside the scope of Section 130 assignments, and the IRS ruled that as long as the payments were "unfunded" and "unsecured" and the plaintiff had no right to demand payments from the assignee, there was no constructive receipt).

The plaintiffs have no unilateral right to accelerate, defer, increase, or decrease the amount of payments from the assignee. In fact, under the structure contemplated by these transactions, the plaintiff does not have the right to demand *anything* from the assignee other than the promised periodic payments as they become due. Again, the Allstate and NABCO documents I've seen do this. I have not reviewed other company's documents, but I would assume any other reputable entrants in this field would do the same.

These structures should be viewed as being subject to substantial restrictions and limitations. After all, the annuity will be owned by the assignee, will be issued in the name of the assignee, and will be fully subject to the claims of the assignee's general creditors. Given these facts, the IRS would not have an easy time arguing that these amounts have somehow been "set aside for" or "otherwise made available to" the plaintiffs.[18]

Of course, as these cases involve taxable damages (not Section 104 damages), these payments always represent income to the plaintiff. However, the plaintiff should not suffer acceleration of his or her income merely

because of the interposition of a new obligor. If any equity remains in our Byzantine federal income tax system, the periodic payments will be taxed to the plaintiff only as they are actually received.

There does not appear to be any authority directly on point which analyzes the constructive receipt doctrine in the context of a structured settlement of a non-physical injury recovery with a non-qualified assignment. In Revenue Ruling 2003-115,[19] the IRS recently considered the assignment of non-taxable periodic payments to an assignment company. Although the periodic payments were qualified settlement payments, pursuant to Section 130(a), and although the settlement payments were otherwise non-taxable, pursuant to Section 104(a)(2), the IRS analyzed the assignment of the qualified periodic settlement payments to an assignment company in light of the constructive receipt and economic benefit doctrines.

Revenue Ruling 2003-115, seems to indicate that there should be no constructive receipt in the context of non-physical injury structures which employ assignments, because the claimants have made irrevocable elections relating to their periodic payments while their control of the receipt of the payments was subject to substantial limitations or restrictions. The reasoning of Revenue Ruling 2003-115 suggests that an assignment company should be able to assume responsibility for making non-qualified (and taxable) settlement payments on behalf of a defendant insurance company if the restrictions in the settlement documents are followed.

Economic Benefit Doctrine

The economic benefit doctrine is another potentially pertinent rule in trying to decipher the tax consequences to the plaintiff in this context. The Service could argue that the stream of payments the assignee would be required to make to the plaintiff confers an economic benefit upon the plaintiff at the time of settlement. If the Service were successful in this contention, the total value of the entire stream of payments would be gross income to the plaintiff in the year of the settlement.

The claimant ultimately has a different obligor (one other than the defendant), but that hardly spells an economic benefit to accelerate the entire stream of periodic payments into the current year for tax purposes. Indeed, for the Service to be successful in an attack based on the economic benefit doctrine, it would have to prove that the amount is funded, secured, and that the plaintiff need only wait for unconditional payments to arrive at a later time.[20] Here, the payments promised to plaintiffs are far from secured or unconditional. Thus, the economic benefit doctrine should be inapplicable, as long as the annuity is purchased by the assignee and if it names the assignee as the payee.[21]

There is some helpful authority. In Revenue Ruling 72-25,[22] no economic benefit was found to have been conveyed where an employer purchased an annuity to fund payments to an employee and the employer (not the employee) was the named beneficiary under the annuity contract.[23] There are strong arguments that the transaction between the assignor insurance company and the assignee should not trigger application of the economic benefit doctrine.

As long as the assignee (and not the plaintiff) will be the owner and beneficiary of the annuity contract, I find it hard to imagine the Service successfully applying the economic benefit doctrine in this context. Once the annuity is purchased, the annuity will remain an asset of the assignee, and will be subject to the claims of the assignee's general creditors. Those facts make it inappropriate for the Service to assert that the plaintiff has an economic benefit in the entire stream of payments in the year of settlement.

Cash Equivalency

The doctrine of cash equivalency is used far less frequently than the economic benefit and constructive receipt doctrines, but it still surfaces from time to time. The Service could attempt to use the cash equivalency doctrine to force the plaintiff to book the entire stream of payments in the year of settlement (rather than booking the payments as received). To prevail on such a theory, the Service would have to prove that the assignee's promise to pay is unconditional, readily convertible into cash, and the type of obligation which is frequently discounted or factored.[24]

Under the terms of these settlements, the plaintiffs' rights generally cannot be assigned, sold, transferred, pledged, or encumbered. Accordingly, a successful application of the cash equivalency doctrine by the IRS seems improbable.[25] Most settlement documents void the entire settlement if the plaintiff attempts to sell, transfer, or assign rights to the settlement payments.

Lack of Guidance

Until we get some guidance from the Service or the courts, taxpayers and their advisors should be careful to avoid the pitfalls of the constructive receipt, economic benefit, or cash equivalency doctrines in this context. Still, I believe structures increasingly make sense in non-Section 104 cases. Plaintiffs can maximize their chances of prevailing in a dispute with the Service by ensuring that the assignee in these transactions is the owner of the funding annuity, and that such owner also be subject to the claims of the assignee's general creditors.

It is also vitally important that the plaintiff has no right to immediately receive payment of the entire stream of payments, nor to accelerate them. The payment stream should ideally be unfunded, thus diminishing the viability of a claim by the Service that property has been set aside for the plaintiff to draw upon. As long as the deferred payment agreements are binding between the parties, and are made prior to the time the plaintiff has acquired an absolute and unconditional right to receive payment, the plaintiff should not have income until the payments are actually received.[26] As always though, taxpayers should proceed with caution and obtain tax advice *before* any settlement is reached.

ENDNOTES

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1. *Nield v. Commissioner*, T.C. Summary Opinion 2002-110; *Oyelola v. Commissioner*, T.C. Summary Opinion 2004-28; *Medina v. Commissioner* T.C. Summary Opinion 2003-148; *Dorroh v. Commissioner*, T.C. Summary Opinion 2003-93; *Montgomery v. Commissioner*, T.C. Memo. 2003-64; *Cates v. Commissioner*, T.C. Summary Opinion 2003-15; *Porter v. Commissioner*, T.C. Summary Opinion 2003-14.

2. 515 U.S. 323 (1995).

3. *Oyelola v. Commissioner*, T.C. Summary Opinion 2004-28; *Venable v. Commissioner*, T.C. Memo. 2003-240; *Shaltz v. Commissioner*, T.C. Memo. 2003-173; *Henderson v. Commissioner*, T.C. Memo. 2003-168; *Prasil v. Commissioner*, T.C. Memo. 2003-100.

4. T.C. Summary Opinion 2004-28.

5. T.C. Summary Opinion 2003-15.

6. T.C. Memo. 2004-47.

7. Revenue Rulings 77-230, 1977-2 C.B. 214, 79-220, 1979-2 C.B. 74, and 79-313, 1979-2 C.B. 75.

8. Rev. Rul. 79-220, 1979-2 C.B. 74.

9. See Section 130(d).

10. Section 130(c).

11. *Veit v. Commissioner*, 8 T.C. 809 (1947), acq., 1947-2 C.B. 4.

12. Sec. 451; Treas. Regs. Secs. 1.446-1(c)(1)(I), 1.451-1(a), 1.451-2(a).

13. Treas. Reg. §1.451-2(a).

14. *Id.*

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

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

17. See Ltr. Rul. 8435154.

18. See Treas. Reg. Secs. 1.451-1(a) and 2(a).

19. 2003-46 I.R.B. 1052.

20. See *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).

21. See *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).

22. 1972-1 C.B. 127.

23. See *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996) (where the Tax Court held that attorneys' fees paid out under a structured settlement were not funded or secured obligations, but mere promises to pay, and therefore only taxable in the year of actual receipt).

24. See *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), *rev'g and remanding,* 32 T.C. 853 (1959), *opinion on remand*, T.C. Memo 1961-229.

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

26. *Oates v. Commissioner*, 18 T.C. 570, 584-85 (1952), *aff'd*. 207 F.2d 711 (7th Cir.1953); *Amend v. Commissioner*, 13 T.C. 178, 185 (1949).