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TAXATION SECTION
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INCOME/OTHER TAXES COMMITTEE[1]

INCOME FROM THE ASSIGNMENT OF NON-QUALIFIED SETTLEMENT PAYMENTS

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[1] The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

[2] Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

It is unclear under current law whether I.R.C.[3] § 451,[4] concerning the timing of income for Federal income tax purposes, allows insurance company claimants to assign their non-qualified structured taxable settlement payments to an assignment company and recognize gross income in the year(s) in which the payments are actually paid by the assignment company, or requires them to recognize gross income in the year in which the settlement agreement contract is signed.

The statutory rule and the regulations thereunder regarding constructive receipt of income do not appear to directly apply to the situation contemplated here. Most analyses, such as IRS rulings and case law, involve deferred compensation in employee/employer relationships where an employer agrees to defer payment of future compensation for an employee. However, we are not aware of any published guidance involving the deferral of non-qualified periodic settlement payments, which have been assigned by an insurance company to an assignment entity.

This paper proposes amending the Treasury Regulations (under I.R.C. § 451) or implementing administrative guidance, as to the income recognition principles which are applicable to these types of structured settlements.

A clarification in the law under I.R.C. § 451 would enable claimants/taxpayers the benefit of knowing when they must recognize gross income for Federal income tax purposes. Fewer private letter ruling requests would be necessary on the timing of gross income when a structured settlement is arranged, and fewer controversies would result if there were improved published guidance.

[3] Unless otherwise specified, all Section references are to the Internal Revenue Code of 1986, as amended.

[4] The general rule stated in I.R.C. § 451 is that any amount of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

DISCUSSION

I. OVERVIEW

Structured settlements are being used to settle litigated and non-litigated disputes in increasing numbers for many economic and tax reasons. Most structured settlement payments involve qualified assignments within the meaning of I.R.C. § 130 (c) and/or involve periodic payments "on account of personal injuries or physical sickness," as defined by I.R.C. § 104(a) (2). However, an alternative to the typical structured settlement arrangement is becoming increasingly common: where an annuity is purchased to fund a settlement outside the personal physical injury context (such as employment discrimination) and the insurance company assigns its obligations to pay non-qualified periodic settlement payments to an assignment company. The question is whether the insurance company's claimants in such case recognize gross income for Federal income tax purposes in the year in which the settlement agreement is signed, or whether the claimants recognize gross income in the year(s) in which the payments are actually paid by the assignment company?

II. LEGAL BASIS FOR CONSTRUCTIVE RECEIPT OF INCOME

The constructive receipt doctrine prohibits taxpayers from deliberately turning their backs upon income, thereby opportunistically selecting the year in which they want to receive (and report) the income. Treas. Reg. § 1.451-2(a) defines when income is constructively received by a taxpayer:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date,

> the mere crediting on the books of the corporation does not constitute receipt.

This general rule does not appear to directly apply to the situation contemplated here. 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 year(s) in which 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, then there should be no constructive receipt of income. However, the regulations (and the case law), only contain analyses applicable to other types of relationships (for example, employee/employer relationships).

We do not believe the regulations under I.R.C. § 451 consider taxpayers who receive periodic settlement payments from an insurance or an assignment company outside the context of an I.R.C. § 130 qualified assignment. Indeed, the regulations under I.R.C. § 451 provide very little guidance regarding the assignment of insurance settlement payments to an assignment company. In fact, the regulations under I.R.C. § 451 have remained virtually unchanged since their enactment in 1957.

Though the Internal Revenue Service ("IRS") is currently reviewing many forms of deferred compensation arrangements, we are not aware whether the arrangement outlined here is being considered, or whether any changes to I.R.C. § 451 (and the regulations thereunder) are currently being considered by any government body or agency.

III. CURRENT LAW & REASON FOR PROPOSED CHANGE

The assignment of non-qualified settlement payments by an insurance company to an assignment company is not a deferred compensation plan in the traditional sense. Nevertheless, an analysis under the constructive receipt doctrine, particularly where it involves deferred payments, is necessary. Most legal authorities on deferred compensation arrangements involve an employee/employer relationship where an employer agrees to defer payment of future compensation for an employee. For example, in a traditional deferred compensation arrangement, before the compensation is earned by the employee, the employer can agree to pay the employee the compensation in the future, and on a deferred basis.

Many courts have supported deferred compensation arrangements where an employee has made an election to defer some form of compensation (such as bonuses, stock, commissions, etc.) before such amounts are either determined or earned (and, of course, where the employee has no right to withdraw, alter, accelerate or increase payment of the income). See *Veit v. Commissioner*, 8 T.C. 809 (1947); *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953); *Robinson v. Commissioner*, 44 T.C. 20 (1965), *Martin v. Commissioner*, 96 T.C. 814 (1991).

An *irrevocable election* by employees to have their compensation deferred before the amounts are determined (or earned) appears to be an important factor in the cases that have supported deferred compensation arrangements. See *Veit v. Commissioner*, *supra; Commissioner v. Oates*, *supra; Martin v. Commissioner*, *supra*. For example, in *Martin*, the Tax Court considered whether constructive receipt of income applied to two employees who elected to defer receipt of income in connection with their participation in a shadow stock plan. The new deferred compensation plan allowed employees to exchange units they held in the employer's old plan for shares in a shadow stock plan.

Under the terms of the new plan, the employees in *Martin* had the option of receiving lump-sum payments, unless they had previously filed an election with the employer to receive installment payments over a 10 year period. The taxpayers had filed elections to receive the 10 year installment payments of their shadow stock units. The court determined that the employees were not in constructive receipt of benefits because they had no unqualified, vested right to receive immediate payment. The benefits, although available, were not yet credited, set apart, or made available so that the employees could draw upon them. Because the shadow stock plan was unfunded, the court found that the employees' rights were similar to those of unsecured creditors, exposed to an element of risk regarding payment. Accordingly, the court entered a decision in favor of the petitioners, ruling that they were not in constructive receipt of shadow stock plan benefits. *Martin v. Commissioner*, 96 T.C. at 825; See also, *Robinson v. Commissioner*, 44 T.C. at 37.

If plaintiffs for whose benefit an annuity is purchased at the time they settle their case make an irrevocable election to have their non-qualified periodic settlement payments paid to them before the amounts become due or ascertainable, these authorities involving deferred compensation suggest that the plaintiffs/claimants would not have constructive receipt of gross income until the year in which the payments were actually made. Likewise, if an insurance company were to assign its obligations to pay the periodic payments to an assignment company, that mere assignment from one obligor to another should not alter the tax result to the claimants (as long as the claimants have no right to withdraw, accelerate, assign or otherwise access their settlement payments earlier than the scheduled dates in the settlement agreement).

Unfortunately, such an arrangement has not been specifically outlined in the regulations or case law. We have found no published authority expressly bearing on an assignment of non-qualified *taxable* periodic settlement payments to an assignment company. However, recently in Rev. Rul. 2003-115,[5] the IRS considered the assignment of non-taxable periodic payments to a domestic assignment company. Although the periodic payments were qualified settlement payments, pursuant to I.R.C. § 130(a), and though the settlement payments were otherwise non-taxable, pursuant to I.R.C. § 104(a)(2), the IRS did analyze the assignment of qualified periodic settlement payments to an assignment company in light of the constructive receipt and economic benefit doctrines.

A qualified assignment, pursuant to I.R.C. § 130(c) means any assignment of liability to make periodic payments as damages (whether by suit or agreement), or as compensation under any workmen's compensation act, on account of personal injury or sickness (in a case involving physical injury or sickness)—

> (1) if the assignee assumes such liability from a person who is a party to the suit or agreement, or the workmen's compensation claim, and
>
> (2) if—
>
> > (a) such periodic payments are fixed and determinable as to amount and time of payment,
> > (b) such periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments,

[5] 2003-46 I.R.B. 1052

> (c) 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, and
> (d) such periodic payments are excludable from the gross income of the recipient under paragraphs (1) or (2) of section 104(a).

The determination of when the recipient is treated as having received any payment with respect to which there has been a qualified assignment shall be made without regard to any provision of such assignment which grants the recipient rights as a creditor greater than those of a general creditor.

In Rev. Rul. 2003-115, the IRS seems to indicate that there should be no constructive receipt because the claimants had made irrevocable elections relating to their periodic payments while the claimants' control of the receipt of the payments was subject to substantial limitations or restrictions. The reasoning of Rev. Rul. 2003-115 suggests that an assignment company should be able to assume responsibility for making non-qualified (and taxable) settlement payments on behalf of the insurance company if the restrictions in the settlement agreements were followed. Rev. Rul. 2003-115.

IV. REGULATORY OR ADMINISTRATIVE SOLUTION

The regulations under I.R.C. § 451 seem to contemplate the timing or inclusion of gross income commensurate with the taxpayer's services. Indeed, the examples in the regulations deal with employee/employer relationships and/or refer to bonus, interest, dividend income. The regulations refer to this income generally (and unhelpfully) as "earnings." Unfortunately, the regulations give very little guidance as to the timing of gross income for reporting periodic settlement payments.

An assignment company should be entitled to assume the responsibility for making non-qualified periodic settlement payments on behalf of an insurance company if restrictions in the settlement agreement are followed. Taxpayers should have published guidance under the constructive receipt theory to determine when to report those settlement payments. Currently, a taxpayer must request a private letter ruling from the IRS to determine whether an insurance company may assign non-qualified periodic settlement payments to an assignment company. Of course, private letter ruling requests are costly and take substantial time for the IRS to issue. The regulatory change would be a simple one. The examples of constructive receipt of income, at Treas. Reg. § 1.451-2(b) could be amended to include the following language:

> Amounts which are payable pursuant to a settlement agreement are generally not constructively received until the taxpayer actually receives payment, even if payments are made periodically, unless the taxpayer has the right to accelerate the payments. If the taxpayer may draw upon the settlement fund, or if the settlement fund is set apart for the taxpayer, such amount will be constructively received and will constitute gross income for the first taxable year during which such settlement payments may be withdrawn by the taxpayer. If the settlement fund is assigned to another entity for payment, but the taxpayer nevertheless may not withdraw, defer, accelerate or assign his rights to receive the periodic payments, there is no constructive receipt of income caused by such assignment.

I.R.C. § 451 is only applicable for determining the timing of gross income for Federal income tax purposes under the constructive receipt doctrine. Thus, the proposed language in the regulations would not include settlement payments made for *non-taxable* damages, such as "on account of personal injuries or physical sickness," as contemplated in I.R.C. § 104(a)(2).

We believe a regulatory change is the best solution. The proposed change to the regulations would obviate the need for taxpayers to make repeated similar ruling requests on the timing of reporting periodic settlement payments. Such a clarification would also give further guidance and structure to a facet of the periodic settlement and structured settlement industries at a time when there is tremendous growth in the use of structured settlements outside the confines of personal physical injury cases where I.R.C. § 130 qualified assignments are possible. The regulatory change, as outlined here, also would eliminate the time and expense the IRS might spend auditing these taxpayers.

An alternative to regulatory change could be the issuance of a revenue ruling by the IRS on this issue. If a revenue ruling were issued by the IRS which outlined when an insurance claimant must report gross income for amounts received from an assignment company pursuant to a settlement arrangement, taxpayers would have published authority to follow in this context. The revenue ruling presumably would outline instances where a claimant must recognize gross income for periodic settlement payments, including examples when the claimant could draw upon the fund or when the claimant could accelerate, defer, or assign his right to such payments. A revenue ruling would likewise achieve a similar result to the regulatory change suggested here.

V. CONCLUSION

The IRS has stated its intention to provide more published guidance to taxpayers so the public can understand the IRS's position as to how particular issues will be interpreted. The regulatory or administrative solutions proposed here would alleviate the IRS's need to address repeated ruling requests by taxpayers who wish to receive their settlement payments periodically, and resolve the uncertainty surrounding the issue.