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Structured Settlements in Non-Physical-Injury Cases: Tax Risks?

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Increasingly, insurance companies are looking to discharge settlement liabilities in non-physical-injury cases, such as claims for racial discrimination, sexual harassment (without any overt and observable physical harm), wrongful termination, or violations of the Americans With Disability Act or ERISA. 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 are various entrants into what I believe will be a growing field. At least one blue-blooded insurance company starting to market nonqualified structures is Allstate, generally a conservative company. It uses NABCO, an assignment company based in Barbados, to effect the transfer. There seems to be no reason I can discern why that arrangement would not work perfectly, achieving the desired deferral to the plaintiff, as well as the security of payment to the plaintiff.

One question is whether the plaintiffs in those 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'll recognize gross income in the years in which the payments are actually received. If a plaintiff uses 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.

Structured Settlements: The Basics

In its purest form, a structured settlement 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 that 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. Those three rulings were later codified in amendments to the Internal Revenue Code enacted by the Periodic Payment Settlement Act of 1982, providing an impetus for the widespread use of structured settlements. Those three fundamentally important rulings involved different factual situations, but all considered settlement situations that are of continuing interest. See Rev. Ruls. 77-230, 1977-2 C.B. 214, 79-220, 1979-2 C.B. 74, and 79-313, 1979-2 C.B. 75.

Qualified Assignments

Several common types of periodic payments result in favorable tax treatment to the recipient and the payer. 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. Rev. Rul. 79-220, 1979-2 C.B. 74. The plaintiff in that 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. The defendant (or its liability insurer) then transfers that obligation to its substituted obligor, who thereafter remains liable on the payment obligations.

For all of that to work properly, several 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 60 days before the date of the qualified assignment or not later than 60 days after the date of that assignment. See section 130(d).

In determining whether there has been a qualified assignment, any provision in the assignment that grants the recipient rights as a creditor greater than those of a general creditor will be disregarded. Section 130(c). Therefore, the plaintiff may hold a security interest in the entity or qualified funding asset. That 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 payer of the periodic payments will not alter the tax-free nature of the stream of periodic payments.

Current Developments in Structured Settlements

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

Economic Benefit Doctrine

The economic benefit doctrine is potentially pertinent in attempting to decipher the tax consequences to the plaintiff in this context. The IRS could argue that the stream of payments the assignee would be required to make to the plaintiff confers an economic benefit on the plaintiff at the time of settlement. If the IRS were successful in that argument, 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 sufficient to accelerate the entire stream of periodic payments into the current year for tax purposes. Indeed, for the IRS to be successful in 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. 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). 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. 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).

While I couldn't locate any guidance directly on point in this area, there is some helpful authority. In Rev. Rul. 72-25, 1972-1 C.B. 127, no economic benefit was found to have been conveyed when 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. See also *Childs v. Commissioner*, 103 T.C. 634, *Doc 94-10228, 94 TNT 223-15* (1994), *aff'd* 89 F.3d 856, *Doc 96-19540, 96 TNT 133-7* (11th Cir. 1996) (Tax Court held that attorney fees paid out under a structured settlement were not funded or secured obligations, but mere promises to pay, and therefore taxable only in the year of actual receipt). 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 IRS successfully applying the economic benefit doctrine in that 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 IRS to assert that the plaintiff has an economic benefit in the entire stream of payments in the year of settlement.

Constructive Receipt

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: Patsy Plaintiff is offered $1 million in settlement of her racial discrimination claim against Creampuff Cars Inc. After some discussion, Creampuff also offers $50,000 in cash per year for the rest of her life. Creampuff even indicates that Patsy can have $50,000 per year for 10 years, with a lump sum of $200,000 now and an additional $200,000 at the end of 10 years. Is Patsy 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 that 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. See *Veit v. Commissioner*, 8 T.C. 809 (1947), *acq.* 1947-2 C.B. 4.

That common misconception aside, a closer look at the constructive receipt doctrine must begin with acknowledging that most individuals are cash-basis taxpayers. Therefore, their income is generally taxed when it is actually or constructively received. Section 451; Treas. reg. sections 1.446-1(c)(1)(I), 1.451-1(a), 1.451-2(a). 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. *Id.*

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. *Id.* Thus, when a taxpayer has an unrestricted right to receive funds immediately, the taxpayer must recognize the funds as gross income. *Martin v. Commissioner*, 96 T.C. 814, 823 (1991); *Williams v. Commissioner*, 219 F.2d 523 (5th Cir. 1955).

Even so, income is not constructively received when the taxpayer's control over its receipt is subject to substantial limitations or restrictions or when it is a mere unsecured promise to pay. See Treas. reg. section 1.451-2(a); *Ames v. Commissioner*, 112 T.C. 304, *Doc 1999-19165, 1999 TNT 104-6* (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). If an insurance company assigns its obligations to pay nonqualified 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 on the settlement at any time, there should be no constructive receipt. Insurance companies involved in structuring those 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. See LTR 8435154 (an insurance company requested a ruling on the assignability of periodic payments outside the scope of section 130 assignments; 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 those 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 companies' documents, but I would assume any other reputable entrants in the field would do the same.

Those structures should be viewed as being subject to substantial restrictions and limitations. After all, the annuity will be owned by the assignee, issued in the name of the assignee, and fully subject to the claims of the assignee's general creditors. Given those facts, the IRS would not have an easy time arguing that those amounts have somehow been ''set aside for'' or ''otherwise made available to'' the plaintiffs. See Treas. reg. sections 1.451-1(a) and 2(a).

Of course, because those cases involve taxable damages (not section 104 damages), those 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 that analyzes the constructive receipt doctrine in the context of a structured settlement of a non-physical-injury recovery with a nonqualified assignment. In Rev. Rul. 2003-115, 2003-46 IRB 1052, *Doc 2003-23359, 2003 TNT 209-15*, the IRS recently considered the assignment of nontaxable 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 nontaxable, 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.

Rev. Rul. 2003-115 seems to indicate that there should be no constructive receipt in the context of non-physical-injury structures that employ assignments, because the claimants have made irrevocable elections regarding their periodic payments while their 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 nonqualified (and taxable) settlement payments on behalf of a defendant insurance company if the requisite restrictions in the settlement documents are followed.

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 IRS 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 that theory, the IRS would have to prove that the assignee's promise to pay is unconditional, readily convertible into cash, and the type of obligation that is frequently discounted or factored. See *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), *rev'g and rem'g* 32 T.C. 853 (1959), *opinion on remand* T.C. Memo 1961-229.

Under the terms of those 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. See *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983); *Johnston v. Commissioner*, 14 T.C. 560 (1950). Most settlement documents void the entire settlement if the plaintiff attempts to sell, transfer, or assign rights to the settlement payments.

Guidance Is Needed

Until we get some guidance from the IRS or the courts, taxpayers and their advisers 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 IRS by ensuring that the assignee in those transactions is the owner of the funding annuity, and that the owner also be subject to the claims of the assignee's general creditors.

It is also vitally important that the plaintiff have no right to immediately receive payment of the entire stream of payments, or the right to accelerate them. The payment stream should ideally be unfunded, therefore diminishing the viability of a claim by the IRS that property has been set aside for the plaintiff to draw on. As long as the deferred payment agreements are binding between the parties and are made before the plaintiff has acquired an absolute and unconditional right to receive payment, the plaintiff should not have income until the payments are actually received. *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). As always though, taxpayers should proceed with caution and obtain tax advice *before* any settlement is reached.