Structured Settlements and Nonqualified Assignments

Structured settlements and assignments are commonly used in physical injury cases when the recoveries are excludible from income, but can also be very helpful in nonphysical injury suits. This article describes how such arrangements work and focuses on the ramifications of their use with nonphysical injury recoveries.

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Executive Summary

- **Structured settlements and qualified assignments, in widespread use in physical injury cases, facilitate settlement of recoveries excludible from gross income under Secs. 104(a)(2) and 130.**
- **In nonphysical injury cases, structured settlements, paired with nonqualified assignments, may provide plaintiffs with payment security and tax deferral resulting from periodic payments.**
- **Plaintiffs may be able to defer income recognition from nonphysical injury recoveries to when the payments are actually received.**

In today's increasingly litigious society, recoveries for tort actions stemming from physical injuries frequently eclipse seven figures. Structured settlements are being used in such tort actions in increasing numbers. Of course, most traditional structured settlements involve excludible periodic payments made "on account of personal physical injuries." These traditional settlements are frequently paired with Sec. 130 qualified assignments. However, similar settlements may be used with nonqualified assignments in nonphysical injury cases.

This article discusses the basic characteristics of structured settlements and assignments and focuses on how the emerging use of structured settlement payments, in conjunction with nonqualified assignments outside of the physical injury context, affects a plaintiff’s income recognition.

Recent Sec. 104 Cases

Sec. 104(a)(2) provides an exclusion for physical injury recoveries; Sec. 130 provides for qualified assignments of the payment obligation. However, the Sec. 104 exclusion was narrowed considerably by the enactment of the Small Business Job Protection Act of 1996 (SBJPA). Thus, one of the reasons for a growing interest in (and a growing need for) structures outside of Sec. 104 cases is that Sec. 104 does not go far enough.

Indeed, in a slew of recent decisions, the Tax Court has continually held sex discrimination recoveries not excludible under Sec. 104(a)(2).[1] Although the facts vary, the ultimate result (and the underlying rationale) has become almost boilerplate. Courts generally cite *Schleier*[2] for the proposition that, for a recovery to be excludible under Sec. 104(a)(2), the (1) underlying cause of action must be based on tort or tort-type rights; and (2) resulting damages must be recovered on account of personal injuries or sickness. For recoveries after Aug. 20, 1996 (the SBJPA’s effective date), the second prong of *Schleier* requires that the personal injuries or sickness be physical in nature.[3]

In each of these sex discrimination cases, the Tax Court essentially determined that, even if the cause of action was based on tort or tort-type rights, the resulting recovery was not paid on account of personal physical injuries. Accordingly, the recovery was often not excludible from gross income under Sec. 104(a)(2), because sex discrimination alone does not constitute a personal physical injury.

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

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

Structured Settlements

In its purest form, a structured settlement merely calls for periodic payments—payments over time. The use of such 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 life (as opposed to a lump sum) raised a variety of issues, including the appropriate tax treatment of such a payment stream.

The future of structured settlements became more certain after the IRS issued three revenue rulings establishing their tax treatment.[7] The Service clarified that the plaintiff would receive all amounts from a periodic payment settlement free from Federal income tax. These rulings were later codified in amendments to the Code enacted by the Periodic Payment Settlement Act of 1982, providing further impetus for the widespread use of structured settlements. These three fundamentally important rulings involved different facts, but all considered settlement situations of continuing interest.

Qualified Assignments

Having a structured settlement in place does not necessarily mean that the defendant will make each payment. Under a "qualified assignment," for example, the defendant's obligation to make periodic payments is assigned, so that the plaintiff thereafter looks to a third-party obligor for payment, rather than to the defendant. In perhaps the most common model, the defendant's "qualified assignee" purchases an annuity.

If the insurer purchases the annuity and retains exclusive ownership, the plaintiff in a *physical injury* action (who was designated to receive the annuity payments) may fully exclude these payments from gross income, not merely their discounted present value.[8] Further, the plaintiff does not have constructive receipt of the full amount, nor has he or she received an "economic benefit" resulting in taxation. The plaintiff has only an unfunded, unsecured promise to receive regularly scheduled payments in the future.

Qualified assignments (like other types of periodic payments) may result in favorable tax treatment not only to the plaintiff, but also the payer. Basically, 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. If a defendant pays a qualified assignee for assuming its liability, the amount received will not be taxable to the assignee, except to the extent it exceeds the aggregate cost of the "qualified funding asset." Payments by the third-party payer of the periodic payments will not alter the tax-free nature of the stream of periodic payments.

To work properly, a number of technical requirements must be met. Under Sec. 130, a qualified assignment is 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:

1. The assignee assumes the liability from a person who was a party to the suit or agreement;

2. The periodic payments are fixed and determinable as to amount and time of payment;

3. The periodic payments cannot be accelerated, deferred, increased or decreased by the recipient of the payments;

4. 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;

5. The periodic payments are excludible from the recipient's gross income under Sec. 104(a)(2); and

6. 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 an 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 U.S., if all of the following conditions are met:

- The annuity contract or obligation must be used by the assignee to fund periodic payments under a 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 cannot 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 Sec. 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 or after the date of the qualified assignment.

In determining whether there has been a qualified assignment, any provision that grants the recipient rights as a creditor greater than those of a general creditor will be disregarded under Sec. 130(c). 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 of the entire stream of periodic payments.

Structured Settlements in Nonphysical Injury Cases

One current possibility in the structured settlement arena is for a defendant to fund its obligation to make periodic payments in *nonphysical injury* cases by purchasing an annuity and making a *nonqualified* assignment to a third-party obligor. These nonphysical injury cases may encompass any number of tort claims that do not involve physical injuries, such as those for racial discrimination, sexual harassment (without overt and observable physical harm), wrongful termination or violation of the Americans With Disabilities Act of 1990 or the Employee Retirement Income and Security Act of 1974.

One question is whether the plaintiff recognizes gross income for Federal income tax purposes in the year in which the settlement agreement is signed (a devastating tax result), or in the years in which the payments are actually received. If a plaintiff uses a structured settlement in a nonphysical injury case, proper matching and general fairness suggest that he or she should be taxed on the stream of payments only as actually received (absent constructive receipt or economic benefit concerns, addressed below). Regrettably, this is an emerging area; neither the IRS nor the courts have addressed use of structured settlements in this context.

The Basic Transaction

Some savvy insurance companies have created an innovative system for discharging settlement liabilities outside of Sec. 104. The plaintiff consents to allow the insurance company to assign 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 payments.

There may be various entrants into this growing field. At least one well-known 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.[9] There seems no reason why this arrangement would not work perfectly, achieving the desired deferral and security of payment to the plaintiff.

However, there does not appear to be any published IRS or judicial guidance discussing structured settlements in nonphysical injury cases (let alone, structured settlements paired with nonqualified assignments). Obviously, this can make the tax consequences to the plaintiff uncertain. For example, the Service could argue that the total value of the entire stream of payments represents gross income to the plaintiff in the settlement year. It could potentially invoke the constructive receipt, economic benefit or cash equivalency doctrines. Nonetheless, there are strong arguments that a plaintiff should recognize these periodic payments as gross income only when they are actually received from the assignee.

Constructive Receipt

Although constructive receipt concerns can arise in several different circumstances, they most commonly crop up when several different options for settlement are on the table.

> ***Example:*** Plaintiff *P* is offered $1 million in settlement of her racial discrimination claim against *A*, Inc. *P* does not wish to receive a lump sum. After some discussion, *A* also offers $50,000 in cash per year for the rest of *P*'s life. *A* even indicates that *P* can have $50,000 per year for 10 years, with a lump sum of $200,000 up front and an additional $200,000 at the end of 10 years.

Is *P* in constructive receipt of $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 these facts. Only bargaining has occurred and the plaintiff has stated she does not wish to receive a lump-sum settlement. Admittedly, the events that would allow her to receive such a settlement—*P*'s execution of the release—are within her control; nevertheless, there should be no constructive receipt here.[10]

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, under Sec. 451 and Regs. Secs. 1.446-1(c)(1)(i), and 1.451-1(a) and -2(a). The roots of the constructive receipt doctrine prohibit a taxpayer from deliberately turning his or her back on income, thereby attempting to select the tax year. Under Regs. Sec. 1.451-2(a), income is constructively received by a taxpayer when it is set aside, may be drawn on or is otherwise made available to the taxpayer. Thus, when a taxpayer has an unrestricted right to receive funds immediately, he or she must recognize them as gross income.[11] Even so, income is not constructively received when the taxpayer's control over receipt is subject to substantial limits or restrictions or when it is a mere unsecured promise to pay.[12]

Assignments: If an insurance company assigns its obligation to make 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 her otherwise made available so he or she may draw on the settlement at any time, there should be no constructive receipt.

Insurance companies structuring these transactions are careful to ensure that plaintiffs have no right or ability to demand payments from the assignee (who becomes the sole obligor), other than those promised under the settlement agreement terms.[13] Thus, 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.

These structures should be viewed as being substantially limited and restricted. After all, the annuity will be owned by the assignee, issued in the assignee's name and 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 under Regs. Sec. 1.451-1(a) and -2(a).

Of course, in cases involving taxable damages (not Sec. 104 damages), the 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 Federal income tax system, the periodic payments will be taxed to the plaintiff only as 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 nonphysical injury recovery with a nonqualified assignment. However, Rev. Rul. 2003-115[14] considered the assignment of nontaxable periodic payments to an assignment company. Although the periodic payments were qualified settlement payments under Sec. 130(a) otherwise nontaxable under Sec. 104(a)(2), the ruling analyzed the assignment of the payments to an assignment company in light of the constructive receipt and economic benefit doctrines.

That ruling seems to indicate that there should be no constructive receipt in the context of nonphysical injury structures that employ assignments, because the claimants have made irrevocable elections as to their periodic payments while their control of the receipt of the payments was subject to substantial limits or restrictions. This reasoning 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 settlement documents' restrictions are followed.

Economic Benefit Doctrine

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

Even though the claimant ultimately has a different obligor (one other than the defendant), 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 argument based on the economic benefit doctrine, it would have to prove that the amount is funded and secured and that the plaintiff needs only to wait for unconditional payments to arrive at a later time.[15] 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 the assignee is named as the payee.[16]

There is some helpful authority. In Rev. Rul. 72-25,[17] 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.[18] 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, it is hard to imagine the Service successfully applying the economic benefit doctrine. Once the annuity is purchased, it will remain an asset of the assignee and subject to the claims of its general creditors. Thus, it is inappropriate for the IRS to assert that the plaintiff has an economic benefit in the entire stream of payments in the settlement year.

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 it to force a plaintiff to book the entire stream of payments in the settlement year. To prevail, it would have to prove that the assignee's promise to pay is unconditional, readily convertible into cash and a type of obligation frequently discounted or factored.[19]

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.[20] In fact, most settlement documents would void the entire settlement if the plaintiff attempted to sell, transfer or assign rights to the settlement payments.

Conclusion

Until the Service or the courts offer more guidance, taxpayers and their advisers should carefully avoid the pitfalls of the constructive receipt, economic benefit and cash equivalency doctrines in the structured settlement context. Still, structures increasingly make sense in non-Sec. 104 cases. Plaintiffs can maximize their chances of prevailing in a dispute with the IRS by ensuring that the assignee is the owner of the funding annuity and subject to the claims of the assignee's general creditors.

Also vitally important is the plaintiff's lack of a right to immediately receive the entire stream of payments, or to accelerate them. The payment stream should ideally be unfunded, thus diminishing the viability of an IRS claim that property has been set aside on which the plaintiff can draw. As long as the deferred payment agreements are binding between the parties and made before the plaintiff has acquired an absolute and unconditional right to receive payment, he or she should not have to recognize income until the payments are actually received.[21] As always, taxpayers should proceed with caution and obtain tax advice before reaching any settlement.

[1] See *Jared R. Nield,* TC Summ. Op. 2002-110; *Wally O. Oyelola,* TC Summ. Op. 2004-28; *Jacqueline Medina*, TC Summ. Op. 2003-148; *Deforest Dorroh,* TC Summ. Op. 2003-93; *Ed Montgomery,* TC Memo 2003-64; *Stephen G. Cates,* TC Summ. Op. 2003-15; and *Virgie R. Porter,* TC Summ. Op. 2003-14.

[2] *Eric E. Schleier,* 515 US 323 (1995).

[3] *Wally O. Oyelola,* note 1 supra; *Sandar G. Venable,* TC Memo 2003-240; *Stephen G. Shaltz,* TC Memo 2003-173; *Robert G. Henderson,* TC Memo 2003-168; and *Micheal Thomas Prasil,* TC Memo 2003-100.

[4] *Oyelola,* note 1 supra.

[5] *Cates*, note 1 supra.

[6] *Joseph Tamberella,* TC Memo 2004-47.

[7] See Rev. Ruls. 77-230, 1977-2 CB 214; 79-220, 1979-2 CB 74; and 79-313, 1979-2 CB 75.

[8] See Rev. Rul. 79-220, note 7 supra.

[9] See, e.g., Nabco Allstate brochure, at www.deltasettlements.com/Products/TrustServices/SpecialNeedsTrust/R1NABCOBrochureAllstate.pdf.

[10] See *Howard Veit,* 8 TC 809 (1947), acq., 1947-2 CB 4.

[11] *George C. Martin,* 96 TC 814, 823 (1991); and *H.O. Williams,* 219 F2d 523 (5th Cir. 1955).

[12] See Regs. Sec. 1.451-2(a); *Aldrich H. Ames,* 112 TC 304 (1999); and Rev. Rul. 79-313, note 7 supra; see also IRS Letter Ruling 8527050 (4/9/85) (income is not constructively received if the taxpayer's control of its receipt is subject to substantial limits or restrictions).

[13] See IRS Letter Ruling 8435154 (6/1/84) (an insurance company requested a ruling on the assignability of periodic payments outside the scope of Sec. 130 assignments; the IRS ruled that there was no constructive receipt as long as the payments were "unfunded," "unsecured" and the plaintiff had no right to demand payments from the assignee).

[14] Rev. Rul. 2003-115, IRB 2003-46, 1052.

[15] See *John H. Smith,* 324 US 177 (1945) and *George W. Drysdale,* 277 F2d 413 (6th Cir. 1960), rev'g 32 TC 378 (1959).

[16] See *Renton K. Brodie,* 1 TC 275 (1942) and *Olmstead Incorporated Life Agency,* 35 TC 429 (1960), aff'd, 304 F2d 16 (8th Cir. 1962).

[17]

Rev. Rul. 72-25, 1972-1 CB 359.

[18] See also *Richard A. Childs*, 103 TC 634 (1994), aff'd, 89 F3d 856 (11th Cir. 1996) (attorneys' fees paid out under a structured settlement were not funded or secured obligations, but mere promises to pay and, thus, only taxable in the year of actual receipt).

[19] See *Frank Cowden*, 289 F2d 20 (5th Cir. 1961), rev'g and remd'g 32 TC 853 (1959), op. on remand, TC Memo 1961-229.

[20] See *John Reed*, 723 F2d 138 (1st Cir. 1983) and *Harold W. Johnston*, 14 TC 560 (1950).

[21] *James Oates*, 18 TC 570, 584–85 (1952), aff'd, 207 F2d 711 (7th Cir. 1953) and *J.D. Amend*, 13 TC 178, 185 (1949).