New Uses for Structured Settlements

Non-Physical Injury Cases?

By Robert W. Wood

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 ADA 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 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.

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'll 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.

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, which are paired with non-qualified assignments). Obviously, this can make the tax consequences to the plaintiff uncertain. There is a chance 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 these periodic payments as gross income *only* when the payments are actually received from the assignee.

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 IRS 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 IRS 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 IRS 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. 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).

There is some helpful authority. In Revenue Ruling 72-25, 1972-1 C.B. 127, 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. 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) (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). 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 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

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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.

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.

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. Sec. 451; Treas. Regs. Secs. 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. Treas. Reg. §1.451-2(a) defines.

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. *Id.* Thus, where 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 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. See 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). 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. See Ltr. Rul. 8435154 (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. See Treas. Reg. Secs. 1.451-1(a) and 2(a).

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

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. 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.

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. 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 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. Ultimately, taxpayers should proceed with caution and obtain tax advice *before* any settlement is reached.

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