

TAXING STRUCTURED SETTLEMENTS

GREGG D. POLSKY*
BRANT J. HELLWIG**

Abstract: Congress has granted a tax subsidy to physically injured tort plaintiffs who enter into structured settlements. The subsidy allows these plaintiffs to exempt the investment yield imbedded within the structured settlement from federal income taxation. The apparent purpose of the subsidy is to encourage physically injured plaintiffs to invest, rather than presently consume, their litigation recoveries. Although the statutory subsidy by its terms is available only to physically injured tort plaintiffs, a growing structured settlement industry now contends that the same tax benefit of yield exemption is available to plaintiffs' lawyers and non-physically injured tort plaintiffs under general, common-law tax principles. If the structured settlement industry is correct, then all tort plaintiffs and their lawyers may invest their litigation proceeds in a tax-free manner simply by using structured payment arrangements. Structured arrangements, therefore, would be far superior to traditional tax-favored retirement accounts (e.g., 401(k)s, IRAs), which provide the same tax benefit of yield exemption but are subject to significant constraints. Accordingly, if proponents of structured arrangements are correct in their interpretation of the tax law, these arrangements can be described as "super-IRAs" because they provide full yield exemption without any corresponding limitations or restrictions. This Article examines the taxation of structured payment arrangements, ultimately concluding that the structured settlement industry's positions are unpersuasive. Nevertheless, because of the muddled state of the tax law on the issue, this Article recommends legislative and administrative action to close the yield-exemption loophole with respect to its unintended beneficiaries.

INTRODUCTION

A personal injury plaintiff traditionally receives compensation through a lump-sum payment from the defendant or its insurer. This lump sum could be paid pursuant to a judgment rendered by a court

© 2010 Gregg D. Polsky & Brant J. Hellwig. The authors thank Joseph Dodge and Adam Hirsch for providing useful comments on an earlier draft and Adam Scales for supplying background information regarding the structured settlement industry.

* Sheila M. McDevitt Professor of Law, Florida State University College of Law.

** Associate Professor of Law, University of South Carolina School of Law.

or, more commonly, pursuant to a settlement agreement. Occasionally, instead of calling for a lump sum payment, a settlement agreement will provide for periodic payments to be made to the plaintiff over a stated term. These periodic payment arrangements are known as structured settlements.

From the plaintiff's perspective, a structured settlement is akin to the investment of the litigation recovery in an annuity. As with traditional annuities, there exists considerable flexibility in designing the terms of the payment schedule of a structured settlement.¹ Typically, these settlements call for the plaintiff to receive level or increasing cash payments at regular intervals (e.g., monthly) for a fixed term.

Congress has granted a tax subsidy to physically injured tort plaintiffs who enter into structured settlements.² The subsidy allows these plaintiffs to exempt the investment yield imbedded within the deferred payment arrangement from federal income taxation. The apparent purpose of the subsidy is to encourage physically injured plaintiffs to invest, rather than presently consume, their litigation recoveries.

Although the statutory subsidy by its terms is available only to physically injured tort plaintiffs, the structured settlement industry now contends that the same tax benefit of yield exemption is available to plaintiffs' lawyers and non-physically injured tort plaintiffs under general, common-law tax principles. If the structured settlement industry is correct, then all tort plaintiffs and their lawyers may invest their litigation proceeds in a tax-free manner simply by using structured payment arrangements (which we refer to collectively as "structured settlements.")³ Structured settlements, therefore, would be far superior to traditional qualified retirement accounts (e.g., 401(k)s, IRAs) that provide the same tax benefit of yield exemption but are subject to significant constraints.⁴ Accordingly, if proponents of structured settlements

¹ See Lawrence A. Frolik, *The Convergence of I.R.C. § 104(a)(2)*, Norfolk & Western Railway Co. v. Liepelt and *Structured Tort Settlements: Tax Policy "Derailed,"* 51 FORDHAM L. REV. 565, 573 (1983) (describing the numerous forms that structured settlement may take).

² As discussed below, in a structured settlement the plaintiff receives damages through periodic payments rather than in a lump sum.

³ This Article uses the term "structured settlement" to include structured attorney fee arrangements even though the fee arrangements do not involve "settlements" of claims. (Instead these arrangements compensate the attorney for the legal services provided to the plaintiff.) This is done simply for ease of exposition. When referring only to structured attorney fee arrangements, this Article will use the term "structured fee arrangements."

⁴ The amount of money that may be invested in qualified plans each year is limited to \$5000 in the case of IRAs and roughly \$15,000 in the case of employer-provided retirement accounts, and qualified-plan participants face a significant penalty if they withdraw amounts before retirement age. See I.R.C. § 219(b) (2006) (limiting the amount that may be invested

are correct in their interpretation of the tax law, these arrangements can be described as “super-IRAs,” because they provide full yield exemption without any corresponding limitations or restrictions.

This Article examines the taxation of structured settlements. Part I describes a typical structured settlement and explains the tax benefits that these arrangements are designed to provide.⁵ Part II reviews the general background principles of income realization that apply to structured settlements.⁶ Part III then explains how Congress has statutorily modified these principles with respect to structured settlements of physical injury claims.⁷ Parts IV and V address and ultimately reject the argument that the tax benefits of structured settlements are also available to non-physically injured plaintiffs or to trial lawyers.⁸ Part VI addresses a potential loose end, explaining that the tax benefits of structured settlements would not be offset by the imposition of substitute taxation on other parties to the arrangement.⁹ The Article concludes with specific recommendations for action by the Internal Revenue Service (“IRS”), the Treasury Department, and Congress.

I. THE MECHANICS AND POTENTIAL TAX BENEFITS OF STRUCTURED SETTLEMENTS

A. *The Prototypical Structured Settlement*

In a structured settlement, the settlement agreement between the plaintiff and the defendant (or its insurer) calls for the defendant (insurer) to make future specified payments to the plaintiff in exchange for the release of the plaintiff’s claim. In virtually all structured settlements, the defendant (insurer) will immediately assign its obligation to make the specified future payments to a structured settlement company (“SSC”). In exchange for accepting the payment obligation, the SSC receives from the defendant (insurer) a lump sum payment equal to the present value of the future payments owed to the plaintiff. The plaintiff, in turn, agrees to look only to the SSC for the future pay-

in an IRA to \$5000); I.R.C. § 72(t) (assessing 10% penalty for early withdrawal from a “qualified retirement plan”). By comparison, there is no limit on amounts that may be invested in structured settlements, and participants in these arrangements have complete flexibility in setting the payment dates.

⁵ See *infra* notes 10–40 and accompanying text.

⁶ See *infra* notes 41–100 and accompanying text.

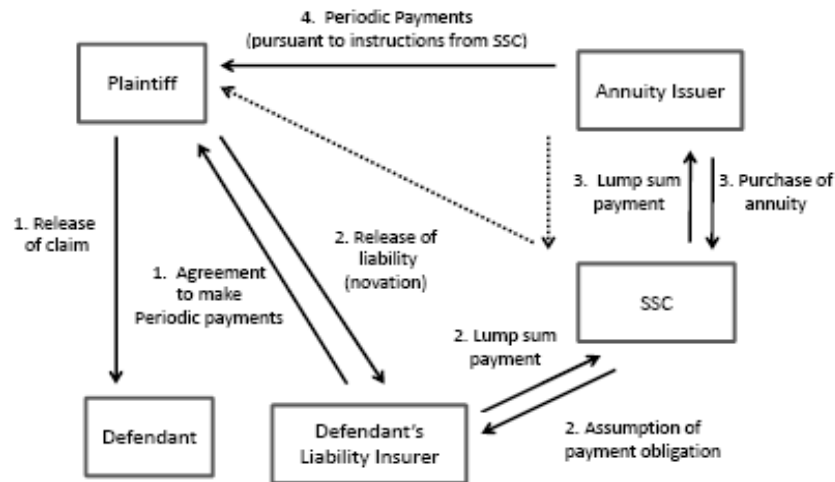
⁷ See *infra* notes 101–152 and accompanying text.

⁸ See *infra* notes 153–234 and accompanying text.

⁹ See *infra* notes 235–262 and accompanying text.

ments.¹⁰ The SSC then uses the lump sum payment that it receives from the defendant (insurer) to purchase an annuity from a life insurance company. This annuity is called the funding asset, and it provides the SSC with the necessary liquidity to satisfy its payment obligations to the plaintiff. Often, the SSC simply directs the annuity issuer to pay the annuity benefits directly to the plaintiff. In almost all cases, the SSC used in a structured settlement is an affiliate of the life insurance company that issues the annuity that serves as the funding asset.

A typical structured settlement of a claim covered by the defendant's liability insurance policy is depicted below:



Assignments to SSCs are not absolutely necessary to implement a structured settlement. The defendant (insurer) could remain obligated to make the future payments to the plaintiff. Nevertheless, assignments are pervasive in the structured settlement industry because they allow the defendants (insurers) to “close their books” with respect to the litigation.¹¹ In addition, assignments provide flexibility by allowing the plaintiff to choose the party that will be obligated to make the future payments.

¹⁰ In technical terms, the plaintiff grants the defendant (insurer) a novation with respect to its obligation to make future payments to the plaintiff. A novation is “the act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party.” BLACK’S LAW DICTIONARY 1168 (9th ed. 2009).

¹¹ By paying the SSC to assume the obligation to make periodic payments, self-insured defendants also obtain a tax advantage by not having to pay tax on the investment yield

Trial lawyers sometimes structure their contingency fees using an identical arrangement.¹² Fees are most commonly structured in cases where plaintiffs have agreed to structure their own recoveries. For instance, in a case where the attorney is entitled to a one-third contingency fee, an attorney might accept a structured fee arrangement that entitles him to receive periodic payments on the same schedule as the plaintiff. Thus, if the plaintiff is entitled to ten annual payments of \$20,000, the attorney would receive ten annual payments of \$10,000.

The mechanics of structured settlements highlight an important issue: if the defendant (insurer) is willing to make a lump sum payment to an SSC and if the plaintiff (or attorney) wishes to invest the lump sum in an annuity, then why doesn't the plaintiff (attorney) simply receive a lump sum payment and then purchase an annuity? In other words, why involve the middleman, the SSC? The answer is that the plaintiff (attorney) seeks the tax benefit described below.¹³

B. Comparative Taxation of Lump Sum Payments and Structures

1. General Tax Rules Governing Lump Sum Payments

To determine the tax advantage of these arrangements, the tax consequences of structured settlements must be compared with the tax consequences of the plaintiff's (attorney's) receipt of a lump sum that is then invested in an annuity. Leaving aside differences in their tax treatment, these transactions are economically equivalent. Accordingly, to assess the tax benefit of structured settlements, it is necessary first to understand the tax rules governing lump sum payments of personal injury damages and attorney's fees, as well as the tax rules that apply to investments in annuities.

that is earned to finance the future payments. *Cf. infra* note 35 (describing how employer in nonqualified deferred compensation arrangements pays tax on the investment yield generated within these arrangements).

¹² Thus, the attorney and the defendant (insurer) first enter into an agreement calling for the defendant (insurer) to make future payments to the attorney. The defendant (insurer) then assigns this liability to an SSC, which receives a lump sum as compensation, and the attorney releases the defendant (insurer) from its future payment obligations. The SSC in turn uses the lump sum to purchase an annuity to fund the future payments due to the attorney.

¹³ Additionally, a structured settlement may provide the recipient with creditor protections that would not be available if the plaintiff simply used a lump-sum recovery to purchase an annuity in the plaintiff's individual name. *See* Adam J. Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 WASH. U. L.Q. 1, 5 n.14 (1995) (discussing the potential creditor protection benefits of structured settlements).

a. *Consequences to the Plaintiff*

If a plaintiff's cause of action arises out of a *physical* injury, then a lump sum recovery of damages is exempt from taxation under I.R.C. § 104(a)(2).¹⁴ On the other hand, if the plaintiff's cause of action arises out of a *non-physical* injury, then a lump sum recovery is taxable. Thus, for example, lump sum settlements of employment discrimination claims are taxable; settlements of automobile accident claims are not.

Personal injury plaintiffs typically hire their attorneys on a contingency fee basis. Under a standard arrangement, the plaintiff agrees to pay the attorney a stated percentage (e.g., one-third) of the gross recovery. As confirmed in 2006 by the U.S. Supreme Court in *Commissioner v. Banks*¹⁵ a plaintiff who compensates an attorney on a contingency basis is treated for tax purposes as receiving the entire recovery (including the attorney fee portion) and then paying the contingent fee to the attorney, even if the plaintiff never formally receives the attorney fee portion of the recovery. A physical injury plaintiff cannot deduct a contingent fee payment because it relates to the production or collection of tax-exempt income (i.e., the tax-free recovery).¹⁶ In contrast, a non-physical injury plaintiff may deduct a contingent fee because it is an expense incurred to generate a taxable recovery.¹⁷ The end result is that a *physical* injury plaintiff's net recovery is tax-free, while a *non-physical* injury plaintiff's net recovery is taxable.¹⁸

b. *Consequences to the Plaintiff's Attorney*

Although a plaintiff's tax consequences depend on whether the claim arises out of a physical injury, an attorney's tax consequences do not depend on the underlying nature of the claim. The attorney's fee is subject to income tax in the year it is received.¹⁹

¹⁴ Punitive damages, however, are taxable even if the underlying cause of action relates to a physical injury. See I.R.C. § 104(a)(2) (2006).

¹⁵ 543 U.S. 426, 433–37 (2005).

¹⁶ I.R.C. § 265(a)(1).

¹⁷ If the non-physical injury litigation is related to the plaintiff's trade or business, then the deduction is authorized by I.R.C. § 162(a). In all other cases, the deduction would be authorized by I.R.C. § 212(1).

¹⁸ The tax consequences to the non-physical injury plaintiff may in fact be more onerous than this. Due to the restrictions on miscellaneous itemized deductions, a non-physical injury plaintiff effectively may be subject to tax on an amount greater than the net recovery. This possibility is discussed *infra* notes 218–228 and accompanying text.

¹⁹ Fee income earned by successful trial lawyers is subject to federal income and employment taxes at a marginal rate of 37.4%. In the case of an attorney that earns more than \$372,950 of taxable income (in 2009), the marginal income tax rate is 35%. See IRC

c. After-Tax Investment in Annuity

If the plaintiff (attorney) were to invest the lump sum payment in an annuity, the tax treatment of the payments received under the annuity would be governed by I.R.C. § 72.²⁰ I.R.C. § 72 prescribes the method for allocating annuity payments between the portion representing the tax-free return of principal and the portion representing the taxable investment yield.²¹ This allocation is determined by the exclusion ratio, defined generally as the ratio that the taxpayer's investment in the annuity bears to the total undiscounted amount of payments expected to be received under the contract.²² For example, assume that a taxpayer pays \$1000 to receive two annual payments of \$553, with the first payment to be received in one year. The exclusion ratio is \$1000/\$1106 or 90.42%. Accordingly, 90.42% (\$500) of each \$553 payment will be considered a tax-free recovery of the initial \$1000 payment, with the remaining 9.58% (\$53) constituting the taxpayer's investment yield, which is taxed as ordinary income.

2. Quantifying the Potential Tax Benefit of Structures

As will be discussed in Part II, the tax treatment of structured settlements turns on whether the SSC's obligation to make future cash payments (the "SSC obligation") is treated, for the purpose of applying the cash method of accounting, as an item of "property."²³ If so, the

§ 1(c); Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 (adjusting for inflation). This figure is the same whether the attorney is single or married filing a joint return. *See* I.R.C. § 1(a), (c). The attorney must also pay federal employment tax on the fee. The marginal employment tax rate on attorneys who are in the 35% tax bracket is 2.4%. *See id.* § 1401(b) (imposing the Medicare component of the self-employment tax at a rate equal to 2.9% of the individual's self-employment income). As one-half of this tax is deductible above-the-line, the effective employment tax rate to a taxpayer in the 35% marginal income tax bracket is 2.3925%. *See id.* §§ 62(a)(1), 164(f). The Old-Age, Survivors, and Disability Insurance component of the self-employment tax (nominally 12.40%) is not levied on earnings from self-employment in excess of \$106,800 (2009 ceiling). *See id.* § 1401(a) (imposing OASDI component of self-employment tax); *id.* § 1402(b) (supplying cap); *see also* News Release, Soc. Sec. Admin., Soc. Sec. Announces 5.8 Percent Benefit Increase for 2009, Oct. 16, 2008, <http://www.ssa.gov/pressoffice/pr/2009cola-pr.htm> (last visited Dec. 30, 2009) (announcing 2009 cost-of-living adjustments).

²⁰ *See* I.R.C. § 72. I.R.C. § 72 would apply to the annuity regardless of whether the lump sum was excluded under § 104(a)(2) as damages received for personal physical injuries.

²¹ *See id.* § 72(b), (c).

²² *Id.*

²³ *See infra* notes 43–100 and accompanying text.

present value of the SSC obligation²⁴ will be taken into account for tax purposes at the time the SSC obligation is created. Accordingly, at that time, the present value of the obligation will be either (a) excluded from gross income under I.R.C. § 104(a)(2) if the settlement relates to a physical injury, or (b) included in gross income.²⁵ In either event, the subsequent investment yield earned on the present value of the SSC obligation will be taxed under the annuity rules of I.R.C. § 72.²⁶ Alternatively, if the SSC obligation is *not* regarded as an item of property for cash method purposes, then the creation of the obligation is a non-event. In that case, the cash payments later made by the SSC will be treated as the litigation recovery or the attorney's fee, as the case may be. Under this view, if I.R.C. § 104(a)(2) applies, then the cash payments would be excluded from gross income in their entirety; in all other cases, the cash payments would be taxed upon receipt.²⁷

a. *Consequences to Parties Who Receive Structured Payments*

Recall that in cases involving a physical injury, a lump sum payment to the plaintiff would be received tax-free; any investment yield thereon, however, would be taxable.²⁸ If the SSC obligation is regarded as an item of property for cash method purposes, then the present value of the SSC obligation would constitute the tax-free recovery and the subsequent cash payments received pursuant to the obligation would be taxed under the annuity rules in I.R.C. § 72. On the other hand, if the SSC obligation is *not* treated as an item of property (and therefore is disregarded under the cash method), then the later cash payments will be treated as the physical injury recovery that is allowed to be received tax-free—even though a portion of each payment represents investment yield. Thus, if the SSC obligation is not treated as an item of property, the plaintiff would be allowed to earn a tax-free yield on the recovery.

²⁴ The present value of the SSC obligation will equal the purchase price of the funding asset, which will equal the amount paid by the defendant (insurer) to induce the SSC to assume the defendant's obligation to make periodic payments. The purchase price of the funding asset may be slightly less than the amount paid to the SSC due to a de minimis administrative fee paid by the defendant (insurer) that is included in the amount paid to the SSC. See *infra* note 256. We ignore this administrative fee for the sake of simplicity.

²⁵ See I.R.C. § 104(a)(2).

²⁶ See *id.* § 72(b), (c).

²⁷ See *id.* § 104(a)(2).

²⁸ See Rev. Rul. 65-29, 1965-1 C.B. 59; Rev. Rul. 76-133, 1976-1 C.B. 34 (each confirming the taxation of investment income generated from the investment of excluded lump-sum recoveries).

The same yield-exemption effect would be present in non-physical injury structured settlements (and in structured attorney-fee arrangements), if the SSC obligation is *not* treated as an item of property. Disregarding the receipt of the SSC obligation in these cases results in deferral of taxation from the time that the obligation is created until the time that cash payments are received pursuant to the obligation. Under the so-called Cary Brown model, deferring tax on a given amount of gross income is economically equivalent to taxing the amount currently and then exempting the investment return on the resulting after-tax amount during the period of deferral.²⁹ Simply put, deferral is “equivalent to exemption of investment income.”³⁰

This yield-exemption effect can be shown mathematically. Assume p represents a given amount of income, r the annual rate of investment return, t the tax rate, and n the period of deferral. Deferring the tax on p for n years would leave the taxpayer with the following amount after the imposition of tax in year n : $[p(1+r)^n](1-t)$. On the other hand, immediately subjecting p to taxation but then allowing the after-tax amount to grow tax free would produce the following after-tax amount: $[p(1-t)](1+r)^n$. Algebraically, these two formulas are identical.³¹ The

²⁹ This effect is dependent on certain assumptions, the most important of which in this context is that the taxpayer’s marginal tax rate is the same at the beginning and the end of the period of deferral. For discussion of the assumptions, see CHRIS H. HANNA, COMPARATIVE INCOME TAX DEFERRAL: THE UNITED STATES AND JAPAN 11–12 (2000).

³⁰ Daniel I. Halperin, *Interest in Disguise: Taxing the “Time Value of Money,”* 95 YALE L.J. 506, 519 (1986).

³¹ This algebra explains why, under the assumptions of the Cary Brown model, traditional IRAs and Roth IRAs provide equivalent tax benefits despite their different mechanics. To illustrate, assume that a taxpayer wishes to invest \$5000 of pre-tax salary until retirement in ten years, at which time the taxpayer will withdraw the entire amount plus its investment return. Assume further that the taxpayer will always be subject to a 40% marginal tax rate and that the taxpayer’s pre-tax rate of investment return is 10%. The taxpayer, using a traditional IRA, will receive an immediate deduction of \$5000, which will absorb the associated \$5000 of salary income. Thus, the taxpayer will not pay immediate tax on the \$5000 of salary; instead, this tax will be deferred until a withdrawal is made from the IRA in ten years. This deferral is analogous to the deferral that results in structured settlements of non-physical injury claims if the SSC obligation is disregarded.

In the traditional IRA, the \$5000 will grow at a 10% rate. Accordingly, in ten years the amount in the IRA will grow to \$12,969. When this amount is withdrawn, the taxpayer will owe tax of 40% of that amount, or \$5188. Thus, the taxpayer will end up with \$7782 (\$12,969–\$5188).

If the taxpayer instead uses a Roth IRA, the taxpayer will get no deduction for making the contribution to the account. Accordingly, the account will be funded with only \$3000, the amount of the \$5000 salary that is left after taxes. The \$3000 amount will grow inside the Roth IRA at a 10% rate to \$7782, and the taxpayer can withdraw this amount tax-free. The taxpayer will therefore end up with the same amount (\$7782) using either the traditional or

yield-exemption effect is illustrated further in the Appendix through specific numerical examples that show the tax benefit of structured settlements if the SSC obligation is not treated as an item of property.³²

b. *Consequences to Other Parties*

The discussion thus far has demonstrated that *not* treating an SSC obligation as an item of property is tantamount to exempting the payee's investment yield from taxation.³³ This analysis implicitly assumed that a tax burden was not imposed on some other party to the structure that would offset this benefit. If such a burden were in fact imposed, the burden would have to be compared to the tax benefit received by the payee (i.e., the plaintiff or the attorney)³⁴ to determine whether structured settlements produce an overall net tax benefit. In other words, to evaluate whether a structured settlement is tax-advantaged, the tax consequences to all parties to the transaction must be considered. If a tax benefit is granted to one party (e.g., the plaintiff), but a perfectly offsetting tax burden is imposed on another other party (e.g., the defendant), the transaction as a whole is not tax-advantaged. In that case, the parties would simply adjust prices to reflect their respective tax consequences, leaving them in the same economic position that they would have occupied absent these tax consequences.³⁵

the Roth IRA. The traditional IRA provides deferral while the Roth IRA provides yield exemption; nevertheless, their results (under the Cary Brown assumptions) are the same.

³² See *infra* app. at 92–94.

³³ See *supra* notes 28–31 and accompanying text.

³⁴ Although the payee receives the nominal tax benefit of yield exemption, the benefit could be shared with the other parties to the structure. For example, the settlement cost to the defendant could be lower than it otherwise would be if the tax benefit was not available to the plaintiff. See *infra* notes 38–40 and accompanying text.

³⁵ To illustrate, consider the taxation of nonqualified deferred compensation. If certain requirements are satisfied, the employee defers taxation of an employer's promise to pay until receipt of payment in cash, and the employer's deduction for compensation is deferred until the same time. In addition, the employer pays tax on any investment yield that is generated by the assets that will fund the payment of deferred compensation between the time that the deferred compensation is earned by the employee and the time that it is actually paid out. The employee receives the benefit of tax deferral. Per the Cary Brown model, the investment yield earned by the employee on the deferred compensation during the period of deferral is effectively exempt from tax. Instead, this tax is incurred by the employer. The extra tax burden on the employer will be taken into account by the employer in negotiating the terms of the deferred compensation arrangement. For example, the employer could set the yield that it is willing to pay on the deferred compensation by reference to its *after-tax* rate of return. In such a case, if the employer and the employee are subject to the same marginal tax rate, the deferred compensation arrangement will not be tax advantaged because the benefit obtained by the employee (yield exemption) is perfectly offset by the burden imposed on the employer (tax liability on what is really the em-

The possibility of substitute taxation in the context of structured settlements, therefore, must be considered, and Part VI does so by analyzing the tax consequences of structured settlements to parties other than the payee.³⁶ In particular, it examines whether the yield exemption afforded the payee is offset or mitigated by a proxy tax on the defendant, its insurance carrier, or the SSC. If such a proxy tax were imposed, the adversely affected party would be expected to adjust its pricing. This adjustment would drive down the yield that the plaintiff (attorney) earns within the structure, perhaps to the point that the plaintiff (attorney) would be in no better position than if the plaintiff (attorney) received a lump sum and then invested it directly. The analysis in Part VI ultimately concludes that none of the other parties to a typical structure likely incurs a substitute tax that would mitigate the yield-exemption benefit received by plaintiffs (attorneys) if the SSC obligation is not treated as an item of property.³⁷ Thus, structured settlements will be tax-advantaged unless SSC obligations are treated as property under the cash method.

c. Shifting of the Tax Benefit

The analysis thus far has implied that the potential tax advantage of structured settlements would be captured entirely by the payee (i.e., the plaintiff or the attorney). Although the yield-exemption benefit is nominally afforded to the payee, other parties to structured settlements could capture all or a portion of the benefit through bargaining.³⁸ For example, defendants or their insurers could capture some of the benefit in the form of lower settlement costs.³⁹ Alternatively, annuity issuers could capture a portion of the benefit by paying lower yields. For the purposes of this Article, it is immaterial how the benefit is in fact shared

employee's yield). See Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 593–94 (2007). In the case of equivalent marginal tax rates, the substitute taxation imposed on the employer precludes the deferred compensation arrangement from producing a net tax benefit to the parties, or stated differently, a net tax detriment to the public fisc.

³⁶ See *infra* notes 235–262 and accompanying text.

³⁷ See *infra* notes 235–262 and accompanying text.

³⁸ See, e.g., Adam F. Scales, *Against Settlement Factoring? The Market in Tort Claims Has Arrived*, 2002 WIS. L. REV. 859, 884 (stating that “there is no real dispute that structured settlements save defendants money”).

³⁹ STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., TAX TREATMENT OF STRUCTURED SETTLEMENT ARRANGEMENTS 5 (1999), available at http://www.jct.gov/jct_html/x-15-99.htm (suggesting that structured settlements are not more frequently employed in personal physical injury cases because defendants attempt to capture the benefit of the tax subsidy by making lower structured settlement offers).

among the parties.⁴⁰ We are content with showing that a tax benefit exists if the SSC obligation is not regarded as an item of property and with describing the nature of such benefit (i.e., the equivalent of yield exemption). For simplicity sake, this Article assumes that no shifting of the tax benefit occurs and, accordingly, that the entire benefit of yield exemption would be captured by the payee.

II. GENERAL TAX TREATMENT OF CONTRACTUAL PAYMENT RIGHTS

As explained above, structured settlements will be tax-advantaged if the SSC obligation is not treated as an item of property under the cash method of accounting.⁴¹ We now turn to this doctrinal issue.

An SSC obligation represents nothing more than an unsecured contractual right to receive future payments of cash. This Part examines the general cash method principles that determine whether a contractual right to future cash payments is treated as an item of property.⁴² These principles provide the background necessary to understand the effect of specific Code provisions on structured settlements of physical injury claims.

A. Cash Method Principles

Individuals generally use the cash method of accounting in computing their taxable income.⁴³ Under the cash method, a taxpayer must include in gross income all items of cash, property, or services that are received during the taxable year.⁴⁴ This seemingly simple rule masks a complex issue that lies at the heart of the cash method: to what extent does a contractual payment right—such as a trade account receivable—constitute an item of “property,” the receipt or creation of which gives rise to immediate income recognition under the cash method? On one hand, accounts receivable and similar contractual payment rights con-

⁴⁰ This statement, however, is not intended to suggest that the potential for economic shifting is unimportant. If policymakers intend to influence the behavior of one party to a transaction through the provision of a tax benefit, the possibility that the tax benefit might be captured by others must be considered in evaluating the likely effectiveness of the tax provision in achieving its intended goals.

⁴¹ See *supra* notes 23–40 and accompanying text.

⁴² See *infra* notes 43–100 and accompanying text.

⁴³ See BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 105.3.1, at 105–48 (2d ed. 1989) (noting that the cash method is widely used among wage earners, employees, and professionals).

⁴⁴ Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 2006). If a specific exclusion from gross income applies to an item, however, then the item would not be included in gross income. See I.R.C. § 102(a) (2006) (excluding gifts from gross income).

stitute property under state law, and the term “property” has been broadly construed under federal tax law to include both tangible and intangible property, regardless of whether the property is liquid or otherwise capable of ready valuation.⁴⁵ On the other hand, if the term included all contractual payment rights, the cash method of accounting would be functionally eliminated. For example, such an expansive interpretation would mean that a garden variety account receivable would be taxed to the extent of its fair market value when it is created, a result that is fundamentally inconsistent with cash method principles. Taxing an account receivable at the time it is created, as opposed to the time it is paid, is the prototypical result under the accrual method of accounting.⁴⁶ Therefore, treating all contractual payment rights as property would effectively merge the cash method into the accrual method.⁴⁷

To defend the separate province of the cash method, courts have long held that the creation of a contractual payment right generally does not give rise to immediate taxation under the cash method. For example, the U.S. District Court for the Western District of Louisiana in the 1920 case of *United States v. Christine Oil & Gas Co.* explained that “where the effect of a transaction is a mere promise to pay, and not an actual payment, it cannot be said to be income, until it has been actually received, and is not subject to be taxed as such until its actual receipt.”⁴⁸ Similarly, the Board of Tax Appeals in the 1928 case of *Zittel v. Commissioner* asserted that “[t]axpayers on a [cash] receipts and disbursements basis are required to report only income actually received no matter how binding any contracts they may have to receive more.”⁴⁹

⁴⁵ For instance, a non-controlling equity interest in a closely-held business constitutes property. Although determining the fair market value of such an interest is an imprecise undertaking, a cottage industry has arisen to value such interests, typically for estate and gift tax purposes.

⁴⁶ See BITTKER & LOKKEN, *supra* note 43, ¶ 105.3.2, at 105–49 (“The basic difference between cash and accrual accounting is that the latter requires accounts receivable and similar claims to be reported when they arise from a credit transaction.”).

⁴⁷ See *id.* (“The basic difference between cash and accrual accounting . . . would be obliterated if cash basis taxpayers were required to treat all claims against employers, clients, and customers as ‘property,’ to be valued and taken into income when the services are rendered, rather than when claims are paid.”); WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 5.02[1], at 5–7 n.22 (4th ed. 2007) (noting that the possibility that a definition of property that includes all contractual payments rights would “swallow[] the cash method of accounting”).

⁴⁸ 269 F. 458, 459–60 (W.D. La. 1920).

⁴⁹ 12 B.T.A. 675, 677 (1928).

The cash method is an imprecise and somewhat crude method of accounting. By ignoring the receipt of valuable contractual rights, the cash method results in inaccurate measurement of economic income.⁵⁰ The imprecision of the cash method is justified, however, on grounds of administrability. The cash method spares standard, everyday commercial transactions—i.e., the provision of services for a future paycheck or the creation of an account receivable upon the performance of services—from the practical difficulties of taxing contractual payment rights as they are earned. An accrual accounting regime would require taxpayers to determine precisely when a contractual payment right is earned and the value of the right at that time.⁵¹ It also would require error correction mechanisms if these valuations prove to be too high or low. Furthermore, taxpayers would incur potential liquidity burdens because taxes would be due on contractual payment rights before they received any cash. In short, under the cash method, precision in income measurement yields to simplicity in taxing everyday commerce.⁵²

B. *The Common Law Economic Benefit Doctrine*

Despite the general rule that contractual payment rights are not treated as property under the cash method, there exists a significant exception. Contractual payment rights that are deemed to provide an “economic benefit” to the taxpayer are treated as property. This terminology is confusing, as the receipt of any contractual payment right with a fair market value greater than zero provides an economic benefit because the recipient’s economic position is improved. Nevertheless, courts have used the phrase “economic benefit” as a term of art to distinguish garden-variety contractual payment rights (e.g., accounts receivable) that are not treated as property under the cash method from the more unusual contractual payment rights that are treated as property.⁵³

1. Purchased Promises to Pay from Third Parties

The origins of the economic benefit doctrine lie in the 1942 Tax Court case *Brodie v. Commissioner*,⁵⁴ which addressed a bonus program

⁵⁰ See Halperin, *supra* note 30, at 510.

⁵¹ See BITTKER & LOKKEN, *supra* note 43, ¶ 105.3.2, at 105–49.

⁵² See *id.* ¶ 105.3.1, at 105–48 (describing the simplicity of the cash method and its attractiveness to laypersons).

⁵³ See, e.g., *United States v. Drescher*, 179 F.2d 863, 865 (2d Cir. 1950).

⁵⁴ 1 T.C. 275, 276–77 (1942).

established by a company for the benefit of its executives. For the tax years at issue, the company unilaterally decided to pay a portion of the executives' bonuses by issuing to them single-premium retirement annuities.⁵⁵ Under the terms of the annuities, no payments would be made until the executive's seventieth birthday, the executive could not assign his payment rights under the contract, and the executive could not surrender the annuity to the insurance company for any value.⁵⁶ The IRS determined that the executives recognized gross income upon receiving the annuity, with the amount of gross income equaling the premium the company had paid for each policy.⁵⁷ Arguing that their inability to assign or surrender the policies precluded current taxation, the executives claimed that the mere receipt of the annuity contract, which was nothing more than the insurer's contractual payment obligation, was not a taxable event.⁵⁸ The Tax Court sided with the IRS, holding that the issuance of the contractual payment obligation resulted in immediate taxation.⁵⁹

Shortly after the Tax Court's decision in *Brodie*, the U.S. Court of Appeals for the Second Circuit addressed the same issue in *United States v. Drescher*.⁶⁰ The taxpayer in *Drescher* was an executive of a company that had purchased \$5,000 single-premium annuity contracts for its executives as part of a deferred compensation plan.⁶¹ The contract irrevocably designated the executive as the annuitant, and the executive possessed the right to name a beneficiary to receive the payment rights upon his death.⁶² The taxpayer, however, could not surrender the annuity for its cash value or assign his rights to future annuity payments during his lifetime.⁶³ In light of these restrictions, the taxpayer claimed that the mere purchase of the annuity by his employer did not give rise to gross income.⁶⁴ He argued instead that he should include amounts in gross income only as the cash payments under the annuity were received.⁶⁵ The Second Circuit disagreed, concluding that the employer's purchase of the annuity conferred upon the taxpayer a presently tax-

⁵⁵ *Id.* at 277.

⁵⁶ *Id.* at 278–79.

⁵⁷ *Id.* at 282–84.

⁵⁸ *Id.* at 282.

⁵⁹ *Id.* at 282–84.

⁶⁰ *Drescher*, 179 F.2d at 864.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *See id.* at 864–65.

⁶⁵ *Id.* at 865.

able benefit: "It cannot be doubted that . . . the plaintiff received as compensation for prior services *something of economic benefit* which he had not previously had, namely, the obligation of the insurance company to pay money in the future to him or his designated beneficiaries" ⁶⁶ Accordingly, the court determined that the insurance company's obligation to the executive was immediately taxable to him. ⁶⁷

The *Brodie* and *Drescher* decisions stand for the proposition that the receipt of a contractual payment obligation issued by a third party to a transaction gives rise to current taxation under the cash method. Using the cash method's terminology, ⁶⁸ a third-party promise is treated as an item of "property" that is taxable upon receipt, notwithstanding the general rule that contractual payment obligations ordinarily are not treated as property. ⁶⁹

2. Funded Second-Party Promises to Pay

The economic benefit doctrine is not limited to the third-party promise context. A series of cases and revenue rulings have established that a contractual payment obligation issued by a second party to the transaction would be immediately taxable if the payment obligation is "funded." A payment obligation is funded if money is set aside in an escrow or trust arrangement to secure the recipient's rights to future payments. In instances where an obligation is funded, the recipient could receive full payment even if the obligor were to become insolvent between the time that the payment obligation is created and the time that cash payments are scheduled to be made.

For example, in the 1946 Tax Court case of *McEwen v. Commissioner*, the employer promised to pay an executive a specified percent-

⁶⁶ *Drescher*, 179 F.2d at 865 (emphasis added). The court devoted the balance of its opinion to determining the proper valuation of the income the taxpayer recognized from the arrangement, rejecting the taxpayer's argument that the prohibition on assignment rendered the annuity valueless. *Id.* The Second Circuit conceded, however, that the amount of income inclusion could be less than the amount of the premium that the company paid for the annuity: "It may not have been worth to him the amount his employer paid for it; but it cannot be doubted that there is a figure, greater than zero although less than the premium cost, which it would have cost him to acquire identical rights." *Id.* at 865-66.

⁶⁷ See *id.* at 865-66.

⁶⁸ Recall that, under the cash method, a taxpayer realizes income upon the receipt of cash, property, or services. See *supra* note 44 and accompanying text.

⁶⁹ In that case, the fair market value of the annuity taxed upon receipt would constitute the "investment in the contract" under I.R.C. § 72, and the excess of the aggregate annuity payments over this amount would constitute the investment yield subject to taxation. See *supra* notes 20-22 and accompanying text (describing annuity taxation).

age of its profits.⁷⁰ Pursuant to this arrangement, the employer annually transferred the requisite profit-sharing amounts to a trust created for the executive's benefit.⁷¹ The funding of the trust by the employer was irrevocable; that is, the trust agreement provided that no part of the trust estate could revert to the employer under any circumstance.⁷² As a result, the trust assets would not be subject to the claims of the employer's creditors in the event of the employer's insolvency.

In determining whether the executive was taxed as the employer transferred amounts to the trust or instead only as cash payments were later paid from the trust, the Tax Court framed the issue as follows: "[W]as 'any economic or financial benefit conferred on the [executive] as compensation' in the taxable year [in which the trust was funded]?"⁷³ The Tax Court answered this question in the affirmative and, accordingly, determined that the taxpayer recognized income at the time of funding.⁷⁴ In doing so, the court placed considerable emphasis on the fact that the trust estate could not revert to the employer under any circumstance.⁷⁵ The *McEwen* decision therefore established the proposition that a second-party promise gives rise to current income inclusion under the cash method if the promise is irrevocably funded.

The Tax Court's decision in *McEwen* laid the foundation for its later decision in *Spruill v. Commissioner*,⁷⁶ the case most commonly associated with the economic benefit doctrine. The employer in *Spruill* transferred \$10,500 to a trust for the benefit of its employee in 1945.⁷⁷ The terms of the trust provided that half of the assets would be distributed to the employee in 1946, with the remaining half distributed in 1947.⁷⁸ In determining the proper year of income inclusion—either when the trust was funded or when the employee received distributions from the trust—the court again examined whether any "economic benefit" had been conferred upon the employee in the year of funding.⁷⁹ Determining that the formation of the trust provided the execu-

⁷⁰ 6 T.C. 1018, 1019 (1946).

⁷¹ The trust agreement provided that the trustee would use the trust assets to purchase government bonds or single-premium annuities that called for payments to the employee beginning at age sixty. *Id.* at 1021–22.

⁷² *Id.* at 1023.

⁷³ *Id.* at 1026 (quoting *Smith v. Comm'r*, 324 U.S. 177, 181 (1945)).

⁷⁴ *See id.*

⁷⁵ *See id.*

⁷⁶ 16 T.C. 244, 247–48 (1951), *aff'd* 194 F.2d 541 (6th Cir. 1952).

⁷⁷ *Id.* at 245.

⁷⁸ *Id.*

⁷⁹ *See id.* at 247.

tive with the requisite economic benefit, the court held that the executive realized gross income at that point.⁸⁰

Following *McEwen*, *Sproull*, and other similar cases, the IRS comprehensively laid out its approach to the taxation of contractual payment obligations through a series of examples in Revenue Ruling 60-31.⁸¹ In the first two examples, an employer merely promised to pay an employee an amount in the future.⁸² In these cases, the IRS concluded that the creation of a contractual payment right in favor of the employee was not a taxable event.⁸³ In the process, the ruling announced that “[a] mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intentment of the cash receipts and disbursements method.”⁸⁴ The IRS reached a different conclusion, however, in the context of a second-party payment obligation that had been irrevocably funded. In Example 4 of the ruling, the employer paid a signing bonus to an escrow agent.⁸⁵ Pursuant to the escrow agreement, the agent was required to distribute to the employee such amount (plus interest) in installments over a five-year period.⁸⁶ If the employee died prior to expiration of the five-year term, the remaining payments were to be made to his estate.⁸⁷ Citing *Sproull*, the IRS determined that the signing bonus constituted income to the employee in the year in which the employer deposited the bonus in escrow.⁸⁸

3. A Unifying Theme

The authorities addressing third-party promises (e.g., *Brodie* and *Drescher*) and the authorities addressing funded second-party promises

⁸⁰ See *id.* at 247–48.

⁸¹ See Rev. Rul. 60-31, 1960-1 C.B. 174.

⁸² *Id.*

⁸³ See *id.*

⁸⁴ *Id.* A similar statement concerning second-party payment obligations was later made by the Tax Court in *Centre v. Commissioner*, 55 T.C. 16, 19 (1970): “The naked promise of an employer to pay compensation at some future date for services currently rendered is not income to a cash basis employee.” Using the cash method’s terminology, a naked promise of any employer is not an item of property. See Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 2006) (requiring “cash, property, or services” to be included in income in the taxable year in which they are received).

⁸⁵ See Rev. Rul. 60-31. Example 3 of the ruling involved a mere promise to pay issued by a book publisher to an author. The example shows that the ruling’s principles apply equally in the independent contractor context as they do in the employment context. See *id.*

⁸⁶ *Id.*

⁸⁷ See *id.* at 176–77.

⁸⁸ *Id.* at 180.

(e.g., *McEwen*, *Sproull*, and Revenue Ruling 60-31) share a unifying conceptual theme: the taxpayer's rights to future payment are not subject to the insolvency risk of the second party to the transaction that gave rise to the promise to pay.⁸⁹ In other words, in both contexts the taxpayer could receive full payment even if the second party became insolvent. Indeed, the similarity of these two strands of the common-law economic benefit doctrine was illustrated in Revenue Ruling 69-50,⁹⁰ which addressed the tax consequences to a physician in a third-party insurance arrangement. In that ruling, a health insurer permitted its participating physicians to irrevocably elect to defer a stated percentage of payments that the insurer owed the physician for treating its patient-subscribers.⁹¹ Stressing that the physician had provided medical services to the patient (as opposed to the health insurer), the ruling held that the deferred amounts were currently taxable to the physician under the economic benefit doctrine.⁹² This analysis would appear to be a straightforward application of the third-party promise rule set forth in *Brodie* and *Drescher*.⁹³ To support its conclusion, however, Revenue Ruling 69-50 described the patients as "fund[ing]" their payment obligations to the physicians with the medical insurance company's promises to pay.⁹⁴ Revenue Ruling 69-50 thus appears to meld the third-party promise strand of the economic benefit doctrine together with the funded second-party promise strand.⁹⁵

Nevertheless, regardless of the specific terminology used (i.e., third-party promise or funded second-party promise), the economic benefit doctrine provides that contractual payment obligations are treated as property under the cash method in all cases where the recipient is protected from the credit risk of the other party to the transaction in which the payment obligation arose.⁹⁶ This is an exception to the general rule that contractual payment obligations are not treated as property under the cash method.⁹⁷

⁸⁹ See *supra* notes 54–88 and accompanying text.

⁹⁰ Rev. Rul. 69-50, 1969-1 C.B. 140.

⁹¹ *Id.*

⁹² See *id.*

⁹³ Although the physicians performed services for the benefit of the patient-subscribers, they received promises to pay from the medical insurance company. The insurer was a third party to the compensation-for-medical-services transaction that gave rise to the promises.

⁹⁴ Rev. Rul. 69-50.

⁹⁵ See *id.*

⁹⁶ See, e.g., *Drescher*, 179 F.2d at 865; *Sproull*, 16 T.C. at 247–48.

⁹⁷ Another exception exists for contractual obligations that can be readily liquidated. See *Cowden v. Comm'r*, 289 F.2d 20, 23 (5th Cir. 1961). This so-called "cash equivalency" doctrine is far more limited, however, as it depends on the ability of the payee to assign the

The economic benefit doctrine represents a sensible application of the cash method of accounting. Recall that the cash method's imprecision is justified in terms of administrability.⁹⁸ The general exclusion of second-party promises ensures that garden-variety accounts receivable and similar payment rights are taxed as they are paid, not when they are created. This rule is easy to apply and it avoids valuation and liquidity concerns. In these respects, third-party promises differ significantly from second-party promises. Unlike second-party promises, third-party promises are not created simply through the performance of services; instead, they involve some degree of negotiation between all three parties. This aspect makes it easy to determine precisely when third-party promises are created.⁹⁹ In addition, third-party promises are almost always purchased for cash. As a result, subjecting third-party promises to immediate taxation will not implicate valuation or liquidity concerns.¹⁰⁰

III. STRUCTURED SETTLEMENTS OF PHYSICAL INJURY DAMAGES

Having explained that third-party promises as well as funded second-party promises have traditionally been regarded as property for

obligation "at a discount not substantially greater than the generally prevailing premium for the use of money." *See id.* at 24. Accordingly, only negotiable instruments of highly solvent obligors would potentially be treated as cash under this doctrine.

⁹⁸ *See supra* note 52 and accompanying text.

⁹⁹ For example, consider a typical account receivable. A promises to pay B \$500 if and when B drafts A's will. The promise to pay is created when B actually drafts the will. At that time, under an accrual regime, B would recognize the \$500 of income. In a two-party arrangement, treating the promise to pay as property would result in the realization event occurring when rights accrue, which can be difficult to determine. In a three-party arrangement (and in funded two-party arrangements), the taxable event would generally coincide with the issuance of the promise to pay from the third party.

¹⁰⁰ Because three-party arrangements are negotiated and third-party promises are purchased for cash, any purported liquidity burden would be entirely self-imposed. A payor would be indifferent between paying cash to the payee and paying cash to a third party for the benefit of the payee. If the payee directs the payor to pay cash to the third party, the payee has no cause to complain about any resulting liquidity burden. This payment of cash also makes valuation of the third-party promise rudimentary. Furthermore, because funded second-party promises involve the deposit of cash into a trust or escrow account from which future payments will be made, imposing immediate taxation on funded second-party promises will not create valuation or liquidity problems.

In addition, in the two-party context, substitute taxation is often imposed on the payor, and this substitute taxation usually offsets (in whole or in part) the tax benefit received by the payee. *See supra* note 35 (describing how, in nonqualified deferred compensation arrangements, a substitute tax is imposed on the employer). In the third-party context, there often is no substitute taxation imposed on any of the parties. For example, in the structured settlement context, there is no substitute taxation imposed on the defendant (or its insurer) or the SSC. *See infra* notes 235–262 and accompanying text. The possible absence of substitute taxation also militates in favor of treating third-party promises differently.

cash method purposes, the discussion can now return to the taxation of structured settlements. These arrangements fall within the third-party promise category, as the structured settlement company has no preexisting relationship with the plaintiff to whom it issues its promise to pay. Under the cases and IRS rulings previously described, the SSC obligation, therefore, would be treated as property under the cash method.¹⁰¹ Consequently, receipt of the SSC obligation would ordinarily constitute an event with tax significance.¹⁰² These general rules, however, have been altered to some extent in the context of payments of damages for physical injury claims.¹⁰³

A. Defendant as Obligor

Before the enactment of the Periodic Payment Settlement Act of 1982 (“PPSA”),¹⁰⁴ there existed some uncertainty over how the I.R.C. § 104(a)(2) exclusion from gross income for damages received on account of a personal injury applied to structured settlements of such claims.¹⁰⁵ Specifically, it was not clear whether a personal injury plaintiff who received a structured settlement could exclude the entirety of each periodic payment as it was received, or whether the exclusion extended only to the present value of the future payment stream. If the exclusion were limited to the present value, then the subsequent yield on this value would be taxable. The IRS previously had ruled that explicit investment yield—that is, the yield generated by the plaintiff’s investment of a lump-sum recovery—fell outside the scope of I.R.C. § 104(a)(2) and therefore was taxable.¹⁰⁶ The issue was whether the same rule would apply to the implicit investment yield embedded within the structured settlement.

Under general cash-method principles, the application of the I.R.C. § 104(a)(2) exclusion to structured settlements would seem clear. If the defendant remained obligated to make the future pay-

¹⁰¹ See *supra* notes 54–69 and accompanying text.

¹⁰² See *United States v. Drescher*, 179 F.2d 863, 865–66 (2d Cir. 1950) (noting that, because the plaintiff received an economic benefit, “[w]hatever present value the life insurance feature had to him [was] clearly taxable.”).

¹⁰³ See *infra* note 148 and accompanying text.

¹⁰⁴ Periodic Payment Settlement Act of 1982, Pub L. No. 97-473, 96 Stat. 2605, 2605 (1983). This legislation added the parenthetical language to I.R.C. § 104(a)(2) clarifying that the exclusion provided in the statute extended to damages received in prosecution for a claim for a personal injury or sickness “whether as lump sums or as periodic payments.” *Id.* § 101(a).

¹⁰⁵ I.R.C. § 104(a)(2) (2006).

¹⁰⁶ See Rev. Rul. 76-133, 1976-1 C.B. 34; Rev. Rul. 65-29, 1965-1 C.B. 59.

ments to the plaintiff, the plaintiff would be left with a mere promise to pay from the second party to the transaction.¹⁰⁷ In the tort context, the “transaction” is the event that precipitated the litigation. Because second-party obligations are disregarded under the cash method, any income tax consequences resulting from the plaintiff’s receipt of the defendant’s promise would be deferred until the periodic payments were received by the plaintiff. Only at that point would the payment of damages be tested for exclusion under I.R.C. § 104(a)(2). Accordingly, the deferred payments would qualify for the I.R.C. § 104(a)(2) exclusion to the same extent as if they had been paid immediately upon settlement, even though the deferred payments clearly include an investment yield component.

The IRS confirmed the foregoing analysis of defendant-issued payment obligations in Revenue Ruling 77-230.¹⁰⁸ In that ruling, the United States had established a trust to pay the future medical expenses of an individual who was physically injured at a government facility.¹⁰⁹ Any funds remaining in the trust upon the individual’s death would revert back to the United States.¹¹⁰ Because of this reversion right, the United States was considered to be the owner of the trust assets for tax purposes and the trust was disregarded as a separate entity.¹¹¹ The trust obligations to make future medical payments therefore were treated as obligations of the United States, which was the second party to the transaction.¹¹² For this reason, the ruling determined that all amounts distributed from the trust (including the income generated on investment of the trust assets) would be excluded from gross income under I.R.C. § 104(a)(2).¹¹³

B. *Defendant’s Insurer as Obligor*

Prior to the enactment of the PPSA in 1982, the analysis was less clear if the payment obligation to the plaintiff was issued by the defendant’s liability insurer instead of the defendant itself. Because the in-

¹⁰⁷ This assumes that the defendant’s contractual obligation was not funded (e.g., through an escrow or trust arrangement).

¹⁰⁸ Rev. Rul. 77-230, 1977-2 C.B. 214.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *See id.*; *see also* I.R.C. § 677(a)(2) (2006). Hence, the income generated through the investment of the trust assets would be taxed to the grantor. In this particular case, however, the trust income was not taxed because the United States was the grantor.

¹¹² *See* Rev. Rul. 77-230.

¹¹³ *Id.*

surer constituted a third party to the transaction that gave rise to the payment obligation (i.e., the event that caused the plaintiff's injury), the insurer's promise to pay would constitute property under the principles articulated in *Brodie v. Commissioner*, *United States v. Drescher*, and Revenue Ruling 69-50.¹¹⁴ Nonetheless, in a pair of revenue rulings issued in 1979, the IRS concluded that the plaintiff's receipt of an obligation of the defendant's insurer was not a receipt of property.¹¹⁵

In Revenue Ruling 79-220,¹¹⁶ the defendant's liability insurer promised to make periodic payments to the plaintiff to settle the plaintiff's personal injury claim. The insurer purchased an annuity to provide a source of liquidity that it could use to satisfy its obligations to the plaintiff, but the insurer retained all ownership rights in the annuity.¹¹⁷ Accordingly, the annuity purchased by the insurer remained subject to the claims of the insurer's creditors.¹¹⁸ Because of this, the IRS held that the insurer's promise did not implicate the economic benefit doctrine.¹¹⁹ As a result, the cash payments received by the plaintiff over time constituted the relevant damages recovery to be excluded under I.R.C. § 104(a)(2).¹²⁰ Implicit in this conclusion is that the obligation of the insurer was not property under the cash method even though it appeared to be a third-party promise.

Revenue Ruling 79-220 was not an aberration. Shortly after its release, the government reinforced it with Revenue Ruling 79-313.¹²¹ Under the facts of this latter ruling, a defendant's insurer agreed to make fifty annual payments to the plaintiff for damages sustained in an automobile accident.¹²² After stressing that the insurance carrier did not segregate its assets in a manner that would protect the plaintiff in the event of the insurer's insolvency, the ruling summarily concluded that the

¹¹⁴ See *supra* notes 54–69 and accompanying text.

¹¹⁵ As a technical matter, the rulings concluded that the creation of the payment obligation was not currently taxable to the plaintiff. Yet in terms of the rule of income recognition under the cash method of accounting, the holdings of the rulings necessarily imply that the IRS did not view the contractual payment obligations as property for this purpose.

¹¹⁶ Rev. Rul. 79-220, 1979-2 C.B. 74.

¹¹⁷ *Id.*

¹¹⁸ In the words of the ruling, the plaintiff “can rely on only the general credit of [the liability insurer] for collection of the monthly payments.” *Id.*; cf. Rev. Rul. 72-25, 1971-1 C.B. 127 (explaining that the purchase of an annuity by employer to provide liquidity to make payments of nonqualified deferred compensation did not operate to fund irrevocably the employer's payment obligation because the employer retained ownership of the annuity and thereby subjected the annuity to the claims of its general creditors).

¹¹⁹ See Rev. Rul. 79-220.

¹²⁰ See *id.*

¹²¹ Rev. Rul. 79-313, 1979-2 C.B. 75.

¹²² *Id.*

plaintiff did not realize the economic benefit of the present value of the future payment stream.¹²³ Accordingly, the periodic cash payments received pursuant to the structured settlement would be excluded under I.R.C. § 104(a)(2).¹²⁴ Again, the implication is that the insurer's obligation was not treated as property under the cash method.¹²⁵

The conclusions of Revenue Rulings 79-220 and 79-313 are difficult to reconcile with the common-law economic benefit doctrine.¹²⁶ Under the *Brodie* and *Drescher* decisions, an insurer's contractual obligation to make future payments to a taxpayer that had no prior relationship with the insurer was determined to provide a taxable economic benefit to the taxpayer.¹²⁷ These authorities appear inconsistent with the conclusions in these rulings.

The rulings also are inconsistent with Revenue Ruling 69-50, whose fact pattern is almost perfectly analogous.¹²⁸ In Revenue Ruling 69-50, a medical insurer had a pre-existing contract with its patient-subscribers that obligated the insurer to pay their medical costs.¹²⁹ Pursuant to the medical insurance contract, the insurer became obligated to make future payments to the physicians who provided treatment to the patient-subscribers.¹³⁰ The implication of Revenue Ruling 69-50, which taxed the physicians on the value of the insurer's promises when they were issued, is that the medical insurer was a third party to the physician-patient relationship, despite the pre-existing contractual obligations of the medical insurer towards the patient.¹³¹ Stated differently, the pre-existing contractual relationship did not cause the medical insurer to step into the shoes of the patient and become the "second party" to the compensation-for-medical-services transaction that gave rise to the contractual payment obligation.¹³² In each of the 1979 rulings, the liability insurer had a pre-existing contract with the defendant that obligated the insurer to pay the defendant's liability costs. Pursuant to this contract, the insurer made promises to make future payments to

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *See id.*

¹²⁶ *See* Frolik, *supra* note 1, at 580 (expressing surprise that the IRS did not apply the economic benefit doctrine in Rev. Rul. 79-220).

¹²⁷ *See Drescher*, 179 F.2d at 865-66; *Brodie v. Comm'r*, 1 T.C. 275, 282-84 (1942).

¹²⁸ *See* Rev. Rul. 69-50, 1969-1 C.B. 140.

¹²⁹ *Id.*

¹³⁰ *See id.*

¹³¹ *See id.*

¹³² *See id.*

the plaintiff.¹³³ To be consistent with Revenue Ruling 69-50, the IRS in the 1979 rulings should have determined that the pre-existing liability insurance contract did not cause the insurer to step into the shoes of the second party and that the I.R.C. § 104(a)(2) exclusion therefore applied only to the present value of the insurer's promise.

Unfortunately, Revenue Rulings 79-220 and 79-313 do not discuss or even mention *Brodie*, *Drescher*, or Revenue Ruling 69-50. It is therefore unclear whether the drafters of the 1979 rulings simply did not consider or respect these precedents, or whether the drafters distinguished them in some way. It is unlikely that the drafters would have intentionally undermined these long-standing authorities, as doing so would have considerable consequences on the taxation of nonqualified deferred compensation arrangements.¹³⁴ More likely, the drafters of the 1979 rulings may have distinguished *Brodie*, *Drescher*, and Revenue Ruling 69-50 on the basis that these latter authorities arose in the context of compensation for services—not in the context of recoveries in tort. Thus, the 1979 rulings may imply that the cash method principles are somehow different for tort recoveries. Perhaps the definition of a second-party promise is broader in the tort context such that it encompasses promises made by insurers who have previously assumed contractual liability for tort liabilities of the defendant.¹³⁵ Although such a rule would explain the divergence of the 1979 rulings from the well-established cash method principles that arose in the deferred compensation context, there appears to be no support in the Internal Revenue Code or the Treasury Regulations for the proposition that the general rules of the cash method are in fact different in the tort context.

C. Third-Party Assignee as Obligor

Not long after the publication of the 1979 revenue rulings, Congress clarified the tax treatment of structured settlements of claims covered by I.R.C. § 104(a)(2).¹³⁶ In the PPSA, Congress amended I.R.C. § 104(a)(2) to provide expressly that the exclusion from gross income applied to all damages received on account of personal injury “whether

¹³³ See Rev. Rul. 79-313, 1979-2 C.B. 75; Rev. Rul. 79-220, 1979-2 C.B. 74.

¹³⁴ See *supra* note 35 (explaining the taxation of nonqualified deferred compensation).

¹³⁵ See Rev. Rul. 79-313; Rev. Rul. 79-220.

¹³⁶ See Periodic Payment Settlement Act of 1982, Pub L. No. 97-473, § 101(a), 96 Stat. 2605, 2605 (1983). At the time, I.R.C. § 104(a)(2) excluded from gross income damages received on account of a personal injury. The statute subsequently was amended to limit the exclusion to damages received on account of personal *physical* injuries.

as lump sums or as periodic payments.”¹³⁷ The legislative history demonstrates that Congress did not seek to effect meaningful change with its elaboration on the I.R.C. § 104(a)(2) exclusion; rather, Congress simply intended to confirm the administrative approach previously taken by the IRS.¹³⁸ Citing Revenue Rulings 79-220 and 77-230, the reports of the House Ways and Means Committee and the Senate Finance Committee indicated that the amendment was “intended to codify, rather than change, present law.”¹³⁹ According to the Conference Committee that reconciled the House and Senate bills, the PPSA explicitly extended the exclusion from gross income for personal injury damages to amounts paid out of a fund “invested and owned by the tortfeasor or an insurer.”¹⁴⁰ Thus, Congress provided legislative ratification of the status quo tax treatment of plaintiffs who received periodic payments of I.R.C. § 104(a)(2) damages from the defendant or its insurer.¹⁴¹ This treatment is fully consistent with the general cash method principle that unfunded second-party promises are not property for cash method purposes if a liability insurer is deemed to “step into the shoes” of its insured as a second party.¹⁴²

Despite the statements in the legislative history that Congress intended merely to ratify existing administrative practice, the PPSA in fact significantly altered the taxation of structured settlements in cases where the defendant or its insurer assigns its payment obligations to a third-party SSC. In addition to amending I.R.C. § 104(a)(2), Congress enacted I.R.C. § 130 to address the tax consequences that arise when an SSC receives a cash payment to assume the obligation to make periodic payments to a plaintiff in cases covered by I.R.C. § 104(a)(2).¹⁴³ Specifi-

¹³⁷ *Id.*

¹³⁸ See S. REP. NO. 97-646, at 4 (1982); H.R. REP. NO. 97-832, at 4 (1982).

¹³⁹ S. REP. NO. 97-646, at 4; H.R. REP. NO. 97-832, at 4. In each report, the respective committees explained that, notwithstanding the administrative guidance supplied by the IRS addressing the application of the economic benefit doctrine to periodic damages payments, “it would be helpful to taxpayers to provide statutory certainty in the area.” S. REP. NO. 97-646, at 4; H.R. REP. NO. 97-832, at 4. Furthermore, the conference committee report accompanying the enacted bill also emphasized that “no negative inference should be drawn as to the appropriate tax treatment of such transactions under present law and administrative rulings.” H.R. REP. NO. 97-984, at 12 (1982) (Conf. Rep.).

¹⁴⁰ H.R. REP. NO. 97-984, at 12.

¹⁴¹ See *id.*

¹⁴² Cf. *supra* notes 115–125 and accompanying text (describing 1979 rulings that allowed for exclusion of periodic payments made by liability insurer to plaintiff).

¹⁴³ See Periodic Payment Settlement Act of 1982, Pub L. No. 97-473, § 101(b), 96 Stat. 2605, 2605–06 (1983). For an enlightening description of the lobbying effort mounted by the insurance industry leading to the enactment of I.R.C. § 130, see Richard B. Risk, Jr.,

cally, Congress provided an exclusion from gross income for amounts received by an SSC in consideration for agreeing to a “qualified assignment.”¹⁴⁴ In general, a “qualified assignment” is an assignment of the liability by the defendant or its insurer to make periodic payments of damages that are excluded from the plaintiff’s gross income under I.R.C. § 104(a)(2).¹⁴⁵ A “qualified funding asset” generally means an annuity, provided that the annuity is used by the SSC to fund its payment obligations.¹⁴⁶

Although the I.R.C. § 130 exclusion by its terms specifically addresses only the tax consequences to the SSC, it is clear that Congress intended for qualified assignments to have no effect on the plaintiff’s tax consequences.¹⁴⁷ That is, Congress intended that plaintiffs would be taxed the same regardless of whether the defendant or insurer retained its payment obligations or made a qualified assignment thereof. By enacting I.R.C. § 130, Congress implicitly abrogated the general rule that a third-party promise is an item of property in the I.R.C. § 104(a)(2) context.¹⁴⁸

Comment, *Structured Settlements: The Ongoing Evolution from a Liability Insurer’s Ploy to an Injury Victim’s Boon*, 36 TULSA L.J. 865, 874 (2001).

¹⁴⁴ I.R.C. § 130(a) (2006). The exclusion applies only to the extent that the cash payment received by the SSC does not exceed the cost of the qualified funding asset, such as an annuity. *See id.*

Whether the statutory exclusion provided by I.R.C. § 130(a) is necessary is not entirely clear. Prior to the enactment of the PPSA, the IRS issued conflicting private rulings on this issue. *Compare* I.R.S. Priv. Ltr. Rul. 82-48-073 (Aug. 31, 1982) (refusing to characterize the fee paid to the SSC as loan proceeds, noting that the SSC “is not repaying the obligee, but is paying a third party designated by the obligee”), *with* I.R.S. Priv. Ltr. Rul. 80-38-044 (June 24, 1980) (excluding the fee paid to the SSC from gross income, reasoning that “the transaction is not, in the economic sense, materially different from a simpl[e] two party loan transaction”). Payments received in exchange for the assumption of a payment obligation to a third party pose difficult issues under the income tax. *See generally* Robert H. Scarborough, *Property Purchase or Payment in Kind? The Oxford Paper Conundrum*, 62 TAX LAW. 823 (2009) (explaining that such transactions could be viewed as (a) a purchase of property/cash for a contingent liability that gives rise to basis as payments are made (the Purchase Model) or (b) a receipt of fee income by the taxpayer that supports deductions when payments of the assumed obligation are made (the Fee Model)).

¹⁴⁵ *See* I.R.C. § 130(c).

¹⁴⁶ *See id.* § 130(d). An annuity that serves as a “qualified funding asset” is exempt from the application of I.R.C. § 72(u), which generally subjects a corporate-owned annuity to current taxation on the inside build-up. *See id.* § 72(u)(3)(C). For further discussion of I.R.C. § 72(u) and its relevance to structured settlements, see *infra* notes 259–262 and accompanying text.

¹⁴⁷ I.R.C. § 130.

¹⁴⁸ A careful parsing of I.R.C. § 130 proves this implicit abrogation. I.R.C. § 130 defines a qualified assignment as one under which “the periodic payments are excludable from the gross income of the recipient under paragraph (1) or (2) of section 104(a).” *Id.* § 130(c)(2)(D). If the traditional third-party rule was applicable, then the purchase by a

This abrogation may be defensible as a policy matter. By not treating an SSC obligation as an item of property under the cash method, Congress provided a tax advantage to structured settlement participants by exempting the embedded investment yield from taxation.¹⁴⁹ Although many justifications have been offered for this tax subsidy, the Joint Committee on Taxation has suggested that Congress offered this subsidy in an attempt to minimize social costs that result when an injured plaintiff over-consumes or otherwise mismanages a lump-sum award of damages intended to finance future medical costs.¹⁵⁰ Yet given that I.R.C. § 104(a)(2) covers all damages on account of personal injuries (including compensation for pain and suffering and lost wages) and not just future medical expenses, the yield exemption is best viewed simply as a tax incentive for certain plaintiffs to invest their litigation recoveries. In any event, if Congress intends for the tax incentive in favor of structured settlements to be effective, it makes little sense to force plaintiffs to invest their litigation recoveries in a debt instrument of the particular defendant that harmed them or that of the particular defendant's insurer. By abrogating the third-party rule in the I.R.C. § 104(a)(2) context, Congress permits a plaintiff to shop around to select the annuity product that best satisfies the plaintiff's investment goals¹⁵¹ without sacrificing the tax benefit of yield exemption.¹⁵²

defendant (insurer) of the SSC obligation in favor of the plaintiff would be treated the same as if the plaintiff received a present, lump-sum payment of damages. Accordingly, the present value of the payment obligation would be excluded from gross income under I.R.C. § 104(a)(2), and the I.R.C. § 104(a)(2) exclusion would have no further application. The periodic payments would therefore *not* be excluded from gross income under I.R.C. § 104(a)(2) as required under I.R.C. § 130; rather, the tax treatment of those payments would be governed by the annuity rules provided in I.R.C. § 72. As a result, if the traditional third-party rule applied, it would be impossible for any assignments to qualify under I.R.C. § 130, which would render the provision useless. To avoid such an absurdity, it must be assumed that Congress implicitly abrogated the traditional third-party promise rule in the I.R.C. § 104(a)(2) context. See Richard B. Risk, Jr., *A Case for the Urgent Need to Clarify Tax Treatment of a Qualified Settlement Fund Created for a Single Claimant*, 23 VA. TAX REV. 639, 656 (2004) ("Congress expressed its intent that, in structured settlements, the judicial doctrine of economic benefit does not apply simply because a sum is set aside irrevocably for the payee's sole benefit . . .").

¹⁴⁹ See *supra* notes 28–31 and accompanying text (describing the yield exemption benefit).

¹⁵⁰ See STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., *TAX TREATMENT OF STRUCTURED SETTLEMENT ARRANGEMENTS* 4–5 (1999), available at http://www.jct.gov/jct_html/x-15-99.htm (describing congressional policy behind the tax subsidy for structured settlements). But see Scales, *supra* note 38, at 869–74 (challenging the myth of the squandering plaintiff).

¹⁵¹ One might expect that plaintiffs will most commonly choose highly rated SSCs to minimize the risk of default. Regardless of the plaintiff's diligence in selecting a highly rated insurance company to serve as the SSC, the plaintiff still may be subject to some

IV. STRUCTURED ATTORNEY'S FEES

Part III explains that Congress has statutorily abrogated the traditional third-party promise rule in the I.R.C. § 104(a)(2) context.¹⁵³ Outside of this specific context, however, it would appear that the third-party promise rule would continue to apply to other types of structured arrangements. Attorneys who structure their fees, however, have argued otherwise. In particular, structuring attorneys have argued that rights to future payments from parties other than their clients (i.e., the second party to the legal services transaction) are not “property.”¹⁵⁴

A. Section 83—A Context-Specific Codification of the Economic Benefit Doctrine

In 1969, Congress enacted I.R.C. § 83, which in general provides that a taxpayer who performs services resulting in a transfer of “property” is taxed on the property’s fair market value at the time the property is received.¹⁵⁵ Accordingly, if a taxpayer receives a contractual payment obligation as compensation for services, the issue under I.R.C. § 83 is the familiar issue of whether the obligation constitutes property. Although the statute is silent as to the definition of property, it is generally accepted that Congress intended to codify the economic benefit

degree of default risk, particularly in the current precarious economic environment, where the solvency of even the most established insurance companies is not beyond question. See Ron Lieber, *Your Insurance Company, and Related Worries*, N.Y. TIMES, Nov. 15, 2008, at B1 (discussing a physically injured plaintiff who “put the proceeds” of a legal settlement into an annuity issued by an insurance company that subsequently collapsed).

¹⁵² Despite this tax advantage afforded to structured settlements of personal injury claims, the Joint Committee on Taxation found that a majority of personal injury awards are paid through lump sums. See STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., TAX TREATMENT OF STRUCTURED SETTLEMENT ARRANGEMENTS 2. The Joint Committee offered a number of explanations for the failure of plaintiffs to avail themselves of the ability to invest effectively their damage awards on a tax-free basis, one of which was that defendants are attempting to capture the benefit of the tax subsidy by making lower structured settlement offers. *Id.* at 5; see also Scales, *supra* note 38, at 884 (noting that “there is no real dispute that structured settlements save defendants money”), 895–96 (proposing that I.R.C. § 72 be amended to permit plaintiffs who receive lump sum damages award to purchase an annuity of their choosing and still receive a tax-exempt investment yield as a means of eliminating the defendant’s negotiation leverage over the tax subsidy). Another reason for the failure of plaintiffs to take advantage of the structured settlement subsidy is that their preference for current consumption is not overcome by the prospect of earning a tax-free investment yield. Yet another possibility is that the effective rate of tax on capital income is low, which would mean that the tax advantage is small. See Calvin H. Johnson, *A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax*, 56 SMU L. REV. 13, 21–32 (2003).

¹⁵³ See *supra* note 148 and accompanying text.

¹⁵⁴ See *infra* notes 154–190 and accompanying text.

¹⁵⁵ See I.R.C. § 83(a) (2006).

doctrine that had developed in the case law.¹⁵⁶ Consistent with this understanding, Treas. Reg. § 1.83-3(e) defines “property” for purposes of the statute as follows:

[T]he term “property” includes real and personal property other than either money or *an unfunded and unsecured promise to pay money* or property in the future. The term also includes *a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor*, for example, in a trust or escrow account.¹⁵⁷

Note the similarities between this definition and the traditional economic benefit doctrine.¹⁵⁸ Both are consistent with the notion that, in order to defer tax upon receipt of a contractual payment obligation, the recipient of the obligation must retain the status of a general unsecured creditor of the second party to the transaction.¹⁵⁹

B. Childs v. Commissioner

The Tax Court wrestled with the definition of property under I.R.C. § 83 when it addressed the tax consequences of structured attorney’s fees in *Childs v. Commissioner* in 1994.¹⁶⁰ The taxpayers were lawyers who had executed a contingent fee agreement with a personal injury client.¹⁶¹ The litigation eventually was settled, with both the client and the attorneys structuring their respective litigation recoveries.¹⁶² Specifically, the defendant’s insurer agreed to make certain payments to the client and to the attorneys, and the insurer then assigned its obligation to

¹⁵⁶ See I.R.S. Tech. Adv. Mem. 93-36-001 (May 12, 1993) (“Section 83 of the Code is generally believed to be a codification of the economic benefit doctrine as it applies to transfers of property as remuneration for services.”); Patricia Ann Metzger, *Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation*, 29 TAX L. REV. 525, 552 (1974) (“Section 83 both codifies and expands the common-law notions of economic benefit as they relate to property transferred in connection with the performance of services.”).

¹⁵⁷ Treas. Reg. § 1.83-3(e) (as amended in 2005) (emphasis added). For background on the development of this regulatory definition, see Brant J. Hellwig, *Nonqualified Deferred Compensation and the Pre-Statutory Limits on Deferral*, in BENDER’S FEDERAL INCOME TAXATION OF RETIREMENT PLANS § 13.03[2][a] (Alvin D. Lurie ed., 2008); Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1125–27 (2005).

¹⁵⁸ See, e.g., *United States v. Drescher*, 179 F.2d 863, 864–65 (2d Cir. 1950).

¹⁵⁹ See *id.* at 865–66.

¹⁶⁰ 103 T.C. 634, 648–53 (1994), *aff’d*, 89 F.3d 856 (11th Cir. 1996).

¹⁶¹ See *id.* at 637.

¹⁶² See *id.* at 640.

make these payments to an SSC.¹⁶³ The SSC thereafter purchased an annuity to fund its assumed payment obligations.¹⁶⁴ The *Childs* case addressed the tax consequences of the arrangement to the attorneys.¹⁶⁵ The precise issue was whether the attorneys recognized income upon the creation of the structured arrangement or only as the scheduled cash payments were received.¹⁶⁶ Resolution of the issue turned on whether the contractual payment obligations issued by the SSC to the attorneys constituted “property” for purposes of I.R.C. § 83.¹⁶⁷

As previously described, Congress enacted I.R.C. § 83 against the backdrop of the common-law economic benefit doctrine, and economic benefit principles were incorporated into the definition in Treas. Reg. § 1.83-3(e).¹⁶⁸ Under the well-established principles of *Brodie v. Commissioner*, *United States v. Drescher*, and Revenue Ruling 69-50, if a service provider receives a contractual payment obligation of a person other than the service recipient, the service provider is deemed to receive property.¹⁶⁹ Although Treas. Reg. § 1.83-3(e) does not limit explicitly the scope of contractual payment obligations that are excluded from the definition of property to promises issued by the service recipient,¹⁷⁰ such a limitation was so well engrained in the doctrine that it did not warrant specific articulation. There is no evidence that Congress intended to reverse the well-established third-party promise rule—a principle that “dates from the dawn of federal tax law”¹⁷¹—through the enactment of I.R.C. § 83.¹⁷²

¹⁶³ See *id.* at 640–41.

¹⁶⁴ *Id.* at 643. The attorneys were named as the annuitants under the annuity, and their respective estates were designated as contingent beneficiaries of their share. The SSC, however, remained the owner of the annuity.

¹⁶⁵ See *id.* at 648–53.

¹⁶⁶ The tax consequences to the client were not in dispute. Based on the facts, the client’s structured settlement would appear to be covered by I.R.C. § 104(a)(2) and, accordingly, the client would have been able to exclude all of the periodic payments from gross income.

¹⁶⁷ *Childs*, 103 T.C. at 653.

¹⁶⁸ See I.R.C. § 83 (2006); Treas. Reg. § 1.83-3(e) (as amended in 2005).

¹⁶⁹ See *Drescher*, 179 F.2d at 865–66; *Brodie v. Comm’r*, 1 T.C. 275, 282–84 (1942); Rev. Rul. 69-50, 1969-1 C.B. 140.

¹⁷⁰ See Treas. Reg. § 1.83-3(e).

¹⁷¹ George L. White, 570-2nd Tax Mgmt. (BNA) Accounting Methods—General Principles, at A-72 n.877 (2004).

¹⁷² See *id.* at A-72 (stating that, although I.R.C. § 83 excludes unfunded and unsecured obligations from the definition of property, “[i]f the transfer is of obligations of a third party, they are ‘property.’”); see also JOSEPH DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY* 748 n.3 (2d ed. 1999) (reaching the same conclusion). If Congress had intended to reverse the third-party promise rule, then the enactment of I.R.C. § 83 would not have codified the economic benefit doctrine; rather, it would have

Returning to the facts of *Childs*, the case should have been resolved rather easily in favor of the IRS. The attorneys provided their services to their client, and their client compensated them by agreeing to a settlement pursuant to which the attorneys received a payment obligation issued by the SSC, a clear third party to the attorney-client relationship.¹⁷³ The client's assignment of the SSC obligation to the attorneys,¹⁷⁴ therefore, constituted payment of the attorney's contingent fee

obliterated it. *But see* I.R.S. Tech. Adv. Mem. 93-36-001 (May 12, 1993) ("Section 83 of the Code is generally believed to be a codification of the economic benefit doctrine as it applies to transfers of property as remuneration for services."); MCKEE ET AL., *supra* note 47, at 5-6 (noting that "[a]s broadly applicable as it is, § 83 was not intended to supplant the substantial body of law governing deferred compensation arrangements"); Metzger, *supra* note 156, at 552 ("Section 83 both codifies and expands the common law notions of economic benefit as they relate to property transferred in connection with the performance of services.").

¹⁷³ See *Childs*, 103 T.C. at 640-41.

¹⁷⁴ In *Commissioner v. Banks*, the U.S. Supreme Court explained that, in a contingent fee arrangement, the entire recovery (including any portion that is paid to the attorney pursuant to the fee agreement) constitutes gross income to the plaintiff. 543 U.S. 426, 433-37 (2005). The plaintiff is then treated as paying the attorney. Accordingly, the fact that the SSC obligation may not, as a formal matter, run through the plaintiff would not change the conclusion that the plaintiff is compensating the attorney with a third-party promise.

The conclusion in *Banks* that the attorney fee portion of the award is deemed to "flow through" the plaintiff on its way to the attorney may result in an unintended application of an excise tax that is imposed on structured settlement factoring transactions. In 2002, Congress enacted I.R.C. § 5891, which imposes an excise tax on certain sales of physical injury structured settlements. Congress apparently was concerned that plaintiffs were selling their rights to future payments to factoring companies at excessive discounts. See STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., TAX TREATMENT OF STRUCTURED SETTLEMENT ARRANGEMENTS 6 (noting that the imposition of the tax on the amount of the discount served a consumer protection goal). The excise tax is imposed whenever structured settlements that qualify under I.R.C. § 104(a)(2) are "transfer[red] . . . for consideration by means of sale, assignment, pledge, or other form of encumbrance" unless the transfer is approved in advance by a court order. I.R.C. § 5891(c)(3) (2006). To avoid the excise tax, the court order must determine, among other things, that the transfer "is in the best interest of the payee, taking into account the welfare and support of the payee's dependents." *Id.* § 5891(b)(2)(ii). In the absence of such a court order, an excise tax is imposed on the transferee equal to forty percent of the amount of the factoring discount. *Id.* § 5891(a). The factoring discount is equal to the excess of the total undiscounted future payments owed to the transferee over the present value of the future payments. See *id.* § 5891(c)(4).

Under *Banks*, a structured attorney's fee arrangement is deemed to flow through the plaintiff. The attorney's right to receive future payments is treated as first received by the plaintiff and then immediately re-transferred from the plaintiff to the attorney in satisfaction of the plaintiff's contractual obligation to pay the attorney for legal services. Unless a court order specifically approves the re-transfer of the payment rights from the plaintiff to the attorney, in compliance with the specific requirements of I.R.C. § 5891, a significant excise tax would appear to be imposed on the attorney at the time the structured fee arrangement is created. This result was not intended by Congress, which was interested in

in the form of property.¹⁷⁵ The attorneys, as a consequence, should have recognized income immediately to the extent of the fair market value of the SSC obligation, which could be readily determined by reference to the purchase price of the annuity.

The Tax Court, however, reached the opposite conclusion.¹⁷⁶ In its analysis, the court simply missed the second-party versus third-party issue. The court focused on the question of whether the SSC obligation was “funded” or “secured” within the meaning of Treas. Reg. § 1.83-3(e).¹⁷⁷ In this manner, the Tax Court mistakenly evaluated the payment obligations of the SSC just as they would have evaluated payment obligations of the client (i.e., the second party).¹⁷⁸ Because the attorneys were relying on the general creditworthiness of the SSC, the court determined that the SSC obligation was neither funded nor secured

protecting plaintiffs from selling their payment rights to factoring companies at huge discounts. Nevertheless, the excise tax would appear to apply based on the terms of the statute and the Supreme Court’s analysis in *Banks*.

¹⁷⁵ One could view the client as irrevocably funding the promise to pay the attorney a contingent fee with the SSC obligation. *Cf.* Rev. Rul. 69-50, 1969-1 C.B. 140 (treating patient-subscriber as funding his promise to his physician with a medical insurer’s promise to pay). Yet, regardless of whether one interprets the arrangement as the transfer of a third-party obligation or the funding of a second-party obligation, the result is the same: the SSC obligation issued in the attorney’s favor constitutes property under I.R.C. § 83, and the attorney is required to include the fair market value of the SSC obligation in gross income at that time.

¹⁷⁶ *See Childs*, 103 T.C. at 653.

¹⁷⁷ *See id.* at 649.

¹⁷⁸ The only plausible way of justifying the result in *Childs* is to characterize the payment obligations as having been issued by the plaintiff to the attorney. As explained by the IRS in a Coordinated Issue Paper that touched on the *Childs* decision:

In essence, the service recipient (the plaintiff) established a portion of its own funds (the potential settlement) as the only source from which the service provider would be paid. Although technically the service provider received a promise from the third party (the defendant), the service provider in substance continued to possess an unsecured interest in a portion of the service recipient’s funds (the potential settlement which otherwise would have been paid to the service recipient), which would not be available until the settlement was paid.

I.R.S. Coordinated Issue Paper 9300.28-00 (Oct. 15, 2004). The distinction that the IRS dismisses as a mere technicality, however, is crucial to the analysis. The attorneys in *Childs* did not accept the plaintiff’s unsecured promise to transfer a portion of the plaintiff’s structured settlement payments as the plaintiff received them; few, if any, plaintiff’s attorneys would agree to such an arrangement. The attorneys in *Childs* structured the arrangement so that their rights to future payment were not subject to the default risk of the service recipient (i.e., the plaintiff). Under well established common law economic benefit principles, the elimination of such default risk causes the contractual payment obligations to constitute property under I.R.C. § 83.

and, accordingly, that it was not property.¹⁷⁹ The attorneys therefore were entitled to defer the recognition of income until they received cash payments from the structured fee arrangement.¹⁸⁰

The Tax Court decision in *Childs*, affirmed by the U.S. Court of Appeals for the Eleventh Circuit without a published opinion,¹⁸¹ is objectively flawed.¹⁸² There simply is no way of reconciling the result in *Childs* with the decisions in *Brodie* and *Drescher* and the analysis in Revenue Ruling 69-50.¹⁸³ Like the executives in *Brodie* and *Drescher* and the physicians in Revenue Ruling 69-50, the attorneys in *Childs* received payment obligations from unrelated insurance companies as compensation for their respective services.¹⁸⁴ Yet *Brodie*, *Drescher*, and the physicians were taxed immediately, while the attorneys in *Childs* were not. Because the Tax Court missed the third-party promise issue, it did not attempt to reconcile its conclusion with these contrary authorities. Despite these obvious flaws, the *Childs* decision now serves as the foundation of a burgeoning industry offering structured payments of attorney's fees.¹⁸⁵

¹⁷⁹ *Childs*, 103 T.C. at 649–53.

¹⁸⁰ *See id.* at 653.

¹⁸¹ 89 F.3d 856, 856 (11th Cir. 1996).

¹⁸² *See* Gordon T. Butler, *Economic Benefit: Formulating a Workable Theory of Income Recognition*, 27 SETON HALL L. REV. 70, 115–17 (1996) (contending that the holding in *Childs* is erroneous because the court failed to recognize that the payment obligation was issued by a third party); Polsky & Hellwig, *supra* note 157, at 1131–35 (same). For revenue rulings reaching a contrary holding in analogous factual circumstances, see Rev. Rul. 77-420, 1977-2 C.B. 172 and Rev. Rul. 69-50, 1969-1 C.B. 140. Nonetheless, additional authority for the Tax Court's flawed interpretation of I.R.C. § 83 in *Childs* does exist. *See* *Minor v. United States*, 772 F.2d 1472, 1476 (9th Cir. 1985) (holding that benefits issued by a third-party did not constitute property because they were "unsecured"). For discussion and criticism of the Ninth Circuit's decision in *Minor*, see Polsky & Hellwig, *supra* note 157, at 1136–39.

¹⁸³ *See* *Drescher*, 179 F.2d at 865–66; *Brodie*, 1 T.C. at 282–84; Rev. Rul. 69-50.

¹⁸⁴ SSCs are affiliates of life insurance companies, but this distinction is of no doctrinal or substantive import.

¹⁸⁵ One commentator has suggested that the result in *Childs* is limited to attorney's fees that stem from a plaintiff's claim that is described in I.R.C. § 104(a)(2):

While the decision in *Childs* broadened the class of payees covered under structured settlements to include attorneys, it leaves intact the requirement that the periodic payments must result from a judgment or settlement where the payments to the claimant are on account of a personal physical injury or sickness within the meaning of § 104(a)(2).

See Risk, *supra* note 148, at 661. The Tax Court, however, did not (nor could not) justify the result in *Childs* with reference to I.R.C. § 104(a)(2), and there is no reason to believe that the tax treatment of structured attorney's fees depends on the nature of the litigation in which the fees were earned.

As illustrated above, by deferring the recognition of income until receipt of cash, the rule in *Childs* allows structuring attorneys to effectively invest their fees on a tax-free basis.¹⁸⁶ Thus, the structured attorney fee industry essentially offers unlimited “super-IRAs” to trial lawyers. Structured fees are superior to IRAs because they allow trial lawyers to invest tax-free without any of the limitations and restrictions that apply to IRAs.¹⁸⁷ There are no dollar limits on the amount of fees that can be invested in a structured fee arrangement and there is no penalty for pre-retirement withdrawals.¹⁸⁸ These arrangements provide all the tax benefits of IRAs without any of the restrictions or limitations, and they are (as a practical matter) available only to the personal injury plaintiff’s bar.¹⁸⁹

In summary, *Childs* was wrongly decided, and its practical implications are significant. Under *Childs*, trial lawyers can easily avoid tax on capital income in a way that was certainly never contemplated by Congress. The IRS should immediately repudiate the *Childs* holding, and the Treasury should clarify that third-party promises (such as SSC obligations) constitute property in the I.R.C. § 83 regulations. Alternatively, Congress should enact legislation to close the loophole.¹⁹⁰

¹⁸⁶ Although it is possible that the investment yield on the fee could be taxed to the payor in the context of nonqualified deferred compensation arrangements, for reasons explained in Part VI below, this form of substitute taxation does not exist in the structured settlement context. *Infra* notes 235–262 and accompanying text.

¹⁸⁷ See *supra* note 4.

¹⁸⁸ Amounts invested in structured settlements can be “withdrawn” before retirement age either by providing for cash payments to be received before then or by selling the SSC obligation for cash.

¹⁸⁹ Structured fee arrangements also compare quite favorably to employer-provided qualified plans. Both provide tax-free compounding. Structured fee arrangements, unlike qualified plans, allow unlimited “contributions” and penalty-free early “withdrawals.” In addition, unlike qualified plans, structured fee arrangements may be created for the exclusive benefit of highly compensated employees. One industry participant has described the structured fee arrangement as “a personal discriminatory retirement plan.” See Structured Settlement Services LLC, *Structured Concept Being Reinvented*, <http://www.structuredsettlements.org/more-info/structured-reinvented/> (last visited Jan. 8, 2010).

¹⁹⁰ Attorneys could argue that structured fee arrangements allow them to “smooth” their income over time and that this smoothing should be allowed. We address this argument in the context of non-physical structured settlements. See *infra* notes 229–231 and accompanying text. We conclude that although income averaging may be defensible as a general policy matter, this argument is not persuasive because (i) income averaging is generally not available outside of the structuring context and there is no compelling policy reason why it ought to be allowed only in this narrow context, and (ii) structuring provides the significant benefit of tax-free investment yield; therefore, it does not simply ameliorate any bunching problem. In addition, very successful attorneys (who would be most likely to structure large amounts of fees) will likely be in the top marginal tax bracket for the rest of their lives; therefore, they would not suffer from any bunching problem.

V. STRUCTURED SETTLEMENTS OF NON-PHYSICAL INJURY DAMAGES

In Part III, we explained that, in cases where the I.R.C. § 104(a) (2) exclusion applies, Congress has abrogated the common law third-party promise rule to allow plaintiffs to obtain a tax-free yield in structured settlements governed by I.R.C. § 130.¹⁹¹ At the time I.R.C. § 130 was enacted, the I.R.C. § 104(a) (2) exclusion applied to all personal injury claims. In 1996, however, Congress narrowed the I.R.C. § 104(a) (2) exclusion to apply only to claims involving a personal *physical* injury.¹⁹² As a result, damages received on account of a non-physical injury now are fully taxable.¹⁹³ This amendment to I.R.C. § 104(a) (2) necessarily restricted the scope of qualified assignments under I.R.C. § 130. Under I.R.C. § 130, qualified assignments are assignments of obligations to make periodic payments that are excluded from gross income under I.R.C. § 104(a) (2).¹⁹⁴ Accordingly, I.R.C. § 130 no longer applies to structured settlements of non-physical injury claims, and it would therefore appear that the third-party promise rule would cause the SSC obligation (a clear third-party promise) to be treated as property under the cash method.

Under this view, non-physical injury structured settlements would be immediately taxable to the plaintiff. Structuring plaintiffs, therefore, would be taxed as if they received a lump-sum recovery equal to the present value of the SSC obligation and subsequently invested the lump sum in the annuity that serves as the funding asset. Although this analysis seems straightforward, the IRS appears to have a different view.

Attorneys could also argue that structured fee arrangements make it easier for them to convince their clients to accept structured settlements and that subjecting structured fee arrangements to immediate taxation would burden them with a liquidity problem. The *Childs* approach avoids this liquidity problem, thus making it easier for attorneys to accept structured fee arrangements, which in turn makes it easier for attorneys to persuade their clients to accept structured settlements that are in the clients' best interests. Although this might be plausible in some cases, the fact remains that yield exemption is a significant tax benefit that results from the *Childs* analysis. In addition, the *Childs* approach is available even in cases where the plaintiff accepts a lump sum. The better approach to the problem would be for the attorney to educate a skeptical client on the present value of the structured settlement so that the client would be willing to accept a favorable structured settlement even if the attorney's fee is taken in a lump sum. Alternatively, the attorney could accept part of the fee in a lump sum and part as a structured fee and use the partial lump sum to pay the tax due in the year of settlement.

¹⁹¹ See *supra* note 148 and accompanying text.

¹⁹² See Small Business Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838.

¹⁹³ See I.R.C. § 104(a) (2) (2006).

¹⁹⁴ See *id.* § 130(c).

A. *The Government's Non-Binding Endorsement of Childs v. Commissioner*

In Private Letter Ruling 2008-36-019,¹⁹⁵ the IRS addressed the tax consequences of a plaintiff's structured settlement of a non-physical tort claim against her employer.¹⁹⁶ To settle the non-wage (e.g., emotional distress) claims of the plaintiff, the employer promised to make future periodic payments to the plaintiff.¹⁹⁷ The employer, as is typical in structured settlements, paid an SSC to assume its obligation to make these payments.¹⁹⁸ The SSC then used the payment to purchase an annuity as the funding asset.¹⁹⁹ Under the third-party promise rule, the fair market value of the SSC obligation that the employer purchased for the benefit of the plaintiff would be currently taxable.²⁰⁰ Nonetheless, the ruling concluded that the plaintiff would recognize income only as cash payments were received pursuant to the arrangement. The IRS reasoned as follows:

Neither the execution of the Assignment [of the employer's obligation to the SSC] nor the purchase of an annuity contract by the [SSC] to fund its obligation to the [plaintiff] shall be viewed as conferring a current economic benefit on the [plaintiff]. After the execution of the . . . Assignment, the [plaintiff] will possess only a mere promise to be paid (*although the identity of the promisor will have changed*).²⁰¹

This analysis perpetuates the mistake made by the Tax Court in *Childs v. Commissioner*.²⁰² By ignoring the context in which the SSC obligation was issued, the ruling creates a seemingly irreconcilable conflict with the long-standing authorities of *Brodie*, *Drescher*, and Revenue Rul-

¹⁹⁵ See I.R.S. Priv. Ltr. Rul. 2008-36-019 (Sept. 5, 2008).

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ See *id.*

¹⁹⁹ See *id.*

²⁰⁰ Because the damage claim did not relate to a personal physical injury, I.R.C. § 104(a)(2) had no application to the facts of the ruling. Even though the plaintiff had been employed by the defendant, I.R.C. § 83 likely does not apply to the structured settlement of the non-wage portion of the claim, as it is difficult to characterize tort compensation that does not relate to the plaintiff's wages as having been transferred "in connection with the performance of services." I.R.C. § 83 (2006). The non-wage injury suffered by the plaintiff in the ruling may have depended on her status as an employee, but the compensated claim by definition did not relate to the provision of services.

²⁰¹ I.R.S. Priv. Ltr. Rul. 2008-36-019 (emphasis added).

²⁰² See 103 T.C. 634, 648–53 (1994) (ignoring the second-party versus third-party issue in ruling that an SSC obligation was not property), *aff'd*, 89 F.3d 856 (11th Cir. 1996).

ing 69-50.²⁰³ The payment obligation in the ruling was issued by the SSC, a third party to both the litigation as well as the employment relationship that gave rise to the litigation.²⁰⁴ Under the long-standing authorities, such a third-party promise constitutes property that is taxable upon receipt.²⁰⁵

Despite the obvious conflict between the ruling and the long-standing authorities, the letter ruling never mentions *Brodie*, *Drescher*, or Revenue Ruling 69-50. The IRS was apparently led astray by the *Childs* decision. Though the ruling does not explicitly cite the *Childs* decision as authority for its conclusion, it does favorably mention and discuss *Childs* in its recitation of relevant authorities.²⁰⁶ The ruling's sloppy analysis—particularly, its failure to address conflicting authorities—and its conclusion are fully consistent with that decision. In one respect, the ruling is even worse than the *Childs* decision. Although the Tax Court in *Childs* apparently overlooked the second-party versus third-party promise issue, the IRS in Private Letter Ruling 2008-36-019 explicitly declared irrelevant the fact that the identity of the promisor had changed when the employer assigned its liability to the SSC.²⁰⁷ Although private letter rulings officially carry no precedential weight,²⁰⁸ the ruling supplies unwarranted credence to the flawed holding of the *Childs* case.

B. A Threat to Capital Income Taxation?

If the conclusion of Private Letter Ruling 2008-36-019 truly represents the position of the IRS in this area, any remaining uncertainty surrounding the validity of the holding in *Childs* will have been eliminated. As a result, the benefit of tax-free investment offered through structured settlements could be expanded far beyond that which Congress intended.²⁰⁹ Theoretically, it could be available to any taxpayer

²⁰³ See I.R.S. Priv. Ltr. Rul. 2008-36-019.

²⁰⁴ See *id.*

²⁰⁵ See *United States v. Drescher*, 179 F.2d 863, 865–66 (2d Cir. 1950); *Brodie v. Comm'r*, 1 T.C. 275, 282–84 (1942); Rev. Rul. 69-50, 1969-1 C.B. 140.

²⁰⁶ I.R.S. Priv. Ltr. Rul. 2008-36-019.

²⁰⁷ The ruling expressly notes that “the identity of the promisor” had changed from the employer to the SSC. *Id.*

²⁰⁸ Rather, private letter rulings are binding only on the IRS with respect to the party to whom it is issued. I.R.C. § 6110(k)(3) (2006).

²⁰⁹ In fact, the benefit of tax-free investing that is granted to non-physical injury plaintiffs and to attorneys under a *Childs* analysis is even more advantageous than that granted to physical injury plaintiffs under I.R.C. § 104(a)(2). The latter plaintiffs cannot sell their structured settlements for cash without triggering the excise tax in I.R.C. § 5891, absent a

who wishes to invest any amount of gross income in any sort of annuity.²¹⁰ A taxpayer could “structure” their receipt of this gross income by causing the payor to simply pay amounts to an SSC, which then promises to make deferred payments to the taxpayer. In fact, commentators have already recognized that the *Childs* decision could be used in the context of installment sales of property.²¹¹ Indeed, if Private Letter Ruling 2008-36-019 and the *Childs* case on which it rests are taken to their logical conclusion, then employees and other service providers could, through the use of structures, easily avoid the limitations and restrictions of IRAs and qualified plans without sacrificing yield exemption.

C. Distinguishing the Ruling from Prior Authorities

Because the ruling’s analysis is conclusory, it is difficult to surmise the IRS’s reasoning to support it. We believe, given the similarity of their respective analyses and conclusions, that it is likely based on the IRS’s favorable opinion of the substantially flawed *Childs* decision. It is possible, however, that the IRS has implicitly drawn a distinction between the cash method rules that apply in the compensation-for-services context and those that apply in the context of tort litigation. The economic benefit doctrine, which includes the third-party promise rule, traditionally has been applied in the service context, where cash method issues arise most frequently. The decisions in *Brodie* and *Drescher*, as well as Revenue Ruling 69-50, all of which treated third-party promises as property under the cash method, involved payment obligations issued as compensation for services.²¹² Private Letter Ruling 2008-36-019, therefore, may signal the IRS’s belief that the third-party promise rule does not apply in the tort recovery context.

court order finding that it is in the best interests of the selling plaintiff. In contrast, I.R.C. § 5891 does not apply to structured payment obligations owned by non-physical injury plaintiffs and attorneys. Accordingly, they can sell their payment rights and never trigger the excise tax. In other words, physical injury plaintiffs receive the benefit of yield exemption at the cost of some illiquidity, but non-physical injury plaintiffs and trial lawyers receive only the benefit of yield exemption.

²¹⁰ See Steven R. Craig & Blake M. Holler, *The Use of Nonqualified Structured Settlements in the Sale of Capital Assets*, J. FIN. SERVICE PROF. 79, 82 (2006) (explaining that the economic benefit doctrine “should not be an issue” because *Childs* addresses this doctrine as it “relates to an assigned annuity contract”).

²¹¹ See *id.* at 81–82 (describing how the structured settlement technique can be used advantageously in the installment sale context).

²¹² See *Drescher*, 179 F.2d at 865–66; *Brodie*, 1 T.C. at 282–84; Rev. Rul. 69-50, 1969-1 C.B. 140.

Support for this view may be found by closely comparing Revenue Ruling 69-50 with the 1979 rulings involving structured settlements of personal injury claims.²¹³ We have already explained that the relevant facts in the rulings appear the same in all material respects, except that the former involves compensation for services and the latter involve tort recoveries.²¹⁴ Yet the rulings come to drastically different conclusions, suggesting that perhaps the cash method rules are different in the tort context. In addition, the facts of the private letter ruling specifically note that the structured portion of the taxpayer's settlement involved the non-wage portion of the settlement.²¹⁵ The wage portion instead was paid through a lump-sum payment.²¹⁶ This again suggests that the IRS was possibly drawing a distinction in how the cash method rules apply to tort recoveries vis-à-vis remuneration for services.

If the IRS in Private Letter Ruling 2008-36-019 implicitly drew a distinction between payment obligations in the tort versus service context, there are two notable consequences. First, the yield-exemption loophole would be relatively narrow, as the tax benefit would be available only to tort plaintiffs. Second, it would mean that the analysis in *Childs* remains flawed, as it involved the tax consequences of compensation for legal services (i.e., not a tort recovery).

We, however, do not believe that the IRS intended the private letter ruling to signal its belief that the tax treatment of third-party payment obligations is context-dependent. Rather, because of the similarity of their respective analyses and conclusions, we believe that the ruling is based on the IRS's misguided adherence to the flawed decision in *Childs*. It would be strange to cite and discuss *Childs* if the ruling's rationale were based on a theory that means that the case was improperly decided. In addition, except when Congress has specifically legislated to the contrary, the cash method rules are not context-specific nor have they been applied by the IRS in a context-specific manner. For example, lottery winnings were historically subject to the same cash method doctrines established in the compensation-for-services context. Problems with this approach led Congress to adopt legislation modifying the constructive receipt doctrine with respect to periodic payments of lottery winnings.²¹⁷

²¹³ Compare Rev. Rul. 79-313, 1979-2 C.B. 75, and Rev. Rul. 79-220, 1979-2 C.B. 74, with Rev. Rul. 69-50.

²¹⁴ See *supra* notes 128-135 and accompanying text.

²¹⁵ See I.R.S. Priv. Ltr. Rul. 2008-36-019 (Sept. 5, 2008).

²¹⁶ See *id.*

²¹⁷ See I.R.C. § 461(h) (2006).

D. Possible Policy Justifications for the Ruling

Although the doctrinal foundation of Private Letter Ruling 2008-36-019 is highly questionable, various policy arguments can be made to support its result. This subpart suggests plausible policy justifications, but ultimately finds them not fully persuasive.

1. Avoidance of AMT

One policy argument in favor of allowing non-physical injury plaintiffs to report gross income from structured settlements only as they receive cash is that it could allow certain plaintiffs to avoid the draconian application of the Alternative Minimum Tax (“AMT”). A brief example illustrates the AMT issue. Suppose a plaintiff successfully prosecutes a defamation suit with the assistance of counsel retained on a contingency basis. The litigation results in a \$3 million settlement, of which the attorney is entitled to \$1 million. The \$3 million dollar settlement is included in the plaintiff’s gross income because the claim is based on a non-physical injury and, accordingly, the I.R.C. § 104(a)(2) exclusion does not apply.²¹⁸ Although the plaintiff may deduct the \$1 million contingent fee under I.R.C. § 212(1) as a cost of producing the \$3 million of gross income,²¹⁹ the deduction suffers from its characterization as a “miscellaneous itemized deduction[]” under I.R.C. § 67(b).²²⁰ As such, the deduction is disallowed in its entirety for AMT purposes.²²¹ The

²¹⁸ See I.R.C. § 104(a)(2). The full \$3 million is included in the plaintiff’s gross income even though the plaintiff may never formally possess for a moment the \$1 million attorney fee portion of the award. The U.S. Supreme Court has held that, for tax purposes, the entire recovery, including the attorney fee portion, is included in the plaintiff’s gross income just as if the plaintiff had received the \$1 million attorney fee portion and then paid it over to the attorney in satisfaction of the plaintiff’s contractual obligation to pay the attorney. See *Comm’r v. Banks*, 543 U.S. 426, 433–37 (2005) (including the contingent attorney fee in the plaintiff’s gross income through application of the assignment of income doctrine); see also Brant J. Hellwig, *The Supreme Court’s Casual Use of the Assignment of Income Doctrine*, 2006 U. ILL. L. REV. 751, 765–95 (criticizing the analytical basis for the decision but not its conclusion, and proposing an alternate rationale for the result).

²¹⁹ See I.R.C. § 212(1). But see Charles Davenport, *Why Tort Legal Fees Are Not Deductible*, 97 TAX NOTES 703, 703–05 (2002) (contending that the attorney fee should be recovered as a transaction-cost offset to the recovery, leaving only the net recovery to be included in gross income); Joseph M. Dodge, *The Netting of Costs Against Income Receipts (Including Damage Recoveries) Produced by Such Costs, Without Barring Congress from Disallowing Such Costs*, 27 VA. TAX REV. 297, 334–347 (2007) (same). For a contrary view, see Brant J. Hellwig & Gregg D. Polsky, *Litigation Expenses and the Alternative Minimum Tax*, 6 FLA. TAX REV. 899, 915–21 (2004).

²²⁰ I.R.C. § 67(b).

²²¹ See *id.* § 56(b)(1)(A).

plaintiff therefore will be forced to pay tax at AMT rates on the full \$3 million settlement. The effect is an unjustifiably high tax rate on the \$2 million of economic income received from the litigation.²²²

The result in Private Letter Ruling 2008-36-019 could be used by plaintiffs to avoid harsh results under the AMT. By spreading the gross income from the recovery over a number of years,²²³ plaintiffs could take advantage of the relatively large zero-rate bracket in the AMT to circumvent the problem.²²⁴ In this manner, Private Letter Ruling 2008-36-019 would permit certain non-physical plaintiffs to exercise a measure of self-help against the AMT.²²⁵

The self-help justification, however, is at once overbroad and underinclusive. It is overbroad because very few non-physical injury plaintiffs are subject to the AMT problem. Due to recent legislation, non-physical injury plaintiffs whose claims arise out of employment-related or civil rights litigation are entitled to deduct their legal fees “above-the-line” in computing adjusted gross income, thereby avoiding the harsh result under the AMT.²²⁶ Thus, for example, the plaintiff in Private Letter Ruling 2008-36-019 would not have been subject to the AMT problem because her discrimination claim was related to her employment. Under current law, the AMT problem would potentially affect only defamation and non-employment-related emotional distress claimants, as well as all plaintiffs who recover punitive damages.²²⁷ Yet the yield-exemption benefit of Private Letter Ruling 2008-36-019 would be avail-

²²² Given the spread between the plaintiff’s tax base for the regular income tax (which allows the deduction, but subjects it to the two percent floor of I.R.C. § 67(a) and the income-based phase-out of I.R.C. § 68(a)) and the tax base for AMT purposes (which disallows the deduction altogether), the plaintiff will owe more AMT liability than regular tax liability.

²²³ In addition, presumably the deduction for the payment of attorney’s fees would be similarly spread out so as to properly match the expense to the income it generated.

²²⁴ The AMT exemption levels for 2009 are \$46,700 for single taxpayers and \$70,950 for married taxpayers filing jointly. *See* I.R.C. § 55(d)(1) (West Supp. 2009).

²²⁵ *See* I.R.S. Priv. Ltr. Rul. 2008-36-019 (Sept. 5, 2008).

²²⁶ As part of the American Jobs Creation Act of 2004, Congress added what is today I.R.C. § 62(a)(20) to permit the deduction for litigation expenses incurred in prosecuting certain types of claims for non-physical injuries (primarily, claims of “unlawful discrimination” as defined in § I.R.C. 62(e)) to be taken in computing adjusted gross income—thereby avoiding the various limitations on itemized deductions. *See* Pub. L. No. 108-357, § 703, 118 Stat. 1418, 1546–47. The legislation, however, failed to reach all types of non-physical injury claims. *See* Hellwig & Polsky, *supra* note 219, at 940–44 (describing the legislation and highlighting its shortcomings).

²²⁷ *See* I.R.C. § 104(a)(2) (2006) (expressly excluding punitive damages from the scope of the gross income exclusion); *id.* § 62(a)(20) (permitting deduction for litigation expenses incurred in action “involving a claim of unlawful discrimination”).

able to all non-physical injury plaintiffs, a much larger class than those affected by the AMT problem. Therefore, although the ruling's approach could help mitigate the AMT problem for an extremely small class of non-physical injury plaintiffs, the ruling will provide the opportunity for tax-free investing to all non-physical injury plaintiffs. At the same time, the self-help justification is underinclusive because only those plaintiffs who are in the economic position to spread their cash flows over time can avail themselves of the AMT relief. A plaintiff who needs to consume the entire after-tax recovery in the current year will have no opportunity to exercise this form of self-help. Likewise, the self-help technique will be available only to plaintiffs whose advisors are sophisticated enough to recognize the AMT problem in advance and understand the opportunity to avoid it through structured settlements.

The better way to deal with the AMT problem is simply for Congress to fix it directly. Litigation costs incurred in connection with a taxable recovery ought to be deductible in full under the AMT.²²⁸ Amending the Code to provide for such a result would solve the AMT problem comprehensively without creating any additional loopholes. It would also leave the traditional cash method principles intact. Altering foundational doctrine to mitigate idiosyncratic legislative defects is risky because it may result in unintended and unanticipated collateral effects.

2. Income Smoothing

Another arguably beneficial policy result from the approach in Private Letter Ruling 2008-36-019 is that it could allow a non-physical injury plaintiff to avoid bunching an unusually large amount of income into a single tax year. This bunching could subject a litigation recovery to a higher tax rate than the plaintiff's normal marginal tax rate.²²⁹ The ruling allows the plaintiff to spread a recovery over a number of years, resulting in an income-smoothing effect. Thus, the ruling's approach can be defended on the basis that it allows non-physical injury plaintiffs an option to average their income.

²²⁸ See I.R.C. § 56(b)(1)(A) (presently disallowing the deduction of any "miscellaneous itemized deduction").

²²⁹ See Gregg D. Polsky & Stephen F. Befort, *Employment Discrimination Remedies and Tax Gross Ups*, 90 IOWA L. REV. 67, 74-78 (2004) (describing the potential bunching of income caused by employment discrimination recoveries).

This justification is not fully persuasive, as the bunching problem applies to a whole host of taxpayers.²³⁰ Congress has experimented with broad-based income averaging rules in the past to alleviate the problem, but currently no such relief is available.²³¹ It is difficult to justify an approach that deviates from settled foundational doctrine in order to allow a very small subset of taxpayers an option that all other taxpayers do not have. Furthermore, although the approach could ameliorate the bunching problem for some non-physical injury plaintiffs, it would simultaneously provide all non-physical injury plaintiffs with the benefit of tax-free investing. As with the AMT problem, if the bunching concern is a problem that should be fixed, Congress should fix it directly and comprehensively without creating new loopholes in unrelated areas.

3. Eliminating the Distinction Between Physical and Non-Physical Damages

Finally, the approach in Private Letter Ruling 2008-36-019 can be defended in terms of horizontal equity. Tort plaintiffs receiving damages for physical injuries arguably should not enjoy a comparative tax advantage over tort plaintiffs receiving damages for non-physical harms. Because the former can enjoy the benefit of tax-free investing of their recoveries, the latter ought to as well, the argument goes. Although this may be persuasive as a normative argument,²³² it ignores the fact that Congress has explicitly decided to treat these two types of plaintiffs quite distinctly. Congress amended I.R.C. § 104(a)(2) in 1996 by inserting the “physical” modifier to the description of personal injury damages that are subject to exclusion from gross income.²³³ Con-

²³⁰ See generally Lily L. Batchelder, *Taxing the Poor: Income Averaging Reconsidered*, 40 HARV. J. ON LEGIS. 395 (2003) (detailing the adverse effects of annual income reporting on low-income taxpayers).

²³¹ See I.R.C. §§ 1301–1305 (1982), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 141, 100 Stat. 2085, 2117.

²³² See, e.g., Karen B. Brown, *Not Color- or Gender-Neutral: New Tax Treatment of Employment Discrimination Damages*, 7 S. CAL. REV. L. & WOMEN'S STUD. 223, 249–67 (1998); J. Martin Burke & Michael K. Friel, *Getting Physical: Excluding Personal Injury Awards Under the New Section 104(a)(2)*, 58 MONT. L. REV. 167, 178–93 (1997); F. Patrick Hubbard, *Making People Whole Again: The Constitutionality of Taxing Compensatory Tort Damages for Mental Distress*, 49 FLA. L. REV. 725, 753–66 (1997); Laura Sager & Stephen Cohen, *Discrimination Against Damages for Unlawful Discrimination: The Supreme Court, Congress, and the Income Tax*, 35 HARV. J. ON LEGIS. 447, 499–505 (1998); Mark J. Wolff, *Sex, Race, and Age: Double Discrimination in Torts and Taxes*, 78 WASH. U. L.Q. 1341, 1439–82 (2000).

²³³ See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838.

gress created this explicit (and almost certainly misguided)²³⁴ distinction, and it is Congress's job to remove it.

VI. TAX CONSEQUENCES TO OTHER PARTIES

Part I.B.2, explained that the effect of deferring the taxation of structured settlements is to exempt from taxation the investment return that is imbedded within the arrangement.²³⁵ As part of that discussion, we noted that this conclusion assumed that a tax burden was not imposed on some other party to the structured settlement that would offset this benefit.²³⁶ If such a burden were in fact imposed, it would have to be compared to the tax benefit received by the payee²³⁷ to determine whether an overall tax benefit results from such structures. In other words, to determine the tax consequences from a structuring transaction, the tax consequences to *all* parties to the transaction must be considered. This Part undertakes the remaining task of evaluating the tax consequences of structured settlements to parties other than the plaintiff or the attorney. It concludes that these other parties do not incur a substitute tax that offsets (partially or wholly) the tax benefit received by plaintiffs or attorneys by structuring their respective litigation recoveries.²³⁸

A. Consequences to the Defendant

When a self-insured defendant structures a settlement, it first promises to make certain future payments to the plaintiff. Shortly thereafter, it makes a lump sum payment to the SSC in consideration for the SSC's assumption of the defendant's obligations to make these periodic payments. Upon the effective assignment of the payment obligation to the

²³⁴ Perhaps the most plausible policy argument in favor of the distinction is based on administrative concerns. If one assumes that non-physical injury damages (e.g., employment discrimination damages) are more likely than physical injury damages (e.g., automobile accident damages) to result in a larger lost wages component, and if allocating damages between wage and non-wage components proves difficult in practice, the distinction may be acceptable as a rough justice solution.

²³⁵ See *supra* notes 23–40 and accompanying text.

²³⁶ See *supra* notes 33–37 and accompanying text.

²³⁷ Although the plaintiff nominally receives the tax benefit of yield exemption, all or a portion of the benefit could be captured by the other parties to the arrangement. For example, the settlement cost to the defendant could be lower than it otherwise would be if the tax benefit was not available to the plaintiff. For discussion of this point, see *supra* notes 38–40 and accompanying text.

²³⁸ As explained below, however, this conclusion is not entirely free from doubt.

SSC, the defendant's obligation to make any future payments with respect to the plaintiff is extinguished.²³⁹

Leaving aside tax consequences for a moment, the defendant is in the same economic position whether or not a settlement is structured. In a lump-sum settlement, the defendant pays a lump-sum amount to the plaintiff in exchange for the release of the plaintiff's claim. In a structured settlement, the defendant obtains the release of the plaintiff's claim by paying a lump-sum amount to the SSC. From the defendant's perspective, the only difference between the two arrangements is the name of the payee on the lump-sum check, which is trivial. The critical tax issue is whether the defendant's indifference between lump-sum and structured settlements remains after tax consequences are introduced.

In a lump-sum settlement, the defendant will receive a deduction equal to the amount of the lump-sum payment at the time of payment. For example, a defendant that pays a lump sum of \$10,000 to settle a claim incurred in connection with the defendant's business will receive a \$10,000 deduction at the time of the lump-sum payment. What if the defendant enters into a structured settlement and instead pays \$10,000 to an SSC, which promises to pay the plaintiff \$11,000 in one year?

In the context of structured settlements of claims involving a personal *physical* injury, the defendant would receive a \$10,000 deduction at the time it makes the payment to the SSC because the structured settlement falls within the scope of I.R.C. § 130.²⁴⁰ Thus, the timing and amount of the deduction are the same, and the defendant therefore suffers no adverse tax consequences when it structures a settlement in lieu of paying a lump sum.

In cases involving non-physical injuries, however, a defendant's tax consequences are less certain.²⁴¹ Under Treas. Reg. § 1.461-4(g)(1), a

²³⁹ The plaintiff, in technical terms, grants the defendant (insurer) a novation with respect to its obligation to make future payments. See *supra* note 10.

²⁴⁰ See Treas. Reg. § 1.461-6(a) (1992) (providing that economic performance occurs when a defendant makes a qualified assignment under I.R.C. § 130). This regulation confirms the result reached by the Tax Court in *Ford Motor Co. v. Commissioner*. See 102 T.C. 87, 94 (1994) (analyzing the tax consequences to defendants who entered into structured settlements of personal injury claims in 1970).

²⁴¹ Structured settlements in these cases do not involve qualified assignments and are therefore not covered by I.R.C. § 130. See I.R.C. § 104(a)(2) (2006) (excluding only payments received on account of physical injuries); *id.* § 130(c)(1) (defining qualified assignment as one involving periodic payments that are excludible under I.R.C. § 104(a)(2)). Because I.R.C. § 130 does not govern the assignment, the special economic performance rule described *supra* note 240 is inapplicable. See Treas. Reg. § 1.461-6(a) (applying only to qualified

tort defendant must make a “payment . . . to the person to which the liability is owed” in order to claim a deduction.²⁴² This language suggests that payment must be made to the plaintiff before any deduction can be taken. Such an interpretation appears consistent with the regulation’s preamble, which explicitly rejected the suggestion of prior commentators that an immediate deduction should be allowed “if the taxpayer pays a third party to assume the liability and the third party becomes primarily liable to satisfy the taxpayer’s liability.”²⁴³ Under such an interpretation, a self-insured defendant’s deduction would be delayed until the plaintiff actually received cash payments from the SSC. In addition, the amount of the deduction would be limited to the amount that the self-insured defendant paid the SSC to assume the defendant’s liability to make future payments to the plaintiff.²⁴⁴ In the hypothetical above, the defendant therefore would receive a deduction of \$10,000 (i.e., the amount that it paid to the SSC) one year later, when the plaintiff receives the \$11,000 payment from the SSC. Because the \$10,000 deduction is delayed, the defendant is taxed more harshly than it would have been taxed had it paid a lump-sum amount to the plaintiff. This extra burden would serve as a proxy tax on the defendant that, under certain conditions, would precisely offset the tax benefit to the plaintiff.²⁴⁵

assignments). Instead, the general economic performance rules found in Treas. Reg. 1.461-4 apply in the non-physical injury structured settlement context.

²⁴² Treas. Reg. § 1.61-4(g)(1) (as amended in 2004).

²⁴³ T.D. 8408, 1992-1 C.B. 155.

²⁴⁴ Treas. Reg. § 1.461-4(g)(1)(i) (providing that the amount of the deduction that is allowed when “payment is made from [another] person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund”).

²⁴⁵ The amount of the burden placed on the defendant would depend on the defendant’s marginal tax rate. If, in the hypothetical involving the \$11,000 delayed payment to the plaintiff, the defendant’s marginal tax is 40% and the discount rate is 10% (as the facts in the example imply because that is the rate of return imbedded within the structured settlement itself), the defendant is effectively forced to make an interest-free one-year loan of \$4000 to the government. The foregone after-tax interest on this loan is \$240 ($\$4000 \times 10\% \times 60\%$). That is the additional tax cost to the defendant of entering into the structured settlement, and it perfectly offsets the tax benefit to a plaintiff that is subject to the same marginal tax rate. Instead of receiving an immediate \$6000 ($\$10,000 \times 60\%$) after taxes from the lump sum settlement, the plaintiff receives \$6600 ($\$11,000 \times 60\%$) after taxes at the end of the year. A plaintiff who invests the after-tax amount from the lump sum settlement for a year receives \$6360 ($\$6000 + 6\% \times \6000) after taxes at the end of the year. The plaintiff is \$240 richer as a result of structuring at the end of one year. More generally, when the plaintiff and the defendant are subject to the same constant marginal tax rate, the benefit to the plaintiff from structuring will be precisely offset by the burden

In recent guidance, however, the IRS appears to have retreated from the interpretation implied by the preamble in cases where a taxpayer/assignor has received a novation of liability in connection with a third-party assignment. In Notice 2003-77, the IRS cited *Maxus Energy Corp. & Subsidiaries v. United States* for the proposition that a “taxpayer’s payment to a settlement fund effectively constitute[s] payment to the person to which the liability [is] owed [if] the claimants agree[] to look solely to the fund to satisfy their claims and, therefore, the taxpayer’s payment to the fund discharge[s] its liability to the claimant.”²⁴⁶ Under this view, a payment by a defendant to an SSC would be treated as a payment “to the person to which the liability is owed” under Treas. Reg. § 1.461-4(g)(1) if the payment to the SSC extinguishes the defendant’s liability to the plaintiff.²⁴⁷ Because structured settlements typically do involve such a novation, a defendant would be able to claim an immediate deduction upon making the lump-sum payment to the SSC, just as if the defendant had instead paid that lump-sum amount directly to the plaintiff. Accordingly, under the *Maxus Energy* view, no proxy tax would be imposed on defendants.²⁴⁸

Before the issuance of Notice 2003-77, it was unclear whether the IRS viewed the quoted language from *Maxus Energy* as having any continuing relevance, as the case was decided based on facts that predated the effective date of Treas. Reg. § 1.461-4(g)(1). Accordingly, the court could not consider the regulation or its preamble in its analysis; instead, the court had to rely on the underlying statutory language, which is ambiguous on this issue.²⁴⁹ The promulgation of the regulation therefore could be interpreted as rendering the quoted language of *Maxus Energy* obsolete. Yet Notice 2003-77 reveals that the IRS, at least for now, has concluded otherwise.²⁵⁰

on the defendant of structuring under the interpretation of Treas. Reg. § 1.461-4(g)(1) implied by the preamble.

²⁴⁶ See I.R.S. Notice 2003-77, 2003-2 C.B. 1182, 1183 (citing *Maxus Energy Corp. & Subsidiaries v. United States*, 31 F.3d 1135, 1144–45 (Fed. Cir. 1994)).

²⁴⁷ Treas. Reg. § 1.461-4(g)(1)(i).

²⁴⁸ See *Maxus Energy*, 31 F.3d at 1144–45.

²⁴⁹ See *id.* at 1143–44.

²⁵⁰ This conclusion may be justifiable because it is possible to interpret the preamble in a manner consistent with *Maxus Energy*. The language of the preamble describes an assignee of a tort liability that becomes “primarily liable” to the tort claimant, suggesting that the drafters of the regulation were assuming that the defendant would remain secondarily liable. See T.D. 8408, 1992-1 C.B. 155. In *Maxus Energy* and in the typical structure, the defendant is completely released from any future liability to the plaintiff once it makes the requisite payment to the SSC. The IRS’s view that *Maxus Energy* has continuing relevance following the issuance of Treas. Reg. § 1.461-4(g)(1) could be based on this distinc-

Despite the somewhat ambiguous law on the issue, SSCs believe that self-insured defendants can, consistent with language in Notice 2003-77, take an immediate deduction in non-physical injury structured settlements. For instance, the form document of the assignment of liability used by one prominent SSC includes the following language:

Assignor [i.e., the defendant in cases where the defendant is self-insured] is hereby completely and irrevocably released and discharged from any liability to Claimant with respect to the Periodic Payment Claim. The sole liability of the Assignor with respect to the Periodic Payment Claim shall be a liability owed to the [SSC], so that the [SSC] is hereby the sole person to whom the liability is owed with respect to the Periodic Payment Claim, within the meaning of U.S. Treasury Regulation § 1.461-4(g)(1)(ii).²⁵¹

Unless the IRS changes its position with respect to the continuing relevance of *Maxus Energy* and thereafter successfully persuades a reviewing court, a self-insured defendant in a non-physical injury suit will be taxed the same whether it pays a lump sum or enters into a structured settlement.²⁵² Accordingly, no proxy tax would be imposed on defendants who enter into structured settlements.²⁵³

In summary, it is clear that no proxy tax on structured settlements will be imposed on self-insured tort defendants in *physical* injury suits or on defendants who are insured.²⁵⁴ With respect to self-insured defendants in non-physical injury suits, the current view of the IRS as ex-

tion. Nevertheless, if the purpose of the “payment . . . to the person to which the liability is owed” rule is to impose a proxy tax on the payor of periodic payments, then it should make no difference whether the defendant’s future liability to the plaintiff is completely eliminated or merely subordinated to the SSC’s liability. *Id.*

²⁵¹ Allstate International Assignments Ltd., Form of Nonqualified Assignment and Release, <http://aiassign.com/forms/9-08/NQNQARIA.doc>. (last visited Jan. 19, 2010).

²⁵² See I.R.S. Notice 2003-77, 2003-2 C.B. 1182.

²⁵³ See *id.* Note that the discussion thus far has focused on defendants that are self-insured and that, accordingly, make the lump sum payment to the SSC themselves. If the defendant is insured against liability for the claim, analyzing the defendant’s tax consequences is far simpler. Regardless of how the insurance company decides to defend the case or settle the matter, the defendant’s tax consequences are unaffected. From a tax perspective, an insured defendant is an uninvolved bystander.

²⁵⁴ Although the typical structured settlement involves an assignment of liability to an SSC, it is theoretically possible that a self-insured defendant would retain the obligation to make future payments to the plaintiff. In such a case, Treas. Reg. § 1.461-4(g)(1) would delay and limit the defendant’s deduction in the manner described above. Accordingly, assuming the defendant is subject to U.S. federal income tax, there would be a proxy tax imposed on the defendant.

pressed in Notice 2003-77 suggests that no proxy tax would be imposed on defendants in this context.

B. *Consequences to Defendant's Insurer*

Under the rules governing the taxation of liability insurers, the defendant's insurer is taxed the same whether it pays a lump-sum amount to the plaintiff or pays the amount to an SSC in a structured settlement.²⁵⁵ Accordingly, there is no proxy tax imposed on the defendant's insurer when cases are resolved through a structured settlement.

C. *Consequences to the SSC*

The typical structured settlement involves an assignment of the liability from the defendant or its insurer to an SSC. From the SSC's perspective, two different tax issues arise.²⁵⁶ First, does an SSC recognize income when it receives the lump sum payment from the defendant (insurer) in consideration for the SSC's promise to make future payments to the plaintiff? Second, how is the SSC taxed when it receives periodic payments from the annuity that serves as the funding asset and then retransfers those payments over to the plaintiff?

Theoretically, the SSC should not realize any net income tax consequences from its role in the structured settlement arrangement apart from any transaction fee it may extract. The SSC serves as a mere intermediary, using funds received from the defendant to purchase an annuity and then forwarding the resulting periodic payments to the plaintiff.

1. Consequences to an SSC Receiving Qualified Assignment

In the context of structured settlements involving *physical* injury plaintiffs, the theoretically correct result has been codified in I.R.C. § 130.²⁵⁷ I.R.C. § 130(a) provides an exclusion from the gross income of

²⁵⁵ See I.R.C. §§ 831–832 (2006).

²⁵⁶ The SSC typically receives a \$250 to \$750 fee for its role in the structured settlement. Although this fee is taxed, the tax is not properly considered a proxy tax on structured settlements, as it simply represents a proper tax on compensation income. For the sake of simplicity, the discussion above assumes that the SSC does not get paid for its role, although the conclusion that there is no proxy tax would be the same if such a payment were received.

²⁵⁷ I.R.C. § 130 excludes from an SSC's gross income the payment it receives from the defendant (or its insurer) to the extent the SSC uses the payment to purchase the funding asset. As stated *supra* note 256, the SSC usually receives a small premium for its role and, under I.R.C. § 130, this premium, which represents a fee for services, is properly taxed.

the SSC for amounts it receives under a qualified assignment, to the extent such amounts are applied toward the purchase of a qualified funding asset. I.R.C. § 130(b) assigns a zero basis in the qualified funding asset, meaning that periodic payments received by the SSC (including investment yield) are included in gross income. Because the SSC is obligated to immediately transfer these amounts to the plaintiff, however, the SSC receives an offsetting deduction.²⁵⁸ As a result, the SSC generally realizes no tax consequences from a structured settlement transaction.

2. Consequences to an SSC Receiving Nonqualified Assignment

Because I.R.C. § 130(a) by its terms applies only to assignments involving *physical* injury plaintiffs, the negative implication of this provision is that assignments in other types of structured settlements subject the SSC to taxation.²⁵⁹ If that is the case, the SSC would recognize fee income upon receipt of payment for the qualified assumption. In turn, the SSC would be entitled to deduct the same *nominal* amount in later years when it makes payments to the plaintiff. The mismatching of timing of the income inclusion and subsequent deduction for the same nominal amounts would impose a tax burden on the SSC.

In addition to the mismatching of the income and deduction attributable to the principal component of the annuity, the perfect netting of income and deduction attributable to the investment income generated by the annuity would not occur in the context of structured settlements outside the I.R.C. § 130 context. I.R.C. § 72(u) accelerates the taxation of income from annuities owned by corporations and other non-natural persons. Although this rule is expressly inapplicable to annuities held as funding assets in structured settlements of *physical* injury damages, there exists no such carve-out for other structures.²⁶⁰ As a result, income from an annuity could be realized by an SSC before the SSC receives the corresponding payment from the annuity. Since the offsetting deduction for the SSC's payment to a plaintiff may be claimed only when the payment is re-transferred to the plaintiff, an ad-

²⁵⁸ See *Tax Treatment of Structured Settlements: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 106th Cong. 9 (1999) (statement of Joseph Mikrut, Tax Legislative Counsel, U.S. Department of the Treasury) ("The payments to the structured settlement company are not subject to tax to the extent they are netted out as payment to the injured person.").

²⁵⁹ See I.R.C. § 130 (limiting the scope of a qualified assignment to cases "involving physical injury or physical sickness").

²⁶⁰ See *id.* § 72(u)(3)(C).

ditional tax burden would be placed on the SSC. The combined tax burdens attributable to the mismatching of income and deductions would have to be compared to the yield exemption benefit to see if structured settlements involving non-physical injuries would remain tax-advantaged on the whole.

To avoid these tax burdens, SSCs involved in structured settlements of non-physical injuries are typically domiciled in Barbados.²⁶¹ Based on the U.S. tax treaty with Barbados, there is no U.S. taxation of the SSC on the lump sum payment that it receives from the defendant or its insurer nor upon the accelerated investment income the SSC realizes by operation of I.R.C. § 72(u).²⁶²

3. Summary

With respect to structured settlements involving physical injury plaintiffs, statutory rules make clear that there is no proxy tax imposed on SSCs. Although SSCs participating in structured settlements in other contexts potentially face an extra tax burden, SSCs that participate in these arrangements are domiciled in Barbados precisely to avoid the prospect of any adverse tax consequences. Based on the U.S.-Barbados treaty, these SSCs will pay no U.S. income tax in connection with their participation in structuring transactions. Accordingly, they too will not be subject to any proxy tax.

CONCLUSION

In I.R.C. § 104(a)(2), Congress has provided a subsidy to physical injury plaintiffs that allows them to invest their litigation recoveries on a tax-free basis through structured settlements. Trial lawyers now claim that the same benefit applies to them under general principles of tax law. They base this conclusion exclusively on the Tax Court's decision in *Childs v. Commissioner*. Since the decision in *Childs*, a burgeoning industry of "nonqualified structured settlements" has emerged to exploit the yield exemption that results from its conclusions. A recent private letter ruling implies that the IRS respects the *Childs* decision.

We have argued that *Childs* is a fantastically flawed decision. The decision ignored critical precedents that were directly on point and

²⁶¹ See Craig & Holler, *supra* note 210, at 80 (noting that "two life insurance companies active in the structured settlement business" devised the "solution" of domiciling "the assignment company offshore to avoid the tax problems of onshore corporate annuity ownership").

²⁶² See United States-Barbados Income and Capital Tax Convention, U.S.-Barb., Dec. 31, 1984, 1991-2 C.B. 436.

were inconsistent with *Childs* reasoning and conclusion. Despite the flaws of the *Childs* decisions, trial lawyers may argue that the result is justifiable because corporate executives often receive large amounts of nonqualified deferred compensation. The analogy between structured fee arrangements and nonqualified deferred compensation, however, is false. In a nonqualified deferred compensation arrangement, the employer is taxed on the executive's investment yield during the period of deferral. As illustrated in this Article, however, no party pays tax on the attorney's investment yield in a structured fee arrangement.²⁶³ This absence of substitute taxation ensures that structured attorney's fees provide a significant tax advantage to the structuring attorney at the expense of the public fisc.

Plaintiffs who receive structured settlements of non-physical injury claims similarly rely on *Childs* to claim the tax benefit of yield exemption. Although non-physical injury plaintiffs can make several plausible policy arguments to support this treatment in this narrow context, we have addressed those arguments and ultimately have found them unpersuasive.

To close the unintended yield-exemption loophole, the IRS should publicly repudiate the holding in *Childs*. The IRS could do so by adopting audit and litigating positions to this effect, and by implementing a unified ruling posture on the issue. Such a firm stand would likely lead to a judicial re-examination of whether the issuance of the SSC obligation is currently taxable to the beneficiary outside of the physical injury context and, hopefully, a more thoughtful resolution of the issue by courts.

Relying on judicial re-examination, of course, takes time and involves some risk that courts will not perform any better. Therefore, we recommend that Treasury or Congress close the yield-exemption loophole. Treasury could, through regulation, clarify that receipt of a third-party promise constitutes a payment under the cash method of accounting. Furthermore, in the context of compensation for services, Treasury could amend the regulatory definition of property under I.R.C. § 83 to explicitly include third-party promises. Such regulatory action would fall well within the scope of Treasury's authority to interpret the Internal Revenue Code. Alternatively, Congress could enact statutory amendments that clarify the issue.

²⁶³ In addition, in a nonqualified deferred compensation arrangement, the employee must remain subject to his employer's insolvency risk to obtain deferral. In a structured fee arrangement, the attorney gets to choose the counterparty SSC that the attorney desires and still (under *Childs*) obtain deferral.

Unless these three actors—the IRS, Treasury, and Congress—are content with having unintended and unlimited tax-free investment vehicles that are available for a small subset of taxpayers, they should act to close the loophole. Otherwise, the structured settlement industry will only continue to expand, undermining the taxation of capital income in the process.

APPENDIX

Part II.B. of the Article explained that if the structured settlement company's obligation (the "SSC obligation") to the plaintiff were disregarded as an item of property for cash method purposes, such that the plaintiff was taxed only as cash payments were received, the effect would be to allow the plaintiff to invest the recovery on a tax-free basis. The same yield-exemption effect would apply where attorneys structure their fees, assuming again that the SSC obligation is disregarded. The purpose of this Appendix is to provide a specific numerical example that illustrates this yield-exemption effect.

Consider the following hypothetical: On January 1 of Year 1, Plaintiff, who suffered a *non-physical* injury, settles with Insurance Company ("IC") for \$1,000,000. Plaintiff decides not to receive the entire after-tax²⁶⁴ amount immediately. Instead, one-third will be received today, another third in one year, and the final third in two years. Deferred amounts will earn interest at the rate of 7%. Plaintiff's marginal tax rate is 35%.

Plaintiff now has two options. The first is to receive a \$1,000,000 lump sum award and invest a portion of the after-tax proceeds (\$650,000) in an annuity that would make future payments in a manner consistent with the desired payout. Alternatively, Plaintiff could enter into a structured settlement.

If Plaintiff chooses the lump sum option, tax in the amount of \$350,000 must immediately be paid, leaving after-tax funds of \$650,000. To create three equal payments, \$418,520 would be invested in an annuity, which would provide two annual payments of \$231,480, one on January 1, Year 2 and the other on January 1, Year 3. After investing the \$418,520 in the annuity, Plaintiff is left with \$231,480 on January 1, Year 1. Plaintiff will therefore receive three equal annual payments of \$231,480. The results to Plaintiff are shown below in Table 1.

²⁶⁴ Recall that non-physical injury damages are taxable. *Cf.* I.R.C. § 104(a)(2) (2006) (excluding damages that result from personal physical injuries).

Table 1: Lump Sum				
	Jan. 1, Year 1	Jan. 1, Year 2	Jan. 1, Year 3	FV on 1/1/3
Payment received	\$1,000,000	\$231,480	\$231,480	
Tax on payment	(\$350,000)	(\$7778)	(\$7778)	
Amount of payment after-tax	\$650,000	\$223,702	\$223,702	
Purchase price of annuity	(\$418,520)	N/A	N/A	
Amount left after taxes and annuity purchase	\$231,480	\$223,702	\$223,702	
Future value of after-tax amount on Jan. 1, Year 3 taking into account Plaintiff's after-tax investment rate of 4.55%	\$253,024	\$233,880	\$223,702	\$710,606

As the Table 1 shows, on January 1 of Year 3 Plaintiff will have \$710,606 from the settlement, assuming all of the after-tax proceeds from the initial payment and the two annuity payments are invested at an after-tax rate of return of 4.55% ($7\% \times (1-.35)$).

If Plaintiff instead opts for a structured settlement, IC would pay \$356,123 and use the remaining \$643,877 to purchase the SSC obligation, which requires the SSC to make the two future payments of \$356,123 to Plaintiff. If the SSC obligation were disregarded, Plaintiff would be taxed only as each of the three \$356,123 payments were received. The consequences of this are shown in Table 2.

Table 2: Structured Settlement				
	Jan. 1, Year 1	Jan. 1, Year 2	Jan. 1, Year 3	FV on 1/1/3
Payment received	\$356,123	\$356,123	\$356,123	
Tax on payment	(\$124,643)	(\$124,643)	(\$124,643)	
Amount of payment after-tax	\$231,480	\$231,480	\$231,480	
Future value of after-tax amount on Jan. 1, Year 3 taking into account TP's after-tax investment rate of 4.55%	\$253,024	\$242,012	\$231,480	\$726,516

This shows that Plaintiff is better off under this scenario than under the lump sum. Instead of having \$710,608 on January 1 of Year 3, Plaintiff has \$726,516, a difference of \$15,910. The \$15,910 amount represents the two tax payments of \$7778 on the annuity yield in Year 2 and Year 3 in Table 1, after an appropriate adjustment to the Year 2

payment to reflect Plaintiff's 4.55% after-tax investment yield.²⁶⁵ In effect, therefore, Plaintiff in the Table 2 scenario has avoided tax on the investment yield of the portion of the \$1,000,000 recovery (i.e., \$643,877) that she invested with the SSC.

To see this yield-exemption effect more clearly, consider what would happen if Plaintiff received a lump sum of \$1,000,000 and then was allowed to invest the after-tax recovery in a tax-exempt annuity. Plaintiff would owe immediate tax of \$350,000, leaving a remainder of \$650,000. To equalize the payments, Plaintiff would buy an annuity for \$418,520, which would make two annual payments of \$231,480. The annuity purchase would leave Plaintiff with \$231,480 (\$1,000,000 less \$350,000 tax less \$418,520 annuity purchase price) on January 1, Year 1. Thus, Plaintiff will receive three equal payments of \$231,480. Plaintiff's results are shown below in Table 3.

Table 3: Immediate Payment, Followed by Investment in Tax-Exempt Annuity				
	Jan. 1, Year 1	Jan. 1, Year 2	Jan. 1, Year 3	FV on 1/1/3
Payment received	\$1,000,000	\$231,480	\$231,480	
Tax on payment	(\$350,000)	(\$0)	(\$0)	
Amount of payment after-tax	\$650,000	\$231,480	\$231,480	
Purchase price of annuity	(\$418,520)	N/A	N/A	
Amount left after taxes and annuity purchase	\$231,480	\$231,480	\$231,480	
Future value of after-tax amount on Jan 1, Year 3 taking into account TP's after-tax investment rate of 4.55%	\$253,024	\$242,012	\$231,480	\$726,516

Plaintiff is left with \$726,516, the same amount as in Table 2, where the SSC obligation was disregarded, which allowed Plaintiff to report income only as cash payments were received. Table 3, therefore, shows that disregarding the SSC obligation has the same economic effect as yield exemption.

²⁶⁵ $(\$7,778 \times 1.0455) + \$7,778 = \$15,910$.