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IRS Speaks Out on Employment Lawsuit Settlements

By Robert W. Wood

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Claims for wrongful termination, sexual harassment, and various forms of discrimination (especially race, gender, age, and disability) have burgeoned over the last few decades. To a lesser (but still significant) extent, litigation over the tax treatment of the resulting settlements and judgments has also been active. Several tax cases in this field have even gone to the U.S. Supreme Court.[1]

In 1996 Congress amended section 104 to require a ''physical'' injury or ''physical'' sickness for its exclusion from income to be available. The legislative history to this 1996 law makes it clear that the primary target of this amendment was employment litigation.[2] In the 1980s and early 1990s, it had become commonplace for most discrimination (and other types of employment) recoveries to be largely allocated to nontaxable emotional distress damages rather than to taxable income.

The case law was mixed, with some taxpayers succeeding in excluding their damages from income and others failing. Still, exclusions from income under the auspices of section 104 were rampant. All that changed in 1996 with the tightening of section 104. Or did it?

The IRS and taxpayers have struggled with the changes to section 104 and the sometimes metaphysical qualities of just what is physical.[3] To some extent, the IRS has been hoist with its own petard. Indeed, although the statute itself was changed 13 years ago, the IRS has still not revised its regulations under section 104.[4] Moreover, the IRS has not issued notices or announcements even though that form of guidance is easier to churn out than regulations.

The IRS has failed to give its views (save in private letter rulings) for how section 104 in this context should be applied. Those really in the know may know, but many tax advisers and taxpayers need better and clearer guidance. All these years later, the (to my mind) best evidence of the Service's views of section 104 remains the ''bruise'' ruling, LTR 200041022 (July 17, 2000), *Doc 2000-26382*, *2000 TNT 201-10*. This ruling bifurcates a sexual harassment recovery into the pre-physical and post-physical parts, the latter being excludable.[5]

New Dawn

The IRS has released a memorandum titled ''Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements.'' Although it was released in July 2009,[6] it bears a date of October 22, 2008. It is a memorandum addressed to various IRS employees from John Richards, senior technician reviewer in Employment Tax Branch 2.

Noting that the memorandum cannot be used or cited as precedent, its stated purpose is to outline the information necessary to determine the income and employment tax consequences (and appropriate reporting) of employment-related settlements and judgments. It states that it supersedes a memorandum dated September 9, 2004.

Party Line

The memo is 20 pages long, and should be useful reading for employment lawyers (both plaintiff and defendant) as well as tax lawyers and accountants. The IRS lays out the predictable references to the origin of the claim doctrine, the nature of severance pay, back pay and

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[1]*See United States v. Burke*, 504 U.S. 229 (1992); *Commissioner v. Schleier*, 515 U.S. 323 (1995); and *Commissioner v. Banks*, 543 U.S. 426 (2005).

[2]H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 300 (1996).

[3]*See* Robert W. Wood, ''It's All About the Proof,'' *Tax Notes*, May 25, 2009, p. 1007, *Doc 2009-9514*, or *2009 TNT 98-9*; ''Getting Physical: Emotional Distress and Physical Sickness,'' *Tax Notes*, Oct. 20, 2008, p. 281, *Doc 2008-19673*, or *2008 TNT 204-27*; ''Physical Sickness and the Section 104 Exclusion,'' *Tax Notes*, Jan. 3, 2005, p. 121, *Doc 2004-24100*, or *2005 TNT 2-41*.

(Footnote continued in next column.)

[4]In fact, in one of the ill-fated *Murphy* opinions decided by the D.C. Circuit, the court stopped short of castigating the IRS and Treasury, but the court's displeasure over the lack of regulatory attention was palpable. *See Murphy v. IRS*, 460 F.3d 79, 83 (D.C. Cir. 2006), *Doc 2006-15916*, *2006 TNT 163-6*, 493 F.3d 170 (D.C. Cir. 2007), *Doc 2007-15777, 2007 TNT 129-4*.

[5]*See* Robert W. Wood, ''What Litigation Recoveries Are Excludable as 'Physical'?'' *TaxPractice*, Feb. 19, 2001, p. 230, *Doc 2001-3922*, or *2001 TNT 28-58*.

[6]''Service Explains Tax Consequences and Reporting Obligations for Employment-Related Settlement Payments,'' Program Manager Technical Advice (PMTA), 2009-035, Oct. 22, 2008, *Doc 2009-15305*, *2009 TNT 129-19*.

front pay (all wages), the nature of punitive damages (always taxable), etc. The memo even includes a helpful list of different causes of action, including those arising under the Back Pay Act (5 U.S.C section 5596(b)(1)), Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act, the Fair Labor Standards Act (FLSA), and many others.

Concerning our old friend section 104, the memorandum predictably specifies that for an exclusion to be available, the claim must be for a tort or tort-like injury. Naturally, the memo cites *Commissioner v. Schleier*.[7] It goes on to address what constitutes physical injury.

Here, the memo disappoints. It merely cites Rev. Rul. 85-97.[8] That old saw involved a bus accident. The memo states:

> NOTE: Damages recovered from an employment-related dispute generally are not recoveries for a personal physical injury. Thus, employment-related judgment/settlement amounts will generally be included in the employee's gross income. Therefore, the most difficult questions usually are whether the amounts are wages for employment tax purposes, and the proper reporting of the amount (Form 1099 or Form W-2, and reporting of attorneys' fees on Form 1099).[9]

Attorney Fees

The memo spends a brief two pages on attorney fees and *Commissioner v. Banks*.[10] Interestingly, the memo states that *Banks* resolved a conflict in the circuits, the Supreme Court agreeing with the commissioner that taxpayers must include contingent fees in income. There is no mention of the fact that the Supreme Court enunciated this as a ''general rule,'' nor that the Supreme Court identified exceptions it was not addressing.

Nevertheless, regarding attorney fees and so-called fee-shifting statutes, the memo states:

> The Service's position is that generally fees awarded to prevailing plaintiffs under federal and state fee-shifting statutes belong to the plaintiff and not to the lawyer. See, e.g., *Evans v. Jeff D.*, 475 U.S. 717, *reh'g denied* 476 U.S. 1179 (1986).[11]

Indeed, the Service notes:

> We construe *Banks* and the AJCA [the American Jobs Creation Act of 2004 provision allowing an above-the-line deduction] as endorsing the Service's position that attorneys' fees awarded under a fee-shifting statute constitute an item of gross income to the client. Although the Court in *Banks* did not decide this issue, it noted that the AJCA redresses the concern for many, if not most, claims governed by fee-shifting statutes.[12]

[7]515 U.S. 323 (1995), *Doc 95-5972*, *95 TNT 116-8*.

[8]1985-2 C.B. 50, amplifying Rev. Rul. 61-1, 1961 C.B. 14.

[9]*See supra* note 6, at 6.

[10]543 U.S. 426 (2005).

[11]*See* PMTA 2009-035, *supra* note 6, at 7.

[12]*Id.*

Employment Taxes

The IRS's memo does a credible job of dealing with FICA and FUTA taxes, and with the authorities detailing back pay and front pay. There has been some litigation (which the Service notes) concerning front pay, with the Fifth Circuit holding that only the back pay portion of a settlement was wages for FICA purposes.[13] The IRS notes (with evident glee) that most appellate courts have disagreed with the Fifth Circuit.

The employment tax discussion also notes such important decisions as *United States v. Cleveland Indians Baseball Co.*[14] Here again, the IRS is able to state that the Supreme Court ''agreed with the Service's long-standing position, holding that employment taxes on back wages are calculated with respect to the period during which the wages are actually paid, rather than the period during which the wages should have been paid.''[15]

One of the most interesting discussions in the memo concerns allocations of payments. Arguably, this is the elephant in the room. The memo notes that settlements and judgments can comprise multiple elements, each of which may or may not be wages. The IRS seems to think this allocation issue is only a wage versus nonwage one. Indeed, the IRS does not confront the issues associated with the allocation of excludable and taxable amounts, although presumably the same principles should apply.

The memo notes that a court award may break everything down piece by piece. In the case of a settlement payment, however, the IRS notes that ''the parties must determine the elements of the settlement amount.''[16] But how do we do this? The IRS says one should consider all the facts and circumstances.

More particularly, the Service notes that it generally considers the following facts and circumstances in determining whether to accept an allocation of damages in a settlement agreement or in a final judgment:

- whether there was a bona fide adversarial settlement concerning the allocation of payment between types of recoveries (for this the IRS cites *Robinson v. Commissioner*[17]); and
- whether the terms are consistent with the true substance of the underlying claims.[18]

Attorney Fees as Wages

In what is so far a vanilla memo, I found the extent to which the IRS addresses Rev. Rul. 80-364 to be surprising.[19] That 1980 ruling considers whether attorney fees and interest awarded with back pay are wages for employment tax purposes. After a recitation of the different factual situations analyzed in the revenue ruling, the memo addresses settlement payments, noting (quite

[13]*Dotson v. United States*, 87 F.3d 682 (5th Cir. 1986).

[14]532 U.S. 200 (2001), *Doc 2001-11045*, *2001 TNT 75-7*.

[15]*See* PMTA 2009-035, *supra* note 6, at 10.

[16]*Id*.

[17]102 T.C. 116 (1994), *Doc 94-1439*, *94 TNT 23-18*, *aff'd*, 70 F.3d 34 (5th Cir. 1995), *Doc 95-10932*, *95 TNT 238-7*, *cert. denied*, 519 U.S. 824 (1996).

[18]*See* PMTA 2009-035, *supra* note 6, at 10-11.

[19]1980-2 C.B. 294.

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correctly) that most employment-related disputes are settled rather than tried. The memo then states:

> Whether attorneys' fees recovered in a settlement of an action under a fee-shifting statute are excluded from wages is an open question. For example, if a suit for back pay under Title VII is settled, and provides for back pay and attorneys' fees in the settlement agreement, the question arises whether the portion of the settlement characterized as attorneys' fees is wages.[20]

The memo states that if this issue arises, the IRS National Office should be contacted for guidance.

In my experience, virtually no one in practice suggests that the plaintiff attorney fees in even a strictly wage case should be treated as wages. The IRS seemingly would also want to avoid this result.

In fact, in TAM 200244004 (June 19, 2002), *Doc 2002-24564*, *2002 TNT 213-18*, the IRS addressed wage treatment for attorney fees related to an employment discrimination suit brought under the ADEA. The Service acknowledged that the ADEA contains a fee-shifting component. Not only that, but under the analysis in Rev. Rul. 80-364, had the employee prevailed in litigation under the ADEA, he would have received an award of attorney fees.

That would be in addition to the back wage award. Thus, TAM 200244004 concludes that the attorney fees paid under a settlement agreement in such an employment suit are not wages for federal employment tax purposes. That result (however one reaches it) seems appropriate.

Of course, the IRS has said — in this very same memo — that the presence of a right to a statutory fee as a means of avoiding gross income to the client is not necessary. The above-the-line deduction (for employment cases) takes care of that problem, the memo says. Here, of course, the Service is talking not of income, but of wage characterization, something the above-the-line deduction would not fix.

To state the pure analytical case, consider a lawsuit (brought by one person or many) which seeks only wages, with no other types of damages. Such suits are rare, but they do occur (some FLSA cases, for example, are of this ilk). If the plaintiff will receive 100 percent wages, and the lawyer is being paid a contingent fee of 40 percent, how is the employment and income tax withholding to be accomplished?

The choices would seem to be:

> 1. Withhold on the client's share only, and pay the lawyer his gross 40 percent fee with no withholding;
>
> 2. Withhold on 100 percent, thus shorting the lawyer, and doubtless requiring continued relations between client and lawyer at least into the next tax year, with the lawyer having a claim on monies withheld and paid over to the IRS; or
>
> 3. Withhold only on the client's 60 percent, but at a rate (for both income and employment tax purposes) that takes into account the 40 percent being paid to the lawyer with no withholding. The idea of this new math would be to attribute the income (as wages) to the client, as if the client were really receiving the full 100 percent.

If anyone were to pick choice 2 or choice 3 (both non-choices as far as I'm concerned), there are interesting analytical issues. For example, query how the plaintiff would deduct the legal fees. Even an above-the-line deduction would not make the plaintiff whole.

Quite apart from the timing problem created by withholding, how could the plaintiff recover his share of the employment taxes on the lawyer's 40 percent contingent fee? These are interesting questions, but they are purely academic.

After all, would *anyone* select choice 2 or choice 3? In my experience, no. I can count on one hand the number of times in 30 years of tax practice I've heard an employer in a wage case bristle about the potential need to withhold on the lawyer's share of the funds. In the paucity of cases in which I have heard such bristling, it has uniformly (and quite easily I might add) been dispelled.

It might be dispelled by someone like me arguing that there is a right to a statutory fee, so that TAM 200244004 provides some comfort. Alternatively, it might be dispelled by plaintiff's counsel saying unabashedly to the employer: ''If you withhold on the lawyer fees too, this case will not settle.'' That can be pretty convincing, even if it isn't overly analytical.

It seems that such stonewalling by the plaintiff's counsel (if you want to call it that) is likely to have the desired effect. Surely, most companies are not too concerned about their exposure to failure to withhold penalties (even in a 100 percent wage case) if they don't withhold on the attorney fees. Put differently, in all likelihood, the companies are far more afraid of failing to settle the lawsuit than they are of being accused of failing to withhold on the attorney fees.

I will admit that this is a messy area. How to treat contingent legal fees in a 100 percent wage case represents an interesting analytical conundrum. But as a practical matter, I've found it to be a nonissue. If the IRS's ''call the National Office'' admonition means that the Service is thinking differently on this, I foresee a mess, one that probably won't end up gaining the IRS either revenue or friends.

Third-Party Payors

An interesting (although brief) discussion in the memo concerns third-party payors. The IRS correctly notes that an agency other than the employing agency may, in some cases, pay an amount to an employee in satisfaction of a settlement or judgment. When this occurs, the Service notes, the agency having control of the payment of wages is responsible for withholding.

Reporting

Finally, the memo discusses reporting requirements, including wage reporting, special requirements for back pay, Form 1099 reporting, and payments to attorneys. These topics are only briefly noted, with no detail.

[20]*See* PMTA 2009-035, *supra* note 6, at 12.

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Helpfully, however, the memo does include several charts. Tax rules rarely seem to lend themselves to charts, and for that reason, these charts are worth a look. As fun as it is to have some charts, they may give the illusion of precision. In the area of the taxation of employment settlements, it is an understatement to say that the current state of the law is not precise.

Conclusion

There has not exactly been an outpouring of guidance from the IRS on the tax issues arising in employment litigation since 1996. That's too bad. We badly need more guidance on the section 104 issues; and we need more guidance on fringe and pension benefit issues. It is a step in the right direction that the Service has issued some guidance in the memo, but it isn't all that helpful.

In some ways, it is good that the IRS may be focusing on the wage versus nonwage issue. I have long thought that the Service does not give it enough attention. Indeed, it seems to me that practice regarding wage versus nonwage allocations in settlements varies too wildly. Sometimes the wage versus nonwage issue is addressed without fair regard to the causes of action and the facts. The IRS probably should look at such issues more closely.

However, the suggestion that attorney fees may be subject to wage withholding is frightening, at least to me. I admit I may be overreacting. After all, perhaps the IRS might respond to calls to the National Office with ''don't worry, don't require withholding on the attorney fees.''

In any case, if you are an employment lawyer, tax practitioner, plaintiff, or defendant in an employment dispute, this memo is worth reading. Given that not too much guidance is being issued on these matters, you have to take what you can get.

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Office of Chief Counsel
Internal Revenue Service
memorandum

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date: October 22, 2008

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subject: Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements

The purpose of this memorandum is to outline the information necessary to determine the income and employment tax consequences, and appropriate reporting of employment-related judgments or settlement payments made by the Service. For your convenience, the memorandum includes charts that can be used as reference tools. This memorandum supersedes the memorandum issued to you dated September 9, 2004. It reflects comments and suggestions received from FSLG and GLS, as well as recent case law and amendments to the Code.

This advice may not be used or cited as precedent.

PMTA 2009-035

I. Overview. Determining the correct treatment of employment-related settlement payments is a four-step process. First, determine the character of the payment and the nature of the claim that gave rise to the payment. For example, a payment could be for a lost wages claim brought under Title VII of the Civil Rights Act of 1964. Second, determine whether the payment constitutes an item of gross income. Third, determine whether the payment is wages for employment tax purposes (Federal Insurance Contributions Act (FICA), and income tax withholding). Fourth, determine the appropriate reporting for the payment and any attorneys' fees (Form 1099 or Form W-2).

II. Character of the payment and nature of the claim. Whether a payment is includable in gross income and whether it is wages for purposes of employment taxes depend upon the character of the payment. The following describes the types of settlement payments or awards that may be received in connection with an employment-related dispute.

A. Character of the payment

1. **Severance pay.** Severance pay is a payment made by an employer to an employee upon the involuntary termination of employment. The right to receive severance pay and the amount of severance pay are usually based on the employee's length of service.
2. **Back pay.** Back pay is compensation paid to an individual to compensate the individual for remuneration that would have been received up to the time of settlement or court award but for the employer's wrongful conduct. For example, back pay is awarded to an employee if the employee is illegally terminated by an employer, or to an applicant for employment who is not hired for illegal reasons. Under those circumstances, the back pay relates to a period when no services for the employer were performed. Certain federal statutes, *e.g.*, Title VII of the Civil Rights Act of 1964, and the Age Discrimination in Employment Act (ADEA) of 1967, specifically authorize the recovery of back pay as a remedy for unlawful agency conduct.
3. **Front Pay.** Front pay is paid to an individual to compensate the individual for remuneration that would have been received after the settlement date or court award but for the employer's wrongful conduct and the circumstances – *e.g.*, extreme animosity between the employer and employee – which make it impracticable to place the employee in the position.

4. **Compensatory damages**. Compensatory damages include compensation for physical injury and non-physical injury, *e.g.*, humiliation and defamation, and for the intangible elements of personal injury such as emotional distress and pain and suffering.
5. **Consequential damages.** Consequential damages are compensation for damage, loss, or injury that do not flow directly and immediately from the act of the party, but are consequences or results of such act.
6. **Punitive/liquidated damages.** Generally, liquidated and punitive damages are not directly related to the actual loss incurred. Liquidated damages are amounts that parties agree to pay in the event of a breach of an agreement as a substitute for compensatory damages. Liquidated damages may also be imposed by statute, *e.g.*, the Fair Labor Standards Act of 1938 and the Equal Pay Act of 1963. Punitive damages punish the wrongdoer for wrongful conduct. An award of punitive damages against the government is possible only when the government waives its sovereign immunity, *e.g.*, the Civil Rights Act and the Americans with Disabilities Act, below.
7. **Restoration of benefits.** Restoration of benefits may include the payment of health insurance premiums, Thrift Savings Plan employer and employee contributions, and other retirement contributions.

B. Nature of the claim

1. **Back Pay Act** (5 U.S.C. § 5596(b)(1)). The Back Pay Act covers employees of federal government agencies and other employees of the federal government. Under the Back Pay Act, back pay is awarded to an employee who is found by the appropriate authority under applicable law, rule, regulation, or collective bargaining agreement to have been affected by a wrongful personnel action that resulted in the withdrawal or reduction of all or part of the employee's pay, allowances, or differentials.
2. **Title VII of the Civil Rights Act of 1964,** 42 U.S.C. § 2000e, as amended by **the Civil Rights Act of 1991,** 42 U.S.C. § 1981a**.** Title VII of the Civil Rights Act of 1964, as amended by the Civil Rights Act of 1991, prohibits discrimination in employment based on race, color, sex, religion, and national origin, and provides for the award of back pay and attendant benefits, compensatory damages, compensation for emotional distress, and punitive damages.

3. **Age Discrimination in Employment Act (ADEA) of 1967** (29 U.S.C. § 621)**.** As made applicable to the federal government under 29 U.S.C § 633a, the ADEA provides for an award of back pay and other equitable relief, but does not provide for the recovery of compensatory damages of a tort-like nature (*e.g.*, emotional distress) or liquidated damages.
4. **Americans with Disabilities Act of 1990 (ADA).** Employing the remedial scheme of Title VII and the Civil Rights Act of 1991**,** the ADA authorizes the recovery of back pay, compensation for noneconomic damages such as emotional distress, and punitive damages.
5. **Fair Labor Standards Act of 1938 (FLSA)** (29 U.S.C. § 201). The FLSA requires the payment of minimum wages and overtime pay. The FLSA provides for recovery of unpaid wages, unpaid overtime compensation, and non-punitive liquidated damages, but not compensatory damages of a tort-like nature (*e.g.*, for emotional distress).
6. **Equal Pay Act of 1963 (EPA)** (29 U.S.C. § 206(d)). The EPA is an amendment to the FLSA, prohibiting discrimination on account of gender in the payment of wages by employers. The EPA provides for recovery of unpaid wages, unpaid overtime compensation, and liquidated damages.
7. **State statutes.** State statutes often parallel federal workers' rights statutes, but may provide for broader remedies. The remedies available under a particular state statute under which a suit is brought or could have been brought determine whether a claim thereunder sounds in tort (see discussion of IRC § 104(a)(2) below).
8. **Common law wrongful termination.** As for any tort under the common law, a broad range of remedies are available.

III. Income taxation of judgment/settlement payments.

A. **IRC § 104(a)(2).** This section excludes from gross income the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness. Standing alone, emotional distress is not considered a physical injury or a physical sickness for purposes of § 104(a)(2). However, recoveries paid for medical care described in § 213(d)(1)(A) and (B) attributable to emotional distress are excludable under § 104(a)(2). The § 104(a)(2) exclusion does not apply to amounts previously deducted as medical expenses under § 213.

B. **Is there a settlement?** Section 104(a)(2) and the regulations thereunder

require that the payment be in settlement of a claim in order to be excluded from gross income. Section 1.104-1(c) of the Income Tax Regulations provides that the damages must have been received through prosecution of a legal suit or in a settlement agreement in lieu of prosecution of a suit. This requirement means that a colorable claim under a workers' rights statute or under the common law must have been asserted. A general release of claims against the employer, e.g., under a termination plan or severance package, is not a claim for § 104 purposes. *See*, *e.g.*, *Abrahamsen v. United States*, 44 Fed. Cl. 260 (1999), *aff'd*, 228 F.3d 1360 (Fed. Cir. 2000).

C. **What was the payment for?** For the payment to be excluded under § 104(a)(2), the claim must be for a tort or tort-like injury. The remedies available under the statute or common law determine whether the claim is tort-like in nature. If back pay and liquidated damages are the only remedies available, then the payment is an item of gross income because the recovery is not for a tort-like physical injury. In order for the amount to be excluded from gross income under § 104(a)(2), the taxpayer must demonstrate that the amount was received on account of personal <u>physical</u> injuries or <u>physical</u> sickness, or as reimbursed expenses for medical treatment for emotional distress. *See*, *e.g.*, *Prasil v. Commissioner*, T.C. Memo. 2003-100, applying the two tests set forth in *Commissioner v. Schleier*, 515 U.S. 323, 336-37 (1995), to the current version of § 104(a)(2), *i.e.*, under current law (1) a claim must be based upon tort or tort-type rights, and (2) the taxpayer must show that the damages were received on account of personal physical injuries or physical sickness.

D. **What is a personal physical injury?** Our administrative position is that observable or documented bodily harm, such as bruising, cuts, swelling or bleeding is evidence of personal physical injury. If there has in fact been a personal physical injury, compensatory damages for consequential emotional distress related to the injury are also excludable from gross income.

In Rev. Rul. 85-97, 1985-2 C.B. 50, *amplifying* Rev. Rul. 61-1, 1961 C.B. 14, the Service considered a situation where an individual received a lump sum payment in settlement of an action against a bus company for negligent operation of a bus that caused him serious bodily injury and the concomitant loss of wages and earning capacity. The ruling holds that the entire recovery was for personal injuries excludable from gross income, including the portion allocable to lost wages.

Note: Damages recovered from an employment-related dispute generally are not recoveries for a personal physical injury. Thus, employment-related judgment/settlement amounts will generally be included in the employee's gross income. Therefore, the most difficult questions usually are whether the amounts are wages for employment tax purposes, and the proper reporting of the amount (Form 1099 or Form W-2, and reporting of attorneys' fees on Form 1099).

IV. Income taxation of attorneys' fees.

A. Taxable awards or settlements.

A. Taxable awards or settlements. In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Supreme Court resolved a conflict among the circuits and agreed with the Commissioner that, under the anticipatory assignment of income doctrine, a taxpayer must include in gross income the entire amount of a judgment or settlement, including the portion paid to the attorney as a contingent fee. The Court rejected suggestions that the lien law of a particular state controls the federal tax consequences of a fee arrangement between a client and an attorney or that such an arrangement constitutes a joint venture for tax purposes.

In *Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003), *cert. denied*, 543 U.S. 1145 (2005), the Court of Appeals for the Ninth Circuit held that attorneys' fees paid by a former employer in settlement of a wrongful termination suit were not received pursuant to a reimbursement or other expense allowance arrangement within the meaning of § 62(a)(2)(A) and the implementing regulations. The payment of fees by the employer, the court reasoned, does not satisfy the business connection requirement of § 62(a)(2)(A). Thus, the fees were includible in the taxpayer's gross income.

In the American Jobs Creation Act of 2004 (AJCA), Congress added § 62(a)(19)[20][1] to the Code to ameliorate the result in *Biehl*. Under this provision, employees may reduce gross income by attorneys' fees and court costs paid to pursue a claim of unlawful discrimination (as defined in § 62(e)) and certain other claims. This reduction in any given year is limited to the amount of the award includible in the taxpayer's income for the year. Employees who receive recoveries not described in § 62(a)(19)

[1] The AJCA changed the definition of adjusted gross income by providing for the deduction at § 62(a)(19). Subsequent legislation redesignated § 62(a)(19) as § 62(a)(20). See Pub. L. No. 109-135, § 412(q)(1)(A)-(B).

[20] can deduct the attorneys' fees only on Schedule A as miscellaneous itemized deductions, which are subject to the two percent floor of § 67.[2]

> **Caution**: Section 62(a)(20) is a deduction provision; it does not affect whether an amount is included in gross income, whether an amount is wages for employment purposes, or the information return reporting of an amount.

B. **Nontaxable awards or settlements.** If an award or settlement payment is excluded from gross income under § 104(a)(2), the entire payment is excluded from gross income regardless of whether the taxpayer uses a portion of the excludable payment to pay his attorney under a contingent fee or other arrangement. However, § 265(a)(1) of the Code prohibits the taxpayer from taking a deduction for the fees paid to the attorney.

See the discussion below for proper reporting of attorneys' fees.

C. Fees recovered under fee-shifting statutes. A statute that includes a provision allowing a court to award attorneys' fees to the prevailing party is commonly referred to as a fee-shifting statute. The Service's position is that generally fees awarded to prevailing plaintiffs under federal and state fee-shifting statutes belong to the plaintiff and not to the lawyer. *See, e.g., Evans v. Jeff D.*, 475 U.S. 717, *reh'g denied*, 476 U.S. 1179 (1986). We construe *Banks* and the AJCA as endorsing the Service's position that attorneys' fees awarded under a fee-shifting statute constitute an item of gross income to the client. Although the Court in *Banks* did not decide this issue, it noted that the AJCA redresses the concern for many, if not most, claims governed by fee-shifting statutes. 543 U.S. at 438-39. Moreover, in *Vincent v. Commissioner*, T.C. Memo. 2005-95, the Tax Court, agreeing with the Commissioner, held that the taxpayer was required to include in gross income attorneys' fees awarded under a state fee-shifting statute. The Tax Court held that it was not bound by an opinion of the California Supreme Court holding that under state law, the fees belonged to the attorney and not to the client. *Accord*, *Green v. Commissioner*, T.C. Memo. 2007-39.

[2] IRC § 67(a) provides that individuals are allowed miscellaneous itemized deductions for any taxable year only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income, where § 62 defines adjusted gross income.

V. Employment tax treatment (FICA tax and income tax withholding).

A. General rules.

1. **FICA.** FICA tax is owed on all remuneration paid by an employer to its employees. *See* IRC §§ 3101; 3111. One-half of the applicable FICA taxes are imposed against the employee; the remaining one-half are imposed against the employer. The employer is required to withhold from the employee's pay the employee half of FICA taxes. FICA taxes consist of the Old-age, survivors, and disability insurance portion (OASDI or social security) (IRC §§ 3101(a); 3111(a)), and the Hospital Insurance portion (HI or Medicare) (IRC §§ 3101(b); 3111(b)). The OASDI portion is applied to wages paid up to a dollar amount which is set annually (*e.g.*, $102,000 for 2008). The Medicare portion is not capped. The OASDI and Medicare portions of FICA tax are imposed separately against the employee and employer at the rate of 6.2 percent and 1.45 percent respectively (totaling 12.4% and 2.9% respectively). IRC §§ 3101; 3102; 3111.

   Note for Federal Government Employees: Employees covered under the Civil Service Retirement System who have continuously performed services since December 31, 1983, are generally not subject to social security taxes. IRC § 3121(b)(5). Employees covered under the Federal Employees' Retirement System (FERS), however, are generally subject to social security taxes. Remuneration for services paid to federal employees is generally subject to Medicare taxes. IRC § 3121(u)(1).

2. **Income Tax Withholding**. An employer is required to withhold income tax on remuneration for employment (wages) paid to its employees. IRC § 3402(a).

3. **FUTA**. Payments made by federal agencies are not subject to the Federal Unemployment Tax Act (FUTA) tax. IRC § 3306(c)(6).

B. If not income, then not wages.

Amounts excludable from gross income under § 104(a)(2) and non-economic damages are not wages for FICA and income tax withholding purposes.

C. Severance Pay.

Section 31.3401(a)-1(b)(4) of the Employment Tax Regulations provides that any payments made by an employer to an employee on account of dismissal, *i.e.*, involuntary separation from the service of the employer, constitute wages for income tax withholding

purposes regardless of whether the employer is legally bound by contract, statute, or otherwise, to make such payments. Severance pay, like the pay it replaces, is includible in gross income and is wages for FICA and income tax withholding purposes. *See*, *e.g*., *Abrahamsen v. United States*, 228 F.3d 1360 (Fed. Cir. 2000).

D. **Back pay.** The Service and the courts agree that back pay is wages for FICA and income tax withholding purposes, except where received on account of a personal physical injury or physical sickness. *Social Security Board v. Nierotko*, 327 U.S. 358 (1946). S*ee also Tanaka v. Dep't of Navy*, 788 F.2d 1552, 1553 (Fed. Cir. 1986); Rev. Rul. 96-65. 1996-2 C.B. 6.

The Service's position is that back pay awarded for an illegal refusal to hire is wages for federal employment tax purposes. Rev. Rul. 78-176, 1978-1 C.B. 303. Rev. Rul. 78-176 holds that amounts paid in settlement of a Title VII action to job applicants who were wrongly refused employment on the basis of race are wages for employment tax purposes. The ruling reasons that *Nierotko* applies to this situation because the individuals could not be made whole unless they received social security credit for the back pay.

Rev. Rul. 78-176 was cited with approval in *Melani v. Board of Higher Ed.*, 652 F. Supp. 43 (S.D.N.Y. 1986), *aff'd*, 814 F.2d 653 (2d Cir. 1987). However, in *Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998), the Eighth Circuit rejected the Service's position in Rev. Rul. 78-176. The court held that FICA tax and income tax withholding do not apply unless an actual employer-employee relationship existed. The Eighth Circuit has jurisdiction over causes of action arising in Minnesota, the Dakotas, Iowa, Nebraska, Missouri, and Arkansas. If the cause of action arose in the Eighth Circuit, contact CC:TEGE:EOEG:ET2 for guidance.

E. **Front pay.** The Service's position is that front pay constitutes wages for FICA purposes. Most appellate courts addressing the issue have agreed. *Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999); *Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998); and *Hemelt v. United States*, 122 F.3d 204, 209 (4th Cir. 1997). However, in *Dotson v. United States*, 87 F.3d 682, 689 (5th Cir. 1996), the 5th Circuit held that only the back pay portion of a settlement was wages for FICA tax purposes. The Fifth Circuit includes Texas, Louisiana, and Mississippi. If the cause of action arose in the 5th Circuit, contact CC:TEGE:EOEG:ET2 for guidance.

F. **Restoration of benefits.** Contact CC:TEGE:EOEG:ET2 for questions on the appropriate tax and reporting treatment of such payments.

G. **Emotional distress damages.** Amounts paid for medical care described in § 213(d)(1)(A) and (B) on account of emotional distress are excluded from gross income under § 104(a)(2) if the expense has not been previously deducted under § 213, and are not wages for employment tax purposes.

H. **Are employment taxes calculated based on the year of payment or when the wages would have been payable absent the wrongful conduct?** In *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001), the Supreme Court agreed with the Service's long-standing position, holding that employment taxes on back wages are calculated with respect to the period during which the wages are actually paid, rather than the period during which the wages should have been paid.

I. **Allocation of payments.** A judgment or settlement payment may comprise multiple elements, each of which may or may not be wages. A court award may break down the amount of the award into its elements such as back pay, emotional distress damages, and interest, making it much easier to determine which portion(s) constitutes wages. However, in the case of a settlement payment, the parties must determine the elements of the settlement amount. This determination is made by considering all the facts and circumstances, including the remedies available for the particular claim. For example, a settlement payment may have to be allocated between back pay and other compensatory damages (*e.g.*, emotional distress). As discussed, back pay is wages subject to employment taxes, but emotional distress damages are not. Proper allocation is also necessary to ensure proper reporting of the payment (Form W-2 or Form 1099).

Note: The Service generally considers the following facts and circumstances in determining whether to accept an allocation of damages in a settlement agreement or in a final judgment:

1. Whether there was a bona fide adversarial settlement as to the allocation of payment between types of recoveries. *Robinson v. Commissioner*, 102 T.C. 116 (1994), *aff'd*, 70 F.3d 34 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996).
2. Whether the terms are consistent with the true substance of the underlying claims. For example, compensatory damages in the

nature of tort-like remedies (*e.g.*, emotional distress) are not available for ADEA claims. Thus, for such a claim it would not be appropriate to allocate recovery amounts to emotional distress.

J. Attorneys' fees and interest.

1. **Court awards.** Rev. Rul. 80-364, 1980-2 C.B. 294, considers whether attorneys' fees and interest awarded with back pay are wages for employment tax purposes. The ruling describes three situations.

   In Situation 1, after termination of employment by a company, an individual filed a complaint for back pay. The court awarded the individual $8X in back pay, $1X in attorneys' fees, and $1X in interest. The ruling holds that although the entire $10X is includible in gross income, only the back pay award of $8X is wages for federal employment tax purposes; the interest and attorneys' fees were excluded from wages because they were separately identified.

   In Situation 2, an individual sues the individual's employer for $15X for back pay. Pursuant to a court order, the employer paid the individual $10X. The court order did not indicate that a portion of the award was for attorneys' fees or interest. The employee paid $1X in attorneys' fees. The ruling holds that the entire $10X is income to the employee and is also wages for federal employment tax purposes even though $1X was spent on attorneys' fees.

   In Situation 3, a union files a claim for breach of a collective bargaining agreement on behalf of its members against a company. The union and the company entered into a settlement agreement, later approved by a court, which provided that the company would pay the union $40X in settlement of all claims. The union paid $6X of the settlement for attorneys' fees and returned $34X dollars to the employees for back pay owed to them. The back pay was distributed to the employees in proportion to their claims. The ruling holds that the $6X paid by the union in attorneys' fees is not remuneration for employment and thus is not wages. In addition, the $6X is not includible in the employees' gross income. Although not stated, the $34X paid from the union to the employees would be wages subject to federal employment tax.

An award of attorneys' fees under a fee-shifting statute would not be wages under Situation 1 of the ruling. By contrast, as described in Situation 2, the payment of attorneys' fees by the employee (*e.g.*, contingent attorneys' fees) from a court award consisting solely of back pay would not affect the characterization of the recovery, or some part thereof, as back pay (and thus wages).

Note that in *Biehl*, discussed above, the Tax Court and the Ninth Circuit held that attorneys' fees paid from a court award could not be excluded from income as a payment under an "accountable plan" within the meaning of §§ 62(a)(2)(A), 62(c), and the regulations thereunder. Likewise, the accountable plan rules cannot serve to remove the portion of a settlement owed as attorneys' fees from wages if the settlement amount would otherwise be properly characterized as wages. *Biehl*, 351 F.3d at 985-86, *aff'g* 118 T.C. 467 (2002). Although attorney's fees may be deductible under § 62(a)(20), this provision does not affect whether a recovery of attorney's fees is gross income, or whether such amount is wages for employment tax or information reporting purposes.

2. **Settlement payments.** Most employment-related disputes are settled administratively rather than through litigation. Whether attorneys' fees recovered in a settlement of an action under a fee-shifting statute are excluded from wages is an open question. For example, if a suit for back pay under Title VII is settled, and provides for back pay and attorneys' fees in the settlement agreement, the question arises whether the portion of the settlement characterized as attorneys' fees is wages. In *Banks*, the Supreme Court indicated that the taxpayer did not receive an award of attorneys' fees under a fee-shifting statute when the attorneys' fees were paid pursuant to a settlement agreement rather than a court award, notwithstanding that the statute under which the taxpayer sued provided for awards of attorneys' fees. If this issue arises, contact CC:TEGE:EOEG:ET2 for guidance.

VI. Third Party Payors. An agency other than the employing agency may in some cases pay an amount to an employee in satisfaction of a court award or in settlement of an employment-related dispute. In such cases, the agency having control of the payment of wages is responsible for income tax withholding. *See* IRC § 3404 ("If the employer is the United States . . . , or any agency or instrumentality [of the United States], the return of the amount deducted and

withheld upon any wages may be made by any officer or employee of the United States . . ., or of such agency or instrumentality, . . . having control of the payment of such wages . . . ."). Similarly, the agency having control of the payment of wages must withhold and pay FICA taxes. *See* IRC § 3122 ("In the case of [FICA taxes] with respect to service performed in the employ of the United States [or in the employ of an instrumentality of the United States]. . ., the determination of the amount of remuneration for such service, and the return and payment of the taxes imposed by this chapter, shall be made by the head of the Federal agency or instrumentality having the control of such service, or by such agents as such head may designate."). A third-party payor responsible for employment taxes under §§ 3404 and 3122 is also responsible for the related Form W-2 reporting requirements under § 6051(a).

VII. Reporting requirements.

A. Wage reporting. Under § 6051, the employer is required to furnish information returns (Form W-2, Wage and Tax Statement) to employees reporting the amount of wages, withholding, and other information. Copies of these information returns are also required to be filed by the employer with the Social Security Administration (SSA). Treas. Reg. § 31.6051-2(a). Thus, an amount paid as back pay to an employee is generally reportable by the employer to the employee and to the Social Security Administration on a Form W-2. The wage reporting requirement applies regardless of whether the payment is also reportable to the employee's attorney under § 6045(f) (see discussion below).

B. Special reporting requirements for back pay. With respect to payments to employees of back pay under a statute, there are procedures for reporting to SSA (in addition to the Form W-2 reporting) that are described in Social Security Publication 957, Reporting Back Pay and Special Wage Payments to the Social Security Administration. These procedures could apply in the case of an employee who received a back pay award in one year that related to several prior years in which the wages should have been paid. Back pay is allocated to the periods in which the wages should have been paid for social security benefit purposes only, not the computation of FICA tax. This reporting treatment is based on *Nierotko*, 327 U.S. at 358. *See also Cleveland Indians Baseball Co.*, 532 U.S. at 200. The Treasury Financial Manual indicates that federal agencies are required to do the reporting required by Publication 957. *See* TFM Volume I, Part 3, Chapter 4000, section 4050.40. Note that this may benefit employees by providing them with needed quarters of coverage for social security benefit purposes.

C. **Form 1099 reporting.** If a settlement or judgment payment is income but does not constitute wages, the payment will be subject to reporting under § 6041 on Form 1099-MISC. If the payment is excludable from gross income pursuant to § 104(a)(2) or any other section, there is no reporting required.

D. **Payments to attorneys.** Under § 6045(f), every person making a payment in the course of his trade or business "to an attorney in connection with legal services" is required to report the payment on Form 1099, regardless of whether the payment constitutes income to the attorney.

The following charts describe the reporting requirements for payments made to employees and attorneys. The first chart describes the income and employment tax consequences and proper reporting of payments made to employees as compensation for various types of damages. The four charts that follow address the reporting treatment of attorneys' fees for employees and attorneys.

Tax and Reporting Treatment of Judgment/Settlement Payments to Employees

Payment Character	Income Taxable?	Wages (FICA and ITW)?	Reporting Requirement
Back pay (other than lost wages received on account of personal physical injury or physical sickness)	Yes	Yes [1]	W-2
Front pay	Yes [2]	Yes	W-2
Dismissal/severance pay	Yes	Yes	W-2
Compensatory or consequential damages paid on account of personal physical injuries or physical sickness	Generally, no	No	None
Compensatory damages not paid on account of personal physical injuries or physical sickness (*e.g.*, emotional distress)	Generally, yes	No	1099-MISC, Box 3
Consequential damages not paid on account of personal physical injuries or physical sickness	Yes	No	1099-MISC, Box 3
Punitive/Liquidated damages	Yes	No	1099-MISC, Box 3
Interest	Yes	No	1099-INT, Box 1 (if $600 or more)
Costs	Yes	No	1099-MISC, Box 3
Medical expenses	Generally, no	No	None
Overtime	Yes	Yes	W-2

Restoration of benefits: Health Premiums, TSP employee and employer contributions, and retirement contributions	To be determined	To be determined	To be determined
Taxes—employee income tax or employee portion of FICA	Yes	Yes. See Publication 15-A	W-2
Travel—if requirements of § 62(c) (accountable plan) are met	No	No	No
Travel—if requirements of § 62(c) are not met	Yes	Yes	W-2

[1] If the case is in the 8th Circuit, and involves an illegal refusal to hire, contact CC:TEGE:EOEG:ET2 for guidance.
[2] If the case is in the 5th Circuit, contact CC:TEGE:EOEG:ET2 for guidance.

Tax and Reporting Treatment of Attorneys' Fees

Total Employer Payment Made Jointly to Attorney and Employee:

Nature of Payment	Income Taxable to employee?	Reporting to Employee	Reporting to Attorney
Court award designating attorneys' fees[1]	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2).	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.
Settlement payment	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Box 14 of 1099-MISC in the amount of the check payable jointly to employee and attorney Treas. Reg. § 1.6045-5(a), and (f) Ex. 1.

Separate Employer Payments to Employee, and to Attorney for Attorneys' Fees:

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Court award designating attorneys' fees[1]	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2) even though paid separately to attorney. Treas. Reg. §1.6041-1(f)(1) and (2).	Box 14 of 1099-MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2) even though attorneys' fees paid separately to attorney. Treas. Reg. §1.6041-1(f)(1) and (2).	Box 14 of 1099-MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.
Settlement payment	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Box 14 of 1099-MISC to attorney in the amount of check payable to attorney. Treas. Reg. § 1.6045-5(a), and (f) Ex. 3.

[1] Workers rights statutes, such as Title VII, generally include fee-shifting provisions.

Total Employer Payment to Employee:

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Court award designating attorneys' fees[1]	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	None. *See*, *e.g.*, Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099-MISC or W-2).	None. *See*, *e.g.*, Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.
Settlement payment	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	None. *See*, *e.g.*, Treas. Reg. § 1.6045-5(a), (d)(4), and (f) Ex. 4.

[1] Workers rights statutes, such as Title VII, generally include fee-shifting provisions.

Total Employer Payment to Attorney:

Nature of Payment	Income Taxable to Employee?	Reporting to Employee	Reporting to Attorney
Court award under fee-shifting statute designated as attorneys' fees[1]	Yes—attorneys' fees generally taxable to employee.	Attorneys' fees reportable in Box 3 of 1099-MISC (not W-2). Treas. Reg. § 1.6041-1(f)(1) and (2).	Total amount of check reported on 1099-MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).
Court award without designation of attorneys' fees	Yes—attorneys' fees generally taxable to employee.	The total award is reportable, as appropriate (on 1099 or W-2).	Total amount of check reported on 1099-MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).
Settlement payment	Yes—attorneys' fees generally taxable to employee.	To be determined, based on the nature of the action. If wages, reportable on W-2. If not wages, reportable in Box 3 of 1099-MISC.	Total amount of check reported on 1099-MISC, box 14. Treas. Reg. § 1.6045-5(a) and (d)(4).

[1] Workers rights statutes, such as Title VII, generally include fee-shifting provisions.

Service Rules on Treatment of Periodic Payments for Nonphysical Injuries

In a letter ruling obtained by Tax Analysts, the Service has ruled that an individual using the cash receipts and disbursements accounting method won't be in actual or constructive receipt of periodic payments from a legal settlement until she receives the cash payment, and she must include each payment in her income in the year she receives it.

Citations: not available at time of publication

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Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact: * * *, ID No. * * *
Telephone Number: * * *

Index Number: 451.14-00

Date: June 2, 2008

Refer Reply To: [CC:ITA:3] - PLR-150850-07

LEGEND:

taxpayer = * * *
Employer = * * *
Assignee = * * *
Annuity ssuer = * * *
Date a = * * *
Date b = * * *

Dear * * *:

This responds to your letter dated November 13, 2007, requesting a ruling on the proper federal income tax treatment for certain periodic payments the taxpayer will receive in settlement of various claims against Employer.

REQUESTED RULINGS

(1) The taxpayer will not be in actual or constructive receipt of periodic payments until she receives the applicable cash payment.

(2) The taxpayer will include each of the periodic payments in her income in the year in which she receives such payment.

APPLICABLE FACTS

The taxpayer files her federal income tax return on a calendar year basis under the cash receipts and disbursements method of accounting.

The taxpayer has asserted that from Date a to Date b, while employed by Employer she was subjected to a pattern of hostile employment practices. Taxpayer filed a complaint seeking damages arising from alleged lost overtime-wages (the "Wage Claim") and from alleged non-physical injuries, including emotional distress and mental anguish (the "Non-Wage Claim" and, together with the Wage Claim, the "Claims").

As a result of negotiations, taxpayer and Employer (the "Parties") agreed to settle taxpayer's Claims. Under a proposed Settlement Agreement and Release, Employer agrees to pay taxpayer an initial lump sum of cash (the "Lump Sum Payment") in settlement of her Wage Claim, together with a specified schedule of periodic payments (the "Periodic Payments") in settlement of her Non-Wage Claim.

In the Settlement Agreement and Release, taxpayer will agree that she may change neither the timing nor the amount of the Periodic Payments in order to accelerate, defer, increase or decrease such payments. Taxpayer further will agree that she may not sell, mortgage, encumber or anticipate all or any portion of the Periodic Payments by assignment or other means.

The Settlement Agreement and Release reserves the right of the Employer to enter into a "Non-Qualified Assignment," under which the Assignment Company ("Assignee") will make the Periodic Payments directly to the taxpayer. Furthermore, as part of the Settlement Agreement and Release, taxpayer will agree to allow Employer to enter into a Non-Qualified Assignment with Assignee and acknowledges that upon the Assignee's acceptance of a Non-Qualified Assignment, the Assignee will become the sole obligor with respect to the specified Periodic Payments. Under the Nonqualified Assignment Agreement, the Assignee agrees, for good and valuable consideration, to make the Periodic Payments to taxpayer.

Under the Non-Qualified Assignment Agreement, the Assignee will make the Periodic Payments directly to the taxpayer. The Assignee's obligation to make the Periodic Payments is no greater than that of Employer; however, the Assignee's obligation to make the Periodic Payments will continue regardless of the subsequent bankruptcy or insolvency of the Employer.

The Non-Qualified Assignment will be an irrevocable contract requiring the Assignee to make the specified Periodic Payments to the taxpayer. Under no circumstances can the taxpayer elect to receive the commuted value of the remaining Periodic Payments.

The Assignee's obligation under the Non-Qualified Assignment to make Periodic Payments will be discharged by transmitting, by the due date for each payment, a valid check or its electronic equivalent in the specified sum for the taxpayer. Similar to the Settlement Agreement and Release, the Non-Qualified Assignment prohibits changes to the timing or the amount of the Periodic Payments and prohibits the taxpayer from accelerating, deferring, increasing or decreasing the scheduled Periodic Payments. In addition, the taxpayer may not sell, assign, encumber or anticipate all or any portion of the Periodic Payments by assignment.

The Non-Qualified Assignment further specifies that the taxpayer has no rights against the Assignee other than those-of an unsecured general creditor. The Non-Qualified Assignment states that all

rights of ownership with respect to any annuity contract purchased by the Assignee belong exclusively to the Assignee; taxpayer will not be a third party beneficiary of any such annuity contract.[1] The Non-Qualified Assignment also states that no assets have been set aside to secure the Periodic Payments.

By settling her Non-Wage Claim for an agreed schedule of Periodic Payments and permitting Employer to assign its obligation to make such payments to the Assignee (the "Assignment Transaction"), the taxpayer can address her desire to use the settlement as a source for meeting future needs, including retraining and financial planning.

The Taxpayer has represented that:

1. The Periodic Payments represent compensation to the taxpayer for non-physical personal injuries and sickness she incurred during the course of her employment with Employer

2. The Periodic Payments represent payments made by Employer to settle taxpayer's Non-Wage Claim and are not wages for federal income tax purposes.

3. Employer's Periodic Payments in settlement of the taxpayer's Non-Wage Claim will constitute a taxable recovery to the taxpayer pursuant to section 61 of the Internal Revenue Code and are not exempt from federal income tax under section 104(a)(2).

LAW AND ANALYSIS

Section 451 of the Code provides that an item of gross income shall be included in a taxpayer's gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations, provides, in part, that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.

Section 1.451-2(a) of the Regulations, provides, in part, income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 66-45, 1966-1 C.B. 95 states that the phrase 'or otherwise made available was added to section 1.451-2(a) of the Regulations to make it clear that it is a right of withdrawal during the taxable year, rather than the formal setting apart or crediting of income, which causes income to be constructively received.

In Rev. Rul. 67-203, 1967-1 C.B. 105, a winner of the Irish Sweepstakes reported his income on the cash receipts and disbursements basis, and, by reason of being a minor his winnings were to be held by the Irish court until he reached majority. Rev. Rul. 67-203 holds that the economic benefit

doctrine applies and requires the inclusion of the present value of the sweepstakes winnings in the minor's gross income at the time the funds are paid over to the Irish court.

Rev. Rul. 2003-115, 2003-2 C.B. 1052, holds that neither the constructive receipt doctrine nor the economic benefit doctrine applied to a claimant regarding the settlement of a claim under the September 11 Victim Compensation Fund where (i) the claimant irrevocably elected to receive periodic payments while the claimant's control of receipt of payment was subject to substantial restrictions; (ii) the Fund assigned its obligation to make such periodic payments to an assignment company pursuant to a "qualified assignment" described in section 130; and (iii) the assignment company funded its obligation to make periodic payments by purchasing an annuity contract described in section 130(d).

Williams v. U.S., 219 F.2d 523 (5th Cir. 1955) holds that a seller is in constructive receipt of income where the buyer agrees to pay the full purchase price and the seller self imposes limitations on an escrow, which does not make the sales proceeds any less available to the seller.

In *Commissioner v. Brooklyn Gas Co.*, 62 F.2d 505 (2d Cir. 1933), a gas company engaged in rate litigation and obtained an interlocutory order staying reduced rates and directing that money collected in excess be impounded. The gas company was permitted to withdraw the impounded money upon issuing a bond. The court held that the money was taxable in years earned, not in the year litigation was finally terminated, because the taxpayer had dominion and control over the money without any restriction

In *Childs v. Commissioner*, 103 T.C. 634 (1994, aff'd without op. 89 F.3d 856 (11th Cir. 1996), the taxpayer received a structured settlement agreement, which provided that the defendant's insurance company assigned its obligation to Assignee, who then purchased an annuity from its subsidiary. Assignee remained the owner of the annuity policy, maintained the right to change the beneficiary without the consent of the taxpayer; and the taxpayer's rights under the annuity policy were not greater than those of a general creditor. The Tax Court held that the fair market value of taxpayer's right to receive payments under the settlement agreement was not includable income in the year in which the settlement agreement was effected because the promise to pay was neither fixed nor secured. The court further held that the doctrine of constructive receipt was not applicable because the taxpayer did not have a right to receive payment before the time fixed in the settlement agreement.

In *Sproull v. Commissioner*, 16 T.C. 244 (1951), aff'd, 194 F. 2d 541 (1952), the Tax Court held that an economic benefit or financial benefit is conferred to the taxpayer, and as a result, the taxpayer recognizes income under the economic benefit doctrine where money is place in trust for the taxpayer, taxpayer is not required to do anything to earn such funds, and the trust contained no restriction on taxpayer's right to assign or otherwise dispose of the money placed in trust.

Under *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), and Rev. Rul. 68-606, 1968-C.B. 42, a freely transferable, readily marketable right to a future payment stream, not subject to setoffs, is equivalent to cash and therefore is taxed at its fair market value when the right to such payment is received by a cash basis taxpayer.

Timing of Income for Federal Income Tax Purposes

Generally, the taxpayer's method of accounting determines when an amount is treated as received for Federal income tax purposes. In the instant case, Taxpayer reports on the cash receipts and disbursements method of accounting for Federal income tax purposes.

Under the cash receipts and disbursements method of accounting, all items which constitute gross income (whether in the form of cash, property, or services) are to be reported as income in the taxable year in which such items are actually or constructively received, or where the taxpayer is conferred an economic benefit.

A. Actual Receipt

Income is actually received when it is reduced to the taxpayer's possession, dominion, or disposition. See *Brooklyn Gas*. Under the Non-Qualified Assignment, taxpayer will not receive, nor in any way possess or control, the amount paid to the Assignee by the Employer. Nor will taxpayer receive any property at the time the Employer enters into the Non-Qualified Assignment, other than the contractual promise of the Assignee to make the scheduled payments. A mere unfunded, unsecured promise to pay does not result in income to a taxpayer on the cash receipts and disbursements method of accounting. Rev. Rul. 60-31, 1960-1 C.B. 174, and *U.S. v. Christine Oil & Gas Co.*, 269 F. 458 (Cir. 1920). Thus, the taxpayer shall not be viewed as being in actual receipt of cash or property when she enters into the Settlement Agreement and Release with the Employer or when the Employer and the Assignee enter into the Non-Qualified Assignment.

B. Under Equivalency

Under the "cash equivalency" doctrine, a cash basis taxpayer may be treated as being in receipt of income if that taxpayer receives a promise or other contractual obligation that can readily be converted into cash by the taxpayer. *Cowden v. Comm'r*, 289 F.2d 20, 24 (5th Cir. 1961), *rev'g and rem'g* 32 T.C. 853 (1959), *on remand*, 20 T.C.M. 1134 (1961). The taxpayers in *Cowden* were lessors unclear an oil, gas, and mineral lease who were entitled under the lease to deferred payments. Shortly after entering into the lease, the taxpayers assigned their rights to the deferred payments in exchange for an amount which represented a normal market discount from the amount of future payments they otherwise would have received. The Court stated:

> We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

289 F.2d at 24.

Under the Non-Qualified Assignment, the taxpayer will not be able to assign, encumber or otherwise transfer her right to receive the Periodic Payments. Both the Settlement Agreement and Release, executed by the Employer and the taxpayer, and the Non-Qualified Assignment, executed by the Employer and the Assignee, will provide that the taxpayer will have no right to modify the schedule of Periodic Payments, or to accelerate, defer, increase, decrease, anticipate, sell, assign, or encumber any payment.

Based upon the fact that the taxpayer's right to payments under the Non-Qualified Assignment will be neither assignable nor transferable, the taxpayer's limited right to payments shall not be treated as equivalent to cash. Although the Non-Qualified Assignment between the Employer and the Assignee will provide for the Assignee to fund its obligations by acquiring an annuity contract, the taxpayer will have no rights in the annuity contract and thus will continue to possess only an unsecured and unfunded promise to pay. The Assignee's purchase of an annuity contract, under which the Assignee has all rights of ownership does not create a cash equivalent right that ripens into a benefit of the taxpayer.

C. Constructive Receipt

A cash basis taxpayer is in constructive of income, as, opposed to actual receipt, when income although not actually reduced to a taxpayer s possess on s credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." Section 1.451-2(a) of the Regulations. The phrase "or otherwise made available" was added to the Regulation to make it clear that a taxpayer's right to raw on income during the taxable year, even if it is not formally set apart or credited, causes income to be constructively received. Rev. Rul. 66-45, 1966-1 C.B. 95. A taxpayer will not have current income under the constructive receipt doctrine merel because he seeks deferral of payments as part of a negotiated settlement. See *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983). if, however, the taxpayer has a Current right to receive all of the funds before a deferral mechanism is established, current income cannot be avoided. *Williams v. United States*.

Under the Non-Qualified Assignment, the taxpayer will not have a right to draw on or otherwise accelerate her receipt of the Periodic Payments scheduled to be made by the Assignee. The amounts to be paid by the Assignee will come from its general assets, which are subject to claims of the creditors of the Assignee. The Non-Qualified Assignment specifically provides that "None of the Periodic Payments may be accelerated, deferred, increased or decreased and may not be anticipated, sold, assigned, or encumbered. Any attempts to do so will be void."

Thus, under the Non-Qualified .Assignment, the taxpayer will have no ability to receive any Periodic Payment (either partially or in full) before the time the Assignee is scheduled make any payment. The Non-Qualified Assignment will be entered into only after a Settlement Agreement and Release is negotiated between taxpayer and the Employer. During these negotiations the taxpayer's payment rights will be established. The negotiated Settlement Agreement and Release will fix the taxpayer's rights prior to the time when she has an unqualified right to demand immediate payment. She will therefore not have a current right to receive a settlement payment before her right to receive Periodic Payments under the Settlement Agreement is established. Under the Settlement Agreement and Release and the Non-Qualified Assignment, taxpayer will be entitled to specified payments only at specified times, and the taxpayer will be prohibited from altering either the timing or the amount of any payments. Accordingly, the taxpayer shall not be viewed as constructively receiving any of the applicable payments at any time before the Assignee makes the Periodic Payments in cash pursuant to the schedule set forth in the Settlement Agreement and Release. Furthermore, Assignee s purchase of an annuity contract to fund its obligations under the Non-Qualified Assignment does not amount to a setting apart or crediting of funds for the taxpayer's benefit given that she will possess no rights under the annuity contract. Childs. (No constructive receipt where settlement agreement stipulated that attorney's rights under annuity policies, acquired by assignment company to fund obligation to make periodic payment of attorney's contingent fee arising-from client's settlement, were no greater than rights of a general creditor.)

D. Economic Benefit

Under the "economic benefit doctrine," a taxpayer on the cash method of accounting may be treated as having received income in a year prior to actual or constructive receipt in certain limited circumstances. See, e.g., Sproull v. Comm'r, 16 T.C. 244,247 (1951), *aff'd per curiam,* 194 F.2d 541 (6th Cir. 1952). A cash-basis taxpayer is taxed currently on the value of the economic benefit conferred when the taxpayer is assured the benefit of future payments, even though such payments will not be-made or made available to the taxpayer until subsequent taxable years. A taxpayer is treated as receiving the current economic benefit of future payments when a payor unconditionally and irrevocably establishes a separate founder trust of assets exclusively for the taxpayer's benefit. *Sproull*, 16 T.C. at 248 *supra* (the economic benefit doctrine requires current inclusion in income of an amount irrevocably transferred to a trust to be paid, with earnings, to an employee over the following two years, or to his estate should he die earlier); Pulsifer v. Commissioner, 64 T.C. 245, 247 (1975) (Irish Sweepstakes winnings irrevocably deposited with an Irish court for the benefit of a minor sweepstakes winner are currently includible in income under the economic benefit doctrine); Rev. Rul. 67-203, 1967-1 C.B. 105.

Neither the execution of the Non-Qualified Assignment nor the purchase of an annuity contract by the Assignee tO fund its obligation to the taxpayer shall be viewed as conferring a current economic benefit on the taxpayer. After the execution, of the. Non-Qualified Assignment, the taxpayer will possess. Only a mere promise to be paid (although the identity of the promisor will have changed). Moreover, no amount will be set aside from which to make the scheduled payments, nor will a separate fund be recoverably and unconditionally set aside for the benefit of the taxpayer. Furthermore, taxpayer has no rights against the Assignee other than that of a general creditor.

Based on the above, neither the "constructive receipt" doctrine, the "cash equivalency" doctrine, nor the "economic benefit" doctrine shall apply to the taxpayer's facts regarding the Periodic Payments.

RULINGS

Based solely on the facts and representations submitted, we conclude and rule as follows:

(1) The taxpayer will not be in actual or constructive receipt of the Periodic Payments until she receives the applicable cash payment.

(2) The taxpayer will include each of the Periodic Payments in her income in the year in which she receives such payment.

DISCLAIMERS AND LIMITATIONS

This ruling is based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on Examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied regarding the deductibility of any amounts by Employer under section 1.461-4 of the Regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
Associate Chief Counsel
(Income Tax & Accounting)

FOOTNOTE

[1] Pursuant to the Non-Qualified Assignment Agreement, the Assignee will fund the Periodic Payments by purchasing an annuity contract issued by the Annuity Issuer. All rights of ownership and control of such annuity contact shall be and remain vested in the Assignee.

END OF FOOTNOTE

Tax Analysts Information

Code Section: Section 451 -- Year of Inclusion; Section 104 -- Damage Awards/Sick Pay; Section 61 -- Gross Income Defined
Jurisdiction: United States
Subject Area: Individual income taxation
Settlements and dispute resolution
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*Structured Settlements Plus Nonqualified Assignments— Expanding the Field of Structures**

By
Robert W. Wood

Robert Wood provides background on Code Sec. 104 and looks at the tax ramifications of the emerging use of structured settlement payments and nonqualified assignments outside of the physical injury context.

In today's increasingly litigious society, recoveries for tort actions stemming from physical injuries frequently eclipse seven-figure dollar amounts. Structured settlements are being used to settle tort actions in increasing numbers. Of course, most traditional structured settlement payments involve excludable periodic payments made "on account of personal physical injuries." These traditional structured settlements are frequently paired with Code Sec. 130 qualified assignments.

Even so, emerging practice suggests the use of structured settlement payments and nonqualified assignments *outside* of the physical injury context. It is this important new area that is my focus, but to get there, I want to begin with some background.

Recent Code Sec. 104 Authority

The Code Sec. 104 exclusion was winnowed down considerably with the enactment of the Small Business Job Protection Act of 1996.[1] If I am right that there is growing interest in (and a growing need for) structures *outside* of Code Sec. 104 cases, one of the reasons is tautological: Code Sec. 104 does not go far enough.

Indeed, in a slew of recent decisions, the Tax Court has time and again found sex discrimination recoveries to not be excludable under Code Sec. 104(a)(2).[2]

Although the facts in the underlying cases vary from case to case, the ultimate result (and the underlying rationale) has become almost boilerplate. Courts generally cite *E.E. Schleier*[3] for the proposition that for a recovery to

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be excludable under Code Sec. 104(a)(2):

- The underlying cause of action must be based upon tort or tort-type rights.

Unfortunately, there does not appear to be any published guidance from the IRS (or the courts) discussing structured settlements in nonphysical injury cases (let alone structured settlements that are paired with nonqualified assignments).

- The resulting damages must be recovered on account of personal injuries or sickness.

For recoveries after August 20, 1996 (the effective date of the Small Business Job Protection Act), the second prong of *Schleier* has been held to require that the personal injuries or sickness be *physical* in nature.[4]

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

The tax consequence of a racial discrimination recovery is not much different in this respect. For example, in *W.O. Oyelola*, the Tax Court held that a taxpayer was not entitled to exclude a racial discrimination recovery because the taxpayer failed to prove that the recovery was received on account of personal physical injuries or sickness. In *T.V. Cates*, the Tax Court reached a similar conclusion.

Wrongful termination recoveries in recent years have followed a similar path. For example, in *J. Tamberella*,[5] the Tax Court held that an individual may not exclude the proceeds of a wrongful termination recovery under Code Sec. 104(a)(2), because the taxpayer failed to show that any portion of the recovery was received on account of personal physical injuries or sickness.

Current Trends in Structured Settlements

One current possibility in the structured settlement arena is for a defendant to fund its obligation to make periodic payments in nonphysical injury cases by purchasing an annuity and employing a nonqualified assignment to a third-party obligor. These nonphysical injury cases may involve any number of tort claims that do not involve physical injuries, such as claims for racial discrimination, sexual harassment (without any overt and observable physical harm), wrongful termination or violations of the ADA or ERISA.

One question is whether the plaintiffs in such cases recognize gross income for federal income tax purposes in the year in which the settlement agreement is signed (a *devastating tax result*), or whether they recognize gross income in the years in which the payments are actually received. If a plaintiff usees a structured settlement in a nonphysical injury case, proper matching and general fairness suggest that the plaintiff should be taxed on the stream of payments only as they are actually received (absent constructive receipt or economic benefit concerns, which are addressed below).

Regrettably, this is an emerging area, and neither the IRS nor the courts have addressed the use of structured settlements in this context. With this as our backdrop, let's examine a brief history of structured settlements and Code Sec. 130 qualified assignments.

Background on Structured Settlements

In its purest form, a structured settlement merely calls for periodic payments, payments over time. The use of periodic payments to compensate victims of personal injuries was not widespread until the late 1970s. The idea that a tort victim would receive a stream of payments payable over his or her lifetime (as opposed to a lump-sum) raised a variety of issues, one of which was the appropriate tax treatment for such a stream of payments.

The future of structured settlements was more certain after the IRS issued several revenue rulings establishing the tax treatment of structures. The IRS made clear that the plaintiff would receive all amounts from a periodic payment settlement free from federal income tax. These three revenue rulings were later codified in amendments to the Internal Revenue Code enacted by the Periodic Payment Settlement Act of 1982, providing a further impetus for the widespread use

of structured settlements. These three fundamentally important revenue rulings involved different factual situations, but all considered settlement situations that are of continuing interest.[6]

Funding Periodic Payments with Qualified Assignments

Several common types of periodic payments result in favorable tax treatment to the recipient and the payor. Perhaps the most common model involves the purchase of an annuity by a "qualified assignee" of the defendant. If the insurer purchases the annuity and retains its exclusive ownership, the plaintiff in the physical injury action (who was designated to receive the annuity payments) may exclude from gross income the full amount of these payments, not merely their discounted present value.[7] The plaintiff in this situation does not have constructive receipt of the full amount, nor has he received an "economic benefit" resulting in taxation. He has only an unfunded, unsecured promise to pay regularly scheduled payments in the future.

Once a structured settlement is in place, it does not necessarily follow that the *defendant* will make each payment. A "qualified assignment" of the defendant's obligation to make periodic payments is possible, so that the plaintiff thereafter looks to a third-party obligor for payment rather than to the defendant.

Under Code Sec. 130, if a defendant pays a qualified assignee for assuming its liability to make periodic payments to an injured plaintiff, the amount received will not be taxable to the assignee, except to the extent that it exceeds the aggregate cost of the "qualified funding asset." The basic model of a qualified assignment is that the defendant (or its liability insurer) first gives the plaintiff a promise to pay money in the future. Then, the defendant (or its liability insurer) transfers that obligation to its substituted obligor, who thereafter remains liable on the payment obligations.

For all of this to work properly, a number of technical requirements must be met. A qualified assignment is defined as any assignment of a liability to make periodic payments as damages on account of *physical* injury or sickness if all of the following requirements are met:

- The assignee assumes the liability from a person who was a party to the suit or agreement.
- The periodic payments are fixed and determinable as to amount and time of payment.
- The periodic payments cannot be accelerated, deferred, increased or decreased by the recipient of the payments.
- The assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability.
- The periodic payments are excludable from the gross income of the recipient under Code Sec. 104(a)(2).
- The amount received by the assignee for assuming a periodic payment obligation must be used to purchase a "qualified funding asset."

A "qualified funding asset" is defined as any annuity contract issued by a company licensed to do business as an insurance company under the laws of any state, or any obligation of the United States, if all of the following conditions are met:

- The annuity contract or obligation must be used by the assignee to fund periodic payments under any qualified assignment.
- The periods of the payments under the annuity contract or obligation must be reasonably related to the periodic payments under the qualified assignment, and the amount of any such payment under the contract or obligation must not exceed the periodic payment to which it relates.
- The annuity contract or obligation must be designated by the taxpayer as being taken into account under Code Sec. 130(d) with respect to the qualified assignment.
- The annuity contract or obligation must be purchased by the taxpayer not more than 60 days before the date of the qualified assignment or not later than 60 days after the date of that assignment.[8]

In determining whether there has been a qualified assignment, any provision in the assignment that grants the recipient rights as a creditor greater than those of a general creditor will be disregarded.[9] Thus, the plaintiff may hold a security interest in the entity or qualified funding asset. This can make qualified assignments more attractive to a settling plaintiff, who may achieve security by virtue of the qualified assignment that would otherwise be prohibited, without risking constructive receipt on the entire stream of periodic payments.

Code Sec. 104(a)(2) provides the exclusion for recoveries received

on account of physical injuries or sickness, but Code Sec. 130 provides for a type of assignment so that payments by a third-party payor of the periodic payments will not alter the tax-free nature of the stream of periodic payments.

The Basic Transaction

Now, let's turn *outside* the Code Sec. 104 area, but without turning away from structures. Some savvy insurance companies have created an innovative system for discharging settlement liabilities. The plaintiff is asked to consent to the insurance company assigning its payment obligation to an assignee who will become the sole obligor. The assignee then has the opportunity to purchase an annuity from the assignor insurance company to fund the periodic payments to the plaintiff.

There may be various entrants into what I believe will be a growing field. At least one blueblood insurance company starting to market the nonqualified structure is Allstate, generally a conservative company. It uses NABCO, an assignment company based in Barbados, to effect the transfer. There seems no reason I can discern why this arrangement would not work perfectly, achieving the desired deferral to the plaintiff and the security of payment to the plaintiff.

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

Constructive Receipt

Constructive receipt concerns can arise in the structured settlement area in several different circumstances. Most commonly, constructive receipt concerns are raised when several different options for a settlement are discussed.

> **Example.** Paula Plaintiff is offered $1 million in settlement of her racial discrimination claim against Atrocious Automobiles, Inc. After some discussion, Atrocious also offers $50,000 in cash per year for the rest of her life. Atrocious even indicates that Paula can have $50,000 per year for 10 years, with a lump-sum of $200,000 now and an additional $200,000 at the end of 10 years. Is Paula in constructive receipt of the $1 million for tax purposes? As long as no legal document releasing her claim is executed calling for the lump-sum payment, there should be no constructive receipt on the facts of this example. All that has occurred is bargaining in which the taxpayer has said she does not wish to receive a lump-sum settlement. Admittedly, the events that would allow the receipt of the lump-sum settlement—the taxpayer's execution of the release—are within the control of the taxpayer; nevertheless, there should be no constructive receipt here.[10]

This common misconception aside, a closer look at the constructive receipt doctrine must begin with acknowledging that most individuals are cash basis taxpayers. Hence, their income is generally taxed when it is actually or constructively received.[11] At its root, the constructive receipt doctrine prohibits a taxpayer from deliberately turning his or her back on income, thereby attempting to select the year in which he or she is taxed.[12]

Income is considered constructively received by a taxpayer when it is set aside, may be drawn upon, or is otherwise made available to the taxpayer.[13] Thus, where a taxpayer has an unrestricted right to receive funds immediately, the taxpayer must recognize the funds as gross income.[14]

Even so, income is not constructively received where the taxpayer's control over its receipt is subject to substantial limitations or restrictions, or when it is a mere unsecured promise to pay.[15] If an insurance company assigns its obligations to pay nonqualified periodic settlement payments to an assignment company, a claimant should not have to recognize gross income for federal income tax purposes until the payments are actually made by the assignment company. Under traditional assignment of income principles, if the assignment of insurance payments to an assignment company is not credited to a claimant's account, set

apart for him or otherwise made available so he may draw upon the settlement at any time, there should be no constructive receipt.

Insurance companies involved in structuring these transactions are careful to make sure the plaintiffs have no right or ability to demand any payments from the assignee (who becomes the sole obligor), other than those promised under the terms of the settlement agreement.[16]

The plaintiffs have no unilateral right to accelerate, defer, increase or decrease the amount of payments from the assignee. In fact, under the structure contemplated by these transactions, the plaintiff does not have the right to demand *anything* from the assignee other than the promised periodic payments as they become due. Again, the Allstate and NABCO documents I've seen do this. I have not reviewed other companies' documents, but I would assume any other reputable entrants in this field would do the same.

These structures should be viewed as being subject to substantial restrictions and limitations. After all, the annuity will be owned by the assignee, will be issued in the name of the assignee and will be fully subject to the claims of the assignee's general creditors. Given these facts, the IRS would not have an easy time arguing that these amounts have somehow been "set aside for" or "otherwise made available to" the plaintiffs.[17]

Of course, as these cases involve taxable damages (not Code Sec. 104 damages), these payments always represent income to the plaintiff. However, the plaintiff should not suffer acceleration of his or her income merely because of the interposition of a new obligor. If any equity remains in our Byzantine federal income tax system, the periodic payments will be taxed to the plaintiff only as they are actually received.

There does not appear to be any authority directly on point that analyzes the constructive receipt doctrine in the context of a structured settlement of a nonphysical injury recovery with a nonqualified assignment. In Rev. Rul. 2003-115,[18] the IRS recently considered the assignment of nontaxable periodic payments to an assignment company. Although the periodic payments were qualified settlement payments, pursuant to Code Sec. 130(a), and although the settlement payments were otherwise nontaxable, pursuant to Code Sec. 104(a)(2), the IRS analyzed the assignment of the qualified periodic settlement payments to an assignment company in light of the constructive receipt and economic benefit doctrines.

Rev. Rul. 2003-115 seems to indicate that there should be no constructive receipt in the context of nonphysical injury structures that employ assignments, because the claimants have made irrevocable elections relating to their periodic payments while their control of the receipt of the payments was subject to substantial limitations or restrictions. The reasoning of Rev. Rul. 2003-115 suggests that an assignment company should be able to assume responsibility for making nonqualified (and taxable) settlement payments on behalf of a defendant insurance company if the restrictions in the settlement documents are followed.

Economic Benefit Doctrine

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

The claimant ultimately has a different obligor (one other than the defendant), but that hardly spells an economic benefit to accelerate the entire stream of periodic payments into the current year for tax purposes. Indeed, for the IRS to be successful in an attack based on the economic benefit doctrine, it would have to prove that the amount is funded and secured and that the plaintiff need only wait for unconditional payments to arrive at a later time.[19] Here, the payments promised to plaintiffs are far from secured or unconditional. Thus, the economic benefit doctrine should be inapplicable, as long as the annuity is purchased by the assignee and if it names the assignee as the payee.[20]

There is some helpful authority. In Rev. Rul. 72-25,[21] no economic benefit was found to have been conveyed where an employer purchased an annuity to fund payments to an employee and the employer (not the employee) was the named beneficiary under the annuity contract.[22] There are strong arguments that the transaction between the assignor insurance company and the assignee should not trigger application of the economic benefit doctrine.

As long as the assignee (and not the plaintiff) will be the owner and beneficiary of the annuity

contract, I find it hard to imagine the IRS successfully applying the economic benefit doctrine in this context. Once the annuity is purchased, the annuity will remain an asset of the assignee, and will be subject to the claims of the assignee's general creditors. Those facts make it inappropriate for the IRS to assert that the plaintiff has an economic benefit in the entire stream of payments in the year of settlement.

Cash Equivalency

The doctrine of cash equivalency is used far less frequently than the economic benefit and constructive receipt doctrines, but it still surfaces from time to time. The IRS could attempt to use the cash equivalency doctrine to force the plaintiff to book the entire stream of payments in the year of settlement (rather than booking the payments as received). To prevail on such a theory, the IRS would have to prove that the assignee's promise to pay is unconditional, readily convertible into cash, and the type of obligation that is frequently discounted or factored.[23]

Under the terms of these settlements, the plaintiffs' rights generally cannot be assigned, sold, transferred, pledged or encumbered. Accordingly, a successful application of the cash equivalency doctrine by the IRS seems improbable.[24] Most settlement documents void the entire settlement if the plaintiff attempts to sell, transfer or assign rights to the settlement payments.

Lack of Guidance

Until we get some guidance from the IRS or the courts, taxpayers and their advisors should be careful to avoid the pitfalls of the constructive receipt, economic benefit or cash equivalency doctrines in this context. Still, I believe structures increasingly make sense in non-Code Sec. 104 cases. Plaintiffs can maximize their chances of prevailing in a dispute with the IRS by ensuring that the assignee in these transactions is the owner of the funding annuity, and that such owner also be subject to the claims of the assignee's general creditors.

It is also vitally important that the plaintiff has no right to immediately receive payment of the entire stream of payments, or to accelerate them. The payment stream should ideally be unfunded, thus diminishing the viability of a claim by the IRS that property has been set aside for the plaintiff to draw upon. As long as the deferred payment agreements are binding between the parties and are made prior to the time the plaintiff has acquired an absolute and unconditional right to receive payment, the plaintiff should not have income until the payments are actually received.[25] As always though, taxpayers should proceed with caution and obtain tax advice *before* any settlement is reached.

ENDNOTES

* Portions of this article may have been adapted from Mr. Wood's book, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS (2d ed. 1998).

1 Small Business Job Protection Act of 1996 (P.L. 104-188).

2 *See J.R. Nield*, TC Summ. Op. 2002-110; *W.O. Oyelola*, TC Summ. Op. 2004-28; *J. Medina,* TC Summ. Op. 2003-148; *D. Dorroh*, TC Summ. Op. 2003-93; *E. Montgomery*, 85 TCM 985, Dec. 55,071(M), TC Memo. 2003-64; *T.V. Cates*, TC Summ. Op. 2003-15; *V.R. Porter*, TC Summ. Op. 2003-14.

3 *E.E. Schleier,* SCt, 95-1 USTC ¶50,309, 515 US 323, 115 SCt 2159.

4 *Oyelola, supra* note 2; *S.G. Venable,* 86 TCM 254, Dec. 55,263(M), TC Memo. 2003-240; *S.G. Shaltz*, 85 TCM 1489, Dec. 55,188(M), TC Memo. 2003-173; *R. Henderson*, 85 TCM 1469, Dec. 55,183, TC Memo. 2003-168; *M.T. Prasil*, 85 TCM 1124, Dec. 55,108(M), TC Memo. 2003-100.

5 *J. Tamberella,* 87 TCM 1020, Dec. 55,556(M), TC Memo. 2004-47.

6 *See* Rev. Rul. 77-230, 1977-2 CB 214; Rev. Rul. 79-220, 1979-2 CB 74; and Rev. Rul. 79-313, 1979-2 CB 75.

7 Rev. Rul. 79-220, *id.*

8 *See* Code Sec. 130(d).

9 Code Sec. 130(c).

10 *See H. Veit*, 8 TC 809, Dec. 15,718 (1947), *acq.,* 1947-2 CB 4.

11 Code Sec. 451; Reg. §§1.446-1(c)(1)(I), 1.451-1(a) and 1.451-2(a).

12 Reg. §1.451-2(a) defines.

13 *Id.*

14 *G.C. Martin*, 96 TC 814, 823, Dec. 47,414 (1991); *H.O. Williams*, CA-5, 55-1 USTC ¶9220, 219 F2d 523.

15 *See* Reg. §1.451-2(a); *A.H. Ames*, 112 TC 304, Dec. 53,397 (1999); Rev. Rul. 79-313, *supra* note 6. *See also* LTR 8527050 (June 26, 1985) (income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions).

16 *See* LTR 8435154 (June 1, 1984) (where an insurance company requested a ruling on the assignability of periodic payments outside the scope of Code Sec. 130 assignments, and the IRS ruled that as long as the payments were "unfunded" and "unsecured" and the plaintiff had no right to demand payments from the assignee, there was no constructive receipt).

17 *See* Reg. §§1.451-1(a) and -2(a).

18 Rev. Rul. 2003-115, IRB 2003-46, 1052.

19 See *J.H. Smith,* SCt, 45-1 USTC ¶9253, 324 US 177, 65 SCt 891; *G.W. Drysdale*, CA-6, 60-1 USTC ¶9415, 277 F2d 413, *rev'g,* 32 TC 378, Dec. 23,604 (1959).

20 *See R.K. Brodie,* 1 TC 275, Dec. 12,907 (1942); *Olmstead Inc. Life Agency,* 35 TC 429, Dec. ¶24,499 (1960), *aff'd*, CA-8, 62-2 USTC ¶9511, 304 F2d 16.

21 Rev. Rul. 72-25, 1972-1 CB 127.

22 *See also R.A. Childs*, 103 TC 634, Dec. 50,239 (1994), *aff'd*, CA-11, 96-2 USTC ¶50,504, 89 F3d 856 (where the Tax Court held that attorneys' fees paid out under a structured settlement were not funded or secured obligations, but mere promises to pay, and therefore only taxable in the year of actual receipt).

ENDNOTES

[23] *See F. Cowden, Sr.*, CA-5, 61-1 USTC ¶9382, 289 F2d 20, *rev'g and rem'g*, 32 TC 853, Dec. 23,670 (1959), *opinion on remand*, 20 TCM 1134, Dec. 24,979(M), TC Memo. 1961-229.

[24] *See J.E. Reed*, CA-1, 83-2 USTC ¶9728, 723 F2d 138; *H.W. Johnston*, 14 TC 560, Dec. 17,578 (1950).

[25] *J.F. Oates*, 18 TC 570, 584–85, Dec. 19,049 (1952), *aff'd*, CA-7, 53-2 USTC ¶9596, 207 F2d 711; *J.D. Amend*, 13 TC 178, 185, Dec. 17,122 (1949).

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