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HEADLINE: 2008 TNT 30-19 ATTORNEY COMMENTS ON FORTHCOMING GUIDANCE ON USE OF QUALIFIED SETTLEMENT FUNDS FOR BENEFIT OF SINGLE CLAIMANT. (Section 468B -- Designated Settlement Funds;) (Release Date: JANUARY 25, 2008) (Doc 2008-3015)

CODE: *Section 468B* -- Designated Settlement Funds;
Section 461 -- Year of Deduction;
Section 104 -- Damage Awards/Sick Pay

ABSTRACT: Richard Risk of the Risk Law Firm has submitted to Treasury comments on the forthcoming issuance of guidance on the use of qualified settlement funds established for the benefit of a single claimant and whether economic benefit attaches.

SUMMARY:

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Richard Risk of the Risk Law Firm, Tulsa, Okla., commenting on the forthcoming issuance of guidance on the use of qualified settlement funds established for the benefit of a single claimant and whether economic benefit attaches, has provided Treasury with two important documents that support the contention by advocates of injury victims that economic benefit does not attach simply because there is determined to be solely one claimant to settlement proceeds.

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From: Richard B. Risk, Jr. [dick@risklawfirm.com]
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To: Eric San Juan
Cc: Jeffery G. Mitchell; Michael J. Montemurro; Glenn F.
Mackles; Jody J.2 Brewster; Eric Solomon
Subject: Single Claimant Guidance for QSFs

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Eric,

I receive reports that the issuance of published guidance on the use of QSFs established for the benefit of a single claimant and whether economic benefit attaches is near. I understand that you have been working diligently on this project. The settlement community is anxiously awaiting its release,

You and I have visited in the past, and I am sure you have seen my article published in the Virginia Law Review on this topic (attached). Since that article came out, I have come across two important documents not cited in that article that seem to support the contention by advocates of injury victims that economic benefit does not attach simply because there is determined to be just one claimant to the settlement proceeds:

1. In Thomas v. U.S. (article attached), husband and wife taxpayers had won a lottery in December 1992 and wanted economic benefit to apply in that year, as the 20 percent tax rate was due for an increase to 28 percent in 1993. The lottery funds were placed in a distinct fund pending verification of the lottery ticket, but were not in irrevocable trusts maintained exclusively for the benefit of prizewinners. The award was also subject to a future event -- verification of the winning ticket. The IRS took the position, and the court agreed, that the lottery funds did not meet the technical requirements of the economic benefit doctrine in 1992. Thus, the IRS argued, the couple should be taxed in 1993 when the lottery jackpot was actually paid to the winners. This ruling favors single claimants of QSFs. Thomas v. *U.S., 45 F.Supp.2d 618, 620 (1999),* aff'd, 213 F.3d 927 (6th Cir. Ohio 2000).

2. The legislative history of the Tax Reform Act of 1986 (P.L. 99-514), as chronicled in House Conference Report No. 99-841, Sept. 18, 1986 (to accompany H.R. 3838), 5 U.S. Cong. News '88 Bd, Vol. -- 24, 4932, Settlement funds:

> "The conference agreement generally follows the Senate bill. The conference agreement clarifies that: (1) the provision

> does not affect the treatment of payments made for certain personal injury liability assignment within the meaning of *section 130*: (2) payments from a designated settlement fund to a claimant are treated as having been made by the taxpayer for purposes of determining the claimant's taxable income."

The plain meaning of this text suggests that a qualified assignment made from a settlement fund (DSF or QSF) is unaffected by the fact that the assignment is made by a substitute obligor and not the original obligor. *Rev. Proc. 93-34* partially addresses this by clarifying that the settlement fund becomes a party to the suit or agreement, but leaves open the issue of whether the transfer of funds to a settlement fund causes economic benefit to attach to the settlement or judgment proceeds simply because there is just one settling claimant. However, part two of the cited paragraph in the legislative history unequivocally provides that the taxable status of payments from a settlement fund is unchanged when the funds are transferred to the settlement fund and then used to fund periodic payments bargained for in the claimant's settlement with the settlement fund. Payments made by an original obligor ("a person who is a party to the suit or agreement") or payments from an obligation assigned by an original obligor to a third party are never deemed to be an economic benefit to the claimant. The legislative history of Code *section 468B* strongly suggests that nothing changes when the money is transferred to a settlement fund and that the tax treatment of payments to a claimant is unaffected.

Additionally, I note that the IRS ruled previously in favor of four taxpayers who were each sole beneficiaries of identical qualified settlement funds, declaring "no inclusion in gross income will be required of the beneficiaries of the funds as a result of the transfer of settlement proceeds to funds." Obviously, the IRS found that economic benefit did not attach simply because the QSF was established for the benefit of a sole individual. *PLR 9736032.* Conceded that a private ruling may not be used or cited as precedent, per Code *section 6110(k)(3),* unless the Secretary of the Treasury establishes otherwise by regulations. However the U.S. Supreme Court determined in *Hanover Bank v. Commissioner, 369 U.S. 672, 686-87 (1962),* that private rulings issued by the IRS reflect that agency's interpretation of the statute and, thus, may be used as evidence in litigation of tax matters.

I trust that Treasury is taking the legislative history into account in developing the anticipated guidance, and that the guidance will not be inconsistent with the intent of Congress in the tax treatment of payments to claimants.

Regards,

Dick Risk

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Debunking the QSF Single-Claimant Myth
Courts Have Said No Economic Benefit if Future Event Must Occur

(2006-2) -- The U.S. Treasury Department and the IRS are committed to issue published guidance on the use of qualified settlement funds (QSFs) to do structured settlements with single claimants. However, the outcome of that guidance can only be favorable to the payees because, if a QSF is established to "resolve or satisfy" the claim or claims that were or could have been asserted against the original defendants or their insurers, as the Internal Revenue Code and Treasury Regulations require, the claimants cannot be deemed to have economic benefit.

QSFs were originally used, at the initiative of defendants, to settle mass tort claims. When plaintiffs began requesting courts to create them for cases with smaller numbers of claimants, some opponents came up with the canard that economic benefit occurs if there is a single claimant or if there is already an allocation among multiple claimants. Economic benefit would mean that the intended payee loses the tax breaks offered by a structured settlement. This ploy was designed to disturb plaintiffs and their attorneys into foregoing the use of QSFs for those cases.

The Internal Revenue Service official responsible for ruling on QSF issues recently confirmed that, under existing guidance, the economic benefit theory is not true. Jeffery G. Mitchell, a branch chief in the IRS's Income Tax & Accounting Division, on March 9, 2006, said to attendees at a seminar in Washington, DC., sponsored by the Society of Settlement Planners (SSP), that the test found in *Sproull v. Commissioner, 16 T.C. 244, 247 (1951),* aff'd, *194 F.2d 541 (6th Cir. 1952),* and refining case law can be relied on for determining whether an individual has economic benefit in the assets of a QSF. Mitchell's branch has been assigned to issue rulings on *Internal Revenue Code section 468B*, which is the basis for QSFs, also known as "468B Trusts." Mitchell confirmed that economic benefit does not automatically occur simply because a QSF is established ultimately for the benefit of a single plaintiff. Each case is subject to a review of facts and circumstances.

Economic Benefit Doctrine

In *United States v. Drescher, 179 F,2d 863 (2d Cir. 1950),* cert. denied. *340 U.S. 821 (1950),* the employee received economic benefit of an annuity contract purchased by his employer in the year such contract was delivered to him, even though the contract was non-assignable.

Sproull, supra, became the seminal case to define the economic benefit doctrine when there was no constructive receipt, taxing amounts an employer paid to an interest-bearing trust as compensation for an employee's past services. No one other than the employee had any interest in or control over the monies in the trust, and the employee was required to take no further action to earn or establish his rights to the amounts in trust. The trustee's duties were limited to holding, investing, and paying the amounts in trust to the employee or his estate in the event of his prior death in the two taxable years following the creation of the trust. The Tax Court held that "there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit." The court noted "the trust agreement contained no restriction whatsoever on petitioner's right to assign or otherwise dispose of the interest thus created in him."

The economic benefit doctrine normally involves situations in which a cash method taxpayer elects to defer income he has a right to receive by arranging to have the money deposited in a third-party account. To account properly for such situations, courts developed the doctrine, beginning with Sproull, to require the inclusion in income of such amounts for the taxable period in which the fund was created. The economic benefit doctrine requires a cash method taxpayer to include in gross income items not actually received during the reporting period when the Sproull elements are present. Every court that has subsequently faced the question of whether the economic benefit doctrine applied to a particular situation has echoed these conditions of the Sproull trust, as restated in *Thomas v. U.S., 45 F.Supp.2d 618, 620 (1999),* aff'd., *213 F.3d 927 (6th Cir. Ohio 2000)* (citations omitted), quoting:

> (1) There must be some fund in which money or property has been placed;
>
> (2) The fund must be irrevocable and beyond the reach of the creditors of the party who transferred the funds to the escrow or trust; and
>
> (3) The beneficiary must have vested rights to the money, with receipt conditioned only on the passage of time.

Other courts have followed that a taxpayer may still have an economic benefit in a trust even though there are restrictions on assignment. Some rulings have favored the taxpayer, going against the IRS. One IRS position favors taxpayers,

It was held in *Drysdale v. Commissioner, 277 F.2d 413 (6th Cir. 1960),* for example, that the economic benefit doctrine does not apply where the beneficiary's ability to obtain trust amounts is subject to a future condition or forfeiture. Drysdale, the taxpayer, was found not to have economic benefit of funds placed in trust by the employer where the use of those funds was conditioned upon his death, his reaching the age of 65, or his retirement from full time activity.

In *Minor v. United States, 772 F.2d 1472 (9th Cir. 1985),* the taxpayer did not have economic benefit in funds placed in trust under a deferred compensation agreement where the funds were conditioned upon limiting his practice after retirement and not competing with his present employer. The Minor court ruled there is no economic benefit when the beneficiary's right to receive the income is restricted or conditioned upon future events. The opinion in Reed v. Commissioner, 723, F.2d 138, 147 (1st Cir. 1983), held that economic benefit for a cash basis taxpayer requires that taxpayer's contractual right to future payment be evidenced by an instrument which is not only nonforfeitable but also readily assignable. A QSF requires a future event before anyone has a right to receive any amount from it, and certainly provides no evidence of a nonforfeitable and assignable contractual right.

The IRS has also argued against economic benefit applying and prevailed. In *Thomas, supra,* husband and wife taxpayers had won a lottery in December 1992 and wanted economic benefit to apply in that year, as the 20 percent tax rate was due for an increase to 28 percent in 1993. The lottery funds were placed in a distinct fund pending verification of the lottery ticket, but were not in irrevocable trusts maintained exclusively for the benefit of prizewinners. The award was also subject to a future event -- verification of the winning ticket. The IRS took the position, and the court agreed, that the lottery funds did not meet the technical requirements of the economic benefit doctrine in 1992. Thus, the IRS argued, the couple should be taxed in 1993 when the lottery jackpot was actually paid to the winners. This ruling favors single claimants of QSFs.

The IRS summarized the currently evolved test in *Private Ruling 200138006:*

> "[I]n order for a taxpayer to include an amount in income under the economic benefit doctrine, the amount must be set aside irrevocably, for the taxpayer's sole benefit, without restrictions or conditions based upon the occurrence of future events."

Motive for the Myth

Some liability insurers allegedly profit from structured settlements through tortious and illegal practices such as misrepresentation of the true present value of the periodic payments and undisclosed rebating or reduced-commission arrangements with the annuity producers in exchange for the producer being selected. See, for example, *Macomber v. Travelers Prop and Cas. Corp., et al, 804 A.2d 180 (Conn. 2002)* (the "short-changing" and "rebating" schemes alleged have given rise to causes of action for fraud, negligent misrepresentation, breach of contract, unjust enrichment, civil conspiracy, and violations of state unfair trade practices and unfair insurance practices statutes). Not all liability insurers and defendants engage in these practices.

The National Association of Insurance Commissioners (NAIC), in a communique to state insurance regulators in December 2004, defined "Inappropriate Solicitation Activities" as practices whereby an insurance producer: ". . . (c) engages in activity that otherwise may be known as or understood to be 'bid-rigging' or inappropriate steering of business which is contrary to the interests of the client/consumer." Some liability insurers having affiliated life insurance companies allegedly steer the highly profitable annuity business to the life insurance company, denying the payee the benefit of free market competition.

The annuity producers selected by the defendants or their insurers, often to the exclusion of an annuity producer selected by the claimant, receive the undisclosed commissions built into the annuity's cost, which are arguably part of the claimant's recovery, as are attorney fees,

A QSF meets the requirements of Treas. Reg. (*26 C.F.R.) section 1.468B-1(c)* if it is established by any governmental authority (including a court of law) and is subject to its continuing jurisdiction; is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred, giving rise to at least one claim asserting liability arising, among other things, out of a tort or breach of contract; and is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor and related persons. IRS rulings consistently hold that there are no other requirements, including justification, for establishing a QSF.

When a QSF is established, the defendants and their insurers are released and dismissed from any lawsuit, the payor receiving a tax deduction under *IRC. section 461(h)*. The QSF, under governmental authority supervision and with an independent administrator, may allow the claimant to select the annuity producer and annuity issuer. Neither the defendant nor its insurer has any say in an annuity transaction between a QSF and a claimant.

Single Claimant Issue Contrived

The issue raised by those who want to see the use of QSFs by plaintiffs curtailed is whether a QSF established for the benefit of a single claimant can enter into an agreement with that claimant to make periodic payments, then make a "qualified assignment" of the obligation to a third party under *section 130 of the Internal Revenue Code (26 U.S.C. section 130*). As long as the promised payments are excluded from the payee's gross income under *section 104(a)(2)* for personal physical injury or physical sickness, the obligation may be assigned, unless the claimant or payee has constructive receipt or economic benefit of the funding asset or the money to purchase it. See S. Rep. No. 97-646, at 4 (1982). The ability to assign the obligation, if the funding asset is an annuity or obligation of the United States, allows the payee to receive not only the original amount tax-free but also the growth while the asset is held by the assignee.

Code *section 130* requires that a "qualified assignment" must be made by the "person who is a party to the suit or agreement." That used to refer only to the defendant or its liability insurer, which allowed the defendant or insurer to insist on handling the annuity placement. But, *Revenue Procedure 93-34, 1993-2 C.B. 470,* provides that a QSF described in Treasury Regulations (*26 C.F.R.) section 1.468B*-l(c)(2) will be considered "a party to the suit or agreement" for purposes of Code *section 130,* if certain requirements are satisfied. When a QSF receives the transfer of funds from the original defendant or its insurer, the QSF, in effect, becomes a substitute defendant to "resolve or satisfy one or more contested or uncontested claims."

Constructive receipt is a doctrine holding that income is "constructively received" by a cash-basis taxpayer when it is set apart for him or otherwise made available so that he may draw upon it any time, without substantial limitations or restrictions. See *26 U.S.C. section 451*; *26 C.F.R section 1.451-2(a)*. Under the doctrine of constructive receipt a taxpayer may not deliberately ignore income in the year it occurs and instead elect another year for which he will report it. Constructive receipt has not been raised as an issue in whether a single-claimant QSF can make a qualified assignment.

Although taxation of deferred compensation plans, including structured settlements, is generally analyzed under the constructive receipt doctrine, the concept of economic benefit, which is quite different from constructive receipt, provides an alternate method of determining when a taxpayer receives taxable benefits.

Lobbying by Insurers

In a letter dated June 19, 2003, the SSP requested through its counsel, Skadden, Alps, Slate, Meagher and Flom, that the Department of Treasury and the Internal Revenue Service issue guidance under *section 130 of the Internal Revenue Code*. Specifically, the SSP, which is a plaintiff advocacy nonprofit organization, requested guidance to clarify that the assignment of a liability to make periodic payments does not fail to be a "qualified assignment" under *section 130* solely because the settlement proceeds are held temporarily in a QSF under *Treas. Reg. section 1.468B*-l(c) before the liability is assigned. *Section 130 of the Code* provides that, in the case of a "qualified assignment" of a liability to make periodic payments of damages on account of personal injury, the assignee may exclude from gross income the amount it receives for assuming the liability to the extent assets are acquired to fund the periodic payments.

This project first appeared on the Treasury and IRS Priority Guidance Plan on April 23, 2004, in a quarterly update, and remains on the "to-do" list. Mitchell explained that the delay has been due to diversions caused by the need for tax rulings on relief funds for natural disasters such as the recent hurricanes, floods and a tsunami, plus the departure of several key people from Treasury and the IRS.

Since that request was made, this question has become a politically charged matter. The defense interests have lobbied Treasury not to publish the requested guidance with the argument that increased use of the QSF will reduce the use of structured settlements. A letter, dated May 10, 2004, to senior Treasury and IRS officials from the National Structured Settlements Trade Association, said: "If the defense is unable to participate in a negotiation that seeks to match payments and needs on a cost efficient basis, the defense will have no stake in the process and will correspondingly lessen its interest in helping to promote the use of structured settlements."

IRS Has Already Ruled

While Treasury and the IRS are committed to issuing published guidance specifically on qualified assignments from QSFs, such guidance already exists for those who believe in the doctrine of stare decisis, which is the underpinning of our legal system. From the Latin "to stand by things decided," stare decisis is the "doctrine of precedent, under which it is necessary for a court to follow earlier judicial decisions when the same points arise again in litigation," according to Black's Law Dictionary, 7th Ed. (1999), 1414.

The IRS cited Sproull in *Revenue Ruling 2003-115,* issued as guidance for those opting for periodic payments from the September 11th Victim Compensation Fund of 2001 *Revenue Ruling 2003-115* provides the necessary guidance for a structured settlement with a QSF established for the benefit of a single claimant:

> "The economic benefit doctrine, developed in case law, provides that if a promise to pay an amount is funded and secured by the payor, and the payee is not required to do anything other than wait for the payments, an economic benefit is considered to have been conferred on the payee and the amount of such benefit is considered to have been received. In Sproull, the court found that an economic benefit had been conferred on a taxpayer

> when the taxpayer's employer established a trust to compensate the taxpayer for past services. In 1945, the employer transferred money to the trust to be paid to the taxpayer in 1946 and 1947. The taxpayer was the trust's sole beneficiary. The court held that the taxpayer received compensation in 1945 in an amount equal to the value of the amount transferred to the trust for the taxpayer's benefit because such transfer to the trust provided the taxpayer with an economic benefit.
>
> "Not all rights to receive periodic payments, however, trigger application of the economic benefit doctrine. *Rev. Rul. 79-220, 1979-2 C.B. 74,* concludes that a right to receive certain periodic payments under the facts of the ruling does not confer an economic benefit on the recipient. In *Rev. Rul. 79-220,* a taxpayer entered into a settlement with an insurance company for the periodic payment of nontaxable damages for an agreed period. The taxpayer was given no immediate right to a lump sum amount and no control of the investment of the amount set aside to fund the insurance company's obligation. The insurance company funded its obligation with an annuity payable directly to the taxpayer. The insurance company, as owner of the annuity, had all rights to the annuity and the annuity was subject to the claims of the general creditors of the insurance company. The ruling concludes that all of the periodic payments are excluded from the taxpayer's gross income under *section 104(a)(2)* because the taxpayer did not receive, or have the economic benefit of, the lump sum amount used to fund the annuity. Further, the ruling holds that if the taxpayer dies before the end of the agreed period, the payments made to the taxpayer's estate under the settlement agreement are also excludable from the gross income of the estate under *section 104(a)(2)*."

There are many inherent characteristics of well-drafted QSF documents that prevent a single claimant from having economic benefit or constructive receipt in the QSF's assets. Essentially, as long as the QSF is established and operated according to Treasury Regulations to "resolve or satisfy" the claim or claims, there must be a future event (the settlement with the QSF), and that blocks the claimant from having economic benefit in the QSF's assets.

Whether the claimant has current economic benefit of the QSF assets depends on a facts and circumstances test. Economic benefit does not occur automatically solely because there is only one claimant. If there is no economic benefit or constructive receipt, the QSF may assign a periodic payment obligation under the provisions of *section 130*. To say otherwise goes against well-settled case law.

At a minimum, Treasury must recognize this when it issues its guidance. A ruling adverse to the taxpayer would be inconsistent with this case law and almost certain to be challenged. For Treasury to confirm that a single-claimant QSF is subject to the Sproull test will be a good result. No less favorable ruling is expected. An even better result would be for Treasury to adopt the common-sense approach to interpreting congressional intent used by the IRS in Private Ruling 97-03038, when it said that economic benefit was not applicable to a qualified assignment.

By comparison, a "qualified assignment" under *section 130* contains all of the elements of Sproull that would cause the payee to have economic benefit of the "qualified asset" held by the assignee, and that has never been an issue. Under a qualified assignment, the amount is set aside irrevocably for the taxpayer's sole benefit, without restriction or condition based upon the occurrence of future events. Since 1988 (TAMRA), the payee additionally can be given a security interest in the annuity contract, putting the payee ahead of general creditors. Since 2002, the payee has a right under *section 5891* to sell future payments, with advance written approval from a state court. If the Sproull test were applied, every qualified assignment would fail.

The IRS acknowledged in Private Ruling 97-03038 that the 1988 amendment to *section 130(c) of the Code* "was intended to allow assignments of periodic payment obligations without regard to whether the recipient has the current economic benefit of the sum required to produce payments." Nothing in the legislation or its history spelled out congressional intent, but it was obvious to the IRS that economic benefit was never meant to be applied to a qualified assignment, It should be even more obvious with the QSF.

In a QSF, unlike a qualified assignment, the claimant has absolutely no rights to the QSF's assets until there is an agreement between the QSF and the claimant. Further, the QSF's assets are subject to any unforeseeable claims by other claimants not immediately identified, but who could emerge. Inasmuch as a QSF must be established to "resolve or satisfy" a claim or claims, in order to meet the conditions of a QSF, by definition the claimant is restricted from having any benefit until the occurrence of a future event -- a settlement with the QSF to give up the claim against it. As long as a QSF is established to meet the definition in *Treas. Reg. section 1.468B-1(c)(2)*, "to resolve or satisfy" a claim or claims, and operates that way, the claimant does not have economic benefit.

It is inconsistent for opponents of QSFs to raise the economic benefit argument for single-claimant QSFs, where the law is well settled, and ignore the qualified assignment scenario, where economic benefit is avoided only because the IRS believes it was never intended by Congress that injury victims should lose their tax benefits for this reason.

Treasury or the IRS justifiably could take the same position with single-claimant QSFs that the IRS took with qualified assignments, declaring that economic benefit universally does not apply to a QSF. By definition, because a QSF must "satisfy or resolve" the claim or claims, there is a future event that prevents economic benefit from occurring. Blanket treatment would be more justified for a QSF than the IRS position on qualified assignments. Such position might allow the use of standardized or uniform documents, as when making a qualified assignment. Whether a QSF remains subject to a facts and circumstances test al la Sproull or is exempted by a blanket ruling that economic benefit does not apply, the result will be a good one for the taxpayer.

While the anticipated published ruling specific to the QSF will dispel the myth, there is no reason for a single claimant to avoid a QSF, because precedent already exists in court decisions. Stare decisis!

The author, an attorney in Tulsa, Oklahoma, is a founding member of the Society of Settlement Planners, chairman of its Legal Committee and an ex officio director. He is widely published In his private practice, he has either administered or prepared documents for more than 100 qualified settlement funds.

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