

Section 468B

funds created for the benefit of
single claimants

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Panelists

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Topics of Discussion

- History of the controversy
- Framing the issues
- Arguments
- Treasury's basis for decision
- Political aspects

History of the Controversy

- 1983 – Periodic Payment Settlement Act of 1982 codified revenue rulings and added new section 130, creating the “qualified assignment”
- 1986 – Section 468B added to Internal Revenue Code as “Special Rules for Designated Settlement Funds”
- 1993 – Treas Reg section 1.468B was published, creating qualified settlement fund (QSF)
- 1993 – Rev Proc 93-34 allows qualified assignment by making 468B fund a “party to the suit or agreement”
- 1997 – NSSTA report to membership warning against use of the QSF in

- 1999–2001 structured settlement annuity sales grew from \$4B to \$6B, concurrent with advent of plaintiff advocacy in general and the proliferation of 468B use specifically
- June 19, 2003 – Skadden Arps requests published guidance on section 130 qualified assignments from single-claimant 468B funds
- July 24, 2003 – NSSTA responds, arguing that Rev Proc 93-34 was meant for mass tort cases
- April 23, 2004 – 468B issue added to Priority Guidance Plan of Treasury and IRS
- May 10, 2004 – NSSTA letter expresses strong opposition to issuance of guidance but makes no argument for alternative position

Framing the Issues

Can a section 130 qualified assignment be made by a QSF created for the benefit of a single claimant?

“The periodic payments of personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments.”

H.R. Rep. No 97-832 (1982)

S. Rep. No. 97-646 (1982)

- Income, although not actually reduced to a taxpayer's possession, is *constructively received* 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.”

Treasury Regulations section 1.451-2(a)

- Under economic benefit doctrine, the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by taxpayer of the amount funded.
- A “fund” is created when an amount is irrevocably placed with a third party, and a taxpayer’s interest in such fund is “vested” if it is non-forfeitable.
- This is a common-law doctrine.

See Sproull v. Comm’r, 16 T.C. 244 (1951), *aff’d per curiam*, 195 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960 C.B. 174 (Situation 4).

Tax Argument Overview

- Congress has expressed at least three times that a payee in a structured settlement may have specific rights without constructive receipt or economic benefit:
 - ◆ Tax Act of 1982 codifying, *inter alia*, Rev Rul 79-220
 - ◆ TAMRA of 1988 amending section 130 to give payee greater rights than general creditor
 - ◆ Section 5891 was added effective in 2002, giving rights to sell future payments, if court approval is obtained

See handout, Skadden Arps letter, June 19, 2003, to Treasury and IRS

Arguments Against Guidance

- ◆ NSSTA letter to Treasury and IRS, May 10, 2004:
 - ★ Single-claimant funds will significantly reduce the use of structured settlements
 - ★ Proposed single-claimant approach is counter to structured settlement tax rules adopted by Congress and longstanding positions of Treasury and the IRS

- ★ Rev Proc 93-34 was intended to apply to mass tort situation, not single-plaintiff case
- ★ Asserted rationale [concerns over safety, security and long-term viability of annuities] for requested guidance approving the single-claimant 468B approach has been discredited as false and misleading

See handout, May 10, 2004, letter from NSSTA to Treasury and IRS

“The National Structured Settlement Trade Association strongly opposes the issuance of any guidance that would allow a trust for a single claimant to be used under Code section 468B to undertake a structured settlement qualifying under Code section 130. Any such guidance, if issued, would significantly reduce the use of structured settlements to resolve the claims of physically injured claimants, thereby undermining the long-standing legislative policy to promote structured settlements. In addition, such guidance would effectively overturn the economic benefit doctrine and constitute a renunciation of clear and longstanding published positions of Treasury and the I.R.S.”

NSSTA letter to Treasury and IRS, May 10, 2004

“...NSSTA is working to preserve the free and vigorous settlement negotiation process that has worked so well over the past 20 years and has built the success of the business in which we all participate. NSSTA is seeking to ensure that neither side in the negotiation is placed at a disadvantage by regulatory fiat.”

NSSTA letter to its Membership, Oct. 2, 2003

“[It will be bad news if] IRS changes their thinking and permit[s] single case qualified settlement funds. KATIE BAR THE DOOR! Any and all life agents, investment brokers and trust officers will now place annuities. This is highly unlikely, but still an option.”

Structured settlement general agent letter to defense-oriented producers, soliciting monthly assessment “to combat the efforts of SSP on single case 468(b) [*sic.*],” May 7, 2004

Background of Request For Clarifying Guidance

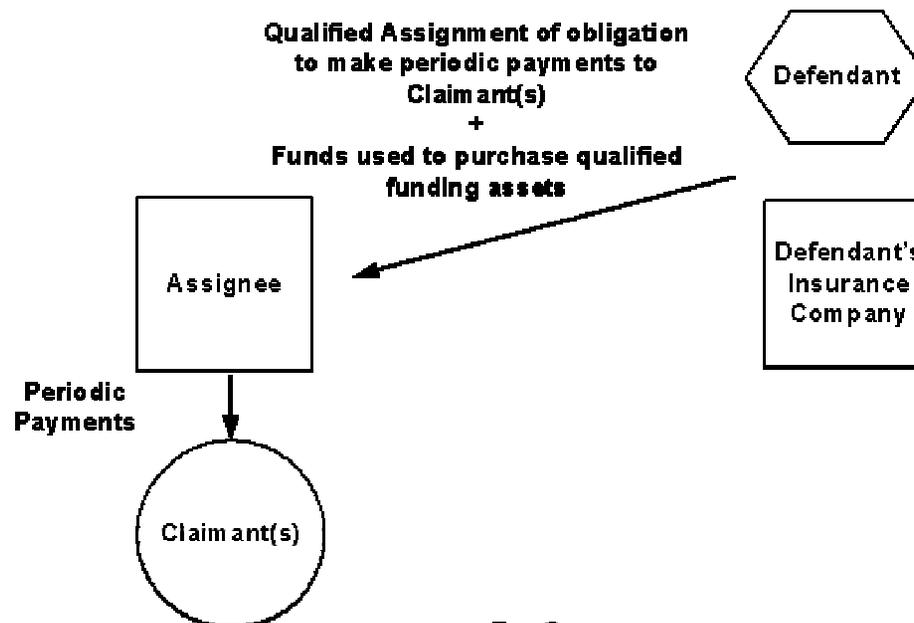
- In a letter dated June 19, 2003, Skadden Arps requested clarification that a single-claimant qualified settlement fund ("QSF") may make a qualified assignment for purposes of section 130.
- Rev. Proc. 93-34 provides that a QSF can make a qualified assignment.
- Even so, some have argued that doctrine of economic benefit precludes use of a QSF where the QSF involves only a single claimant.

Background (cont'd)

- See Scenario #1 -- “Defendant (or defendant's insurance company) makes a qualified assignment under section 130 of its obligation to make periodic payments to one or more claimants”
- Section 130(a) excludes from assignee's gross income the lump-sum amount received to extent used to purchase “qualified funding assets” (i.e., US Treasury obligations or an annuity).

Background (con't)

Scenario 1: Defendant (or Defendant's Insurance Company) makes a qualified assignment



Tax Consequences

Assignee does not include the lump-sum amount in income to the extent the amount is used to purchase qualified funding assets (i.e., annuity or obligations of the United States). See Section 130.

Periodic payments are excluded from Claimant's gross income. See section 104(a)(2).

As of 1988, Claimant is not in receipt of money or other assets held by the Assignee even if Claimant has rights in the money or other assets greater than those of a general creditor. See section 130.

Background (cont'd)

- As originally enacted in 1982, section 130(c)(2)(C) required that “assignee does not provide to [claimant] rights against the assignee greater than those of a general creditor.”
- Legislative history explained that periodic payments of personal injury damages are “excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments.”

Economic Benefit Doctrine

- Judicial doctrine
- If a promise to pay an amount is funded and secured by payor, and payee is not required to do anything other than wait for payments, economic benefit has been conferred on payee, and amount of benefit is considered to have been received by payee.
- *Sproull* (6th Cir. 1952) aff'd Tax Court decision
- Looks to rights of payee; arguably is relevant who would get funds if transferor or payee went bankrupt

Section 130 Amendment

- In 1988, section 130(c)(2)(C) repealed
- New language added in section 130(c) – “[T]he determination for purposes of this chapter of when the recipient is treated as having received any payment with respect to which there has been a qualified assignment shall be made without regard to any provision of such assignment which grants the recipient rights as a creditor greater than those of a general creditor.”

Section 130 Amendment (cont'd)

- Legislative history to 1988 amendment states that "no amount is currently includible in the recipient's income solely because the recipient is provided creditor's rights that are greater than the rights of a general creditor."
- Thus, claimant can now hold a security interest in funds or assets held by assignee.
- If assignee goes bankrupt, claimant (as opposed to the assignee's creditors) has the priority claim.

PLR 9703038

- Assignee (a trustee) used settlement proceeds to purchase funding assets and gave the claimant a security interest in the funding assets.
- Ruled there was a qualified assignment notwithstanding assignee held settlement proceeds and qualified funding assets in trust.
- “[T]he 1988 amendment to section 130(c) was intended to allow assignments without regard to whether the recipient has the current economic benefit of the sum required to produce the periodic payments.”

Why Use a QSF

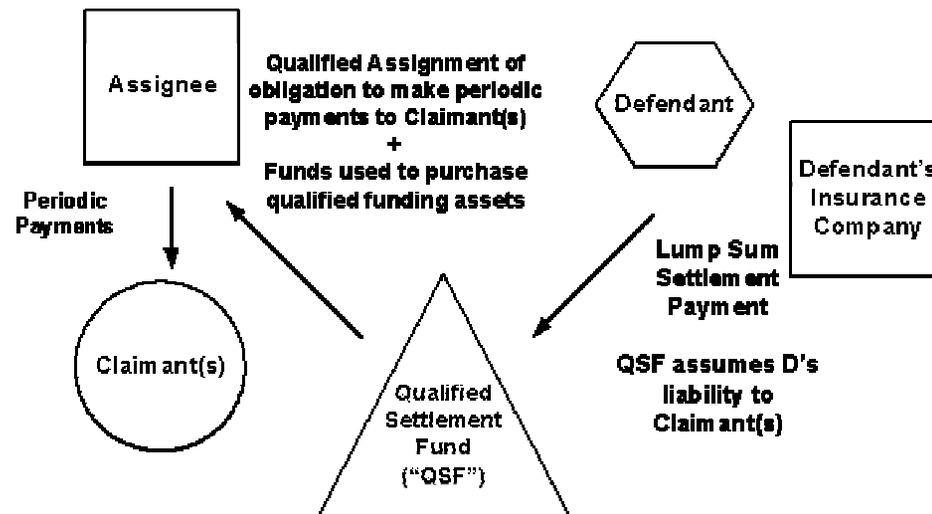
- Some defendant's insurance companies have agreed to structured settlement in past only if the annuity funding future payments is issued by insurance company's affiliate
- Many reasons why claimant may not want annuity issued by defendant's insurance company's affiliate
 - ◆ Financial rating of affiliate
 - ◆ Rate of return / interest rate offered by affiliate
 - ◆ Lack of diversity offered in the underlying investments

Qualified Assignment Using QSF

- See Scenario #2 – “Defendant (or defendant's insurance company) pays a lump sum settlement amount to a QSF, which makes a qualified assignment of the obligation to make periodic payments to the claimant”

Qualified Assignment Using QSF (cont'd)

Scenario 2: Defendant (or Defendant's Insurance Company) pays a lump sum to a QSF, which then makes a qualified assignment of its obligation to make periodic payments to Claimant.



Tax Consequences

Qualified Settlement Fund ("QSF") is taxed on earnings on QSF assets. Rev. Proc. 93-34 specifically permits a QSF to make a qualified assignment.

Assignee does not include lump-sum amount in income to extent used to purchase qualified funding assets.

Claimant excludes periodic payments from income.

Claimant is not in receipt of money or other assets held by QSF trustee or Assignee.

Use of QSF

- Rev. Proc. 93-34 permits QSF to make qualified assignment (treats assigning QSF as a "party to the suit or agreement" for purposes of section 130)
- QSF is—
 - ◆ Solely a creature of Treasury regulations
 - ◆ Used as temporary structure in settlements
 - ◆ Established by and subject to continuing jurisdiction of court or governmental authority
 - ◆ Taxed at highest individual tax rate
- Neither Rev. Proc. 93-34 nor QSF regulations preclude use of QSF in case of single claimant

Economic Benefit Should Not Apply

- Application of economic benefit doctrine to QSFs arguably would—
 - ◆ Blow up *all* QSFs
 - ◆ Result in double taxation of QSF income
 - ◆ Result in administrative complexity
- No principled reason for different results depending on number of claimants
- Aware of no abuses in use of QSFs to facilitate qualified assignments

Single-Claimant QSFs Should be Permitted to Make Assignments

- Will result in competition among annuity providers (and thus better terms for claimant's annuity)
- Will result in more structured settlements in cases where claimants today refuse to accept annuity of defendant's insurance company's affiliate
- Should make no difference to a defendant that its lump-sum payment is used in qualified assignment

Possible Additional Safeguards

- If Treasury decides additional safeguards are necessary, Rev. Rul. 2003-115 provides possible guidance
- Rev. Rul. 2003-115 applied to September 11 Victim Compensation Fund
- Before funding of QSF, claimant—
 - ◆ Makes irrevocable election to take periodic payments
 - ◆ Agrees to qualified assignment under section 130
 - ◆ Agrees it has no right or power to control investments

Conclusion

- Clarification of Rev. Proc. 93-34 requested
- Confirmation that if guidance is adverse to claimants, guidance will not apply retroactively to blow up past qualified assignments