United States Court of Appeals,

Eleventh Circuit.

Richard A. CHILDS, Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.

Mimi P. CHILDS, Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.

John C. SWEARINGEN, Jr. and Suzanne N. Swearingen, Petitioners-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.

Ben B. PHILIPS, Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.

No. 95-8762.

November 27, 1995.

On Appeal from the Decisions of the United States Tax Court

Brief for Appellees Swearingen and Philips

Patrick G. Jones, Nelson Mullins Riley & Scarborough, L.L.P., 400 Colony Square, Suite 2200, 1201 Peachtree Street, Atlanta, Georgia 30361, (404) 817-6000, Counsel for Appellees Swearingen and Philips.

***III** STATEMENT REGARDING ORAL ARGUMENT

Pursuant to Local Rule 28-2(c), Appellees Swearingen and Philips respectfully inform the Court that they believe that oral argument is unnecessary since the questions presented offer no special difficulties requiring oral argument. Should the Court hold oral argument, however, Appellees Swearingen and Philips request leave to participate.

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***VII** STATEMENT REGARDING ADOPTION OF BRIEFS OF OTHER PARTIES

Pursuant to Local Rule 28-2(e) and FRAP 28(i), Appellees Swearingen and Philips hereby adopt by reference the Brief of Petitioners-Appellees Childs in its entirety.

STATEMENT OF JURISDICTION

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Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1986.[FN1] This is an appeal by the Commissioner of Internal Revenue from the decisions of the United States Tax Court entered after trial.

FN1. Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1986, as amended and in effect during the years in issue (the "Code").

***2** STATEMENT OF THE ISSUE

Whether the Tax Court erred in holding that the taxpayers' rights to receive payments for legal fees in the future under structured settlement agreements were not property under Code Section 83.

STATEMENT OF THE CASE

I. Course of Proceedings and Disposition in the Court Below

The appeal in this case is from the Tax Court's decisions, in consolidated cases, rejecting the Commissioner's determination of deficiencies in Appellees' 1986 and 1987 income taxes. After trial, the Tax Court (Honorable Irene F. Scott) held for the Appellees. The Commissioner appealed.

II. Statement of the Facts

A. Background of the Lawsuits

During 1986 and 1987, Appellees John C. Swearingen, Jr. ("Swearingen"), Ben B. Philips ("Philips") and Richard A. Childs ("Childs") practiced law in Columbus, Georgia as shareholders (collectively the "Shareholders") of Swearingen, Childs & Philips, P.C., a professional corporation (the "Professional Corporation"). Swearingen, Childs and Philips were the only shareholders of the Professional Corporation. Doc. 80 at 4. [FN2]

FN2. "Doc." references are to the documents in the original record as numbered by the Clerk of the Tax Court and transmitted to this Court. "Ex." references are to the separately certified exhibits that were attached to the parties' several stipulations of facts or admitted at trial.

On September 21, 1984, Jermeral C. Garrett ("Garrett"), a minor, was severely injured as a result of an explosion and fire that occurred at the premises where he lived with his mother, Annette Jones ("Mrs. Jones"), and his stepfather, Willie James Jones ("Mr. Jones"). Mr. Jones was also severely injured as a result of the explosion and fire, and he died from his injuries on October 12, 1984. *Id.* at 5.

On October 17, 1984, Swearingen, Childs and Philips, individually, and the Professional Corporation, agreed to represent Mrs. Jones, individually and on behalf of Garrett and as administratrix of the Estate of Mr. Jones, pursuant to a contingency fee agreement (the "Fee Agreement"). Under the Fee Agreement, Swearingen, Childs and Philips individually, and the Professional Corporation, were entitled to receive as attorneys' fees a sum equal to (i) 33-1/3% of the gross amount(s) recovered on behalf of Mrs. Jones, individually and as administratrix of the Estate of Mr. Jones and on behalf of her son Garrett, if the case(s) were settled before suit was tried, and (ii) 40% of any gross amount(s) recovered if the case(s) were settled after suit was tried. The Fee Agreement provided that if nothing was recovered on behalf of the plaintiffs or paid upon the claim(s) or cause(s) of action, then the Shareholders and the Professional Corporation received nothing for their services rendered. *Id.* at 5-6.

B. Garrett Litigation

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On May 7, 1985, Garrett, acting by and through Mrs. Jones, and Mrs. Jones individually, brought suit against Columbus Propane Gas Service, Inc. ("Columbus Propane") in the United States District Court for the Middle District of Georgia (the "Garrett Litigation"). Garrett and Mrs. Jones were represented by Swearingen, Childs and Philips pursuant to the Fee Agreement. *Id.* at 7-8.

The liability insurance carriers for Columbus Propane were Georgia Casualty & Surety Company ("Georgia Casualty") and Stonewall Insurance Company ("Stonewall") (collectively the "Liability Carriers" and individually a "Liability Carrier"). Georgia Casualty was Columbus Propane's primary insurance carrier, with a policy limit of $1,000,000, while Stonewall was the secondary insurer that provided excess (umbrella) insurance coverage to Columbus Propane in excess of $1,000,000 up to $10,000,000. *Id.* at 7-8.

The trial in the Garrett Litigation was scheduled to commence on March 24, 1986. Around the middle of March a tentative settlement of the Garrett Litigation was reached, which required court approval because Garrett was a minor. Court approval was received on April 25, 1986. *Id.* at 8-10.

On that same date, Mrs. Jones, as next friend and mother of Garrett, and Mollie Hood ("Mrs. Hood"), as Garrett's guardian, executed a Release and Indemnity Agreement (the "Garrett Settlement Agreement"). *Id.* at 10; Exs. 9-I and 11-K, Ex. "B". Under the Garrett Settlement Agreement, the Liability Carriers, acting as independent contractors and as liability insurers for Columbus Propane, agreed to obtain payments in accordance with the Agreement. The Garrett Settlement Agreement provided for both lump sum payments and structured payments in accordance with a payment schedule set forth therein. Doc. 80 at 10; Doc. 66 at ¶ 28; Ex. 11-K, Ex. "B," ¶ VI.

Under the Garrett Settlement Agreement, the structured payments were to be made or paid through annuities purchased from Executive Life Insurance Company ("Executive Life"), or such other assignee as Georgia Casualty and Stonewall designated, subject to ratification by Garrett's guardian. The parties agreed that Executive Life or other assignee so designated would at all times be directly responsible for the structured payments; however, Georgia Casualty and Stonewall were likewise responsible for the structured payments on a pro rata basis consistent with the premiums paid by each company. Doc. 80 at 10-11; Doc. 66 at ¶ 32; Ex. 11-K, Ex. "B," ¶ VII.

The Garrett Settlement Agreement provided that Georgia Casualty and Stonewall would not segregate or set aside specific assets to fund any payments made thereunder, it being understood and agreed that Garrett and his lawful guardian were general creditors of the Liability Carriers to the extent of their respective obligations for the payments made under the Agreement. Doc. 80 at 11; Doc. 66 at ¶33; Ex. 11-K, Ex. "B," ¶ VIII.

The Garrett Settlement Agreement also provided that Georgia Casualty and Stonewall or their assignees "shall be the owner of any annuity policies issued to fund the payments set forth herein and said entities shall retain all rights of ownership." Doc. 80 at 10-11; Doc. 66 at ¶ 35; Ex. 11-K, Ex. "B," ¶ XI.

The Garrett Settlement Agreement also provided that neither Garrett, his guardian, his heirs, beneficiaries or assigns had the right to accelerate, commute or otherwise reduce to present value the payments scheduled therein, nor did they have the right to transfer, assign, anticipate, mortgage or otherwise encumber in advance any payment or part of any payment due therein. Doc. 80 at 14; Doc. 66 at ¶ 37; Ex. 11-K, Ex. "B," ¶ XIII.

The Garrett Settlement Agreement further provided that Georgia Casualty and Stonewall could make a "qualified assignment," within the meaning of Code Sections 130(c) and 104(a) (2), of their obligations to make periodic payments required under the Agreement, to First Executive Corporation ("First Executive"), the sole

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shareholder of Executive Life, or such other assignee as they may designate, subject to ratification by Garrett's guardian. Garrett's guardian also acknowledged that in the event of such an assignment, the assignee (First Executive) was to assume the same obligations, rights and duties as the assignor. However, such an assignment did not discharge the liability of Georgia Casualty or Stonewall to the extent of their pro rata obligation for the periodic payments under the Garrett Settlement Agreement. Doc. 80 at 14; Doc. 66 at ¶ 34; Ex. 11-K, Ex. "B," ¶ IX.

Under the Assignment and Assumption Agreement (the "Garrett Assignment"), Georgia Casualty and Stonewall assigned to First Executive, and First Executive assumed, the obligations of Georgia Casualty and Stonewall to make the payments to the plaintiffs in the Garrett Litigation as set forth in the Schedule of Structured Payments attached thereto as Exhibit C. Doc. 80 at 14. In consideration of the assumption by First Executive of the obligations described in the immediately preceding paragraph, Georgia Casualty and Stonewall agreed to deliver to First Executive a sum sufficient to purchase an annuity that would provide adequate payments to First Executive to enable it to meet such obligations, plus a fee as determined by First Executive. Doc. 80 at 11 and 14; Ex. 22-V, ¶ 2. In order to meet its payment obligations under the Garrett Assignment, First Executive agreed to purchase an annuity from Executive Life after receiving the payments from Georgia Casualty and Stonewall. First Executive purchased six annuity contracts from Executive Life, with each of the Shareholders being named an annuitant under one annuity contract (the "Garrett Annuities"). Doc. 80 at 14; Ex. 22-V, ¶ 3.

The Garrett Assignment provided as follows:

The parties to this Agreement agree (1) that any periodic payments hereunder shall not be capable of being accelerated, deferred, increased, or decreased by Jones, Hood, Garrett, or any other recipient hereunder and (2) that said persons, or any other recipient hereunder, shall not have, by reason of this Agreement, any right against First Executive other than the rights of a general creditor.

Ex. 22-V, ¶ 5; Doc. 80 at 15.

First Executive was the owner of each of the annuity contracts. As owner, First Executive had the right to change the annuitants. Doc. 80 at 15. The annuity contracts provided as follows: "Every right and privilege of this certificate belong to the Owner. The Owner needs only the consent of any irrevocable beneficiary to exercise any right or privilege." Ex. 22-V.

Executive Life was placed into conservation proceedings on April 11, 1991 by order of the Superior Court of the State of California for the County of Los Angeles, and an interim order of the Court limited payments to annuitants to 70% of the periodic payments payable to them. Doc. 66 at ¶ 56; Ex. 23-W. First Executive filed for relief under Chapter 11 of the United States Bankruptcy Code on May 13, 1991. Doc. 66 at ¶ 57; Ex. 24-X. Swearingen received the first five structured payments due under his Executive Life annuity contract, but only 70% of the sixth payment. Swearingen wrote to Stonewall and Georgia Casualty calling upon them to pay the 30% shortfall, which Georgia Casualty subsequently paid. Doc. 66 at ¶ 58; Exs. 25-Y and 26-Z; Doc. 80 at 15.

C. Jones Litigation

On September 18, 1986, Mrs. Jones, individually and as personal representative and administratrix of the Estate of Mr. Jones, brought a wrongful death suit against Columbus Propane in the United States District Court for the Middle District of Georgia, based on the death of her husband (the "Jones Litigation"). Doc. 80 at 15. Mrs. Jones was represented by Swearingen, Childs and Philips. Doc. 66 at ¶¶ 5 and 59; Ex. 27-AA.

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A new fee agreement was entered into with respect to the Jones Litigation that was identical to the Fee Agreement entered into in October 1984, except that the fee for settlement after trial was increased from 40% to 45% (the "New Fee Agreement"). Doc. 66 at ¶ 59-a; Ex. 54-BB; Doc. 80 at 16. A jury trial in the Jones Litigation commenced on or about September 14, 1987. Doc. 66 at ¶ 59-b; Exs. 27-AA and 35-AI, p. 2, ¶ II; Doc. 80 at 16.

A settlement was reached in the Fall of 1987. Doc. 80 at 16. On November 11, 1987, Mrs. Jones, individually and as administratrix of the estate and personal representative of Mr. Jones, and Mr. Jones' mother and siblings, executed a Release and Indemnity Agreement (the "Jones Settlement Agreement"). Doc. 80 at 16-17; Doc. 66 at ¶66; Ex. 35-AI. (The Garrett Settlement Agreement and the Jones Settlement Agreement will be hereinafter referred to collectively as the "Settlement Agreements.") In consideration for certain payments to be made under the Jones Settlement Agreement, Mrs. Jones and the estate's beneficiaries agreed to release their claims against Columbus Propane and the other entities and individuals named therein. Stonewall, the excess insurance carrier, agreed to make a lump sum payment in the amount of $464,431.00 to Mrs. Jones, individually and as the administratrix and representative of the estate of Mr. Jones, and Swearingen, Childs, Philips and the Professional Corporation, with Mrs. Jones' portion to be used to satisfy the claims of all beneficiaries of the Estate of Mr. Jones. Stonewall also agreed to make certain structured payments through annuities purchased from Manufacturers Life Insurance Company ("Manufacturers Life"). Doc. 80 at 17; Ex. 35-AI. The Jones Settlement Agreement provided that structured payments would be made to Swearingen, Childs and Philips for their attorneys' fees. Doc. 66 at ¶ 68; Ex. 35-AI, ¶ V.3.

Under the Jones Settlement Agreement, Stonewall was entitled to make a "qualified assignment" of its obligations to make future and structured payments under the Agreement pursuant to Code Section 130(c) to Manulife Service Corporation ("Manulife"). If this assignment was made, Manulife was to be directly responsible for the structured payments. Manulife's obligations for the payments were guaranteed by Manufacturers Life pursuant to a Guaranty Agreement in the form attached to the Jones Settlement Agreement. Doc. 80 at 18; Doc. 66 at ¶ 69; Ex. 35-AI, ¶ VI, Ex. "A". A Qualified Assignment and Consent Agreement was never executed by any of the Shareholders' with respect to their attorneys' fees. Doc. 2 at pp. 210-11, and 215-16; Exs. 79-CA and 81-CC.

Under the Jones Settlement Agreement, following the payment by Stonewall of the premium necessary to fund the structured payments, Stonewall remained obligated to the structured payment recipients on a pro tanto basis to the extent that the obligation for future periodic payments was not first satisfied by Manulife or Manufacturers Life. Exs. 35-AI, ¶ VI; and Ex. 79-CA.

The Jones Settlement Agreement also provided that no party receiving future payments thereunder had the right to accelerate, commute or otherwise reduce to present value the payments scheduled therein, and no party had the right to transfer, assign, mortgage or encumber in advance any scheduled payments set forth therein. Ex. 35-AI, ¶ X; Doc 80 at 19.

On November 11, 1987, Mrs. Jones and the Professional Corporation signed a Notice of Settlement, Satisfaction and Dismissal that dismissed with prejudice all claims in the Jones Litigation, which was filed with the United States District Court for the Northern District of Georgia on November 12, 1987. Doc. 80 at 19; Exs. 36-AJ and 84-CF.

Stonewall purchased three annuity contracts from Manufacturers Life, with each of the Shareholders being named an annuitant under one of them (the "Jones Annuities"). Stonewall is the owner of all three of the Jones Annuities, with all rights of ownership, including the right to change the annuitants. Doc. 80 at 19; Exs. 42-AP,

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43-AQ and 44-AR. Under the Jones Annuities, the annuitants -- Swearingen, Childs and Philips -- did not have the right to assign the payments, accelerate the payments, designate the payee, change the terms or times of payments, transfer or sell the payments, or designate a new beneficiary. Doc. 80 at 19.

D. Tax Treatment

The Appellees are cash basis taxpayers; thus, they did not report any income in 1986 resulting from the structured portion of the Garrett Litigation because no structured payments were received by them, either actually or constructively, during that year. In 1987 the Appellees included in gross income the structured settlement payments actually received by them in that year from the Garrett Litigation settlement. None of the Appellees reported any income in 1987 resulting from the structured portion of the Jones Litigation because no structured payments were received by them, either actually or constructively, during that year.

The Commissioner took the position in her Notice of Deficiency for each of the Shareholders that, under Code Section 83, the fair market value of each Shareholder's right to receive payments under his annuities was includable in his gross income for the taxable year in which each such annuity was purchased. Code Section 83 was the only authority cited in each Notice of Deficiency in support of the Commissioner's position. In her Answers the Commissioner also took the position that the amounts used to purchase the annuities were "constructively received" by the Shareholders in the taxable years when the annuities were purchased. The Tax Court held for the Appellees on all issues and the Commissioner appealed.

III. Standard of Review

The Tax Court's decisions are subject to *de novo* review by this Court.

SUMMARY OF ARGUMENT

This case concerns the tax treatment of the Shareholders' rights to receive payments for legal fees in the future under the Settlement Agreements. The issue is a straightforward one -- are such rights "property" for purposes of Code Section 83. More specifically, were the promises to pay money to the Shareholders under the Settlement Agreements "funded" for purposes of Code Section 83.

The Commissioner makes three principal arguments in support of her position that such promises were not funded. First, the Tax Court incorrectly identified the Liability Carriers as the obligors, whereas the correct obligors were the Shareholders' clients. The Commissioner argues that if the Tax Court's test is applied to the clients, their promises were funded, if not paid in full, by the transfer to the Shareholders of a portion of the clients' right to receive payments of money from the Liability Carriers in the future. Because the rights to future payments from the Liability Carriers that the clients transferred to the Shareholders are not subject to the claims of the clients' creditors, the clients's promises are funded and constitute property for purposes of Code Section 83. The Commissioner also argues that for purposes of the funding test, the obligor must be the person or entity for whom the taxpayer performed services; therefore, only the clients can be obligors.

The primary flaw in the Commissioner's argument is that she assumes there can be only one obligor. Neither the Code nor the Regulations contain such a limitation. In fact, the Regulations contemplate that there can be more than one obligor. In the Jones litigation, Stonewall is the obligor, and because it owns the Jones Annuities, those annuities are not beyond the reach of Stonewall's creditors. Thus, Stonewall's promises were not funded. Concerning the Garrett litigation, the Tax Court is correct that the Liability Carriers are obligors. However, it is sub-

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mitted that First Executive is also an obligor because it assumed the obligations of the Liability Carriers. While the funds to purchase the Garrett Annuities and the Garrett Annuities themselves are beyond the reach of the Liability Carriers' creditors, the Garrett Annuities are not beyond the reach of the creditors of First Executive. Thus, the promises to pay in the Garrett Litigation were not funded either.

With respect to the Commissioner's argument that only the person for whom the services are performed can be the obligor for purposes of Code Section 83, this is in direct conflict with case law and the Regulations. Moreover, regardless of who the obligors are, in both the Jones Litigation and Garrett Litigation, the Shareholders did not have a nonforfeitable interest in the Jones Annuities or Garrett Annuities. Thus, under the Tax Court's test, none of the promises were funded.

The Commissioner argues that "forfeitability" is not relevant in determining whether "property" has been transferred, but is relevant only in determining when a taxpayer who receives property as payment for services must take the value of that property into income under Code Section 83. The Commissioner, however, confuses "forfeitability" with the concept of "substantial risk of forfeiture." The "substantial risk of forfeiture" test applies only if "property" has been transferred in connection with the performance of services. The concept of "forfeitability" applies in determining whether what has been transferred is in fact property. The Commissioner completely ignores the cases cited by the Tax Court that support its holding that the beneficiary must have a nonforfeitable interest in the assets that have been set aside.

Second, the Commissioner argues that even if the Liability Carriers were the obligors, the promises to pay with respect to the Garrett Litigation were funded under the Tax Court's test. This argument fails to recognize that First Executive is an obligor and that the Garrett Annuities are not beyond the reach of its creditors. Also, the Shareholders do not have a nonforfeitable interest in the Garrett Annuities.

Finally, the Commissioner argues that the Tax Court's definition of "funding" is incorrect, and that assets do not have to be placed beyond the reach of the obligor's creditors for funding to occur. Under the "correct" definition, argues the Commissioner, the promises to make future payments with respect to both the Garrett Litigation and the Jones Litigation were funded, even if the Liability Carriers were the obligors. The Commissioner's position, however, is in conflict with published revenue rulings, private letter rulings and case law.

The decisions of the Tax Court were correct and should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY HELD THAT THE SHAREHOLDERS' RIGHTS TO RECEIVE PAYMENTS FOR LEGAL FEES IN THE FUTURE UNDER THE SETTLEMENT AGREEMENTS WERE NOT FUNDED AND DID NOT CONSTITUTE "PROPERTY" UNDER CODE SECTION 83

A. The Tax Court's Opinion and the Commissioner's Arguments

The Commissioner states that the appeal in these consolidated cases concerns the proper tax treatment of an attorney's receipt of the right to receive payment of compensation for professional services, where, as the result of the settlement of tort litigation, the fee is to be paid *in the form of an annuity,* and an annuity policy has been purchased from an insurance company to provide sufficient moneys to make the payments as they come due.

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Brief for Commissioner (hereinafter "Commr. Br.") at 20 (emphasis added). This is not a correct statement because the legal fees were not paid in the form of an annuity. If that were the case, the Shareholders would have been the owners of the annuities, which they clearly were not. The Commissioner's statement would be correct if the emphasized language was replaced with "in the ***17** future," so that the clause reads "the fee is to be paid in the future." The Commissioner made a similar mistake in her "Statement of the Issue." *Id.* at 3. The Commissioner does get it right on page 15 of her Brief, where she states:

This income tax case involves the question whether the value of the right to receive payments of attorney's fees *in the form of future payments of money* is reportable as income when that right is received, or whether instead only the amounts of the cash payments are reportable as they are actually received. (Emphasis added.)

Accordingly, this appeal concerns the proper tax treatment of an attorney's receipt of the right to receive payments for legal fees in the future under structured settlement agreements where an annuity has been purchased to provide a source of money to make the future payments.

The Tax Court correctly held that the Settlement Agreements were nothing more than "unfunded and unsecured promises to pay money in the future, ... [and thus] were not property within the meaning of section 83." Doc. 80 at 30. Code Section 83 deals with the tax treatment of property transferred in connection with the performance of services, and provides, in relevant part, as follows:

(a) GENERAL RULE. -- If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of --

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person ***18** having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

Thus, in order for Code Section 83 to apply, there must be a transfer of "property" to a person in connection with the performance-of services. The sole issue in this appeal is whether the Shareholders' rights to receive future payments under the Settlement Agreements constitute "property."

The Regulations define "property" to include

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

Treas. Reg. § 1.83-3(e). The Tax Court applied this Regulation to the facts in the present case as follows:

Therefore, if the agreement to pay annuities received by petitioners in these cases are to be held to be taxable under section 83, it is necessary that in addition to the promise to pay by Georgia Casualty and Stonewall, the evidence show such promise to be either "funded" or "secured."

Doc. 80 at 23.

***19** Relying on *Sproull v. Commissioner,* 16 T.C. 244 (1951), *aff'd,* 194 F.2d 541 (6th Cir. 1952), *Centre v. Commissioner,* 55 T.C. 16 (1970), and *Minor v. United States,* 772 F.2d 1472 (9th Cir. 1985), the Tax Court found that

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funding occurs when no further action is required of the obligor for the trust or insurance proceeds to be distributed or distributable to the beneficiary. Only at the time when the beneficiary obtains a nonforfeitable economic or financial benefit in the trust or insurance policy is the provision for future payments secured or funded. However, if the trust or policy is subject to the rights of general creditors of the obligor, funding has not occurred.

Doc. 80 at 26. Thus, an obligation is “funded” when (i) assets are set aside by the obligor and no further action is required of the obligor for the assets to be distributed or distributable to the beneficiary, (ii) such assets are beyond the reach of the creditors of the obligor, and (iii) the beneficiary has a nonforfeitable interest in the assets that have been set aside.[FN3]

FN3. These are the same fundamental concepts of the economic benefit doctrine, which have been codified in Code Section 83. John F. Cooper, *The Economic Benefit Doctrine: How an Unconditional Right to a Future Benefit Causes a Current Tax Detriment,* 71 Marq. L. Rev. 217, 273 (1988).

The Tax Court held that the promises to pay the structured legal fees to the Shareholders were not “funded” by the obligors because (i) the Shareholders were neither the owners of nor irrevocable beneficiaries under the annuity policies, (ii) the policy owners had the right to change the annuitant of each policy ***20** without the consent of the annuitant, and (iii) the Shareholders had no right to accelerate, defer, increase or decrease the periodic payments. *Id.* at 27. In addition, the Tax Court held that the promises to pay were not “secured” because there was no specific property set aside to secure the annuities and because the Shareholders had no greater rights than those of a general creditor. *Id.* at 29-30. Thus, the promises to make future payments to the Shareholders were unfunded and unsecured, and were not property within the meaning of Code Section 83. *Id.* at 30.

The Commissioner argues that the Tax Court erred in holding that the promises to make future payments were unfunded.[FN4] Her first argument is that the Tax Court incorrectly identified the Liability Carriers as the obligors, and thus applied its test to the wrong promises. According to the Commissioner, the correct obligors were the Shareholders' clients, and their promises were fully funded. This is so, argues the Commissioner, even though the Shareholders did not have nonforfeitable interests in the annuities, because “forfeitability” is not relevant in determining whether funding has occurred. Second, even if the Liability Carriers were the obligors, the promises to pay with respect to the Garrett Litigation were funded under the Tax Court's test, although the Commissioner admits that the promises to pay with respect to the Jones Litigation were not funded under that test. Finally, the Commissioner argues that the Tax Court's definition of “funding” is ***21** incorrect because there is nothing in the Regulations under Code Section 83 that requires assets to be placed beyond the reach of the obligor's creditors for funding to occur. Under the “correct” definition, argues the Commissioner, the promises to make future payments with respect to both the Garrett Litigation and the Jones Litigation were funded, even if the Liability Carriers were the obligors. As shown below, the Commissioner is wrong on all counts.

FN4. The Commissioner did not appeal the Tax Court's holding that the promises were unsecured.

B. The Liability Carriers and First Executive Were the Obligors, and Their Obligations Were Not Funded

The Commissioner's first argument is that the Tax Court incorrectly identified the Liability Carriers as the obligors, while the correct obligors were the Shareholders' clients. Commr. Br. at 25. The Commissioner states that for tax purposes

the settlement transactions involved here are analytically no different from the clients' receiving a cash payment from the liability insurers, followed by the clients' using a portion of that cash to buy annuity contracts payable

to taxpayers to satisfy a promise by the clients to pay their fee to taxpayers in future installments ... and then delivering the annuity contracts to taxpayers.

Id. at 25-26. This statement is false and contrary to the record because the Shareholders in fact never received the annuity contracts. The Commissioner's hypothetical would be more accurate if she postulated that the clients bought annuity contracts payable to the Shareholders, and the *clients* maintained ownership of the annuities. Under that hypothetical, the clients' promises to pay the Shareholders would *not* be funded because the annuity contracts would be subject to the creditors of the clients.

***22** Nevertheless, the Commissioner argues that "viewed in this light," the clients' obligation to pay part of their recovery to the Shareholders has been paid in full, because they transferred to the Shareholders a portion of their right to receive payments of money from an insurance company in the future. If not paid in full, argues the Commissioner, the clients' promises have at least been "funded" because the rights to future payments from the Liability Carriers that were transferred to the Shareholders are not subject to the claims of the clients' creditors. Thus, because the clients' promises are funded, they constitute "property" for purposes of Code Section 83. *Id.* at 27.

The primary defect in the Commissioner's argument is that she assumes there can be only one obligor. Nowhere in Code Section 83 or the Regulations thereunder is there a limitation on the number or identity of the obligors. In fact, as discussed below, the Regulations contemplate that in some cases there will be more than one obligor (*e.g.,* where the obligor is not the person for whom services are performed).

It is true that under the Fee Agreement and the New Fee Agreement the clients agreed to pay the Shareholders a percentage of what was recovered on their behalf by the Shareholders. However, in the Jones Litigation Stonewall agreed to make certain payments to the Shareholders pursuant to the Jones Settlement Agreement, and therefore became an obligor. Stonewall purchased the Jones Annuities from Manufacturers Life to provide a source of funds for its obligations, and Stonewall was the owner of each of ***23** the Jones Annuities. Thus, the Jones Annuities were subject to the claims of Stonewall's creditors.

In the Garrett Litigation, the Liability Carriers agreed to make certain payments to the Shareholders pursuant to the Garrett Settlement Agreement. In addition, the Liability Carriers paid First Executive a sum sufficient to purchase the Garrett Annuities, in consideration for the assumption by First Executive of the Liability Carriers' obligations to make payments to the Shareholders under the Garrett Settlement Agreement. Thus, it is submitted that there were two obligors -- the Liability Carriers, who transferred the premium amount to First Executive; and First Executive, which transferred the premium amount to Executive Life. While the initial transfer by the Liability Carriers would appear to put the transferred funds and the Garrett Annuities beyond the reach of their creditors, the Shareholders still did not have nonforfeitable rights in the Garrett Annuities because they were subject to the claims of First Executive's creditors.

The Commissioner also argues that only the person for whom the services are performed can be the obligor for purposes of Code Section 83; thus, the Liability Carriers cannot be the obligors. Her argument is based on the fact that in each of the cases relied on by the Tax Court in formulating its "funding" test -- *Sproull, Centre* and *Minor* -- the obligor was the recipient of the services performed. Commr. Br. at 27. The Appellees do not dispute that the Liability Carriers and First Executive were not the parties for whom services were rendered by the Shareholders. In this regard, ***24** however, "[t]he property need not be transferred by the person for whom the services are performed for section 83 to control." *Adair v. Commissioner,* 50 T.C.M. 620, 627 (1985). Moreover, the Regulations explicitly state that "[t]his paragraph applies to a transfer of property in connection with the per-

formance of services *even though the transferor is not the person for whom such services are performed.*" Treas. Reg. § 1.83-l(a)(1) (emphasis added). Therefore, it is absolutely clear that it makes no difference for purposes of analyzing Code Section 83 that the Shareholders did not perform services for the obligors.

The Commissioner concludes that if the clients are the obligors, the application of the Tax Court's rule for determining when an obligation is funded "leads inevitably to the conclusion that the clients' promises were funded, if not fully performed." Commr. Br. at 28. Her argument goes as follows. First, the clients were the recipients of the Shareholders' services and the clients did not have to do anything else for the structured payments to be made to the Shareholders. *Id.* In addition, each Shareholder received an interest in "what amounts to an annuity policy ... when the settlement agreements in the Garrett and Jones cases became effective, and that interest was and is beyond the reach of the clients' creditors." *Id.* However, even assuming (i) that the clients were the obligors, (ii) that nothing else was required of them for the structured payments to be made to the Shareholders, and (iii) that the assets were beyond the reach of the clients' creditors, the clients' obligations still would not be ***25** funded because the Shareholders did not have a nonforfeitable interest in the assets that were set aside.

The Commissioner's response is that "forfeitability" is not relevant in determining whether "property" has been transferred, but is relevant only in determining when a taxpayer who receives property as payment for services must take the value of that property into income under Code Section 83. Commr. Br. at 28. The Commissioner, however, confuses "forfeitability" with the concept of "substantial risk of forfeiture." Section 83(a) provides that where property is transferred to a person in connection with the performance of services, the fair market value of such property over the amount paid for it will be included in the gross income of the service provider "in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture ...." The "substantial risk of forfeiture" test applies only if "property" has been transferred in connection with the performance of services. The concept of "forfeitability" applies in determining whether what has been transferred is in fact "property." The Commissioner completely ignores the three cases cited by the Tax Court in holding that the beneficiary must have a nonforfeitable interest in the assets that have been set aside. For example, in *Minor* the Ninth Circuit Court of Appeals stated that "[i]n cases where courts or the IRS have found a current economic benefit to have been conferred, the employer's ***26** contribution has always been secured *or the employee's interest has been nonforfeitable.*" 772 F.2d at 1474 (emphasis added).

The Commissioner's second argument is that even if the Tax Court is correct that the Liability Carriers were the obligors, there is a critical distinction between the settlements in the Garrett Litigation and the Jones Litigation, which distinction the Tax Court ignored. This distinction is that in the Jones Litigation, Stonewall purchased the Jones Annuities from Manufacturers Life and remained the owner of the Annuities, while in the Garrett Litigation there was a "qualified assignment" of the Liability Carriers' obligations to First Executive, which purchased and became the owner of the Garrett Annuities from Executive Life.

The Commissioner admits that under the Tax Court's definition of funding, the Tax Court was correct in holding that the obligations in the Jones Litigation were not funded because the Jones Annuities were subject to the rights of Stonewall's creditors. Commr. Br. at 31. Concerning the Garrett settlement, when the Liability Carriers paid to First Executive the money necessary to purchase the Garrett Annuities from Executive Life, the Liability Carriers transferred that money and the Garrett Annuities beyond the reach of their creditors. Thus, argues the Commissioner, because the Liability Carriers did not need to do anything else to cause the future payments to be made to the Shareholders, "the promise to pay taxpayers' fees with respect to the Garrett settlement was fully funded." *Id.* at 32.

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***27** There are two problems with the Commissioner's argument. First, it fails to recognize that First Executive is an obligor and that the Garrett Annuities are not beyond the reach of First Executive's creditors. Second, the Shareholders still do not have a nonforfeitable interest in the Garrett Annuities, regardless of the identity of the obligor.

C. The Tax Court Applied the Correct Definition of Funding

The Commissioner's third argument is that there is nothing in the language of Regulations section 1.83-3(e), which defines "property," to require that assets be placed beyond the reach of the obligor's creditors for funding to occur. Commr. Br. at 33. The Commissioner supports her argument with "general understandings" and definitions of "fund" from The American Heritage Dictionary and The American College Dictionary, concluding that "[t]he term 'funded' as used in the context of the regulation ... describes an investment, an earmarking or appropriation of assets, or a transfer to a third party to arrange or provide for future payment." *Id.* at 34. Thus, "[t]he liability insurers' purchases of annuity policies that provide cash flows precisely equal to the future payments owed to taxpayers here plainly was a method of 'funding' those obligations." *Id.*[FN5]

FN5. The Commissioner also argues that the language in the settlement documents and Code Section 130 shows that the promises "were 'funded' within the ordinary meaning of that term." Commr. Br. at 35-36.

***28** The Commissioner's position in her Brief is clearly at odds with the position of the Internal Revenue Service (the "Service") in Rev. Rul. 79-220, 1979-2 C.B. 74. In that ruling a liability insurance carrier, as part of a settlement, agreed to provide monthly payments to the defendant for the longer of the defendant's lifetime or 20 years. The liability carrier purchased a single premium annuity contract from another insurance company, and directed the insurance company to make the annuity payments directly to the defendant. The liability carrier was the owner of the annuity contract and had all rights of ownership, including the right to change the annuitant.

The Service found that there was a continuing obligation by the liability carrier to make the monthly payments to the defendant for the agreed period. The liability carrier's

purchase of a single premium annuity contract from the other insurance company *was merely an investment by [the liability carrier]* to provide a source of funds for [the liability carrier] to satisfy its obligation to [the defendant]. .... [H]ere, the arrangement was merely a matter of convenience to the obligor and did not give the recipient any right to the annuity itself.

Id. at 104 (emphasis added). The Service held that the defendant "had a right to receive only the monthly payments and did not have the actual or constructive receipt or the economic benefit of the lump-sum amount that was invested to yield that monthly payment." *Id.*

The facts in Rev. Rul. 79-220 are very similar to the facts in this case. In both situations a liability carrier paid for an ***29** annuity and directed the insurance company to make payments to the annuitant, but the liability carrier remained liable for the payments to the annuitant. Under the Commissioner's proposed definition, the liability carrier in the ruling would have "funded" its obligation. The Service, however, found to the contrary in Rev. Rul. 79-220, holding that the defendant in the revenue ruling "had a right to receive only the monthly payments and did not have the actual or constructive receipt or the economic benefit of the lump-sum amount that was invested to yield that monthly payment." *Id.*

The Commissioner's position is also contrary to a longstanding position of the Service in the "rabbi trust" area.

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"Rabbi trusts" are considered by the Service to be unfunded and do not result in current taxation to the employee precisely because the assets are subject to the claims of the obligor's creditors. In a typical "rabbi trust" arrangement, an employer places funds in a trust for the benefit of an employee, but the trust's assets remain subject to the employer's creditors. The first ruling on this type arrangement, which involved a synagogue and its rabbi, was Priv. Ltr. Rul. 8113107 (Dec. 31, 1980). In that ruling, the Service stated as follows:
Pursuant to the [economic benefit] theory, the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the 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 the fund is "vested" if it is nonforfeitable.

***30** The Service concluded that a fund had not been created that would trigger taxation of the employee on the funding of the trust. Because the assets of the trust were subject to the claims of the employer/obligor's creditors, the employer/obligor could not be viewed as having irrevocably placed the funds with a third party. This failure also prevented the rabbi from receiving a vested nonforfeitable interest in the trust. Thus, the principal and interest of the trust could only be included in the rabbi's gross income in the year he actually received it, or when it was otherwise made available to him.

The Service has since issued numerous similar rulings where it concluded that the exposure of trust assets to the creditors of the obligor was sufficient to prevent the application of the economic benefit doctrine to nonqualified employee benefits. *See, e.g.,* Priv. Ltr. Rul. 8325100 (Mar. 23, 1983); Priv. Ltr. Rul. 8329070 (April 21, 1983); Priv. Ltr. Rul. 8418105 (Jan. 31, 1984); Priv. Ltr. Rul. 8439012 (June 22, 1984); Priv. Ltr. Rul. 8509023 (Nov. 29, 1984); Priv. Ltr. Rul. 8641039 (July 15, 1986); Priv. Ltr. Rul. 8702021 (Oct. 10, 1986); Priv. Ltr. Rul. 8711033 (Dec. 12, 1986); Priv. Ltr. Rul. 8722035 (Feb. 27, 1987); and Priv. Ltr. Rul. 8727028 (April 3, 1987). *Cf.* Gen. Couns. Mem. 39230 (May 7, 1984). Thus, it is clear that placing the obligor's assets beyond the reach of its creditors is a valid and essential - part of the funding test for purposes of Code Section 83.

The Commissioner is grasping at straws when she cites to nonlegal dictionaries and general understandings to support her ***31** argument that the assets need not be placed beyond the reach of the obligor's creditors. She ignores the case law cited by the Tax Court. *See Minor,* 772 F.2d at 1475 ("If the employee's interest is unsecured *or not otherwise protected from the employer's creditors,* the employee's interest is not taxable property ..." (emphasis added)). She also ignores the intent of Code Section 83 and the language of Regulations section 1.83-3(e), Rev. Rul. 79-220 and numerous private letter rulings. There is neither a legal basis nor a policy reason for this Court to adopt the Commissioner's reasoning; whereas, the Tax Court's well-reasoned opinion properly applies the law to conclude that the Shareholders' rights to receive payments for legal fees in the future under the Settlement Agreements did not constitute "property" under Code Section 83.

CONCLUSION

For the foregoing reasons, the decisions of the Tax Court should be affirmed.

Richard A. CHILDS, Petitioner-Appellee, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant. Mimi P. CHILDS, Petitioner-Appellee, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant. John C. SWEARINGEN, Jr. and Suzanne N. Swearingen, Petitioners-Appellees, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant. Ben B. PHILIPS, Petitioner-Appellee, v. COMMISSIONER OF INTERNAL
1995 WL 17057704 (C.A.11) (Appellate Brief)

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