Washington and Lee University School of Law

Washington and Lee University School of Law Scholarly Commons

Scholarly Articles

Faculty Scholarship

5-2009

Close the Yield Exemption Loophole Created by Childs

Brant J. Hellwig
Washington and Lee University School of Law, hellwigb@wlu.edu

Gregg D. Polsky
University of South Carolina School of Law

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlufac

Part of the Taxation-Federal Commons

Recommended Citation

Brant J. Hellwig & Gregg D. Polsky, *Close the Yield Exemption Loophole Created by Childs*, 123 Tax Notes 1141 (2009).

This Article is brought to you for free and open access by the Faculty Scholarship at Washington and Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Scholarly Articles by an authorized administrator of Washington and Lee University School of Law Scholarly Commons. For more information, please contact christensena@wlu.edu.

Close the Yield Exemption Loophole Created by *Childs*

By Gregg D. Polsky and Brant J. Hellwig

Gregg D. Polsky is the Sheila M. McDevitt Professor of Law at the Florida State University College of Law, and Brant J. Hellwig is an associate professor of law at the University of South Carolina School of Law. The authors thank Joseph Dodge, Calvin Johnson, and Joseph Mikrut for their comments and criticisms of the proposal, without holding them responsible for any errors or conclusions.

The proposal would reverse the holding of *Childs v. Commissioner*, 103 T.C. 634 (1994), and clarify that a contractual payment obligation received by a service provider is subject to immediate taxation under section 83 if the obligor is a person other than the recipient of the service provider's services. As a result, the proposal would ensure the appropriate taxation of investment income in structured payment arrangements. The proposal is based on a more comprehensive article by the authors, forthcoming in volume 51 of the *Boston College Law Review*, titled "Taxing Structured Settlements," a draft of which is available at http://ssrn.com/abstract=1403248.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue without raising tax rates, because the best systems have taxes that are unavoidable to reach the lowest feasible tax rates. Shelf Project proposals defend the tax base and improve the rationality and efficiency of the tax system. Given the calls for economic stimulus, some proposals may stay on the shelf for a while. A longer description of the Shelf Project is found at "The Shelf Project: Revenue-Raising Proposals That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

Copyright 2009 Gregg D. Polsky and Brant J. Hellwig. All rights reserved.

Overview

Section 83 generally requires that a service provider realize gross income on the receipt of property. Courts and the IRS have traditionally concluded that property includes obligations to pay issued by a party other than the recipient of the services.[1] Yet, in the 1994 case of *Childs v. Commissioner*,[2] the Tax Court determined that a third-party obligation issued to a tort plaintiff's attorney was not property. The economic effect of the ruling was to exempt from tax the investment yield earned by the attorney on his fee income. This proposal would legislatively overturn the *Childs* decision, thus ensuring the appropriate taxation of investment income earned by attorneys.[3] It also would prevent taxpayers from using the reasoning and conclusion of *Childs* to avoid tax on investment yield in other contexts.

Current Law

Under the cash method of accounting, a taxpayer must include in gross income all items of cash, property, or services that are received during the tax year.[4] Courts and the IRS have long held that third-party payment obligations constitute property and that, accordingly, the receipt of such a promise results in gross income.[5] In contrast, the receipt of a second-party promise generally has no immediate tax consequences under the cash method.[6]

In 1969 Congress enacted section 83, which generally provides that a taxpayer who receives property in exchange for services is taxed on the property's fair market value at the time the property is received or, if later, at the time the property is substantially vested.[7] The statute is silent regarding the definition of property. Nevertheless,

---

[1]*See, e.g., Brodie v. Commissioner*, 1 T.C. 275 (1942); *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950); Rev. Rul. 69-50, 1969-1 C.B. 140; Rev. Rul. 77-420, 1977-2 C.B. 172. One commentator notes that "this rule dates from the dawn of federal tax law." George L. White, *Accounting Methods — General Principles*, at A-64 (BNA Tax Mgt. Portfolio No. 570, 1996).

[2]103 T.C. 634 (1994), *Doc 94-10228*, *94 TNT 223-15*, *aff'd without written opinion*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-19540*, *96 TNT 133-7*.

[3]This proposal is based on Gregg D. Polsky and Brant J. Hellwig, "Taxing Structured Settlements," 51 *B.C. L. Rev.* __ (forthcoming 2010). A draft is *available at* http://ssrn.com/abstract=1403248.

[4]*See* reg. section 1.446-1(c)(1)(i). However, if a specific exclusion from gross income applies to an item, the item would not be included in gross income. *See, e.g.*, section 102(a) (excluding gifts and bequests from gross income).

[5]*See* authorities cited in note 1 *supra*.

[6]*See, e.g., United States v. Christine Oil & Gas Co.*, 269 F. 458, 459-460 (W.D. La. 1920); *Zittel v. Commissioner*, 12 B.T.A. 675, 677 (1928); *Centre v. Commissioner*, 55 T.C. 16, 19 (1970); Rev. Rul. 60-31, 1960-1 C.B. 174. However, a second-party promise will be treated as property if it is "funded." *See, e.g., Sproull v. Commissioner*, 16 T.C. 244 (1951).

[7]Section 83(a). Property is substantially vested if it is not subject to a substantial risk of forfeiture or if it may be

(Footnote continued on next page.)

given that section 83 was enacted to clarify the tax treatment of restricted stock[8] and not to substantially alter basic cash method principles,[9] it has been assumed that Congress intended that the historical definition of property apply.[10]

In *Childs v. Commissioner*,[11] a case involving a structured attorney fee arrangement, the Tax Court considered the definition of property under section 83. The taxpayers were attorneys who had executed a contingent fee agreement with a personal injury client. The case was eventually settled, and both the client and the attorneys structured their respective litigation recoveries.

In a typical structure, the defendant (or its liability insurer) makes a lump sum payment to a structured settlement company (SSC) in exchange for the SSC's obligation to make specified future payments to the plaintiff (or, in the case of a structured fee arrangement, to the plaintiff's attorney). The SSC then uses the lump sum payment to purchase an annuity, usually from an affiliated life insurance company. This annuity provides the SSC with the necessary funds to satisfy its periodic payment obligations. Often, the SSC simply directs the annuity issuer to pay the annuity benefits directly to the plaintiff (or the attorney). The end result is that the defendant (or its liability insurer) is relieved of any future liability, and the plaintiff (or the attorney) receives a periodic payment obligation of the SSC.

In *Childs*, the issue was whether the SSC's periodic payment obligation in favor of the attorneys constituted property under section 83. If so, the fair market value of the SSC payment obligation would be immediately includable in the attorneys' gross incomes. If not, the attorneys would realize gross income only as they received cash payments.[12]

Under the traditional rule that third-party promises constitute property, the value of the periodic payment obligation would be immediately taxable. The attorneys provided services to their client, the plaintiff, and received as compensation the payment obligation from the SSC, a third party to the attorney-client relationship. The Tax Court, however, reached the opposite conclusion, allowing the attorneys to report income only as the cash payments were received by them. In reaching that conclusion, the Tax Court failed to address the third-party promise issue. The Eleventh Circuit summarily affirmed without a reported opinion.[13]

Reasons for Change

Childs allows attorneys who structure their fees to defer realization of income from the time they have fully earned their fees (that is, at the time of settlement) to the time they receive cash payments. Deferring tax on the fee income is economically equivalent to taxing the fee income currently and then exempting the investment return on the resulting after-tax amount during the deferral period.[14] *Childs* thus allows attorneys to earn tax-free yields on their fee income. As a result of *Childs*, structured fee arrangements are far superior to traditional qualified retirement vehicles (for example, 401(k) accounts and IRAs). While qualified retirement vehicles provide the same benefit of yield exemption, they are subject to a host of significant restrictions and limitations. In structured fee arrangements, no dollar limits apply to the amount of fees that can be invested, nor is there a penalty for pre-retirement-age withdrawals.[15] In short,

---

transferred to another person whose rights in the property would not be subject to a substantial risk of forfeiture. *See* section 83(a) and (c).

[8]H.R. Rep. No. 91-413 (1969), 1969-3 C.B. 200, 254-255; S. Rep. No. 91-552, 1969-3 C.B. 423, 500-501 (each explaining that the purpose of section 83 was to reform the "present law treatment of restricted stock plans" because that treatment was "significantly more generous than the treatment specifically provided in the law" for similar types of deferred compensation arrangements).

[9]*See* William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 5.02(1), at 5-6 n.20. ("As broadly applicable as it is, section 83 was not intended to supplant the substantial body of law governing deferred compensation arrangements.")

[10]*See* TAM 9336001 (May 12, 1993), *93 TNT 189-19*. (Noting that section 83 codified the economic benefit doctrine, which treats second-party promises as property under the cash method); Constance M. Hiatt, "Nonqualified Deferred Compensation Plans," SJ013 ALI-ABA 457, 468 (2003) (same); Patricia Ann Metzer, "Constructive Receipt, Economic Benefit and Assignment of Income: A Case Study in Deferred Compensation," 29 *Tax L. Rev.* 525, 552 (1974). In this regard, it is noteworthy that regulations later promulgated under section 83 interpret the term "property" consistently with traditional cash method authorities. For example, the economic benefit doctrine is preserved in those regulations. *See* reg. section 1.83-3(e) (providing that property 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").

[11]*Supra* note 2.

[12]The tax treatment of the plaintiff's structured settlement was uncontroversial because her payments were nontaxable under sections 104(a)(2) and 130.

[13]The *Childs* decision has been criticized on the grounds that it is inconsistent with well-established tax doctrine. *See, e.g.*, Gordon T. Butler, "Economic Benefit: Formulating a Workable Theory of Income Recognition," 27 *Seton Hall L. Rev.* 70, 199-220 (1996); Polsky and Hellwig, "Taxing the Promise to Pay," 89 *Minn. L. Rev.* 1092, 1131-1135 (2005). Also, the IRS has noted that the *Childs* court failed to address the third-party issue. *See* IRS Coordinated Issue Paper, "Transfer or Sale of Compensatory Options or Restricted Stock to Related Persons" (Oct. 14, 2004), p. 19, *Doc 2004-20541*, *2004 TNT 204-14*.

[14]*See* E. Cary Brown, "Business Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen*, 300, 309-310 (1948); Calvin H. Johnson, "Soft Money Investing Under the Income Tax," 1989 *Ill. L. Rev.* 1019 (1990); Daniel I. Halperin, "Interest in Disguise: Taxing the 'Time Value of Money,'" 95 *Yale L. J.* 506, 519 (1986) ("deferral is equivalent to exemption of investment income"). Several assumptions are required to ensure this equivalence. *See* Chris H. Hanna, *Comparative Income Tax Deferral: The United States and Japan* 11-12 (2000).

[15]Amounts can be "withdrawn" early from structured fee arrangements by providing for cash payments to be made before the attorney reaches retirement age. Alternatively, attorneys using structured fee arrangements can sell their periodic payment rights for cash without any tax penalty.

these arrangements provide all the tax benefits of IRAs without any of the accompanying restrictions or limitations.[16]

Further, none of the other parties to a structured arrangement incur any tax burden by participating in the structure.[17] This is significant because it ensures that the transaction as a whole is tax advantaged.[18] For example, if a burden were imposed on the defendant as a result of its participation in a structured fee arrangement, the burden would offset — possibly entirely — the yield exemption benefit afforded to the attorney. Yet, there is no offsetting burden imposed on the defendant or any other party to the structured fee arrangement. For example, a defendant that pays a lump sum amount to a tort plaintiff or to the plaintiff's attorney receives a deduction when the lump sum is paid.[19] If the defendant instead enters into a structured arrangement, it receives a deduction when the lump sum is paid to the structured settlement company. Accordingly, the defendant's tax consequences are the same whether it pays a lump sum amount or enters into a structured arrangement.[20] This same tax neutrality exists for the other parties involved in structured arrangements, such as the defendant's liability insurer, the structured settlement company, and the annuity issuer.[21]

To illustrate the tax advantage of structured fee arrangements, assume that on January 1 of year 1, a plaintiff agrees to settle a medical malpractice claim against a defendant for $3 million, and the plaintiff's attorney (Attorney) is entitled to $1 million of the recovery under a contingent fee agreement. Attorney, who is subject to a 35 percent marginal tax rate, decides that she does not want to receive her entire fee immediately. Instead she wants to receive one-third immediately, another third in exactly one year, and the final third in exactly two years. Deferred amounts will earn interest at the rate of 7 percent.

To achieve her objective, Attorney has two options. She could receive a $1 million lump sum immediately and invest a portion of the $650,000 after-tax amount in an annuity that would make payments to her in a manner consistent with her desired payout. Alternatively, she could enter into a structured fee arrangement that pays her as she wishes.

If Attorney chooses the lump sum fee option, she would pay immediate tax of $350,000, leaving her with an after-tax amount of $650,000. To create three equal payments, she would invest $418,520 in an annuity, which would provide two annual payments of $231,480, one on January 1 of year 2 and one on January 1 of year 3. After investing the $418,520 in the annuity, she is left with $231,480 on January 1 of year 1. Attorney therefore will receive three equal annual payments of $231,480. The results to Attorney under this scenario are contained in Table 1. It illustrates that Attorney would have $710,606 on January 1 of year 3, assuming that she invests everything at her after-tax rate of return of 4.55 percent (7% x (1 - 0.35)).

If Attorney instead opts for a structured fee arrangement, the defendant would pay her $356,123 and use the remaining $643,877 to make a lump sum payment to the structured settlement company,[22] which would agree to pay Attorney two future payments of $356,123. Under *Childs*, Attorney would be taxed only as each of the three $356,123 payments was received. The consequences of this arrangement are shown in Table 2.

As the tables indicate, Attorney is better off under the structured fee arrangement than under the lump sum scenario. Instead of having $710,608 on January 1 of year 3, Attorney has $726,516, a difference of $15,910. The $15,904 amount represents the two tax payments of $7,778 on the annuity yield in year 2 and year 3 in Table

[16]Structured fee arrangements also compare favorably with employer-provided qualified plans. Both provide tax-free compounding. Structured fee arrangements, unlike qualified plans, effectively allow unlimited contributions and penalty-free early withdrawals. Also, unlike qualified plans, structured fee arrangements may be created for the exclusive benefit of highly compensated employees. As a result, structured fee arrangements have been marketed as "personal discriminatory retirement plan[s]." *See* "Structured Settlement Services LLC, Structured Concept Being Reinvented," *available at* http://www.structuredsettlements.org/sub/structured-settlement-reinvented.jsp (last visited Apr. 29, 2009).

[17]*See* Polsky and Hellwig, "Taxing Structured Settlements," *supra* note 3, at 38-44 (analyzing the tax consequences to other parties to structured arrangements and concluding that no tax burden is imposed on them).

[18]To determine whether a transaction is tax advantaged, the tax consequences of all parties to the transaction must be considered. *See* David I. Walker, "Is Equity Compensation Tax Advantaged?" 84 *B.U. L. Rev.* 695, 699-700 (2004); Michael S. Knoll, "The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," 50 *Wm. & Mary L. Rev.* 115, 126 (2008); Ethan Yale and Polsky, "Reforming the Taxation of Deferred Compensation," 85 *N.C. L. Rev.* 571, 580 (2007).

[19]*See* section 461(h). Of course, this assumes that the tort liability is incurred in connection with the defendant's trade or business.

[20]*See* "Taxing Structured Settlements," *supra* note 3 at 38-42. In contrast, a tax burden is placed on an employer that agrees to pay nonqualified deferred compensation, assuming the employer is subject to U.S. taxation. In that context, the employer effectively pays tax on the employee's investment yield. *See id.* at 10 n.22; Yale and Polsky, *supra* note 18, at 578-579. In the structured attorney fee context, because no other party is burdened by using a structure, no one pays tax on the attorney's investment yield.

[21]*See id.* at 42-44. In some contexts, structured settlement companies are domiciled in Barbados or Bermuda to ensure that there is no offsetting tax burden imposed on them. *See id.* at 43-44. *See also* Steven R. Craig and Blake M. Holler, "The Use of Nonqualified Structured Settlements in the Sale of Capital Assets," *Journal of Financial Service Professionals* 79, 80 (explaining the use of offshore structured settlement companies).

[22]As discussed above, the defendant would be indifferent regarding either this option or the lump sum fee option because in both cases it would receive an immediate $1 million deduction.

Table 1. Lump Sum Fee Payment

	January 1, Year 1	January 1, Year 2	January 1, Year 3	FV on January 1, Year 3
Payment received	$1,000,000	$231,480	$231,480	
Tax on payment	($350,000)	($7,778)[a]	($7,778)	
Amount of payment after tax	$650,000	$223,702	$223,702	
Purchase price of annuity	($418,520)	N/A	N/A	
Amount left after taxes and annuity purchase	$231,480	$223,702	$223,702	
Future value of after-tax amount on January 1, year 3 taking into account Attorney's after-tax investment rate of 4.55 percent	$253,024	$233,880	$223,702	$710,606

[a]The tax on annuity income is determined under section 72. Attorney's investment in the annuity is $418,520 and his expected payments total $462,960. Therefore, Attorney's exclusion ratio is 90.4 percent, which means that each $231,480 payment results in $22,222 of gross income. At a 35 percent marginal tax rate, the tax due is $7,778.

Table 2. Structured Fee Arrangement Under *Childs*

	January 1, Year 1	January 1, Year 2	January 1, Year 3	FV on January 1, Year 3
Payment received	$356,123	$356,123	$356,123	
Tax on payment	($124,643)	($124,643)	($124,643)	
Amount of payment after tax	$231,480	$231,480	$231,480	
Future value of after-tax amount on January 1, year 3 taking into account Attorney's after-tax investment rate of 4.55 percent	$253,024	$242,012	$231,480	$726,516

Table 3. Immediate Fee Payment, Followed by Investment in Tax-Exempt Annuity

	January 1, Year 1	January 1, Year 2	January 1, Year 3	FV on January 1, Year 3
Payment received	$1,000,000	$231,480	$231,480	
Tax on payment	($350,000)	($0)[a]	$0	
Amount of payment after tax	$650,000	$231,480	$231,480	
Purchase price of annuity	($418,520)	N/A	N/A	
Amount left after taxes and annuity purchase	$231,480	$231,480	$231,480	
Future value of after-tax amount on January 1, year 3 taking into account Attorney's after-tax investment rate of 4.55 percent	$253,024	$242,012	$231,480	$726,516

[a]There is no tax on the annuity income in years 2 or 3 because the annuity is hypothesized to be tax exempt.

1, after an appropriate adjustment to the year 2 payment is made to reflect Attorney's 4.55 percent after-tax investment yield.[23] In effect, Attorney in the Table 2 scenario has avoided tax on the investment yield of the portion of her $1 million fee that she had invested with the SSC ($643,877).

To see this yield exemption effect more clearly, consider what would happen if Attorney received a lump sum fee of $1 million and then was allowed to invest her after-tax recovery in a tax-exempt annuity. Attorney would owe immediate tax of $350,000, leaving her with $650,000. To equalize her payments, Attorney would buy an annuity for $418,520, which would make two annual payments of $231,480 to her. This would leave Attorney with $231,480 on January 1 of year 1 ($1 million less $350,000 tax, less the $418,520 annuity purchase price). Thus, Attorney would receive three equal payments of $231,480. As reflected in Table 3, the arrangement leaves Attorney with $726,516 on January 1 of year 3 — the same amount as in Table 2 when the *Childs* rule was applied. Table 3 therefore shows that the *Childs* rule has the same economic effect as yield exemption.

In addition to allowing a small subset of generally high-income taxpayers to obtain "super IRA" treatment,[24] the *Childs* rule creates the possibility that other taxpayers could attempt to exploit its departure from

[23]($7,778 x 1.0455) + $7,778 = $15,910.

[24]It is possible that other parties to the structured arrangement could capture some of the tax benefit under the *Childs* rule. For example, defendants or liability insurers could capture the benefit in the form of lower settlement amounts. The subsidy in

(Footnote continued on next page.)

foundational cash method rules. Thus, for example, other service providers could begin structuring portions of their gross income in hopes of obtaining similar favorable treatment. Also, promoters of at least one listed transaction have cited the anomalous *Childs* rule to support the marketed tax benefits.[25] A legislative reversal of *Childs* is therefore appropriate.

Explanation of the Provision

The provision defines property for purposes of section 83 to include a contractual right to future payment if the person who is obligated to make the payment is not the recipient of the service provider's services. For example, if an employee receives, in connection with the performance of services for his employer, a payment obligation of any person other than the employer, the employee will be treated as having received property under section 83.

Under the provision, all persons that are related to one another are treated as a single person for purposes of determining whether the payment obligor is a person other than the recipient of the service provider's services. Persons are related if they are related within the meaning of section 267(b) or section 707(b), substituting "80 percent" for "50 percent" each place it appears in those sections. Thus, for example, if an employee of a wholly owned subsidiary receives a payment obligation of the parent corporation, the obligation is not treated as property. Under the related-party rule, the parent corporation and its wholly owned subsidiary are treated as a single person; accordingly, the same person would be deemed to have both received the services and issued the obligation.

Also, an obligor and all of its successors under section 381(a) are treated as a single person for purposes of applying the provision. Further, if all or substantially all of the assets of the trade or business for which the service provider provided services are transferred to another person, the assumption of an obligation in favor of the service provider by the transferee will not be treated as a receipt of property by the service provider.

Other than clarifying that third-party promises are property, the provision does not change the definition of property under section 83. Thus, for example, funded second-party promises remain property for purposes of section 83.

---

section 104(a)(2) that allows physically injured personal injury claimants to invest tax free has been criticized on the grounds that defendants and insurers were capturing the benefit. *See, e.g.*, Adam F. Scales, "Against Settlement Factoring? The Market in Tort Claims Has Arrived," 2002 *Wis. L. Rev.* 859, 884 (2002).

[25]*See, e.g.*, Draft Opinion Letter from Arthur Andersen to Mr. Client (1999), in Enron Investigation Report, app. D., at 340 (citing *Childs*'s treatment of third-party promises to support its favorable tax opinion regarding the executive compensation strategy, which was later designated by the IRS as a listed transaction in Notice 2003-47, 2003-2 C.B. 132, *Doc 2003-15718, 2003 TNT 127-5*).