For Opinion See 89 F.3d 856

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.

September 29, 1995.

On Appeal from the Decisions of the United States Tax Court

Brief for the Appellant

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***I** STATEMENT REGARDING ORAL ARGUMENT

Counsel for the Commissioner of Internal Revenue believe that oral argument would be helpful to the Court because of the complexity of the question presented.

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CITATIONS

Cases:

Note: Authorities marked with an asterisk in the margin are those upon which the Commissioner primarily relies.

***2** STATEMENT OF JURISDICTION

The Commissioner mailed statutory notices of deficiency in income taxes for 1986 and 1987 to taxpayers Richard A. Childs, Mimi P. Childs, John C. Swearingen, Jr., Suzanne N. Swearingen, and Ben B. Philips on April 16, 1992.[FN1] (Doc. 3 at 1; Doc. 6 at 1; Doc. 9 at 1; Doc. 13 at 1; Exs. 52-AZ, 53-BA, 92-CN.)[FN2] Taxpayers, within the 90-day period provided in Section 6213, Internal Revenue Code of 1986,[FN3] filed petitions in the United States Tax Court seeking redeterminations of the proposed ***3** deficiencies. (Docs. 3, 6, 9, 13.)[FN4] The Tax Court had subject-matter jurisdiction over the cases under I.R.C. §§ 6213, 6214, and 7442 (1986).

FN1. Except where the context requires otherwise, references herein to "taxpayers" shall, for convenience, refer collectively to Richard A. Childs, John C. Swearingen, Jr., and Ben B. Philips. Mimi P. Childs (notwithstanding that she filed a separate petition in the Tax Court) and Suzanne N. Swearingen are parties to this case solely because they filed joint income tax returns with their husbands for the years in issue.

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.

FN3. Except as noted, all statutory references are to the Internal Revenue Code (26 U.S.C.) ("I.R.C." or the "Code") as in effect in 1986 and 1987, the years in issue. The Internal Revenue Code of 1954 was redesignated the Internal Revenue Code of 1986 by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2085.

FN4. The petitions of taxpayers Childs were timely filed on July 10, 1992. (Doc. 3 at 1; Doc. 6 at 1.) The petitions of taxpayers Swearingen and Philips were filed on July 17, 1992, but the envelopes in which the petitions were mailed were postmarked on July 15, 1992. (Doc. 9; Doc. 13.) The petitions of taxpayers Swearingen and Philips therefore were timely under I.R.C. §§ 6213 and 7502 (1986).

The Tax Court consolidated the cases for trial, briefing, and opinion. (Doc. 65.) In accordance with its opinion (Doc. 80), which is reported at 103 T.C. 634, the Tax Court, on March 16, 1995, entered its decisions (Docs. 85-88) pursuant to I.R.C. § 7459 (1986). The decisions were final and disposed of all claims with respect to all parties to each of the respective consolidated cases. The Commissioner filed her notice of appeal on June 7, 1995 (Doc. 89), within 90 days after entry of the decisions. This appeal, therefore, is timely under I.R.C. § 7483 (1986). This Court has jurisdiction over this appeal pursuant to I.R.C. § 7482 (1986).

STATEMENT OF THE ISSUE

Whether the Tax Court erred in holding that an attorney's right to receive his attorney's fee in the form of annuity payments as the result of the settlement of personal injury litigation did not constitute "property" within the meaning of I.R.C. § 83.

***4** STATEMENT OF THE CASE

(1) *Course of proceedings and disposition in the court below*

The instant appeal is from the Tax Court's decisions, in consolidated cases, rejecting the Commissioner's determination of deficiencies in taxpayers' 1986 and 1987 income taxes. The parties stipulated to some of the facts (Docs. 66-70), and a trial was held (Docs, l, 2). The Tax Court (Honorable Irene F. Scott) ruled in favor of taxpayers. (Doc. 80.) The Commissioner appealed. (Doc. 89.)

(2) *Statement of the facts*

The facts relevant to this appeal, as stipulated by the parties, found by the Tax Court, or otherwise reflected in the record, may be summarized as follows:

Taxpayers Richard Childs, John Swearingen, and Ben Philips are attorneys. During the years in issue, they practiced law in Columbus, Georgia, with the firm of Swearingen, Childs & Philips, P.C., a professional corporation engaged in the practice of law. (Doc. 66 at 2; Doc. 80 at 4.)

In September 1984, Willie Jones and his minor stepson, Jermeral Garrett, were severely injured by an explosion in their home near Phenix City, Alabama. (Doc. 66 at 2; Doc. 80 at 5.) Mr. Jones later died from his injuries. (Doc. 66 at 3; Doc. 80 at 5.) Annette Jones (Mr. Jones's widow and Garrett's mother) and taxpayers, individually, and the law firm of Swearingen, Childs & Philips entered into a contingency fee agreement in which the attorneys agreed to represent Mrs. Jones in all causes ***5** of action that she might bring individually, on behalf of Garrett, and as administratrix of Mr. Jones's estate. Under the agreement, if the case were settled before trial, the fees paid to the attorneys were to be equal to one-third of the gross amounts recovered. If the cases were settled after trial, the fees were to be 40 percent of the gross amounts recovered. (Doc. 66 at 2-4; Doc. 80 at 5-6; Ex. 1-A.)

(a) *The Garrett litigation*

Garrett (acting by and through Mrs. Jones) and Mrs. Jones (acting on her own behalf with a claim for loss of Garrett's services) filed a suit against Columbus Propane Gas Service, Inc., claiming that it was responsible for the explosion. (Doc. 66 at 2; Doc. 80 at 7-8.) Columbus Propane's primary liability insurer was Georgia Casualty & Surety Company, with coverage up to $1 million. Stonewall Insurance Company was the secondary insurer, providing excess coverage up to $10 million. (Doc. 66 at 5; Doc. 80 at 7.) Georgia Casualty engaged Charles Bradford of Structured Annuity Settlements, Inc., to assist in negotiating a settlement of the Garrett suit. (Doc. 66 at 6; Doc. 80 at 7.) Taxpayer Philips did most of the negotiating with Mr. Bradford. (Doc. 80 at 7.)

To avoid problems in collecting attorneys' fees that might result in the event of a structured settlement of the Garrett claim, it was determined that any settlement agreement should make specific provision for the payment of taxpayers' fees. (Doc. 80 at 12; *see* Doc. 2 at 110-117.) Mrs. Jones was of the view that if she and Garrett were to receive payments in respect ***6** of their claims over time, then taxpayers likewise should receive payment of their fees over time. (Doc. 1 at 61-62; Doc. 2 at 109; Doc. 80 at 12.) Mr. Bradford further suggested that, rather than taxpayers' simply receiving the designated portion of the payments made to the clients over time, a settlement should provide for structured payments to taxpayers separate from those of the clients because the timing of taxpayers' need for money would be different from those of the clients. (Doc. 1 at 69-70.) Mr. Bradford gave taxpayers several different structured payment schedules from which each of them could choose. (Doc. 2 at 106-107.)

In April 1986, the parties reached a “structured settlement” of the Garrett case, *i.e.*, a settlement involving future payments. (Doc. 66 at 8; Doc. 80 at 9.) Since Garrett was a minor, approval of the settlement by an Alabama state court was required, and was obtained in April 1986. (Doc. 66 at 15; Doc. 80 at 9-10; Ex. 11-K.) Taxpayer Philips deemed the form of the settlement to be advantageous because he wanted a settlement that would protect Garrett and the money received; he did not consider Mrs. Jones to be qualified to protect Garrett's money. (Doc. 1 at 59; Doc. 2 at 109; Doc. 80 at 9.)

The settlement was embodied in a “Release and Indemnity Agreement,” whereby Garrett agreed to dismiss the suit and to release Columbus Propane from any claims arising out of the explosion. (Doc. 66 at 8; Ex. 9-1.) Georgia Casualty and Stonewall agreed to pay, on behalf of Columbus Propane, a lump sum to Garrett, a series of other payments to him for the rest of ***7** his life, and a series of future payments to taxpayers as attorney's fees. The future payments to Garrett and taxpayers were “to be made or paid through annuities purchased from Executive Life Insurance [Company]” (Ex. 9-I at 6). Taxpayer Philips was to be paid $52,155 per year in 1987 and 1988. Taxpayer Childs was to be paid $1,324.57 per month for ten years, beginning on January 2, 1987, together with $6,000 per year in the years 1996 through 1999. Taxpayer Swearingen was to receive six annual payments of $11,734.21, commencing on January 2, 1987, and annual payments ranging from $10,000 to $22,000 for the next ten years. (Ex. 9-1 at 7-8.)

The release agreement provided that Executive Life “shall be at all times directly responsible for the structured payments” and that Georgia Casualty and Stonewall “shall likewise be responsible for said payments on a pro rata basis” (Ex. 9-I at 8-9). The agreement provided that Georgia Casualty and Stonewall could make a “qualified assignment” to First Executive Corporation (the parent corporation of Executive Life) of their obligations to make the future payments. (Ex. 9-I at 9.) The assumption of liability by First Executive would not discharge the liability of Georgia Casualty and Stonewall. (Ex. 9-I at 10.) The agreement specifically reserved to Georgia Casualty and Stonewall the right “to fund their obligations herein through Executive Life Insurance Company or comparably rated life insurance company,” and provided that they, or their assignees, “shall be the owner of any annuity policies issued to fund the payments set forth herein” (Ex. 9-I at 10). The agreement also ***8** provided that Georgia Casualty and Stonewall “shall not segregate or set aside specific assets to fund any payments made hereunder” and that Garrett “shall be a general creditor of [Georgia Casualty and Stonewall] to the extent of their respective obligations for the payments made hereunder” (Ex. 9-I at 9). Mrs. Jones executed a second release and indemnity agreement respecting her claim for the loss of Garrett's services. (Doc. 80 at 10.) The release agreements served to release Columbus Propane from any obligation for any payment to Garrett, to Mrs. Jones, or to taxpayers. (Doc. 80 at 10; Ex. 9-I at 9.)

Taxpayers, their clients, Georgia Casualty, Stonewall, and First Executive executed an “Assignment and Assumption Agreement” providing for “a qualified assignment [that] . . . meets the requirements of Section 130 of the Internal Revenue Code” (Ex. 10-J at 3) pursuant to which First Executive assumed Georgia Casualty's and Stonewall's deferred payment obligations (Doc. 66 at 13; Doc. 80 at 14; Ex. 10-J). With amounts received from Georgia Casualty and Stonewall, First Executive would purchase annuities from Executive Life to cover those obligations. (Doc. 66 at 13-14; Doc. 80 at 14; Ex. 10-J at 4.) Payments under the annuities could not be accelerated, deferred, increased, or decreased by the recipients, and they would have no rights against First Executive other than those of a general creditor. (Doc. 66 at 14; Doc. 80 at 14-15; Ex. 10-J at 5.)

Each of taxpayers subsequently was named as an annuitant under an annuity policy purchased from Executive Life, and their respective estates were designated as beneficiaries (*i.e.*, the ***9** payee for any payments due after the death of the annuitant). First Executive was the owner of the annuities, and had the right to change the annuitant. (Doc. 66 at 18; Doc. 80 at 13, 15; Ex. 22-V.) The total value (cash plus premiums on annuity policies to cover future payments) of the Garrett settlement was $1,300,000; taxpayers and their firm received one-third of that amount ($433,333) as their fee, of which $125,469.82 was in the form of cash. (Ex. 14-N.) Of those fees, each of taxpayers received $133,333 in value (cash plus premiums on annuity policies to cover future payments), and the balance of $33,333 in cash was paid to taxpayers' firm. (Doc. 2 at 158; Ex. 14-N.) In addition, taxpayers' law firm was reimbursed out of the plaintiffs' lump sum payment for the expenses of the suit that it had paid. (Ex. 14-N.)

Not all of the deferred payments in the Garrett litigation were paid on time. Executive Life had financial troubles, was placed into conservatorship, and did not make some of the annuity payments to the attorneys. On such occasions, the attorneys notified Georgia Casualty and Stonewall, which then made the payments. (Doc. 66 at 18-19; Doc. 80 at 15.)

(b) *The Jones litigation*

In September 1986, Mrs. Jones, individually and as administratrix of the estate of Mr. Jones, brought a separate wrongful death suit against Columbus Propane. (Doc. 66 at 20; Doc. 80 at 15.) In the fall of 1987, the parties reached a structured settlement of the suit. (Doc. 66 at 21; Doc. 80 at 16.) In the release agreement executed to implement the ***10** settlement, Stonewall agreed to pay a cash lump sum to Mrs. Jones and taxpayers. (Doc. 66 at 22; Doc. 80 at 17; Ex. 35-AI at 6-7.) Stonewall also agreed to “cause to be made . . . through annuities purchased from Manufacturers Life Insurance Company” (Ex. 35-AI at 6) certain future payments to Mrs. Jones. The release agreement provided that “[t]he following additional payments otherwise payable to Annette Jones . . . at her direction are to be made to her attorneys in the discharge of all obligations of the parties executing this release to pay attorney's fees to [taxpayers]” (Ex. 35-AI at 8). Taxpayer Philips was to be paid $1,000 per month commencing in January 1992, such payments to continue for the longer of his life or 20 years, with the amount of the payments to compound at 3 percent per year. Also starting in January 1992, taxpayer Swearingen was to receive monthly payments of $1,000 for five years, of $1,200 for the next five years, of $1,400 for the next five years, of $1,600 for the next five years, then of annual payments of $1,800 for the rest of his life. Taxpayer Childs was to be paid $49,000 in January 1988 and $49,050 in April 1988. All such payments to taxpayers were explicitly stated to be made at the direction of Mrs. Jones to discharge her liability to pay attorney's fees to taxpayers. (Doc. 66 at 22-23; Doc. 80 at 17-18; Ex. 35-AI at 8-9.)

The release agreement provided that Stonewall could make a “qualified assignment” to Manulife Service Corporation (a subsidiary of Manufacturers Life) of Stonewall's obligations to make the future payments called for in the agreement. (Doc. 66 ***11** at 24; Doc. 80 at 18; Ex. 35-AI at 10.) The agreement stated that, if such an assignment were made, Manulife thereafter “shall at all times be directly responsible for the structured payments” (Ex. 35-AI at 10) and that Manulife's obligations would be “guaranteed” by Manufacturer's Life (Ex. 35-AI at 10). The agreement further recited that Stonewall “shall remain obligated as a guarantor,” but “only to the extent that the obligation for such benefits cannot be first satisfied by Manulife Service Corporation or its primary guarantor Manufacturers Life” (Ex. 35-AI at 10-11). The payments called for under the agreement could not be accelerated, deferred, increased, or decreased by the recipients, and the recipients could not transfer, assign, or encumber the future payments. (Ex. 35-AI at 12.)

Mrs. Jones executed a “Qualified Assignment and Consent Agreement” in which Manulife would assume Stonewall's deferred payment obligations. With amounts received from Stonewall, Manulife could purchase annuities from Manufacturers Life to cover those obligations. (Doc. 66 at 24; Ex. 35-AI at Ex. B.) The record does not reflect that the contemplated qualified assignment to Manulife of Stonewall's obligations under the Jones settlement was ever made.

Each of taxpayers subsequently was named as an annuitant under an annuity policy purchased from Manufacturers Life. The respective estates of taxpayers Swearingen and Philips were designated as beneficiaries of their annuities. Taxpayer Childs's wife was designated as beneficiary of his annuity. Stonewall was the owner of the annuities and had the right to ***12** change the annuitant. (Doc. 66 at 26-28; Doc. 80 at 19-20; Exs. 42-AP, 43-AQ, 44-AR.) The total value (cash plus premiums on annuity policies to cover future payments) of the Jones settlement was $1,000,000; taxpayers and their firm received 45 percent of that amount ($450,000) as their fee, of which $146,850 was in the form of cash. Of those fees, each of taxpayers received $125,000 in value (cash plus premiums on annuity policies to cover future payments), and the balance of $75,000 was paid in cash to taxpayers' firm. (Ex. 41-AO at Ex. 2 thereto.) In addition, taxpayers' law firm was reimbursed out of the plaintiffs' lump sum payment for the expenses of the suit that it had paid. (Ex. 41-AO.)

(c) *Tax treatment of the attorneys' annuities*

On his 1986 tax return, each taxpayer reported as income the cash amounts that he received in 1986 as attorney's fees for the Garrett litigation but did not report as income any portion of his deferred payments or the fair market value or cost of the annuity policies attributable to that litigation. (Doc. 66 at 28-29; Doc. 80 at 20.) On his 1987 tax return, each taxpayer reported as income the annuity payments received that year from the Garrett litigation and the cash amounts received that year from the Jones litigation but did not report as income any portion of the deferred payments from the Jones litigation or the fair market value or cost of the annuities attributable thereto. (Doc. 66 at 29; Doc. 80 at 20.)

The Commissioner determined that, under I.R.C. § 83, the fair market value of the right to receive payments under the ***13** Garrett annuities was includable in each attorney's income for 1986, and the fair market value of the right to receive payments under the Jones annuities was includable for 1987. (Doc. 66 at 29-30; Doc. 80 at 20-21.) The Commissioner determined income tax deficiencies for 1986 and 1987, respectively, of $37,176.42 and $34,792.85 against taxpayer Childs, of $40,977.76 and $44,952.00 against taxpayer Swearingen, and of $41,965 and $22,610 against taxpayer Philips, in each case together with additions to the tax for substantial understatement of liability under I.R.C. § 6661. (Exs. 52-AZ, 53-BA, 92-CN.) Taxpayers petitioned the Tax Court for redetermination of the deficiencies. (Docs. 3, 6, 9, 13.)[FN5]

FN5. The Commissioner's notices of deficiency made other, unrelated adjustments to taxpayers' income tax liabilities (Exs. 52-AZ, 53-BA, 92-CN), but the parties settled these issues (Doc. 71).

In general, where property is transferred in connection with the performance of services, the excess of the fair market value of the property over the amount (if any) paid for the property is included in the gross income of the service provider in the first taxable year in which the rights of the recipient are transferable or are not subject to a substantial risk of forfeiture. I.R.C. § 83(a). Treasury regulations provide that “the term ‘property’ includes real and personal property other than 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 ***14** 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 reasoned that “[s]ince section 83 property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future, it must necessarily include a promise to pay money in the future that is either secured or funded” (Doc. 80 at 23). The Commissioner contended that the promises to pay money to taxpayers in the future were funded and secured. The Tax Court, however, agreed with taxpayers that the promises were unfunded and unsecured. The court concluded that the promises were not funded by the annuity policies because taxpayers were not the owners of the annuities and the owners, First Executive and Stonewall, had the right to change the annuitants. (Doc. 80 at 26-27.) The court also held that various guarantees to which the Commissioner pointed did not make the promises “secured” and that even if taxpayers had a lien for their attorney's fees claim, their rights under such lien were not equivalent to property being set aside as security for the annuities. (Doc. 80 at 27-29.) Accordingly, the court concluded that I.R.C. § 83 did not require taxpayers to report income in the years in issue because ***15** no “property” was transferred.[FN6] (Doc. 80 at 30.) From that ruling, the Commissioner has appealed.[FN7]

FN6. Because the Tax Court determined that taxpayers' right to receive future payments was not "property," it did not consider taxpayers' other arguments that that right was not taxable under I.R.C. § 83 during the years in issue, or their arguments with respect to the value of that right. Accordingly, if this Court reverses the decision on appeal, it should remand these consolidated cases to the Tax Court for further proceedings.

FN7. The Tax Court also rejected (Doc. 80 at 30-33) the Commissioner's alternative argument that even if the attorneys did not have income under I.R.c. § 83, they had income under the constructive receipt doctrine. *See* Treas. Reg. § 1.451-2 (a). The Commissioner does not challenge that ruling herein, so the question of constructive receipt is not involved in this appeal.

(3) *Standard of review*

The only question in this appeal is whether the Tax Court erred in formulating and applying rules of law to undisputed facts. The Tax Court's ruling is, therefore, subject to *de novo* review by this Court. *See, e.g.*, *Young v. Commissioner*, 926 F.2d 1083, 1089 (11th Cir. 1991).

SUMMARY OF ARGUMENT

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. ***16** Taxpayers are attorneys who represented the plaintiffs on a contingent fee basis in suits arising from personal injuries to Jermeral Garrett and the death of Willie Jones. In connection with the settlement of those cases, it was agreed that, at the direction of Mrs. Jones (the widow of Jones and the mother of Garrett) and to satisfy her obligation to pay attorney's fees, the defendant's liability insurers would make future payments to taxpayers and would buy annuity policies from a different insurance company to cover the amount of the payments due. The liability insurers' obligation to pay under the Garrett settlement was "assigned" to another insurance company, and the annuity policies purchased to cover the payments were the property of the assignee. The annuity policies purchased to cover the payments due under the Jones settlement remained the property of the liability insurer.

Taxpayers reported as income the cash payments that they received. The Commissioner determined that taxpayers should have reported as income the value of the rights to receive future payments in the years in which they received those rights, and determined deficiencies accordingly. The Tax Court rejected the Commissioner's determination, holding that taxpayers had received only the unfunded and unsecured promises of the liability insurers to pay money in the future, and that those promises did not constitute "property" subject to taxation under I.R.C. § 83. That was error.

1. Under I.R.C. § 83, a taxpayer who receives property in connection with the performance of services must include in his ***17** income the fair market value of the property at the time his interest becomes transferable or is no longer subject to a substantial risk of forfeiture. I.R.C. § 83(a). For purposes of I.R.C. § 83, the term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. Treas. Reg. § 1.83-3(e). Thus, the promises to pay money to taxpayers in the future are "property" if they were "funded." The Tax Court held that an obligation is funded when the obligor has placed assets with which to pay the obligation beyond the reach of his general creditors, no further action on the obligor's part is required to cause the obligation to be paid, and the promisee obtains a nonforfeitable in-

terest in the funding asset. The court held that, since taxpayers never acquired any interest in the funding assets here--the annuity policies purchased to fund the payments to them--the liability insurers' promises to pay were not funded.

The Tax Court erred, first, in concluding that the liability insurers were the obligors whose promises had to be funded. The promise to pay made to taxpayers was made by their clients, and the clients fulfilled that promise by transferring to taxpayers part of their right to receive payments in the future from the liability insurers. The transferred asset--the undertaking of an insurance company to make a stream of future payments/is essentially an annuity contract, and it is undisputed that such a contract may constitute a funding asset. The Tax Court was also wrong to make forfeitability an element of its test, because whether a right or interest is subject to forfeiture has no ***18** bearing on whether it constitutes property for purposes of I.R.C. § 83. Under the language of the statute, forfeitability is a separate inquiry from the “property” inquiry.

2. Even assuming that the Tax Court was correct in treating the liability insurers as the obligors, rather than taxpayers' clients, the liability insurers' promises to pay taxpayers in the future were “funded.” First, the Tax Court misapplied its own test for funding in the settlement of the Garrett case. There was a qualified assignment of the liability insurers' obligations in that case to another insurance company, and the annuity policies (the funding assets) from which the future payments were to be made were the property of the assignee and, hence, out of the reach of the liability insurers' creditors. Since the liability insurers did not need to take further action for taxpayers to receive their payments, the promise to pay taxpayers' fees with respect to the Garrett settlement was fully funded, and the Tax Court erred in concluding otherwise.

Second, there is no basis for holding that the insurer's promise is not funded with respect to the Jones settlement even though the liability insurer remained the owner of the annuity policies (which were therefore not beyond the reach of its creditors). The term to “fund” means only to provide a fund or assets from which to pay an obligation, without the further requirement that the assets be transferred out of the reach of the obligor's creditors. And requiring the removal of assets beyond the reach of creditors simply makes no sense where, as ***19** here, the obligor (1) is not the employer of or recipient of services from taxpayers and (2) is itself an insurance company, the promise of which may itself constitute a funding asset.

The decisions of the Tax Court should be reversed and the consolidated cases remanded to the Tax Court for further proceedings.

***20** ARGUMENT

THE TAX COURT ERRED IN HOLDING THAT TAXPAYERS' RIGHT TO RECEIVE THE ATTORNEY'S FEES OWED TO THEM BY THEIR PLAINTIFF CLIENTS IN THE FORM OF ANNUITY PAYMENTS FROM THE DEFENDANT'S LIABILITY INSURER AS THE RESULT OF THE SETTLEMENT OF PERSONAL INJURY LITIGATION DOES NOT CONSTITUTE “PROPERTY” WITHIN THE MEANING OF I.R.C. § 83

A. *Introduction*

The appeal in these consolidated cases concerns the proper treatment, for income tax purposes, 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.

In general, the tax treatment of a transfer of property in connection with the performance of services is governed by I.R.C. § 83, App., *infra*. That statute requires the person who performs the services to include in his gross income the excess of the fair market value of the transferred property over the amount, if any, paid therefor in the first taxable year in which the property is either transferable or not subject to a substantial risk of forfeiture. I.R.C. § 83(a)(1). A person's rights in property are subject to a substantial risk of forfeiture "if such person's rights to full enjoyment of such property are ***21** conditioned upon the future performance of substantial services by any individual." I.R.C. § 83(c)(1). As the broad language of I.R.C. § 83 suggests, its rules respecting compensatory transfers of property apply to all property transfers "in connection with the performance of services," not just services performed by employees, *pagel, Inc. v. Commissioner*, 91 T.C. 200, 205 (1988) (I.R.C. § 83 applies to transfer of stock options to independent contractor), *aff'd*, 905 F. 2d 1190 (8th Cir. 1990). Further, I.R.C. § 83 applies to transfers of "property," not just of stock. *E.g.*, *Zuhone v. Commissioner*, 883 F. 2d 1317, 1323 (7th Cir. 1989) (transfer of royalty interests in oil wells).

The Tax Court's decision below turned on whether the promises to pay taxpayers their attorney's fees in the form of specified future payments of money constituted "property" within the meaning of I.R.C. § 83. The term "property" is not defined in I.R.C. § 83. It is, however, defined in the implementing regulations thereunder, which provide, in pertinent part (Treas. Reg. § 1.83-3(e), App., *infra*):

For purposes of section 83 and the regulations thereunder, the term "property" includes 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.

The Tax Court agreed with the Commissioner that "[s]ince section 83 property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future, it must necessarily include a ***22** promise to pay money in the future that is either secured or funded" (Doc. 80 at 23). To define the term "funded," the Tax Court looked (Doc. 80 at 23-26) to three cases that involved the question whether the present value of deferred compensation is currently includible in an employee's income, but which did not involve the interpretation of a statute or regulation using the terms "unfunded" or "funded." In the first of those cases,, *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952), money transferred by an employer into a trust for the benefit of an employee, to be paid to the employee in later years as compensation for past services, was held to be taxable to the employee when it was paid into the trust for his benefit. In the second case, *Centre v. Commissioner*, 55 T.C. 16 (1970), an insurance policy, of which the employer was the owner and beneficiary, that had been purchased by the employer as a means of funding a deferred compensation liability to an employee was assigned to the employee after his termination. In that case, the court held that the employee realized taxable income only when the policy was assigned to him and not earlier, when the premiums were paid. Finally, in *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985), an employer established a trust for its own benefit to hold the assets of a deferred compensation plan for its physician employees. Physicians participating in the plan could designate the portion of their fees that would be deferred, and the employer paid the deferred portion of the physicians' fees into the trust. Since the physicians had no interest in the trust, but were only incidental beneficiaries, ***23** and since the trust was subject to the claims of the employer's creditors, the court of appeals held in *Minor* that the employer's payments into the trust with respect to an employee were not currently taxable to the employee.

From those cases, the Tax Court synthesized the following standard for determining when funding occurs (Doc. 80 at 26):

[F]unding 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.

Applying that test here, the Tax Court concluded that the liability insurers, Georgia Casualty and Stonewall, were the obligors, and that their promises to make future payments to taxpayers were not funded by the annuity policies because taxpayers were not the owners of the annuities, and the owners of the annuity policies (First Executive and Stonewall) had the right to change the annuitants. (Doc. 80 at 26-27.) The court went on to hold, therefore, that the promises were not "property" within the meaning of I.R.C. § 83. (*Id*., at 30.) That was error.

We shall demonstrate below, first, that, even assuming, *arguendo*, that the Tax Court's formulation of the rule for determining when a promise is "funded" is correct, the court reached the wrong result here because it identified the wrong entities--the liability insurers--as the obligors and, accordingly, applied its test to the wrong promises. On the facts here, taxpayers' clients-- Garrett, acting through ***24** Mrs. Jones, and Mrs. Jones on her own behalf and in her capacity as the administratrix of the estate of Mr. Jones--were the obligors, and, as we shall explain, their promises to taxpayers were fully funded. Next, we shall show that even if the liability insurers are properly to be treated as the obligors, the promises to pay taxpayers' fees with respect to the Garrett litigation (*i.e.*, the promise made in 1986 to make future payments to taxpayers) nevertheless were funded, even under the Tax Court's funding standard. Finally, we shall demonstrate that the Tax Court's definition of funding is not correct and that, under the correct definition, the promises to make future payments of fees with respect to both the Garrett litigation and the Jones litigation were funded.

B. *Taxpayers' clients--not the liability insurers--were obligated to pay taxpayers' fees, and their promises to pay in the future were "funded" by the assignments to taxpayers of the clients' rights to receive payments from the liability insurers*

As stated, the Tax Court concluded that the liability insurers, Georgia Casualty and Stonewall, were the obligors of the promises to pay taxpayers' fees, and that their promises to make future payments to taxpayers were not funded by the annuity policies purchased from Executive Life and Manufacturers Life because taxpayers were not the owners of the annuity policies and the owners of the annuities (First Executive and Stonewall) had the right to change the annuitants. (Doc. 80 at 26-27.) The principal flaw in the Tax Court's analysis is that the liability ***25** insurers were not the obligors with respect to the legal fees owed to taxpayers.

The only persons obligated to pay legal fees to taxpayers were taxpayers' clients (*i.e.*, Mrs. Jones in her three capacities--individually, on behalf of Garrett, and as administratrix of Mr. Jones' estate). Under their fee agreement, the clients agreed to pay taxpayers as their fees specified percentages of the gross amounts that taxpayers recovered on behalf of the clients. (Exs. 1-A, 54-BB.) The various agreements settling the Garrett and Jones cases and setting up the structured settlements provided a mechanism for satisfying the *clients'* promises to taxpayers. Instead of having the liability insurers pay money to the clients, who in turn would pay a portion to taxpayers, the parties arranged to have the liability insurers make current and future payments directly to taxpayers.

Thus, 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[FN8] and then ***26** delivering the annuity contracts to taxpayers. That this is essentially what occurred here is made explicit by the language of the release agreement in the Jones litigation, which describes the future payments to taxpayers as “additional payments otherwise payable to Annette Jones” that “at her direction are to be made to her attorneys in discharge of all obligations of the parties executing this release to pay attorney's fees” (Ex. 35-AI at 8), and, further, as being “in discharge of her obligation for attorneys fees” (Doc. 35-AI at 9). The release in the Garrett litigation contains no similar provision but, rather, merely describes the future payments to the attorneys as amounts that the liability insurers have agreed to pay. (Ex. 9-I at 7-8.) The parties, however, stipulated below that, in both settlements, Mrs. Jones had to authorize the payments to the attorneys. (Doc. 67 at 7.)

FN8. Since Mrs. Jones would not agree to taxpayers' receiving an immediate payment of their fees when she and Garrett were to receive payments on their claims over time, her promise to pay a specific portion of the amounts recovered as attorney's fees could be nothing other than a promise to pay part of the fees in the future--*i.e.*, a promise of deferred compensation.

Viewed in this light, it becomes clear that the clients' obligation to pay part of their recovery to taxpayers has been performed in full: part of what the clients recovered was the right to receive money payments from an insurance company in the future, and they transferred a portion of that right to taxpayers. At the very least, it is clear that the *clients'* promises to pay a portion of the amount recovered to taxpayers in the future have been funded--if not actually paid--by the *clients'* assignment to taxpayers of portions of their rights to ***27** receive future payments of money from the liability insurers. Because the rights to future payments from the liability insurers that the clients thus transferred to taxpayers are not subject to the claims of the *clients'* creditors, the clients' promises are “funded” and constitute “property” for purposes of I.R.C. § 83. In this regard, we note that, although in stating its test for determining whether funding has occurred, the Tax Court repeatedly used the term “obligor” (Doc. 80 at 26, 27, 29 n.10), the obligor in *Sproull*, *Centre*, and *Minor*--the cases on which the court relied in formulating that test--was the *recipient of services* (in those cases, the employer of the taxpayer involved), which is generally to be expected in cases involving the transfer of property as compensation for services. Indeed, in *Minor*, the Ninth Circuit read Treas. Reg. § 1.83-3(e) as providing that “[i]f the employee's interest is unsecured or not otherwise protected from the *employer's* creditors, the employee's interest is not taxable property.” *Minor*, 772 F.2d at 1475 (emphasis added). *Cf. Belsky v. First Nat. Life Ins. Co.*, 818 F.2d 661 (8th Cir. 1987) (executive benefit plan was “unfunded” and, hence, outside the reach of ERISA under 29 U.S.C. § 1003(b)(5), where employer had purchased insurance to fund its liabilities, but employer was owner and beneficiary of insurance); *Belka v. Rowe Furniture Corp.*, 571 F. Supp. 1249 (D. Md. 1983) (same). In the instant cases, taxpayers did not render services to the liability insurers, and the Tax Court therefore erred in treating the insurers as the obligors in determining whether taxpayers' right to receive future payments was funded.

***28** The application of the Tax Court's rule for determining whether there is funding of the clients' promises to pay fees to taxpayers in the instant cases leads inevitably to the conclusion that the clients' promises were funded, if not fully performed. As noted, the clients here were the recipients of taxpayers' services, and the clients needed do nothing further for the structured payments to be made to taxpayers. Each taxpayer received an interest in what amounts to an annuity policy--*i.e.*. the undertaking of an insurance company to make a determinable series of money payments in the future--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. In this context, the Tax Court correctly recognized that an insurance policy--an insurance company's promise to pay--is property. (Doc. 80 at 26.) *See Dependahl v. Falstaff Brewing Co.*, 653 F.2d 1208, 1213-1214 (8th Cir. 1981) (death benefit plan holding, as source of payment, life insurance policies on covered employees was funded), *cert. denied*, 454 U.S. .968 and, *sub nom*. *Dependahl v. Kalmanovitz*, 454 U.S. 1084 (1981); *Centre v. Commissioner*, 55 T.C. at 20 (employee received taxable income when insurance policies were assigned to him by employer).

The last element of the Tax Court's test to be considered is its statement that funding occurs when the taxpayer obtains a “nonforfeitable” economic or financial benefit. (Doc. 80 at 8.) Under the language of I.R.C. § 83, however, forfeitability is not relevant to the determination whether “property” has been transferred. Under I.R.C. § 83, where property is transferred, ***29** the service provider has income 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.” I.R.C. § 83(a). Thus, under the language of the statute., forfeitability is a separate inquiry from the “property” inquiry, and is relevant only in determining the *time* as of which a taxpayer who receives property as payment for services must take the value of the property into income under I.R.C. § 83(a). Moreover, because I.R.C. § 83 contemplates that the service provider will have income even where property is forfeitable (either because the risk of forfeiture is not substantial or because the property is transferable), the Tax Court's nonforfeitability requirement is at odds with the statute.[FN9]

FN9. Taxpayers argued below that there was a “substantial” risk of forfeiture here, but the Tax Court did not reach the issue. That question would have to be addressed on remand.

C. *Even if the liability insurers are deemed to be the obligors with respect to the payment of taxpayers' fees, their promises to pay taxpayers in the future were “funded” by the purchase of annuity policies*

1. We have shown above that the clients--taxpayers' employers with respect to the Garrett and Jones cases/are the promisors with respect to the promise to pay legal fees to taxpayers, and that the clients have funded (if they have not fully performed) their promise by assigning to taxpayers a ***30** portion of their rights to receive future payments from Columbus Propane's liability insurers, Georgia Casualty and Stonewall. Under this analysis, of course, the Commissioner is entitled to prevail with respect to both the Garrett and Jones settlements, and if this Court agrees with the analysis, there is no need for it to proceed further.

The Tax Court, however, did not consider the clients to be the obligors. Rather, it concluded that the liability insurers were the obligors. (Doc. 80 at 26, 27.) It further concluded that the purchase of annuity policies to provide the source for payment of the future payments that the insurers promised to make in the release agreements did not result in the funding of those promises in either the Garrett case or the Jones case. (Doc. 80 at 26-27.) There is, however, a critical distinction between the settlement arrangements in the Garrett and Jones cases that the Tax Court erroneously failed to give effect, and, even under the Tax Court's analysis, that distinction mandates that those settlements have a different result.

In the Jones case, the release agreement by which the Jones settlement was effected provided that the liability insurer (Stonewall) could make a “qualified assignment” to Manulife of its obligations to make the future payments called for in the agreement. (Doc. 66 at 24; Doc. 80 at 18; Ex. 35-AI at 10.) It was contemplated, in that event, that Stonewall would pay to Manulife an amount sufficient to cover the premiums on annuity policies to cover the various future payments that Manulife would thus be obligated to make, that Manulife would purchase such ***31** annuity policies from Manufacturers Life, and that Manulife would be the owner of those annuity policies. (Ex. 35-AI at 10 & Ex. B thereto.) It does not appear, however, that any such assignment ever was made. Instead, rather than acting through a qualified assignment to Manulife, Stonewall itself purchased annuity policies from Manufacturers Life naming each of taxpayers as an annuitant, and Stonewall remained the owner of the annuities and had the right to change the annuitant. (Doc. 66 at 26-28; Doc. 80 at 19-20; Exs. 42-AP, 43-AQ, 44-AR.)

Applying the Tax Court's definition of funding to the Jones settlement, and assuming that the liability insurer, Stonewall, was the obligor with respect to the promise of future payments to taxpayers, then the Tax Court was correct in its conclusion that Stonewall's purchase of annuities from Manufacturers Life did not result in the funding of that promise. That is because, under the Tax Court's definition, funding has not occurred "if the . . . policy is subject to the rights of general creditors of the obligor" (Doc. 80 at 26), and, since Stonewall remained the owner of the annuity policies and had the right to change the annuitants thereunder, the annuities were subject to the rights of Stonewall's general creditors. (We shall show at pp. 33-39, *infra*, however, that the Tax Court's standard is incorrect.)

With respect to the Garrett settlement, however, the situation was different-- there was a "qualified assignment" of the liability insurers' obligations under the settlement of that case. In the Garrett case, taxpayers, their clients, the liability insurers (Georgia Casualty and Stonewall), and First ***32** Executive executed an "Assignment and Assumption Agreement" providing for "a qualified assignment" under I.R.C. § 130 (Ex. 10-J at 3) pursuant to which First Executive assumed the liability insurers' deferred payment obligations (Doc. 66 at 13; Doc. 80 at 14 Ex. 10-J). With amounts received from Georgia Casualty and Stonewall, First Executive agreed to, and it did, purchase annuities from Executive Life to cover those obligations. (Doc. 66 at 13-14, 18; Doc. 80 at 13-15; Ex. 10-J at 4; Ex. 22-V.) First Executive was the owner of the annuity policies, and it had the right to change the annuitant. (Doc. 66 at 18; Doc. 80 at 13, 15; Ex. 22-V.)

Thus, in contrast to the situation in the Jones case, when the liability insurers paid to First Executive an amount sufficient to buy annuity policies to cover the deferred payment obligations called for in the Garrett settlement, the liability insurers transferred that money beyond the reach of their general creditors. Since First Executive, not the liability insurers, was the owner of the annuity policies that it subsequently purchased from Executive Life to fund its payment obligations, the annuity policies likewise were not subject to the claims of general creditors of the liability insurers. Since the liability insurers (the obligors) needed do nothing further to cause the future payments to be made to taxpayers, the promise to pay taxpayers' fees with respect to the Garrett settlement was fully funded.

2. We demonstrated above that, even assuming, *arguendo*, that the Tax Court's standard for determining whether a promise ***33** is funded is correct and that the liability insurers (rather than taxpayers' clients) are properly deemed to be the promisors with respect to the promises to pay taxpayers in the future, the promises to pay taxpayers with respect to the Garrett settlement were funded. That is because the liability insurers funded those promises by transferring funds with which to purchase annuity policies to cover such payments to a third party, First Executive, and, thus, beyond the reach of general creditors of the liability insurers. Under that analysis, however, the promises of the liability insurer (Stonewall) to pay taxpayers in the future with respect to the Jones settlement were not funded because, although Stonewall similarly purchased annuity policies to cover the future payments, it retained ownership of the policies and the right to change the annuitants thereunder, and, accordingly, the policies were not beyond the reach of Stonewall's general creditors. As we shall explain below, we believe that there is no rational basis for making such a distinction in the circumstances here, and that the promises to pay taxpayers in the future should be deemed to be funded with respect to both the Garrett *and* the Jones settlements even if the liability insurers are deemed to be the obligors under the promises to pay taxpayers in the future.

To begin with, there is nothing in the language of Treas. Reg. § 1.83-3(e), which defines "property" for purposes of I.R.C. § 83, to require that assets be placed beyond the reach of the promisor's creditors for funding to occur. To the contrary, the second sentence of the regulation, indicating that property ***34** "*includes* a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor" (Treas. Reg. § 1.83-3(e); emphasis added), strongly suggests that funding may also exist where assets are set aside to provide for payment, but not necessarily beyond the reach of creditors. Indeed, in general understanding, the notion that an obligation is funded does not necessarily mean that funds have been placed beyond the reach of the obligor's general creditors. Rather, the term connotes only that a fund has been provided for the payment of the obligation. So far as applicable in the present context, the verb "fund" has been defined as "[t]o provide money for paying off the interest or principal of [an obligation]" (*The American Heritage Dictionary* 539 (2d college ed. 1982)) and "to provide a fund to pay [an obligation]" (*The American College Dictionary* 492 (1970)).[FN10] The term "funded" as used in the context of the regulation obviously is not limited to an actual payment of the obligation. Rather, it describes an investment, an earmarking or appropriation of assets, or a transfer to a third party to arrange or provide for future payment. The 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.

FN10. The noun "fund" is defined as "[a] sum of money or other resources set aside for a specific purpose" (*The American Heritage Dictionary* 539 (2d College ed. 1982)).

***35** We note, in this regard, that the documents of the Garrett settlement use the verb "to fund" in precisely this sense. The release and indemnity agreement in the Garrett case provides that the liability insurers "reserve the right to fund their obligations herein through Executive Life Insurance Company" and that they or their assignees would be the owners of "any annuity policies issued to fund the payments set forth herein" (Ex. 9-I at 10). The assignment and assumption agreement in the Garrett settlement recites that the liability insurers had agreed to buy annuity policies "to assure the ready availability... of funds [with which to pay the amounts called for in the release agreement], to serve as a medium for payment of said funds, and to assure the payment of such funds" (Ex. 10-J at 2), and it requires First Executive to buy an annuity policy "to fulfill its periodic payment obligations" (Ex. 10-J at 4). Similarly, the release and indemnity agreement in the Jones settlement states that Stonewall was to make its "structured payments through annuities purchased from Manufacturers Life Insurance Company" (Ex. 35-AI at 6).

Further support for the position that the obligations here were "funded" is found in I.R.C. § 130, which governs the tax consequences of an amount received for agreeing to a "qualified assignment" of a liability to make periodic payments of personal injury damages. The settlement arrangements here were designed to include "qualified assignments" under I.R.C. § 130, namely the liability insurers' assignment to First Executive of their obligations in the Garrett settlement (Ex. 10-J at 3) and ***36** Stonewall's contemplated assignment to Manulife of its obligations in the Jones settlement (Ex. 35-AI at 10 & Ex. B p. 1). There are various requirements that must be satisfied in order for there to be a "qualified assignment" under I.R.C. § 130, and many of the features of these transactions were shaped by those requirements.

Under I.R.C. § 130(a), the amount received for agreeing to accept a qualified assignment (*i.e.*, the amounts received by First Executive and to have been received by Manulife) is not included in gross income to the extent the amount does not exceed the cost of any "qualified funding asset." A "qualified funding asset" includes "any annuity contract issued by a company licensed to do business as an insurance company under the laws of any State" if the annuity contract "is used by the assignee to fund periodic payments under any qualified assignment" and meets several other requirements. I.R.C. § 130(d). The point of the arrangements here was that the annuities would be "qualified funding assets" used to "fund periodic payments" to the attorneys. Because annuity policies were purchased with which to pay the amounts promised to taxpayers, the promises were "funded" within the meaning of I.R.C. § 130.

The foregoing shows that the promises of the liability insurers in this case (assuming that they are considered to be the promisors here) were “funded” within the ordinary meaning of that term. Further, it shows that the concept of a funded obligation does not necessarily require that the assets with ***37** which the obligation is to be paid be placed beyond the reach of the obligor's creditors.

Thus, absent a statutory or regulatory requirement to do so--and there is no such requirement here--there is no reason to require, in the circumstances of the Jones settlement, that assets be transferred beyond the reach of Stonewall's general creditors before they can be deemed to fund a promise for purposes of I.R.C. § 83. After all, Stonewall is an insurance company. Insofar as pertinent here, Stonewall's undertaking in the Jones settlement was the promise of an insurance company to make specified future payments of money to each of taxpayers. Stonewall took funds sufficient, if properly invested, to produce a stream of funds in the amount of its payment obligations to taxpayers and invested them in annuity contracts from a different insurance company-- Manufacturers Life--to provide for the payments to taxpayers. *See* Rev. Rul. 79-220, 1979-2 C.B. 74, 75 (insurance company's purchase of annuity contract in amount of annuity it agreed to pay to claimant of damages from its insured was merely an investment to provide source of funds to satisfy obligation to damage claimant). To be sure, since Stonewall remained the owner of the annuity policies, the annuities were not removed from the reach of its general creditors. But if Stonewall had made a qualified assignment of its payment obligations to Manulife, as had been contemplated, then Manulife would have been the owner of the Manufacturers Life annuities, and although the annuities would then be beyond the reach of Stonewall's general creditors, they would be within the reach of ***38** the creditors of Manulife. (*See* Ex. 35-AI at Ex. B.) It makes no sense, in the circumstances here, to require that the promise to pay of one insurance company be substituted for that of another in order for taxpayers to have received property for purposes of I.R.C. § 83.

Moreover, it would be particularly illogical, even if Stonewall is deemed to be the promisor, to require that funding assets be transferred beyond the reach of Stonewall's creditors in order for Stonewall's promise to be funded, because here Stonewall was not the recipient of the services for which taxpayers were being paid. In the compensation-related area of qualified pension plans, for example, the allowance of favorable tax treatment only for pension funds that are not held by the employer is designed to insure that the funds will actually benefit the employees concerned. *Trebotich v. Commissioner*, 492 F.2d 1018, 1023-1024 (9th Cir. 1974). It has similarly been held that, for a plan to be funded within the meaning of other ERISA provisions, the assets set aside to fund the plan must be separate from the general assets of the employer (*Dependahl v. Falstaff Brewing Corp.*, 653 F.2d at 1214 (considering whether a plan was unfunded within the meaning of 29 U.S.C. § 1003(b)(5))):

Funding implies the existence of a *res* separate from the ordinary assets of the [employer] corporation. All whole-life insurance policies which have a cash value with premiums paid in part by corporate contributions to an insurance firm are funded plans. The employee may look to a *res* separate from the corporation in the event the contingency occurs which triggers the liability of the plan.

Since Stonewall was not the employer of or recipient of services from taxpayers, there is no policy end to be furthered ***39** by imposing the requirement that Stonewall transfer assets beyond the reach of its general creditors in order for its promises to make deferred payments in connection with taxpayers' performance of services to be funded. We submit, therefore, that where, as here, an insurance company that is not the recipient of services from its promisees sets aside funds to provide sufficient money with which to make the promised future payments, the insurance company's promise is funded within the meaning of Treas. Reg. § l.83-3(e), and therefore is property for purposes of I.R.C. § 83, even if such assets are not beyond the reach of the insurer's general creditors. Stonewall's purchase of annuity contracts from Manufacturers Life represents such a setting aside, and Stonewall's undertaking to pay taxpayers thus could not more clearly be “property” for purposes of I.R.C. § 83. The term “property” used in I.R.C. § 83 is broader than the definition of that term set forth in Treas. Reg. § 1.83-3(e), and there is no policy purpose to be served in according the regulation a reading narrower than its language requires.

***40** CONCLUSION

For the reasons set forth above, the decisions of the Tax Court should be reversed and the consolidated cases remanded to the Tax Court for further proceedings.

Appendix not available.

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 17110345 (C.A.11) (Appellate Brief)

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