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, Petitioner-Appellee,

v.

Commissioner of Internal Revenue, Respondent-Appellant.

Ben B. Philips, Petitioner-Appellee,

v.

Commissioner of Internal Revenue, Respondent-Appellant.

No. 95-8762.

November 24, 1995.

On Appeal from the Decisions of the United States Tax Court

Brief of Petitioners-Appellees Childs

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***III STATEMENT REGARDING ORAL ARGUMENT**

The taxpayers submit that the issues in this appeal can be addressed adequately in the briefs without oral argument. However, the taxpayers wish to participate in any oral argument that is scheduled either in their case or the related cases.

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

Taxpayers adopt the argument and citation of authority in the brief for Petitioners-Appellees John C. Swearingen, Jr. and Suzanne N. Swearingen, and Ben B. Philips.

***2 STATEMENT OF JURISDICTION**

This is an appeal by the Commissioner from an adverse decision rendered by the Tax Court. This Court has jurisdiction over this appeal pursuant to I.R.C. §7482(1986)

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***3 STATEMENT OF THE ISSUES**

1. Whether the contractual rights of the taxpayers to receive future periodic payments for services rendered constitute I.R.C. Section 83 property.

2. If so, whether any I.R.C. Section 83 property was transferred to the taxpayers.

***4 STATEMENT OF THE CASE**

A. Course of Proceedings and Disposition in the Court Below

The Commissioner determined that the amounts paid for annuities to facilitate future promised payments should have been included as income in the taxpayers' return in each year the annuities were purchased under I.R.C. § 83. The taxpayers filed a petition in Tax Court (Doc. 3), and after trial, the Tax Court held that the promises of future payments and the annuities purchased to facilitate such payments do not constitute Section 83 property (Doc. 80, p. 2). The Commissioner filed this appeal from that decision.

B. Statement of the Facts

The taxpayers/attorneys, including Richard A. Childs, who practiced individually and together in a professional corporation at that time (Doc. 66, p. 2; Doc. 80, p. 2, 4), represented a family of claimants in two related personal injury actions arising out of an explosion and fire in the family's home, which severely injured the minor son, Garrett, and killed his step-father, Jones (Doc. 66, p. 2; Doc. 80, p. 4). Attorney fees were contracted on a contingency fee basis of thirty-three and one-third percent of any recovery before trial, and forty percent of any recovery after trial with the attorneys to receive nothing until and unless a recovery was made (Doc. 66, p. 3, 4; Doc. 80, p. 5-6; Ex. 1-A).

***5** Mrs. Jones, acting on behalf of herself, her minor child, Garrett, and the estate of her deceased husband, Mr. Jones, as appropriate, was the responsible plaintiff in each of the cases (Doc. 66, p. 4). Each case was settled prior to trial after protracted negotiations between the attorneys, primarily Philips, and a structured settlement specialist hired by the liability carriers (Doc. 66, p. 5-8; Doc. 66, p. 19-21). The settlements were embodied in settlement documents that provided in part for the structured payment of attorney fees separately by the liability carriers who could and did purchase annuities to facilitate the agreed upon future payments.

A Release and Indemnity Agreement among all the parties, as part of other settlement documents, was executed in each case, both of which for various reasons contained similar, but not identical, provisions. Pertinent specifics of the settlement of each case are set forth below.

1. The Garrett Litigation

The Garrett litigation was initiated by Mrs. Jones on behalf of Garrett and herself to recover damages for the personal injuries sustained by Garrett (Doc. 66, p. 2).

Under the Garrett Release and Indemnity Agreement, the liability carriers for the defendant agreed to make both lump sum and structured payments in accordance with a payment schedule set forth therein to the claimants and the attorneys (Doc. 66, p. 8). The structured payments were to be ***6** made or paid through annuities purchased from Executive Life Insurance Company ("Executive Life"), who was to assume direct responsibility for the structured payments; however, Georgia Casualty and Stonewall Insurance remained responsible for the struc-

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tured payments on a pro rata basis consistent with the premiums paid by each company (Doc. 66, p. 9).

The Agreement provided that Georgia Casualty and Stonewall would not segregate or set aside specific assets to fund any payments required by the Agreement, and that the claimants were general creditors of the insurance companies (Doc. 66, p. 10). The Agreement further provided that “no payments... shall be accelerated, deferred, increased or decreased by the [claimants]...” (Doc. 66, p. 10).

The Agreement further provided that Georgia Casualty and Stonewall Insurance could make a “qualified assignment”, within the meaning of I.R.C. § 130(c) and 104(a)(2), of their payment obligations under the Agreement to First Executive Corporation (“First Executive”), the sole shareholder of Executive Life, but such assignment would not discharge the liability of Georgia Casualty or Stonewall, and 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. 66, p. 11)

The Release and Indemnity Agreement also provided:
***7** “Neither the lawful guardian of Jermeral C. Garrett, Jermeral C. Garrett nor his heirs, beneficiaries or assigns shall have the right to accelerate, commute or otherwise reduce to present value the payments scheduled herein; nor shall they have the right to transfer, assign, anticipate, mortgage or otherwise encumber in advance any payment or part of any payment due herein.” (Doc. 66, p. 12)

The Agreement did not become effective until ratification by the Circuit Court of Russell County, Alabama (which was required by the laws of the State of Alabama because Garrett was a minor) on April 25, 1986 (Doc. 66, p. 14).

In April 1986, a separate Assignment and Assumption Agreement was executed by the parties to facilitate the assignment to First Executive (Doc. 66, p. 12-13; Ex. 9-I). The Assignment and Assumption Agreement provided,
“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.” (Doc. 66, p. 14)

First Executive retained the right to change the annuitants (Doc. 66, p. 18) on the annuity contracts issued by its subsidiary, Executive Life. 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. ***8** Thereafter, the liability carriers were called upon and made the payments that were not made by Executive Life under the annuity contracts (Doc. 66, p. 19).

2. The Jones Litigation

The Jones litigation was filed to recover for the wrongful death of Jones. It was resolved in 1987 by execution of a Release and Indemnity Agreement, which also provided for lump sum and structured payments to the clients and attorneys (Doc. 66, p. 21; Ex. 35 A-l). All claims against the primary defendants were released (Doc. 66, p. 21). Structured payments were to be made through annuities purchased from Manufacturers Life Insurance Company (“Manufacturers Life”) (Doc. 66, p. 22).

Stonewall Insurance was entitled to make a “qualified assignment” under I.R.C. § 130(c) of its obligations to

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make future and structured payments to Manulife Service Corporation ("Manulife"), who would become directly responsible for the structured payments (Doc. 66, p. 23; Ex. A to Ex. 35-AI).

A Qualified Assignment and Consent Agreement followed which allowed Stonewall Insurance to assign to Manulife its obligations to make structured payments was executed by Mrs. Jones (Doc. 66, p. 24). It provided that she had no rights against Manulife greater than those of a general creditor, that Manulife could purchase an annuity policy to satisfy its obligations to make structured payments which would be the sole property of Manulife, and Mrs. Jones would have no right or interest therein (Doc. 66, p. 24).

***9** Under the Release and Indemnity Agreement, Stonewall Insurance remained obligated as a guarantor to the extent that the future periodic benefits were not first satisfied by Manulife (Doc. 66, p. 24).

The Release and Indemnity Agreement further provided that,
"No party receiving future periodic or structured payments hereunder shall have the right to accelerate, commute or otherwise reduce to present value the payments scheduled herein; nor shall any party have the right to transfer, assign, mortgage or encumber in advance any scheduled payments set forth herein." (Doc. 66, p. 25)

Stonewall Insurance purchased annuity policies to fund the periodic payments to the attorneys (Doc. 66, p. 25, 26). The attorneys were named as the annuitants, but Stonewall was the owner of each and retained the right to change the annuitant (Doc. 66, p. 26-28; Doc. 80, p. 19-20; Exs. 42-AP, 43-AQ, 44-AR).

The taxpayers reported as income in the years of settlement only the amounts of the structured payments they actually received.

C. Standard of Review

The standard for review is whether the Tax Court erred in formulating or applying a rule of law.

*10 SUMMARY OF THE ARGUMENT

For I.R.C. Section 83 to apply, there must be Section 83 property, and it must be transferred to the service provider. Section 83 property does not include an unfunded promise to pay. A promise to pay is unfunded unless assets are set aside by the promisor which are beyond the reach of the promisor's creditors, and the promisee receives some vested, nonforfeitable right in such assets. This was the definition adopted and correctly applied by the Tax Court to the facts in this case.

The taxpayers received only a promise to be paid in the future, which, along with the annuities that were purchased by the insurers to facilitate payment, could not be assigned, accelerated, transferred, reduced to present value, or seized by the taxpayer's creditors. The taxpayers received only the rights of a general, unsecured creditor. The annuities remained subject to claims of the insurer's creditors, and the insurer remained liable for the promised payments if the annuities failed.

This does not constitute funding in the Jones litigation because the annuities were not set aside beyond the reach of the insurer's creditors, and the taxpayers received no vested, nonforfeitable rights of any kind in the annuities or any other asset. Funding did not occur in the, Garrett litigation, although the annuities were placed beyond the creditors of the liability insurer, because the ***11** taxpayers received no vested, nonforfeitable rights in these annuities or any other asset. This is true in both cases regardless of the identity of the Section 83 transferor or transferors. Section 83 applies to third parties as well as the service recipient.

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If Section 83 property was created, this property was not transferred to the taxpayers because they did not incur the risk of loss of a beneficial owner as required by Section 83 regulations, which said risk was retained by the insurers through the continuing obligation to pay, even if the annuities failed.

Reduced to their essence, the arguments of the Commissioner are that the mere promise of a third party obligor, especially an insurance company (as opposed to the service recipient) to pay the service provider for services rendered, should of itself constitute Section 83 property, and the mere segregation or designation of an asset for payment purposes by the third party obligor or the service recipient should constitute funding of a promise under Section 83, even if the asset is not set aside beyond the reach of creditors or vested in the recipient. These arguments fail to meet the minimum requirements enumerated in Section 83 and the regulations issued under it, and disregard the holdings of applicable case law, cases in related areas, and even the Commissioner's own formulation of the economic benefit doctrine. Moreover, the adoption of these propositions would constitute an unwarranted intrusion into basic principles of cash method accounting.

The decision of the Tax Court was correct and should be affirmed.

***12 ARGUMENT AND CITATIONS OF AUTHORITY**

THE TAX COURT CORRECTLY HELD THAT THE CONTRACTUAL RIGHTS OF THE TAXPAYERS TO RECEIVE FUTURE PERIODIC PAYMENTS AND THE ANNUITIES PURCHASED BY THE OBLIGORS TO FACILITATE THESE PAYMENTS DO NOT CONSTITUTE I.R.C. SECTION 83 PROPERTY

A. I.R.C. Section 83

Relying on early opinions formulating the common law economic benefit doctrine such as *Commissioner v. Smith*, 324 U.S. 177 (1945) and *E.T. Sproull v. Commissioner*, 16 T.C. 244 (1951), in 1966, prior to passage of Section 83, general counsel defined the economic benefit doctrine as follows:

The principle generally known as the "economic benefit" doctrine delimits one form of property the fair market value of which must be included in gross income. Pursuant to this 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 such a fund is "vested" if it is nonforfeitable. Gen. Couns. Mem. 33733 (Nov. 21, 1966).

In 1969, Congress passed I.R.C. § 83 which applies the economic benefit doctrine to the area of compensation for services rendered. Section 83, ***13** which applies only to payment for services, embodies the common law concepts to varying degrees, but utilizes different terminology.

Section 83 provides in pertinent part:

(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 having the beneficial interest in such property are transferrable 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

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a substantial risk of forfeiture, whichever is applicable.

For Section 83 to apply, there must be (1) Section 83 property, (2) transferred to the service provider, (3) in exchange for services rendered. If these requirements are met, (a) the fair market value of this property if ascertainable (b) ***14** is taxable when either (i) the property is transferred or (ii) not subject to a substantial risk of forfeiture.[FN1]

FN1. This brief addresses only the first two requirements for the economic benefit doctrine of Section 83 property and transferability. The concept of transferability is discussed because it is related to funding for Section 83 property purposes. Because the Tax Court determined that there was no Section 83 property, it did not address the other Section 83 requirements.

B. The Promises of Future Payment and/or the Annuities That Were Purchased Do Not Constitute Section 83 Property.

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. Conversely, it does include a funded promise to pay.[FN2] It also includes a beneficial ownership interest in assets which are transferred or set aside from the claims of creditors of the transferror in a trust or escrow account, Treas. Reg. §1.83-3(e).

FN2. The Commissioner does not contend that the promises to pay annuities are secured. The Tax Court found they were not, Doc. 80, p. 27-28.

Section 83 specifically encompasses the transfer of property *from anyone* for the rendering of services. I.R.C. Section 83 "applies to a transfer of ***15** property in connection with the performance of services even though the transferor is not the person for whom such services are performed," Treas. Reg. §1.83-1(a)(1). See *also Adair v. Commissioner*, 50 T.C. 620, 627 (1950). The definition of property remains the same regardless of the identity of the transferror.

Although the Code section and the regulations do not define the term "funded" as used in 1.83-3(e), funding occurs when assets are set aside by the obligor which are beyond the reach of the obligor's creditors, and the transferee receives some vested, non-forfeitable right in the assets that are set aside, *Centre v. Commissioner*, 55 T.C. 16 (1970); *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985); Gen. Couns. Memo 33733, *supra*.[FN3]

FN3. The funding test applied by the Tax Court, although worded differently, contains these essential elements, he Tax Court stated, "[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." The Commissioner's objection to this test is addressed later in this brief.

***16** Permeating this concept of "funded" is the principle that the transferee must receive at least a certain amount of rights of some kind in the fund for an economic benefit to arise, see *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983); *Davies. a Model for Corporate Income Tax*, 124 U.Pa.L.Rev. 299, at 321 (1975); *Midgley Federal Income Taxation of Private Annuitants*, 406 Geo.Wash. L.Rev., 679, at 689 (1972).

The purchase of an annuity for the convenience of the obligor to pay contractually promised periodic future pay-

ments does not constitute "funding" of the promise or a "fund" to which the promisee has a vested interest. In Rev. Rul. 72-25, 1972-1 C.B. 127, an employer purchased an annuity contract to fund the payment of a deferred compensation liability to an employee who had the right to receive deferred compensation payments. The employer was the applicant, owner and beneficiary of the annuity contract, and it was subject to the claims of general creditors. The employee had no interest in the annuity contract. Under the deferred compensation arrangement, no escrow account or trust fund was created, and assets were not segregated by the employer to the employee. The employee's benefits under the agreement could not be sold, transferred, assigned or pledged. The Commissioner concluded that since the employee has no present interest in the account, or in the annuity contract, the deferred compensation is includable in the employee's income in the year in which the ***17** payments are received or otherwise made available, and not in the year of the purchase of the annuity.

In *Centre v. Commr.*, 55 T.C. 16 (1970), upon which the Tax Court relied, the employer purchased life insurance on the employee to fund future compensation payments. The insurance remained an asset of the employer subject to the rights of its creditors and the employee acquired no immediate rights thereto. The Court held that the amount spent to procure the insurance was not taxable to the employee who "still has only a contract right to his deferred compensation", 55 T.C. at 20. Taxation occurred only when the employee received the policies because the employee had no vested rights in them prior to that time.

In Rev. Rul. 79-220, 1979-2, C.B. 74, the Commissioner recognized that the purchase of an annuity by an obligor to defray future promised payments does not constitute funding under the economic benefit doctrine in a factual scenario that is analogous if not identical to the facts in this case.[FN4] The taxpayer ***18** initiated a damage claim against the defendant. Before trial, the claim was settled by a lump sum payment and the promise of the defendant's liability carrier to make future monthly payments. The defendant's liability carrier purchased an annuity from another insurance company to provide a source of funds to defray these payments. The insurance carrier remained obligated for the payments. The question was whether the interest portion of the promised monthly payments could be excluded under I.R.C. § 104(a)(2) of the Code, which depended in part on whether the claimant had the economic benefit of the discounted present value of the periodic payments. Thus, the Commissioner was called upon to decide whether the economic benefit doctrine applied to all the payments even though I.R.C. § 104(a)(2) excluded the principal amounts from taxation. Relying on Rev. Rul. 72-25, the Service ruled that the purchase of the single premium annuity contract by the insurer from another insurance company was merely an investment by the purchaser to provide a source of funds to satisfy its obligations which did not give rise to an economic benefit.

> FN4. The Commissioner cites this ruling ostensibly in support of its argument that the annuities do not have to be transferred beyond the reach of the obligor's creditors to constitute funding, see Commrs. Br., p. 37. This ruling implies the exact opposite conclusion.

The exclusion from gross income provided by section 104(a)(2) of the Code applies to the full amount of the monthly payments received by *A* in settlement of the damage suit because A *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*, If *A* should die before the end of 20 years, the payments made to *A's* estate under the settlement agreement are also excludable from income under section 104. [Emphasis added.]

***19** A similar decision was reached by the Commissioner in Rev. Rul. 79-313, 1979-2 C.B. 75 which involved periodic payments promised by the insurer in a personal injury settlement who was not required to purchase an

annuity to fund these payments.

In *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985), a physician was practiced medicine pursuant to an agreement with a county health care providing corporation whereby the physician agreed to render medical services to the subscribers of the plan in exchange for scheduled fees. After the execution of the agreement, the corporation adopted a deferred compensation plan for participating physicians which the physician joined by supplemental agreement. The physician elected to receive only a portion of the scheduled fee with the balance to be contributed to the trust in which the physicians were the trustees established under the deferred compensation plan. A separate account was maintained for each physician, and the trustees purchased annuities to fund the payment of benefits under the plan. Benefits were payable for death, disability, or if the physician left the service area to practice elsewhere.

The Court cited example 3 of Rev. Rul. 60-31, 1960-1 C.B. 179, outlining the parameters required for economic benefit. Couching its analysis in terms of current valuation (which is one of several terms that the courts have used to wrestle with the confusing and conflicting terminology), the court concludes that ***20** an economic benefit is capable of evaluation only where there is a contribution to a deferred compensation plan which is nonforfeitable, fully vested in the employee and secured against the employer's creditors by a trust arrangement. Citing 26 C.F.R. §1.83-3(e), the Court stated that, "if 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.

It should be noted that in giving effect to the trust language that made the employer the beneficiaries of the trust, although the physicians were the trustees, the court refused to apply a "substance-over-form" or other similar restructuring analysis. Since there was no evidence that the arrangement was anything other than an arms length bargain, the court honored its key terms.

In *Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983), the Court found that there was an absence of funding under facts that are more favorable to the Commissioner than those in the present case because the taxpayer in *Reed* had the right to assign future payments.
The Commissioner next contends that in 1973 Reed received a taxable economic benefit by virtue of Cvengros' deposit of the sales proceeds into the escrow account. The Commissioner argues that upon the December 27, 1973 closing, there were no open transactions remaining and Reed's right to future payment from the escrow account was irrevocable, being conditioned only upon the passage of time; hence, Reed received the "cash equivalent" of the sales proceeds deposited in the escrow account. The Commissioner ***21** points out that Reed could have assigned his irrevocable right to receive future payment of the escrow funds.
This argument, which was largely embraced by the Tax Court, is predicated upon a misapplication of various cases the Commissioner says espouse the economic benefit doctrine. See Kuehner v. Commissioner, 214 F.2d 437, 440-41 (1st Cir. 1954); Williams v. United States, 219 F.2d 523, 527 (5th Cir. 1955); Watson v. Commissioner, 613 F.2d 594, 597 (5th Cir. 1980); Oden v. Commissioner, 56 T.C. 569, 575 (1971); Pozzi v. Commissioner, 49 T.C. 119 (1967). These cases held that escrow arrangements were ineffective to defer income tax because of the existence of one of two factors, not present in the instant case: (1) the taxpayer received some present, beneficial interest from the escrow account; see Kuehner, 214 F.2d at 440 (investment income); (2) the escrow arrangement was the product of the taxpayer's self-imposed limitation on funds the taxpayer had an unqualified, vested right to control. See Williams, 219 F.2d at 526-27 (escrow was self-imposed limitation); Oden, 56 T.C. at 577 (same). *Reed*, *supra,* at 145-146

In the cases where the courts have determined that funding occurred, the courts have always found that the bene-

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ficiary received some present, nonforfeitable interest in the asset that was set aside by the obligor, see *Ward v. Commr.*, 159 F.2d 502 (2nd Cir. 1947); *U.S. v. Drescher*, 179 F.2d 863 (2nd Cir. 1950); *Goldsmith v. U.S.*, 586 F.2d 810 (Ct. Cl. 1978); *Genshaft v. Commr.*, 64 T.C. 282 (1975); *Drysdale v. C.I.R.*, 277 F.2d 413 (6th Cir. 1960); *Frost v. Commr.*, 52 T.C. 89(1969).

***22** The requirement of a vested right for funding is also recognized in related areas. In *Belskey v. The First National Life Insurance Company*, 818 F.2d 661, (8th Cir. 1987), the 8th Circuit was called upon to determine whether an executive compensation plan was funded for ERISA purposes.[FN5] The employer established a deferred compensation plan pursuant to which it paid sums to a bank. The bank was required to purchase certain insurance policies on lives of plan members, but the plan members had no rights in the policies. Distinguishing the case *of Dependahl v. Falstaff Brewing Corp.*, 653 F.2d 1208, (8th Cir. 1981) which involved a plan where the policies were assignable to participants under certain conditions, the Court held that the cash value of the insurance policies simply became a general, unpledged, unrestricted asset of the bank, which in turn could be used to fund the plan but did not constitute a separate fund. The Commissioner acknowledges that “Rabbi Trusts” are unfunded precisely because the trust assets remain subject to the employers creditors, see Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).[FN6]

FN5. Employee Income Retirement Security Act of 1974, 29 U.S.C. 1003, *et.seq*.

FN6. This letter ruling incorporates verbatim the General Council's formulation of the economic benefit doctrine, see Gen. Couns. Mem., *supra*. This formulation has been described as the most detailed analysis of the Treasury's position on the economic benefit doctrine that is available, see *Cooper. The Economic Benefit Doctrine: How An Unconditional Right To A Future Benefit Can Cause A Current Tax Detriment*, 71 Marquette Law Review, 1988.

***23** In the Jones and Garrett claims, the defendant's insurer agreed to make periodic payments to the taxpayers. In the Jones litigation, the insurer purchased annuities from another insurance company to provide a source of funds for these payments. The insurer was the owner of these annuities, and the annuities were subject to the claims of the insurer's creditors. The insurer remained liable for these payments after the purchase of the annuities. The insurer had a right to change the beneficiaries of the annuity policies or do anything else with respect to them without any violation of its contractual rights. The taxpayers are contractually prohibited from selling, transferring, assigning, pledging, or otherwise encumbering in any way the contractual rights or the annuities. They cannot increase or decrease the payments or alter payment times. These rights are solely those of a general, unsecured creditor. Thus, in the Jones litigation, the promises to pay are not funded because the annuity is subject to the creditors of the obligor, and the taxpayers received no vested or nonforfeitable interest in the annuities.

***24** In the Garrett litigation, the liability insurer paid a subsequent insurer to assume its contractual payment obligations, and the subsequent insurer purchased the annuities to which, as in the Jones litigation, the taxpayers had no rights. While the amounts paid to the subsequent insurer may be beyond the creditors of the liability carrier, they still remain unvested as to the taxpayers. While the first and second requirements of the definition of funding (setting aside an asset beyond the reach of creditors) may be satisfied in the Garrett litigation, the remaining requirement of a vested, nonforfeitable right to taxpayers is not.

The Commissioner disputes this definition as applied by the Tax Court when the Section 83 service recipient and the transferor are different and argues that the promise of a third party transferor should be deemed funded

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under Section 83 even if the funding asset is not beyond the reach of the third party transferor's creditors, and presumably (since the Commissioner did not address this aspect of the funding test), even if the service provider receives no vested rights in whatever asset constitutes the fund. In such a case, according to the Commissioner, the mere “earmarking” of some asset or segregating it for this particular purpose such as depositing money into a savings account or simply making an accounting entry should constitute funding, Commrs. Br., p. 18, 34, 35. (Factually, however, this was not done (Doc. 66, p. 10)). The Commissioner finds support for this proposition in the use of the word “includes” in the portion of Treas. Reg. § 1.83-3(e) which provides that Section 83 property “includes a ***25** beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor.” Commrs. Br., p. 34.

This argument is fallacious for a number of reasons. To construe the phrase “includes assets set aside from the reach of the transferor's creditors” to imply that it also includes assets that are not set aside from the transferor's creditors is prima facie absurd.[FN7] Perhaps the focus of the construction is on the word “transferred,” but this term has to mean that the funding asset is given over or assigned to the service provider which is something more than being set aside beyond the claims of creditors, not less. It also is irreconcilable with the definition of funding that has been adopted by the General Council and the Commissioner on many prior occasions, and by practically every court that has considered the issue. It is logically inconsistent with the rule that Section 83 applies to transfers to a service provider from anyone regardless of whether or not the transferor is the service recipient. It leads to two different definitions of Section 83 property ***26** depending on the identity of the transferor;[FN8] and finally, the adoption of a different test when the Section 83 transferor is not the service recipient would negate the basic tenet of cash method accounting that the taxpayers must actually or constructively receive something[FN9] before a taxable event occurs because the promise of the third party to pay for services rendered, regardless of form and structure, would always be taxable when made.

FN7. A general rule of statutory construction is that an inclusive phrase followed by examples includes things of the same class, see *Berniger v. Meadow Green-Wildcat Corp.*, 945 F.2d 4 (1st Cir. 1991). Here, the Commissioner argues that it includes the exact opposite of the examples.

FN8. The Commissioner suggests that the set aside requirement is particularly nonsensical when the third party transferor is an insurance company, Commrs. Br. p. 18-19, 37, 38-39, because its promise alone can constitute a fund. An insurance company does not occupy special status under § 83. Any asset with value can constitute a fund including an insurance policy, but only if it is treated in such a way to meet the funding test. *Compare Belskey*, *supra.,* with *Dependant*, supra. The annuities do not meet the funding test in this case, and the fact that they were issued by an insurance company does not change this result.

FN9. I.R.C. § 451; Treas. Reg. 1.451-2(j)

The Commissioner further argues that the Tax Court misapplied this funding test by focusing on the insurance carrier, Commrs. Br., p. 24-26, rather than the service recipient as the Section 83 transferor. The transactions that occurred according to the Commissioner “are analytically no different from the ***27** 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 fees to taxpayers in future installments and then delivering the annuity contracts to taxpayers.” Commrs. Br. p. 25-26.

This is a constructive receipt argument which the Commissioner lost at trial and abandoned here, but now sur-

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reptitiously seeks to graft onto the provisions of Section 83. Such an analysis is inapplicable for all the reasons that constructive receipt is inapplicable.[FN10] The agreement between all the parties was made prior to the time that the clients had any obligation to pay anything to the attorneys and prior to the time that the attorneys had the right to receive anything from the clients. The only rights of the taxpayers are those set forth in the assignment agreements. The taxpayers had no right to receive any payment for their services until these agreements became effective, and the amounts they could receive as well as the timing of the receipt are set forth therein. The taxpayers never had the right to receive immediate payment which they somehow ***28** deferred, and no fund or liability or anything of this nature was set aside for them or set aside for their clients from which they could draw at a time of their choosing or their clients could use to buy an annuity.

FN10. The requirements for and limitations on constructive receipt are generally known and well accepted. See *for example* Treas. Reg. § 1.451-2(a); *Avery v. Commr.*, 292 U.S. 210 (1934); *Howard Veit*, 8 T.C. 810 (1947); *Cowen v. Commr.*, 32 T.C. 583 (1959).

The Court found no evidence that would remotely suggest that the clients received the money, then purchased the annuity policies for the taxpayers.[FN11] Assuming for argument purposes only, however, that this did occur, these annuities so purchased clearly were not then "delivered" to the taxpayers because as the Court found the taxpayers received only the very restricted right to receive future payments. Also assuming for purposes of argument that the clients were Section 83 transferors, so that there were multiple transferors, or the clients were the only transferors, the only rights that the clients received that they could then transfer to the taxpayers were unfunded, unsecured contractual rights to receive periodic payments in the future. They could not transfer more than they had. While the settlement agreements may have relieved a future obligation that the clients otherwise may have had, it did not provide to the taxpayers anything more than the unfunded promises of others for future payment. The "vested" ***29** prong of the funding test was not met regardless of who the Section 83 transferors were.

FN11. The Tax Court specifically found as a matter of fact that the taxpayers had no right to receive fees until "recovered" by their clients which did not occur until the subsequent settlements had been agreed upon, Doc. 80, p. 32.

The Commissioner implies throughout its brief that funding occurred because either the clients or the liability carriers did everything required of them to cause future payments to be made to the taxpayers, see Commrs. Br., p. 27, 32. This assertion adopts the rationale of Rev. Rul. 69-50, 1969-1 C.P. 140 (taxation resulted to physician because patients did everything required to satisfy their obligations to physician by contracting with an insurance company to pay fees); and, Rev. Rul. 77-420, 1977-2 C.P. 1972 (result is the same even if payment to physician subject to substantial restrictions), but the Commissioner does not cite these rulings. In Footnote 1 of *Minor*, *supra,* the Court noted that these Revenue Rulings were inapplicable to the economic benefit doctrine because the physician constructively received the income prior to the transfer. This assertion is factually inaccurate as to the liability carriers because they remained liable for payment of the fees even after they contracted for the purchase of annuities. Moreover, whether the client had done everything required to facilitate future payments to the attorneys relates only to the set-aside aspect of the funding test, if it has any relationship to the test at all.

In both cases, the taxpayers did not receive Section 83 property.

*30 C. There Was Not a Transfer of Section 83 Property

If Section 83 property exists, there must be a transfer of it to be taxable. An essential factor necessary for there

to be a transfer of Section 83 property is that the transferee incurs the risk of a beneficial owner that the value of the property at the time of transfer will not decline substantially. The term "beneficial owner" implies that one has to receive some of the benefits and incur the detriments as if he were the owner. The exact terminology of Treas. Reg. §1.83-3(a)(6) provides:
(6) Risk of Loss. An indication that no transfer has occurred is the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially. Therefore, for purposes of this (6), risk of decline in property value is not limited to the risk that any amount paid for the property may be lost.

This regulation is not couched in terms of whether the transferor or service recipient is relieved of liability, but whether the *transferee* bears the risk that the property will decrease in value. That the transferor may have satisfied its obligations through this arrangement is irrelevant. Did the transferees (i.e. the taxpayers) incur the risk that the value of the property at the time of transfer will decline substantially? The answer under any or all of the facts can only be no. The primary insurer, Georgia Casualty, in the first action, and Stonewall Insurance Company in the second, remained liable as guarantors on the promises they ***31** made. They remained the owners of the annuities and those ownership rights remained subject to their general creditors. They remained obligated to fulfill the promises of periodic payments even if the annuities failed to pay, and the taxpayers incurred no risk that the periodic payments would not be made even if the annuities failed. The settlement documents specifically provided for the contingency that the annuities may fail, and left the burden of this possibility on the insurers. Indeed, Executive Life, the annuity issuer under the 1986 settlement, did in fact fail, and Georgia Casualty incurred the detriment for that failure.

In this case, the taxpayers received only a promise to be paid. Under Georgia law, this constitutes a chose in action. A chose in action is a right to recover a debt through an action in Court, *Kilgore v. Buick*, 229 Ga. 445, 192 S.E.2d 256 (1972); *Greenwood v. Greenwood*, 178 Ga. 605, 173 S.E. 858 (1934). A chose in action (or right to bring a claim) is not an ownership interest. It does not rise to a sufficient level under Georgia law for a lien to attach, and it cannot be obtained by a judgment-creditor except through garnishment of the promisor, *Kilgore*, *supra*.

In the present case, the parties to the Garrett and Jones litigation, including the taxpayers, executed at arm's length documents of settlement that delineated and defined their rights. As a result of those documents, the taxpayer received only a right to receive from the defendants periodic payments over a ***32** period of years, which is not an ownership interest. The defendant insurance company exercised its rights to provide for these payments through the purchase of annuity contracts from a third party insurer and retained the rights of ownership. The retention of the ownership rights deprived the taxpayer of an ownership interest of any kind or a beneficial interest that is akin to an ownership interest. Even after the annuity policies were purchased, the defendant insurers remained liable for the periodic payments. This fact negates a transfer of the risk of loss to the taxpayers. Under the authorities cited above, if Section 83 property does exist in this case, there has been no transfer of it.

D. The Application of Section 83 to This Case Would Create an Unwarranted Extension of the Economic Benefit Doctrine

The Commissioner's basic argument to support funding of the promises to pay can be distilled into two related propositions which the Commissioner urges this Court to adopt. The first is that the mere promise of a third party to pay the provider for services rendered to the recipient constitutes a funded promise under Section 83. The second, and related proposition, is that the creation or mere designation of an asset by the service recipient

or a third party to defray the promised monthly payments constitutes funding under Section 83.

Aside from the failure of these propositions to meet the minimum requirements enumerated in the Section 83 regulations, applicable case law, and ***33** even the Commissioner's own formulation of the economic benefit doctrine, their adoption would create an unwarranted revision of the principles of cash method accounting.

The series of cases that validate the right of a taxpayer to agree to structured payments prior to the time that payment is due, see for example, *Amend v. Commissioner*, 13 T.C. 178 (1949); *Veit v. Commissioner*, 8 T.C. 810 (1947); *Robinson v. Commissioner*, 44 T.C. 20 (1965); and, *Charles B. Schniers*, para. 69.39 P-H T.C., or that avoid acceleration of taxation to the current year on contractual periodic payments revised by contractual novation, see *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953; *Commissioner v. Olmstead Incorporated Life Agency*, 304 F.2d 16 (8th Cir. 1962), mitigate against the extension of the economic benefit doctrine to the factual pattern of this case. Although these various cases rarely refer to economic benefit per se, they present factual overtones that IRS pronouncements deem pertinent to an economic benefit analysis (including some factors in this case). For example, in *Olmstead* when the insurance company and the agent revised the contract so that the agent could receive periodic payments over a different time period, the company also issued its annuity to the agent to fund the payments. Unless the historical requirements of the economic benefit doctrine are retained, practically every transaction relating to the extension of credit for services rendered other than accounts receivable would be taxable, see *Davies. A Model of Corporate Income Taxation*, *supra*. The ***34** doctrines of constructive receipt and cash equivalency would be rendered meaningless in analogous circumstances. Taxpayers would lose the often affirmed and well recognized benefits of tax planning and minimization. As stated in *Minor* , *supra,* and *Reed*, supra, it is more appropriate to consider a case of this type under constructive receipt and/or cash equivalency. The cash equivalency doctrine was not raised, and constructive receipt, as the Commissioner agrees, does not apply.

***35 CONCLUSION**

Based on facts as found by the Tax Court which are undisputed, and the application of pertinent legal authority as argued herein, the decision 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, Petitioner-Appellee, v. Commissioner of Internal Revenue, Respondent-Appellant. Ben B. Philips, Petitioner-Appellee, v. Commissioner of Internal
1995 WL 17110344 (C.A.11) (Appellate Brief)

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