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The Use of Nonqualified Structured Settlements in the Sale of Capital Assets

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Abstract: *Structured settlements—and the annuities used to fund them—have long been used to assure tax-free payments to the victims of catastrophic injuries while transferring the liability for payment from one party (the defendant) to another (the life carrier's assignment company). In recent years there has been expanded use of structured settlements into other areas such as employment cases and business disputes. These "nonqualified" structures have given rise to new markets for structured settlements altogether. The "structured sale" is a concept that will be of interest to any financial adviser with clients who may be seeking tax deferral in selling a capital asset. This technique combines the installment sale rules covered by IRC Sec. 453 with structured settlement methodologies to create a way for the seller of property to combine the tax deferral of the installment sale with the safety of payments backed by a high-quality annuity.*

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Background

Structured settlements are used by lawyers as a tool to bridge the gap between parties in a negotiated or litigated legal dispute involving a personal injury or a wrongful death. This article will describe some of the basics of the structured settlement market and the differences between structures that are qualified under IRC Sec. 130 and those not qualified under Sec. 130. We will then discuss the structured sale concept that has grown out of the nonqualified structured settlement.

At the core of a structured settlement is an agreement by the plaintiff to accept a stream of periodic payments instead of a lump sum. While a structured settlement could be as simple as the defendant making payments over time, the plaintiff's attorney isn't likely to accept such a proposal. Since 1982 (when Sec. 130 was codified), if periodic payments were part of the negotiation, the parties have used a structured settlement with a "qualified assignment" of the periodic payment obligation and an annuity purchased by the assignee to guarantee those payments. This process has tax advantages to all involved. To the plaintiff, all payments under the annuity will be received income tax free.[1] The corporate defendant (or its casualty insurance carrier) gets a tax deduction for the payment in the year it is made and is released from any further liability or obligation. In a structured settle-

ment of this type, using a process described later in this article, the owner of the structured settlement annuity is a domestic corporation but avoids the tax consequences that would normally be attributable to corporate owner of an annuity.[2]

Section 130 is attractive for reasons other than just its tax benefits. The qualified assignment is also preferred by both parties in the transaction because, at the end of the process, the relationship between the parties is over. The defendants have paid their money and have no further obligation to fund periodic payments. The plaintiffs can feel secure in receiving payments from the life insurance company under the annuity contract. Both parties know that the plaintiff can look to no one other than the life company for payment.

There exists a demand for structured settlements with an assignment of the periodic payment obligation even for cases that do not qualify for Sec. 130 treatment. An excellent example is in employment cases. In employment litigation, unlike personal injury, the cash award is taxable to the plaintiff as are the contingency fees paid to the plaintiff's attorney. Without the ability to spread payments over time, the plaintiff can be exposed to harsh tax consequences.[3] Unfortunately, using a traditional structured settlement arrangement with the life insurance company's assignment company doesn't work due to the adverse tax consequences to the company.[4] But having the defendant (employer) make unsecured periodic payments to the plaintiff (wronged employee) would have these bitterly adverse parties entangled financially for an extended period of time. A better solution needed to be developed.

To avoid the problem of a taxable assignment company, two life insurance companies active in the structured settlement business have created "nonqualified assignment companies" to solve this problem. Their solution to the problem of how to avoid the taxes at the assignment company level was to domicile the assignment company offshore to avoid the tax problems of onshore corporate annuity ownership. In conversations that we've had with one of these companies, we learned that the carrier looked at a number of countries as situs for this entity and finally chose Barbados over Ireland. One important factor was that while both countries have valid tax treaties with the United States[5] and are **not** seen as tax havens, the Barbadian dollar is fixed to the U.S. dollar and does not fluctuate, while currency conversion issues with the euro would complicate doing business with an assignment company in Ireland.

Structured Settlements—The Process

As we turn our discussion to the use of nonqualified structured settlements in capital transactions, a description of some mechanics of the process itself will be extremely helpful. A structured settlement, in its purest sense, is the product of a negotiation between two parties that results in payments over time in exchange for something of value. A plaintiff accepts periodic payments and in exchange for making those payments, the defendant receives a release of all claims.

The process followed by the parties in a settled legal dispute is surprisingly similar to a negotiated sale transaction. The parties each come to the table with an idea of what their proposition is worth. The plaintiff may start with a demand or the defendant may start with an offer. What follows may look like a series of counteroffers in a sale transaction. After the parties have agreed to the terms of the settlement, those terms are memorialized in a document called the settlement agreement and release. This document specifies the terms of the periodic payments the defendant will make to the plaintiff and that the plaintiff will release the defendant from all claims. This document is carefully drafted and any monies that subsequently flow are carefully handled to assure that the plaintiff does not have constructive receipt or, in any other way, spoil tax benefits.

The next document that is executed is an agreement between the defendant and a third-party assignment company called the assignment. This document assigns all of the defendant's periodic payment obligations to the assignment company, which purchases the structured

settlement annuity from a life carrier. The annuity serves as the funding asset to meet the periodic payment obligation. The defendant will write a check to the assignment company, which is either a subsidiary or an affiliate of the life company writing the annuity. The assignment company will purchase and own the structured settlement annuity.

The periodic payment terms the parties negotiate prior to the execution of these documents and the purchase of the annuity are subject to very few limitations. A single annuity contract can provide for a lifetime income stream, different streams of periods certain, and scheduled lump sums to meet a variety of cash flow needs that a claimant may have.

Following this logic, we turn our focus to the sale of a capital asset.

The Cash Sale

Party A has asset Z for sale. B is an interested and qualified buyer. After A and B negotiate to a cash price, a sale agreement specifying the terms of the sale is written. When the terms of the agreement are met, B deposits the agreed amount into escrow and title to the property is transferred.

The Installment Sale

Party A has asset Z for sale. B is an interested and qualified buyer. A is interested in a tax deferral but is not sure of how to achieve it.

One tax-favored way to dispose of a capital asset is the installment sale method. Installment sales, covered under Sec. 453, allow for payments to be taxed in the year received. The taxpayer files Form 6252 with his or her federal tax return in the year of the sale and in each year a payment is received. In the year of the sale, the form determines the profit percentage—how much of each payment will be treated as capital gain. If basis is more than zero, a portion of each payment received will be treated as return of capital. A portion will be ordinary income, attributable to interest in the transaction.[6]

While the installment sale method is tax friendly to A, he or she has a number of risks to bear:

- Credit risk—reliance on B's performance over time.
- Repossession risk—an outcome of credit risk. A may be forced to reclaim the collateral property Z at a reduced value.
- Prepayment risk—early note disposition. Early repayment accelerates taxation and possibly forces reinvestment under less favorable conditions.
- Design limitations—Due to risks noted above, it is prudent to not to stretch out payments (defer taxes) too long.

The traditional installment sale method can be attractive to A, particularly if he or she wants to be an aggressive lender. By issuing an installment note to B, A can achieve his or her tax deferral objective and, as long as B meets his or her obligations, A achieves his or her goals. If A feels he or she can charge a high enough interest rate to bear the risks noted above, a traditional installment sale might be a suitable answer. As to repossession risk in a rising market, aggressive investors may see repossession more as an opportunity than a risk.

But what if A likes the tax deferral of the installment sale but doesn't want to bear the risks inherent in the installment sale? Is there a suitable alternative?

Blending the Structured Settlement and the Installment Sale—The "Structured Sale"

In the scenario above, A and B come to terms on the sale of the property, and negotiate to a cash price. A tells B that he or she wishes to enter into a structured sale and B agrees to cooperate. The structured settlement specialist works with A to determine how much of the negotiated cash amount will be taken upfront for any cash that A may want and for selling expenses, and then to determine how the periodic payments will be structured. An amendment to the sale agreement describing the periodic payments will be delivered to escrow. When the other terms of the sale agreement are met, B deposits the agreed cash amount into escrow and signs the assignment document. The escrow agent wires funds to the assignment company.

After the close of escrow, B holds title to the prop-

erty and A holds a note from B. B has assigned the payment obligation to a third party. The assignment company will begin making payments to A per the terms of the agreement, with the annuity as the funding asset. Under the terms of the assignment document, the life carrier may make annuity payments directly to A.

Questions from Advisers

While attorneys and CPAs are both familiar with installment sales, they may not be well versed in structured settlements. It is also likely that they have not seen these two tools used together, so they may have questions about the transaction.

Is There a Problem with Constructive Receipt?

Constructive receipt is not a concern if the transaction is properly handled. The structured sale process must be entered into *before* A has an unrestricted right to receive it immediately.[7] In a structured sale, the documents need to be placed in escrow so that funds can be wired to the assignment company on closing day. Constructive receipt *will* be a problem if, after escrow has closed, A has skipped all the formalities of the structured sale and has simply instructed the escrow agent to wire funds to the annuity company of A's choice.

What about Economic Benefit?

It should not be an issue here. *Childs v. Commissioner*[8] also addresses economic benefit as it relates to an assigned annuity contract. In this case, A has status that is no greater than that of an unsecured creditor of the insurance carrier issuing the annuity.

Does This Transaction Result in Disposition of the Installment Note?

Disposition of the note occurs when the note is actually paid off or if it were deemed to be constructively paid off. It is important not to accidentally create a disposition because taxes are due in the year of the disposition.[9] The assignment of the periodic payment obligation from B to the assignment company is not a disposition because A's position is not materially changed after the assignment.[10]

If A Still Holds B's Note, Is B Still Liable for Payment under Any Circumstance?

B's original note is not extinguished because the assignment company is not in the business of lending; it is in the business of making guaranteed payments. The assignment document, however, is clear that the assignee accepts *all liability* to make periodic payments.[11]

Is the Annuity Safe from A's Creditors?

Because the annuity is not owned by A (it is owned by the assignment company) the corpus of the sold asset is safe from creditors. This, of course, presumes the sale transaction itself was not entered into as a fraudulent conveyance.

Does the Offshore Element of the Transaction Make It Risky?

No. While the payment from B is made to the offshore assignment company, the money is sent immediately back to the domestic life carrier (where the premium is taxed).

Applications of the Structured Sale

While the different uses for this technique are just beginning to be explored, two areas that appear to be natural are in business succession planning and in the sale of real estate. Following are two simple case examples.

The Retiring Business Owner

Business owner Joe, age 60, owns 51% of a closely held corporation with Dave and Gary. Their buy/sell agreement has a formula calling for the purchase of a withdrawing shareholder's stock by the remaining shareholders. Joe's shares are valued at $2 million and, per the terms of the agreement, Gary and Dave are to make quarterly installments of principal and interest at the applicable federal rate mid-term rate over seven years. Joe is ready to step aside, but both buying and selling parties

have some concerns:

- While Joe respects and trusts Dave and Gary and will hold a security interest in the business during the buyout period, he is not interested in the prospect of being forced out of retirement if things do not work out as planned. Joe would like to retire in another part of the country.
- Dave and Gary are concerned about the $82,000 quarterly payments that must be made to fund the installment note. They would prefer a longer funding period to reduce the financial burden on them.
- All parties are willing to renegotiate the terms of Joe's buyout if a mutually agreeable result can be achieved.

Using the structured sale approach, the following result can be achieved. Dave and Gary negotiate a 10% valuation discount on Joe's shares and fund the transaction with $1.8 million, which they finance partly with cash and partly through using their line of credit. Debt service will be significantly less than required under the buyout agreement.

Joe receives payments of $41,000 per quarter over 15 years without the risk of being forced out of retirement to help protect his interest in the business. The assignment company is the responsible payor, but it is backed by a "promise to pay" from the life company issuing the annuity. Joe more than doubles the period over which he will pay taxes on the sale of his business interest.

Older Couple Liquidating a Real Estate Position

Real estate investors are notoriously tax averse and a couple, Mike and Lynne, are no different. They have utilized Sec. 1031 tax-deferred exchanges over their investment career but now would like to get out of the business of owning and managing rental real estate.

Their CPA has suggested options such as a Sec. 1031 exchange into a tenant-in-common investment (TIC)[12] and an installment sale carrying the paper themselves. Both options carry risks that Mike and Lynne are not interested in bearing.

A structured sale would work this way: After Mike and Lynne get an acceptable offer from a qualified buyer, they make a counter offer asking that the buyer cooperate with the structured sale. Assuming the buyer agrees, the sale agreement includes additional language that sets up a 20-year payment stream based on the cash price that had been negotiated. The structured sale delivers the desired results without the risks of other deferral methods.

Ethical and Other Issues to Consider

No Track Record

The structured sale is built on two time-tested techniques—the installment sale and the structured settlement. When combined this way, they become a single new technique with no track record of its own. Because of this, practitioners advising clients on structured sales have a greater than normal ethical obligation to provide full disclosure to all involved in the transaction. For the structured sale to work, the financial adviser must act as an educator and a process facilitator, not a salesperson. First, the seller of the property (who will achieve the desired value and tax benefits for his or her property) and his or her own tax and legal advisers must become comfortable with this technique. Then, the buyer of the property (who will gain no benefit from the structure) and his or her advisers must understand it so that they will cooperate. In addition, real estate agents, business brokers and escrow officers—who typically deal in boilerplate transactions—must be educated early in the process. If educating these people is left until the end, with the escrow time clock running out, the seller may be forced to accept a cash sale because key players didn't know the rules to the game.

Limited Product Availability with Limited Access

Of the two annuity writers with offshore assignment companies, only one is currently using its product for structured sale transactions. The other company plans to start later in 2006. We have had

conversations with two additional companies that are presently developing their own offshore assignment companies and have given initial indication that they are interested in structured sales, but there is no firm date as to when they will enter the market. We believe the market for structured sales will benefit with added competition and capacity.

Structured settlement annuities simply aren't available through traditional distribution outlets for retail annuities, so financial advisers wanting to use the structured sale technique will need to work collaboratively with a structured settlement broker that is well versed in the technique. There still exists a risk that as the public becomes more aware of this technique, unscrupulous or lazy financial advisers wanting to use traditional retail annuities may simply try to mimic the process without the formality of the assignment. This, of course, will cause negative outcomes for the client, who will lose the desired tax benefits and will likely cause malpractice litigation against the financial adviser and any other adviser who may have participated in the improper transaction.

Conclusion

The structured sale represents a unique opportunity to provide new solutions for a client who wishes to sell a capital asset and wants, in return, tax deferral on the sale proceeds and the safe, predictable income that can be provided by an annuity. While the structured sale technique is new, we believe that if it is implemented properly, it is a suitable approach for a conservative client. Ultimately, each client should rely on his or her own competent tax and legal advisers before entering into a transaction. ■

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(1) While a lump sum settlement is tax free under §104 (a)(2) under §130, all payments under the annuity are tax-free.
(2) Regarding the assignment company, IRC §130 states, "Any amount received for agreeing to a qualified assignment shall not be included in gross income to the extent that such amount does not exceed the aggregate cost of any qualified funding assets." Normally, under corporate ownership of an annuity, IRC §72(u) would apply. Sec. 72(u) treats as income "any income received or accrued" during a calendar year where the annuity is owned by a nonnatural person.
(3) In discrimination cases, plaintiffs get an "above-the-line" tax deduction for legal fees. All others report legal fees as a miscellaneous itemized deduction, subject to the 2% deductible. If subject to the alternative minimum tax these deductions may be lost altogether.
(4) Without the §130 protection, the assignment company would be taxed when it receives payment from the assignor, then would purchase the annuity from the life insurance company (its parent) using nondeductible dollars. The parent would in turn report the premium received as taxable income.
(5) TIAS 11090 1991-2 C.B. 436.
(6) § 453.
(7) *Childs v. Commissioner, 89 F.3d 856;* 1996 U.S. Appeals. Childs is the seminal case for attorneys being allowed to structure their legal fees. The case in essence gave the benefits of an assigned structured settlement annuity to someone who was not a claimant in a legal action, providing that constructive receipt and economic benefit and not been broached.
(8) Ibid.
(9) §453.
(10) Rev Rul. 82-122. This ruling addresses the issue of whether the substitution of a new obligor would be a disposition of an installment note under §453 of the Code. When the actions of the obligor result in a change, such as a transfer to a third party, such a change is ordinarily not treated as a disposition because the change has not materially changed the rights arising from the original transaction.
(11) Sample assignment language: "The Assignor hereby assigns and the Assignee hereby assumes all of the Assignor's liability to make Periodic Payments."
(12) TICs are a relatively new ownership form in the §1031 exchange market. Often real estate investors will enter into a §1031 exchange, relinquishing a rental house or a small apartment building to acquire an interest in a TIC. This type of ownership may allow them to make like-kind exchanges of smaller properties into a fractional interest in a much larger property and not be involved in the management of the smaller property.