Settlement Professionals Inc.
INTEGRATED FINANCIAL & SETTLEMENT SERVICES

Deferring the Legal Fee

A Guide to Tax Savings and Smart Investing

Jack Meligan
Financial Advisor
Founder, Society of Settlement Planners
Government Benefits Specialist

Tony Alfieri
Personal Injury Attorney
Settlement Planner
Government Benefits Specialist

Jeremy Babener
Tax & Settlement Attorney
Former Fellow, U.S. Treasury
NYU Law JD & Tax LLM

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SETTLEMENT PROFESSIONALS, INC.
1800 Blankenship Rd., Ste. 160 • West Linn, OR 97068
Office: (800) 666-5584 / Local: (503) 699-8929 • Fax: (503) 699-8511 • Web: SettlePro.com
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Foreword

By Joseph Di Gangi

I have worked with trial attorneys and their injured clients for over 30 years. In that time I have witnessed their laser focus on the success of their clients and cases. Unfortunately, that focus often largely neglects their own finances. The best example of this is the historically underutilized strategy of deferring legal fees. At each recovery, contingent fee attorneys can substantially decrease the taxes they pay, increase the long-term value of their fees, and create stable cash flow for retirement.

As a plaintiff advisor I regularly urge planning and tax-deferred investments to make a plaintiff's lawsuit recovery support their financial future. I do the same for attorneys – and deferring fees is one of the best strategies available.

Thanks to authors Jack Meligan, Jeremy Babener, and Anthony Alfieri, "Deferring the Legal Fee" provides attorneys and their trusted advisors the consummate guide to understanding the critical choices, tax implications, and fully vetted documents that are needed to properly design, build, and manage great attorney fee deferral solutions.

Good luck,

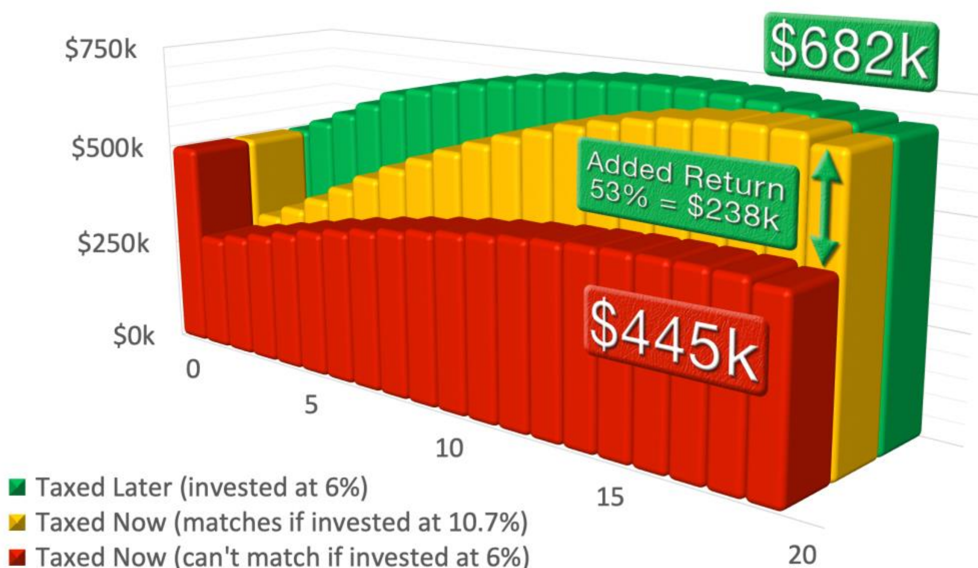
Joseph Di Gangi
Settlement Architect
Elana Financial & Settlement Architects

Deferring Fees to Get More

As a contingent fee attorney you have **unique access to the benefits of a "Deferred Fee,"** which is similar to your clients' option to use a "structured settlement." You can achieve many investment goals, including substantial tax savings. Fee deferrals offer **three major tax benefits**:

1. You can "spread" your fees over many years to avoid tax rate "spikes."
2. You can delay receiving fees until you reach your lower tax rate years (e.g., retirement).
3. You can achieve tax-free build-up until payout, like an Individual Retirement Account, but without the contribution cap or requirement to do the same for your employees.

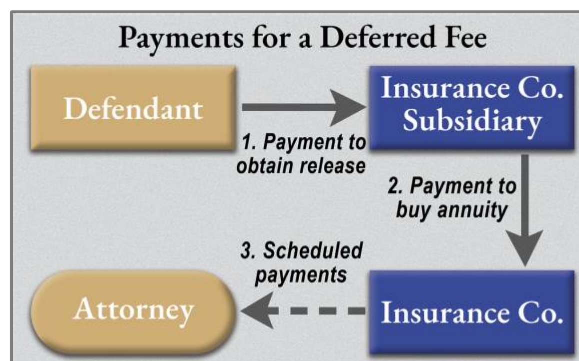
To match the advantages of a Deferred Fee, the same amount taken in a lump sum and immediately taxed must grow at a rate-of-return that is 15%-35% higher. This typically means taking on more risk. For example, a Deferred Fee of $500k growing at a rate of 6% would be matched by a lump sum fee growing at 10.7%. If they grow at the same rate-of-return, the Deferred Fee results in $238k more.



Settlement Professionals, Inc. ("SPI") has helped attorneys obtain these benefits since the U.S. Tax Court recognized the strategy in 1994.[1] In this Guide we discuss "Traditional" and "Modern" Fee Deferral options, explain the tax concepts involved (with attached source materials), and highlight what to watch for in implementation. Special care is needed when seeking the added benefits of Modern arrangements. We also provide template documentation and language to effect Fee Deferrals and obtain informed client consent.

[1] *Richard A. Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996).

<u>The Traditional Fee Deferral</u>. Effecting a Traditional Fee Deferral, sometimes called a "Structured Fee," is similar to effecting a "structured settlement." Both involve the use of a settlement annuity, and you can do both at the same time. In both cases, the defendant is released of liability upon paying a life insurance company subsidiary to make scheduled payments to the claimant or attorney. In both cases, the life insurance company sells to its subsidiary (the "Assignment Company") an annuity with a matching payment schedule and directs annuity payments to the claimant or attorney. In the case of a Deferred Fee, payments to the attorney are made "on behalf of" the claimant.



To effect this strategy you need your **client's consent**, which you can obtain any time before settlement. *Page 9* provides template language you can use in your standard engagement letter or to amend an engagement already in place.

Take care in **directing payments to yourself rather than your firm** – doing so risks premature taxation. *Page 14* provides a template Deferred Compensation Agreement to avoid that risk. If your firm is taxed as a partnership (e.g., most LLCs) or S corporation you should consult your firm's tax advisor to avoid any inconsistent tax positions. SPI regularly works with attorneys' tax professionals – they consistently encourage the transaction.

As we discuss below, many attributes of a Deferred Fee are necessary to avoid premature taxation on scheduled payments. Documentation provided by life insurance companies offering Traditional Deferred Fee arrangements typically address most tax requirements, including that you not "own" the annuity funding your payments. However, no documentation can make a Deferred Fee possible once you settle your case – **make sure to explore (and incorporate) the arrangement before settlement**. As we discuss below, the effectiveness of documentation and mechanics for Modern Deferred Fees are more varied and less reliable – safely achieving the benefits offered requires review from both tax and investment perspectives. SPI monitors the Deferred Fee marketplace for that purpose.

While the mechanics of all Traditional Deferred Fees are the same, the annuities and payment schedules used are specific to the attorney involved. Typically, **payments can begin as early as six months after settlement and last as long as the attorney prefers**. Designing the schedule to maximize your financial interests and minimize tax is an exercise in understanding your goals. SPI has found enormous variance in what benefits different attorneys.

<u>Bankruptcy & Other Benefits</u>. Deferred Fees offer significant advantages beyond the three tax benefits discussed above.

The arrangement can block your creditors from the growing investment value of your Deferred Fees. In fact, though dependent on state law, courts have allowed attorneys to **keep Deferred Fees after bankruptcy**.[2] While asset protection trusts sometimes offer similar protection, their primary purpose can appear improper.

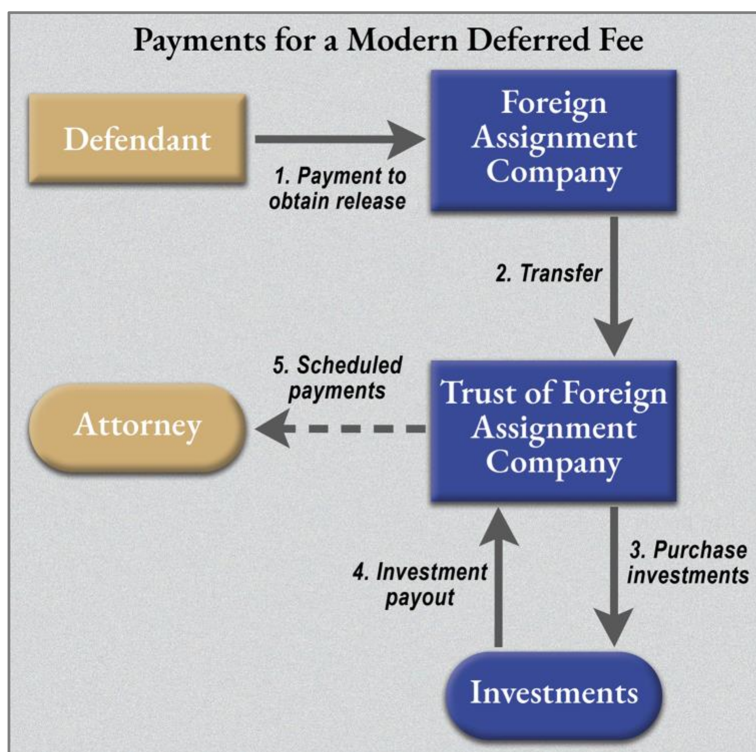
[2] *E.g.*, *In re Lynch*, 321 B.R. 114 (Bankr. S.D.N.Y., 2005) (applying New York law); *Canfield v. Orso*, 283 F.3d 686 (5th Cir. 2002) (applying Louisiana law).

Deferred Fees offer **unique access to certain investment opportunities**. Only through a Deferred Fee (or structured settlement) can you fully customize an annuity's payment schedule – otherwise tax penalties generally apply.[3] SPI works with claimants and attorneys to leverage that opportunity, minimizing non-invested capital and de-risking portfolios through strategies like dollar-cost averaging (planned buying of an investment with fluctuating value over time). Also, because many highly rated life insurance companies facilitate Deferred Fees, you can diversify fee investments even within Traditional arrangements.

If your client is taxable on her recovery, **delaying your fees can reduce your client's taxes**. For example, consider a client settling a taxable claim for verbal harassment – claimants are generally taxed on recoveries for non-physical injuries.[4] Unfortunately, she will be taxed on what she keeps, and also, on what you keep![5] Spreading your fees out in the future likely helps her avoid the same tax rate "spike" that you avoid by using a Deferred Fee. For the same reason, she should consider a structured settlement for herself. Notably, either one of you, or both of you, can choose to delay receipt of payments.

Life insurance companies effecting Deferred Fees have also offered the use of variable and indexed annuities in the arrangement. However, **for market-based returns SPI has consistently found Modern Deferred Fee arrangements to be more competitive**.

The Modern Fee Deferral. You can access greater flexibility and returns by not limiting yourself to Traditional arrangements offered by life insurance companies. By working with other programs you can (1) invest in **growing markets**, (2) **borrow against your investments** before payout, and (3) **re-defer payments as you go** to maximize the value of the program. Investment options range widely, including money market funds, portfolios for varying risk levels, and name-brand exchange-traded funds ("ETFs"). If desired, you can even appoint your own financial advisor to manage invested fees.



As you might expect, using Modern Deferred Fee programs can add risk beyond investment losses. SPI consistently monitors the mechanics, benefits, and risks of programs available.

Most Modern programs incorporate the standard setup – defendant pays a third-party company (the "Assignment Company"), which buys investments to fund payments to you. Unlike in the Traditional option, the Assignment Company in the Modern option typically buys investments from unrelated issuers rather than its parent.

[3] Internal Revenue Code Section 72(q)(2)(D).
[4] Babener, Jeremy, *Tax Treatment of Damages for Stress-Induced Physical Ailments*, Practical Tax Strategies (Vol. 89, No. 3).
[5] *See* *Commissioner v. Banks*, 543 U.S. 426 (2005).

For additional security, some programs use a bank-administered trust to hold the investments. A U.S. bank trustee mitigates several types of risk – for example, it creates a **U.S. presence to control despite** a **program's formation in a tax-favored country like Barbados or Ireland**.

Modern programs raise a number of tax issues that can affect you, as we discuss in the below section. Most issues present one of two concerns to watch for: (a) you may face **premature taxation** because your return is sufficiently tied to the program's underlying investment, and (b) your payout is **exposed to risk by aggressive tax positions** of the Assignment Company. These programs must navigate many nuanced tax issues, sometimes including positions based on U.S. tax treaties.

Modern programs and their options also raise structural and investment issues to consider. These include (i) your selection within a program's investment menu and (ii) any risk to your payout from other program clients, lines of business, or non-compliance with investment or tax regulations. For example, the program's structure may require certain government filings to avoid liability exposure.

Tax Issues for Deferred Fees. Deferring taxes on your fees past settlement requires navigating a number of tax rules and principles the IRS can use to treat you as receiving money before you do. In the **only on-point court decision** (*Childs v. Commissioner*) the U.S. Tax Court ruled against the IRS and for the attorneys. The attorneys had used a Traditional Deferred Fee to postpone taxation of their fees until payout years later. The Eleventh Circuit Court of Appeals affirmed the decision in 1996, and since then, the IRS has cited *Childs* with positive references.[6] The Tax Court's explanation in *Childs* discussed and rejected several of the IRS' potential arguments against a Deferred Fee's effective tax deferral. Below, we discuss those and other arguments, tax issues for the provider that can affect you, and how your use of a Deferred Fee can affect your clients.

Cash Equivalency. For tax purposes, you are **treated as receiving money** when you receive its "cash equivalent." For example, you owe tax on a solvent company's promise to pay you if its promise is unconditional, transferrable, and similar to debt regularly sold or borrowed against at typical borrowing rates.[7] Many Traditional Deferred Fee programs prevent the sale of Deferred Fee payments on their face. And, rates to sell Deferred Fee payments make courts unlikely to treat them as cash equivalents.

Constructive Receipt. You are taxed on money that you "constructively receive," which occurs if it is **set aside for your sole benefit and can be drawn on at your discretion**.[8] IRS rules give the example of taxing a shareholder on stock dividends once they are payable at her request.[9]

Preventing constructive receipt of Deferred Fees depends in part on **using or modifying your client engagement letter to avoid the right to immediate payment** at settlement. In *Childs*, the court ruled that the attorneys did not constructively receive their Deferred Fees at settlement because, before settlement, they modified their right to collect fees so that they could only collect on the deferred schedule of their Deferred Fee arrangements. *Page 9* provides template language you can use in your standard engagement letter or to amend an engagement already in place.

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[6] *E.g.,* IRS Private Letter Ruling 200836019; IRS Field Service Advice Memorandum 200151003.
[7] *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), *rev'g* and *remanding*, 32 T.C. 853 (1959), *opinion on remand*, T.C. Memo 1961-229.
[8] Treas. Reg. § 1.451-2(a).
[9] Treas. Reg. § 1.451-2(b).

Some Modern Deferred Fee arrangements offer benefits that could cause an attorney to "constructively receive" their fees when creating the arrangement. For example, some programs offer attorneys the ability to "re-defer" their fees, postponing payouts long after establishing the arrangement. The U.S. Tax Court has ruled that, when done properly, re-deferral can effectively postpone both payment and taxation.[10] Of course, doing so "properly" is all about the details, documentation, and mechanics.

Deferred Compensation Rules. In general, you are currently taxed on deferred compensation unless it is arranged under a "qualified plan" (like a 401(k) plan) or there is a "substantial risk" that you will not receive the compensation.[11] However, IRS rules exempt deferred compensation paid to a non-employee who provides services to multiple clients.[12] Deferred Fee documentation typically references the requirements to memorialize the inapplicability of the nonqualified deferred compensation tax rules. Moreover, most arrangements preserve the risk of an attorney not receiving compensation by establishing the attorney as a general creditor without special rights to program assets.

Economic Benefit. In general, you are taxed on the value of property received for services once it is "transferrable" or "not subject to a substantial risk of forfeiture," whichever comes first.[13] Similarly, you are treated as receiving money or property before actually possessing it when you obtain its "economic benefit" – when it is **separated from the payors' assets, protected from the payors' creditors, and your receipt is guaranteed.**[14] For example, when an employer funded an investment trust naming an employee as sole beneficiary, the employee was taxed on the value of assets placed in trust.[15]

Deferred Fee programs typically address the economic benefit concern by exposing Deferred Fee investments to the payors' creditors. Fortunately, because the payor's only business is Deferred Fees, its assets and debts should match exactly, de-risking creditor exposure. This was very likely the case in *Childs*. Since 1988, some standard Deferred Fee programs have been able to offer protections from creditor risk. That year, Congress passed legislation overriding the economic benefit rule, preventing taxation that would otherwise result from guarantees and secured interests in annuities funding standard structures.[16]

Economic Substance. The IRS has taxed money before it is received based on the "substance" of relevant transactions. For example, the IRS ruled that annuity policyholders should be treated as owners of investments made by an annuity company based on the policyholders' level of control over related cash and investments held by the company.[17] **Traditional Deferred Fee documentation emphasizes that the attorney does not own the underlying investments** and that all payments are made at the convenience of the attorney's client.

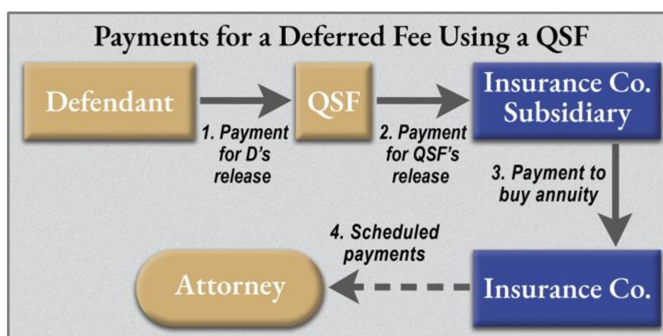
Modern Deferred Fee arrangements offer a variety of benefits – the details and mechanics are critical to avoiding premature taxation under an "economic substance" attack. For example, some arrangements allow attorneys to **borrow against their invested fees**. To avoid an unintended tax result the mechanics must navigate the IRS' past success in taxing loan recipients who expect payment from their

[10] *Veit v. Commissioner*, 8 T.C. 809 (1947), *acq.*, 1947-2 C.B. 4 (1947); *Veit v. Commissioner*, 8 T.C.M. 919 (1949); *see also Martin v. Commissioner*, 96 T.C. 814 (1991).
[11] Tax Code Section 409A.
[12] Treas. Reg. § 1.409A-1(f)(2).
[13] Tax Code Section 83(b).
[14] *E.g.*, *Minor v. United States*, 772 F.2d 1472 (9th Cir. 1985).
[15] *Sproull v. Comm'r*, 16 T.C. 244 (1951), *aff'd*, 194 F.2d 541 (6th Cir. 1952).
[16] *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. 541 (1988).
[17] I.R.S. Rev. Rul. 80-274; *accord* I.R.S. Rev. Rul. 77-85.

lender,[18] including a U.S. Tax Court decision taxing a settlement payee who borrowed the amount he expected to receive over several years.[19]

Another benefit offered by Modern programs is for attorneys to **direct investment strategy**. Here again, the mechanics must navigate IRS policy taxing investment earnings even if not yet received. The IRS previously ruled that, under specific circumstances, a variable annuity policyholder would not be taxable on annuity investment returns until payout even though the policyholder could allocate funds among pre-set investment options.[20] The IRS indicated a number of necessary attributes for a successful arrangement, including the policyholders' exclusive access to the investment options.[21] The various Modern Deferred Fee programs act on this guidance in different ways. Some programs appear to ignore it.

Qualified Settlement Funds. To allow defendants to **"pay and walk away" without agreeing to claimants' use of settlement proceeds**, both Traditional and Modern Deferred Fee arrangements can make use of a qualified settlement fund (a "QSF"). A QSF is a trust or account funded at settlement that allows claimants to release defendants' liability before considering whether to use a structured settlement or Deferred Fee, or how to resolve claimant creditor liens (e.g., of Medicare claims). Typically, defendants can still deduct their settlement payment.[22]



Use of a QSF can benefit claimants and attorneys by allowing time to determine the best use of settlement funds before losing the option to defer payment through a structured settlement or Deferred Fee. Deferral is generally impossible after cash is received by either claimant or attorney. QSF rules preserve the claimant's ability to receive settlement proceeds tax-free.[23] And, the IRS has strongly indicated that QSFs typically preserve the tax deferral option of structured settlements and Deferred Fees.[24] SPI regularly advises on and coordinates the use of QSFs.

Program Taxation. A standard Deferred Fee program uses a domestic Assignment Company, which becomes liable to make Deferred Fee payments to the attorney and buys an annuity to do so. A special tax rule exempts the Assignment Company from taxation when it receives a lump sum payment from the defendant and uses the lump sum to purchase an annuity from a U.S. life insurance company.[25]

Modern Deferred Fee programs take many forms. A program using a domestic Assignment Company that makes non-annuity investments must ensure that it will not owe tax on the defendant's (or QSF's) payment. Otherwise, the **program exposes its investments to great risk**. Programs using a foreign Assignment Company (for example, in Barbados or Ireland) must ensure eligibility for the applicable

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[18] I.R.S. TAM 2000040004.
[19] *Heyn v. Commissioner*, 39 T.C. 719 (1963).
[20] I.R.S. Rev. Rul. 2003-91.
[21] I.R.S. Rev. Rul. 2003-92.
[22] Treas. Reg. § 1.461-6(b); Treas. Reg. § 1.468B-3.
[23] Treas. Reg. § 1.468B-4.
[24] *See* Babener, Jeremy, *Treasury Decides to Pass on Single-Claimant Qualified Settlement Fund Guidance for Now*, N. Carolina Lawyers Weekly, Dec. 14, 2009.
[25] Tax Code Section 130.

U.S. tax treaty and that the treaty's exemptions apply to the Assignment Company's income. There are many technical nuances that, if ignored, result in significant investment risk.

Some Modern Deferred Fee programs use a trust to hold the investments of the Assignment Company.[26] A professional or bank acting as trustee lends legitimacy to the arrangement, and for foreign Assignment Companies, a domestic trustee establishes a responsible party subject to U.S. jurisdiction. However, to avoid premature taxation under the economic benefit doctrine (see above), the trust's investments are not protected from the general creditors of the Assignment Company upon insolvency. Thus, **a program's aggressive tax position risks the IRS seizing your investments**. SPI pays special attention to programs' tax positions to protect clients' investments.

Defendant Taxation. Defendants considering a structured settlement or Deferred Fee arrangement primarily focus on their **ability to deduct settlement payments**, whether made to plaintiff, attorney, or a structuring program. Though somewhat technical, IRS rules and case law provide them this option.[27] *Page 13* provides template language you can use to satisfy a defendant's deduction and liability concerns.

Client Taxation. For tax purposes, a claimant receives amounts paid to her lawyer (whether by a defendant or a Deferred Fee program).[28] If your client receives her settlement tax-free, your Deferred Fee arrangement will not affect her. If a portion of her settlement is taxable, and non-deductible to her,[29] **the arrangement will likely benefit her by delaying the year in which she is taxed**.

[26] Typically the trust is typically a so-called "Rabbi Trust," formed using the guidelines of I.R.S. Rev. Proc. 92-64.
[27] For standard structured fees, *see* Treas. Reg. § 1.461-6. For Modern Deferred Fees, *see* IRS Notice 2003-77; Treas. Reg. § 1.461-4(1)(iv); and *Maxus Energy Corp. v. United States*, 31 F.3d 1135 (Fed. Cir. 1994).
[28] *Commissioner v. Banks*, 543 U.S. 426 (2005).
[29] Since 2017, most legal fees in personal injury are not deductible. *See* Tax Code Section 67(g).

Template Documentation & Language

Because Deferred Fees are executed as part of a settlement, it's important to make sure the other parties understand that they will not be harmed by your arrangement.

Below, we have included explanations and letters to both clients and defendants for that purpose. If you are a member of a multi-lawyer law firm, you will also need to execute a deferred compensation agreement. This will ensure that neither you nor your firm face negative tax consequences because of the Deferred Fee.

Included discussion and documents:

- Client Fee Agreement Insert and Pre-Recovery Letter to Permit Deferred Fees
- Client Fee Amendment and Pre-Recovery Letter to Permit Deferred Fees
- Language Assuring Defendants of Their Protection and Ability to Deduct
- Agreement to Effect a Fee Structure in a Multi-Lawyer Law Firm

Modifying Client Engagements for Fee Structures

The next page provides two write-ups for you to copy, paste, and use in client engagements to allow your use of Deferred Fees. They are meant (1) for New Client Engagements and (2) for Pre-Existing Client Engagements.

Both are intended to obtain client consent for you to structure fees. In both, we strive to accomplish several goals:

1. **Put the client at ease.** You need the client's consent to structure your fee. Fortunately, doing so will not harm them. A great way to put them at is to reference the similarity of the Deferred Fee structure to the client's option to use a structured settlement. To emphasize the similarity, it is helpful to refer to a Deferred Fee as a "Structured Fee." Both achieve tax-advantaged investment via deferral and both are effected in connection with the recovery.

2. **Allow time to schedule your fee structure payments.** Deciding on your schedule typically comes after deciding to use a fee structure. Since effecting a fee structure involves client interaction, which can delay settlement, we drafted language that allows you discuss and obtain consent long before you decide on your schedule. With our language, you can wait to finalize the schedule until the date of settlement.

3. **Protect the tax strategy.** In the flagship case on Deferred Fees, the U.S. Tax Court emphasized that the lawyers who structured their fees did not have the right to those fees at the time of recovery. Before that time, the lawyers modified their client fee arrangement. Our language is intended to do just that.

4. **Avoid a common tax mistake.** Some lawyers amend their fee agreements in a manner that provides the lump sum fee option even through settlement. Lawyers who do this are probably taxable on the value of any Deferred Fee they accept. This is because they still have the right to demand their fee at the time of recovery.

In both the materials (1) for new clients and (2) for pre-existing clients, we identify language for you to insert or modify in [bracketed language]. Of course, you are welcome to modify and use any language as you see fit.

New Client Engagements – Engagement Letter Insert & Pre-Recovery Letter

For new client engagements, we recommend (1) adding the below Engagement Letter Insert into the fee section of your engagement agreement. Then, before recovery, (2) provide the client the following Fee Modification Letter after filling in the [bracketed language].

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1. Engagement Letter Insert for all future clients – add to description of fees

Like you, we may have the tax-advantaged option in your case to receive our compensation in lump sum or periodic payments. For plaintiffs, this is called a "structured settlement" because settlement payments are "structured" over time. If you wish to use this option, we would be glad to call on a professional to advise you. For legal fees, it is sometimes called a "Structured Fee." So that we may use our option, we ask that you consent at engagement. By signing this agreement, you agree that we may modify our right to fees in your case one time by shifting our right to receive some or all of the present value of our fees to a later date.

2. Fee Modification Letter for clients who signed the above – use once you decide to structure fees in their case

Re: Our Decision to Invest Fees

Dear [Client],

We have discussed that you have the tax-advantaged option to invest money you receive from this case by using a "structured settlement." You can only choose this option if you do so before finalizing your settlement or award.

My law firm also has a similar option to invest our fees, which is called a "Structured Fee." We do so by modifying the timing (but not the value) of our right to fees. Allowing more time means we get to invest the fees that we've earned.

Of course, it is important that we inform you of the modification. It will not affect you if, as we expect, your recovery is not taxable. If you are taxed, our use of a Structured Fee may help you by delaying your taxes. We are modifying our right to fees by (1) reducing the amount due at recovery to $[____________], and deferring payment of the remaining present value until [Month, Day, Year], or later if identified in a "Structured Fee Assignment Agreement."

Please let me know if you have any questions. Of course, if you would like to discuss your option to use a structured settlement further please let me know.

Sincerely,

[Lawyer]

Pre-Existing Clients – Fee Amendment for Clients w/out Previous Engagement Insert

For clients who signed an engagement agreement without the insert on the previous page, we recommend that you use the following client letter to amend your fee arrangement. Because affecting your fee technically amends your fee arrangement, it is important to note that the client speak with outside counsel. Though they rarely request to speak with other counsel, including the note provides you additional protection and helps you comply with legal ethics rules.

Re: Helpful Option to Invest Recovery or Fees

Dear [Client],

As an injured person demanding compensation you likely have the option to invest money you receive with significant tax advantages. You can only choose this option if you do so before finalizing your settlement or award. I would be glad to call on a professional who specializes in securing these benefits – many call the option a "structured settlement" because you will receive payments "structured" over time.

My law firm has a similar option to invest our fees. It is called a "Structured Fee." Our use of it would not affect you if, as we expect, your recovery is not taxable. If you are taxed, my use of a Structured Fee may help you by delaying your taxes. [Very few people wish to report taxable income earlier than needed. But, if you do, please let me know.]

Like you, we must decide to "structure" before finalizing your settlement or award. If we do, we will fill out the box below. Since this affects how we receive fees in your case we ask for your consent. Of course, you are welcome (and always advised) to get independent advice. And, we'd be glad to answer any questions you have.

Client Consent

I agree that my attorney's law firm may modify its right to fees in my case one time by providing me a completed copy of this letter. Under no circumstances may doing decrease the recovery I receive.

Signed: ____________________________

Name: ____________________________

Date: ____________________________

[Law Firm] Fee Modification

We hereby modify our fee rights as follows:

- Our immediate fees at recovery shall be limited to $__________.
- The present value of our remaining fees shall be payable on [Month, Day, Year], or later if identified in a "Structured Fee Assignment Agreement."

Signed: ____________________________

Name: ____________________________

Title: ____________________________

Date: ____________________________

Assuring Defendants of Protection & Deductibility

Adding a step or structure to a settlement can delay or cause confusion. But, using a structured settlement or Deferred Fee should not – these arrangements have been vetted and used many times. With the language below you can quickly address defendants' two mostly likely concerns: (1) liability and (2) their ability to take a tax deduction upon making payment.

The answer is different if the structured settlement or Deferred Fee will be Traditional, Modern, or us a Qualified Settlement Fund. As discussed above, a Traditional arrangement uses an annuity as an investment and only supports tax-free proceeds (e.g., amounts received for personal physical injuries). A Modern arrangement is one that fails either of those two requirements.

E-mail 1: Traditional Arrangements

We plan to use a structured settlement for payment of our [client's and/or firm's] compensation. This will not affect [defendant's] liability or ability to deduct the settlement payment.

We will use standard industry language to fully release [defendant] upon its payment, including from potential claims relating payment and payment structuring. [Defendant] will accrue a full deduction for its payment under Treasury Regulation § 1.461-6(a).

We work with expert advisors on this subject. Please let me know if you have any questions.

E-mail 2: Modern Arrangements

We plan to use a structured settlement for payment of our [client's and/or firm's] compensation. This will not affect [defendant's] liability or ability to deduct the settlement payment.

We will use standard industry language to fully release [defendant] upon its payment, including from potential claims relating payment and payment structuring. [Defendant] will accrue a full deduction for its payment under Treasury Regulation § 1.461-4(g)(1)(iv).

We work with expert advisors on this subject. Please let me know if you have any questions.

E-mail 3: Qualified Settlement Funds

We plan to use a qualified settlement fund for payment of our [client's and/or firm's] compensation. This will not affect [defendant's] liability or ability to deduct the settlement payment.

We will use standard industry language to fully release [defendant] upon its payment, including from potential claims relating payment and payment structuring. [Defendant] will accrue a full deduction for its payment under Treasury Regulation § 1.468B-3(c).

We work with expert advisors on this subject. Please let me know if you have any questions.

Effecting Fee Structure in a Multi-Lawyer Law Firm

If you practice law in a multi-lawyer firm, arranging for Deferred Fees involves the added step of addressing compensation issues within the firm. Fortunately, the documentation and arrangement is quite straight forward.

Once the partners agree on a lawyer's deserved portion of a particular contingency fee, the firm and lawyer can enter into a simple Deferred Compensation Agreement. We have provided an example on the next page for firms treated as a partnership for tax purposes.

In short, the law firm agrees to accept deferred fee payments (with a present value equal to the portion of the fee being structured). Then, under the Deferred Compensation Agreement, the firm commits to allocating and distributing those amounts to the lawyer. To avoid premature taxation, the lawyer must not "own" the right to those payments directly, but rather have the right to be allocated and distributed those amounts.

Whichever option is pursued, it is important to modify the contingency fee agreement to incorporate the possibility that the attorney fee may be structured (see *Page 10*).

DEFERRED COMPENSATION AGREEMENT

This Deferred Compensation Agreement (this "Agreement") is entered into as of [Date] signed by both of the parties [Law Firm] (the "Law Firm") and [Lawyer] (the "Lawyer," together, the "Parties").

The Law Firm entered into an agreement with [Plaintiff Client] (the "Plaintiff") as of [Date] to represent Plaintiff in connection with a litigation matter (the "Fee Agreement"). The Lawyer was primarily responsible for [originating and representing] the Plaintiff in this matter.

The Law Firm wishes to recognize the substantial contribution of the Lawyer. It will do so by allocating certain amounts received in the future to the Lawyer. For the convenience of the Law Firm, it has or will arrange to receive deferred payments of fees under the Fee Agreement ("Client Payments" made by a "Payor")).

Therefore, the Parties agree as follows:

1. Deferred allocation. The Law Firm shall allocate and distribute to the Lawyer amounts received in connection with the Fee Agreement as set forth in the attached **Schedule A** (the "Lawyer Payments"). This grant of a profits interest to such future amounts replaces the Lawyer's right to allocations of amounts received in connection with the Fee Agreement except as stated in **Schedule A**.

2. Direct payments. For the convenience of both Parties, the Law Firm plans to direct payments by the Plaintiff or any other obligor of the Client Payments to the Lawyer to satisfy the Lawyer Payments.

3. Tax and reporting. The Parties shall each be responsible for their own tax obligations and tax reporting with respect to the Client Payments and Lawyer Payments.

4. Death. In the event of the Lawyer's death prior to the last of the Lawyer Payments, the unpaid Lawyer Payments shall be paid to the estate of the Lawyer.

5. General creditor status. The Law Firm has agreed for the Client Payments to be paid by a third party assignment company (the "Assignment Company"). For its own convenience, the Assignment Company has purchased or may purchase certain investments to fund the Client Payments. The Parties understand that neither an interest in any such investment. Further, the Parties understand that the Client Payments cannot be modified or accelerated by either Party. Any attempt to do so or receive value in respect of the Client Payments ahead of schedule shall be void. Nothing in this Agreement shall be deemed to create a trust, segregated asset account, or security interest. This Agreement does not create any ownership by the Law Firm on behalf of the Lawyer. The Lawyer shall have no interest in any asset of the Law Firm in connection with this Agreement.

6. Successors of attorney. This Agreement is binding on the Lawyer and on his successors and assigns. The Lawyer's spouse, if any, agrees to be bound by equivalent terms, regardless of other spousal rights.

7. Successors of firm. This Agreement is binding on the Law Firm, its direct and indirect owners, and its and their respective successors and assigns. The Law Firm agrees to obtain from any subsequent owner in interest their consent to be bound by this Agreement as a condition to being granted ownership in the Law Firm.

8. Governing law. This Agreement shall be construed in accordance with the laws of the state in which the Law Firm has its principal office at the time that this Agreement is executed.

9. Entire agreement. This Agreement constitutes the entire agreement between the Parties with respect to the Lawyer's compensation to related to the Fee Agreement.

	[Law Firm]
By: ____________________	By: ____________________
Name: ____________________	Name: ____________________
	Title: ____________________

Deferred Compensation Agreement

Schedule A

Payee: **[Lawyer]**

Schedule of Payments:

Cases & Authorities

The first several pages of this Guide walked through the tax treatment of Deferred Fees and cited the flagship case of *Childs v. Comm'r* (U.S. Tax Court, 1994). Here, we provide that cases and other relevant authorities.

Richard A. Childs v. Comm'r, 103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996) 18

Childs is the flagship case for fee structures. The U.S. Tax Court concluded, and the 11th Circuit Court of Appeals affirmed, that the attorneys who used a Deferred Fee would only recognize their fees for tax purposes as they received their Deferred Fee payments over many years. Before settlement, the attorneys modified their fee agreement so that they would not be entitled to fees upon settlement. The U.S. Tax Court decision considered Section 83, constructive receipt, economic benefit, and other arguments made by the IRS to tax the lawyers.

Comm'r v. Banks and Comm'r v. Banaitis, 543 U.S. 426 (2005) 32

In *Banks* and *Banaitis*, the U.S. Supreme Court held that the full amount of a recovery, including the contingent legal fee portion, is taxable to the plaintiff. An amount received directly by the lawyer is treated, for tax purposes, as being (1) received by the plaintiff and then (2) paid by the plaintiff to the lawyer. The decision supports fee structures by tying lawyers' deferral option to the favorable authorities on plaintiffs' ability to defer taxation, including IRS Rev. Rul. 2003-115 and IRS Priv. Ltr. Rul. 200836019.

IRS Revenue Ruling 2003-115 40

In 2003, the IRS concluded that plaintiff who enter into a structured settlement for tax-free damages can obtain tax-free investment returns. The Ruling considered plaintiffs entering into structured settlements with the 9/11 Victim Compensation Fund, and memorialized favorable analysis for plaintiffs on the tax doctrines of constructive receipt and economic benefit. Because the claims at issue give rise to tax-free proceeds, the structured settlements were "qualified" under IRS Code Section 130.

IRS Private Letter Ruling 200836019 45

In 2008, the IRS concluded that a plaintiff who entered into a "non-qualified" structured settlement can also defer receiving proceeds for tax purposes. The Ruling considered a plaintiff who sued an employer for non-physical injuries, and memorialized favorable analysis for plaintiffs on the tax issues of actual receipt, cash equivalency, constructive receipt, and economic benefit. It favorably cited *Childs*.

IRS Notice 2005-1 53

IRS Code Section 409A taxes certain deferred compensation. However, this Notice and IRS Regulation Section 1.409A-1(d)(1) exempt compensation if (1) the service provider (e.g., a law firm) performs services for multiple clients or (2) the deferred compensation takes the form of a grant of a profits interest to the service provider (e.g., a lawyer) in the future income of the employer.

Treasury Regulation Sections 1.461-6(a), 1.461-4(g)(1)(iv), 1.468B-3(c) 80

IRS Code Section 461(h)(C) generally denies a payor the ability to deduct payments to satisfy tort and workers' compensation liability. However, these regulations allow the deduction for payments made (1) to fund a "qualified" structured settlement, (2) to fund a "non-qualified" structured settlement with proper mechanics, and (3) to fund a qualified settlement fund.

103 T.C. 634
United States Tax Court.

Richard A. CHILDS, et al.,[1] Petitioners
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent.

Nos. 15639–92, 15640–92, 16256–92, and 16257–92.
|
Nov. 14, 1994.

***635** Ps are attorneys who received a structured settlement in payment of attorney's fees with respect to two related cases. In the first case, the settlement agreement provided that defendant's two insurance companies, Georgia Casualty and Stonewall, were to assign their obligation to a third insurance company, First Executive. First Executive purchased an annuity for each P from its subsidiary, Executive Life. First Executive remained the owner of the annuity policies and maintained the right to change beneficiaries under the policies without the consent of Ps. Further, the parties to the settlement agreement agreed that Ps' rights under the annuity policies were no greater than those of a general creditor. In the second case, Stonewall purchased an annuity for each P in his individual capacity, and Stonewall remained the owner of the individual policy. Likewise, Stonewall maintained the right to change beneficiaries without the consent of the individual Ps, and the settlement agreement stipulated that Ps' rights under the annuity policies were no greater than those of a general creditor.

1. *Held:* The fair market values of Ps' rights to receive payments under the settlement agreements were not includable in income under sec. 83, I.R.C., in the year in which the settlement agreements were effected, since the promises to pay under the structured settlements were neither funded nor secured and thus did not meet the definition of property for purposes of sec. 83.

2. *Held, further,* the doctrine of constructive receipt is inapplicable, since Ps had no right to receive the attorney's fees prior to the time the agreement fixing a structured settlement was entered into.

Attorneys and Law Firms

Jacob Beil, Columbus, GA, for petitioners in docket Nos. 15639–92 and 15640–92.

Richard A. Childs, Columbus, GA, for petitioner in docket No. 15640–92.

Sylvia K. Kochler and Patrick G. Jones, Atlanta, GA, for petitioners in docket Nos. 16256–92 and 16257–92.

Lourdes M. DeSantis, Amy A. Campbell, and Charles P. Hanfman, Atlanta, GA, for respondent.

Opinion

SCOTT, Judge:

[1] Cases of the following petitioners are consolidated herewith: Mimi P. Childs, docket No. 15640–92; John C. Swearingen, Jr., and Suzanne N. Swearingen, docket No. 16256–92; and Ben P. Philips, docket No. 16257–92.

Respondent determined deficiencies in petitioners Richard A. Childs' and Mimi P. Childs' income tax for the taxable years 1986 and 1987 in the amounts of $37,176.42 and $34,792.85, respectively, and additions to tax under section 6661[2] for the taxable years 1986 and 1987 in ***636** the amounts of $9,294 and $8,698, respectively. Respondent determined deficiencies in the income tax of petitioners John C. Swearingen, Jr., and Suzanne N. Swearingen for the taxable years 1986 and 1987 in the amounts of $40,977.76 and $44,952, respectively, and additions to tax under section 6661 for the taxable years 1986 and 1987 of $12,910 and $11,238, respectively. Respondent determined deficiencies in the income tax of petitioner Ben P. Philips for the taxable years 1986 and 1987 in the amounts of $41,695 and $22,610, respectively, and additions to tax for the taxable years 1986 and 1987 under section 6661 of $10,424 and $5,653, respectively.

Some of the issues raised by the pleadings have been disposed of by agreement of the parties, leaving for decision: (1) Whether petitioners are required to include in income in the years here in issue, either under section 83 or by reason of constructive receipt, the value of amounts to be paid under structured settlement agreements covering future years for services rendered with respect to two related personal injury claims; and (2) if petitioners are required to include in income the fair market value of the right to receive future payments of attorney's fees in the year the agreement for such future payments was entered into, what is the amount of such fair market value.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

All petitioners resided in Columbus, Georgia, at the time of the filing of their petitions in these cases. Petitioners Richard A. Childs and Mimi P. Childs filed a joint Federal income tax return for each of the taxable years 1986 and 1987 on the cash basis of accounting. Petitioners John C. Swearingen, Jr., and Suzanne N. Swearingen filed a joint Federal income tax return for each of the years 1986 and 1987 on the cash basis of accounting, and petitioner Ben P. Philips filed an individual Federal income tax return for each of the years 1986 and 1987 on the cash basis of accounting.

Mr. Ben Philips (Mr. Philips) is a trial lawyer whose practice is largely limited to handling personal injury and products liability cases. During the tax years at issue, Mr. Richard ***637** A. Childs (Mr. Childs), Mr. Philips, and Mr. John C. Swearingen (Mr. Swearingen) engaged in the practice of law in Columbus, Georgia, as a professional corporation known as Swearingen, Childs & Philips, P.C. Mr. Childs, Mr. Philips, and Mr. Swearingen were the only shareholders of the professional corporation (the law firm).

Mr. Willie James Jones (Mr. Jones), along with his wife, Mrs. Annette Jones (Mrs. Jones), and her son, Jermeral C. Garrett (Garrett), a minor, lived near Phoenix City, Alabama, in a community called Salem. On September 21, 1984, Mr. Jones and Garrett sustained serious bodily injuries as a result of an explosion and fire caused by the accumulation of gas in the Joneses' home. On October 12, 1984, Mr. Jones died from the injuries he received from the explosion.

Mr. Jones was survived by his widow, his mother, and several brothers and sisters. Mr. Jones had no will and, therefore, his estate was distributed according to the intestacy laws of Alabama.

In the latter part of September 1984, Mr. Philips was informed of the explosion by Mr. Jones' brother,

[2] All section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

who asked Mr. Philips to investigate the situation. Mr. Philips then visited Mrs. Jones, who requested Mr. Philips and his law firm to pursue for her any possible claims against those responsible for the explosion. Within a few days, Mr. Swearingen and Mr. Childs visited the scene of the explosion to further investigate.

Pursuant to a contingency fee agreement (the Garrett fee agreement) executed on October 17, 1984, Messrs. Philips, Swearingen, and Childs (the attorneys) agreed to represent Mrs. Jones. According to the Garrett fee agreement, the law firm's representation of Mrs. Jones was for causes of action that Mrs. Jones might bring individually, on behalf of Garrett, and as administratrix of the estate of Mr. Jones. Under the agreement, if the cases were settled before trial, the fees paid to the attorneys were to be a sum equal to 33 ⅓ percent of the gross amounts recovered by Mrs. Jones, individually, as administratrix of the estate of Mr. Jones, and on behalf of her son, Garrett. If the cases were settled after trial, the attorneys were to receive 40 percent of the gross amounts recovered. Under the agreement, if nothing was recovered on behalf of the plaintiffs, or paid upon the claims or causes of action, the attorneys received nothing for their services rendered. ***638** The agreement provided that the compensation to the attorneys was for "services already rendered and * * * to be rendered" in the actions to be brought by Mrs. Jones. Mrs. Jones agreed to bear all expenses of litigation, whether or not any amounts were recovered. The attorneys were authorized to pay out of money due Mrs. Jones any and all doctors' bills, hospital bills, other medical bills, and expenses incurred. According to the Garrett fee agreement, if, after investigation, the attorneys deemed it unwise to proceed further with the cases, the attorneys had the right to withdraw, but Mrs. Jones would not be held liable for any costs or expenses incurred if they withdrew.

The agreement expressly granted to the attorneys full and complete authority to handle the claims and file whatever legal proceedings were necessary and proper. There was no provision in the fee agreement for payment for services rendered after a settlement was concluded.

The attorneys filed personal injury claims (the claims) with Columbus Propane Gas Service, Inc. (Columbus Propane), on behalf of Mrs. Jones, as mother and next friend of Garrett, and on her own behalf for loss of services of Garrett, and for Mr. Jones' death, claiming that Columbus Propane was responsible for the explosion and resulting injuries. The liability insurance carriers for Columbus Propane were Georgia Casualty & Surety Co. (Georgia Casualty) and Stonewall Insurance Co. (Stonewall). Georgia Casualty was Columbus Propane's primary insurance carrier, with coverage up to $1 million. Stonewall was the secondary insurer, providing excess (umbrella) insurance coverage up to $10 million.

After the claims were filed, Columbus Propane notified Georgia Casualty of the claims. During the latter part of 1984, Georgia Casualty attempted to negotiate a settlement of Mrs. Jones' claims. Georgia Casualty engaged the services of Charles S. Bradford (Mr. Bradford) of Structured Annuity Settlements, Inc., to attempt to negotiate a structured settlement on its behalf with Mrs. Jones. Mr. Philips was the attorney who did most of the negotiating with Mr. Bradford. Mr. Philips initially demanded $5 million to settle the claims arising from the injuries to Garrett, and an additional $5 million to settle the claims arising from the death of Mr. Jones, for a total of $10 million. After this demand by Mr. Philips, settlement negotiations ceased.

***639** On May 7, 1985, Garrett, acting by and through Mrs. Jones, and Mrs. Jones individually, filed a suit against Columbus Propane in the U.S. District Court for the Middle District of Georgia, Columbus Division (the Garrett litigation). The Garrett litigation was assigned Civil Action No. 85–90–COL.

Neither Georgia Casualty nor Stonewall Insurance was named as a defendant in the Garrett litigation.

The attorneys prepared the complaint, interrogatories, and numerous other documents in the Garrett litigation, and they also represented Mrs. Jones in the taking of fifteen depositions.

Georgia Casualty retained Lokey & Bowden, a law firm in Atlanta, Georgia, as its counsel. Mr. Glenn Frick (Mr. Frick) of Lokey & Bowden acted as lead counsel for Georgia Casualty. Stonewall retained Lord, Bissell & Brook, a law firm in Atlanta, Georgia, as its counsel.

The trial in the Garrett litigation was scheduled to commence on March 24, 1986. During March 1986, the parties to the Garrett litigation renewed settlement negotiations. On March 5, 1986, Mr. Bradford met with Mr. Philips and Mr. Childs to present a proposal for the settlement of the Garrett litigation. On March 7, 1986, in a letter to Mr. Philips, Mr. Bradford proposed a settlement which included payment of legal fees in the amount of $150,000. Mr. Philips rejected the settlement offer proposed by Mr. Bradford.

At this point, the law firm sent a letter to Messrs. Frick, Roger Sullivan, and Clifton Shepherd of Georgia Casualty, and to Mr. E.A. Anderson of Stonewall. In this letter, the position of the law firm on settlement of the Garrett litigation and wrongful death claim was set forth. The law firm, on behalf of the plaintiffs, offered to settle the Garrett litigation for $2.4 million and the wrongful death claims for $2 million. At this point, litigation had not been initiated with respect to the claim based on Mr. Jones' wrongful death. The law firm's offer as to the Garrett litigation was rejected, and there was no response as to the wrongful death claim. Soon thereafter, the law firm lowered its offer for settlement of the Garrett litigation to $2 million. After the lower offer was made, Mr. Bradford began to make proposals for settlement ***640** based on structured payments[3] to the plaintiffs and to the attorneys for their fees.

Mr. Philips was concerned with effecting a settlement of the Garrett litigation in a manner to protect Garrett and to preserve the money received. At the time, Garrett was under 10 years old, and Mr. Philips did not consider Mrs. Jones to be qualified to protect Garrett's money.

Around the middle of March 1986, Mr. Bradford and Mr. Philips reached a tentative settlement of the Garrett litigation. This tentative settlement was a structured settlement for the payment on behalf of Garrett and also for legal fees. Since Garrett, a minor who was a resident of Alabama, was a party to the settlement, court approval of the settlement was required.

On April 25, 1986, the Circuit Court of Russell County, Alabama (the Alabama court), approved the terms of the Garrett release agreement and a second release agreement dealing with Mrs. Jones' claim for lost services. Also on April 25, 1986, the Honorable Robert Elliott, U.S. District Judge for the Middle District of Georgia, entered his Order dismissing the Garrett litigation with prejudice pursuant to rule 41 of the Federal Rules of Civil Procedure.

The first Release and Indemnity Agreement (the Garrett release agreement) was executed by Mrs. Jones, as next friend and mother of Garrett, and by Mollie Hood, as Garrett's guardian.[4] A second Release and Indemnity Agreement (the second Garrett release agreement) was executed by Mrs. Jones. This release dealt with her claim for lost services. The Garrett release agreement and the second Garrett

[3] "Structured payments" and "structured settlements" refer to payments to be made at various times in the future.

[4] Mollie Hood was Garrett's grandmother. Because of his doubt of Mrs. Jones' ability to handle financial matters, Mr. Philips had arranged to have Mrs. Hood appointed Garrett's guardian.

release agreement served to release Columbus Propane from any claims arising from damage done to or injuries sustained by Garrett because of the explosion. The releases also authorized the law firm to consent to an order dismissing the Garrett litigation.

According to the Garrett release agreement, Georgia Casualty and Stonewall would pay to Garrett a lump-sum payment of $240,469.82, along with extended structured payments. The structured payments were to be paid through the ***641** purchase of annuities from Executive Life Insurance Co. (Executive Life), but neither Georgia Casualty nor Stonewall was released from its obligation to make the payments. The Garrett release agreement provided that Georgia Casualty and Stonewall, or their assignees, were the owners of any annuity policies issued to provide for the payments under the structured settlement. Georgia Casualty and Stonewall were not required to segregate or set aside specific assets to fund any of the structured payments.

The Garrett release agreement provided for a future assignment of the obligations of Georgia Casualty and Stonewall as to the structured payments in the Garrett release agreement to First Executive Corp. (First Executive), which would assume the obligations on behalf of Georgia Casualty and Stonewall without releasing the insurance companies' liability. The release agreement specifically provided—

> X. If the obligation of Stonewall Insurance Company or Georgia Casualty & Surety to make periodic payments herein is assigned, then the rights and obligations of this agreement as to the assignee shall remain unchanged.

In consideration for the assumption by First Executive, Georgia Casualty and Stonewall were to deliver to First Executive a sum sufficient to purchase an annuity which would provide adequate payments to First Executive to enable it to meet the obligations assumed, plus a fee as determined by First Executive.

During negotiations of a settlement of the Garrett litigation, a proposal was discussed that would have given Garrett a structured settlement, but would not have provided specifically for the payment of legal fees. During these discussions, Mr. Philips consulted with the State Bar of Georgia to determine if such a settlement was accepted, what amount would be allowable as legal fees, and how the attorneys might collect this amount. It was determined that if such a settlement was made, at the time it was made the attorneys would be entitled to the agreed percentage of the present value of the structured settlement. Because of the problems which would result, a decision was reached to specifically provide for the payment of the legal fees in any settlement.

The Garrett release agreement provided for the payment of legal fees to the attorneys for services in connection with the ***642** Garrett litigation. A schedule of structured payments to the attorneys was set forth in an attachment to the release agreement, which was incorporated into the agreement. During negotiations with Mr. Bradford concerning the settlement of the Garrett litigation, several different alternatives for payment of legal fees were discussed. Mr. Bradford insisted that some portion of the legal fees be paid in a structured format, even though Mr. Philips had expressed a desire to receive his fee immediately. One factor that the attorneys considered in making a decision on how to handle payment of the legal fees was Mrs. Jones' statement that she did not want the attorneys to receive their fee immediately, if she and Garrett were to take a structured settlement. Before the negotiations resulted in an agreed settlement, the parties agreed that all of the legal fees would be paid in a structured format.[5] Each of the attorneys was given several options as to the structure of the payments to him and

[5] It appears that some part of the $240,469.82 cash payment was to be used for payment of medical expenses and litigation

each made his decision from the options offered.

According to the Garrett release agreement, Mr. Philips was to be paid $52,155 on January 2, 1987, and $52,155 on January 2, 1988. Mr. Childs was to be paid $1,324.57 per month for 10 years beginning on January 2, 1987, and $6,000 per year on August 1 of 1996, 1997, 1998, and 1999. Mr. Swearingen's share of the legal fees was to be paid to him in six annual payments of $11,734.21, commencing on January 2, 1987, along with the following payments made on August 1 of the year indicated:

Year	Amount
1992	$10,000
1993	10,000
1994	10,000
1995	20,000
1996	10,000
1997	10,000
1998	22,000
1999	12,000
2000	12,000
2001	12,000

***643** Sometime after April 1, 1986, the attorneys were each named as annuitants under an annuity policy purchased by Georgia Casualty and Stonewall from Executive Life, and their respective estates were designated as primary beneficiaries. There were no contingent beneficiaries named.

According to the Garrett release agreement, if any party entitled to receive payments under the Garrett release agreement died prior to the receipt of the payment, future payments were to be made to a

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expenses, and some was to be paid to the attorneys. However, this payment is not in issue here and, in fact, the record does not show whether this payment was for attorneys' fees or other uses.

lawfully designated representative or beneficiary, unless the payments terminated on the death of the party under the terms of the Garrett release agreement. The Garrett release agreement also provided that neither Garrett, his guardian, his heirs, his beneficiaries, nor his assigns had the right to accelerate payments or reduce the payments to their present value.

On April 14, 1986, Mrs. Jones, Mrs. Hood as guardian for Garrett, each of the attorneys, Georgia Casualty, Stonewall, and First Executive, the parent company of Executive Life, executed an Assignment and Assumption Agreement providing for "a qualified assignment [which] * * * meets the requirements of Section 130 of the Internal Revenue Code, as amended" of the deferred payment liability of Georgia Casualty and Stonewall to Garrett, Mrs. Jones, and the attorneys. This agreement provided that with amounts received from Georgia Casualty and Stonewall, First Executive would purchase from Executive Life annuity contracts to cover the deferred payment liabilities of Georgia Casualty and Stonewall. Petitioners were annuitants under the policies and, as such, the beneficiaries. Paragraph 5 of this agreement provided—

> 5. *No Right of Acceleration/Status as General Creditor.* 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.

The owner of the Garrett annuities, including those under which the attorneys were annuitants, was First Executive. Each of these Garrett annuities contained a provision stating that the owner of the annuity could exercise any right or ***644** privilege of ownership, including changing the beneficiary under the policy by written request while the beneficiary was living.

Not all of the deferred payments in the Garrett litigation have been paid on time. Executive Life has had financial troubles and has missed some payments in connection with the Garrett settlement. On such occasions, the attorneys have notified Georgia Casualty and Stonewall, and these companies have made the payments to the extent not made by Executive Life.

On September 18, 1986, Mrs. Jones, individually and as personal representative and administratrix of the estate of Mr. Jones, brought a separate wrongful death suit against Columbus Propane in the U.S. District Court for the Middle District of Georgia, based on the death of Mr. Jones (the Jones litigation). Stonewall was not a named defendant in the Jones litigation.

In connection with the Jones litigation, the attorneys and the law firm provided legal services, including, but not limited to, filing pleadings and motions, preparing memoranda of law, requesting the production of documents, preparing interrogatories, and also representing the plaintiff in depositions.

After the attorneys had offered to settle the Jones litigation for $2 million, there was not much discussion of a settlement until around the middle of September 1987, when a jury trial in the Jones litigation had commenced. At this point, the defendants in the Jones litigation offered a settlement of $600,000, which was rejected. Even though the trial had commenced, the parties agreed that further trial be continued and settlement negotiations continued. Mrs. Jones and the law firm entered into an amended fee agreement (the Jones fee agreement) with respect to the Jones litigation, which changed the legal fees the law firm would receive if the Jones litigation went to trial from 40 percent to 45 percent. Stonewall hired Allan J. Richardson & Associates, Inc. (Richardson & Associates), and its

structured settlement negotiator, James L. Gilbert, to assist in the settlement negotiations in the Jones litigation. Mr. Gilbert began to send the attorneys settlement proposals which included payment of legal fees. Mr. Gilbert never presented a proposal that provided for all of the settlement amount to be paid immediately, ***645** and he always insisted that at least some part of the legal fees be paid in a structured format. He offered several options for the structured payment of attorney's fees.

In the fall of 1987, the parties in the Jones litigation reached a settlement. On November 11, 1987, Mrs. Jones, individually, and as administratrix of the estate and personal representative of Mr. Jones, along with Mr. Jones, mother and siblings, executed a Release and Indemnity Agreement (the Jones release agreement). According to the Jones release agreement, Mrs. Jones agreed to release the claims which arose out of the death of Mr. Jones against Columbus Propane and other entities and individuals named therein. Stonewall agreed to make a lump-sum payment in the amount of $464,431 to Mrs. Jones, individually and as the administratrix and representative of the estate of Mr. Jones, the attorneys, and the law firm.[6] Mrs. Jones' portion of the lump-sum payment was to be used to satisfy the claims of all other beneficiaries of the estate of Mr. Jones. Stonewall also agreed to make certain structured payments to Mrs. Jones through annuities purchased from Manufacturers Life Insurance Co. (Manufacturers Life).

The Jones release agreement also provided for the payment of legal fees for the Jones litigation. Mr. Gilbert had presented the attorneys with several options as to the payment of the legal fees, each involving structured payments. Originally, the options that Mr. Gilbert presented involved long-term annuities. As he prepared the different proposals, Mr. Gilbert tried to determine each attorney's attitude towards the structured payments. According to the Jones release agreement, Mr. Philips was to receive $1,000 per month beginning on January 15, 1992, and payable thereafter each month of each year so long as Mr. Philips lived, but for 20 years certain. Mr. Philips' payments were to be compounded annually by a factor of 3 percent. Mr. Swearingen was to receive monthly payments of $1,000 for 5 years and monthly payments of $1,800 commencing on January 15, 2012, and continuing for the remainder of his life. Also, Mr. Swearingen was to receive monthly payments commencing on January 15 of the year indicated and ***646** continuing in each instance for 5 years thereafter (totaling sixty payments) as follows:

Year	**Amount**
1997	$1,200
2002	1,400
2007	1,600

Mr. Childs requested that he receive his part of the legal fees immediately, but that arrangement was not acceptable to Mr. Gilbert. Mr. Childs, from the alternatives offered to him, chose to receive payments of $49,000 on January 15, 1988, and $49,050 on April 15, 1988.

[6] This payment is not in issue in this case, nor does the record show the use of the part of the payment received by the attorneys.

The Jones release agreement allowed Stonewall to assign its obligation for the structured payments under the Jones release agreement to Manulife Service Corp. (Manulife). Manulife would then become directly responsible for the structured payments, and Manufacturers Life would guarantee the structured payments. In the case of such an assignment, the Jones release agreement provided that Stonewall would remain obligated as a secondary guarantor after Manufacturers Life's guarantee. The Jones release agreement provided that no party that was to receive payments had the right to accelerate the payments or reduce the payments to their present value. As in the Garrett litigation, petitioners agreed that their rights under the policies were no greater than those of a general creditor.

On November 11, 1987, Mrs. Jones and the attorneys signed a Notice of Settlement, Satisfaction and Dismissal, which dismissed with prejudice all claims in the Jones litigation. On November 24, 1987, Richardson & Associates completed three applications to purchase annuities (the Jones annuities) from Manufacturers Life in order to fund the structured payments of attorney's fees to the attorneys. On December 15, 1987, Manufacturers Life issued three annuity policies with respect to payment of the structured attorney's fees to the attorneys. Each policy expressly provided that Stonewall was the owner of the policy and that, as such, it had all rights of ownership. Under the Jones annuities, the annuitants, who were the attorneys, did not have the right to assign the payments, accelerate the payments, designate the payee, change the terms or times of payments, transfer ***647** or sell the payments, or designate a new beneficiary. Under the Swearingen policy, Stonewall retained the power to change the beneficiary. Under the Childs annuity, Stonewall had the power to change the designated payee as long as Richard Childs was living. Under the Philips annuity, Stonewall also reserved the right to change the beneficiary.

On October 14, 1987, Stonewall issued two checks. One check was payable to Manufacturers Life in the amount of $536,069. This check was to purchase the Jones annuities. The second check in the amount of $464,431 was made payable to Annette Jones, individually, and as administratrix of the estate of Willie J. Jones, and the attorneys.

The law firm had paid all the expenses of the Garrett litigation and the Jones litigation. After the cases were settled, the law firm was reimbursed for the expenses it had paid.

Mr. Philips discussed with Mr. Bradford the tax consequences of the deferral of payment of the legal fees. Mr. Philips also discussed the tax consequences of the deferral of payment of attorney's fees with his accountant.

On their 1986 tax returns, the Swearingens, the Childses, and Mr. Philips each reported only the cash amounts received in 1986 as attorney's fees in the Garrett litigation. Petitioners neither reported any portion of the deferred payments for attorney's fees agreed to in the Garrett litigation, nor the fair market value or cost of the annuity policies purchased for these payments. On their 1987 tax returns, the Swearingens, the Childs, and Mr. Philips each reported the first structured payments received as attorney's fees from the Garrett litigation, and the cash amounts received as attorney's fees in the Jones litigation, but neither reported any portion of the deferred payments under the structured agreement in the Jones litigation, nor the fair market value or cost of the annuities purchased to provide for such deferred payments. In the notice of deficiency issued to each, the Swearingens, the Childses, and Mr. Philips, respondent determined that the fair market value of the right to receive payments under the Garrett annuities was includable in each attorney's income in 1986, and the fair market value of the right to receive payment under the Jones annuities was includable in the attorney's taxable income for 1987, under the provisions of section 83. Respondent further determined ***648** that a portion of the amounts received from the Garrett annuities in 1987, and reported by each petitioner in 1987, was not

taxable to that petitioner in 1987, since the fair market value of the Garrett annuities had been included in taxable income in 1986. In her answer, respondent alleged, in the alternative, that each of the attorneys constructively received a total fee equal to the value of the annuity purchased for him in the year the annuity was purchased.

OPINION

Section 83[7] provides that if property is transferred to any person in connection with the performance of services, the person who performed the services is required to include in income the fair market value of such property (less any amounts which were paid for such property) in the first taxable year in which such property becomes transferable or is not subject to a substantial risk of forfeiture, whichever comes first.

Section 321(a) of the Tax Reform Act of 1969, Pub.L. 91–172, 83 Stat. 487, 588, added section 83 to the Internal Revenue Code of 1954. Congressional intent in enacting section 83 "was to equate the tax treatment of restricted stock plans involving employers and employees to the tax treatment accorded other types of deferred compensation arrangements." *Centel Communications Co. v. Commissioner,* 92 T.C. 612, 628 (1989) (citing H.Rept. 91–413 (Part 1) (1969), 1969–3 C.B. 200, 254; S.Rept. 91–552 (1969), 1969–3 C.B. 423, 500), affd. 920 F.2d 1335 (7th Cir.1990). We have held, however, that Congress intended section 83 to apply to all restricted stock, and not merely stock transferred for less than full value by employers to employees. *Alves v. Commissioner,* 79 T.C. 864 (1982), affd. 734 F.2d 478, 481–482 (9th Cir.1984). Also, clearly section 83 applies to property other ***649** than stock. See *Montelepre Systemed, Inc. v. Commissioner,* 956 F.2d 496 (5th Cir.1992) (holding a contractual right to be section 83 property), affg. T.C.Memo. 1991–46.

Section 1.83–3(e), Income Tax Regs., provides that "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." Property also includes a beneficial interest in assets which are transferred or otherwise "set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Sec. 1.83–3(e), Income Tax Regs.

Since 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. Therefore, if the agreements to pay annuities received by petitioners in these cases are to be held to be taxable under section 83, it is necessary that in addition to the promise to pay by Georgia Casualty and Stonewall, the evidence show such promise to be either "funded" or "secured".[8]

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[7] SEC. 83(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 transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

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

[8] Petitioners Swearingen and Philips argue, in the alternative, that petitioners were at most third-party beneficiaries in the Garrett settlement agreement and the Jones settlement agreement. We need not address this argument due to our holding with regard to whether the promises to pay were funded or secured.

Neither the statute nor the regulations under section 83 defines when a promise to pay is "funded". However, in other contexts, we have considered the question of when an obligation was funded. In *Sproull v. Commissioner,* 16 T.C. 244 (1951), affd. 194 F.2d 541 (6th Cir.1952), an employer established a trust to compensate an employee for past services. The employee, or in the event of his death the employee's estate, was the sole beneficiary under the trust. In 1945, the employer distributed money to the trust to be paid out to the employee in two installments in 1946 and 1947. We held that the employee received compensation in 1945 in an amount equal to the value of the amount paid over for the employee's benefit, since the employee was the owner of the beneficial interest in the trust. We concluded that the establishment of the trust itself conferred an economic and financial benefit on the taxpayer which was properly taxable to him in the year the fund was irrevocably paid over for his benefit.

***650** In *Centre v. Commissioner,* 55 T.C. 16 (1970), an employment agreement between an employee and his employer entered into in 1955 required the employer to maintain an insurance policy as a means of funding the employer's obligation to make deferred compensation payments. The employer remained the owner and beneficiary of the policy until the employee terminated his employment prior to normal retirement age, unless termination was by reason of willful breach by the employee of the employment agreement. The employee terminated his employment on December 15, 1962, and in 1964 was assigned the policy pursuant to an agreement between the employee and the employer after a suit was commenced by the employee when the employer refused to voluntarily assign the policy. We held that the employee realized taxable income in 1964 when the policy was assigned to him and not when the premiums were paid by the employer. Since the employer was both the owner and the beneficiary of the policy while the premiums were being paid, we concluded that the employee did not obtain such an interest in the policy as to realize income until the policy was assigned to him.

In *Minor v. United States,* 772 F.2d 1472 (9th Cir.1985), a physician's employer established a deferred compensation plan under which the physician would be paid for future services by a designated percentage of the fee he was entitled to receive under the fee schedule, if the physician had not participated in the plan. Each physician employee could elect to receive a percentage from 10 percent to 90 percent of the fee under the fee schedule, and the balance would go into a deferred compensation fund. To provide for the deferred compensation payments, the employer established a trust under which the employer was the settlor and beneficiary. Three of the physicians, including the plaintiff in the case involved, were trustees. The Court of Appeals for the Ninth Circuit held that since the employee had no right, title, or interest in the trust, and since the employee benefited only incidentally from the trust, the employee was not taxed on amounts paid into the trust when the trust was funded. The Court of Appeals for the Ninth Circuit pointed out that because the deferred compensation plan was not secured from the employer's creditors and was, therefore, neither nonforfeitable nor fully vested, no amount of ascertainable value had ***651** been conferred on the employee which would cause the funds paid into the plan to be taxable to him in the year paid in.

Taken together, these cases stand for the proposition that funding occurs when no further action is required of the obligor for the trust or insurance proceeds to be distributed or distributable to the beneficiary. Only at the time when the beneficiary obtains a nonforfeitable economic or financial benefit in the trust or insurance policy is the provision for future payments secured or funded. However, if the trust or policy is subject to the rights of general creditors of the obligor, funding has not occurred. *Minor v. United States, supra.*

Under the annuity policies issued pursuant to the Garrett litigation, Georgia Casualty and Stonewall were the obligors, but the owner of the policies was First Executive. Petitioners were the annuitants

and, in this sense, only the beneficiaries of the policies. First Executive had the right to change the beneficiary of the annuity by written request while that annuitant of that policy was living. Under the Assignment and Assumption Agreement between Georgia Casualty, Stonewall, and petitioners, the parties agreed that the periodic payments could not be accelerated, deferred, increased, or decreased by the recipients of the payments. Under this Assignment and Assumption Agreement, petitioners agreed that they were to have no rights against First Executive other than the rights of a general creditor. Since petitioners did not own the policies, and since First Executive had the right to change the annuitant or beneficiary of each policy without the consent of the annuitant, the promises to pay petitioners under the Garrett litigation structured agreement were not funded promises by the obligors, Georgia Casualty and Stonewall.

In the Jones litigation, the owner of each of the policies was Stonewall. Stonewall maintained the right to change the beneficiary under each of the policies in which Swearingen, Philips, and Childs were the annuitants. Also, petitioners agreed that they did not have the right to accelerate, defer, increase, or decrease the periodic payments. They further agreed that their rights under the Assignment and Assumption Agreement were no greater than the rights of a general creditor. Petitioners were neither the owners nor were they irrevocable beneficiaries under the policies, and so these annuities were unfunded.

***652** For many of the reasons discussed above, we hold that the promises to pay were not secured. Petitioners argue that the promises were not secured since they were not granted a security interest in the property respondent contends was securing the obligation, because they were granted no rights in the property itself. Respondent argues that the guarantees by the insurance companies, Georgia Casualty, Stonewall, and First Executive, caused the promises to be secured. Respondent also argues that the fact that the insurance companies were required to maintain adequate reserves caused the promises to pay to be secured. Further, respondent argues that these promises were secured since under Georgia law attorneys have a lien superior to all other liens, except tax liens on actions, judgments, and decrees for money.

It is well settled that a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay. *Berry v. United States,* 760 F.2d 85 (4th Cir.1985), affg. per curiam 593 F.Supp. 80, 85 (M.D.N.C.1984); *Brand v. Commissioner,* 81 T.C. 821, 828 (1983). Therefore, the mere fact that several insurance companies guaranteed the payments to petitioners is irrelevant to our determination of whether petitioners' right to receive the future payments was secured. Also, we are not persuaded by respondent's argument that the attorneys' claims were secured since such claims are superior to all other claims under Georgia law, except tax liens. Assuming respondent is correct as to the superiority of attorneys' claims, such superiority is not equivalent to property being set aside as security for the annuities.[9] The contracts for structured payments were themselves payment for the attorney's fees, so the attorneys no longer had a lien for services.

***653** Even though the insurance companies were required to maintain adequate reserves for all policy

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[9] Under Georgia law, an attorney's lien attaches upon actions, judgments, and decrees for money. Ga.Code Ann. 15–19–14 (Michie 1990). This lien attaches to the fruits of labor and skill of the attorney, whether realized by judgment or decree, or by virtue of an award, or in any other way, as long as they are the result of his execution. *Thomas v. Travelers Ins. Co.,* 185 S.E. 922 (Ga.Ct.App.1936); *Camp v. United States Fidelity & Guaranty Co.,* 157 S.E. 209, 210 (Ga.Ct.App.1931). Thus, under Georgia law, insurance proceeds deposited in escrow from a procured settlement were held to fall within the meaning of this language. *John J. Woodside Co. v. Irwin,* 53 S.E.2d 246 (Ga.Ct.App.1949). However, in the instant cases, by agreement the attorneys accepted a structured settlement for payment of their fees with specific provisions as to payment. Therefore, the attorneys had been paid by the contractual agreement and had no attorney's liens to be enforced.

holders, this is not equivalent to specific property securing the annuities being set aside.

From the facts of these cases, we conclude that the promises to pay were neither funded nor secured. This is evident from the fact that if Executive Life or First Executive were to be placed into conservatorship, the payments to the annuitants would not have been guaranteed by any specific fund or property.[10] Thus, no property secured the promises to pay the future amounts due petitioners under the Garrett agreement.

The promises to pay under the Jones agreement were also unsecured. In the Assignment and Assumption Agreement, the parties agreed that petitioners had no greater rights than those of a general creditor.

Since we have concluded that the agreements by Georgia Casualty and Stonewall to pay petitioners in the future were unfunded and unsecured promises to pay money in the future, these agreements were not property within the meaning of section 83. Therefore, no amount that represents the value of the future payments is includable in income of any petitioner under section 83 in the year the promises were received.

Respondent contends that if we conclude that the value of the right to future payments which petitioners received is not income taxable to petitioners under section 83, petitioners should be held to have constructively received the amounts paid for the annuity contracts in the years the annuities were purchased. Respondent raised this issue by amended answer. The parties disagree as to whether respondent or petitioners have the burden of proof on this issue. However, we do not reach this question, since under the proven facts in these cases we conclude petitioners did not constructively receive the amounts paid for the annuity contracts in the year of the purchase of those contracts.

***654** Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Under section 1.451–2(a), Income Tax Regs., income is constructively received by a taxpayer in the taxable year in which such income is credited to the taxpayer's account, is set apart for the taxpayer, or is otherwise made available so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

"Under the constructive-receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment." *Martin v. Commissioner,* 96 T.C. 814, 823 (1991). Generally, there must be an amount that is immediately due and owing that the obligor is ready, willing, and able to pay. The amount owed must either be credited to the taxpayer or set aside for the taxpayer so that the taxpayer has an unrestricted right to receive it immediately, and the taxpayer being aware of these facts, declines to accept the payment. The doctrine of constructive receipt is essentially a question of fact. *Avery v. Commissioner,* 292 U.S. 210, 215 (1934).

[10] In fact, Executive Life was placed into conservatorship on Apr. 11, 1991, at which time payments to petitioners were limited to 70 percent of the periodic payments payable to them. Mr. Swearingen received the first five structured payments due under the Executive Life annuity contract in 1991, but only received 70 percent of the sixth payment from Executive Life. Though the shortfall was paid by Georgia Casualty, it is clear that the annuity policy owned by First Executive did not fully secure the promise between the obligors, Georgia Casualty and Stonewall and, the obligees, petitioners Swearingen, Philips, and Childs.

Under the original fee agreement dated October 17, 1984, between petitioners and Mrs. Jones, both as next friend of Garrett and as administratrix of Mr. Jones' estate, petitioners were to receive 33 ⅓ percent of the gross amount recovered in the litigation if the case was settled before the suit was tried, and 40 percent of any gross amount recovered if the case was settled after the suit was tried. "Recovered" implies amounts that petitioners' clients actually received, rather than amounts that petitioners' clients had a right to receive. Petitioners' clients recovered no money from the litigation until after April 25, 1986, the date of the judgment in the Garrett litigation approving the Garrett release agreement. Under the Garrett release agreement, petitioners were to receive structured payments. Petitioners were not entitled to their fees until recovery by their clients, so their right to receive payment arose only after settlement or disposition of ***655** the case. Thus, for the Garrett litigation, petitioners did not become entitled to their attorney's fees until the judgment was entered, by which time the structured settlements had been agreed upon.

Likewise, in the Jones litigation, petitioners had no right to receive payment until the settlement was effected on November 11, 1987, by which time the parties had agreed upon payment of attorney's fees in installments. The right of petitioners to receive payment of fees existed only after the Jones release agreement became effective, since any rights arising from the fee agreement were dependent on amounts recovered for petitioners' clients. Petitioners had no right to receive any moneys prior to such time as their clients "recovered" amounts from their claims. Petitioners never had the right to receive immediate payment, and no fund or property was set aside for petitioners which they could draw from at a time of their choosing. Because each of the deferred payment agreements was binding between the parties and was made prior to the time when petitioners acquired an absolute and unconditional right to receive payment, petitioners, who were on a cash basis, were not required to report the proceeds as income until actually received. *Oates v. Commissioner,* 18 T.C. 570, 584–85 (1952), affd. 207 F.2d 711 (7th Cir.1953); *Amend v. Commissioner,* 13 T.C. 178, 185 (1949).

Most of the cases we discuss in connection with the meaning of "funded" or "secured" as used in section 83 deal at least in part with questions of constructive receipt. From the holdings in those cases, and for the same reason we concluded that the promises to pay were not "funded" or "secured", it is clear that petitioners did not constructively receive their attorney's fees for each case in the year that case was settled. In the year each structured fee agreement was entered into, there was no money or property available at petitioners' unfettered demand from that structured fee agreement.

We hold that petitioners did not constructively receive the fees which were the subject of the structured fee agreements until payments of the amounts in accordance with those agreements. Therefore, we do not reach the issue of the fair market value of petitioners' right to receive payments for attorney's fees in future years.

***656** Because of issues settled by the parties,

Decisions will be entered under Rule 155.

125 S. Ct. 826
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, Petitioner,
v.
John W. BANKS, II.
Commissioner of Internal Revenue, Petitioner,
v.
Sigitas J. Banaitis.

Nos. 03–892, 03–907.
|
Argued Nov. 1, 2004.
|
Decided Jan. 24, 2005.

Synopsis
Background: In separate actions, taxpayers petitioned for redetermination of taxability of litigation settlement proceeds. In both cases, the United States Tax Court, 2001 WL 196751 and 2002 WL 22018, upheld taxation of portion of recovery paid to taxpayers' attorneys as contingent fees. Taxpayers appealed. In both cases, the United States Courts of Appeals for the Sixth Circuit, Clay, Circuit Judge, 345 F.3d 373, and for the Ninth Circuit, Thomas, Circuit Judge, 340 F.3d 1074, reversed on the attorney fee issue. Certiorari was granted.

The Supreme Court, Justice Kennedy, held that when litigant's recovery constitutes taxable income, such income includes portion of recovery paid to litigant's attorney as contingent fee.

Reversed and remanded.

Chief Justice Rehnquist took no part in decision.

Procedural Posture(s): On Appeal.

****826 *426** *Syllabus*[*]

Respondent Banks settled his federal employment discrimination suit against a California state agency and respondent Banaitis settled his Oregon state case against his former employer, but neither included fees paid to their attorneys under contingent-fee agreements as gross income on their federal income tax returns. In each case petitioner Commissioner of Internal Revenue issued a notice of deficiency, which the Tax Court upheld. In ****827** Banks' case, the Sixth Circuit reversed in part, finding that the amount Banks paid to his attorney was not includable as gross income. In Banaitis' case, the Ninth Circuit found that because Oregon law grants attorneys a superior lien in the contingent-fee portion of any recovery, that part of Banaitis' settlement was not includable as gross income.

Held: When a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. Pp. 830–834.

(a) Two preliminary observations help clarify why this issue is of consequence. First, taking the legal

expenses as miscellaneous itemized deductions would have been of no help to respondents because the Alternative Minimum Tax establishes a tax liability floor and does not allow such deductions. Second, the American Jobs Creation Act of 2004—which amended the Internal Revenue Code to allow a taxpayer, in computing adjusted gross income, to deduct attorney's fees such as those at issue—does not apply here because it was passed after these cases arose and is not retroactive. Pp. 830–831.

(b) The Code defines "gross income" broadly to include all economic gains not otherwise exempted. Under the anticipatory assignment of income doctrine, a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party, *e.g., Lucas v. Earl,* 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731, because gains should be taxed "to those who earned them," *id.,* at 114, 50 S.Ct. 241. The doctrine is meant to prevent taxpayers from avoiding taxation through arrangements and contracts devised to prevent ***427** income from vesting in the one who earned it. *Id.,* at 115, 50 S.Ct. 241. Because the rule is preventative and motivated by administrative and substantive concerns, this Court does not inquire whether any particular assignment has a discernible tax avoidance purpose. P. 831.

(c) The Court agrees with the Commissioner that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. However, in the context of anticipatory assignments, where the assignor may not have dominion over the income at the moment of receipt, the question is whether the assignor retains dominion over the income-generating asset. Looking to such control preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits. In the case of a litigation recovery the income-generating asset is the cause of action derived from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. Respondents' counterarguments are rejected. The legal claim's value may be speculative at the moment of the assignment, but the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. In these cases, the taxpayer retained control over the asset, diverted some of the income produced to another party, and realized a benefit by doing so. Also rejected is respondents' suggestion that the attorney-client relationship be treated as a sort of business partnership or joint venture for tax purposes. In fact, that relationship is a quintessential principal-agent relationship, for the client retains ultimate dominion and control over the underlying claim. The attorney can make tactical decisions without consulting the client, but the client still must determine whether to settle or ****828** proceed to judgment and make, as well, other critical decisions. The attorney is an agent who is duty bound to act in the principal's interests, and so it is appropriate to treat the full recovery amount as income to the principal. This rule applies regardless of whether the attorney-client contract or state law confers any special rights or protections on the attorney, so long as such protections do not alter the relationship's fundamental principal-agent character. The Court declines to comment on other theories proposed by respondents and their *amici,* which were not advanced in earlier stages of the litigation or examined by the Courts of Appeals. Pp. 831–833.

(d) This Court need not address Banks' contention that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee-shifting provisions, such as those applicable in ***428** his case brought under 42 U.S.C. §§ 1981, 1983, and 2000e *et seq.* He settled his case, and the fee paid to his attorney was calculated based solely on the contingent-fee contract. There was no court-ordered fee award or any indication in his contract with his attorney or the settlement that the contingent fee paid was in lieu of statutory fees that might otherwise have been recovered. Also, the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes. Pp. 833–834.

No. 03–892, 345 F.3d 373; No. 03–907, 340 F.3d 1074, reversed and remanded.

KENNEDY, J., delivered the opinion of the Court, in which all other Members joined, except REHNQUIST, C.J., who took no part in the decision of the cases.

Attorneys and Law Firms

Philip N. Jones, Counsel of Record, for Respondent Banaitis in 03-907, Duffy Kekel, LLP, Portland, OR, Russell R. Young, Counsel of Record, for Respondent Banks in 03-892, Mayer, Brown, Rowe & Maw, LLP, Chicago, IL, Joint Supplemental Brief for Respondents.

Paul D. Clement, Acting Solicitor General, Counsel of Record, Department of Justice, Washington, D.C., for the Petitioner.

Robert G. Wilson, James R. Carty, Cotkin, Collins & Ginsburg, APC, Los Angeles, CA, Glenn P. Schwartz, The John Marshall Law School, Chicago, IL, Russell R. Young, Counsel of Record, Roger J. Jones, Mayer, Brown, Rowe & Maw LLP, Chicago, IL, William J. Wise, Querrey & Harrow, Ltd., Chicago, IL, Brief for the Respondent.

Theodore B. Olson, Solicitor General, Counsel of Record, Eileen J. O'Connor, Assistant Attorney General, Thomas G. Hungar, Deputy Solicitor General, David B. Salmons, Assistant to the Solicitor General, Richard Farber, Kenneth W. Rosenberg, Attorneys, Department of Justice, Washington, D.C., for Petitioner.

Opinion

Justice KENNEDY delivered the opinion of the Court.

***429** The question in these consolidated cases is whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent-fee agreement is income to the plaintiff under the Internal Revenue Code, 26 U.S.C. § 1 *et seq.* (2000 ed. and Supp. I). The issue divides the courts of appeals. In one of the instant cases, *Banks v. Commissioner,* 345 F.3d 373 (2003), the Court of Appeals for the Sixth Circuit held the contingent-fee portion of a litigation recovery is not included ****829** in the plaintiff's gross income. The Courts of Appeals for the Fifth and Eleventh Circuits also adhere to this view, relying on the holding, over Judge Wisdom's dissent, in *Cotnam v. Commissioner,* 263 F.2d 119, 125–126 (C.A.5 1959). *Srivastava v. Commissioner,* 220 F.3d 353, 363–365 (C.A.5 2000); *Foster v. United States,* 249 F.3d 1275, 1279–1280 (C.A.11 2001). In the other case under review, *Banaitis v. Commissioner,* 340 F.3d 1074 (2003), the Court of Appeals for the Ninth Circuit held that the portion of the recovery paid to the attorney as a contingent fee is excluded from the plaintiff's gross income if state law gives the plaintiff's attorney a special property interest in the fee, but not otherwise. Six Courts of Appeals have held the entire litigation recovery, including the portion paid to an attorney as a contingent fee, is income to the plaintiff. Some of these Courts of Appeals discuss state law, but little of their analysis appears to turn on this factor. *Raymond v. United States,* 355 F.3d 107, 113–116 (C.A.2 2004); *Kenseth v. Commissioner,* 259 F.3d 881, 883–884 (C.A.7 2001); *Baylin v. United States,* 43 F.3d 1451, 1454–1455 (C.A.Fed.1995). ***430** Other Courts of Appeals have been explicit that the fee portion of the recovery is always income to the plaintiff regardless of the nuances of state law. *O'Brien v. Commissioner,* 38 T.C. 707, 712, 1962 WL 1147 (1962), aff'd, 319 F.2d 532 (C.A.3 1963) *(per curiam); Young v.*

Commissioner, 240 F.3d 369, 377–379 (C.A.4 2001); *Hukkanen–Campbell v. Commissioner,* 274 F.3d 1312, 1313–1314 (C.A.10 2001). We granted certiorari to resolve the conflict. 541 U.S. 958, 124 S.Ct. 1712, 1713, 158 L.Ed.2d 398 (2004).

We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits.

I

A. *Commissioner v. Banks*

In 1986, respondent John W. Banks, II, was fired from his job as an educational consultant with the California Department of Education. He retained an attorney on a contingent-fee basis and filed a civil suit against the employer in a United States District Court. The complaint alleged employment discrimination in violation of 42 U.S.C. §§ 1981 and 1983, Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.,* and Cal. Govt.Code Ann. § 12965 (West 1986). The original complaint asserted various additional claims under state law, but Banks later abandoned these. After trial commenced in 1990, the parties settled for $464,000. Banks paid $150,000 of this amount to his attorney pursuant to the fee agreement.

Banks did not include any of the $464,000 in settlement proceeds as gross income in his 1990 federal income tax return. In 1997 the Commissioner of Internal Revenue issued Banks a notice of deficiency for the 1990 tax year. The Tax Court upheld the Commissioner's determination, finding that all the settlement proceeds, including the $150,000 Banks had paid to his attorney, must be included in Banks' gross income.

***431** The Court of Appeals for the Sixth Circuit reversed in part. 345 F.3d 373 (2003). It agreed the net amount received by Banks was included in gross income but not the amount paid to the attorney. Relying on its prior decision in *Estate of Clarks ex rel. Brisco–Whitter v. United States,* 202 F.3d 854 (2000), the court held the contingent-fee agreement was not an anticipatory assignment of Banks' income because the litigation recovery was not already earned, vested, or even relatively ****830** certain to be paid when the contingent-fee contract was made. A contingent-fee arrangement, the court reasoned, is more like a partial assignment of income-producing property than an assignment of income. The attorney is not the mere beneficiary of the client's largess, but rather earns his fee through skill and diligence. 345 F.3d, at 384–385 (quoting *Estate of Clarks, supra,* at 857–858). This reasoning, the court held, applies whether or not state law grants the attorney any special property interest (*e.g.,* a superior lien) in part of the judgment or settlement proceeds.

B. *Commissioner v. Banaitis*

After leaving his job as a vice president and loan officer at the Bank of California in 1987, Sigitas J. Banaitis retained an attorney on a contingent-fee basis and brought suit in Oregon state court against the Bank of California and its successor in ownership, the Mitsubishi Bank. The complaint alleged that Mitsubishi Bank willfully interfered with Banaitis' employment contract, and that the Bank of California attempted to induce Banaitis to breach his fiduciary duties to customers and discharged him when he refused. The jury awarded Banaitis compensatory and punitive damages. After resolution of all appeals and post-trial motions, the parties settled. The defendants paid $4,864,547 to Banaitis; and, following the formula set forth in the contingent-fee contract, the defendants paid an additional $3,864,012

directly to Banaitis' attorney.

***432** Banaitis did not include the amount paid to his attorney in gross income on his federal income tax return, and the Commissioner issued a notice of deficiency. The Tax Court upheld the Commissioner's determination, but the Court of Appeals for the Ninth Circuit reversed. 340 F.3d 1074 (2003). In contrast to the Court of Appeals for the Sixth Circuit, the *Banaitis* court viewed state law as pivotal. Where state law confers on the attorney no special property rights in his fee, the court said, the whole amount of the judgment or settlement ordinarily is included in the plaintiff's gross income. *Id.,* at 1081. Oregon state law, however, like the law of some other States, grants attorneys a superior lien in the contingent-fee portion of any recovery. As a result, the court held, contingent-fee agreements under Oregon law operate not as an anticipatory assignment of the client's income but as a partial transfer to the attorney of some of the client's property in the lawsuit.

II

To clarify why the issue here is of any consequence for tax purposes, two preliminary observations are useful. The first concerns the general issue of deductibility. For the tax years in question the legal expenses in these cases could have been taken as miscellaneous itemized deductions subject to the ordinary requirements, 26 U.S.C. §§ 67–68 (2000 ed. and Supp. I), but doing so would have been of no help to respondents because of the operation of the Alternative Minimum Tax (AMT). For noncorporate individual taxpayers, the AMT establishes a tax liability floor equal to 26 percent of the taxpayer's "alternative minimum taxable income" (minus specified exemptions) up to $175,000, plus 28 percent of alternative minimum taxable income over $175,000. §§ 55(a), (b) (2000 ed.). Alternative minimum taxable income, unlike ordinary gross income, does not allow any miscellaneous itemized deductions. § 56(b)(1)(A)(i).

***433** Second, after these cases arose Congress enacted the American Jobs Creation Act of 2004, 118 Stat. 1418. Section 703 of the Act amended the Code by adding § 62(a)(19). *Id.,* at 1546. The amendment allows a taxpayer, in computing adjusted gross income, to deduct "attorney fees and court costs paid by, or on behalf ****831** of, the taxpayer in connection with any action involving a claim of unlawful discrimination." *Ibid.* The Act defines "unlawful discrimination" to include a number of specific federal statutes, §§ 62(e)(1) to (16), any federal whistle-blower statute, § 62(e)(17), and any federal, state, or local law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship ... or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law," § 62(e)(18). *Id.,* at 1547–1548. These deductions are permissible even when the AMT applies. Had the Act been in force for the transactions now under review, these cases likely would not have arisen. The Act is not retroactive, however, so while it may cover future taxpayers in respondents' position, it does not pertain here.

III

The Internal Revenue Code defines "gross income" for federal tax purposes as "all income from whatever source derived." 26 U.S.C. § 61(a). The definition extends broadly to all economic gains not otherwise exempted. *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 429–430, 75 S.Ct. 473, 99 L.Ed. 483 (1955); *Commissioner v. Jacobson,* 336 U.S. 28, 49, 69 S.Ct. 358, 93 L.Ed. 477 (1949). A taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. *Lucas v. Earl,* 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930); *Commissioner v. Sunnen,* 333 U.S. 591, 604, 68 S.Ct. 715, 92 L.Ed. 898 (1948); *Helvering v. Horst,* 311 U.S. 112, 116–117, 61 S.Ct. 144, 85 L.Ed. 75

(1940). The rationale for the so-called anticipatory assignment of income doctrine is the principle that gains should be taxed "to those who earned them," ***434** *Lucas, supra,* at 114, 50 S.Ct. 241, a maxim we have called "the first principle of income taxation," *Commissioner v. Culbertson,* 337 U.S. 733, 739–740, 69 S.Ct. 1210, 93 L.Ed. 1659 (1949). The anticipatory assignment doctrine is meant to prevent taxpayers from avoiding taxation through "arrangements and contracts however skillfully devised to prevent [income] when paid from vesting even for a second in the man who earned it." *Lucas,* 281 U.S., at 115, 50 S.Ct. 241. The rule is preventative and motivated by administrative as well as substantive concerns, so we do not inquire whether any particular assignment has a discernible tax avoidance purpose. As *Lucas* explained, "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Ibid.*

Respondents argue that the anticipatory assignment doctrine is a judge-made antifraud rule with no relevance to contingent-fee contracts of the sort at issue here. The Commissioner maintains that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. We agree with the Commissioner.

In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. *Glenshaw Glass Co., supra,* at 431, 75 S.Ct. 473; see also *Commissioner v. Indianapolis Power & Light Co.,* 493 U.S. 203, 209, 110 S.Ct. 589, 107 L.Ed.2d 591 (1990); *Commissioner v. First Security Bank of Utah, N. A.,* 405 U.S. 394, 403, 92 S.Ct. 1085, 31 L.Ed.2d 318 (1972). In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance the question becomes whether the assignor ****832** retains dominion over the income-generating asset, because the taxpayer "who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Horst, supra,* at 116–117, 61 S.Ct. 144. See also *Lucas,* ***435** *supra,* at 114–115, 50 S.Ct. 241; *Helvering v. Eubank,* 311 U.S. 122, 124–125, 61 S.Ct. 149, 85 L.Ed. 81 (1940); *Sunnen, supra,* at 604, 68 S.Ct. 715. Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.

In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. We do not understand respondents to argue otherwise. Rather, respondents advance two counterarguments. First, they say that, in contrast to the bond coupons assigned in *Horst,* the value of a legal claim is speculative at the moment of assignment, and may be worth nothing at all. Second, respondents insist that the claimant's legal injury is not the only source of the ultimate recovery. The attorney, according to respondents, also contributes income-generating assets—effort and expertise—without which the claimant likely could not prevail. On these premises respondents urge us to treat a contingent-fee agreement as establishing, for tax purposes, something like a joint venture or partnership in which the client and attorney combine their respective assets—the client's claim and the attorney's skill—and apportion any resulting profits.

We reject respondents' arguments. Though the value of the plaintiff's claim may be speculative at the moment the fee agreement is signed, the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. *Lucas, supra; United States v. Basye,* 410 U.S. 441, 445, 450–452, 93 S.Ct. 1080, 35 L.Ed.2d 412 (1973). Though *Horst* involved an anticipatory assignment of a predetermined sum to be paid on a specific date, the holding in that case did not depend on ascertaining a liquidated amount at the time of assignment. In each of the cases before us, as in *Horst,* the taxpayer retained control over the income-generating asset, diverted some of

the income produced to another party, and realized a benefit by doing so. As Judge ***436** Wesley correctly concluded in a recent case, the rationale of *Horst* applies fully to a contingent–fee contract. *Raymond v. United States,* 355 F.3d, at 115–116. That the amount of income the asset would produce was uncertain at the moment of assignment is of no consequence.

We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes. The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. Restatement (Second) of Agency § 1, Comment *e* (1957) (hereinafter Restatement); ABA Model Rules of Professional Conduct Rule 1.3, and Comment 1; Rule 1.7, and Comment 1 (2002). The client may rely on the attorney's expertise and special skills to achieve a result the client could not achieve alone. That, however, is true of most principal-agent relationships, and it does not alter the fact that the client retains ultimate dominion and control over the underlying claim. The control is evident when it is noted that, although the ****833** attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions. Even where the attorney exercises independent judgment without supervision by, or consultation with, the client, the attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party. Restatement §§ 13, 39, 387.

The attorney is an agent who is dutybound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal. In this respect Judge Posner's observation is apt: "[T]he contingent-fee lawyer [is not] a joint owner of his client's claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable." ***437** *Kenseth,* 259 F.3d, at 883. In both cases a principal relies on an agent to realize an economic gain, and the gain realized by the agent's efforts is income to the principal. The portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income.

This rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship. Cf. Restatement § 13, Comment *b,* and § 14G, Comment *a* (an agency relationship is created where a principal assigns a chose in action to an assignee for collection and grants the assignee a security interest in the claim against the assignor's debtor in order to compensate the assignee for his collection efforts). State laws vary with respect to the strength of an attorney's security interest in a contingent fee and the remedies available to an attorney should the client discharge or attempt to defraud the attorney. No state laws of which we are aware, however, even those that purport to give attorneys an "ownership" interest in their fees, *e.g.,* 340 F.3d, at 1082–1083 (discussing Oregon law); *Cotnam,* 263 F.2d, at 125 (discussing Alabama law), convert the attorney from an agent to a partner.

Respondents and their *amici* propose other theories to exclude fees from income or permit deductibility. These suggestions include: (1) The contingent-fee agreement establishes a Subchapter K partnership under 26 U.S.C. §§ 702, 704, and 761, Brief for Respondent in No. 03–907, pp. 5–21; (2) litigation recoveries are proceeds from disposition of property, so the attorney's fee should be subtracted as a capital expense pursuant to §§ 1001, 1012, and 1016, Brief for Association of Trial Lawyers of America as *Amicus Curiae* 23–28, Brief for Charles Davenport as *Amicus Curiae* 3–13; and (3) the fees are deductible reimbursed employee business expenses under § 62(a)(2)(A) (2000 ed. and Supp. I), Brief for ***438** Stephen B. Cohen as *Amicus Curiae.* These arguments, it appears, are being presented for the first

time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories. In addition, we do not reach the instance where a relator pursues a claim on behalf of the United States. Brief for Taxpayers Against Fraud Education Fund as *Amicus Curiae* 10–20.

IV

The foregoing suffices to dispose of Banaitis' case. Banks' case, however, involves a further consideration. Banks ****834** brought his claims under federal statutes that authorize fee awards to prevailing plaintiffs' attorneys. He contends that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee-shifting provisions. See *Venegas v. Mitchell,* 495 U.S. 82, 86, 110 S.Ct. 1679, 109 L.Ed.2d 74 (1990) (observing that statutory fees enable "plaintiffs to employ reasonably competent lawyers without cost to themselves if they prevail"). In the federal system statutory fees are typically awarded by the court under the lodestar approach, *Hensley v. Eckerhart,* 461 U.S. 424, 433, 103 S.Ct. 1933, 76 L.Ed.2d 40 (1983), and the plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court-awarded attorney's fees can exceed a plaintiff's monetary recovery. See, *e.g., Riverside v. Rivera,* 477 U.S. 561, 564–565, 106 S.Ct. 2686, 91 L.Ed.2d 466 (1986) (compensatory and punitive damages of $33,350; attorney's fee award of $245,456.25). Treating the fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit. Furthermore, it is urged that treating statutory fee awards as income to plaintiffs would ***439** undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general.

We need not address these claims. After Banks settled his case, the fee paid to his attorney was calculated solely on the basis of the private contingent-fee contract. There was no court-ordered fee award, nor was there any indication in Banks' contract with his attorney, or in the settlement agreement with the defendant, that the contingent fee paid to Banks' attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover. Also, the amendment added by the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.

* * *

For the reasons stated, the judgments of the Courts of Appeals for the Sixth and Ninth Circuits are reversed, and the cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

THE CHIEF JUSTICE took no part in the decision of these cases.

Rev. Rul. 2003-115 (IRS RRU), 2003-46 I.R.B. 1052, 2003-2 C.B. 1052, 2003 WL 22436848

Internal Revenue Service (I.R.S.)

IRS RRU
Revenue Ruling

GROSS INCOME; COMPENSATION FOR INJURIES OR SICKNESS; DISASTER RELIEF PAYMENTS

Published: November 17, 2003
Released: October 29, 2003

ISSUES

(1) Are periodic payments made to a claimant of the September 11th Victim Compensation Fund of 2001 (Fund) pursuant to an Award Determination Agreement among the claimant, the Special Master, and an assignment company (Agreement) excluded from the gross income of the claimant under §§ 139(f) and 104(a)(2) of the Internal Revenue Code?

(2) Is the amount transferred by the United States to an assignment company pursuant to an Agreement and in exchange for the assignment company's assuming the United States' obligation to make periodic payments to a claimant excluded from the gross income of the assignment company under § 130(a)?

FACTS

On September 11, 2001, terrorist-related airline crashes occurred in New York, Virginia, and Pennsylvania. Following the attacks, the United States Government, under Title IV of the Air Transportation Safety and System Stabilization Act (Act), Pub. L. No. 107-42, 115 Stat. 230 (2001), created the Fund. The Act authorizes an award of compensation to any individual physically injured and to the personal representative of any individual killed as a result of the September 11th terrorist-related airline crashes.

To receive an award, a claimant must file a claim with the Fund no later than December 22, 2003. The Special Master, appointed under section 404 of the Act to administer the Fund, reviews the claim and notifies the claimant of any additional information needed to process the claim. Once the Special Master receives sufficient information to make an initial evaluation of the claim, the Special Master determines the claim to be substantially complete and notifies the claimant by letter. When a claim is determined to be substantially complete, the claimant is deemed to have waived any right to file a civil action or be a party to an action in any federal or state court for damages sustained as a result of the September 11, 2001, airline crashes, except to recover collateral-source obligations or to recover from a person who is a knowing participant in a conspiracy to hijack an aircraft.

The Special Master, within 120 days of his determination that the claimant's application is substantially complete, must determine (1) whether the claimant is entitled to an award and (2) the amount of the award. Once the Special Master makes an award determination, the claimant is notified in writing. The claimant then has 21 days to either accept the award determination or appeal it by requesting a hearing before the Special Master. Alternatively, a claimant, following the submission of a claim, may proceed directly to a hearing process for purposes of determining the award amount.

The amount of an award is affected by a number of factors including whether the claimant received an insurance or workers' compensation award as a result of either injuries incurred by, or the death of, the victim from the attack; the income of the victim; the nature, severity and duration of the victim's injuries resulting from the attack; the size of the victim's household, including the number of surviving dependents; and the victim's age. The particular needs of a claimant also may be taken into account in determining the award amount.

The Special Master allows a claimant to make an election to receive an award in the form of periodic payments instead of a lump sum payment. The claimant, however, must elect periodic payments before the Special Master issues the letter notifying the claimant that his or her claim is substantially complete. If a claimant who applies for advance benefits as provided by the Fund desires periodic payments, the claimant must elect periodic payments when he or she files the form applying for advance benefits. An election may not be revoked by the claimant.

When electing to receive periodic payments, the claimant may choose to receive the entire award in periodic payments, or only a portion of the award in periodic payments with the remainder to be received as a single payment. Further, at the time the claimant elects periodic payments, the claimant must choose the period of time over which the payments are to be made and the frequency of payments during that period. For example, a claimant may choose to receive his or her award in monthly payments over twenty years or in monthly payments over the claimant's lifetime. Finally, all periodic payments must be of an equal amount unless the claimant specifies otherwise at the time he or she elects to receive periodic payments.

If a claimant chooses to receive all or a portion of the award in periodic payments, and if the Special Master determines that the claimant is entitled to an award, then the terms of the award are set forth in an Agreement. Each Agreement sets forth the amount to be paid and the frequency and duration of the payments. In addition, an Agreement may state that, if the claimant dies before the entire interest is distributed, the remaining payments are payable to the claimant's estate or to a secondary beneficiary duly designated by the claimant during the claimant's lifetime. Each Agreement provides that no payee or beneficiary shall have the right or power to transfer, mortgage, encumber or anticipate the periodic payments, by assignment or otherwise.

Each Agreement also includes an assignment by the Special Master of the United States' periodic payment obligation to, and an assumption of that obligation by, an assignment company in exchange for a payment from the United States to the assignment company. Each Agreement provides that the assignment company's periodic payment obligation is equal to the periodic payment obligation of the United States prior to the assignment, and that the periodic payments cannot be accelerated, deferred, increased, or decreased by the claimant or any beneficiary or payee. Each Agreement allows the assignment company to fund its obligation to make periodic payments through the purchase of an annuity contract that complies with the requirements set forth in § 130(d) for a qualified funding asset. Under an Agreement, the assignment company is the owner of the annuity, which is subject to claims of the general creditors of the assignment company.

LAW AND ANALYSIS

Issue 1

The first issue concerns whether periodic payments made to a claimant of the Fund pursuant to an

Agreement are excluded from the gross income of the claimant under § 139(f) and § 104(a)(2).

Section 61 provides that, except as otherwise provided by the Code, gross income includes all income from whatever source derived.

Section 139(f) provides that gross income does not include "any amount received as payment under section 406 of the Air Transportation Safety and System Stabilization Act." The § 139(f) exclusion applies to amounts paid to claimants in the form of a lump sum or periodic payments.

Section 104(a)(2) provides that gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as a lump sum or as periodic payments) on account of personal physical injuries or physical sickness.

Neither § 139(f) nor § 104(a)(2) excludes from gross income amounts that are earned from the investment by the claimant of a lump sum amount received as either payment under section 406 of the Act or damages on account of personal physical injuries or physical sickness, respectively. If such a lump sum payment is invested for the benefit of a claimant who has actual or constructive receipt, or the economic benefit, of the lump sum payment, only the lump sum payment is excluded from gross income, and none of the income from the investment of the lump sum payment is excludable from the claimant's gross income. Rev. Rul. 65-29, 1965-1 C.B. 59.

Section 1.451-2 of the Income Tax Regulations provides rules relating to constructive receipt. Under § 1.451-2(a), an amount is constructively received in the taxable year in which such amount is credited to a taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time if notice of intention is given. Income is not constructively received if the taxpayer's control of receipt of the amount is subject to substantial limitations or restrictions. Section 1.451-2(a).

The economic benefit doctrine, developed in case law, provides that if a promise to pay an amount is funded and secured by the payor, and the payee is not required to do anything other than wait for the payments, an economic benefit is considered to have been conferred on the payee and the amount of such benefit is considered to have been received. In *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd.*, 194 F.2d 541 (6th Cir. 1952), the court found that an economic benefit had been conferred on a taxpayer when the taxpayer's employer established a trust to compensate the taxpayer for past services. In 1945, the employer transferred money to the trust to be paid to the taxpayer in 1946 and 1947. The taxpayer was the trust's sole beneficiary. The court held that the taxpayer received compensation in 1945 in an amount equal to the value of the amount transferred to the trust for the taxpayer's benefit because such transfer to the trust provided the taxpayer with an economic benefit.

Not all rights to receive periodic payments, however, trigger application of the economic benefit doctrine. Rev. Rul. 79-220, 1979-2 C.B. 74, concludes that a right to receive certain periodic payments under the facts of the ruling does not confer an economic benefit on the recipient. In Rev. Rul. 79-220, a taxpayer entered into a settlement with an insurance company for the periodic payment of nontaxable damages for an agreed period. The taxpayer was given no immediate right to a lump sum amount and no control of the investment of the amount set aside to fund the insurance company's obligation. The insurance company funded its obligation with an annuity payable directly to the taxpayer. The insurance company, as owner of the annuity, had all rights to the annuity and the annuity was subject to the claims of the general creditors of the insurance company. The ruling concludes that all of the periodic payments are excluded from the taxpayer's gross income under § 104(a)(2) because the taxpayer did not

receive, or have the economic benefit of, the lump sum amount used to fund the annuity. Further, the ruling holds that if the taxpayer dies before the end of the agreed period, the payments made to the taxpayer's estate under the settlement agreement are also excludable from the gross income of the estate under § 104(a)(2).

With respect to a claimant of the Fund, the award claim procedure requires the claimant to make an irrevocable election relating to periodic payments while the claimant's control of receipt of payments is subject to substantial limitations or restrictions. Consequently, the claimant is not in constructive receipt of a lump sum amount. Further, no economic benefit of a lump sum has been conferred on the claimant by the Agreement. The assignment company making the periodic payments to the claimant may fund its obligation with an annuity to which the assignment company has all rights and that it continues to own. The periodic payments under the Agreement are, therefore, amounts "received as payment under section 406 of the Air Transportation Safety and System Stabilization Act" and thus excluded from the claimant's gross income under § 139(f). Moreover, the payments are excluded from the claimant's gross income under § 104(a)(2) as damages received on account of personal physical injuries or physical sickness. Finally, any payments to a successor beneficiary pursuant to the Agreement are excludable from the gross income of the successor beneficiary under §§ 104(a)(2) and 139(f).

Issue 2

The second issue concerns whether the amount transferred by the United States to an assignment company in exchange for the assignment company assuming the United States' obligation to make periodic payments to a claimant is excluded from the assignment company's gross income under § 130(a). Section 130 provides tax-favored treatment to certain structured settlement arrangements. Under § 130(a), any amount received for agreeing to a qualified assignment is excluded from the gross income of the assignee to the extent such amount does not exceed the aggregate cost of any qualified funding assets. Section 130(c) defines a qualified assignment as any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy the following requirements—

(1) the periodic payments must be fixed and determinable as to amount and time of payment;

(2) the periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments;

(3) the assignee's obligation on account of the personal injuries or sickness must be no greater than the obligation of the person who assigned the liability; and

(4) the periodic payments must be excludable from the gross income of the recipient under § 104(a)(1) or (2).

Under § 130(d), a qualified funding asset means any annuity contract issued by an insurance company licensed in the United States, or any obligation of the United States, meeting the requirements set forth in § 130(d)(1) through (4).

Each Agreement meets the requirements set forth in § 130(c)(1) through (4). Moreover, the Special Master is considered a person who is a party to a suit or agreement because the Fund was created to

compensate the victims of the terrorist attack. Accordingly, any payment by the United States to the assignment company for agreeing to a qualified assignment is excluded from the assignment company's gross income under § 130 to the extent such amount does not exceed the aggregate cost of any qualified funding assets purchased by the assignment company to fund the payment obligation assumed by it.

HOLDINGS

Under the facts of this revenue ruling:

(1) Periodic payments made to a claimant of the Fund pursuant to an Agreement are excluded from the gross income of the claimant under §§ 139(f) and 104(a)(2). Similarly, any payments to an estate or secondary beneficiary pursuant to an Agreement are excluded from the gross income of the successor beneficiary under §§ 104(a)(2) and 139(f).

(2) The amount transferred by the United States to an assignment company pursuant to an Agreement and in exchange for the assignment company's assuming the United States' obligation to make periodic payments to a claimant is excluded from the gross income of the assignment company under § 130(a) to the extent the amount transferred does not exceed the aggregate cost of any qualified funding asset purchased by the assignment company to fund the periodic payment obligation.

GRACE PERIODS FOR CERTAIN CLAIMANTS

Any claimant of the Fund who has been notified by the Special Master that his or her claim is substantially complete (or who has applied to receive advance benefits) but who has not made an election relating to periodic payments (including specifying the period of time over which the payments are to be made, the frequency of such payments, and, if the claimant so desires, a periodic-payment stream other than equal payments) may make such election and rely on this revenue ruling provided the claimant makes his or her election before the earlier of (1) December 17, 2003, or (2) the date the Special Master issues the claimant's award determination letter.

In addition, a claimant may rely on this revenue ruling if: (1) before issuance of the claimant's award determination letter, the claimant informed the Special Master of the claimant's wish to receive periodic payments but provided no information regarding the period or frequency of such payments (and, if desired, a periodic-payment stream other than equal payments); (2) before October 28, 2003, the Special Master confirmed in writing that the claimant so informed the Special Master; and (3) the claimant provides the additional information required to perfect his or her election by December 2, 2003.

DRAFTING INFORMATION

The author of the revenue ruling is Shareen S. Pflanz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, please call Shareen Pflanz or Stephen Toomey at (202) 622-4920 (not a toll-free call).

PLR 200836019 (IRS PLR), 2008 WL 4102778

Internal Revenue Service (I.R.S.)

IRS PLR
Private Letter Ruling

Issue: September 5, 2008
June 2, 2008

[CC:ITA:3]

PLR-150850-07

LEGEND:

taxpayer =

Employer =

Assignee =

Annuity =

Issuer

Date a =

Date b =

Dear
This responds to your letter dated November 13, 2007, requesting a ruling on the proper federal income tax treatment for certain periodic payments the taxpayer will receive in settlement of various claims against Employer.

REQUESTED RULINGS:

(1) The taxpayer will not be in actual or constructive receipt of periodic payments until she receives the applicable cash payment.

(2) The taxpayer will include each of the periodic payments in her income in the year in which she receives such payment.

APPLICABLE FACTS:

The taxpayer files her federal income tax return on a calendar year basis under the cash receipts and disbursements method of accounting.

The taxpayer has asserted that from Date a to Date b, while employed by Employer she was subjected to a pattern of hostile employment practices. Taxpayer filed a complaint seeking damages arising from alleged lost overtime wages (the "Wage Claim") and from alleged non-physical injuries, including emotional distress and mental anguish (the "Non-Wage Claim" and, together with the Wage Claim, the "Claims").

As a result of negotiations, taxpayer and Employer (the "Parties") agreed to settle taxpayer's Claims. Under a proposed Settlement Agreement and Release, Employer agrees to pay taxpayer an initial lump sum of cash (the "Lump Sum Payment") in settlement of her Wage Claim, together with a specified schedule of periodic payments (the "Periodic Payments") in settlement of her Non-Wage Claim.

In the Settlement Agreement and Release, taxpayer will agree that she may change neither the timing nor the amount of the Periodic Payments in order to accelerate, defer, increase or decrease such payments. Taxpayer further will agree that she may not sell, mortgage, encumber or anticipate all or any portion of the Periodic Payments by assignment or other means.

The Settlement Agreement and Release reserves the right of the Employer to enter into a "Non-Qualified Assignment," under which the Assignment Company ("Assignee") will make the Periodic Payments directly to the taxpayer. Furthermore, as part of the Settlement Agreement and Release, taxpayer will agree to allow Employer to enter into a Non-Qualified Assignment with Assignee and acknowledges that upon the Assignee's acceptance of a Non-Qualified Assignment, the Assignee will become the sole obligor with respect to the specified Periodic Payments. Under the Nonqualified Assignment Agreement, the Assignee agrees, for good and valuable consideration, to make the Periodic Payments to taxpayer.

Under the Non-Qualified Assignment Agreement, the Assignee will make the Periodic Payments directly to the taxpayer. The Assignee's obligation to make the Periodic Payments is no greater than that of Employer; however, the Assignee's obligation to make the Periodic Payments will continue regardless of the subsequent bankruptcy or insolvency of the Employer.

The Non-Qualified Assignment will be an irrevocable contract requiring the Assignee to make the specified Periodic Payments to the taxpayer. Under no circumstances can the taxpayer elect to receive the commuted value of the remaining Periodic Payments.

The Assignee's obligation under the Non-Qualified Assignment to make Periodic Payments will be discharged by transmitting, by the due date for each payment, a valid check or its electronic equivalent in the specified sum for the taxpayer. Similar to the Settlement Agreement and Release, the Non-Qualified Assignment prohibits changes to the timing or the amount of the Periodic Payments and prohibits the taxpayer from accelerating, deferring, increasing or decreasing the scheduled Periodic Payments. In addition, the taxpayer may not sell, assign, encumber or anticipate all or any portion of the Periodic Payments by assignment.

The Non-Qualified Assignment further specifies that the taxpayer has no rights against the Assignee other than those of an unsecured general creditor. The Non-Qualified Assignment states that all rights of ownership with respect to any annuity contract purchased by the Assignee belong exclusively to the Assignee; taxpayer will not be a third party beneficiary of any such annuity contract.[1] The Non-

[1] Pursuant to the Non-Qualified Assignment Agreement, the Assignee will fund the Periodic Payments by purchasing an annuity contract issued by the Annuity Issuer. All rights of ownership and control of such annuity contact shall be and

Qualified Assignment also states that no assets have been set aside to secure the Periodic Payments.

By settling her Non-Wage Claim for an agreed schedule of Periodic Payments and permitting Employer to assign its obligation to make such payments to the Assignee (the "Assignment Transaction"), the taxpayer can address her desire to use the settlement as a source for meeting future needs, including retraining and financial planning.

The Taxpayer has represented that:

1. The Periodic Payments represent compensation to the taxpayer for non-physical personal injuries and sickness she incurred during the course of her employment with Employer.

2. The Periodic Payments represent payments made by Employer to settle taxpayer's Non-Wage Claim and are not wages for federal income tax purposes.

3. Employer's Periodic Payments in settlement of the taxpayer's Non-Wage Claim will constitute a taxable recovery to the taxpayer pursuant to section 61 of the Internal Revenue Code and are not exempt from federal income tax under section 104(a)(2).

LAW AND ANALYSIS:

Section 451 of the Code provides that an item of gross income shall be included in a taxpayer's gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations, provides, in part, that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.

Section 1.451-2(a) of the Regulations, provides, in part, income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 66-45, 1966-1 C.B. 95 states that the phrase 'or otherwise made available' was added to section 1.451-2(a) of the Regulations to make it clear that it is a right of withdrawal during the taxable year, rather than the formal setting apart or crediting of income, which causes income to be constructively received.

In Rev. Rul. 67-203, 1967-1 C.B. 105, a winner of the Irish Sweepstakes reported his income on the cash receipts and disbursements basis, and, by reason of being a minor his winnings were to be held by the Irish court until he reached majority. Rev. Rul. 67-203 holds that the economic benefit doctrine applies and requires the inclusion of the present value of the sweepstakes winnings in the minor's gross

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remain vested in the Assignee.

income at the time the funds are paid over to the Irish court.

Rev. Rul. 2003-115, 2003-2 C.B. 1052, holds that neither the constructive receipt doctrine nor the economic benefit doctrine applied to a claimant regarding the settlement of a claim under the September 11 Victim Compensation Fund where (i) the claimant irrevocably elected to receive periodic payments while the claimant's control of receipt of payment was subject to substantial restrictions; (ii) the Fund assigned its obligation to make such periodic payments to an assignment company pursuant to a "qualified assignment" described in section 130; and (iii) the assignment company funded its obligation to make periodic payments by purchasing an annuity contract described in section 130(d).

Williams v. U.S., 219 F.2d 523 (5th Cir. 1955) holds that a seller is in constructive receipt of income where the buyer agrees to pay the full purchase price and the seller self imposes limitations on an escrow, which does not make the sales proceeds any less available to the seller.

In Commissionerr v. Brooklyn Gas Co., 62 F.2d 505 (2d Cir. 1933), a gas company engaged in rate litigation and obtained an interlocutory order staying reduced rates and directing that money collected in excess be impounded. The gas company was permitted to withdraw the impounded money upon issuing a bond. The court held that the money was taxable in years earned, not in the year litigation was finally terminated, because the taxpayer had dominion and control over the money without any restriction

In Childs v. Commissioner, 103 T.C. 634 (1994, aff'd without op. 89 F.3d 856 (11th Cir. 1996), the taxpayer received a structured settlement agreement, which provided that the defendant's insurance company assigned its obligation to Assignee, who then purchased an annuity from its subsidiary. Assignee remained the owner of the annuity policy, maintained the right to change the beneficiary without the consent of the taxpayer; and the taxpayer's rights under the annuity policy were not greater than those of a general creditor. The Tax Court held that the fair market value of taxpayer's right to receive payments under the settlement agreement was not includable income in the year in which the settlement agreement was effected because the promise to pay was neither fixed nor secured. The court further held that the doctrine of constructive receipt was not applicable because the taxpayer did not have a right to receive payment before the time fixed in the settlement agreement.

In Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd, 194 F. 2d 541 (1952), the Tax Court held that an economic benefit or financial benefit is conferred to the taxpayer, and as a result, the taxpayer recognizes income under the economic benefit doctrine where money is place in trust for the taxpayer, taxpayer is not required to do anything to earn such funds, and the trust contained no restriction on taxpayer's right to assign or otherwise dispose of the money placed in trust.

Under Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961), and Rev. Rul. 68-606, 1968-C.B. 42, a freely transferable, readily marketable right to a future payment stream, not subject to setoffs, is equivalent to cash and therefore is taxed at its fair market value when the right to such payment is received by a cash basis taxpayer.

Timing of Income for Federal Income Tax Purposes

Generally, the taxpayer's method of accounting determines when an amount is treated as received for Federal income tax purposes. In the instant case, Taxpayer reports on the cash receipts and disbursements method of accounting for Federal income tax purposes.

Under the cash receipts and disbursements method of accounting, all items which constitute gross income (whether in the form of cash, property, or services) are to be reported as income in the taxable year in which such items are actually or constructively received, or where the taxpayer is conferred an economic benefit.

A. Actual Receipt

Income is actually received when it is reduced to the taxpayer's possession, dominion, or disposition. See Brooklyn Gas. Under the Non-Qualified Assignment, taxpayer will not receive, nor in any way possess or control, the amount paid to the Assignee by the Employer. Nor will taxpayer receive any property at the time the Employer enters into the Non-Qualified Assignment, other than the contractual promise of the Assignee to make the scheduled payments. A mere unfunded, unsecured promise to pay does not result in income to a taxpayer on the cash receipts and disbursements method of accounting. Rev. Rul. 60-31, 1960-1 C.B. 174, and U.S. v. Christine Oil & Gas Co., 269 F. 458 (Cir. 1920). Thus, the taxpayer shall not be viewed as being in actual receipt of cash or property when she enters into the Settlement Agreement and Release with the Employer or when the Employer and the Assignee enter into the Non-Qualified Assignment.

B. Cash Equivalency

Under the "cash equivalency" doctrine, a cash basis taxpayer may be treated as being in receipt of income if that taxpayer receives a promise or other contractual obligation that can readily be converted into cash by the taxpayer. Cowden v. Comm'r, 289 F.2d 20, 24 (5th Cir. 1961), *rev'g and rem'g* 32 T.C. 853 (1959), *on remand*, 20 T.C.M. 1134 (1961). The taxpayers in Cowden were lessors under an oil, gas, and mineral lease who were entitled under the lease to deferred payments. Shortly after entering into the lease, the taxpayers assigned their rights to the deferred payments in exchange for an amount which represented a normal market discount from the amount of future payments they otherwise would have received. The Court stated:

> We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

289 F.2d at 24.

Under the Non-Qualified Assignment, the taxpayer will not be able to assign, encumber or otherwise transfer her right to receive the Periodic Payments. Both the Settlement Agreement and Release, executed by the Employer and the taxpayer, and the Non-Qualified Assignment, executed by the Employer and the Assignee, will provide that the taxpayer will have no right to modify the schedule of Periodic Payments, or to accelerate, defer, increase, decrease, anticipate, sell, assign, or encumber any payment.

Based upon the fact that the taxpayer's right to payments under the Non-Qualified Assignment will be neither assignable nor transferable, the taxpayer's limited right to payments shall not be treated as equivalent to cash. Although the Non-Qualified Assignment between the Employer and the Assignee will provide for the Assignee to fund its obligations by acquiring an annuity contract, the taxpayer will

have no rights in the annuity contract and thus will continue to possess only an unsecured and unfunded promise to pay. The Assignee's purchase of an annuity contract, under which the Assignee has all rights of ownership does not create a "cash equivalent" right that ripens into a benefit of the taxpayer.

C. Constructive Receipt

A cash basis taxpayer is in constructive of income, as opposed to actual receipt, when income although not actually reduced to a taxpayer's possession "is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." Section 1.451-2(a) of the Regulations. The phrase "or otherwise made available" was added to the Regulation to make it clear that a taxpayer's right to draw on income during the taxable year, even if it is not formally set apart or credited, causes income to be constructively received. Rev. Rul. 66-45, 1966-1 C.B. 95. A taxpayer will not have current income under the constructive receipt doctrine merely because he seeks deferral of payments as part of a negotiated settlement. *See* Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983). If, however, the taxpayer has a current right to receive all of the funds before a deferral mechanism is established, current income cannot be avoided. Williams v. United States.

Under the Non-Qualified Assignment, the taxpayer will not have a right to draw on or otherwise accelerate her receipt of the Periodic Payments scheduled to be made by the Assignee. The amounts to be paid by the Assignee will come from its general assets, which are subject to claims of the creditors of the Assignee. The Non-Qualified Assignment specifically provides that "None of the Periodic Payments may be accelerated, deferred, increased or decreased and may not be anticipated, sold, assigned, or encumbered. Any attempts to do so will be void."

Thus, under the Non-Qualified Assignment, the taxpayer will have no ability to receive any Periodic Payment (either partially or in full) before the time the Assignee is scheduled make any payment. The Non-Qualified Assignment will be entered into only after a Settlement Agreement and Release is negotiated between taxpayer and the Employer. During these negotiations, the taxpayer's payment rights will be established. The negotiated Settlement Agreement and Release will fix the taxpayer's rights prior to the time when she has an unqualified right to demand immediate payment. She will therefore not have a current right to receive a settlement payment before her right to receive Periodic Payments under the Settlement Agreement is established. Under the Settlement Agreement and Release and the Non-Qualified Assignment, taxpayer will be entitled to specified payments only at specified times, and the taxpayer will be prohibited from altering either the timing or the amount of any payments. Accordingly, the taxpayer shall not be viewed as constructively receiving any of the applicable payments at any time before the Assignee makes the Periodic Payments in cash pursuant to the schedule set forth in the Settlement Agreement and Release. Furthermore, Assignee's purchase of an annuity contract to fund its obligations under the Non-Qualified Assignment does not amount to a setting apart or crediting of funds for the taxpayer's benefit given that she will possess no rights under the annuity contract. Childs. (No constructive receipt where settlement agreement stipulated that attorney's rights under annuity policies, acquired by assignment company to fund obligation to make periodic payment of attorney's contingent fee arising from client's settlement, were no greater than rights of a general creditor.)

D. Economic Benefit

Under the "economic benefit doctrine," a taxpayer on the cash method of accounting may be treated as

having received income in a year prior to actual or constructive receipt in certain limited circumstances. *See, e.g.*, Sproull v. Comm'r, 16 T.C. 244, 247 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952). A cash-basis taxpayer is taxed currently on the value of the economic benefit conferred when the taxpayer is assured the benefit of future payments, even though such payments will not be made or made available to the taxpayer until subsequent taxable years. A taxpayer is treated as receiving the current economic benefit of future payments when a payor unconditionally and irrevocably establishes a separate fund or trust of assets exclusively for the taxpayer's benefit. Sproull, 16 T.C. at 248 *supra* (the economic benefit doctrine requires current inclusion in income of an amount irrevocably transferred to a trust to be paid, with earnings, to an employee over the following two years, or to his estate should he die earlier); Pulsifer v. Commissioner, 64 T.C. 245, 247 (1975) (Irish Sweepstakes winnings irrevocably deposited with an Irish court for the benefit of a minor sweepstakes winner are currently includible in income under the economic benefit doctrine); Rev. Rul. 67-203, 1967-1 C.B. 105.

Neither the execution of the Non-Qualified Assignment nor the purchase of an annuity contract by the Assignee to fund its obligation to the taxpayer shall be viewed as conferring a current economic benefit on the taxpayer. After the execution of the Non-Qualified Assignment, the taxpayer will possess only a mere promise to be paid (although the identity of the promisor will have changed). Moreover, no amount will be set aside from which to make the scheduled payments, nor will a separate fund be irrevocably and unconditionally set aside for the benefit of the taxpayer. Furthermore, taxpayer has no rights against the Assignee other than that of a general creditor.

Based on the above, neither the "constructive receipt" doctrine, the "cash equivalency" doctrine, nor the "economic benefit" doctrine shall apply to the taxpayer's facts regarding the Periodic Payments.

RULINGS:

Based solely on the facts and representations submitted, we conclude and rule as follows:
(1) The taxpayer will not be in actual or constructive receipt of the Periodic Payments until she receives the applicable cash payment.

(2) The taxpayer will include each of the Periodic Payments in her income in the year in which she receives such payment.

DISCLAIMERS AND LIMITATIONS:

This ruling is based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied regarding the deductibility of any amounts by Employer under section 1.461-4 of the Regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to

your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
Associate Chief Counsel (Income Tax & Accounting)

Section 6110(j)(3) of the Internal Revenue Code. This document may not be used or cited as precedent.

Notice 2005-1 (IRS NOT), 2005-2 I.R.B. 274, 2005-1 C.B. 274, 2004 WL 2930998

Internal Revenue Service (I.R.S.)

IRS NOT
Notice

GUIDANCE UNDER § 409A OF THE INTERNAL REVENUE CODE

Released: December 20, 2004
Published: January 10, 2005

***1** This notice provides general and transitional guidance relating to new section 409A of the Code, added as part of the American Jobs Creation Act of 2004. Section 409A provides certain rules relating to nonqualified deferred compensation plans, which generally are effective as of January 1, 2005. This notice provides general guidance with respect to what arrangements are covered by section 409A. In addition, this notice provides transitional guidance generally covering the calendar year 2005.

I. Purpose and Overview

Section 885 of the recently enacted American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418 (the Act), added § 409A to the Internal Revenue Code (Code). Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

As explained more fully below, this notice provides the first part of what is expected to be a series of guidance with respect to the application of § 409A. The Treasury Department and the Internal Revenue Service (Service) intend to incorporate the principles of this notice into additional, more comprehensive guidance in 2005.

Taxpayers should note that although the statute makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

A. Definitions and Coverage

This notice generally outlines the scope of coverage of § 409A. The notice first provides definitions of a nonqualified deferred compensation plan, a plan and the deferral of compensation. Guidance is provided on the application of § 409A to welfare plans, plans covered by § 457, stock appreciation rights, and arrangements between partners and partnerships. This notice provides a definition of a substantial risk of forfeiture.

The definition of nonqualified deferred compensation contains an exception for amounts actually or

constructively received by the service provider within a short period following the lapse of a substantial risk of forfeiture. The exception is intended to address multi-year compensation arrangements, where the right to the compensation is or may be earned over multiple years but is payable at the end of the earning period. For example, a three-year bonus program requiring the performance of services over three years and entitling the service provider to a payment within a short specified period following the end of the third year generally would not constitute a deferral of compensation. The Treasury Department and the Service are, however, concerned about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to be enforced. Accordingly, the Treasury Department and the Service are considering a more restrictive rule under which arrangements involving payments in later taxable years structured to coincide with a lapse in a substantial risk of forfeiture would constitute deferrals of compensation subject to § 409A. However, even under a more restrictive rule, the Treasury Department and the Service anticipate that a payment within a short period following a scheduled vesting date and, in specified circumstances, within a short period following an accelerated vesting date, would be permitted under the statutory authority provided to permit accelerated payments that are not inconsistent with the purposes of the statute. Comments are requested with respect to these issues and the extent to which additional guidance is required to prevent arrangements designed to evade application of § 409A.

This notice does not provide generally applicable methods for calculating the amount of deferrals for a given year. However, a rule is provided for calculation of the amount of deferrals before January 1, 2005 for purposes of applying the effective date provisions. The Treasury Department and the Service anticipate issuing guidance in 2005 providing methods for calculating the amount of deferrals for purposes of all deferrals to which § 409A applies, including deferrals preceding the issuance of the guidance. Until such guidance is issued, certain transition relief is provided to address information reporting and withholding requirements. However, nothing in this guidance should be interpreted to exempt amounts actually distributed to the taxpayer in 2005 from inclusion in income or from applicable reporting or withholding requirements.

B. Nonstatutory Stock Options and Stock Appreciation Rights

The definition of nonqualified deferred compensation contains an exception that generally excludes certain nonstatutory stock options from coverage under § 409A. This exception is consistent with the further exception covering transfers of restricted property, as the taxation of transfers of nonstatutory stock options and transfers of restricted property generally both are governed by § 83. Commentators have pointed out that under certain conditions, stock appreciation rights yield economically equivalent results to nonstatutory stock options exercised in a cashless transaction, and have requested that stock appreciation rights be treated similarly. However, the Treasury Department and the Service are concerned that a general exception for stock appreciation rights may be exploited as a method to avoid application of § 409A, particularly in regard to valuation of the underlying stock where the value is not established by and in an established securities market. In many respects, stock appreciation rights are similar to other forms of nonqualified deferred compensation, particularly where the recipient of a stock appreciation right may receive cash. In such cases, the taxation of stock appreciation rights generally is governed by § 451 and the constructive receipt doctrine. See Rev. Rul. 80-300, 1980-2 C.B. 165.

Accordingly, this notice provides limited exceptions from coverage under § 409A for certain stock appreciation rights which do not present potential for abuse or intentional circumvention of the purposes of § 409A. Under this exception, a stock appreciation right will not constitute a deferral of

compensation if (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such a right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. The Treasury Department and the Service request comments on the extent to which stock appreciation rights should be excepted from coverage under § 409A, in light of the statutory purpose.

The Treasury Department and the Service also are concerned about the potential for taxpayers to avoid application of § 409A by combining an exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights with a requirement or right that the stock acquired by the service provider be repurchased by the service recipient. Accordingly, the Treasury Department and the Service are considering a restriction on the exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights, to options or rights that are not accompanied by an arrangement or agreement under which the service recipient has an obligation or right to repurchase the acquired shares (including repurchases for an amount other than fair market value). In this context, the Treasury Department and the Service also request comments on appropriate techniques for valuation of stock subject to options or stock appreciation rights where the value of such stock is not established by and in an established securities market, in order to ensure that such valuation reflects the actual fair market value of the stock.

To the extent the additional guidance adopts a position on an issue addressed in this notice with respect to stock options or stock appreciation rights that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

C. Change in Control Events

This notice next addresses what constitutes a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation (Change in Control Event) for purposes of § 409A. Section 885(e) of the Act requires that within 90 days of the enactment of the legislation, the Treasury Department and the Service issue guidance on what constitutes a Change in Control Event. Section 409A provides that, to the extent provided by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may permit amounts deferred under the plan to be distributed upon a Change in Control Event.

D. Acceleration of Payments

Except under circumstances specified by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may not permit the acceleration of payments under the plan.

This notice provides circumstances under which payments under the plan may be accelerated, such as to meet the requirements of a domestic relations order or conflict of interest divestiture requirements. Comments are requested as to other circumstances under which a plan should be allowed to accelerate payments under the plan.

E. Effective Dates and Transition Relief

The notice provides guidance on the effective date provisions and transition relief. Section 409A generally is effective with respect to amounts deferred after December 31, 2004. Section 409A also is effective with respect to amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. This notice addresses what amounts will be considered deferred after December 31, 2004, generally providing that an amount will be treated as deferred on or before December 31, 2004 only if the service recipient has a binding legal obligation to pay an amount in a future taxable year and the service provider's right to the amount is earned and vested as of December 31, 2004. Methods of calculating amounts treated as deferred on or before December 31, 2004 are provided. This notice also addresses when a plan under which a deferral is made will be considered materially modified after October 3, 2004.

This notice addresses the requirements of § 885(f) of the Act, which provides that within 60 days of the enactment of the legislation, the Treasury Department and the Service must issue guidance providing that for a limited period and under certain conditions, a nonqualified deferred compensation plan may be amended without violating certain provisions of § 409A to (i) allow a participant to terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or (ii) conform the plan to the provisions of § 409A with respect to amounts deferred after December 31, 2004. This notice provides certain relief addressing the application of the initial deferral election requirements to compensation attributable, in whole or in part, to the performance of services in the years 2004 or 2005. This includes, for example, provisions addressing the deferral of bonuses, including bonuses for services performed in 2004.

F. Application of Information Reporting and Wage Withholding Requirements

This notice next addresses certain information reporting and wage withholding requirements imposed by § 885(b) of the Act with respect to deferred amounts. For information reporting purposes, the Act amends §§ 6041 and 6051 to require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 *(Miscellaneous Income)* or a Form W-2 *(Wage and Tax Statement)*. For wage withholding purposes, the Act amends § 3401(a) to provide that the term "wages" includes any amount includible in gross income of an employee under § 409A. Finally, for purposes of reporting nonemployee compensation, the Act further amends § 6041 to require that amounts includible in gross income under § 409A that are not treated as wages under § 3401(a) must be reported as gross income. This notice does not provide methods for calculating the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a). Consequently, interim guidance is provided with respect to an employer's withholding and reporting obligations where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance providing such methods.

II. Reliance on Transition Guidance; Good Faith, Reasonable Interpretation

This notice provides rules governing the application of § 409A. The Treasury Department and the Service anticipate issuing additional guidance that incorporates this notice. To the extent the additional

guidance adopts a position on an issue addressed in this notice that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

This notice does not provide comprehensive guidance with respect to the application of § 409A. Until additional guidance is issued, to comply with the requirements of § 409A with respect to issues not addressed in this notice, taxpayers should base their positions upon a good faith, reasonable interpretation of the statute and its purpose, which includes consideration of the legislative history. Whether a taxpayer position constitutes a good faith, reasonable interpretation of the statutory language generally will be determined based upon all of the relevant facts and circumstances, including whether the taxpayer has applied the position consistently and the extent to which the taxpayer has resolved unclear issues in the taxpayer's favor. In addition, certain provisions of § 409A provide definitive rules, but allow the Treasury Department and the Service to issue guidance providing exceptions to such rules. For example, § 409A(a)(3) provides that the Treasury Department and the Service may issue guidance providing an exception to the general prohibition against the acceleration of the time or schedule of any payment under a nonqualified deferred compensation plan. A taxpayer position based on an expected exception that the taxpayer speculates that the Treasury Department and the Service will adopt in future guidance is not a good faith, reasonable interpretation of the statutory language. In addition, as discussed above, the Treasury Department and the Service intend to issue guidance in 2005 providing methods for calculating the amount of deferrals for a year for purposes of all amounts of deferrals to which § 409A applies, including deferrals predating the issuance of the anticipated guidance. Accordingly, taxpayers will not be able to rely upon methods of calculation that differ from the methods provided in the 2005 guidance.

III. Request for Comments on Anticipated Guidance

A. Request for Comments

The Treasury Department and the Service request comments on all aspects of the application of § 409A, including but not limited to the topics addressed in this notice. The Treasury Department and the Service specifically request comments with respect to the following:

(1) The application of § 409A to severance plans, including whether to exclude any specific types of severance plans or arrangements (see Q&A 19).

(2) Funding arrangements for nonqualified deferred compensation that involve foreign trusts or similar arrangements, and identification of arrangements that will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors for purposes of the potential exemption from the provisions of § 409A(b) that the Treasury Department and the Service are authorized to provide under § 409A(e)(3).

(3) The application of § 409A to arrangements involving partners and partnerships. Comments are specifically requested with respect to the applicability of § 409A to arrangements subject to § 736, and whether there should be a distinction between payments subject to § 736(a) and (b) and the coordination of the timing rules of § 1.736-1(b)(5) with the rules of § 409A for nonqualified deferred compensation plans. Comments are also specifically requested on whether there should be special rules in applying § 409A in the case of a putative allocation and distribution which is recast, under § 707(a)(2)(A), as a payment to a nonpartner under § 707(a)(1).

(4) Potential additional exclusions from coverage under § 409A with respect to contractual arrangements between businesses (see Q&A 8).

(5) Situations where the acceleration of benefits should be permitted under § 409A(a)(3) (see Q&A 15), particularly in light of the legislative history regarding accelerated payments required for reasons beyond the control of the participant.

All materials submitted will be available for public inspection and copying.

B. Submission of Comments

Comments may be submitted to Internal Revenue Service, CC:PA:LPD:RU (Notice 2005-1), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:RU (Notice 2005-1), Room 5203. Submissions may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov*. Include the notice number (Notice 2005-1) in the subject line.

IV. Guidance

A. Definitions and Coverage

Q-1 What does § 409A provide, in general?

A-1 Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

Q-2 What are the federal income tax consequences of a failure to satisfy the requirements of § 409A?

A-2 Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If a deferred amount is required to be included in income under § 409A, the amount also is subject to interest and an additional income tax. The interest imposed is equal to the interest at the underpayment rate plus one percentage point, imposed on the underpayments that would have occurred had the compensation been includible in income for the taxable year when first deferred, or if later, when not subject to a substantial risk of forfeiture. The additional income tax is equal to 20 percent of the compensation required to be included in gross income.

Q-3 What is a nonqualified deferred compensation plan?

A-3 (a) In general. Except as otherwise provided in this A-3, the term nonqualified deferred compensation plan means any plan (within the meaning of Q&A 9) that provides for the deferral of compensation (within the meaning of Q&A 4). The application of § 409A is not limited to arrangements between an employer and an employee. For example, § 409A may apply to arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership (see Q&A 7 and Q&A 8).

(b) Qualified employer plans. The term nonqualified deferred compensation plan does not include (i) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of § 219(g)(5) (without regard to subparagraph (A)(iii)), (ii) any eligible deferred compensation plan (within the meaning of § 457(b)), and (iii) any plan described in § 415(m). Accordingly, the term nonqualified deferred compensation plan does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE or § 501(c)(18) trust.

(c) Certain welfare benefits. The term nonqualified deferred compensation plan does not include any *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in § 31.3121(v)(2)-1(b)(4)(iv)(C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in § 220, any Health Savings Account as described in § 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of § 105 and § 106.

Q-4 What constitutes a deferral of compensation?

A-4 (a) Deferral of compensation defined. A plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture (within the meaning of Q&A 10). Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under § 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

(b) Compensation payable pursuant to the service recipient's customary payment timing arrangement. A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in §

3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in § 3401(b).

(c) Short-term deferrals. Until additional guidance is issued, a deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, at all times the terms of the plan require payment by, and an amount is actually or constructively received by the service provider by, the later of (i) the date that is 2½ months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10) or (ii) the date that is 2½ months from the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10). For these purposes, an amount that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the date the service provider has a legally binding right to the amount. For example, an employer with a calendar year taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before March 15, 2007. An employer with a September 1 to August 31 taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before November 15, 2007. Notwithstanding the foregoing, if an election is provided to the service provider with respect to the taxable year in which payment of the compensation will occur, and the service provider elects a taxable year later than the taxable year in which he or she obtained a legally binding right to the payment, the arrangement constitutes a deferral of compensation subject to § 409A, including the deferral election timing rules of § 409A(a)(4). In addition, the arrangement continues to be subject to applicable U.S. Federal tax principles which may require immediate income inclusion.

(d) Stock options, stock appreciation rights, and other equity-based compensation. (i) Except as provided in paragraphs (ii), (iii) and (iv), the grant of a stock option, stock appreciation right or other equity-based compensation provides for a deferral of compensation subject to § 409A. Stock appreciation rights generally will be covered by § 409A; however, stock appreciation rights may be structured to comply with the provisions of § 409A. For example, the terms of a stock appreciation right with a fixed payment date generally will comply with the provisions of § 409A.

(ii) Nonstatutory stock options. An option to purchase stock of the service recipient, other than an incentive stock option described in § 422 or an option granted under an employee stock purchase plan described in § 423, does not provide for a deferral of compensation if: (1) the amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer or exercise of the option is subject to taxation under § 83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock option does not constitute a feature for the deferral of compensation. If under the terms of the option, the amount required to purchase the stock is or could become less than the fair market value of the stock on the date of grant, the grant of the stock option may provide for the deferral of compensation within the meaning of this A-4. For purposes of determining the fair market value of the stock at the date of grant, any reasonable valuation method may be used. Such methods include, for example, the valuation method described in § 20.2031-2 of the Estate Tax Regulations. To the extent an arrangement grants the recipient a right

other than to purchase stock at a defined price and such additional rights allow for the deferral of compensation (for example, tandem arrangements involving options and stock appreciation rights), the entire arrangement provides for the deferral of compensation. If the requirements of § 1.424-1 would be met if the nonstatutory option were a statutory option, the substitution of a new option pursuant to a corporate transaction for an outstanding option or the assumption of an outstanding option will not be treated as the grant of a new option or a change in the form of payment for purposes of § 409A. For purposes of the preceding sentence, the requirement of § 1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the option price to the fair market value of the shares subject to the option immediately after the substitution or assumption is not greater than the ratio of the option price to the fair market value of the shares subject to the option immediately before the substitution or assumption.

(iii) Statutory stock options. The grant of an incentive stock option as described in § 422, or the grant of an option under an employee stock purchase plan described in § 423 (including the grant of an option with an exercise price discounted in accordance with § 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation.

(iv) Certain stock appreciation rights. A stock appreciation right with respect to stock of the service recipient does not provide for a deferral of compensation if: (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock appreciation right does not constitute a feature for the deferral of compensation. If, under the terms of the stock appreciation right, the SAR exercise price is or could become less than the fair market value of the underlying stock on the date of grant, the right may be settled upon exercise in a medium other than the traded stock of the service recipient, or there is an agreement or arrangement under which the service recipient will purchase the stock delivered in settlement of the right upon exercise, then the grant of the stock appreciation right may provide for the deferral of compensation within the meaning of this A-4. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

(e) Restricted property. If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income (under § 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income (under § 83) solely due to a valid election under § 83(b). However, a plan under which a service provider obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. For purposes of this paragraph, a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to § 83, § 402(b) or § 403(c).

(f) Earnings. References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation or such income.

Q-5 Who is the service recipient?

A-5 For purposes of § 409A, the service recipient refers to the person for whom the services are performed, and all persons with whom such person would be considered a single employer under § 414(b) (employees of controlled group of corporations), and all persons with whom such person would be considered a single employer under § 414(c) (employees of partnerships, proprietorships, etc., which are under common control).

Q-6 How Does § 409A Apply to Arrangements Covered by § 457?

A-6 The rules of § 409A apply to nonqualified deferred compensation plans under § 457(f) in addition to any requirements already applicable to such plans under § 457(f). Eligible plans under § 457(b) are not subject to the requirements of § 409A. However, nonelective deferred compensation of nonemployees described in § 457(e)(12) and grandfathered plans under prior § 457 transition rules generally are subject to § 409A. Pending additional guidance, length of service awards to *bona fide* volunteers under § 457(e)(11)(A)(ii) are not subject to § 409A. Further, pending additional guidance, State and local government and tax exempt entities may rely on the definitions of *bona fide* vacation leave, sick leave, compensatory time, disability pay, and death benefit plans for purposes of § 457(f) as applicable for purposes of applying § 409A to nonqualified deferred compensation plans under § 457(f). However, State and local government and tax exempt entities may not rely upon the definition of a deferral of compensation for purposes of § 409A as applicable for purposes of the § 457(f) definition of a deferral of compensation. For example, for purposes of § 457(f), a deferral of compensation includes stock options (whether nonstatutory or under § 422 or § 423) and arrangements in which an employee or independent contractor of a State or local government or tax-exempt entity earns the right to future payments for services, even if those amounts are paid immediately upon vesting.

Q-7 How Does § 409A Apply to Arrangements Between a Partnership and a Partner of the Partnership?

A-7 The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan. However, until additional guidance is issued, for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock (see Q&A 4). Specifically, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The § 409A rules governing other stock-based compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments

which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

Q-8 To Which Service Providers Does § 409A Apply?

A-8 Until additional guidance is issued, a service provider for purposes of § 409A includes (i) an individual, (ii) a personal service corporation (as defined in § 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, or (iii) a qualified personal service corporation (as defined in § 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. Section 409A does not apply to arrangements between taxpayers all of whom use the accrual method of accounting. Section 409A also does not apply to arrangements between a service provider and a service recipient if (a) the service provider is actively engaged in the trade or business of providing substantial services, other than (I) as an employee or (II) as a director of a corporation; and (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another. For purposes of the preceding sentence, a person is related to another person if (i) the persons bear a relationship to each other that is specified in § 267(b) or 707(b)(1), subject to the modifications that the language "20 percent" is used instead of "50 percent" each place it appears in §§ 267(b) and 707(b)(1), and § 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or (ii) the persons are engaged in trades or businesses under common control (within the meaning of § 52(a) and (b)). The Treasury Department and the Service intend to issue additional guidance addressing types of service providers not subject to § 409A.

Q-9 What constitutes a plan?

A-9 A plan includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated among or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method or arrangement may constitute a plan regardless of whether it is an employee benefit plan under § 3(3) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended (29 U.S.C. 1002(3)). Unless otherwise specified in this notice, the requirements of § 409A are applied as if (a) a separate plan or plans is maintained for each service provider, and (b) all compensation deferred with respect to a particular service provider under an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)(A)) is treated as deferred under a single plan, all compensation deferred under a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) is treated as deferred under a separate single plan, and all compensation deferred under a plan that is neither an account balance plan nor a nonaccount balance plan (for example, discounted stock options, stock appreciation rights or other equity-based compensation described in § 31.3121(v)(2)-1(b)(4)(ii)) is treated as deferred under a separate single plan. For these purposes a severance plan is either an account balance plan or a nonaccount balance plan, determined in accordance with the rules of this A-9.

Q-10 When is an amount subject to a substantial risk of forfeiture?

A-10 (a) Definition. Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is

substantial. For purposes of this A-10, a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of § 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. However, where an election is granted to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be made subject to a substantial risk of forfeiture.

(b) Enforcement of forfeiture condition. In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted to a service provider by the service recipient corporation, where the service provider owns a significant amount of the total combined voting power or value of all classes of stock of the service recipient corporation or of its parent corporation, there will be taken into account (i) the service provider's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the service provider in the corporation and the extent to which the service provider is subordinate to other service providers, (iii) the service provider's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the service provider's discharge, and (v) past actions of the service recipient in enforcing the restrictions. For example, if a service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

B. Change in Control Events

Q-11 Under what circumstances will payments be permitted upon a change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation?

A-11 (a) In general. Pursuant to § 409A(a)(2)(A)(v), a plan may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in Q&A 12), a change in effective control of the corporation (as defined in Q&A 13), or a change in the ownership of a substantial portion of the

assets of the corporation (as defined in Q&A 14) (collectively referred to as a Change in Control Event). To qualify as a Change in Control Event, the occurrence of the event must be objectively determinable and any requirement that any other person, such as a plan administrator or board of directors compensation committee, certify the occurrence of a Change in Control Event must be strictly ministerial and not involve any discretionary authority. For purposes of this paragraph (a), a payment also will be treated as occurring upon a Change in Control Event if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the compensation deferred thereunder within 12 months of the Change in Control Event. The plan may provide for a payment on any Change in Control Event, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a Change in Control Event.

(b) Identification of relevant corporation(s). To constitute a Change in Control Event as to the plan participant, the Change in Control Event must relate to (i) the corporation for whom the participant is performing services at the time of the Change in Control Event, (ii) the corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable), or (iii) a corporation that is a majority shareholder of a corporation identified in (i) or (ii), or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in (i) or (ii). For example, assume Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B will constitute a Change in Control Event to plan participants performing services for Corporation B or Corporation C, and to plan participants for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but will not constitute a Change in Control Event as to Corporation A or any other corporation of which Corporation A is a majority shareholder. Notwithstanding the foregoing, a sale of Corporation B may constitute an independent Change in Control Event for Corporation A, Corporation B and Corporation C if the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see Q&A 14). For purposes of this paragraph, a majority shareholder is a shareholder owning more than 50% of the total fair market value and total voting power of such corporation.

(c) Attribution of stock ownership. For purposes of this A-11, Q&A 12, Q&A 13 and Q&A 14, § 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if a vested option is exercisable for stock that is not substantially vested (as defined by §§ 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this paragraph (c).

Q-12 What is a change in the ownership of a corporation?

A-12 (a) Change in the ownership of a corporation. For purposes of § 409A, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b)), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not

considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q&A 13)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-12 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see Q&A 14 for rules regarding the transfer of assets of a corporation).

(b) Persons acting as a group. For purposes of paragraph (a), persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. *See* § 1.280G-1, Q&A 27(d), Example 4.

(c) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

Q-13 What is a change in the effective control of a corporation?

A-13 (a) Change in the effective control of the corporation. For purposes of § 409A, notwithstanding that a corporation has not undergone a change in ownership under Q&A 12, a change in the effective control of a corporation occurs on the date that either --

(i) Any one person, or more than one person acting as a group (as determined under paragraph (iv)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 35 percent or more of the total voting power of the stock of such corporation; or

(ii) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election, provided that for purposes of this paragraph (ii) the term corporation refers solely to the relevant corporation identified in Q&A 11, paragraph (b) for which no other corporation is a majority shareholder for purposes of that paragraph (for example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term corporation for purposes of this paragraph (ii) would refer solely to Corporation A).

In the absence of an event described in paragraph (i) or (ii), a change in the effective control of a corporation will not have occurred.

(b) Multiple Change in Control Events. A change in effective control also may occur in any transaction in which either of the two corporations involved in the transaction has a Change in Control Event under A-12 or A-14. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O's stock. P has undergone a change in ownership of a substantial portion of its assets under A-14 and O has a

change in effective control under this A-13.

(c) Acquisition of additional control. If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-13), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q&A 12).

(d) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(e) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

Q-14 What is a change in the ownership of a substantial portion of a corporation's assets?

A-14 (a) Change in the ownership of a substantial portion of a corporation's assets. For purposes of § 409A, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(b) Transfers to a related person. There is no Change in Control Event under this A-14 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to --

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in paragraph (iii).

For purposes of this paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

C. Acceleration of Payments

Q-15 Under what conditions may a plan permit the acceleration of the time or schedule of any payment under the plan?

A-15 (a) In general. Except as provided in paragraphs (b) through (f) below, a plan may not permit the acceleration of the time or schedule of any payment under the plan. It is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of § 409A are otherwise satisfied with respect to such deferral of compensation. For example, if a nonqualified deferred compensation plan provides for a lump sum payment of the vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the requirements of § 409A if the service recipient reduces the vesting requirement to 5 years of service, even if a service provider becomes vested as a result and qualifies for a payment in connection with a separation from service.

(b) Domestic relations order. A plan may permit such acceleration of the time or schedule of a payment under the plan to an individual other than the plan participant as may be necessary to fulfill a domestic relations order (as defined in § 414(p)(1)(B)).

(c) Conflicts of interest. A plan may permit such acceleration of the time or schedule of a payment under the plan as may be necessary to comply with a certificate of divestiture (as defined in § 1043(b)(2)).

(d) Section 457 plans. A plan subject to § 457(f) may permit an acceleration of the time or schedule of a payment to a participant to pay income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the participant under § 457(f) at the time of the vesting.

(e) *De minimis* and specified amounts. A plan that does not otherwise provide for *de minimis* cashout

payments may be amended to permit the acceleration of the time or schedule of a payment to a participant under the plan, provided that (i) the payment accompanies the termination of the entirety of the participant's interest in the plan; (ii) the payment is made on or before the later of (A) December 31 of the calendar year in which occurs the participant's separation from service from the service recipient or (B) the date 2½ months after the participant's separation from service from the service recipient; and (iii) the payment is not greater than $10,000. Such an amendment may be made with respect to previously deferred amounts under the plan as well as amounts to be deferred in the future. In addition, a nonqualified deferred compensation plan that otherwise complies with § 409A may be amended with regard to future deferrals to provide that, if a participant's interest under the plan has a value below an amount specified by the plan at the time that amounts are payable under the plan, then the participant's entire interest under the plan shall be distributed as a lump sum payment.

(f) Payment of employment taxes. A plan may permit the acceleration of the time or schedule of a payment to pay the Federal Insurance Contributions Act (FICA) tax imposed under § 3101 and § 3121(v)(2) on compensation deferred under the plan (the FICA Amount). Additionally, a plan may permit the acceleration of the time or schedule of a payment to pay the income tax at source on wages imposed under § 3401 on the FICA Amount, and to pay the additional income tax at source on wages attributable to the pyramiding § 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA Amount, and the income tax withholding related to such FICA amount.

(g) Definition of plan. For purposes of this A-15, the term plan has the meaning provided in Q&A 9, except that the provisions treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

D. Effective Dates and Transition Guidance

Q-16 When does section 409A become effective?

A-16 (a) In general. Except as provided in Q&As 19 through 23, § 409A is effective with respect to (i) amounts deferred in taxable years beginning after December 31, 2004; and (ii) amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A is effective with respect to earnings on amounts deferred only to the extent that § 409A is effective with respect to the amounts deferred. Accordingly, § 409A is not effective with respect to earnings on amounts deferred before January 1, 2005 unless § 409A is effective with respect to the amounts deferred.

(b) Date of deferral for effective date purposes. For purposes of determining whether § 409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005 if (i) the service provider has a legally binding right to be paid the amount and (ii) the right to the amount is earned and vested. For purposes of this A-16, a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture (as defined in § 1.83-3(c)) or a requirement to perform further services. Accordingly, amounts to which the service provider does not have a legally binding right before January 1, 2005 (for example because the service recipient retains discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider has a legally binding right before January 1, 2005, but the right to which is subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004 are not considered deferred before January 1, 2005 for purposes of the effective

date. Notwithstanding the foregoing, an amount to which the service provider has a legally binding right before January 1, 2005, but for which the service provider must continue performing services to retain the right only through the completion of the payroll period (as defined in Q&A 4) which includes December 31, 2004, shall not be treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date.

Q-17 For purposes of the effective date, how is the amount of compensation deferred under a nonqualified deferred compensation plan before January 1, 2005 determined?

A-17 (a) Nonaccount balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) equals the present value as of December 31, 2004 of the amount to which the participant would be entitled under the plan if the participant voluntarily terminated services without cause on December 31 of that taxable year, and received a full payment of benefits from the plan on the earliest possible date allowed under the plan following the termination of services, to the extent the right to the benefit is earned and vested (as defined in Q&A 16) as of December 31, 2004. For purposes of determining the present value of the benefit, the actuarial assumptions contained within the plan are used provided such assumptions are reasonable; otherwise, reasonable actuarial assumptions must be used. Amounts to which the participant would not be entitled upon termination, such as early retirement subsidies for which the participant would not have attained sufficient service if he or she terminated services on December 31, 2004, are not includible as compensation deferred under the plan as of December 31, 2004.

(b) Account balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)) equals the portion of the participant's account balance as of December 31, 2004 the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004.

(c) Equity-based compensation plans. For purposes of determining the amounts deferred before January 1, 2005 under an equity-based compensation plan, the rules of paragraph (b) governing account balance plans are applied except that the account balance is deemed to be the amount of the payment available to the participant on December 31, 2004 (or that would be available to the participant if the right were immediately exercisable) the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004. For this purpose, the payment available to the participant excludes any exercise price or other amount which must be paid by the participant.

(d) Earnings. Earnings on amounts deferred under a plan before January 1, 2005 include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004 or such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004 generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available under a stock option, stock appreciation right or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future

payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004 to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(e) Definition of plan. For purposes of this A-17, the term plan has the same meaning provided in Q&A 9, except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan does not apply for purposes of the actuarial assumptions used in paragraph (b). Accordingly, different reasonable actuarial assumptions may be used to calculate the amounts deferred by a participant in two different arrangements each of which constitutes a nonaccount balance plan.

Q-18 When is a plan materially modified?

A-18 (a) In general. Except as otherwise provided in this A-18 and Q&A 19, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Such benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments may be allowed upon request if participants are required to forfeit 10 percent of the amount of the payment (a "haircut") would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. Also, it is not a material modification to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of § 31.3121(v)(2)-1(d)(2). It is not a material modification for a participant to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of § 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that enhances an existing benefit or right or adds a new benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under § 409A. For example, the addition of a right to a payment upon an unforeseeable emergency would be considered a material modification. The reduction of an existing benefit is not a material modification. For example, the removal of a "haircut" provision generally would not constitute a material modification.

(b) Adoption of new arrangement. It is presumed that the adoption of a new arrangement or the grant of an additional benefit under an existing arrangement after October 3, 2004 will constitute a material modification of a plan. However, the presumption may be rebutted by demonstrating that the adoption of the arrangement or grant of the additional benefit is consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a stock appreciation right on November 1, 2004 is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar stock appreciation rights (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a) and this paragraph (b), the grant of an additional benefit under an existing arrangement that consists solely of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004 will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that

the additional deferral of compensation is subject to § 409A. A plan may be amended to comply with the provisions of the preceding sentence in accordance with the rules of Q&A 19.

(c) Suspension or termination of a plan. Amending an arrangement to stop future deferrals thereunder is not a material modification of the arrangement or the plan. Amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs.

(d) Equity-based compensation. Provided that the cancellation and reissuance occurs on or before December 31, 2005, it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under Q&A 4 with a stock option or stock appreciation right that would not have constituted a deferral of compensation under § 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right. The preceding sentence only applies if (i) the number of shares which form the basis of the new stock option or new stock appreciation right corresponds directly to the number of shares subject to the original stock option or stock appreciation right; and (ii) the new stock option or new stock appreciation right does not provide any additional benefit to the service recipient (other than the benefit directly due to a change in form of the award to a form not treated as a deferral of compensation). A replacement stock option or replacement stock appreciation right will be treated as meeting the requirements of clause (i) of the preceding sentence if the new grant is made in accordance with the principles of § 1.424-1(a)(5) except to the extent necessary to ensure that the new grant does not violate § 409A. For example, a stock option originally issued with an exercise price discounted below the value of the shares subject to the option on the date of grant could be amended, without causing a material modification of the option, to be excluded from the definition of deferral of compensation by eliminating the discount on the exercise price below the value of the shares subject to the option on the original date of grant. Similarly, a stock appreciation right could be converted to a stock option or stock appreciation right that, based on its terms, would be excluded from the definition of deferral of compensation.

(e) Definition of plan. For purposes of this A-18, the term plan has the same meaning provided in Q&A 9, except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

Q-19 Under what conditions may a plan adopted before December 31, 2005 be operated and amended without violating the requirements of § 409A(a)(2), (3) and (4)?

A-19 (a) In general. A plan adopted before December 31, 2005 will not be treated as violating § 409A(a)(2), (3) or (4) only if (i) the plan is operated in good faith compliance with the provisions of § 409A and this notice during the calendar year 2005, and (ii) the plan is amended on or before December 31, 2005 to conform to the provisions of § 409A with respect to amounts subject to § 409A.

(b) Good faith compliance. A plan will be treated as operated in good faith compliance during the calendar year 2005 if it is operated in accordance with the terms of this notice and, to the extent an issue is not addressed in this notice, a good faith, reasonable interpretation of § 409A, and, to the extent not inconsistent therewith, the plan's terms, provided that the plan sponsor does not exercise discretion under the terms of the plan, or that a participant does not exercise discretion with respect to that

participant's benefits, in a manner that causes the plan to fail to meet the requirements of § 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan and exercises such discretion, the plan will not be considered to be operated in good faith compliance with § 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a plan participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of § 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 10% of the participant's benefits (a "haircut") will be considered a failure of the plan to meet the requirements of § 409A with respect to that participant, but not with respect to all participants under the plan.

(c) Payment elections. With respect to amounts subject to § 409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election and the election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the plan is so amended and the participant makes the election on or before December 31, 2005. Similarly, an outstanding stock option or stock appreciation right that provides for a deferral of compensation subject to § 409A may be amended to provide for fixed payment terms consistent with § 409A, or to permit holders of such rights to elect fixed payment terms consistent with § 409A, and such amendment or election will not be treated as a change in the form and timing of a payment under § 409A(a)(4) or an acceleration of a payment under § 409A(a)(3), provided that the option or right is so amended and any elections are made, on or before December 31, 2005.

(d) Severance plans. Provided that the plans are otherwise amended in compliance with paragraph (a), a plan that provides severance pay benefits, and that is either (i) a collectively bargained plan or (ii) covers no service providers who are key employees (as defined in § 416(i) and the regulations thereunder), is not required to meet the requirements of § 409A during the calendar year 2005 with respect to such severance pay benefits. Benefits that are provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA (29 U.S.C. § 1002(2)(B)(i)) that satisfies the conditions in 29 CFR § 2510.3-2(b)(1)(i) through (iii) are considered severance pay for purposes of this paragraph (d). Benefits provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA) are in all cases severance pay within the meaning of this paragraph (d) if the benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

Q-20 Under what conditions may a plan adopted before December 31, 2005 provide a participant a right to terminate participation in the plan, or cancel an outstanding deferral election with regard to amounts subject to § 409A, and receive a payment of amounts subject to the termination or cancellation, without violating the requirements of § 409A(a)(2), (3) and (4)?

A-20 (a) Plan amendment. A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election, without causing the plan to fail to conform to the provisions of § 409A(a)(2), (3) or (4), provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the calendar year 2005 or, if later, in the taxable year in which the amounts are earned and vested (as defined in Q&A 16). Solely for purposes of effecting the relief provided in this A-20, neither the availability of the election to the participant nor the making of the election by the participant will be treated as resulting in a violation of the requirements of § 409A(a)(2), (3) or (4) or causing amounts the

participant continues to defer to be includible in income under § 451 or the doctrine of constructive receipt (although these provisions may still apply for other reasons). There is no requirement that the opportunity to terminate participation in a plan or to cancel a deferral election be granted, or that if granted, be granted to all plan participants. A termination or cancellation may be made with respect to elective or nonelective deferred compensation and may be undertaken by the service recipient or at the election of the participant. A termination or cancellation under this paragraph may apply in whole or in part to one or more plans in which a participant participates and to one or more outstanding deferral elections the participant has made with regard to amounts subject to § 409A.

(b) Payments. Provided that the plan amendment is adopted in accordance with paragraph (a), a provision permitting a payment to a participant during calendar year 2005 or, if later, the taxable year in which the amount is earned and vested (as defined in Q&A 16), upon a termination of participation in the plan or the cancellation of a deferral election with regard to amounts subject to § 409A, will not be treated as causing a plan to violate the provisions of § 409A(a)(2), (3) or (4), and a payment from a plan pursuant to such an amendment will not be treated as a violation of the provision of § 409A(a)(2), (3) or (4), provided that the full amount of the distribution is included in the participant's income in calendar year 2005 or, if later, the participant's taxable year in which the amount is earned and vested (as defined in Q&A 16).

(c) Partial terminations and cancellations. For purposes of this Q&A 20, the termination of participation in the plan or the cancellation of an outstanding deferral election with regard to amounts subject to § 409A includes a termination or cancellation that results in a lower amount of deferrals for the period, without a complete elimination of the deferrals.

(d) Definition of plan. For purposes of this A-20, the definition of plan under Q&A 9 applies, except that the rule requiring the aggregation of all account balance plans, all nonaccount balance plans, and all other plans does not apply.

Q-21 Under what conditions will deferral elections under a plan in existence on or before December 31, 2004, made with respect to deferrals relating all or in part to services performed on or before December 31, 2005, be exempt from the requirements of § 409A(a)(4)(B) relating to the timing of elections?

A-21 With respect to deferrals subject to § 409A that relate all or in part to services performed on or before December 31, 2005, the requirements of § 409A(a)(4)(B) relating to the timing of elections will not be applicable to any elections made on or before March 15, 2005, provided that (a) the amounts to which the deferral election relate have not been paid or become payable at the time of election, (b) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (c) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than a requirement to make a deferral election after March 15, 2005), (d) the plan is otherwise operated in accordance with § 409A with respect to deferrals subject to § 409A and (e) the plan is amended to comply with the requirements of § 409A in accordance with Q&A 19. For purposes of this A-21, a nonqualified deferred compensation plan will be treated as in existence before December 31, 2004 only if a written plan document (a) identifies a specific amount or type of compensation that is subject to the plan and not otherwise payable at the time of the deferral election, and (b) provides that a participant in the plan may elect to defer the compensation beyond the taxable year in which the amount otherwise would have been payable. Solely for purposes of effecting the relief provided in this A-21, neither the availability of the election to the participant nor the making of the election by the participant will be treated as causing amounts the

participant defers to be includible in income under § 451 or the doctrine of constructive receipt.

Q-22 Until additional guidance is issued, under what conditions may deferral elections be made with respect to bonus compensation?

A-22 Section 409A(a)(4)(B)(iii) provides that in the case of any performance-based compensation based on services performed over a period of at least 12 months, an election to defer such compensation may be made no later than 6 months before the end of the period. The Treasury Department and the Service anticipate issuing guidance that sets forth the requirements for compensation to qualify as performance-based compensation. The Treasury Department and the Service anticipate that those requirements will be more restrictive than the requirements outlined in this A-22. Until additional guidance is issued, a deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be treated as meeting the requirements of § 409A(a)(4) if the election is made at least 6 months before the end of the service period. For purposes of this transition relief, the term bonus compensation refers to compensation where (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may include payments based upon subjective performance criteria, but (i) any subjective performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and (ii) the determination that any subjective performance criteria have been met must not be made by the participant service provider or a family member of the participant service provider (as defined in § 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family). Bonus compensation may also include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Notwithstanding the foregoing, bonus compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established, or that is based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient.

Q-23 Under what circumstances will payments be permitted based upon elections under a qualified plan for periods ending on or before December 31, 2005.

A-23 For periods ending on or before December 31, 2005, an election as to the timing and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the participant under a qualified plan will not violate § 409A, provided that the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments. For purposes of this paragraph, a qualified plan means a retirement plan qualified under § 401(a). For example, where a nonqualified deferred compensation plan provides as of October 3, 2004 that the time and form of payment to a participant will be the same time and form of payment elected by the participant under a related qualified plan, it will not be a violation of § 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005 and on or before December 31, 2005 pursuant to the payment election under the related qualified plan. Notwithstanding the foregoing, other provisions of the Code and common law tax doctrines continue to apply to any election as to the timing and form of a payment under a nonqualified deferred compensation plan.

E. Information Reporting Requirements for Deferred Amounts

Q-24 What information reporting requirements are imposed by § 885(b) of the Act?

A-24 The Act adds §§ 6041(g)(1) and 6051(a)(13), which require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 *(Miscellaneous Income)* or a Form W-2 *(Wage and Tax Statement)*, respectively. The Act requires annual reporting of all compensation deferred under the plan for the year regardless of whether such compensation is includible in gross income pursuant to § 409A(a)(1)(A). However, neither § 6041(g)(1) nor § 6051(a)(13) requires the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC or a Form W-2 is not required to be filed.

Q-25 What constitutes deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13)?

A-25 Deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13) generally include all deferrals of compensation within the meaning of § 409A that occur during the year and that are made under a nonqualified deferred compensation plan within the meaning of § 409A(d). *See* Q&A 4 (definition of a deferral of compensation) and Q&A 3 (definition of a nonqualified deferred compensation plan). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year.

Q-26 Do the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan?

A-26 Yes. The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) generally apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)). However, amounts deferred that are not reasonably ascertainable (as defined in § 31.3121(v)(2)-1(e)(4)) are not required to be reported until such deferrals become reasonably ascertainable (regardless of whether the service provider is an employee). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year under a nonqualified deferred compensation plan.

Q-27 Is there a minimum amount of aggregate deferrals for the year with respect to an individual employee below which the information reporting requirement imposed by § 6051(a)(13) does not apply?

A-27 Yes. The Act authorizes the Secretary of the Treasury, through regulations, to establish a minimum amount of deferrals below which the information reporting requirement imposed by § 6051(a)(13) does not apply. The Treasury Department and the Service anticipate providing the authorized guidance in future regulations. Until such guidance is provided, however, employers may rely on this notice to exclude from the information reporting requirement imposed by § 6051(a)(13) all deferrals for the year with respect to an individual employee under one or more nonqualified deferred compensation plans if the aggregate amount of such deferrals does not exceed $600.

Q-28 What is the effective date for the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13)?

A-28 The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) are effective for amounts actually deferred in calendar years beginning after December 31, 2004. Additionally, such information reporting requirements apply to income (whether actual or notional) attributable to amounts actually deferred in calendar years beginning after December 31, 2004. For purposes of §§ 6041(g)(1) and 6051(a)(13), amounts are considered actually deferred at the time the service provider has a legally binding right to the compensation as described in Q&A 4. Thus, the information reporting requirements are not effective for amounts actually deferred in calendar years beginning before January 1, 2005, (or for income attributable to such amounts) notwithstanding that § 885(d) of the Act may treat such amounts as having been deferred in a calendar year beginning on or after such date under the general effective date provisions.

Q-29 How should an employer report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6051(a)(13)?

A-29 An employer should report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 12 of Form W-2 using code Y. The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that will provide a method for calculating the amount of deferrals for the year. Neither § 6051(a)(13) nor this notice affect the rules for reporting deferred compensation in Box 11 of Form W-2.

Q-30 How should a payer report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6041(g)(1)?

A-30 A payer should report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 15a of Form 1099-MISC. The instructions for Form 1099-MISC provide additional information relating to this reporting requirement. However, the information reporting requirement imposed by § 6041(g)(1) does not apply to deferrals that are required to be reported under § 6051(a)(13) (without regard to any *de minimis* exception). Additionally, § 6041(g)(1) does not require the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC is not required to be filed.

F. Wage Withholding for Employees

Q-31 What wage withholding requirements are imposed by § 885(b) of the Act?

A-31 The Act amends § 3401(a) (defining wages for income tax withholding purposes) to provide that the term "wages" includes any amount includible in gross income of an employee under § 409A. The amount is treated as a payment of wages in the taxable year in which the amount is includible in the employee's gross income. The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for computing the amount includible in gross income of an employee under § 409A.

Q-32 When are amounts that are includible in gross income under § 409A treated as a payment of wages for income tax withholding purposes?

A-32 For the calendar year 2005, amounts includible in gross income under § 409A but neither actually nor constructively received by an employee may be treated as having been paid by an employer for income tax withholding purposes on any date on or before December 31, 2005. However, nothing in § 409A prevents the inclusion of amounts in gross income and in wages for income tax withholding purposes under any other provision or rule of law on a date earlier than December 31, 2005. Thus, amounts includible in gross income under § 409A and either actually or constructively received by an employee during the calendar year 2005 are considered a payment of wages when received by the employee for purposes of withholding, depositing, and reporting the income tax at source on wages.

Q-33 How should an employer report to an employee amounts includible in gross income under § 409A and in wages under § 3401(a) as required by § 6051(a)(3)?

A-33 An employer should report amounts includible in gross income under § 409A and in wages under § 3401(a) in box 1 of Form W-2 as part of the total wages, tips, and other compensation paid to the employee during the year. Additionally, an employer should report such amounts in box 12 of Form W-2 using code Z. The amount reported in box 12 using code Z should include all amounts deferred under the plan for the taxable year and all preceding taxable years that are currently includible in gross income under § 409A and in wages under § 3401(a). The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements relating to an employee or business that is terminated prior to the issuance of additional guidance that will provide a method for calculating the amounts includible in gross income under § 409A and in wages under § 3401(a).

G. Reporting Nonemployee Compensation

Q-34 What reporting requirements relating to nonemployee compensation are imposed by § 885(b) of the Act?

A-34 The Act adds § 6041(g)(2), which requires a payer to report to a nonemployee any amount includible in gross income under § 409A that is not treated as wages under § 3401(a). However, § 6041(g)(2) does not require the reporting of amounts includible in gross income under § 409A that are treated as having been paid to a person with respect to whom a Form 1099-MISC is not required to be filed.

Q-35 How should a payer report to a nonemployee amounts includible in gross income under § 409A and not treated as wages under § 3401(a) as required by § 6041(g)(2)?

A-35 A payer should report the amounts includible in gross income under § 409A and not treated as wages under § 3401(a) in box 7 (nonemployee compensation) of Form 1099-MISC. Additionally, a payer should report such amounts in box 15b of Form 1099-MISC. The amount reported in box 15b should include only the amounts includible in gross income under § 409A and not included in wages under § 3401(a). The instructions for Form 1099-MISC provide additional information relating to this reporting requirement.

Q-36 What are the SECA tax consequences of a failure to satisfy the requirements of § 409A?

A-36 Gross income of a self-employed individual (for example, a nonemployee director, partner, or independent contractor) derived by the individual from any trade or business is generally subject to tax

in accordance with the Self-Employment Contributions Act (SECA) when includible in gross income. *See* §§ 1401, 1402(a). Accordingly, an amount derived from an individual's trade or business that is includible in the self-employed individual's gross income under § 409A is generally subject to the application of SECA taxes at the time such amount is includible in gross income.

Q-37 Does § 885 of the Act affect the imposition of the employee tax and the employer tax under the Federal Insurance Contributions Act (FICA) with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d)?

A-37 No. Section 885 of the Act does not affect the imposition of the employee tax and the employer tax under FICA with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d). Thus, remuneration for employment constituting wages within the meaning of § 3121(a) is taken into account for FICA tax purposes in accordance with the rules for wage inclusion under §§ 3121(a) and 3121(v)(2).

H. Interim Reporting for Expedited Form W-2

Q-38 What are an employer's withholding and reporting obligations where an employee is terminated or a business files a final Form 941 prior to the issuance of further guidance providing methods for calculating the amount of deferrals for the year and the amounts includible in gross income under § 409A and in wages under § 3401(a)?

A-38 An employer is generally required to issue a Form W-2 reporting compensation paid during a calendar year no later than January 31 of the succeeding calendar year. However, if an employee's employment is terminated before the close of the calendar year, an employer must furnish an expedited Form W-2 if requested to do so by the employee. Additionally, an employer may, at its option, furnish a Form W-2 to such an employee at any time after the termination but no later than January 31 of the succeeding calendar year. *See* § 31.6051-1(d)(i). In addition, if an employer makes a final return on Form 941, the employer must furnish expedited Form W-2s to employees and file expedited Form W-2s with the Social Security Administration. *See* §§ 31.6051-1(d)(ii), 31.6071(a)-1. If an employer furnishes an expedited Form W-2 before the issuance of additional guidance providing methods for determining the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a), the employer need not report an amount described in Q&A-25 (deferrals for the year) or in Q&A-31 (amounts includible in gross income and wages) on the Form W-2. However, if an employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that requires the employer to report a deferral for the year or an amount includible in gross income and wages, then the employer must subsequently furnish a corrected Form W-2. See § 31.6051(c).

V. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and, regarding the employment tax and information reporting requirements, Neil D. Shepherd of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the Service participated in its development. For further information regarding this notice, contact Stephen Tackney (202) 927-9639; or for further information regarding the employment tax and information reporting requirements, Neil D. Shepherd (202) 622-6040; or regarding the submission of comments, contact LaNita Van Dyke (202) 622-7180 (not toll-free calls).

Treasury Regulation Sections 1.461-6(a)

(a) Qualified assignments of certain personal injury liabilities under section 130. In the case of a qualified assignment (within the meaning of section 130(c)), economic performance occurs as a taxpayer-assignor makes payments that are excludible from the income of the assignee under section 130(a).

Treasury Regulation Section 1.461-4(g)(1)(i) & (iv)

(g) Certain liabilities for which payment is economic performance—(1) In general—(i) Person to which payment must be made. In the case of liabilities described in paragraphs (g)(2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. Thus, except as otherwise provided in paragraph (g)(1)(iv) of this section and § 1.461–6, economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section. Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed. The amount of economic performance that occurs as payment is made from the other person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund. For special rules relating to the taxation of amounts transferred to "qualified settlement funds," see section 468B and the regulations thereunder. The Commissioner may provide additional rules in regulations, revenue procedures, and revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (g).

* * *

(iv) Assignments. If a person that has a right to receive payment in satisfaction of a liability described in paragraphs (g)(2) through (7) of this section makes a valid assignment of that right to a second person, or if the right is assigned to the second person through operation of law, then payment to the second person in satisfaction of that liability constitutes payment to the person to which the liability is owed.

Treasury Regulation Section 1.468B-3(c)

Economic performance—(1) In general. Except as otherwise provided in this paragraph (c), for purposes of section 461(h), economic performance occurs with respect to a liability described in § 1.468B–1(c)(2) (determined with regard to § 1.468B–1(f) and (g)) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.