Childs v. Commissioner, 103 T. C. 640 (1994)

Attorneys receiving structured settlement payments for fees must report income only when actually received, not when the right to receive future payments is secured, under the cash method of accounting.

Summary

In Childs v. Commissioner, attorneys represented clients in personal injury and wrongful death cases, securing structured settlements that included deferred payments for their fees. The IRS argued that the attorneys should report the fair market value of these future payments as income in the year the settlements were agreed upon, under Section 83 or the doctrine of constructive receipt. The Tax Court held that the attorneys' rights to future payments were neither funded nor secured, and thus not taxable under Section 83. Furthermore, under the cash method of accounting, the attorneys were not required to report income until payments were actually received, as they did not have an unqualified right to immediate payment.

Facts

Attorneys from Swearingen, Childs & Philips, P. C. represented Mrs. Jones and her son Garrett in personal injury and wrongful death claims following a gas explosion. They negotiated structured settlements with the defendants' insurers, Georgia Casualty and Stonewall, which included deferred payments for attorney fees. The attorneys reported only the cash received in the tax years in question, not the fair market value of the annuities purchased to fund future payments. The IRS asserted deficiencies, arguing the attorneys should have reported the value of future payments under Section 83 or the doctrine of constructive receipt.

Procedural History

The IRS issued notices of deficiency to the attorneys, asserting they should have reported the fair market value of their rights to future payments as income. The attorneys petitioned the U. S. Tax Court, which held that the rights to future payments were not taxable under Section 83 because they were unfunded and unsecured promises. The court also ruled that under the cash method of accounting, the attorneys were not required to report income until actually received, rejecting the IRS's constructive receipt argument.

Issue(s)

1. Whether the attorneys were required to include in income the fair market value of their rights to receive future payments under structured settlement agreements in the year the agreements were entered into, under Section 83.
2. Whether the attorneys constructively received the amounts paid for the annuity contracts in the years the annuities were purchased.

Holding

1. No, because the promises to pay were neither funded nor secured, and thus not property within the meaning of Section 83.
2. No, because the attorneys did not have an unqualified, vested right to receive immediate payment and no funds were set aside for their unfettered demand.

Court's Reasoning

The court analyzed whether the attorneys' rights to future payments constituted "property" under Section 83, which requires inclusion of the fair market value of property received in connection with services in the year it becomes transferable or not subject to a substantial risk of forfeiture. The court held that the promises to pay were unfunded and unsecured, as the attorneys had no ownership rights in the annuities and their rights were no greater than those of a general creditor. The court cited cases like Sproull v. Commissioner and Centre v. Commissioner to establish that funding occurs only when no further action is required of the obligor for proceeds to be distributed to the beneficiary, and that a mere guarantee does not make a promise secured. The court also rejected the IRS's argument that the attorneys' claims were secured by their superior lien rights under Georgia law, as the structured settlements constituted payment for services, eliminating any attorney's lien. On the issue of constructive receipt, the court held that the attorneys, using the cash method of accounting, were not required to report income until actually received, as they did not have an unqualified right to immediate payment. The court emphasized that the attorneys' right to receive fees arose only after their clients recovered amounts from their claims.

Practical Implications

This decision clarifies that attorneys receiving structured settlement payments for fees must report income only when actually received, not when the right to receive future payments is secured, under the cash method of accounting. This ruling impacts how attorneys should structure and report income from settlements, particularly in cases involving deferred payments. It also affects the IRS's ability to assert deficiencies based on the value of future payments under Section 83 or the doctrine of constructive receipt. Attorneys should carefully consider the tax implications of structured settlements and may need to adjust their accounting methods or negotiate settlement terms to optimize tax treatment. This case has been cited in subsequent decisions involving the taxation of structured settlements, such as Amos v. Commissioner, 47 T. C. M. (CCH) 1102 (1984), which also held that the right to future payments under a structured settlement was not taxable under Section 83 until actually received.