Structured Settlements

A Win-Win Technique with Tax Benefits

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In personal injury and wrongful death cases, a special tax provision allows plaintiffs to avoid income taxation for awards and settlements. After receipt, however, any investment earnings generated by these sums become subject to general taxation rules, as well as creditor attachment and other dissipation challenges. Structured settlements can be a more tax-efficient and cost-effective solution. A properly executed settlement can provide payments well into the future, as well as a current lump sum if warranted. Payments are allowed to grow tax-free until they are distributed, and attorney’s fees can often be structured as well. Coupled with financial planning to determine payment timing and amounts, structured settlements can often offer a more prudent solution and greater financial security than a single, upfront, lump-sum payment.

When a $1 million dollar personal injury award costs the defendant only $400,000, everybody can be a winner thanks to the Periodic Payments Settlement Act of 1982 (Pub. L. No. 97-473, January 14, 1983). This was the case following a recent wrongful death suit in which the surviving spouse and children were awarded a series of future payments, instead of a lump-sum check. The settlement had a projected total payout of $1.5 million based on the plaintiffs’ life expectancies, and a guaranteed minimum payout of $950,000.

The Periodic Payments Settlement Act creates statutory authority for special tax and financial planning benefits by amending I.R.C. §104 (a)(2) to read “gross income does not include the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries.” In addition, the Act created I.R.C. § 130 in order to allow assignment of certain personal injury liabilities and facilitate its purpose—to encourage the use of structured settlements.

The term “structured settlement” refers to the resolution of personal injuries that involves the payment of ongoing payments over a period of time, instead of a single lump sum. This approach is particularly useful in cases where the plaintiff expects to live for a long period of time, and the future value of the payments can be calculated and structured to provide a more predictable income stream.
injury claims in exchange for a payment schedule which features future sums. Widely used since the late 1970’s, a typical structure can provide the injured party with more (after tax) income than traditional lump-sum settlements. As explained below, the technique can produce monetary benefits for both sides, and important planning opportunities for an injured plaintiff.

AVOIDING TAXES ON FUTURE GAIN

Perhaps the greatest attraction of structured settlements is the cost effectiveness which arises from special tax treatment. I.R.C. § 104 provides ample authority for excluding personal injury awards from taxable income. However, once the award is received, future gain from investment is no longer sheltered. With structured payments, the funds can be invested on a tax-free basis for future payment to the recipient. This tax advantage translates to more money to the claimant and lower costs for the defendant. In many cases, the cost of payments advantage is so obvious to both parties that settlement may be reached earlier and risky appeals can be avoided.

Settlements are usually structured according to the needs of the parties. Even attorney fees can be paid in a lump sum or similarly structured. A typical settlement may include an immediate lump sum, ongoing support payments, cost-of-living increases, plus future lump sums for education and retirement costs.

In one large case, an attorney received $5 million over the first five years and $2 million in payments over the next 25 years. The claimant received 30 years of guaranteed tax-free income totaling $52 million plus $1.5 million in immediate cash for litigation costs and current expenses. The total out-of-pocket cost to defendant was only $11.5 million! This type of custom-tailored compensation schedule offers an excellent opportunity for financial planning. In addition, delayed receipt avoids creditors, protects the spendthrift from dissipation, and compounds tax deferred.

COST-EFFECTIVE

Structured settlements can often cost about 10%-20% less to provide a plaintiff with the same benefits as if he or she had invested the recovery directly. In other words, a structured settlement costing a defendant $500,000 can yield payouts equivalent to the plaintiff investing a lump sum of $550,000 to $600,000. A simple split of this advantage could save the defendant $25,000-$50,000 while also improving the plaintiff’s return by 5% to 10%.

OWNERSHIP AND CONTROL

While I.R.C. §104 excludes personal injury awards from taxable income, it contains no ruling on income generated by those awards. In Rev. Rul. 76-133, 1976-1 C.B. 34 (1976), a minor’s award was invested in bank certificates of deposit for his sole use and benefit. Although the order prohibited withdrawal of both principal and interest for a five year period, the I.R.S. held that the interest from the account should be included in the gross income of the minor. Despite the lack of immediate control over the funds, the fact that the minor’s future benefit was secured with specific assets was sufficient to pierce the protection of I.R.C. §104, causing the income generated by those assets to be taxed.

In contrast, in Rev. Rul. 79-220, 1979-2 C.B. 74 (1979), a defendant’s insurer agreed to provide the injured plaintiff with a scheduled series of future payments. To fund the obligation, the insurer acquired and owned a single premium annuity contract. The plaintiff had no control or rights in the contract and relied fully upon the casualty company’s general credit. Differentiating itself from IRC Rev. Rul. 76-133, Rev. Rul. 79-220 ruled that the plaintiff did not have a security interest in the assets that were acquired to fund the award. As a result, the income generated by the award prior to receipt was not included in his gross income and, therefore, not taxable.

I.R.C. § 130 was enacted to keep structured settlements attractive in cases where the defendant may not be a secured credit risk. The section allows assignment of the periodic payment obligation away from the original obligor. By selecting a solvent and secure third party assignee, often a top rated life insurance company (versus a casualty insurer or a failing defendant), the plaintiff receives the assurance that the payment schedule will be met. In many cases, performance bonds can be acquired...
to further inure payment although, in reality, the assignee’s credit quality is usually sufficient in and of itself.

**FUNDING VEHICLES**

There is widespread misbelief that annuity contracts must be used in structured settlements. While annuities have been popular for their simplicity, they are not always cost-effective and can give rise to objections regarding long-term credit worthiness. Recognizing these problems, I.R.C. §130(d) specifically authorizes obligations of the U.S. Government as qualified funding assets. A zero coupon bond trust or combination of Government bonds is often more cost effective and can provide additional financial benefits to both sides. In most cases, both options be will be explored by the diligent practitioner.

Logistically, the present value of the settlement amount is used to fund a trust with U.S. Government obligations, or to purchase an annuity contract. The resulting vehicle will provide scheduled payments which can be readily adapted to client needs. Payments may be designed for a certain (guaranteed) period of time or for life (contingent). Often, a life payment option is combined with a guaranteed term of, say, 20 years to avoid windfall savings due to premature demise of the claimant. If desired, surviving beneficiaries can be designated to receive future payments in the absence of the original claimant. Especially in complicated payout situations, the input of an experienced consultant is invaluable.

**FUNDING VEHICLE LINKED TO S&P 500**

I.R.S. Letter Ruling 199942001 has been used to support the use of periodic payments where the amount is based upon the results of a particular investment vehicle. In this case, plaintiff’s future payments were linked to the S&P 500 Index. The IRS found that the I.R.C. § 130(c)(2)(A) requirement that payments be “fixed,” was meant to mean that the obligation to make the payments is unwaivable, and not that the amount of the payment was known for certain. In this situation, the value was required to be paid, regardless of the results of the index upon the value of the payment. While such letter rulings are not definitive, the concept addressed in this ruling opens up new opportunities in portfolio diversification and tax-advantaged leveraging of a settlement.

**KNOWLEDGE OF THE COST**

Regardless of whether a Government bond trust or a fixed or variable annuity contract is used, the present value of the funding vehicle is arguably the central issue. Many casualty companies have suggested that knowledge of the cost of the annuity or bond trust may constitute constructive receipt and could affect the plaintiff’s tax treatment. Most practitioners consider such rhetoric to be mere negotiation posturing. Clearly, the plaintiff’s lawyer must know the cost to determine the appropriateness of the offer, as well as the amount of any contingency fees.

Going even further, some states actually require disclosure to determine the amount of attorney fees. Even more supportive is the I.R.S. position in Private Ruling 8330035 which confirms that mere knowledge of the value of an annuity contract will not jeopardize the tax-free nature of the payments. (Hint: Even without cooperation from defense counsel, it is relatively easy to hire an expert to determine the value of the offer.)

**CONSTRUCTIVE RECEIPT**

Usually an issue of plaintiff’s control over the present value, constructive receipt occurs whenever a plaintiff has unqualified access to the present value of a settlement. As a result, it is critical to enter into the structured settlement option prior to the final settlement of the action. In other words, once plaintiffs have received rights to a specific payment, they cannot take the money and attempt to gain shelter under I.R.C. §104 by later buying an annuity, or funding a bond trust. The structured settlement agreement must be entered into prior to releasing defendants from the claim.

Along these same lines, attorneys should carefully and deliberately distinguish between lump-sum payments versus structured settlement values during negotiations. After first negotiating the present value of the periodic payments, a custom-tailored specific payment schedule can be developed to meet the needs of the claimant. In the interim, it is important to avoid the constructive receipt problem, which could arise if the claimant was offered the present value amount in full satisfaction. Since the value of the structure is presumably greater (to the claimant) than the receipt of the present value, this is largely an academic issue which illustrates the importance of strict compliance with I.R.S. requirements.

Because the plaintiff must avoid access and control over the annuity or bond trust, the plaintiff cannot have a security interest in the specific funding assets. This means that the plaintiff assumes the status of an unsecured creditor of the owner of the funding vehicle. In most cases, a substituted entity of high credit quality is used as the owner through an I.R.C. §130 assignment. To address the issue of credit risk, many annuity companies have set up separate corporations for the express purpose of accepting such assignments. On the U.S. Government bond trust side, it is a simple matter to place the bonds in a trust with an accredited and insured investment firm or, for a fee, with a bank trust department. Clearly, the bond trust can be one of the safest ways to protect plaintiffs against the risk of default of the third party assignee.

**MEDICAL REVESIONARY TRUSTS**

In appropriate multiple payment settlements, it may be desirable to retain a reversionary interest in the unused portion of otherwise allocated funds. This often
occurs where substantial future expenses are coupled with a reduced life expectancy which, in turn, could lead to a windfall for the heirs. While available for all defendants, it is especially attractive where the defendant has no income tax liability, such as a not-for-profit entity or government agency.

In Rev. Rul. 77-230, the United States as defendant created a trust to pay plaintiff’s future medical expenses. The trust provided that payments could fluctuate depending on needs and, if needed, the corpus could be invaded. The I.R.S. relied upon I.R.C. § 677(a) in ruling that the U.S. owned the trust because (1) it was the trustor, (2) trust income in excess of medical expenses would be accumulated, and (3) the reversionary interest was retained by the trustor. Because the owner (U.S.) was not subject to federal income tax, income earned by the trust was not taxable whether distributed to the plaintiff, added to principal, or eventually distributed to the trustor upon termination of the trust.

SPECIAL NEEDS TRUSTS

Special Needs Trusts are designed to protect people with physical or mental disabilities by optimizing their financial planning opportunities. Often used in conjunction with structured settlements, they protect assets from creditors and preserve both Social Security Disability Insurance benefits and Medicaid entitlements. Upon death, assets in the Special Needs Trust can often be transferred to the family or next generation.

CONCLUSION

Structured settlements offer plaintiffs greater awards at lower cost to defendants. At the same time, they provide creditor and spendthrift protection, along with unique estate and investment planning opportunities. In addition, structured settlements are receiving a big boost from the national movement to cap damage awards. Already the preferred solution in many cases, structured settlements will probably play an even more prominent role in the future.

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