PRACTICE TIPS FOR STRUCTURED SETTLEMENTS

BY STEVEN E. HOLLINGWORTH

Clients are often unaware of the range of settlement payment options available to them. This situation puts the burden on their attorneys to understand the basics of structured settlements and their potential benefits. This article can serve as a checklist for an attorney to use to identify the issues involved and avoid missed opportunities for both client and the attorney.

What is a structured settlement?

A structured settlement is an agreement with the defendant (or the defendant's insurer), to discharge its liability by making a series of periodic payments rather than a traditional lump sum. Because few plaintiffs are content to rely on the defendant's credit, the defendant is typically required, as part of the settlement, to make an immediate lump-sum payment to an assignment company, usually an insurance company or an affiliate, which assumes the defendant's payment obligation. The assignment company then purchases an annuity to fund its payment obligations. Thus, in a structured settlement, an insurance company or other credit-worthy payor is obligated to make the periodic settlement payments, rather than the defendant.

Defendants generally do not care whether a settlement is structured or not. In either case, the defendant is simply making a lump-sum payment and receiving a discharge of its liability. The current deductibility of the settlement payment is unaffected.

What are the potential benefits of a structured settlement?

The primary benefits are tax-related. The tax benefits can be significant, even when a plaintiff's recovery is exempt from income tax, such as in a settlement of a claim for physical personal injury. Absent a structured settlement, a lump sum from a personal injury claim can be received free of tax, but all income from the investment of that lump sum will be taxable. In a structured settlement, however, all of the annuity payments received are free of tax, even if those payments reflect an investment return.

When a plaintiff's recovery is subject to income tax, a structured settlement can result in deferral of the tax, both on the lump sum itself and the income earned in payment of the annuity. The tax-deferred investment growth can result in tax savings comparable to a 401(k) or IRA.

Can attorneys get similar benefits for structuring their fees?

Attorneys paid on a contingent-fee basis can elect to have their fees paid in periodic installments, similar to their client's recovery.[1] An attorney can thus enjoy tax-deferred investment growth on the deferred attorneys' fees, and they often can utilize the deferred fees as a retirement vehicle. Structured attorneys' fees can also spread income among multiple years to avoid taxation of the entire lump sum at the highest marginal tax rates.

What are the payment options for a structured settlement?

A typical structured settlement provides for part of the proceeds to be paid immediately in lump sum, with the remainder to be paid periodically. Payments can be weekly, monthly or at other set intervals. Starting dates can be set to coincide with expenses and expected life events, such as a college education or retirement.

Traditionally, annuity payments were paid in amounts that were either fixed or indexed for inflation. However, more recently, options have expanded to include payments linked to an investment portfolio or index. For example, in PLR 201435006, the Internal Revenue Service approved a structured payment plan that increased the periodic payments in line with the S&P 500 Index.

What timing issues are involved in a structured settlement?

Until a binding settlement is reached, the plaintiff's right to its recovery is too speculative and contingent to be subject to income tax. Similarly, an attorney's contingent fee is not considered earned for income tax purposes until the plaintiff has received the recovery for income tax purposes.

However, once a settlement agreement has been signed or amounts have been paid to the trust account of the plaintiff's attorney, both the attorney and the plaintiff may be deemed to have constructively received those payments for income tax purposes.[2] Any later arrangement to defer payment of the settlement may then be ineffective to avoid immediate taxation.[3] Therefore, the elements of the structure must be incorporated into the settlement agreement, and all of the documentation relating to the structure should be arranged and in place before the settlement and releases become legally binding.

What documents should be in place by the time a settlement is signed?

1. **Attorney Fee Agreement**
   If an attorney wishes to structure his or her fees, the attorney's fee agreement should permit the attorney to receive payment either in lump sum or periodic

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payments. If the fee agreement doesn't permit this election, the attorney should modify the fee agreement with the client before the settlement agreement is final.

2. Settlement Agreement Provisions

It is critical that the plaintiff have no enforceable right to an immediate lump-sum payment with respect to any portion of a recovery that is to be paid periodically. Instead, the defendant must only be obligated to make those payments in installments. The settlement agreement can further require the defendant to make a lump-sum payment to one or more insurance companies or affiliates that will assume the payment obligation. The settlement agreement should make clear the plaintiff cannot own any annuity that will fund the payment obligation or have any right to accelerate, delay, pledge or assign any payments thereunder. However, in the case of a qualified assignment, discussed below, the plaintiff may have a security interest in the annuity.[4]

3. Documentation for Qualified Assignment or Non-qualified Assignment

In the case of a nontaxable settlement, such as a personal injury claim, the defendant's assignment of its payment obligation is referred to as a qualified assignment. Qualified means that under section 130 of the Internal Revenue Code, the payment the defendant makes is not taxable income to the assignment company except to the extent it exceeds the cost of the annuity purchased to fund the obligation.

For a recovery that would be taxable income to the plaintiff, the exclusion under section 130 does not apply. In these cases, structuring is carried out via a non-qualified assignment.[5] The defendant's assignment is generally made to a foreign affiliate of a U.S. insurance company, so as not to subject the assignment company to tax on the receipt of the defendant's payment. The foreign affiliate's payment obligations are typically guaranteed by the U.S. insurance company.

Because the form of assignment varies depending on the tax treatment of the settlement, it is important for the attorney or other tax advisor to analyze the tax treatment of the plaintiff's expected recovery. For example, a settlement can often consist of taxable and nontaxable elements, such as a personal injury claim that settles on appeal after an award of punitive damages. Furthermore, settlements in the employment context may be taxable and subject to withholding in whole or in part.[6] It is generally advisable for any settlement to document the parties' agreement on the tax reporting and allocation of the plaintiff's recovery between claims with differing tax treatment.[7]

Does a structured settlement require the defendant's cooperation?

Not necessarily. Where there are multiple claims against the defendant, the plaintiff's attorney should consider forming a qualified settlement fund (QSF). A QSF is simply a trust or separate account formed to resolve claims. The QSF must be established or approved by a court or government agency and subject to the continuing jurisdiction of that court or agency.[8] Any responsible person, including the plaintiff's attorneys, can be the administrator of the QSF.

Upon making payment to the QSF, the defendant can be discharged from liability, without further involvement in payments from the QSF.[9] A QSF is a separate entity for income tax purposes. Consequently, neither plaintiffs nor their attorneys should be considered to have received payment for income tax purposes until the administrator actually distributes the settlement proceeds from the QSF. A QSF can thus be a useful vehicle in which to park funds pending their further distribution. For example, a QSF can give a client or the client's attorneys the flexibility to structure a settlement without the defendant's involvement, and it may even allow additional time to decide whether they are interested in structuring their recovery.

Distributions from the QSF have the same character for income tax purposes as if they were paid directly by the defendant.[10] Thus, payments from a QSF formed to resolve a physical personal injury claim will continue to be tax-free to the plaintiff. Payments from the QSF can be in the form of lump sums, structured settlements or any combination of the foregoing.

Dot your i's and cross your t's.

Structured settlements have been approved by the courts and the IRS. However, obtaining the desired tax benefits depends on timely and accurate documentation. A prudent attorney should consider involving tax counsel whenever a structured settlement is proposed.

Structured settlements may not be available or appropriate in every circumstance. Indeed, some clients may prefer complete control over the entire lump sum. However, the significant tax benefits that a structure can provide deserve careful consideration. NL

1. *Childs v. Commissioner*, 103 T.C. 634 (1994); *aff'd without op.* 89 F.3d 856 (11th Cir. 1996).
2. *See* Treas. Reg. § 1.451-2(a).
3. *See, Williams v. United States*, 219 F.2d 523 (5th Cir. 1955).
4. IRC §130(c).
5. *See,* PLR 200836019.
6. *See, e.g., Domeny v. Commissioner*, T.C. Memo. 2010-9.
7. *See* Steven E. Hollingworth, "Tax Issues From Employment-Related Damage Recoveries," *Communiqué*, Vol. 33, Nos. 6 & 7 (June/July 2012), p. 32-32.
8. Treas. Reg. §1.468B-1.
9. Treas. Reg. §1.468B-3(c).
10. Treas. Reg. §1.468B-4.

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