THE DEFINITIVE GUIDE

Frequently Asked Questions About Structured Settlements

Statutes, IRS Rulings and Judiciary Law Shape Structures

Frequently Asked Questions About Structured Settlements

What is a structured settlement?

In very basic terms, a structured settlement means that payments promised to be made by the released party will not be made all at once.

In 2001, Congress defined a structured settlement, for purposes of regulating the selling of future payments, as an arrangement—

"(A) which is established by—

(i) suit or agreement for the periodic payment of damages excludable from the gross income of the recipient under section 104(a)(2), or

(ii) agreement for the periodic payment of compensation under any workers' compensation law excludable from the gross income of the recipient under section 104(a)(1), and

"(B) under which the periodic payments are—

(i) of the character described in subparagraphs (A) and (B) of section 130(c)(2), and

(ii) payable by a person who is a party to the suit or agreement or to the workers' compensation claim or by a person who has assumed the liability for such periodic payments under a qualified assignment in accordance with section 130."

26 U.S.C. § 5891(c)(1).

That is the traditional structured settlement. Recently, the concept has become much broader, however, than just payment of damages excludable from gross income. Product innovations by life insurance companies provide for "non-qualified" assignments of periodic payment obligations through the use of reinsurance assumption agreements (to avoid the tax consequences of annuities when not used in section 130 qualified assignments) and the use of offshore assignees (to own annuities without the tax consequences applicable to entities taxed under U.S. law) with U.S.-based guarantors.

One insurance industry trade association would like you to believe that a structured settlement is a "completely voluntary agreement between the injury victim and the defendant." That is a mischaracterization because a structured settlement can be arranged between the injury victim and a qualified settlement fund, which is a substitute for the adversarial original defendant. The cooperation of the original defendant, therefore, is not required.

The primary advantages are twofold. First, the tax-free damage payment for a personal physical injury or physical sickness or workers' compensation claim is extended not just to the money paid by the released party, but to all the growth of that money while it is in the possession of the party responsible for making future payments. If the funding asset costs, for example, $1 million and the lifetime payout from that asset is $2 million, the whole $2 million is income tax-free. If the plaintiff takes the $1 million as a cash lump sum instead, that part is income tax-free, but the first dollar earned on it is a taxable event. By taking the $1 million in a structured settlement, the income taxes on the second $1 million are avoided.

Second, the releasor receives spendthrift protection from dissipation of the money due to bad judgment, bad advice, bad habits, bad company or just plain bad luck. It is widely believed that 90 percent of all large cash awards are gone within five years.

Some people believe the inflexibility of a structure is a disadvantage. But, for those who might otherwise be inclined to dissipate a large settlement, inflexibility also means indestructibility. In the event of unforeseen circumstances, a structured settlement payee can petition a state court to allow the sale of future payments at a discount for present value. The court must determine that the proposed factoring transaction is in the best interest of the payee and any dependents.

What are the advantages of a structured settlement over a cash settlement?

The primary advantages are twofold. First, the tax-free damage payment for a personal physical injury or physical sickness or workers' compensation claim is extended not just to the money paid by the released party, but to all the growth of that money while it is in the possession of the party responsible for making future payments. If the funding asset costs, for example, $1 million and the lifetime payout from that asset is $2 million, the whole $2 million is income tax-free. If the plaintiff takes the $1 million as a cash lump sum instead, that part is income tax-free, but the first dollar earned on it is a taxable event. By taking the $1 million in a structured settlement, the income taxes on the second $1 million are avoided.

Second, the releasor receives spendthrift protection from dissipation of the money due to bad judgment, bad advice, bad habits, bad company or just plain bad luck. It is widely believed that 90 percent of all large cash awards are gone within five years.

What are a structured settlement's disadvantages?

Some people believe the inflexibility of a structure is a disadvantage. The ability to sell future payments at a discount somewhat negates that objection.

Others, who have a tolerance for market risk, believe they can do better by taking a cash settlement and investing in potentially higher yielding equities. IRS approval of the variable annuity as a qualified funding asset provides both benefits.

Under what authority are the payments tax-free?

Section 104 of the Internal Revenue Code of 1986 (IRC or "the Code"), as amended [also known as 26 USC § 104], provides:

"Compensation for injuries or sickness.

(a) In general. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."

This is amplified in Treasury Regulations (also known as 26 CFR) § 1.104-1 (c), which provides in part that the term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Unless otherwise provided by law, gross income means all income from whatever source derived. [IRC § 61(a).]

When did structured settlements originate?

The concept as we know it today probably began in the 1970s, the tax treatment being first clarified in 1979 with the issuance of two revenue rulings by the Internal Revenue Service (IRS).

REVENUE RULING 79-220 [1979-2 C. B. 74]: An insurance company purchased and retained exclusive ownership in a single premium annuity contract to fund monthly payments agreed to in the settlement of a damage suit. The issue was whether the exclusion from gross income under IRC § 104(a)(2) applied to the full amount of monthly payments received in the settlement or only to the discounted present value of such payments. Payments were to be the same amount each month, guaranteed for the lifetime of the plaintiff or 20 years, whichever was longer. The IRS said the recipient may exclude the full amount of the payments from gross income under section 104(a)(2) of the Code, and that payments made to the estate after the recipient's death are also fully excludable from taxable income.

REVENUE RULING 79-313 [1979-2 C. B. 75]: A taxpayer received payments in a settlement with an insurance company for personal injury as a result of an accident. The insurance company agreed to make 50 consecutive annual payments, each of which would be increased each year by five percent. The entire amount of the payments received, including the growth of the annuity, is excludable from gross income under section 104(a)(2) of the Code. The IRS noted that "the taxpayer has neither actual nor constructive receipt, nor the economic benefit of the present value of the damages." The settlement in 79-313 also provided that "the taxpayer does not have the right to accelerate any payment or increase or decrease the amount of the annual payments specified."

Several years earlier, in Revenue Ruling 65-29 [1965-1 C.B. 59] issued in January 1965, the IRS concluded that income realized from the investment of a lump-sum payment representing the discounted present value of a damage award for personal injuries was not excludable from gross income under IRC § 104(a)(2). However, the plaintiff in that case had been given "unfettered control over the lump-sum payment and over the income from the investment of such payment." Revenue Ruling 76-133 [1976-1 C.B. 34] reached a similar conclusion with regard to a court approved settlement awarded a minor and transmitted by the clerk of the court, in the name of the minor, to a savings and loan association for deposit in certificates of deposit.

Both of these earlier rulings were cited as background in Revenue Ruling 79-220. Apparently the IRS was persuaded in 1979 that the continuing obligation of the insurance company was similar to an arrangement made by an employer to provide for payment of deferred compensation to an employee, which the IRS had approved in 1972 in Revenue Ruling 72-25 [1972-1 C.B. 127]. The single premium annuity contract purchased by the liability insurance company from another insurance company was merely an investment to provide a source of funds for the liability insurer to satisfy its obligation. In both cases, the arrangement was merely a matter of convenience to the obligor and did not give the recipient any right in the annuity itself.

When were structured settlements first reflected in the Internal Revenue Code?

The Periodic Payment Settlement Tax Act of 1982 [P.L. 97-473, Sec. 101(a)] added after *whether by suit or agreement* the words *and whether as lump sums or as periodic payments*, for tax years ending after 1982. This codified the 1979 revenue rulings. Both the House and Senate committee reports gave the reason for the change that "it would be helpful to taxpayers to provide statutory certainty in the area."

The Periodic Payment Settlement Tax Act of 1982 also inserted a new section 130 into the Code "providing that, under certain circumstances, any amount received for agreeing to undertake an assignment of a liability to make periodic payments as personal injury damages is not included in gross income," according to the House committee report. "Specifically, any amount so received will not be included in gross income to the extent it is used to purchase an annuity or an obligation of the United States if the annuity or obligation is designated (under regulations prescribed by the Secretary) to fund the periodic payments and the purchase is made within 60 days before or after the date of the assignment."

What is the effect of section 130 of the Code?

The original defendant or liability insurer that agreed to make the future payments to the plaintiff can be taken "off the hook" and receive a tax deduction for the amount paid to purchase the annuity or government obligation. Prior to 1983, the defendant or its liability insurer owned the funding asset. The plaintiff was merely a general creditor of the obligor. If the obligor became insolvent, the plaintiff stood in line with all other general creditors to be paid from whatever assets existed, including the annuity the obligor had purchased. The obligor was not allowed a tax deduction on the annuity's cost because the annuity was simply another form of asset than the cash. A tax deduction could be taken only when payments were made to the plaintiff and for the years in which the payments were made. From the plaintiff's perspective, he or she remained beholden to the defendant or liability insurer to receive the future payments.

With section 130, the liability to make future payments can be transferred to a third party new to the case. The transaction is called a "qualified assignment." Not only would the original defendant's tort liability be extinguished, so too would the liability to make the future payments promised in the settlement agreement. The third party is usually affiliated with the annuity issuer. Once the assignee accepts the future payment obligation, the original obligor is off the hook and gets to take a current year tax deduction for the whole amount it paid for the settlement, including any cash at the time of settlement and the annuity's purchase price.

The third-party assignee has no income tax liability for accepting the payment with which to purchase the annuity, as long as the payment does not exceed the aggregate cost of any funding assets.

Other stipulations of a qualified assignment made under section 130 of the Code provide that:

- such payments are fixed and determinable as to amount and time of payment;
- such periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments;
- the assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability, and;
- such periodic payments are excludable from the gross income of the recipient under paragraph (1) or (2) of section 104(a).

Workers' compensation claims, which are excludible from taxable income under section 104(a)(1), originally could not be assigned under section 130. This was changed in 1997 for claims filed after August 5 of that year by P.L. 105-34 § 962 (a).

Who is allowed to make the qualified assignment of the future payment obligation?

According to section 130 of the Code, "the assignee assumes such liability from a person who is a party to the suit or agreement, or the workmen's compensation claim." Also, a designated settlement fund (DSF) established under IRC § 468B or a qualified settlement fund (QSF) established under Treasury Regulations § 1.468B-1, which has assumed the tort liability from the original party, may stand in the shoes of the original party and make a qualified assignment. *See* Rev. Proc. 93-34.

What are the primary documents in a structured settlement?

The Settlement Agreement and Release, which extinguishes the tort liability (or workers' compensation claim) in exchange usually for cash at the time of settlement and a promise of future payments, and the Qualified Assignment, which transfers the future payment liability to a third party under authority of IRC § 130.

The qualified assignment document may or may not release the original obligor, depending on the form. It may also contain a pledge of a security interest in the qualified funding asset.

If a lawsuit has been filed, the releasee likely will require a Dismissal with Prejudice. If one of the claimants is a minor or protected adult (incompetent), court approval of the settlement is usually required by the laws of the jurisdiction.

What are some of the common mistakes found in documents?

The most common mistake is the lack of understanding by the drafter in what is happening. Under no circumstances should it be stated that the plaintiff or claimant is going to purchase an annuity. That is for the defendant, its liability insurer or the assignee.

A variation of that error has the cost of the annuity shown as consideration being paid to the releasor (plaintiff). It is the future payments on the dates specified that comprises the consideration, along with any cash lump sum at the time of settlement. The annuity cost may be shown elsewhere in the settlement agreement, such as in the section permitting the qualified assignment, but should not be shown as consideration to the releasor. The annuity cost is really the consideration being paid by the releasee to the third-party assignee for assuming the future payment obligation.

Archaic language reflecting vestiges of superseded tax law is another. For example, the recitation as the reason for the damage payments should include references to "personal *physical* injury or *physical* sickness," to track with the 1996 changes in the Code.

Likewise, it no longer suffices to say that all damages are being paid within the meaning of IRC § 104(a)(2), when taxable punitive damages are listed in that citation along with excludable damages. While it is not customary to have punitives in a settlement, it is not unusual for an attorney to file a prayer for punitives in the original complaint. Often the plea is abandoned at settlement, but that needs to be clarified in the final settlement documents. In *Barnes v. Commissioner* [T.C. Memo 1997-25], punitive damages had been mentioned in the pleadings and the plaintiff's attorney also referred in the negotiations to the "likelihood" of there being punitive damages. The settlement agreement did not include any specific allocation of damages. The IRS allocated half of the damages to taxable punitive damages, the remaining half to excludable personal injury damages.

Sometimes the defense counsel insists on having, in addition to the Settlement Agreement and Release, which addresses the structured settlement, a second document called something like a General Release of All Claims. This is a problem because both documents usually purport to represent the entire agreement between the parties. Obviously, this is an impossibility. The worse problem is that one document might correctly show the consideration to the releasor as a combination of immediate and future payments, while the other shows the entire amount being paid by the releasee, including the annuity premium to the assignee, as the consideration. Not only does this introduce the obvious ambiguity, it creates a fatal constructive receipt flaw that will cause an adverse tax consequence.

Some people attempt to duplicate the terms of the Settlement Agreement and Release in the court order approving the settlement. This, too, runs the danger of conflicting language. It is best to refer to the settlement agreement in the court order and append it, without repeating the terms.

Another impossibility is when the document text requires the payee to keep the annuity company apprised of any change in the payee's mortality.

What is meant by constructive receipt?

Constructive receipt is the doctrine that taxes income before it is actually received. It is explained in Treasury Regulations § 1.451-2(a): *"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."*

What is meant by economic benefit?

Under the principle generally known as "economic benefit," the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A "fund" is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in such fund is "vested" if it is nonforfeitable. This is a common law doctrine, attributable to the landmark case *E.T. Sproull v. Commissioner*, 16 T.C. 244 (1950), aff'd 194 F.2d 541 (6th Cir. 1952).

Do qualified assignments with security interest override the economic benefit doctrine?

The economic benefit doctrine was intended to be overridden, according to the IRS, when Congress amended section 130 of the Code in 1988 to allow security position ahead of general creditors. The original language of section 130(c)(2)(C) read: "the assignee does not provide to the recipient of such payments rights against the assignee which are greater than those of a general creditor." The Technical and Miscellaneous Revenue Act [P.L. 100-647 at § 6079(b)(1)(A)] changed the language to disregard "any provision of such assignment which grants the recipient rights as a creditor greater than those of a general creditor."

The House Report explained the reason for this change as follows: "Recipients of periodic payments under structured settlement arrangements should not have their rights as creditors limited by provisions of tax law."

Normally, the right to assume ownership of an annuity contract would trigger the economic benefit doctrine. While the Code does not specifically say so, the IRS acknowledged in Private Ruling 97-03038 that the 1988 amendment to section 130 (c) of the Code "was intended to allow assignments of periodic payment obligations without regard to whether the recipient has the current economic benefit of the sum required to produce payments."

How can constructive receipt affect structured settlements?

A structured settlement cannot be used if the settlement is complete or the judgment is final. As a general rule, a plaintiff cannot be in constructive receipt of the defendant's lump-sum offer if the plaintiff has not agreed to provide a release. The requirement that the plaintiff must agree to release the claim is a "substantial limitation" that keeps the constructive receipt doctrine from operating. Once the plaintiff agrees to provide a release or drop an appeal, the plaintiff is in constructive receipt of the money offered, assuming there are no other existing limitations on its receipt and that it is collectible.

Until a settlement is final, the parties can continue to negotiate. Mere negotiations do not trigger the constructive receipt doctrine, allowing a structured settlement to be used.

A plaintiff can reject an amount offered and counter with a higher amount, conditioned on agreeing to a structured settlement. If the defendant agrees to the higher amount it will spend, and discussions continue as to the timing and amount of each periodic payment, there is still no constructive receipt as long as the plaintiff has not agreed to release the claim. Even after these details are agreed upon and the plaintiff has agreed to release the claim if a mutually acceptable settlement agreement can be drafted, there is still no constructive receipt.

A structured settlement is feasible even after a verdict has been reached. There is no constructive receipt because verdict findings cannot be reduced to the plaintiff's possession. Even when the judgment has been entered in the amounts found by the jury, there is still no constructive receipt until the judgment becomes final and non-appealable. However, there must exist good faith appellate issues that would put the amount of the judgment in doubt. A tax-motivated appeal for the sole purpose of allowing more time to negotiate a structured settlement likely would not be accepted by the IRS as avoiding constructive receipt.

If the defendant offers to pay the judgment if the appeal is dropped, there is still no constructive receipt because the release is conditioned upon acceptance of the offer. A structured settlement is still an option.

Once a judgment has been entered and the time to appeal or seek reconsideration has expired, the plaintiff is in constructive receipt of the judgment amount, which rules out a structured settlement.

If the plaintiff negotiates in terms of how much the defendant will spend, in present-value dollars, is there constructive receipt?

No. There are two private rulings on this: *"[D]isclosure by defendant of the existence, cost, or present value of the annuity will not cause you to be in constructive receipt of the present value of the amount invested in the annuity."* [Priv. Rul. 83-33035.] *"[K]nowledge of the existence, cost, and present value of the annuity contract used to fund the settlement offer...will not cause the family to be in constructive receipt of the amount payable under the annuity contract or the amount invested in the annuity contract."* [Priv. Rul. 90-17011.]

If the plaintiff engages a structured settlement producer to handle the transaction, is there constructive receipt?

No. Whether the defendant or plaintiff selects the producer is of no consequence to the constructive receipt issue as long as the money to fund the future payments goes directly to the annuity issuer or assignee. It is okay for a producer, even the plaintiff, to handle the check to fund future payments if the check is payable to the annuity issuer or assignee. There exists a "substantial limitation" to the producer or plaintiff being able to cash the check. Thus, there is no constructive receipt. Structured settlements handled by producers of the plaintiff's choice are very common and accepted as a practice of the industry.

Why are punitive damage payments not excluded from income?

Public policy. Congress was looking for a way to achieve tort reform, and was able to achieve that through tax reform. Until 1996, the Code was not clear on this issue, and the court jurisdictions were divided. Public Law 104-88 § 16 said that the exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness."

This law, known as the Small Business Job Protection Act of 1996, also marked the first time the word *physical* had been used in section 104 as a requirement for exclusion from gross income. (However, section 130 always has contained the word *physical* as a prerequisite to a qualified assignment, in referring to tort claims under IRC § 104(a)(2).) Damages for emotional distress alone, even if that condition leads to a physical injury, say for example an ulcer, do not qualify for the exclusion under section 104(a)(2) for tort claims. However, workers' compensation claims based solely on emotional distress remain exempt from taxation under section 104(a)(1).

The good news to come out of this law for structured settlements was the clear statement that the origin of the claim is the test that will determine the tax treatment of all damages that flow from the claim. The congressional joint committee language states: *"If an action has its origins in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom would be treated as payments involving physical injury or physical sickness...."* This means that claims by survivors in a wrongful death case qualify for the exclusion, even though they may not have received the physical injuries. (There is an exception in the Code for Alabama, which treats wrongful death awards as punitive damages. A wrongful death in that state will be treated as a physical injury, as in any other state, eligible for the exclusion.)

The origin-of-the-claim test also means that damages for lost wages, if a result of a personal physical injury or physical sickness, are excludible. The courts had been divided on this issue, since wages ordinarily are subject to income taxation.

Why are medical expense reimbursements not excluded from income?

To avoid a double tax benefit. An exclusion is not allowed for compensation payments to the extent they are attributable to and not exceeding deductions allowed to the recipient as medical expenses in a prior year.

How do structures avoid tax penalties for annuities not held by natural persons and premature distributions?

Section 72(u) of the code does indeed make income accrued or received each year on the contract taxable as ordinary income, if not owned by a natural person. This would be disastrous for the assignment company except for the fact of the exception in subsection (3)(C) when the annuity "is a qualified funding asset (as defined in section 130(d), but without regard to whether there is a qualified assignment."

Section 72(q) imposes a 10 percent penalty generally for distributions to taxpayers under age 59½ or unless the payments begin within a year and are substantially equal over the annuitant's life expectancy. However, the same exception exists under subsection (2)(G) for a 130 (d) qualified asset.

The language of these exceptions allows the original defendant or liability insurer to own the annuity and avoid adverse tax consequences without making a qualified assignment, as long as all payments are excludible from income under IRC § 104(a)(1) or (2).

What makes the taxation different if the defendant, insurer or assignee, rather than the injury victim, owns the annuity?

If a lump-sum damage 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 received as damages within the meaning of section 104(a)(2) of the Code, and none of the income from the investment of such payment is excludable under section 104.

What is a qualified settlement fund (QSF) and how is it created?

The enactment of 26 U.S.C. § 468B created special rules for designated settlement funds, which the Secretary of the Treasury, through statutory and inherent authority, broadened in concept through the issuance of Treasury Regulations § 1.468B-1, creating the QSF to *"resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability...(ii) Arising out of a tort...."* [26 C.F.R. § 1.468B-1(c)(2).]

The authority of the court to create and oversee the QSF is absolute:

"A fund, account, or trust satisfies the requirements of this paragraph (c) [defining a qualified settlement fund] if... it is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority." [26 C.F.R. § 1.468B-1(c)(1).]

How does a QSF operate?

The fund administrator, on behalf of the qualified settlement fund, settles claims originally asserted against the defendant resulting from the event by entering into settlement agreements with persons asserting those claims. Once the fund is established and defendant has paid the agreed upon settlement amount into the fund's account, the liability for all such claims originally asserted against the original defendant are transferred to the qualified settlement fund through a novation. A novation has the effect of adding a new party as substitute obligor which was not a party to the original duty, and discharging the original defendant by agreement of all parties, completely extinguishing any alleged liability of the defendant.

The fund then is considered "a party to the suit or agreement" for purposes of making a qualified assignment of the future payment liability under section 130 (c) of the Code. This has been affirmed by the Internal Revenue Service through the issuance of Revenue Procedure 93-34, which says in pertinent part:

"This revenue procedure provides rules under which a designated settlement fund described in section 468B(d)(2) of the Internal Revenue Code or a qualified settlement fund described in section 1.468B-1 of the Income Tax Regulations will be considered 'a party to the suit or agreement' for purposes of section 130. In general, section 130 provides that an assignee may exclude from gross income amounts it receives for assuming the liability of a party to a suit or agreement to make described periodic payments of damages to a claimant." Rev. Proc. 93-34 § 1.

Once the settlement funds are paid out, either to the plaintiffs, lien holders, their attorneys, or to a third-party assignee under a section 130 qualified assignment, the trust closes and the administrator files a final tax return. Usually the existence of a QSF is of short duration.

May a QSF be used to settle a workers' compensation claim?

No. However, a QSF may be used for other than physical injury tort claims, including: claims under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended, 42 U.S.C. 9601 et seq.; arising out of a breach of contract or violation of law; and, in other matters designated by the commissioner of the IRS in a revenue ruling or revenue procedure. However, a physical injury tort claim is the only cause of action where damage payments may be assigned under section 130.

Who did Congress intend should benefit from the income tax-free payments?

Until 1999, Congress never said. When the two 1979 revenue rulings were codified in IRC § 104(a)(2) in 1982, the legislative history was silent on the reason for the tax break and who should benefit. Subsequent amendments to sections 104 and 130 also failed to provide a definitive answer. Some believed that the tax savings should be shared between the injury victim and the liability insurer.

In 1999, Congress belatedly confirmed that its intent all along was to subsidize injury victims through the Internal Revenue Code by excluding from gross income the amount of damages (except punitive) in a case involving personal physical injury or physical sickness. Codified at 26 U.S.C. § 104(a)(2), Congress said the tax exclusion is an incentive for that individual or his or her guardian to elect guaranteed future periodic payments rather than a lump sum, which might be dissipated causing the injury victim ultimately to become a ward of society. The term *subsidy* was used in the following excerpt from the Joint Committee on Taxation, *Tax Treatment of Structured Settlement Arrangements*, March 16, 1999:

"[I]t can be argued that the choice of the lump sum settlement may create an externality, that is, a cost to taxpayers at large, not borne by the individual who chooses the lump sum settlement. This externality could arise as follows. The amount of damages in a case involving personal physical injuries or physical sickness may be based on the lifetime medical needs of the recipient. If a recipient chooses a lump sum settlement, there is a chance that the individual may, by design or poor luck, mismanage his or her funds so that future medical expenses are not met. If the recipient exhausts his or her funds, the individual may be in the position to receive medical care under Medicaid or in later years under Medicare. That is, the individual may be able to rely on Federally financed medical care in lieu of the medical care that was intended to have been provided by the personal injury award. Such a 'moral hazard' potential may justify a subsidy to encourage the use of a structured settlement arrangement in lieu of a lump sum payment to the recipient, to reduce the probability that such individuals need to make future claims on these government programs. Under the structured settlement arrangement, by contrast to the lump sum, it is argued that because the amount and period of the payments are fixed at the time of the settlement, the payments are more likely to be available in the future to cover anticipated medical expenses ... ." [JCX-15-99, III.]

How does a plaintiff's attorney exercise due diligence in approving an annuity company?

The financial strength of the annuity issuer or guarantor is extremely important, since the releasor ultimately will look mainly to that life insurance company or guarantor for future payments. Usually the assignee is a shell company affiliated with the annuity issuer, often having no assets except ownership of the annuities that fund its future payment obligations. A shell company is not rated by the independent analysts. Sometimes the assignee is a bona fide separate insurance company with assets and reserves of its own, and ratings by the independent analysts. In other arrangements, a secondary guarantee of the assignee's obligations is provided by a certificate or surety bond from another insurance company, or the parent holding company guarantees payments of the assignee.

The closest thing to a minimum standard for an annuity issuer or guarantor is contained in the Uniform Periodic Payment of Judgments Act of 1990, a model law adopted by the National Conference of Commissioners on Uniform State Laws. To become a qualified insurer, an insurance company must be an admitted insurer in the state and must request designation by the insurance commissioner. The insurer must have a minimum of $100,000,000 of capital and surplus, exclusive of any mandatory security valuation reserve, and must have at least the following minimum ratings from two nationally recognized rating organizations: A.M. Best, A+; Moody's, Aa3; Standard & Poor's, AA-; Duff & Phelps, AA-

Price should always be a criterion, but not the sole factor. Other considerations in selecting a company might be the options available, including a cash refund option at the death of the measuring life or a high rated age.

What is secured creditor status in a structure?

It is an option offered by most assignment companies to give the plaintiff a security interest in the annuity contract, no longer being a general creditor of the assignee. In the event the assignee defaults on its payments, the plaintiff can perfect ownership in the annuity contract. However, if ownership is taken, all future growth of the annuity is a taxable event.

It is a better option if the annuity issuer will guarantee the obligations of the assignee (shell company). In this way, the annuity company subsidizes the assignee to cure the insolvency. Ownership of the annuity is retained by the assignee, and the plaintiff continues to receive tax-free growth. Sometimes both options are offered, usually at no extra cost to the releasee.

What is a rated age?

It is a hypothetical age assigned to a prospective annuity measuring life by medical underwriters, based on any factor in the person's health history that statistically reflects a shorter life expectancy. For example, a 50 year old male might be assigned a rated age of 65, meaning that the person has a life expectancy of a 65 year old male, which is shorter than that of a relatively healthy 50 year old male. This is also called a "rate up" of 15 years.

The condition warranting the rated age does not need to be related to the incident that gave rise to the physical injury or sickness claim. Anything in a person's health history is a factor to be considered.

If an annuity is to make guaranteed

payments for the annuitant's lifetime, the cost should be less to provide that same benefit for someone with an impaired life expectancy than for a healthy person. That is what is called "mortality risk," and life insurance companies are in the business of assuming it.

For the same premium amount, a person with a rate up will receive higher monthly benefits than will a person in good health of the same chronological age. This is just the opposite of life insurance underwriting, when the premium to insure someone with health problems costs more.

Do estate taxes need to be considered in structures?

Yes. The present value of the guaranteed payments from a structured settlement remaining at the death of the annuitant may be included by the IRS in the decedent's taxable estate. (Section 104 excludes payments from *income* tax, not *estate* tax.)

In a few years, the amount excluded from estate tax will be up to $1 million for an individual, $2 million for a married couple. (It is $675,000 for an individual in 2000.) While there may be no estate tax due when the structured settlement payee dies, if the wife will receive the remaining guaranteed payments, there could be estate tax due at the second death. Care should be taken to provide enough liquidity to pay estate taxes. This can be accomplished by maintaining a cash reserve outside the structure, or by opting for a cash refund from the annuity in the structure. There are also other methods of providing estate tax liquidity, such as using life insurance owned by a trust outside the estate, funded from the unified credit or through annual gift tax exclusions.

Be aware of IRC § 2039 regarding estate taxes on annuities. An estate tax professional should be consulted when the structure, combined with other assets in an estate, warrant.

What are some other benefits of a structured settlement?

In addition to tax advantages and spendthrift protection, a structured settlement can survive bankruptcy. (See *In re: Robin Belue and Mary Ellen Belue*, 238 B.R. 218.)

A structure can relieve a guardian from annual court reporting requirements, usually required in most states for monies recovered on behalf of a minor, and the filing of income tax returns. If payments are deferred through a structured until the payee reaches majority age (usually 18), there may be no regular accounting to the court, once the court approves the structured settlement on behalf of the minor.

A structure relieves the unsophisticated investor of the burden of managing a large amount of money that must last a lifetime. If the fixed annuity contains life-contingent payments, both the size of the payment and the duration for lifetime are guaranteed.

For the sophisticated investor, a structure making monthly payments provides the ability for "dollar cost averaging" as a taxable reinvestment strategy.

Can a person with a moderate risk propensity agree to a variable annuity and still get tax benefits of a structure?

Yes. The IRS approved the use of a variable annuity in a structured settlement in Private Ruling 199943002, released October 29, 1999. A variable is like having a family of mutual funds inside an annuity structure. A private ruling may not be cited as precedent.

Until this ruling, the traditional school of thought was that the "fixed and determinable" language in IRC § 130 automatically excluded a variable annuity, since the size of the payment is determined by the performance of the underlying investments. However, the IRS explained that the contract need only to fix the method of determining the payment size, and that the actual payment amount can vary.

For those who would not be satisfied by the rate of return of a traditional fixed annuity, where the payment size is guaranteed by the annuity issuer, regardless of how the market performs, a variable annuity offers that alternative. The special tax break for injury victims is preserved also.

How do you calculate an internal rate of return on a fixed annuity?

If the payments are for a period certain only or are guaranteed future lump sums, the calculation is easy. For life-contingent payment streams, the calculation usually takes into account the size and number of payments to be made over the annuitant's life expectancy. Of course, the real rate of return cannot be known in that case until the annuitant dies. If the annuitant dies earlier than normal life expectancy, the rate of return will be figured on the number of payments that had been made at the time of death, or that will be made by the end of the guaranteed period, if there are guaranteed payments remaining at death. If the annuitant lives beyond life expectancy and the period certain, the actual rate of return will increase the longer the person lives.

So, discussing annuity performance yields when there are life-contingent payments to be made can be very misleading. Without knowing in advance the date of the annuitant's death, actual yields cannot be calculated.

Can attorney fees be structured?

Yes. See *Childs v. Commissioner* [103 T.C. 36, aff'd 11th Circuit, No. 95-8762.] These are set up similar to traditional deferred compensation plans. The assignment companies vary widely in their policies for accepting attorney fee structures and in the procedures used. The employment agreement between the attorney and the client should provide for the attorney taking all or part of the attorney fee in future payments, measured in present value dollars.

The tax treatment is different for the attorney than for the injury victim. The attorney fee payments are entirely taxable, but only for the years in which the payments were made. By deferring income taxes on the amount set aside to fund the future payments, the money grows to the attorney's benefit. Even when it is taxed in the year of distribution, what remains should be larger than if the taxes were paid on the original amount in the year of the settlement.

Additionally, the attorney may avoid the super tax brackets by spreading the income over several years. This is a tangible tax savings.

Can structured settlements be done for taxable payments?

Yes. Just as there are advantages for attorneys to structure their fees, plaintiffs who receive taxable damage payments can benefit. Examples of taxable payments would be from cases involving age discrimination, sex discrimination, sexual harassment, punitive damages, wrongful termination, emotional distress, pre- and post-judgment interest, and wrongful detainment or imprisonment. Attorney fees can also be done through the reinsurance agreement, rather than through the method described in the previous topic.

Through the reinsurance agreement, a claimant with a personal injury that is not eligible for income exclusion under IRC § 104(a)(2) may still receive future periodic payments, being liable to pay taxes on them only in the year in which they are received. This cannot be used in settlements that represent past or future wages to the payee, due to the reporting requirements for FICA or other employment-related tax withholding.

The reinsurance agreement is priced similarly to an annuity and can provide life-contingent payments and period certain guarantees like an annuity. Since it is not an annuity, it avoids the tax consequences of IRC § 72(q) and (u). The original obligor must be a state chartered insurance company, however.

For taxable payments from a non-insurance company, a settlement trust can be used. A settlement trust cannot guarantee lifetime payments, unlike an annuity or reinsurance agreement, and the investment yield is usually not guaranteed. Trusts do have high liquidity.

Statutes, IRS Rulings and Judiciary Law Shape Structures

The rules that govern structured settlements are found in statutes, regulations, rulings by the IRS, and case law made by judges. Following is a compilation of several that affect structures.

PURPOSE OF STRUCTURED SETTLEMENTS:

Injury Victim, Not Insurer, Should Receive Benefit from Tax Exclusion

JOINT COMMITTEE ON TAXATION, TAX TREATMENT OF STRUCTURED SETTLEMENT ARRANGEMENTS, MARCH 16, 1999 (JCX-15-99, III.): "[I]t can be argued that the choice of the lump sum settlement may create an externality, that is, a cost to taxpayers at large, not borne by the individual who chooses the lump sum settlement. This externality could arise as follows. The amount of damages in a case involving personal physical injuries or physical sickness may be based on the lifetime medical needs of the recipient. If a recipient chooses a lump sum settlement, there is a chance that the individual may, by design or poor luck, mismanage his or her funds so that future medical expenses are not met. If the recipient exhausts his or her funds, the individual may be in the position to receive medical care under Medicaid or in later years under Medicare. That is, the individual may be able to rely on Federally financed medical care in lieu of the medical care that was intended to have been provided by the personal injury award. Such a 'moral hazard' potential may justify a subsidy to encourage the use of a structured settlement arrangement in lieu of a lump sum payment to the recipient, to reduce the probability that such individuals need to make future claims on these government programs. Under the structured settlement arrangement, by contrast to the lump sum, it is argued that because the amount and period of the payments are fixed at the time of the settlement, the payments are more likely to be available in the future to cover anticipated medical expenses."

EXCLUSION FROM TAXABLE INCOME:

Personal Physical Injury or Sickness and Workers' Comp Payments Excluded

INTERNAL REVENUE CODE, SECTION 104, COMPENSATION FOR INJURIES AND SICKNESS: This section of the Code allows claimants to exclude from their gross income monies received for physical injuries or sickness whether by suit or agreement and whether as lump sums or as periodic payments. The Periodic Payment Settlement Act of 1982 amended this section to allow the recipient to exclude from gross income all of the payments from a suit or agreement, whether paid all at once or in the future. The Small Business Job Protection Act of 1996 inserted the word "physical" into IRC § 104 (a)(2) in describing injury or sickness, and removed punitive damages from the exclusion. The text of IRC § 104 is excerpted as follows:

(a) In General: Except in the case of amounts attributable (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for prior taxable year, gross income does not include:

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness... For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

Damages May be Established Either by Lawsuit or Settlement in Lieu of a Suit

TREASURY REGULATIONS (ALSO KNOWN AS 26 CFR) § 1.104-1(C): The term "damages received (whether by suit or agreement)" means an amount received through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Unless otherwise provided by law, gross income means all income from whatever source derived, as per IRC § 61(a).

Origin of Claim is Test; Loss of Consortium Damages Not Taxable to Spouse

104TH CONGRESS, 2ND SESSION, HOUSE REPORT 104-586: This accompanied H.R. 3448, which was enacted as Public Law 104-188, the Small Business Job Protection Act of 1996, applicable sections 1605 (a)-(d), amending IRC § 104(a)(2). "The bill [H.R. 3448] provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law."

Emotional Distress Payments Taxable Unless Stemming from Physical Injury

104TH CONGRESS, 2ND SESSION, HOUSE REPORT 104-586 (SEE ABOVE): "The bill [H.R. 3448] also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not is excess of the amount paid for medical care attributable to emotional distress."

Personal Injury Payments Excluded When Annuity Not Owned by Claimant

REVENUE RULING 79-220, 1979-2 C.B. 74: An insurance company purchased and retained exclusive ownership in a single premium annuity contract to fund monthly payments agreed to in the settlement of a damage suit. The issue was whether the exclusion from gross income under IRC § 104(a)(2) applied to the full amount of monthly payments received in the settlement or only to the discounted present value of such payments. Payments were to be the same amount each month, guaranteed for the lifetime of the plaintiff or 20 years, whichever was longer. The IRS said the recipient may exclude the full amount of the payments from gross income under section 104(a)(2) of the Code, and that payments made to the estate after the recipient's death are also fully excludable from taxable income. Apparently the IRS was persuaded in 1979 that the continuing obligation of the insurance company was similar to an arrangement made by an employer to provide for payment of deferred compensation to an employee, which the IRS had approved in 1972 in Revenue Ruling 72-25 [1972-1 C.B. 127]. The single premium annuity contract purchased by the liability insurance company from another insurance company was merely an investment to provide a source of funds for the liability insurer to satisfy its obligation. In both this ruling and in Revenue Ruling 79-313, the arrangement was merely a matter of convenience to the obligor and did not give the recipient any right in the annuity itself. This ruling, along with Revenue Ruling 79-313, started the structured settlement concept. It later was codified in IRC § 104.

Increasing Monthly Payments from Annuity Excludable from Income

REVENUE RULING 79-313, 1979-2 C.B. 75: A taxpayer received payments in a settlement with an insurance company for personal injury as a result of an accident. The insurance company agreed to make 50 consecutive annual payments, each of which would be increased each year by five percent. The entire amount of the payments received, including the growth of the annuity, is excludable from gross income under section 104(a)(2) of the Code. The IRS noted that "the taxpayer has neither actual nor constructive receipt, nor the economic benefit of the present value of the damages." The settlement in 79-313 also provided that "the taxpayer does not have the right to accelerate any payment or increase or decrease the amount of the annual payments specified." This ruling, along with Revenue Ruling 79-220, started the structured settlement concept. It later was codified in IRC § 104.

Growth Income Taxable When Annuity Owned by Plaintiff

REVENUE RULING 65-29, 1965-1 C.B. 59: Income realized from the investment of a lump-sum payment representing the discounted present value of a damage award for personal injuries is not excludable from gross income under IRC § 104(a)(2). However, the plaintiff in that case had been given "unfettered control over the lump-sum payment and over the income from the investment of such payment." This ruling was followed later, in 1979, in establishing structured settlements where the plaintiff did not have constructive receipt of the funds that would provide future payments. The ruling predates the structured settlement concept.

Growth Income Taxable When Settlement Proceeds Owned by Trust

REVENUE RULING 76-133, 1976-1 C.B. 34: Income realized from the investment of a lump-sum payment from a court approved settlement awarded a minor and transmitted by the clerk of the court, in the name of the minor, to a savings and loan association for deposit in certificates of deposit, is not excludable from gross income under IRC § 104 (a)(2). The plaintiff was considered to have control over both the lump-sum and the income from the investment. This ruling predates the structured settlement concept.

Defendant Generally May Deduct Amounts Paid in Settlement

PRIVATE RULING 9723043: Provides a good overview of the requirements a defendant must satisfy in order to deduct amounts paid pursuant to a settlement. Generally, amounts paid in settlement of lawsuits are currently deductible in the acts which gave rise to the litigation were performed in the ordinary conduct of a taxpayer's business. The origin and character of the claim, rather than its potential consequences to the taxpayer, are the controlling test. Only "business" expenses are currently deductible; personal or capital expenses are not.

Attorney Fees are Considered Income to Plaintiff When Injury is Non-Physical and Taxable to Plaintiff

COMMISSIONER V. BANKS, 543 U.S. ____ (2005), 125 S. CT. 1025: The U.S. Supreme Court ruled on January 24, 2005, that attorney fees in taxable damage cases must be taxed first to the plaintiff then taxed again to the attorney. The Supreme Court 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." This decision overrules several circuits, which had ruled attorney fees were not the plaintiff's income. Taxable damage cases affected by this ruling include non-physical injuries such as libel and slander, interference with business relations, bad faith insurance actions for economic damage, intellectual property suits, etc. The claimant may deduct as a miscellaneous itemized deduction that portion of the fees and costs that exceeds two percent of adjusted gross income. However, large recoveries can cause the claimant to be subject to the alternative minimum tax (AMT), which does not allow deduction of attorney fees and costs, often producing a very high tax rate. The ruling is retroactive.

The ruling generally does not affect physical injury cases, such as medical malpractice, product liability and vehicle accidents, because the recovery is not income.

Attorney Fees in Employment Discrimination and Civil Rights Cases Are Deductible, Even Though Recovery is Taxable

The American Jobs Creation Act, which became effective October 22, 2004, provides for an above-the-line deduction for attorney fees in judgments and settlements of employment discrimination and civil rights cases, even though they are non-physical injuries. The types of cases are listed in the statute and include: Title VII, Title IX, Civil Rights Act, age discrimination in employment, Americans with Disabilities Act, and other named federal laws and state and federal common law employment discrimination causes of action.

CONSTRUCTIVE RECEIPT AND ECONOMIC BENEFIT:

Plaintiff Must be Restricted from Any Control over Funding Asset

TREASURY REGULATIONS, SECTION 1.451: Constructive Receipt. Constructive receipt is the doctrine that taxes income before the income is actually received. 2(a) General Rule. 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. Significant private letter ruling excerpts from the Internal Revenue Service have further defined constructive receipt as it applies to structured settlements.

Disclosure and Knowledge of Annuity's Existence, Cost or Present Value are Okay

PRIVATE RULING 83-33035: "Disclosure by defendant of the existence, cost or present value of the annuity will not cause you to be in constructive receipt of the present value of the amount invested in the annuity."

PRIVATE RULING 90-17011: "Knowledge of the existence, cost and present value of the annuity contract used to fund the settlement offer...will not cause the family to be in constructive receipt of the amount payable under the annuity contract or the amount invested in the annuity contract."

Economic Benefit of Fund Results in Inclusion

E.T. SPROULL V. COMMISSIONER, 16 T.C. 244 (1950), AFF'D 194 F.2D 541 (6TH CIR. 1952): Established common law principle generally known as "economic benefit." The creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A "fund" is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in such fund is "vested" if it is nonforfeitable.

ALLOCATION OF DAMAGES:

Failure to Allocate Causes Entire Award to be Taxable

PRIVATE RULING 9809053: Where an award or settlement is not allocated between taxable and tax excluded amounts, the IRS has ruled that the total amount of the award needs to be shown as income and the attorney fee deducted as an offset. In some cases, this may trigger alternative minimum tax.

IRS Not Bound by Trial Court's Damage Allocation

TECHNICAL ADVICE MEMORANDUM (TAM) 9634002: The IRS is not bound by a trial court allocation of damages. In this ruling, jobs were transferred to another state, and a union filed a suit which included Racketeer Influenced and Corrupt Organizations Act (RICO) claims. In 1992, a settlement was negotiated and approved with a final court order and judgment. No withholding of claim funds for federal income taxes was required, the court said, because the suit was not about lost wages. In 1995, the court clarified its earlier order and stated that the action was based predominately on tort-like claims. The taxpayer said the IRS was barred from challenging the court's determination (*res judicata* and collateral estoppel). The IRS said that it could review the allocation because it did not have the opportunity to be heard at the trial and hearing. The IRS looks to the nature of the underlying claim, not its validity or state court approval.

Taxable and Non-Taxable Payments Must be Properly Allocated

***BARNES V. COMMISSIONER*, T.C. MEMO 1997-25:** Punitive damages had been mentioned in the pleadings and the plaintiff's attorney also referred in the negotiations to the "likelihood" of there being punitive damages. The settlement agreement did not include any specific allocation of damages. The IRS allocated half of the damages to taxable punitive damages, the remaining half to excludable personal injury damages.

Pre-Judgment Interest Taxable Notwithstanding Language of Agreement

***ROZPAD V. COMMISSIONER*, U.S. COURT OF APPEALS, 1ST CIRCUIT, 98-1254:** Decision involves an allocation issue arising from a medical malpractice case filed in Rhode Island state court, Joseph S. and Kathleen M. Rozpad had received a $2 million judgment, which later settled on appeal for $800,000. The settlement specified that no portion of the settlement was allocated to pre-judgment interest. The taxpayers excluded all of the proceeds when filing their income tax returns. Tax Court ruled and the appellate court held that pre-judgment interest is not damages and is taxable, and that the original judgment provided sufficient guidance to determine a proper allocation. The court said the IRS was not bound by language in the settlement agreement purporting to eliminate any interest on the awards in allocating a reasonable amount of interest. The interest at issue was found to be separate and distinct from damages received as a result of the injuries.

ASSIGNMENT OF FUTURE PAYMENT OBLIGATION:

Obligor May Accept Proceeds Without Tax Consequence

INTERNAL REVENUE CODE, SECTION 130, CERTAIN PERSONAL INJURY LIABILITY AGREEMENTS: This section of the Code, added by the Periodic Payment Settlement Act of 1982, permits the amount of money used to purchase an annuity or government obligation to fund payments of a settlement agreement for a personal injury suit to be excluded from the assignee's gross income. The Taxpayer Relief Act (formerly called the Balanced Budget Act) of 1997 added workers' compensation payments under IRC § 104(a)(1) to the language of IRC § 130, making them eligible for qualified assignment the same as physical injury or physical sickness tort claim payments under IRC § 104(a)(2), but applicable to claims under workmen's compensation acts filed after the date of the enactment of the Taxpayer Relief Act (August 5, 1997).

(a) In General: Any amount received for an agreement to a qualified assignment shall not be included in gross income to the extent that such amount does not exceed the aggregate cost of any qualified funding assets.

(b) Treatment of Qualified Funding Asset: In the case of any qualified funding asset:

(1) the basis of such asset shall be reduced by the amount excluded from gross income under subsection (a) by reason of the purchase of such asset, and

(2) any gain recognized on a disposition of such asset shall be treated as ordinary income.

(c) Qualified Assignment: For the purpose of this section, the term "Qualified Assignment" means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of personal injury or sickness or as compensation under any workmen's compensation act:

(1) if the assignment assumes such liability from a person who is party to the suit or agreement or the workmen's compensation claim, and

(2) if:

(a) such payments are fixed and determinable as to amount and time of payment,

(b) such periodic payments cannot be accelerated, deferred increased or decreased by the recipient as such payments,

(c) the assignee does not provide to the recipient of such payments rights against the assignee which are greater than those of a general creditor,

(d) the assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability, and

(e) such periodic payments are excludable from the gross income of the recipient under paragraph (1) or (2) of section 104 (a).

(d) Qualified Funding Asset: For purposed of this section, the term "Qualified Funding Asset" means any annuity contract issued by a company licensed to do business as an insurance company under the laws of any State, or any obligation of the United States, if:

(1) such annuity contract or obligation is used by the assignee to fund periodic payments under any qualified assignment,

(2) the periods of the payments under the annuity contract or obligation are reasonably related to the periodic payments under the qualified assignment, and the amount of any such payment under the contract or obligation does not exceed the periodic payment to which it relates.

(3) such annuity contract or obligation is designated by the taxpayer (in such manner as the secretary shall by regulations prescribe) as being taken into account under this section with respect to such qualified assignment, and

(4) such annuity contract or obligation is purchased by the taxpayer not more than sixty days before the date of the qualified assignment and not later than sixty days after the date of such assignment.

Security Interest in Annuity Not Constructive Receipt

TECHNICAL AND MISCELLANEOUS REVENUE ACT (TAMRA), P.L. 100-647 AT § 6079(B)(1)(A): Amended section 130 of the Code in 1988 to allow security position ahead of general creditors. The original language of section 130(c)(2)(C) read: "the assignee does not provide to the recipient of such payments rights against the assignee which are greater than those of a general creditor." TAMRA changed the language to disregard "any provision of such assignment which grants the recipient rights as a creditor greater than those of a general creditor." The House Report explained the reason for this change as follows: "Recipients of periodic payments under structured settlement arrangements should not have their rights as creditors limited by provisions of tax law." Normally, the right to assume ownership of an annuity contract would trigger the economic benefit doctrine. While the Code does not specifically say so, the IRS acknowledged in Private Ruling 97-03038 that the 1988 amendment to section 130(c) of the Code "was intended to allow assignments of periodic payment obligations without regard to whether the recipient has the current economic benefit of the sum required to produce payments."

AUTHORIZATION TO USE VARIABLE ANNUITY:

Equity-Based Funding Asset Within 'Fixed and Determinable' Rule

PRIVATE RULING 199943002: Released October 29, 1999, this ruling allows the use of a variable annuity with periodic payments of damages being calculated pursuant to an objective formula based on the performance of the Standard & Poor's 500 Stock Index and/or a mutual fund portfolio designed to achieve long-term growth of capital and moderate current income in a "qualified assignment" under section 130. "...periodic payments that are determined with reference to an objective index are 'fixed and determinable as to amount and time of payment.' Specifically, we believe that the term 'fixed' means that the assignee's obligation to make the periodic payments is fixed with finality by the terms of the settlement agreement and the term 'determinable' means that there is an objective basis for calculating the amount and time of the periodic payments." A variable is like having a family of mutual funds inside an annuity structure. Until this ruling, the traditional school of thought was that the "fixed and determinable" language in IRC § 130 automatically excluded a variable annuity, since the size of the payment is determined by the performance of the underlying investments. However, the IRS explained that the contract need only to fix the method of determining the payment size, and that the actual payment amount can vary.

Variable annuities have not been used extensively in structured settlements, probably because the current distribution system is not comprised of licensed securities sales representatives and because commission sharing is tightly regulated. Only one company in the structured settlement marketplace has offered a variable annuity product.

Payment Amount Tied to Consumer Price Index Allowed

PRIVATE RULING 9437028: Dated June 17, 1994, this ruling allowed annual increases in periodic payments from a structured settlement to be tied to the Consumer Price Index, up to 10 percent, with no decreases. Performance was guaranteed by the annuity issuer, with no risk borne by the payee. Some commentators believe this was the precursor to the IRS allowing the use of the variable annuity as a qualified funding asset, because it also avoids the 'fixed and determinable as to time and amount of payment' rule in IRC § 130(c)(2).

BANKRUPTCY'S EFFECT:

Structured Settlement Payments Survive Bankruptcy

***IN RE: DAVID LYNN ALEXANDER AND LYNDIA KAY ALEXANDER*, 227 B.B. 658:** Debtors were allowed to keep their structure payments in a ruling by the U.S. Bankruptcy court for the Northern District of Texas, Lubbock Division, entered in December 10, 1998. They had lost their two children in 1989 and were receiving periodic payments through a qualified assignment of the future payment liability to Capital Assignment Corporation, which had purchased an annuity from Commonwealth Life Insurance Company.

Plaintiff May Not Discharge Obligation to Purchaser in Bankruptcy

***IN RE: ROBIN BELUE AND MARY ELLEN BELUE*, 238 B.R. 218:** An injury victim's attempt to discharge his debt in bankruptcy, after selling future periodic payments from a structured settlement to a factoring company, was denied by the U.S. Bankruptcy Court, District of Western Michigan, on March 8, 2000. [Case No. GG 99-07513, Chapter 13.]

QUALIFIED SETTLEMENT FUNDS (QSF):

QSF May Be Established for as Few as One Claim, Releasing Defendant

TREASURY REGULATIONS, SECTION 1.468B: Qualified Settlement Fund. A qualified settlement fund (QSF) can be established to receive a cash settlement from a defendant or insurer, whereupon with court approval the defendant and insurer are released from tort liability. The QSF then stands in the shoes of the defendant or insurer to execute a settlement agreement with the claimant or claimants. The QSF has the same authority to enter into a periodic payment agreement as the original defendant or insurer and to make a "qualified assignment" of that obligation within the meaning of IRC § 130(c). Treasury Regulations § 1.468B, which became effective January 1, 1993, says that a fund, account or trust meets the requirements of a qualified settlement fund (QSF) if: 1(c)(2) It is established to resolve or **satisfy one or more contested or uncontested claims** that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to **at least one claim** asserting liability. (Emphasis added.)

QSF Substitutes for Original Party-Defendant to Assign Payment Obligation

REVENUE PROCEDURE 93-34: Qualified Settlement Fund as 'Party to the Suit or Agreement.' A qualified settlement fund (QSF) literally stands in the shoes of the original self-insured defendant or its liability insurer, after that party is released and no longer involved in any transactions affecting the future distribution of the settlement monies, to make a "qualified assignment" of the future payment obligation under IRC § 130 (c), preserving all tax benefits: Section 1. "This revenue procedure provides rules under which a designated settlement fund described in section 468B(d)(2) of the I.R.C. or a qualified settlement fund described in section 1.468B-1 of the Income Tax Regulations will be considered 'a party to the suit or agreement' for purposes of section 130. In general, section 130 provides that an assignee may exclude from gross income amounts it receives for assuming the liability of a party to a suit or agreement to make described periodic payments of damages to a claimant."

ATTORNEY FEE STRUCTURES:

Appellate Court Affirms Right of Attorney to Take Periodic Payments for Fees

***CHILDS V. COMMISSIONER*, 103 T.C. 36, AFF'D 11TH CIRCUIT, NO. 95-8762:** Attorney fee structures are permitted The IRS had levied assessments for income tax deficiencies on three Georgia attorneys who had accepted future payments as part of their compensation from their clients. The attorneys successfully challenged the IRS in Tax Court in late 1994 and prevailed again in 1996 when the IRS appealed. The 11th Circuit said in its entirety: "This appeal is affirmed for the reasons expressed in the Tax Court's opinion, which is attached marked Appendix." It is significant that this affirmation was without further comment, suggesting that the original opinion was considered to be well reasoned and that not one of the IRS' arguments in the appeal was persuasive.

***COMMISSIONER V. BANKS*, 543 U.S. ____ (2005), 125 S. CT. 1025:** The Supreme Court held on January 24, 2005, that attorney contingency fees were included in the income of the plaintiff stating that "as a general rule, when a litigant's recovery constituted income [for tax purposes], the litigant's income includes the portion of the recovery paid to the attorney as a contingency fee." This actually strengthens the position that the plaintiff is entitled to structure the attorney fee, as part of his or her own recovery, on the theory that the payments to the attorney are in satisfaction of the plaintiff's fee obligation and are being made to the attorney as a convenience to the plaintiff.

PAYMENT PURCHASES (FACTORING TRANSACTIONS):

Plaintiffs May Sell Future Payment Rights with Impunity, if Advance Approval is Obtained from State Court

Section 5891 was added to the Internal Revenue Code [26 U.S.C. § 5891] effective January 23, 2002, imposing a 40 percent tax on the discount amount of any structured settlement factoring transaction not approved in advance by an "applicable state court" under an "applicable state statute." This applies only to structured settlements defined in sub-section 5891(c)(1) where the income is excluded under IRC § 104(a)(1) or (2). The court must apply a best interest test, taking into account the welfare and support of the payee's dependents. If approved, such transactions "made for consideration by means of sale, assignment, pledge, or other form of encumbrance or alienation for consideration" bear no adverse tax consequences for either the payee, the original assignor or the current obligor.

Most qualified assignments executed prior to the enactment of section 5891, and for a couple years afterward, contained contractual restrictions against factoring that had no basis in the tax law. Even today, defendants, insurers and assignment companies routinely present qualified assignment documents to settling claimants containing these unwarranted restrictions. State courts, when reviewing applications to approve payment purchases, are inconsistent on whether they will enforce the contractual restriction.

PRIVACY RIGHTS OF THE CLAIMANT:

Health Insurance Portability & Accountability Act of 1996 (HIPAA) is Meant to Protect Privacy of Individuals, Including Injury Victims

45 C.F.R. PARTS 160 AND 164: The promulgating regulations of the Health Insurance Portability & Accountability Act (HIPAA), which took effect April 14, 2003, impose civil and criminal penalties on health care providers who do not adequately protect against the unauthorized disclosure of an individual's private medical information. Civil fines up to $25,000 can be imposed for multiple violations of the same rule in a calendar year. Criminal penalties for knowing or intentional misuse of protected identifiable private health information can be up to $250,000 in fines and/or 10 years in prison.

In physical injury tort litigation, the historical practice of disseminating sensitive medical records to insurance underwriters to seek cheaper annuity costs for rated ages, has been based on the premise that the plaintiff waives all rights to privacy when the lawsuit it filed. HIPAA is intended to preempt state law that gives weaker privacy rights. Claimants may also have a right to sue as a privacy violation tort under common law.

MEDICARE AND MEDICAID:

Medicare Set-Aside Arrangements Needed to Recognize Government's Right to Recover Payments for Services

MEDICARE SECONDARY PAYER (MSP) STATUTE, 42 U.S.C. § 1395y(b)(2): This 1981 statute provides that "Medicare will not pay for items and services for which a Medicare beneficiary has received payment or can reasonably expect payment from a 'primary plan.'" Under this law, Medicare can recover from, but is not necessarily limited to, liability insurance, no-fault insurance, automobile insurance, self insurance, workers' compensation awards, judgments, settlements and compromises. Initially, only Medicare liens for past services were being recovered. In 1999, an enforcement program created Medicare Set-Aside (MSA) arrangements where an agreed portion of the recovery is reserved for post-settlement injury related Medicare covered services. When that amount is exhausted, Medicare takes over payment for future services. Currently, MSAs are required only for workers' compensation recoveries, but the Center for Medicare and Medicaid Services is showing an interest in requiring them for catastrophic tort recoveries as well, which is already authorized under the statute.

Proceeds from Judgment or Settlement Can Cause Loss of Medicaid Eligibility

MEDICAID DISABILITY TRUSTS, 42 U.S.C. § 1396p(d)(4)(A): Proceeds from a physical injury judgment or settlement may be counted in a "means test" that can make the claimant ineligible for this public assistance. All that will have been done is replacement of Medicaid benefits with settlement proceeds until they have been exhausted. Through the creation of a "Medicaid Disability Trust," also known as a "(d)(4)(A) Trust," to receive a lump sum or periodic payments, or both, from a judgment or settlement, the claimant can shield these assets from being counted. These are also inaccurately called "Special Needs Trusts" or "Supplemental Needs Trusts" because there is no requirement in the authorizing statute, 42 U.S.C. § 1396p(d)(4)(A), to consider the special needs of the beneficiary.

The claimant can still receive regular monthly income, including Supplemental Security Income (SSI) payments, and possess other assets up to the maximum allowed by state Medicaid guidelines, while the money in the trust can pay for items not covered by Medicaid and to enhance lifestyle. The trust can pay for medical, dental, ophthalmic and auditory care; psychological support services; supplemental nursing or physical therapy care; rehabilitation; medical procedures desirable in the discretion of the trustee, even though the procedures may not be necessary or life-saving; differentials in cost between housing and shelter for a shared or private room in an institutional setting; expenditures for travel and transportation for both the client and caregivers; and similar care which other assistance programs may not otherwise provide. The trust also can provide non-medical assistance such as education, including computer service and Internet access; entertainment, including pets; and such other items needed to assure as natural and pleasant a life as is possible.

Important Notices and Disclaimers

This compilation does not purport to give tax advice to the reader, who should seek independent counsel from a tax professional. Tax laws are subject to change at any time.

The summary of laws, regulations, rulings and court decisions is not necessarily a complete list and is not intended to provide legal or tax advice. Individuals should engage their own professional advisors who should rely on their own research and interpretation.

While a Private Ruling may provide a good indication as to how the IRS may rule on a similar set of facts, IRC § 6110(k)(3) provides that a Private Ruling (formerly known as a Private Letter Ruling) may not be cited as precedent.

However, in *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962), the U.S. Supreme Court held that, while taxpayers may not rely on unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws and may be used as evidence.

A court decision in one jurisdiction does not necessarily provide the binding precedent (*stare decisis*) for another jurisdiction, although it may be persuasive. There are examples in this summary of apparently conflicting decisions. Likewise, an IRS ruling that has not subsequently been codified or incorporated into the Treasury Regulations, is subject to a challenge in court. Likewise, a Technical Advice Memorandum (TAM) is a communication between the IRS and its field offices as guidance to its agents. A TAM applied to a taxpayer as an adverse action is also subject to a court challenge.

Technical Advice Memoranda and Private Rulings are released by the IRS to the public on the IRS website. Names of actual taxpayers and other parties are expurgated from released Private Rulings.

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