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Structured Settlements Provide Peace Of Mind

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Special Feature

Estate Planning

Headlines in recent years have covered personal injury awards for everything from faulty tires to Fen-Phen and beyond. With large personal injury jury awards, structured settlements are gaining popularity because they provide significant guarantees as well as tax-free benefits to claimants.

The National Structured Settlement Trade Association (www.structured-settlement.info) defines a structured settlement as a voluntary agreement in settlement over a personal injury that involves payments made over a period of time based upon a capital needs analysis.

In addition to structured settlement payments, a claimant generally requires some partial immediate cash disbursement be made up front to meet immediate medical and legal obligations.

Expenses typically included in a structured settlement are medical, surgical and hospital bills, home and automobile modifications, rehabilitation, homemaker and custodial services, job retraining, and most equipment and service expenses.

Structured settlements frequently are used with a special needs trust in order to further ensure financial security and preserve government benefit eligibility for Social Security and Medicaid. Please note that these trusts must be carefully drafted in order to qualify.

The Periodic Payment Settlement Act of 1982 limited the qualified funding options for structured settlements to annuities and government bonds via IRC §130, which reinforced and expanded §104(a). The Tax Reform Act of 1986 made further modifications to §130 to include wrongful death.

Structured settlements are being used today in non personal-injury areas as well to solve financial needs in other areas such as divorce, lottery winnings, employment severance and workers compensation cases. However, the tax-free benefits are not available as they are in the personal injury area.

Award Trends

The current award trends in the Personal Injury 2002 edition published by Jury Verdict Research, in Horsham, Pa. (www.juryverdictresearch.com), points out that awards of $1 million and above have increased from 10 percent of all awards in the 1995-97 period to 18 percent in the 2000-01 period.

Another point of interest is that the award trend under $500,000 since 1995 has either stayed level or declined. Many factors have contributed to these trends such as increased medical expenses or increased cost of litigation.

Personal injury awards cover a myriad of areas within the area of liability such as: product liability, medical malpractice, government negligence, business negligence, personal negligence, premises liability, police negligence and vehicular liability.

Attractive Option

Structured settlements have grown to more than $6 billion annually in 2003 and are rarely considered in awards under $100,000. When a personal injury claim is settled, attorneys and their clients are generally faced with two options: a cash settlement or a structured settlement or some combination of these two.

Structured settlements have many advantages, which make them attractive.

• *Financial Security* — Peace of mind is key! A Philadelphia Inquiry headline on July 20, 2002, reads as follows: "From casinos to foreclosure to arson case: Luck that won lottery left Bucks man years ago."

A windfall coming from a lottery or a personal injury claim can be lost just as quickly to poor judgment, loans to family members and friends, and to a weak investment decision- making process.

In fact, H. Roy Kaplan's book "Lottery Winners" demonstrates how quickly the money can disappear — most of the money will be gone within five years.

A structured settlement avoids the need for a second chance as funds are guaranteed and therefore do not get dissipated.

• *Income Advantages* — Structured settlements funded by qualifying annuities as compensation for personal injury claims receive favorable tax treatment under various sections of the tax code whether by litigation or agreement for lump sums or structured settlements.

However, only structured settlements receive favorable tax treatment on future earnings on the claim proceeds whereas lump sum proceeds earnings are taxable, which may or may not be an issue.

Sec. 104(a) in general states: 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 —

(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;

Meanwhile, §130 states that certain personal injury liability assignments due to physical injury or wrongful death are

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excluded from assignee's gross income.

(a) In general

Any amount received for agreeing 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 purposes of this section, the term "qualified assignment" means any assignment of a liability to make periodic payments as damages (whether by suit or agreement), or as compensation under any workmen's compensation act, on account of personal injury or sickness (in a case involving physical injury or physical sickness) —

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

(2) if —

(A) such periodic 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 of such payments,

(C) 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

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

The determination for purposes of this chapter of when the recipient is treated as having received any payment with respect to which there has been a qualified assignment shall be made without regard to any provision of such assignment which grants the recipient rights as a creditor greater than those of a general creditor.

(d) Qualified funding asset

For purposes 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 60 days before the date of the qualified assignment and not later than 60 days after the date of such assignment.

• *Rev. Rul. 79-220* — The issue: Does the exclusion from gross income provided by §104(a)(2) of the Internal Revenue Code of 1954 apply to the full amount of monthly payments received in settlement of a damage suit or only to the discounted present value of such payments?

The exclusion from gross income provided by §104(a)(2) of the code applies to the full amount of the monthly payments received by "A" in settlement of the damage suit because "A" had a right to receive only the monthly payments, and did not have the actual or constructive receipt or the economic benefit of the lump-sum amount that was invested to yield that monthly payment.

If "A" should die before the end of 20 years, the payments made to "A's" estate under the settlement agreement are also excludable from income under §104.

• *Rev. Rul. 79-313* — The issue: Are payments received by the taxpayer, under the circumstances described below, excludable from the gross income of the taxpayer under §104(a)(2) of the Internal Revenue Code?

In 1977, the taxpayer sustained severe and permanent personal injuries as the result of being struck by an automobile. Thereafter, the taxpayer brought an action against "X," the owner-operator of the automobile. X carried automobile liability insurance with "M," an insurance company.

Sect. 104(a)(2) of the code provides that, except in the case of amounts attributable to (and not in excess of) deductions allowed under §213 for any prior taxable year, gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.

Sect. 1.104-1(c) of the Income Tax Regulations provides that the term "damages received (whether by suit or agreement)" means an amount received (other than workers' 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.

The annual payments to be received by the taxpayer are amounts received through a settlement agreement entered into in lieu of the prosecution of a legal suit based upon tort or tort rights within the meaning of section 1.104-1(c) of the regulations.

Rev. Rul. 65-29, 1965-1 C.B. 59, holds that, when the taxpayer actually received the present value of an award for personal injury in a lump sum and invested it, any interest earned on the amount invested was taxable.

However, in the instant case, even though the settlement agreement provides for increasing payments to be made annually, the taxpayer has neither actual nor constructive receipt, nor the economic benefit of the present value of the damages.

Therefore, all payments received by the taxpayer in this case, pursuant to the settlement agreement, are excludable from the gross income of the taxpayer under §104(a)(2) of the code.

Resources

The Internet has many resources on structured settlements. Many of the bigger players in the business, such as AIG, Met, GE (to spin off structured settlement division), Travelers (Citigroup), Hartford, Allstate, and John Hancock (recently merged into Manulife), offer basic information.

Moreover, an excellent book on this topic, "Structured Settlements: An Alternative Approach to the Settling of Claims," by Joseph W. Huver, can be found at National Underwriter Publishing.

The guaranteed stream of structured settlement payments are generally taxfree and structured to meet medical and other living expense needs of the claimant for either life or a fixed period, thus eliminating financial uncertainty. Peace of mind is the key to understanding structured settlements.

The U.S. Treasury issued Revenue Ruling 2003-115, which permitted victims of the Sept. 11 attacks to choose a tax-free structured settlement in lieu of lump sum settlements, provided that the claimant elected to do so before their claim was substantially complete (claims were to be filed by Dec. 22, 2003).

The service ruled that payments from the assignment companies to the claimants or their successor beneficiaries are tax-free under §§139(f) and 104(a)(2).

For further information about structured settlements, please contact The National Structured Settlements Trade Association (www.StructuredSettlement.info) at 202-466-2714.