By Theda "Teddy" Snyder

Making the Case for Structured Settlements

The advantages often outweigh the problems of the additional complexity

Structured settlements help settle cases. Because structured settlements can earn tax-free income, claimants can get more money, and because payments are scheduled to suit the claimant's circumstances, the money will be there in time of need. Using structured settlements can help settle a case that would otherwise go to trial, because plaintiffs are more likely to settle when they see how the money will increase over time. For minors, structured settlements are better than blocked accounts because the rate of return is usually significantly better. Additionally, payouts can be timed to match the young person's growing maturity. Moreover, structured settlements can preserve the public benefits of a claimant. And attorneys who represent claimants can reap tax benefits by structuring their fees.

Lawyers who avoid structured settlements may simply misunderstand the fundamentals of their application. First, a structured settlement has to be just that—a settlement of a disputed claim. Once the settlement is paid, or final judgment entered and there are no more rights to appeal, it is too late.

Any settlement that calls for two or more installments is a structured settlement. Once a judgment is final—that is, there are no pending postjudgment motions and the time to appeal has passed—the claimant has constructive receipt[1] of the money and can compel payment.

To pay a structured settlement, defendants and insurers typically purchase an annuity from a life insurance company in order to make the deferred payments. Because of this practice, the plaintiff does not have to rely on the defendant's credit but rather on that of a highly rated major life insurance company. The defendant or its insurer pays for the annuitized portion of the settlement at the same time it pays the up-front portion. In turn, the defendant receives a release at the time of settlement. Once the structured settlement is in place, neither the defendant nor its insurer is obliged to have anything further to do with the claim, nor do they administer the payments.

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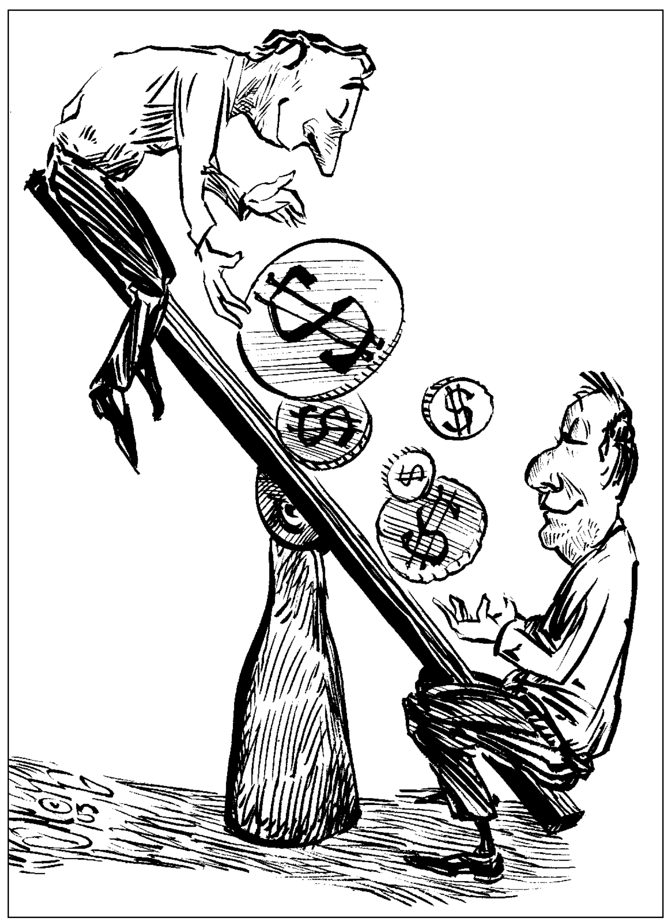
The annuities used for structured settlements are not the variable ones that financial planners sell. Annuities used for settlements require payments that are fixed, typically guaranteed for a stated period of time. The three most common types are known as lump sums, period certain payments, and lifetime annuities with or without a guarantee period. Payments can start and end at any time the claimant chooses and, subject to minimum payment rules, fund at any amount. In the most common arrangements, period certain payments (payments made for a defined term only) and lump sum payments are guaranteed to be made on the scheduled date whether or not the claimant is living. A guarantee period within a lifetime annuity means that payments in the guarantee period will be made even if the claimant has died. A claimant who survives the guarantee period will continue to receive payments as long as he or she lives. The value of the principal can never decline. Cases involving settlements of more than $50,000 for adults or $10,000 for minors are good candidates for structured settlements, but smaller cases can also be structured.

If the claimant has constructive receipt of a lump sum settlement, the investment income on the settlement is taxable, but in a structured settlement, there is no constructive receipt until the time of the deferred payment. The terms of a structured settlement provide that the payments cannot be altered or accelerated. The claimant is not the legal



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owner of the annuity policy—the assignee affiliated with the life insurance company is. Therefore, the claimant does not technically receive the money until the life insurance company pays it, and for physical injury claimants it is all tax-free.

Tax Benefits

If a lump sum payment to a claimant would be tax-free, then in a settlement that takes the form of a structured settlement, the entire payment—principal and interest—is tax-free. The most commonly applied statute for this exemption is IRC Section 104, which provides that payments made to compensate a physical injury, whether by lump sum or periodic payment, are excluded from gross income.[2] Through the use of a uniform qualified assignment,[3] the obligor (the defendant and/or the insurer) purchases an annuity and assigns the duty to make continuing payments to an affiliate of the life insurance company. All the money—the original settlement plus the investment income—is considered as compensation for the physical injury and therefore is tax-free. In cases in which the settlement is not tax-free to the claimant, a structured settlement can provide tax-deferred income on the principal while averaging out payments to help avoid high taxation, such as in an employment case that involves payment of back wages or a business case in which the recipients want the settlement to fund their retirements.

Structured settlements also can help claimants avoid the temptations that can arise with a lump sum payment. Studies show that claimants tend to dissipate the money they receive in settlements within a short time of receiving it.[4] Then, when the medical bills that the monies were intended to satisfy come due, the claimant has no resources to meet those needs. With a structured settlement, payments arrive when the claimant needs the money. Under a long-term monthly payment plan, for example, the money is there for the claimant month after month, no matter what the stock market does and no matter how much interest rates fluctuate. If the claimant fritters away all the money from one payment, another one will come along later. With a lifetime payout plan, the claimant cannot outlive this regular flow of income. Another benefit is that claimants with structured settlements typically receive a rate of return that is higher than what is available to the general public. This benefit results from the practice by annuity companies of investing hundreds of millions of dollars at a time over long periods. Because of this, the companies are able to get the best rates of return and can reduce the hills and valleys of interest rate fluctuations.

Specific Applications

Structured settlements should always be considered for minors. Because they cannot receive money in their own name, minors have fewer settlement alternatives. One alternative is to invest the settlement in a blocked account at a bank until the child turns 18.[5] However, blocked passbook savings accounts currently are returning little more than .5 percent annual interest, while structured settlements can provide a far better investment return. Moreover, blocked accounts are paid in full upon majority. In contrast, structured settlement payments can be timed to keep earning tax-free income until the money is needed, such as over four or more years of college. If the child will need money for future medical expenses (for example, scar revision surgery) a sufficient amount can be deposited in a blocked account, with the balance to be structured.

A structured settlement is also a good choice for a claimant who needs to preserve access to public benefits. Low-income claimants receiving Supplemental Security

How to Apply Structured Settlements to Obtain Beneficial Results for Clients

■ Bridging the Negotiation Gap

Structured settlements can help settle cases. For example, the parties to a suit may differ greatly on how to evaluate a claim by a 40-year-old male with a lower back disk injury. The claimant is still working and is concerned about his retirement. This settlement proposal bridges the gap between the demand and offer. The payout of this structured settlement design assures him of getting the money he needs. The total net cost to the insurer is $244,630.

	Expected Payout
Cash at settlement	$100,000
Supplemental monthly income: $500 per month to age 65	$150,000
Monthly lifetime income: commencing at age 65, $3,000 per month for life, guaranteed for 10 years	$540,000
Total	**$790,000**

■ Structuring a Medicare Set-Aside Trust

A structured settlement in a workers' compensation case may involve consideration of Medicare. In specified cases, principally those involving settlements of $250,000 or more, Medicare requires that the primary payer take Medicare's interest into account. In this example, the structured settlement broker obtains records of the last two years of medical expenditures by the insurer for the applicant, who was born in 1948. These are forwarded to an expert for analysis. The expert's review projects expenses that would otherwise be paid by Medicare to be $4,000 per year for the life of the applicant. The total cost to the insurer for the settlement is $396,000.

	Expected Payout
Cash at settlement (less attorney fees)	$125,000
Money to seed Medicare set-aside trust	$ 5,000
Annual payments to Medicare set-aside trust: $4,000 every year for life	$ 92,000
Monthly lifetime income paid to the applicant: commencing 45 days after WCAB approval, $1,500 every month for 10 years certain and for life	$423,000
Total	**$645,000**

—T. S.

AN INJURED CLAIMANT HAS FOUR BASIC FINANCIAL NEEDS:

- INCOME
- LIQUIDITY
- SECURITY
- CAPITAL APPRECIATION

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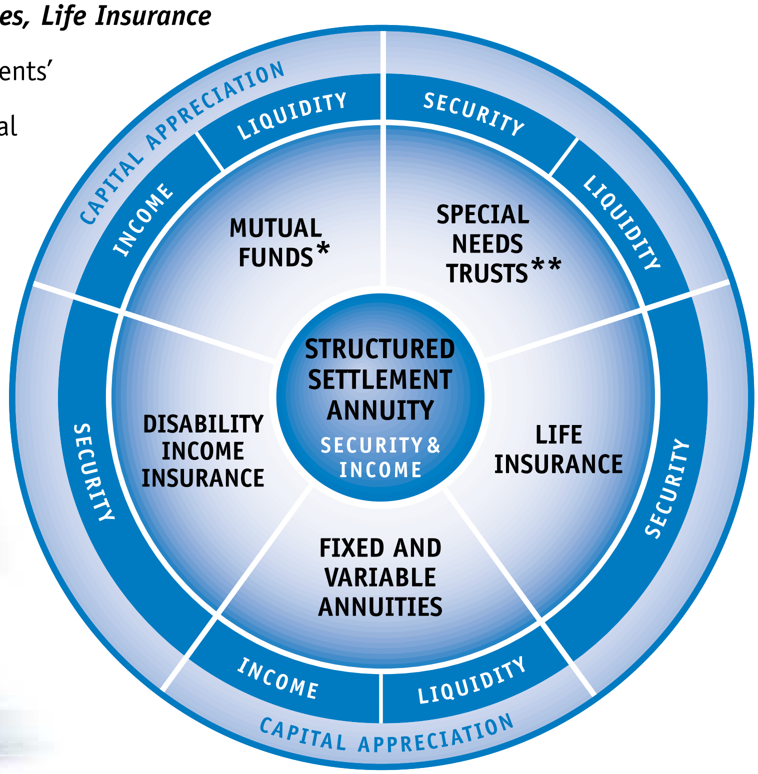

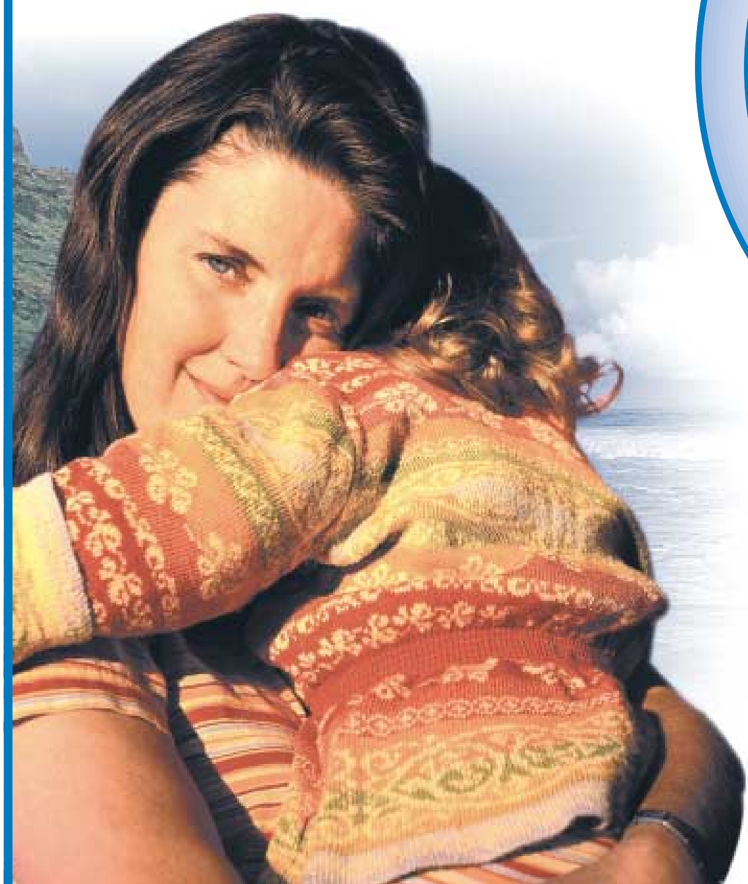

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Income (SSI) will stop receiving full benefits upon receipt of a settlement that exceeds the amount allowed by the need-based rules.[6] Receipt of a settlement can also render a claimant ineligible for Medi-Cal benefits. These rules prescribe strict resource[7] and income[8] tests. Using a structured settlement to fund a special needs trust[9] can preserve SSI and Medi-Cal benefits while providing supplemental income to make the benefit recipient's life more comfortable. Structuring typically produces greater income than depositing a large lump sum in a special needs trust, because the payments funding the trust over time are fully tax-free, and all the money is working for the injured person. Cautious trustees often invest only a percentage of the settlement in order to preserve principal for the beneficiary's lifetime, thereby producing a lower return than a structured settlement would. Trustees must also consider the tax implications of their investment decisions. With a lifetime structure, income is maximized while providing benefits the claimant can never outlive.

Workers' compensation applicants face a different set of circumstances that their attorneys need to address when considering structured settlements. As a result of recent developments,[10] lawyers settling workers' compensation claims must now consider the need for a Medicare set-aside trust to ensure the future access of clients to Medicare benefits. Under Medicare's secondary payer rules,[11] these trusts create a fund to act as the primary payer of expenses arising from the industrial claim that otherwise would be eligible for Medicare. The trusts are typically funded through a structured settlement annuity to reduce the trustee's fees, avoid taxation of investment income earned on the settlement proceeds, and provide payouts timed to match need. Once the trust is depleted, for the applicable time period or permanently, Medicare is supposed to pay the remaining eligible expenses. Good practice dictates that the amount that is set aside be approved by the local center for Medicare and Medicaid services (CMS).

Structured settlement brokers, who are trained in the intricacies of funding settlements, can help lawyers settle cases. Structured settlement brokers attend mediations, settlement conferences, and meetings. These specialists can calculate what it will cost to create a benefit stream for a claimant's future needs. Brokers can assist attorneys in creating special needs trusts and obtaining CMS approval of workers' compensation settlements. They have access to banks with low minimums for trusts and to custodians who can administer medical expense funds. The parties do not pay for the services of these brokers. Rather, the life insurance companies issuing the annuities do. Because these specialists only do one thing—settle cases—lawyers often seek their experience and expertise to help evaluate cases.

In cases involving a lifetime payout, structured settlement brokers can often boost return by obtaining what is called a rated age rather than using a published mortality table to determine life expectancy. For example, consider a 38-year-old male with a congenital condition who settles a physical injury claim arising from a collision. A benefit stream of $1,000 per month for the rest of his life with a 10-year guarantee would cost $172,437 using a published mortality table. However, because the congenital condition reduces his life expectancy, this benefit actually costs $126,132. Using a personalized mortality table produces an investment return that is far in excess of returns offered by generally available investment vehicles.

Structured settlements can also benefit lawyers. Attorneys for claimants often choose to structure their fees as a tax-planning device.[12] Attorneys who structure their fees get the same benefits of security and high returns as their clients. Attorney's fees are tax-deferred until received; attorneys may structure their fees to save for their children's college expenses or retirement. Structuring allows attorneys to create tax-deferred funds without regard to IRS rules about contribution limits or payout timing. Payment can occur before age 59½ or after age 70½ without penalty. Moreover, attorneys who structure their fees need not put aside a like amount for their employees, as is the case with qualified benefit plans.

Lawyers who understand the mechanics of structured settlements appreciate the benefits to their clients, whether they are claimants or defendants. These lawyers actively adopt structured settlements as another tool in their negotiation arsenal. Structured settlements are infinitely flexible and can be designed to meet the claimant's individual needs, limited only by the funds that are available and the imagination of the parties. ■

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[1] 26 C.F.R. §1.451-2 provides: "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...."

[2] I.R.C. §104(a) excludes from gross income "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." Also excluded are amounts received as workers' compensation for personal injuries or sickness.

[3] I.R.C. §130 defines a "qualified assignment" as "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, on account of personal injury or sickness (in a case involving physical injury or physical sickness)."

[4] WILLIAM F. FLAHAVEN, CALIFORNIA PRACTICE GUIDE—PERSONAL INJURY §4:213 (Rutter 2002).

[5] PROB. CODE §§3602, 3611.

[6] SOCIAL SECURITY ADMINISTRATION, A DESKTOP GUIDE TO SSI ELIGIBILITY REQUIREMENTS, Pub. No. 05-11001 summarizes applicable standards. Information is also available at http://www.ssa.gov.

[7] 42 U.S.C. §1382b; 20 C.F.R. §§416.1201 *et seq.*; 22 C.C.R. §§50401 *et seq.*

[8] 42 U.S.C. §1382a; 20 C.F.R. §§416.1100 *et seq.*; 22 C.C.R. §§50501 *et seq.*

[9] 42 U.S.C. §1396p. *See also* Terry M. Magady, *Something Special,* LOS ANGELES LAWYER, Feb. 2002, at 26.

[10] Memorandum from the Center for Medicare Management, Workers' Compensation: Commutation of Future Benefits (July 11, 2001) (interpreting and clarifying Medicare regulations and manuals defining Medicare as a secondary payer only).

[11] Medicare regulation 42 C.F.R. §411.46 provides: "If a lump-sum compensation award stipulates that the amount paid is intended to compensate the individual for all future medical expenses required because of the work-related injury or disease, Medicare payments for such services are excluded until medical expenses related to the injury or disease equal the amount of the lump-sum payment."

[12] Childs v. Commissioner, 103 T.C. 36 (1994), *aff'd,* 89 F. 3d 856 (11th Cir. 1996).