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Non-qualified structured settlements: More cash for you, less for the IRS

By Kelly Ramsdale

SPECIAL FEATURE Tax & Estate Planning

How many times have we heard that we live in a litigious age and that people sue each other for just about everything?

While some cases are sensationalized and ridiculous, most are genuine claims where someone was physically, emotionally or financially harmed.

Settlements are never nearly enough to make the plaintiff "whole" in any way, especially financially, so handing a huge chunk over to the Internal Revenue Service is especially painful.

Did you ever wonder how the plaintiffs of such cases are treated by the IRS?

In cases where an actual "physical" injury has occurred, any recovery a plaintiff receives is treated as income tax-free per Internal Revenue Code § 104(a)(2).

On the other hand, however, cases of non-physical injury are fully taxable in the year they are received. Examples of non-physical injury matters include:

- employment;
- discrimination;
- false arrest;
- breach of contract;
- sexual harassment;
- punitive damages;
- property damages;
- fraud;
- some estate distributions;
- environmental claims;
- psychological/emotional distress;
- coverage buyouts;
- property disputes; and
- E&O/D&O claims.

Not only is there not enough money to realistically compensate certain plaintiffs at settlement for their losses, but they are further affected by the IRS taking a large portion. In some cases where punitive damage awards are won, the plaintiff can actually walk away owing money after paying attorney's fees and the IRS.

Deferring Taxes

There is, however, a tool that may be used to defer taxes so the settlement funds can grow before having to pay the tax man: Non-qualified structured settlements.

The basic idea behind this tool is that, in a lawsuit, it is determined that the defendant has the obligation to pay the plaintiff. The concept of obligation is critical. The defendant funds that obligation – or any part of it – via the structured settlement annuity.

When the structured settlement annuity is purchased on behalf of the plaintiff, it must be purchased by the defendant. The defendant then assigns the obligation to the assignment company, which in turn purchases the structured settlement annuity from the life insurance company.

The defendant has his full and final release, and the plaintiff now has a stream of payments coming in (in any format they choose) for the terms of the structured settlement. The key to the tax-deferral is that the plaintiff at this point doesn't have what is called "constructive receipt" or "economic benefit" of the funds. He simply has the right to receive the payments.

The funds grow in the structure before they reach the plaintiff, and are taxable only in the year they are received. Let's say the plaintiff chooses to take half their settlement in cash and half in a structured settlement annuity deferred for five years, paying for the rest of his life. He would pay tax only on the cash in the year he settled his case.

Meanwhile, the funds parked in the annuity grow tax-deferred until they are fully paid out. Therefore, the plaintiff wouldn't receive another 1099 for five years and, then, that annual 1099 would only include the amount paid out in that year. The rest of the money remains in the structure to grow tax-deferred.

Continued...

How to do it

However, very specific steps must be followed. There is language that must be put into the settlement documents to protect the plaintiff from the IRS, and an additional document, which outlines the details of the assignment between the defendant and the assignment company, is required.

Therefore, constant communication between the plaintiff's attorney and a plaintiff-only structured settlement consultant is a must. If any of the steps are missed, it could be costly to the plaintiff.

Some of the rules one must be aware of include:

• *The plaintiff is not the owner of the annuity.* This is a good thing because, since he technically does not own it, it cannot be taken from him.

For example, if the plaintiff gets into some legal trouble down the road and people think of him as the person who won all that money a few years back, they may think they can sue him to get that money. However, he doesn't own it – he simply has the right to sit back and collect the money. This is also a convenient feature if the plaintiff gets divorced in the future.

• *Once the benefits are locked in, they are locked in.* The benefits and rate of return are fixed and determinable. If the market dives anywhere down the road, the annuity is safe. Whatever the plaintiff would have invested in fixed income vehicles, he would put into the structure.

Also, the plaintiff would take cash at the time of settlement for more aggressive investing, keeping in mind that with higher rewards come higher risks.

It is important to note that the tax-deferral passes on to the beneficiary, which can be very useful as an estate planning tool.

• *None of the structured settlement payments may be accelerated, deferred, increased or decreased, and may not be anticipated, sold, assigned or encumbered.*

Not the same

A structured settlement annuity is not the same as the annuities that can be purchased from various life insurance agents and financial planners. They are specifically created and used for lawsuits, and most insurance agents and financial planners have never heard of a structured settlement annuity.

Parties from the defense typically do not have any objection to using a structured settlement annuity. They get their "full and final" release by the plaintiff and, very importantly, they get the full tax write-off for having paid the settlement dollars in that year.

The only objection a plaintiff's attorney may have is if a structured settlement consultant, who works for the defense, tries to force the use of a life insurance company related to the defense insurance carrier. This is just one more reason for the plaintiff's attorney to stay in constant touch with the plaintiff-only structured settlement consultant.

If you find yourself in a case where a settlement is a good possibility, it may make sense to call a plaintiff-only structured settlement consultant. You may really be doing a service to your client with the tax savings this product can deliver. An added benefit is that you could structure your attorney fees much the same way your client does.

Non-qualified structured settlements have been around for several years, and have numerous benefits that make them an attractive option for those settling non-physical injury cases. As such, more and more people are finding out how great they can be. Don't you already give the IRS enough?

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