PERSPECTIVE

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What Lawyers Should Know About Structured Settlements

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Whether you are a plaintiffs' lawyer or defense lawyer, you should know the basics of structured settlements. You might think these financial products are limited to auto accidents and other personal injury cases. Once perhaps, but today, that's no longer true. They have become increasingly popular in employment cases and even family law cases.

So whatever your legal practice, you should know the basic building blocks of structured settlements. Plaintiff lawyers need to know how these arrangements can benefit their clients. Defendants are frequently asked to accommodate these arrangements. There is generally no reason they should not do so if they understand the mechanics.

Structured settlements involve payments over time that, once established, can't be changed. Payouts can vary materially. One structure might call for a five-year payout in five annual installments. Another might specify level monthly payments over 25 years. Some provide joint and survivor benefits, where the plaintiff and his or her spouse receive payments for their joint lives.

Payments can increase over time. They can increase at specified intervals, providing extra payments in years when educational or medical expenses are anticipated. They are highly flexible, but the stream of payments must be set when the settlement documents are signed.

Structured settlements are funded with life insurance annuities. In that sense, they really are financial products. They are marketed by structured settlement brokers. Some brokers cater to the plaintiff's lawyers, some to the defense, and some to both sides of the aisle.

The idea of a structured settlement is for the plaintiff to receive periodic payments, but for the defendant to pay in a lump sum. After all, no plaintiff wants to trust the defendant to make payments over time. The life insurance company steps into the gap and provides a financial product that ensures the payments.

Structured settlements can help manage money for plaintiffs and their families that might exhaust a lump sum. Such structuring can make it easier to regularize finances and arrange estate planning. They can even help with asset protection.

As with other tax-advantaged assets, timing and formalities are important. Keep in mind that structured settlements must be implemented before the case is concluded. Prior to the resolution of the plaintiff's case, the settlement documents must be revised to state that the defendant will pay periodic payments to the plaintiff. The defendant then pays all or a portion of the lump sum to a third party, which assumes the defendant's obligation to make the periodic payments.

The third party is an affiliate of a U.S. life insurance company. That third party affiliate uses the settlement proceeds to purchase life insurance annuities that fund the periodic payments to the plaintiff. Properly timed and documented, the plaintiff is treated as only receiving the periodic payments as and when they are actually paid in cash.

If the case is a personal physical injury case, a lump sum recovery should be tax free under Section 104 of the tax code. But if the plaintiff wants periodic payments instead, each of those payments is also tax free. Thus, the excludible nature of Section 104 recoveries applies to the entire stream of payments, even though some of the payments 10 or 15 years later really represent interest on the settlement proceeds.

Traditionally, structured settlements were arranged only in personal physical injury cases where a lump sum settlement to the plaintiff would be tax-free. Thus, the original goal of structuring was to have each periodic payment (both the principal and the interest) to be received without tax worries. Assuming proper timing and documentation, this tax result is well settled.

In fact, structures are implemented frequently via form documents without tax lawyers. What's more, it isn't only personal physical injury cases that are structured today.

An outgrowth of traditional structured settlements in personal physical injury cases involves taxable damages.

That is, structured settlements are now used where damages to the plaintiff are not for personal physical injuries and therefore are not tax-free. Rather than a taxable lump sum that is taxed as a lump sum, the plaintiff may wish to receive a series of periodic payments. Each payment such a plaintiff receives will, of course, still be taxable.

With proper timing and documentation, the federal income tax treatment of this arrangement is also well settled. As noted, such structures are generally implemented via form documents without tax lawyers. The big advantage is that the plaintiff is taxable on the periodic payments only when and as they are received.

The terms "qualified" and "nonqualified" assignments are often used when describing structured settlements. A qualified assignment refers to a plaintiff's structure for tax-free periodic payments for personal physical injury or wrongful death damages. A nonqualified assignment is one where the payments are taxable.

More technically, the distinction refers to tax issues facing the insurance companies, rather than tax issues facing the plaintiff. Qualified assignments benefit from more generous tax treatment to the insurance and annuity companies. The insurance companies that issue the life insurance annuities have affiliate assignment companies that direct the periodic payments to the plaintiff.

Assignment companies are common to all structured settlements because the structuring plaintiff can have no ownership interest in the annuity. Someone other than the issuing life insurance company must hold the annuity. In a qualified assignment, Section 130 protects insurance companies and their affiliates against adverse tax consequences.

Again, timing is key in structuring legal fees. The federal income tax doctrines are highly formal. They include the constructive receipt, economic benefit, and the cash equivalency doctrines. To some extent, all are addressed by the formal and scripted documents that the life insurance industry uses for structured settlements.

Whatever your role in a case or however you come into contact with structured settlements, they deserve a second look. They can help provide stability and predictable economic and tax results. But they are highly formalistic and require time to select and document. Consider them carefully, and don't leave them until the eve of settlement!

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