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Tax Alert

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How Lawsuit Structured Settlements Work And Are Taxed

Unless you've been involved in a lawsuit, you may not know about structured settlements. You may have heard of them on late night TV. "It's your money," some TV ads will exclaim. "Cash in your structured settlement and use your money now!" These TV ads are from factoring companies that buy up lawsuit structured settlements, but how do you get one in the first place?

If you are a successful plaintiff in a lawsuit, your contact with structure settlements may be personal. You may have received one, be evaluating one now, or have considered one but opted for cash. Even if you already have a structure, you may not know how they operate and why they're set up in the way they are. Structured settlements are mostly about taxes. If you are injured in a car accident and receive a $300,000 settlement from the other driver or insurer, it's tax free, which is one of the rules how settlements are taxed.

When you invest the $300,000, your investment earnings are taxable. If you receive a structured settlement instead of the $300,000 cash, you'll get payments over a term of years or your lifetime (however you choose), and each payment is fully tax free. Thus, a structure converts your after-tax earnings into a tax free return. Structured settlement brokers (a special type of insurance agent) consult as a case approaches settlement. Brokers are paid standardized commissions by the life insurance company that issues the annuity.

Brokers can run financial projections based on a term of years, payments over your life, over your joint life with your spouse, etc. You can even call for no payments for say 10 or 15 years, with payments starting thereafter as a way to fund your retirement. Structured settlements are very flexible. Provided that you consider these issues *before* signing a settlement agreement in your case, you can structure as much or as little as you want and take the rest in cash.

They have to be set up properly, and you can't own the annuity policy or the tax benefits won't work. Rather than paying the cash to you or your lawyer, the defendant will send the money for the structure to a life insurance company's subsidiary called an "assignment company." The assignment company will buy the annuity from its parent life insurance company, and the assignment company will hold the policy and pay you each month as the contract requires.

Special provisions in the tax code allow this structure. Apart from special benefits to insurance companies, the arrangement allows you to be a mere recipient of the periodic payments over time. Even though you're guaranteed to receive each payment, the tax code doesn't treat you as *owning* anything except an expectation of each payment.

Like other tax deferral ideas, their results are more impressive the longer their term and the slower they pay out. They aren't for everyone, and you shouldn't structure every nickel you receive. Once they are set up, they generally can't be changed. The "cash it in and get your money!" advertising on TV are factoring companies that buy structures at a discount from accident victims who need the cash now. Most states require a court hearing before they can buy a structure, and you may be selling your structure at a deep discount, so be careful.

Although structured settlements for physical injury accidents are the most popular kind, there are other types of structured settlements too. The same concept is used in non-tax free settlements (like a contract dispute) or employment lawsuit settlements. The idea is to stretch out the payments even though each installment will be taxable when paid.

These settlements are a little like having the defendant pay the money in installments. However, most plaintiffs don't want to rely on a defendant and want a reliable third party to pay them, growing the funds with investment income in the process. In 2008, the IRS issued a key ruling approving these damage structures. There is even more interest in these now, given the harsher ways that legal settlements are taxed after the 2017 tax reform.

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