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Creating Value with Structured Settlements Begins by Understanding Elements of the Internal Revenue Code

By Duke Wolpert

Structured settlement annuities pay future periodic payments and are plans customized to meet future needs. Because the annuity earns investment income over the life of the contract, the total payout is frequently much more than the cost to buy the structured settlement annuity. This often raises a common question: Couldn't the claimant invest that money and produce the same result? Generally speaking, the answer is "no." In part, the answer lies in the Internal Revenue Code (IRC).

Constructive Receipt

In a settlement, is the money close or in hand? Once a person can freely or constructively gain access to the money, the government will apply the appropriate tax liability rules. IRC Section 1.451-2(a) defines "constructive receipt" as an amount that is "constructively received in the taxable year in which such amount is credited to a taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time if notice of intention is given." Constructive receipt is enough to lose the benefits of taking the settlement in periodic payments. But special language in a structured settlement agreement creates restrictions. The Internal Revenue Service

(IRS) then treats the tax status of the money according to when the claimant actually receives it.

Proper documentation containing the exact wording the IRS requires can help avoid the claimant having constructive receipt at the time of settlement. To meet tax code requirements, special language restricts the claimant's ability to change payment receipt dates, and the amount of the payments also is immutable. Because of these restrictions, the claimant does not have constructive receipt and avoids tax on the investment income; the defense gets a full release at the time of settlement and walks away from the claim.

The defense pays the settlement to a life insurance company chosen by the parties. The life insurance company issues an annuity contract binding itself to make future guaranteed payments. This arrangement is spelled out in the settlement document.

At the time of settlement, parties must agree on a structured settlement. If the case goes to final judgment (no more post-trial proceedings or appeals), the claimant can legally compel payment. That ability equals constructive receipt for tax purposes, and the opportunity to structure payments is lost.

As another caution, life insurance companies will accept funding directly from the defense only. Once the claimant receives settlement money, even if to an attorney's trust account, the claimant has constructive receipt. A claimant cannot structure a settlement without cooperation from the defense and vice versa.

Physical Injury Claims

Settlements of physical injuries, including workers' compensation buyouts, are not taxed. The tax code philosophy is that compensation of an injury loss is not taxable gain. However, once the claimant receives that money, any investment income earned is taxable, so a claimant with an income tax rate of 25 percent would have to find an investment paying six percent ordinary income to earn 4.5 percent after taxes.

In contrast, with a structured settlement of a physical injury claim, all payments—including earned investment income—are tax-free. Because the payment schedule is spelled out in the settlement agreement, the IRS considers all the money paid as compensation for the injury. There is no tax and no tax-reporting ever. Untaxed investment income makes for a more valuable settlement dollar.

Claimants with structured settlements do better financially than those who try to manage their own investments. The rate of return on structured settlements is comparable to that of similarly safe investments. Because the claimant never pays tax on the investment income, the claimant's net yield is higher, and the return is guaranteed. Most investors cannot match that promise. The most valuable benefit may be that the constructive receipt restriction limits the temptation to deplete the whole settlement in a short time.

Minors' Claims

All states have laws protecting minors in settlements. To protect the funds from dissipation by guardians, statutes typically require the money to be invested in a trust, blocked account, or structured settlement. The financial institution holding a trust or blocked account will issue an annual 1099 report of investment income to the account holder and the IRS.

A law known as the "kiddie tax" makes a child's investment income reportable on the parents' tax return and, if more than $2,000, subject to taxation at the parents' rate. As long as the child is a full-time student supported by parents, this continues until the child turns 24 years old. Even if the child's investment income is under the tax threshold, the parents still must report it on a tax return. An investment of just $40,000 earning five percent creates enough investment income to trigger this obligation. Annual taxation of the investment income reduces the return. Each year, parents must pay the kiddie tax out of their own pockets, request payment by the trustee, or, with a blocked account, petition the court for permission to withdraw money to pay the tax.

Another complication arises once the child is old enough to earn a paycheck. The combination of earned and passive income requires a more complicated tax return—at least a 1040A form rather than the simpler 1040EZ form. The cost of professional tax preparation could take a big chunk from a summer job's income working at McDonald's or the mall.

With a physical injury structured settlement, there is no tax effect on the child or the parents. Because of the special constructive receipt language, all the money is tax free. The structured settlement payments never appear on any tax return, keeping things simple for the family.

Structured settlement payouts typically start once the child turns 18 years old. Perhaps the most common structured settlement for a minor is a schedule of four or five annual payments, which are intended to pay for college expenses. But life is not always predictable, and the child may not attend college or may not attend college according to an anticipated schedule. Unlike funds from a qualified tuition plan authorized by Section 529 of the IRC, structured settlement payments for a physical injury can be used for any purpose and will never be subject to taxation.

Taxable Settlements

Employment discrimination, advertising injury, breach of contract, and punitive damages are examples of cases where the claimant is taxed on the settlement. Receipt of a large payment in one year can radically increase the percentage to be paid in taxes. A large payment may trigger the Alternative Minimum Tax (AMT), which calculates a minimum tax by reducing or eliminating deductions and credits. The higher tax bracket doesn't apply only to the settlement money; it applies to all income reported on the return.

By incorporating a structured settlement into the agreement, the defense pays the settlement amount and receives a release at the time of the agreement. The claimant's payments are spread out over time, and taxation of taxable structured settlement money is deferred until actual receipt. In the interim, the money grows.

A taxable structured settlement is like a retirement account. The money stashed in a 401(k) or individual retirement account (IRA) is not taxed in the year it is earned. Investments accumulate until the account holder starts withdrawals. Only then is the withdrawn money taxed; the remainder continues to earn interest without taxation. Without an annual tax rake-off, more money is invested, increasing the total pot. Similarly, starting an investment with the full settlement amount produces more income than starting with a reduced after-tax sum.

Because the claimant does not have constructive receipt of settlement funds until the scheduled payment is actually made, no tax is due before that time. As with a retirement account, payments are typically made over a period of years. Unlike a retirement account, structured settlement payments can start and stop at any age. Structuring a taxable settlement enhances the value because the money will grow on a tax-deferred basis. Not only will the total payment be higher, but the claimant will net more after taxes. Offering an income flow can enhance the value of your settlement dollars.

Many taxable settlements are intended to replace income that would have been earned over time. The settlement agreement can specify dates for monthly or annual payments to replicate lost earnings or profits. Averaging the income over years keeps the maximum amount growing while keeping the tax burden reasonable.

Attorney Fee Structures

Some attorneys structure their fees, and attorneys can defer fees in any type of contingent fee case, whether or not there is a physical injury. The money earns investment income on a tax-deferred basis, and the attorney pays taxes upon actual receipt, which is smart tax planning by the attorney. It is important to note that fees can be structured only as part of the claimant's settlement agreement, not as part of the payment of a judgment.

Technically, claimants receive the money and use the settlement contract to direct payment to their attorneys to satisfy fee obligations. An attorney who wants to delay paying tax on this fee may be doubly motivated to convince the claimant to accept a good settlement offer.

While involved parties are the ones in charge of negotiations, structured settlement brokers can offer customized solutions that assist the parties in resolving their claims. Various scenarios can be created to show how available settlement money can best meet the claimant's future needs. Structured settlement brokers possess experience and skill in creating attractive settlement plans using available funds and can serve to provide win-win solutions for all the parties involved in the negotiation process. CM

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