

Structured Settlements: Explaining Constructive Receipt

Since 1983, the federal tax code has given accident survivors a major financial incentive to settle claims with a structured settlement. Among the benefits, future payments are entirely exempt from state and federal income taxes as well as taxes on interest, dividends and capital gains. Payments can also be tailored for future needs and guaranteed for life or for the life of a spouse.

Importantly, unlike cash settlements, a structured settlement can allow you to maintain eligibility for means-tested government programs. For more information, see NSSTA's handout, *Protect your government benefits with a special needs trust*.

But federal rules are clear that for an injury victim to gain these benefits, he or she may not be in "constructive receipt" of the settlement. Specifically, payments from a structured annuity must be "fixed and determinable" and the claimant may not "accelerate, defer, increase or decrease" payments (Internal Revenue Code section 130). This handout explains the background of constructive receipt and how the IRS has traditionally interpreted its application.

The tax rules enacted by Congress lay down a bright line path for a structured settlement. Congress has stipulated that a structured settlement of a physical injury claim under tort or worker's compensation must have several elements including:

- The periodic payment obligation is negotiated and agreed to by the claimant and the defense at the settlement table in resolution of the tort or worker's compensation claim (or in limited instances is created by judgment under a periodic payment of judgments statute, such as in the medical malpractice area).
- The periodic payments must constitute damages (other than punitive damages) on account of physical injury or sickness in tort or compensation for such physical injury or sickness under worker's compensation. The IRS has held that compensation provided by statute for physical injury or sickness also qualifies. (Treas. Reg. § 1.104-1(c)(2)).
- The periodic payments must be fixed and determinable at time of settlement as to amount and time of payment. Life contingent payments payable for lifetime of the claimant qualify as fixed and determinable for this purpose.
- The claimant must not have the ability to accelerate, defer, increase, or decrease the periodic payments.

The points above represent only a partial listing of the requirements stipulated by the federal tax code for a settlement to qualify for treatment as a structured settlement. For a complete explanation, see *Structured Settlements and Qualified Assignments: How federal tax rules benefit all parties in a claim* available at NSSTA.com.

The claimant must not have "constructive receipt" or the "economic benefit" of the lump sum paid to fund the structured settlement

In enacting the structured settlement tax rules, Congress stated: "This provision is intended to codify, rather than change, present law. Thus, the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments. See I.R.S. Rev. Rul. 79-220 and I.R.S. Rev. Rul. 77-230." (House Rept. No. 97-832, 97th

Cong., 2d Sess. (1982), at 4; Sen. Rept. No. 97-646, 97th Cong., 2d Sess. (1982), at 4).

In I.R.S. Rev. Rul. 79-220, the I.R.S. held that where the plaintiff and defendant had agreed to settle a personal injury claim on the basis of the defendant's promise to make future periodic payments, the full amount of such payments constituted tax-free damages under Code section 104(a)(2). 1979-2 C.B. 74.

This was because the plaintiff “had a right to receive only the monthly payments and did not have the actual or constructive receipt or the economic benefit of the lump sum amount” that was invested by the defendant to yield that monthly payment. *Id.*, at 74. The Service reasoned that the plaintiff “had no right to the discounted present value of the monthly income (the discounted value of which, at date of settlement, was less than the total monthly payments to be provided) or to control the investment of that amount.” *Id.* The defendant possessed the ownership rights in the annuity, including the right to change the beneficiary.

As discussed above, in a tax-qualified structured settlement, the claimant and the defendant agree at the settlement table to settle the physical injury claim in exchange for defendant’s obligation to make future periodic payments to the claimant. The claimant never has any actual or constructive receipt of the economic benefit of a lump sum.

By contrast, the I.R.S. stated in I.R.S. Rev. Rul. 79-220, “if a lump-sum damage payment is invested for the benefit of a claimant who has actual or constructive receipt or the economic benefit of the lump-sum payment, only the lump sum payment is treated as damages within the meaning of section 104(a)(2) of the Code.” *Id.*, at 75.

Thus, where a defendant settles its tort liability in exchange for paying a lump sum into a trust established for the benefit of the claimant, the claimant has actual or constructive receipt or the economic benefit of the lump sum. There are no adverse or competing interests to those of the claimant when the lump sum is paid into the trust. The defendant’s tort liability has been extinguished in exchange for payment of the lump sum. In such a situation, it has been the longstanding published position of the I.R.S. that the claimant has realized the economic benefit of the lump sum payment of damages and is subject to tax on the earnings from the investment of such lump sum. *See, e.g.*, I.R.S. Rev. Rul. 83-25, 1983-1 C.B. 116 in which the I.R.S. held that the claimant “will be treated as the owner of a trust created for the minor’s benefit by court order as a result of a personal injury suit filed on the [claimant’s] behalf.” *Id.*,

at 117. Under court order, the lump sum damage payment was made into the registry of the court and was then transferred to a trust for the benefit of the claimant, with the court designating a corporate trustee. There were no competing interests in the trust proceeds, and all of the interests merged in the claimant.

The I.R.S. ruled that the claimant “has received the economic benefit of the amount of damages paid into the registry of the court.” *Id.*, at 117. The Service reasoned that, “As the owner of the damages awarded, [the claimant] is considered the grantor of the trust to which the damages were transferred. Because under the provisions of the trust, the income and corpus of the trust will be distributed to [the claimant] or held and accumulated for future distribution to [the claimant] at the discretion of a nonadverse party, [the claimant] will be treated as the owner of the trust pursuant to section 677(a) of the Code.” *Id.* There were no “adverse” parties “having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of a power which the person possesses respecting the trust.” *Id.* [citing Internal Revenue Code section 672(a)].

Similarly, in I.R.S. Rev. Rul. 76-133, 1976-1 C.B. 34, the claimant was held taxable on the earnings from a lump sum payment of damages that was “paid into the registry of the court for the sole use and benefit of the taxpayer” and thereafter was transmitted by the court clerk to a savings institution in the name of the taxpayer for deposit in a certificate of deposit.

Conclusion

In summary, in a tax-qualified structured settlement, the claimant and the defendant agree at the settlement table to settle the physical injury or sickness claim in exchange for the defendant’s obligation to make future periodic payments to the claimant. The claimant receives a promise of future payments. In this way, the Federal tax rules ensure that the future payments are fully tax-free damages to the claimant. The defendant then may assign its periodic payment obligation to a structured settlement assignment company.

