National Structured Settlements Trade Association

# 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.

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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.

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# Structured Settlements and Qualified Assignments: How federal tax rules benefit all parties in a claim

Since 1983, the federal tax code has encouraged the use of structured settlements and qualified assignments to resolve physical injury and death claims. For the defendant, the combined structured settlement and qualified assignment offer several advantages. First, the assignment transfers full responsibility for all future payments to an independent third party. This removes from the defendant all future responsibility to the claimant for this case.

Second, IRS rules are clear that with a qualified assignment, the defendant or insurer may deduct the entire settlement cost immediately to the extent otherwise allowed by the tax code.

Moreover, the structured settlement and qualified assignment often result in open cases resolving faster and more efficiently than is possible with all-cash negotiations. For a claims office, this can reduce overhead costs, including outside legal fees.

## Structured settlements: An introduction

A lump sum recovery used to be the standard in personal injury cases. The injured claimant then faced the daunting challenge of managing a large lump sum to cover substantial ongoing medical and living expenses for decades, even for a life-time. All too often, this lump sum swiftly eroded away. When the money was gone, the claimant was left still disabled and still unable to work. In such cases, responsibility to care for this disabled person fell to Medicaid and the public assistance system.

Structured settlements provide a better approach. A voluntary agreement is reached between the parties at the settlement table to settle the tort claim in exchange for the defendant's agreement to pay damages to the injured claimant in the form of a stream of periodic payments tailored to the future medical expenses and basic living needs of the claimant and his or her family. Often this payment stream is for the rest of the claimant's life to make sure that future medical expenses and the family's basic living needs will be met, and that the claimant will not outlive his or her compensation.

In addition to the benefit of providing long-term financial security for the claimant, a structured settlement often helps to resolve tort cases faster and more efficiently by focusing settlement discussions on what damages the claimant actually has suffered, and how best to match periodic payments to meet those future needs, rather than on an arbitrary lump sum payment for an injury.

## Federal tax rules encourage and govern structured settlements

Congress adopted special tax rules in the Periodic Payment Settlement Tax Act of 1982 to encourage the use of structured settlements to provide long-term financial security to injury victims and their families. (Public Law 97-473, codified in sections 104(a)(2) and 130 of the Internal Revenue Code of 1986, 26 U.S.C. 104(a)(2) and 130). These structured settlement rules have been working effectively for 30 years.

In the Taxpayer Relief Act of 1997, Congress extended the use of structured settlements to worker's compensation to cover physical injuries suffered in the workplace.

## Mechanics of the structured settlement and the qualified assignment process

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 the following key elements:

- 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 periodic payments must be payable by the defendant or its liability insurer ("a party to the suit or agreement") or by an assignee who has assumed the defendant's periodic payment obligation under a qualified assignment under Internal Revenue Code section 130.
- An assignee who has assumed the defendant's periodic payment obligation under a section 130 qualified assignment must fund such periodic payments to the claimant using an annuity (or U.S. Treasury obligations) under which—
  (1) the timing and amount of the payments under the annuity match the timing and amount of the periodic payments due to the claimant under the periodic payment obligation assigned from the defendant;
  (2) the assignee designates the annuity as being used to fund a specified structured settlement; and
  (3) the assignee purchases the annuity within 60 days of the date of the assignment of the periodic payment obligation from the defendant.
- The claimant may be given a security interest in the annuity.

Once the claimant and defense settle the physical injury claim in exchange for periodic payments to be made by the defendant, the full amount of the periodic payments constitutes tax-free damages to the injured claimant. The defendant then may assign its periodic payment obligation to a structured settlement assignment company (typically a single purpose affiliate of a life insurer).

The assignee typically funds its assumed obligation with an annuity purchased from its affiliated life insurer. This assignment is made in exchange for a lump sum payment by the defendant or its liability insurer to the assignee. In this way, the defense can close its books on the liability, and the claimant can receive the long-term financial security of an annuity issued by a financially-strong life insurance company.

The defendant or liability insurer may currently deduct the full amount of the lump sum payment made to the assignee to assume the periodic payment liability. (Treas. Reg. § 1.461-6, 26 CFR §1.461-6).

**Tax advantage to claimant:** Full amount of the periodic payments is tax-free (as compared to a lump sum settlement, in which earnings from investment of the lump sum are fully taxable).

**Tax advantage to defense:** Full current deductibility of lump sum made to close out the claim by way of the lump sum payment to the assignee.

## Conclusion

Since 1983, the federal tax code has explicitly encouraged the use of structured settlements. The qualified assignment process has been an integral part of this process because of the tax and administrative benefits it offers to the defendant and to the liability insurer.

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