Avoiding Pitfalls in the Structured Settlement Area

An Annuity Broker's Overview

by Joseph Hadus

Structured settlements, when first introduced in Michigan, were looked upon by members of the Bar (particularly plaintiff-oriented practitioners) with a certain amount of suspicion and apprehension. With knowledge and experience came a growing acceptance of structured settlements so that, today, especially in the large damage cases, the offer to settle is usually in the structured form. When properly utilized, structured settlements can be an invaluable tool for plaintiff and defendant, yet their use is fraught with pitfalls in the hands of the unfamiliar or uninformed.

Myself, and the people connected with my firm, are annuity brokers representing the defense side. If your practice is predominantly of a plaintiff nature, you are more apt to see us sitting across the conference table from you. Nonetheless, our intimate involvement in putting together these settlements makes us acutely aware (sometimes painfully so) of the problems that can develop.

When an agreement falls apart, the most likely cause is in the taxation aspect and the necessary related agreements.

A review of the tax history of structured settlements discloses the exclusion of compensation for injury has been in the Code since 1917. Certain revenue rulings including 76-133 (income from lump sum investment fully taxable), 77-230 (periodic payments excluded) and 79-220 (insurance company purchased and owned annuity to fund agreed - to future payments - payments excluded); are considered land-mark decisions. PL 97-473 (H.R. 5470), commonly known as the "Periodic Payments Act" effectively codified 79-220. Section 104(a)(2) of the Code was amended by inserting "whether by lump sum or periodic payments" into the exclusion from gross income for personal injury recoveries. In addition, the Act added Sect. 130 dealing with personal injury liability assignments and provided that if a defendant and/or insurance carrier assigns its liability to own an annuity policy and guarantee the payments to a third party assignee, the amount received by the assignee is not taxable as long as it does not exceed the cost of the "qualified funding asset."

"When an agreement falls apart, the most likely cause is in the taxation aspect..."

A word of caution: In employment related settlements, structured settlements can involve taxable and non-taxable elements. Generally, payment for breach of contract, rather than compensation for tort-type injuries, are not excludable under 104(a)(2) RE: *Nussbaum v. Commissioner 45TCM 346, Dec. 39, 575(m). Also Rev. Ruling 78-176, 72-572, 72-341 and PLR 7926055 March 28, 1979* and PLR 8407041 (portion of settlement allocable to salary in sexual harrassment case may be taxable). Personal injury practitioners would do well to obtain and refer to copies of these Revenue Rulings along with P.L. 97-473.

I have observed plaintiff attorneys negotiating on a lump-sum basis and converting it into a structured settlement. In the event of an audit, this would leave a paper trail for the IRS and your file, insurance company file, and annuity broker's file might all provide ammunition for a constructive receipt agreement. The preferred choice is to negotiate on a benefits basis and retain a structured settlement consultant for purposes of determining cost related to a contingent fee agreement.

While on the subject, the IRS ruled in *PLR 8333035* (May 15, 1983) that knowledge of the cost of the annuity was not determinable in determining constructive receipt.

As mentioned, when a settlement becomes unglued, it is often because the language is not correct from a tax standpoint. Rather than wrestle with composing a new settlement agreement, counsel might be well advised to use a sample supplied by the annuity carrier and adopting it to the circumstances of the particular case, the important consideration being that it coincides with PL 97-473. Likewise, with the Qualified Assignment Agreement. The various annuity carriers competitive in the structured settlement market (and at any given time there are only 4 or 5) will, through their licensed broker, happily provide sample agremenets.

In general, Third Party Assignments must include language to the effect that:

- Payments are excludable under 104(a))(2).
- Payments must be fixed and determined as to the amount and time of payment.

- Payments cannot be accelerated, deferred, increased or decreased.
- Plaintiff can have no rights against defendant (or assignee) greater than that of a general creditor.
- Assignee's obligation is the same as the original liability of defendant (or insurance carrier) to make payments.
- Funding asset can only be U.S. bonds or insurance company annuity.
- Funding asset must be purchased not more than 60 days before or after date of assignment.
- Plaintiff can have no incidents of ownership in funding asset (see Treasury Regulation S2042-1(c) "...the term incidents of ownership includes the power to change the beneficiary." (Name the estate to avoid potential problems.)

That this litigation resolution technique, though still a relatively recent development, is here to stay cannot be seriously debated when one considers that in 1979 the casualty insurers spent $50 million to fund structures, and that by 1984, the figure had grown to $3 billion. It continues unabated today. Consider also, pending legislation on both the State and Federal level mandates verdicts in excess of a stipulated ceiling be in the form of structured settlements.

In summary, at the very heart of the structured settlement concept is the recognition that it is a balancing act; the plaintiff ought to receive tax-free payments based on a plan designed with individual needs in mind, while the defendant should be able to resolve the case within fair and equitable cost perameters.

An alumnus of Wayne State University, and with nineteen years' experience in the casualty insurance - financial planning area, Joseph Hadus has been President of Southfield based Structured Benefit Consultants since 1981. His area of expertise lies in the actual settlement of serious damage cases, often after intense negotiations. Hadus, among the top settlement specialists in the country, has conducted seminars throughout the country including one recently for the Oakland County Bar Association.

COMING ATTRACTIONS

NEXT MONTH . . .

LACHES focuses on Attorney Malpractice and Attorney Ethics

UPCOMING FEATURES . . .

Issue	Topic	Deadline
October	Corporate Law	August 18
November	Taxation	September 19
December	Probate, Estates & Trust	October 11
January	Real Estate	November 14
February	Criminal Law Victim's Rights	December 19
March	Family Law Pros & Cons of Family Court	January 16
April	Law Office Management and Economics	February 13
May	Employment Law Discrimination	March 18
June	Computer Law	April 17
July	Mental Health Law Juvenile (Custody, Abuse, Neglect)	May 20
August	Evidence	June 19

If you're interested in writing about these or any other topics related to law or the legal profession, call LACHES at

338-2100 or **398-3937**