Structured Settlements

In this ICAP, we will discuss structured settlements. Structured settlements can be a valuable tool in resolving bodily injury claims for claimants or plaintiffs and their families and/or heirs. They are financially beneficial for all parties due to their ability to provide payments over a long time-period (resulting in more total payout) versus a one-time lump sum payment.

As stated by the National Structured Settlements Trade Association, “For more than 25 years, the federal government has encouraged injury victims and their dependents to use structured settlements. Structured settlements have also attracted strong support from plaintiff attorneys, state attorneys general, legislators, judges, and disability advocates”.

Wikipedia defines a structured settlement as “a financial arrangement whereby a claimant agrees to resolve a personal injury tort claim by receiving periodic payments on an agreed schedule rather than as a lump sum.” Structured settlements are not agreements that are “thrown together” while standing on the courthouse steps. Rather, they are detailed, well-planned financial agreements (and often very creative to meet the plaintiff’s individual needs) that must be drafted within the guidelines of federal (Structured Settlement Protection Act) and state statutes and, in most cases, the settlement must be approved by the presiding court.

So how do structured settlements work? The defendant (and/or the defendant’s liability insurance company) may transfer the responsibility to make future payments to a third party (usually a high rated life insurance company) by means of a “qualified assignment.” The assignment is “qualified” because, if done properly, it qualifies for special tax treatment. The assignee then takes care of making the payments. This process relieves the defendant of further responsibility for the payments and transfers the administration and record keeping responsibilities to the assignee that specializes in these activities, and may offer additional financial security.

In the early 1980’s, Congress enacted a series of laws that were intended to encourage the use of periodic payments of damages to injured parties in order to lessen the chance of premature dissipation of settlement funds. These laws allowed defendants or their insurers to purchase annuities to pay settlement proceeds to the claimants over an extended period. As long as the annuities met certain guidelines, the income received by the claimants would be tax-free.

There are some important benefits to a claimant in structuring a settlement:
1. The claimant receives money when needed. Instead of receiving a lump sum payment which has to be invested at risk and/or managed for a fee (if not immediately spent), the money is paid out over time which better correlates to the actual need for funds.

2. The claimant does not have to pay income tax on the payments received, which includes an “internal buildup” of funds over time. A lump sum payment received also is tax free, but income from investing that money taxable.

Here is an example of how a structured settlement might look when compared to a lump sum settlement using $200,000 as the payout (either paid to the claimant in a one-time lump sum settlement or used as premium to purchase an annuity for payouts over a protracted period of time). Assume that the claimant is a man, aged 45.

One-time lump sum settlement:
Lump sum settlement payment of $200,000:
Total Guaranteed - $200,000
Total Expected – Any possible future growth depends on any amount left after immediate spending and how the remaining money is invested (deducting income taxes on its earnings).

Structured settlement (using $200,00 as premium to purchase an annuity):
Payments of $1,300.00 per month for life (20 year certain)
Total Guaranteed - $312,000
Total Expected - $536,000 (assuming a normal life expectancy)
In this illustration, the claimant receives monthly payments for as long he lives with the first 20 years of payments guaranteed to either the claimant or his heirs in the event of his death. The total expected payments are tax-free.

A typical structured settlement offer will be comprised of the following components:
- A specified lump sum payment (to give the claimant some upfront cash and to cover some immediate needs) – without allowing for an upfront cash payment there is less motivation for the claimant to accept a structured settlement
- A monthly income payment (can start rather immediately or be deferred to start at some point in the future)
- One or more one-time future payments (i.e. for funding college, purchasing a vehicle or future medical costs)

What types of claims are ideal for a structured settlement? Any of the following scenarios would work well for using a structured settlement:
1. Temporarily or permanently disabled claimants
2. Claimants with limited investment or financial management skills
3. Guardianship cases, including minors or incompetents
4. Wrongful death cases where the surviving spouse and/or children need
Advantages

monthly or annual income
5. Severely injured claimants, especially those with shortened life expectancy or mental incompetency
6. Severely injured claimants resulting in greatly diminished earning capacity but with family obligations for spouse and/or children

Claimants often have specific needs that may arise from their injuries resulting in future one-time or ongoing costs or expenditures. The various types of costs or expenditures can include any of the following:
1. Significant ongoing medical costs (i.e. pharmaceutical expenses)
2. Rehabilitation or permanent care facility expenses
3. Future anticipated one-time medical costs (i.e. scar revision or medical hardware removal)
4. Deferred money needed for future college costs
5. Deferred money needed for miscellaneous one-time expenditures (i.e. wedding costs or for a vehicle for a child approaching driving age)
6. Future needed supplemental retirement income

There are other types of cases, as well, that can be considered as candidates for periodic payments:
1. Workers compensation injuries
2. Personal injuries other than physical injury

When structured settlement periodic payments are used, they generally apply to bodily injury claims. However, periodic payments can also be excellent tools in satisfying the claims of homeowner groups, or others who are seeking reimbursement for construction defect claims. Instead of receiving a single large lump sum payment, they receive periodic payments over time in order to correspond more closely to the timing of repair costs. Also, with the emergence of environmental and pollution claims, periodic payments have been considered and used to finance the expense of the extensive clean-ups that are the nature of these claims. At times, annuities are a method to cover the claimant attorney’s fees.

There are many advantages to claimants when they accept a structured settlement. These advantages include:
1. Income (tax-free guaranteed payments)
2. Avoidance of mismanagement
3. Avoidance of expense and worry with regard to financial loss (provides a secure, low-risk source of income)
4. Convenience of regular payments designed to meet claimant’s specific needs
5. Receipt of more total money over time
6. Competitive returns compared with other rates of return
7. Avoidance of risk, expense and delay of going to trial
8. Transference of risk of outliving one’s income to a life insurance company
9. Possible higher benefits from an injury that decreases life expectancy

There are also advantages for the insurer to consider proposing a structured
settlement which include:

1. Earlier settlements including assistance by structured settlement brokers with negotiations and settlement documents
2. Reduced litigation costs
3. Assignment of future liability
4. Avoidance of risk and expense of a jury trial
5. Keeping claim settlements within policy limits (in rare instances where that may be an factor) to avoid exposure to policyholders

In the early 80’s, structured settlements were very attractive and used regularly due to the high interest rates that were available. Not only were claimants accepting structures but their attorneys were also structuring their fees to gain tax benefits. For the past decade or so, we have seen interest rates fall and the financial growth of smaller structured settlements may not be the same as we experienced in the 80’s. However, as illustrated above, structures still can be an effective tool to resolve claims and benefit an injured claimant.

Federal law that currently applies to structured settlements is contained in the Internal Revenue Codes:

- Section 104 Compensation for Injuries or Sickness
- Section 130 Certain Personal Injury Liability Assignments

The Internal Revenue Codes evolved over time and have a history that explains the current condition of the codes.

In a series of rulings issued in 1977 and 1979, the Internal Revenue Service considered whether funded installment payments for settlement of injury claims were entirely excludable from gross income under Internal Revenue Code Section 104, or whether the exclusion should be limited to the present value of the payments made over the period. The IRS concluded that such payments were in fact fully excludable. The Periodic Payment Act of 1983 codified this administrative position and, in addition, dealt with the tax treatment of third-party payers (assignees). The 1983 Act amended the law to clarify that the income tax exclusion for payments received because of injuries or sickness applies not only to lump sum settlements, but also to settlements in the form of periodic payments.

If a defendant does not wish to be responsible for the continuing payment obligations after the structured settlement is accepted, it is possible under Internal Revenue Code Section 130 to assign that obligation of continuing payment to a “qualified assignee”. Purchase of an annuity or U.S. government obligation (referred to as a “qualified funding asset”) is required within a period beginning 60 days before, and ending 60 days after, the assumption of the liability. If it is an annuity, a licensed insurance company must issue it.

In 2000, the National Structured Settlements Trade Association and the National Association of Settlement Purchasers agreed to the language in the “Model State Structured Settlement Protection Act” and it later became law in 2002. The Act
mandated a number of safeguards for those holding structured settlement money and the transfer of annuities. We are sure you have seen the television commercials where you see an individual (a former claimant) saying, “It’s my money and I want it now!” The Structured Settlement Protection Act came about to protect the individual who wants to obtain a lump sum of money from their periodic payments. This legislation demanded approval for all transactions going through a factoring or transaction company by a state court, which would investigate to ascertain if the transaction from structured settlement money to a lump sum payment is good for the client and the client’s dependents. Additionally, the issuers of annuities, the life insurance companies, became part of the process, contrary to factoring companies’ standard policy of years past. Often, life insurance companies were surprised when factoring or transaction companies purchased structured settlement annuities and they became aware of the new owners. The Structured Settlement Protection Act also called for the client receiving a lump sum payment (buy out of a structured settlement) to obtain professional counsel on every aspect of the transaction’s affect upon the future quality of life for the client.

Most states have used the Structured Settlement Protection Act as the pattern for their own individual state statutes. There are key definitions within the Structured Settlement Protection Act that should be noted:

“Annuity issuer,” means an insurer that has issued a contract to fund periodic payments under a structured settlement.

“Dependents,” include a payee’s spouse and minor children and all other persons for whom the payee is legally obligate to provide support, including alimony.

“Discounted present value,” means the present value of future payments determined by discounting such payments to the present using the most recently published Applicable Federal Rate for determining the present value of an annuity, as issued by the United States Internal Revenue Service.

“Independent professional advice,” means advice of an attorney, certified public accountant, actuary or other licensed professional advisor.

“Payee,” means an individual who is receiving tax-free payments under a structured settlement and proposes to make a transfer of payment rights.

“Qualified assignment agreement,” means an agreement providing for a qualified assignment with the meaning of section 130 of the United States Internal Revenue Code, United States Code Title 26, as mended from time to time.

“Structured settlement,” means an arrangement for periodic payment of damages for personal injuries or sickness established by settlement or judgment in resolution of a tort claim or for periodic payments in settlement of a workers’ compensation claim.

“Structured settlement obligor,” means, with respect to any structured settlement,
the party that has the continuing obligation to make periodic payments to the payee
under a structured settlement agreement or qualified assignment agreement.

“Transfer,” means any sale, assignment, pledge, hypothecation or other
alienation or encumbrance of structured settlement payment rights made by a
payee for consideration.

Revenue Ruling 79-220 interprets Section 104(a)(2) and sets out the criteria
required in order to qualify for tax-exempt status under the law. The basic
requirement is that the claimant can have no control over the investment that funds
the periodic payments. They have only the right to receive future payments.

The Periodic Payment Settlement act of 1982 gave statutory certainty to various tax
rulings concerning personal injury damages paid by periodic payments. It also
created Section 130 of the Internal Revenue Code.

Section 130 allows the party accepting the assignment of responsibility for future
periodic payments to exclude the amount received for the assignment from gross
income to the extent of the amount used to purchase specified funding vehicles.
The process is a “qualified assignment,” and the funding vehicle is a “qualified
funding asset.”

Section 130 is very specific regarding the requirements necessary to establish a
qualified assignment:
   1. The assignee assumes the liability from a party to the suit or agreement
   2. The payments are fixed and determinable
   3. The payments cannot be accelerated, deferred, increased or decreased,
      or otherwise changed after the agreement is reached
   4. The assignee’s obligations are no greater than the obligation of the
      assignor
   5. The periodic payments are excludable from the recipient’s gross income
      under Section 104(a)(2)
   6. The injury must be a physical sickness or injury; and
   7. Purchase of a qualified funding asset (an annuity or U.S. Government
      obligation) is required

For ICC, when we consider the use of a structured settlement our claims
representatives, defense counsel, and structure brokers must adhere to both federal
and state statues and codes. As you will see from the following recaps of our five
states, the claimant (customer) must reside in the state, he or she must seek
independent financial advice, and the court must approve the settlement.

The Structured Settlement Protection Act for Illinois is 215 ILCAS 153.153/1 et seq.
House Bill 1410 is entitled “An Act concerning structured settlements.” The customer
must live in the state and approval by a local state court is required. For approval,
the transaction must be in the customer’s best interest. There also exists a 3-day
waiting period to protect the customer.

The State Structured Settlement Protection Act for Indiana is IC 34-50-2 thru 3450-2-
11. The state requires the customer live in the state, and approval by a local court in the state is required. For approval, the transaction must be in the customer’s best interest. There also exists a 10-day waiting period to protect the customer.

**Iowa** uses the Model Structured Settlement Protection Act as its state statute - Chapter 682 Structured Settlement Protection Act.

Chapter 549 governs **Minnesota’s** Structured Settlement Protection Act. The law provides that the customer live in the state, and approval by a local state court is required. For approval, the transaction must be in the customer’s best interest. In addition, a customer must seek independent financial advice to protect their interest. There also exists a 10-day waiting period to protect the customer.

Statutes 407.1060 to 407.1068 set out the requirements for **Missouri’s** State Structured Settlement Protection Act. The customer must live in the state, and approval must be by a local state court. Again, for approval, the transaction must be in the customer’s best interest. In addition, a customer must seek independent financial advice to protect their interest. There also exists a 10-day waiting period to protect the customer.

Structured settlements have proven effective solutions for the needs of bodily injury claimants. Claim professionals, plaintiffs’ attorneys, judges and defense attorneys advocate the use of structured settlements because they effectively meet a claimant’s needs for security as well as provide more benefits over time than a single, lump-sum settlement. In addition, the periodic payment concept is applicable to a variety of other situations.

Resources:


If you have any comments, suggestions, or wish to discuss this ICAP, please contact us at [Claims@ilcasco.com](mailto:Claims@ilcasco.com).