
THE STRUCTURED SETTLEMENT REPORT

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Summit Settlement Services, Inc.

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Release Language • Preserve the Tax Free Status of the Structured Settlement

When a settlement is reached for a cash sum; the claimant provides a full release of all claims for \$x as defined within the settlement agreement and release. When a case involves a structured settlement (cash plus future periodic payments), the full amount of the settlement must NOT be disclosed within the release. Rather, the defendant identifies the up-front cash sum along with the future periodic payment schedule within the structured settlement release.

The inclusion of either the cost of the annuity or the cost of the entire settlement within the Release may raise the question: "Is the Claimant in Constructive Receipt of the entire Settlement Sum?"

In the vast majority of cases, the defendant enters into a qualified assignment within the meaning of IRC Sec. 130. The assignee reviews the Settlement Agreement and often rejects the assignment if the release includes questionable language. However, even if the assignee

accepts the assignment obligation, they are not at risk should the IRS view the periodic payments as taxable in whole or part, see below:

*Constructive Receipt defined:
It is the doctrine that taxes income before the income is actually received.*

Sample Case: Ten years after settlement, the claimant is audited by the IRS and it is determined that the claimant is in constructive receipt of the entire settlement and thus the interest portion of the future periodic payments is taxable to the claimant as paid. What happens next?

The dreaded question: Who will the claimant litigate against?

- Plaintiff Attorney
- Defendant
- Insurer
- Annuity Carrier
- Assignee
- Settlement Consultant

The qualified assignment agreement states that "In the event the Settlement Agreement is declared terminated by a court

of law or in the event that Section 130(c) of the Code has not been satisfied, this Agreement shall terminate. The Assignee shall then assign ownership of any "qualified funding asset," purchased hereunder to Assignor, and Assignee's liability for the Periodic Payments shall terminate."

The Assignment Company has an "unwind" clause.

By the claimant signing an improperly worded release, they have placed themselves at risk (entered the tax-audit lottery)! If the IRS conducts an audit and views the settlement as being constructively received by the claimant; the annuity investment would be treated as a taxable asset of the claimant. Consequently, the interest payments received, in excess of the tax-free principal, would be taxable to the claimant in the year in which the funds were received. Additional penalties may be applied due to the failure to report, and an underpayment of taxes due.

The settlement agreement must be properly worded at time of settlement to avoid possible future litigation.

A fundamental principal of the structured settlement is that the settling defendant must agree to accept the future periodic payment obligation. To rephrase, in order for the structured settlement to be received by the claimant entirely **tax-free**, the defendant must accept the obligation to make the future periodic payments, not simply obligate themselves to purchase an annuity. **Though this may seem a subtle point, the taxability of the settlement turns on this very issue.**

A properly worded release includes pertinent language to allow for the transfer of the periodic payment obligation via a qualified assignment within the meaning of IRC Sec. 130.

Procedurally, the defendant agrees to make the future periodic payments, then instantaneously assigns the periodic payment obligation to the Assignee. The Assignee in turn immediately purchases the structured settlement annuity from the Annuity Carrier.

A personal note from the author, Dorothy Scanlan Stevens.

Over the past month I have seen numerous settlement agreements that were prepared

without consideration of future tax consequences to the claimant. The tax-free status of the structure is placed in jeopardy if the Release includes the following information:

- *identifies the case of the annuity*
- *identifies the total settlement sum (cash + annuity)*
- *states that the defendant is purchasing the annuity as a courtesy to the claimant*

When in doubt about release language, consult your personal Structured Settlement Consultant. Release language is a critical part of my services. I can provide you with proper language that needs to be included within your Settlement Agreement.

If we can be of assistance on a particular case, please contact our office.

Dorothy Scanlan Stevens

Certified Structured
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