STRUCTURES 101

History 101

1918 IRS enacted section 104(a)(2) of the Internal Revenue Code – bodily injury claims are **free of taxation**.

1983 Periodic Payment Act of 1983 – **encourages** the use of structured settlements. IRC Section 104(a)(2) amended to include **periodic payments**.

1988 Section 130(c) amended to permit **qualified assignments**.

1990s The Small Business Job Protection Act amends IRC Section 104(a)(2) to include the words **physical injuries** (1996).
IRC Section 130 was amended to allow qualified assignments of workers compensation claims.
Emergence of Factoring Companies and Plaintiff Brokers.

2000 California enacted the State Structured Settlement Protection Act regarding factoring.

2001 The Victims of Terrorism Tax Relief Act of 2001 included a section entitled "Treatment of Certain Structured Settlement Payments" adding Section 5891 to the Code.
CA Assembly Bill 268 amended to reflect IRC amendments.
Emergence of 468B Trusts, Qualified Settlement Funds.

What is a Structured Settlement?

A structured settlement provides future payments to help compensate the injured claimant for his/her physical injuries. These payments are paid either monthly, quarterly or annually over a specific period of time or for the **lifetime** of the injured claimant. The payments may increase periodically to help hedge against inflation. The payments may include deferred lump sums to pay for future anticipated expenses, i.e., medical expenses, surgeries, automobiles, education, etc. Structured settlements are an important financial tool for managing the proceeds of a bodily injury claim.

What are the Structured Settlement Options?

Three structured settlement options are available for the settlement of a bodily injury claim. The injured claimant may receive his/her settlement as: a) All up-front Cash; b) Future Periodic Payments; or c) Combination of initial up-front Cash plus future Periodic Payments. The up-front cash is used to pay the claimant attorney fees, costs, medical liens and cash to the injured claimant. The future periodic payments will provide specific scheduled periodic payments at frequencies designed to meet the needs of the injured claimant.

<u>Why Should a Claimant Consider a Structured Settlement</u>?

A structured settlement provides **tax-free benefits** to the injured claimant. Internal Revenue Code Section 104(a)(2) of 1986, as amended, allows for all future payments to be received by the claimant completely tax-free. Both the principal and interest income are paid to the injured claimant on a tax exempt basis, <u>forever</u>.

The periodic payment schedule is carefully designed and may provide **guaranteed** future payments. This guarantee will assure the claimant and his/her beneficiaries with certain financial security.

The periodic payment schedule will provide a **customized financial plan** that fits the future financial needs and objectives of the injured claimant. The funds may be scheduled to pay for future educational expenses, supplemental retirement fund, anticipated medical expenses, attendant care, estate development and living expenses of the injured claimant. If payments are scheduled to be paid for "**life**", the claimant can<u>not</u> outlive the investment. Funds are secured for current and future medical needs.

The defendant or their assignee will purchase an **annuity** contract from qualified life insurance companies with the **highest financial ratings** to provide the future periodic payments to the injured claimant. The claimant will have a secure source of income for the future and will not be subject to fluctuations in the financial marketplace or economy. The claimant obtains the **highest investment rate of return** when substandard medical underwriting is available.

When a settlement involves a minor, periodic payments can be made during the **college years** and beyond as opposed to giving a large lump sum to an 18 year old (through a blocked bank account). Deferred lump sum payments provide guaranteed funds for future needs, i.e., college tuition, home purchase, business start-up, estate development and retirement.

If properly constructed, a claimant can settle a bodily injury claim and receive settlement funds into a **Special Needs Trust** and retain his/her eligibility for needs based government entitlements. The structured settlement annuity can make payments directly into the Trust. The Trust funds can be used to pay for medical care and expenses in excess of Medicaid approved expenses. By avoiding constructive receipt of the settlement funds, the claimant may retain his/her government eligibility to Social Security, Medicaid, In Home Health Services, etc.

Claimants can reserve secured creditor status and settlements can include commutation riders to allow the claimants' beneficiaries to liquidate a percentage of the present value of the periodic payments upon the death of the injured claimant. Annuities can be purchased from multiple life insurers to diversify the claimant's investment portfolio.

Studies made by the insurance industry show that accident victims receiving large lump sum payments frequently have nothing left in a very short period of time. Within 2 months, 25% have nothing left; within 1 year, 50% have nothing left; within 2 years, 70% have nothing left; and within 5 years, 90% have nothing left. *Source:* *Journal of Commerce, March 20, 1985.*

Structured settlements are established when both parties agree to resolve the claim with future periodic payments. By entering into a structured transaction, both sides eliminate the risk of a trial in favor of a specific payment schedule that is tax-free forever.

Lump Sum Cash Settlement or Structured Settlement – Which is Best?

The injured claimant will receive either an All-Cash or a Structured Settlement free of income tax since the injuries are paid on account of a bodily injury claim. If the claimant accepts an All-Cash settlement, any interest/dividend income he/she generates over and above the principal settlement is taxable income to the claimant, as earned. Private investment income is not eligible for the favored tax treatment and interest income will be taxed at the claimant's regular tax rate at both Federal and State levels. Unlike private investments, structured settlements have no recurring fees whatsoever.

"The higher the yield, the higher the risk" is a maxim to be remembered when investing an All-Cash settlement. It is the non-investment risk factors associated with cash settlements that present the major problem. Even if the claimant has the financial skills to manage a cash settlement, or has the best expert advice, nothing can eliminate the following "big three" risks:

1. Claimant lives beyond his/her financial means by spending down the principal;
2. With the best intentions, family and friends borrow money and fail to repay the loans, or the Claimant incurs large debts (medical expenses or business ventures), and his/her own debtors seek repayment and lien the Claimant's assets; or
3. Claimant outlives the principal, regardless of prudent money management.

Although an All-Cash settlement may be the simplest method for the defense to close out its case file and the claimant attorney to receive his fee, it is not the safest choice for the injured claimant. Nothing is worse than seeing a claimant run out of money and have no means to pay for his/her future medical and living expenses. The primary reason for structuring a claim is to avoid the dissipation of settlement funds and avoid the very situations (relying on government assistance programs and welfare) that the settlement was designed to cover.

Structured settlements provide a safe, secure, stream of payments to the injured claimant. The payments are custom-tailored to meet the individual claimant's future needs and is intended to make future fixed and determined payments on specific due dates to meet the claimant's anticipated needs. By securing an annuity from a superior life insurer to back-up the periodic payments, the defendant or their assignee provides the injured claimant with a safe, steady, secure stream of future payments.

Structured settlements are virtually risk free. Stock and equity investments remain speculative and inconsistent. Less speculative investments, such as Bonds and Certificates of Deposit, are subject to re-investment fluctuation risk. Structured settlement rates are locked-in at the time of settlement so the claimant is not at risk to volatilities in the financial market that could adversely affect his/her financial independence. Structured settlements are entirely free of local, state and federal income tax - forever.

What are the Advantages to the Claimant?

1. Tax-free payments (tax-free accrual of interest).
2. Payment schedule is tailored to meet all known future financial needs.
3. The income from the structured settlement can be guaranteed and is not subject to change.
4. The guaranteed payments can provide an immediate estate for the Claimant (heirs).
5. The Claimant is comforted by the financial strength of the highest rated life insurance companies underwriting their structured settlement annuities.
6. The structured settlement can make payments over the lifetime of the Claimant, without the possibility of depletion of the settlement proceeds (plaintiff cannot outlive the investment).
7. There are no recurring fees by the Claimant, ever.
8. Obtain the highest investment rates of return available when substandard medical underwriting is available.
9. Deferred lump sums can provide for college to minors, home purchases, business start-up, estate development and retirement.
10. The Claimant attorney can defer his attorney fees via a deferred compensation annuity.
11. The Claimant can request Secured Creditor Status, Commutation Riders and Secondary Promises to Pay from Annuity Carriers on their Assignees.

What are the Advantages to the Defendant?

1. Cost of the structure is less than the amount reserved for the claim.
2. Administration of the file is eliminated.
3. The uncertainty of future medical costs is eliminated.
4. The uncertainty of the final outcome is eliminated.
5. By entering into a Qualified Assignment, the Defendant transfers the periodic payment obligation to a third party. The defendant closes their case file.
6. A structured settlement vs. a cash settlement better assures the Claimant will not become destitute and consequently reliant upon welfare payments from the State.

In summary, structured settlement annuities provide a competitive rate of return and the spendthrift protection of providing benefits to the injured claimant with financial security that is unmatchable by equally secure private investments.