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What is a Structured Settlement?

Formally recognized by the federal government since 1983, a structured settlement is a voluntary agreement between the claimant and the defense under which the victim receives a series of periodic payments. Unlike the investment income from traditional lump-sum settlements, these periodic payments are not subject to federal taxation. This is often one of the most appealing characteristics of a structured settlement.

A structured settlement may be the result of a privately negotiated agreement (for example, in a pre-trial settlement) or may be required by a court order (usually involving minors and persons deemed mentally unfit to maintain a lump-sum settlement). Authorization for structured settlements can be found in sections 130, 104, 461(h), and 72 of the Internal Revenue Code.

The amount and timing of structured settlement payments are strictly up to the negotiating parties. Payments may be in equal amounts at regular intervals. Or, the parties are free to agree to intermittent larger payments that take into account future needs (e.g., to fund a college education in 10 years or a new mechanized wheelchair every four years).

Importantly, once the payment amounts and timetable are agreed to, neither the party obligated to make the payments and the person entitled to receive the payments are legally permitted to alter either the amounts or timing of the payments.

How Is a Structured Settlement Funded?

When a payment schedule is agreed to, the defendant and/or the defendant's insurance company will purchase an annuity, annuities and/or Treasury Bonds to fund the scheduled payments. Typically, these are then assigned to an experienced financial institution (e.g., a life insurance company) which manages the payment schedule for a fee.

As a result of a 1997 change in federal law governing structured settlements in workers compensation cases, defendants are now allowed to take the full amount of the damage payments off their books once the annuit(ies) are assigned. Congress enacted this law to facilitate the use of structured settlements to resolve workers compensation cases.

Different Types of Structured Settlements

Once a plaintiff agrees to structure at least some of the settlement, he must decide on the type that best suits his needs. There are a myriad of ways to structure a settlement and initially, this can be daunting. However, the long-term benefits of structures (outlined above) make this a worthy exercise.

It will help considerably if the plaintiff and counsel evaluate their long-term needs, preferably with an outside professional such as a structured settlement broker. Then they can decide on what type of structure best suits them. Common ways to structure a settlement include:

- **Lifetime.** This is the simplest type of structure, as it will pay the plaintiff according to the schedule agreed to by plaintiff and defense (and their counsel) for as long as he/she lives. These payments can be in equal amounts or there can be “lump sums” built in to pay for such things as a new wheelchair every four years or a college tuition.
- **Joint Lifetime.** This is based on the “second-to-die” principle and is particularly appropriate as a way to ensure that married couples maintain their financial security. With a joint lifetime structure, payments are made according to the agreed-upon schedule until both parties are deceased.
- **Lifetime with Period Certain.** This is a modification on the lifetime structure outlined above. In this case, payments are made to the injured person according to the agreed-upon schedule. However, if the plaintiff dies prematurely, then his or her estate (or a beneficiary named in the contract) would continue to receive payments for the “guarantee” period.
- **Period Certain.** This is essentially similar to the Lifetime structure, except that the parties agree that after a set period, the payments will end and there will be no funds remaining in the structure.

The Importance of Age Rating

Structured settlements are funded most often through the use of annuities (the alternative being Treasury Bills), often with benefits based on life expectancy. If a plaintiff’s life expectancy is reduced statistically for any reason (e.g., smoking, paraplegia, diabetes), then life contingent annuity payments for the individual will increase.

The concept is most commonly referred to as “age rating” or “rated age”. To obtain a rating, a structured settlement broker submits pertinent medical information to the various life insurance companies who provide structured settlement annuities. Such information would generally include pertinent hospital discharge summaries and/or an independent medical exam.

The life insurance companies then have an actuary analyze the material and assign the plaintiff a “rating.” For example, a 15-year-old who has been in a serious accident might be given a rated age of 35. That means the teen’s life expectancy matches that of a typical 35-year-old. The higher the plaintiff’s rated age, the greater the amount of his benefits (i.e., because of his diminished life expectancy).

In this scenario, the 15-year-old receives more money each payment cycle because the life insurance company assumes that it will not have to pay for as many years as it would a typical 15-year-old.

Structured Settlements: Legislative Background

The specific origin of structured settlements is murky. The concept of an extended payment schedule for claimants facing long-term injury costs seems to have emerged in general when punitive damages for physical injuries began rising, and specifically, during the settlement of thalidomide cases. But the process was held back due to a lack of federal law and IRS guidance on the subject.

That changed in 1983, when President Reagan signed legislation (P.L. 97-473) to formalize structured settlements under federal law. According to The National Structured Settlements Trade Association, by enacting the 1983 law, Congress approved specific tax rules to encourage and permit the use of structured settlements to resolve physical or personal injury claims and lawsuits. First, Section 104(a)(2) of the Internal Revenue Code was amended to clarify that the full amount of a structured settlement's periodic payments constitutes damages which are received by the victim free of any federal tax liability. (By contrast, the investment earnings on a lump sum are generally taxable.)

Second, Congress adopted IRC Section 130 to facilitate secure, long-term funding arrangements, through annuity contracts or Treasury securities, for tort victims needing long-term care and support.

Why Structured Settlement Payments Are Tax-Free

There is a clear legislative history behind structured settlements showing the belief of Congress that injury victims receiving long-term payments are far less likely to dissipate their earnings prematurely and end up on public assistance. (See *Congressional Record* (daily ed.) 12/18/81, at S15005; statement by Sen. Max Baucus, who introduced P.L. 97-473. Also see *Congressional Record* (daily ed.), 10/2/98, at S11340; statement by Sen. John Chaffee.)

As the Congressional tax committees reported in adopting P.L. 97-473, “[T]he 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.” (H.R. Rep. No. 97-832, 97th Cong., 2d sess.(1982), 4; Sen. Rep. No. 97-646, 97th Cong. 2d sess. (1982), 4)

That is why federal tax rules prohibit the claimant from being able to “increase, decrease, accelerate or defer” payments once claimant and defense agree on a specific timetable of

periodic payments (IRC Section 130(c)(2)(B). The IRS agrees that periodic payments constitute tax-free damages for the claimant ((IRC Section 130(c)(2)(D).

Structured Settlements vs. Lump Sum

The following table, based on the hypothetical case of a 46-year-old man injured on the job, shows the benefits of a tax-free structured settlement over a one-time award. The settlement assumes monthly payments of \$600 with a 20 year guarantee instead of a \$96,000 lump-sum payment:

<i>OPTIONS FOR PAYMENT</i>	<i>TOTAL GUARANTEED</i>	<i>TOTAL EXPECTED</i>
SINGLE PAYMENT	\$96,000	\$157,800*
STRUCTURED SETTLEMENT (\$600/month for life; 20 years guaranteed)	\$144,000	\$206,640**

Taking a structured settlement brings the plaintiff an ADDITIONAL extra \$48,840 over 20 years – or more than 30 percent higher than a cash settlement.

* Assuming a 7 percent annual return, 28 percent federal income tax, 3 percent state income tax and an annual payout of \$7,200. The lump-sum payment would be completely gone in 21 years, 10 months.

** Based on normal life expectancy of 28.7 years for a 50 year-old male.

(Note: Statistics come from Safeco Life Insurance.)

Federal Law and Workers Compensation

In August 1997, President Clinton signed tax legislation that included a provision designed to facilitate the use of structured settlements to settle workers compensation cases. The new law allows defendants and their insurers to assign the full amount of annuit(ies) used to settle a workers compensation case to a third party and to write off the full amount of the liability immediately.

Previously, a defendant using a structured settlement for a workers comp case was only able to write off that portion of the payments that were actually made in a given year. This created accounting headaches and discouraged use of structures – even in states that encouraged and/or mandated periodic payments in workers compensation cases. The 1997 law corrected this.

What Size Awards Are Most Likely to Structure?

The Insurance Services Office's latest closed claim survey results indicate that the larger the claim, the more likely IT IS that a structured settlement will be used to resolve it. In claims involving losses of \$75,000 to \$99,999, structured settlements were used less than seven percent (7%) of the time. In claims involving losses of \$1 million or more, structured settlements were used 29 percent (29%) of the time.

The ISO survey concludes, "The average payment in claims involving structured settlements . . . was more than 59 percent greater than the average payment for claims paid in a single lump-sum . . ."

An important caveat: As noted above, there was a 1997 change in federal law that eases the use of structured settlements in workers comp cases. Since many of these cases are now moving on to settlement, there is a greater likelihood that increasing numbers of structured settlements will be used on less serious injuries. Therefore, the disparity in the use of structures by case size will likely diminish.

Social Security Wrap-Arounds

There is an important legal relationship between an injured worker's comp payments and his or her Social Security payments that must be taken into consideration when calculating a settlement. Fortunately, if the settlement is handled properly, there can be benefit to both the plaintiff and defendant and will often involve using a structured settlement.

The core issue is that compensation paid to a plaintiff might reduce his or her Social Security benefits. The reason stems from something called the worker's "Average Current Earnings" (ACE). The ACE represents the total amount of disability benefits a worker may receive *annually*.

An ACE is derived by looking at one's last five years of income, determining the best year, and then multiplying that by 80 percent. This figure is the largest amount a worker may receive in total governmental benefits, both state federal.

For example, if a worker's highest annual income since 1997 is \$30,000, then his ACE is \$24,000 – or \$2,000 per month. Assume too that this person also receives \$1,000 in monthly Social Security payments. Therefore, if the worker receives comp benefits of \$1,500, then social security will reduce the amount they pay by \$500 in order to stay within that person's \$2,000 ACE. Thus, Social Security is saving \$500 per month.

From the defendant's perspective, this hypothetical case represents a raw deal as he is actually picking up the \$500 "tab" formerly paid by Social Security.

By structuring, the plaintiff will continue to receive the entire ACE amount of \$2,000 per month, while the defendant is able to reduce his cost. That's because, by striking a deal with the Plaintiff, the defendant only needs to structure an amount of money equivalent to the difference between the plaintiff's social security benefits and the ACE.

Why would a plaintiff care? The advantage to the plaintiff is that, unlike traditional disability benefits that are inflexible and are reduced significantly when paid to beneficiaries, a structured settlement can provide flexibility and full benefits to beneficiaries.

For the plaintiff, there is a benefit as well. Unlike traditional benefits that can be reduced significantly upon death, a structured settlement will, if set up properly, continue to pay beneficiaries as the claimant wishes.

Independent Support for Structured Settlements

Plaintiffs and their counsel should be aware that structured settlements have gained widespread praise from many advocates on behalf of persons with disabilities. The following are public statements about the benefits of structured settlements taken from The National Structured Settlements Trade Association (www.NSSTA.com):

Structured settlements are “a benefit that I and thousands of plaintiff attorneys have recommended to clients as one of the best ways to guarantee financial security and independence.”

Bill Garmer, Esq.
Savage, Garmer & Elliott
Governor, Association of Trial Lawyers of America

“After more than 20 years of involvement with personal injury and accident litigation, I've become a firm believer in the benefits of structured settlements.”

Wm. T. (Bill) Robinson, III
Greenebaum Doll & McDonald, PLLC
Board of Governors, American Bar Association
Past President, Kentucky Bar Association

“Congress created structured settlements to provide long-term financial security for victims of serious injuries, many of whom are permanently disabled. Structured settlements meet the victims' ongoing expenses for medical care, living needs, and family support, and serve the public good by ensuring that victims don't dissipate their settlements and wind up on public assistance.”

Alan Reich
President, National Organization on Disability

“Over the past 16 years, structured settlements have proven to be an ideal method for insuring that persons with disabilities, particularly minors, are not tempted to squander resources designed to last years or even a lifetime.”

Thomas Countee
Executive Director
National Spinal Cord Injury Association

“Structured settlements have been adopted by Congress and state legislatures to assure people who need long-term medical and other support will get it.”

Robert Hunter
Consumer Federation of America

“For years, structured settlements have offered great benefit and financial security to injury victims, surviving spouses and children involved in tort cases.

Philip Corboy,
Chair, American Bar Association’s Special
Committee on Medical Professional Liability

Structures and Third-Party Buy-Outs – State Law

Whether claimant or defendant, anyone considering use of a structured settlement to settle a workers compensation claim should be aware of recent state and federal legislation governing a third party’s ability to purchase the payment stream from a Kentucky claimant. In the mid-1990s, companies began aggressive advertising campaigns to convince claimants to sell some or all of their periodic payment stream for cash – often at significant discount.

This attracted considerable attention from wildly diverse groups. Trial lawyers, consumer advocates and disability activists became outraged at the huge discounts on “present value” that their former clients were convinced to accept. Insurers feared a retroactive tax burden if the IRS determined that payments no longer qualified as tax-exempt under federal structured settlement law (See “*Why Structured Settlement Payments Are Tax-Free*” above).

In 1996, Illinois became the first state to enact legislation designed to curb high discounts and abusive practices against claimants. Less than a year later, Kentucky enacted a comprehensive protection law (Kentucky K.R.S. Sec. 454.430 - 435). Among other provisions, it requires that:

No transfer of structured settlement payment rights shall be effective... unless the transfer has been approved in advance in an order of a court of competent jurisdiction, based on the court's express findings that... the transferee has provided to the payee a disclosure statement... setting forth:

- (a) The amounts and due dates of the structured settlement payments to be transferred;*
- (b) The aggregate amount of the payments;*

- (c) The discounted present value of the payments...;*
- (d) The gross amount payable to the payee...;*
- (e) An itemized listing of all... fees, costs, expenses, and charges payable by the payee...;*
- and*
- (f) The amount of any penalty... payable by the payee in the event of any breach of the transfer agreement by the payee....*

Structures and Third-Party Buy-Outs – Federal Law

On January 23, 2002, President George W. Bush signed Public Law No. 107-134, 115 Stat. 2427, "Victims of Terrorism Tax Relief Act of 2001", a federal tax relief act to benefit victims of the September 11 terrorist attacks. That law includes a provision "impos[ing] on any person who acquires directly or indirectly structured settlement payment rights in a structured settlement factoring transaction a tax equal to 40 percent of the factoring discount."

The only exception to the above would occur in cases in which a judge issues a finding that the transfer "does not contravene any Federal or State statute or the order of any court or responsible administrative authority, and is in the best interest of the payee, taking into account the welfare and support of the payee's dependents"