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Structured Settlements in Practice

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I. INTRODUCTION

Settlements in personal injury actions traditionally have been made in the form of a lump sum. Recently, however, increasing numbers of settlements have been made in the form of periodic payments spread over a number of years. Because of this trend,
Montana attorneys will be presented with increasing opportunities to negotiate claims on a structured settlement basis. The attorney’s knowledge of structured settlements and the annuities which typically fund those settlements could make a significant difference in the quality of settlements. The purposes of this article are to provide a basic understanding of structured settlements and to discuss some of the questions which typically arise in structured settlement negotiations.

II. WHAT IS A STRUCTURED SETTLEMENT?

The term “structured settlement” encompasses virtually any payment scheme other than the traditional lump sum. In contrast with the lump sum, a structured settlement consists of the periodic payout of settlement amounts tailored to meet the claimant’s financial needs. Most structured settlements are funded through the purchase by the defendant or its insurer of a single-premium annuity from a life insurance company.

In a given structured settlement the payment scheme might provide any of the following, or a combination thereof: (1) an immediate lump-sum payment for lost wages, incurred medical expenses, special equipment, or home modification; (2) attorney fees in a lump sum or structured over a period of years to take advantage of tax timing; (3) monthly income designed to replace lost wages payable for life or a fixed number of years, and guaranteed for a period certain; (4) an annuity consisting either of monthly or annual payments designed to provide for future medical or rehabilitative expenses; (5) a series of payments to fund future educational expenses; (6) life insurance to provide for children in the event of premature death of the surviving parent; and (7) future lump sums which can serve as inflation stabilizers or opportunity lump sums, or which can fund vacations or other major purchases.

This flexibility creates virtually unlimited opportunity to tailor a settlement to each claimant’s specific needs. The structured settlement might be very simple or quite complex. The complexity of the structure, and the ability of that structure to meet the needs of the claimant, are limited only by the creativity of the parties involved and the products available in the structured settlement.

2. Approximately $1.5 billion was invested in structured settlement annuities in 1983, and that figure is expected to grow to $3 billion by 1986. Id.

3. A thorough discussion of structured settlements could easily be the subject of an entire textbook. See H. Miller, Structured Settlements: The Art of Advocacy Settlements (1983). This article is designed merely to discuss some of the major issues in structured settlement negotiations.
annuity market.4

III. ADVANTAGES OF STRUCTURED SETTLEMENTS

A. Tax-favored Status

A key advantage of structured settlements in personal injury actions is their tax-favored status. It therefore is appropriate to begin a discussion of the advantages of structured settlements by focusing on the relevant Internal Revenue Code provisions, revenue rulings, and regulations.

1. Internal Revenue Code Provisions

Since its inception the Internal Revenue Code has embodied the concept that all income not specifically excluded is included in calculating gross income.5 The Internal Revenue Code specifically excludes from income amounts received as compensatory damages resulting from personal injuries.6 Although various explanations have been set forth to justify the exclusion,7 most commentators agree that Congress preferred to confer a humanitarian benefit on the injured party.8 As one commentator stated, “the taxation of recoveries carved from pain and suffering is offensive, and the victim is more to be pitied rather than taxed.”9 The exemption often

4. An example of a structured settlement based on needs is presented infra at section III, subsection B.
6. I.R.C. § 104(a)(2) (CCH 1984). The IRS recently promulgated Rev. Rul. 84-108, 1984-29 I.R.B. 5, 7, which states that damages received by a surviving spouse and child “in consideration of the release from liability under a wrongful death act, which provided exclusively for payment of punitive damages, are includible in the gross incomes of the wife and child respectively.” Rev. Rul. 84-108 expressly revoked Rev. Rul. 75-45, 1975-1 C.B. 47, which stated that “any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income.” In revoking Rev. Rul. 75-45, the IRS in Rev. Rul. 84-108 expanded the scope of Glenshaw Glass, 348 U.S. at 431, in which the Supreme Court held that punitive damages recovered in anti-trust and fraud cases are includible in gross income. Rev. Rul. 84-108 is reconcilable with Glenshaw Glass, and Rev. Rul. 75-45 probably was not. The consistency between Glenshaw Glass and Rev. Rul. 84-108 may portend future treatment of all punitive damages as includible in the recipient’s gross income.
has been justified on the theory that the claimant/taxpayer does not gain from a personal injury settlement, but rather is only being made whole. In effect, the damage award or settlement is a restoration of capital.  

2. Revenue Rulings

A major factor in the rapid emergence of structured settlements was the issuance by the Internal Revenue Service [IRS] of Revenue Ruling 79-220, which interpreted section 104(a)(2) of the Internal Revenue Code in a structured settlement setting.

In Revenue Ruling 79-220, the IRS contemplated a scenario in which the claimant had brought a personal injury action. The insured's casualty insurer settled with the claimant by providing an immediate lump sum, plus periodic payments of $250 per month for the claimant's life or for twenty years, whichever was longer. In the event of the claimant's death prior to the expiration of the twenty year period, the remaining monthly payments were to become part of the claimant's estate. The claimant had no right to commute or accelerate the monthly payments, nor any discretion regarding the funding of payments, as the casualty insurer had provided for those payments by purchasing a single premium annuity. As the owner of the annuity contract, the casualty insurer had the right to change the beneficiary, although the monthly payments were paid directly to the claimant. Additionally, the claimant was in the position of a general creditor regarding the collectibility of those monthly payments, and the casualty insurer set aside no special fund to guarantee those payments.

Because the claimant had no rights in the annuity, which was merely the funding vehicle for the insurer's obligation, the claimant had neither actual nor constructive receipt of the amount used to purchase the annuity. As a result, the IRS ruled, the structured monthly payments were fully excludable from the claimant's income under section 104(a)(2) of the Internal Revenue Code, even though the payments resulted in part from future interest

12. 26 C.F.R. § 1.451-2(a) (1984) defines "constructive receipt" as follows:
Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.
earnings.\textsuperscript{13}  

Shortly after issuing Revenue Ruling 79-220, the IRS reviewed a settlement agreement where the defendant’s insurer agreed to make fifty annual payments to the claimant.\textsuperscript{14} Each annual payment was to be 5% greater than the previous payment. The claimant had no right to accelerate the payments or to change the amount of those payments. The insurer was not required to set aside any assets to secure its obligation to the claimant, and the claimant possessed only the rights of a general creditor against the insurer. The IRS again ruled that the structured settlement payments were exempt under section 104(a)(2) because the claimant had neither actual nor constructive receipt of the present value of those payments.\textsuperscript{15}  

These revenue rulings permit substantial tax advantages for recipients of properly structured damage settlements resulting from personal injuries. The effect of the rulings is to free investment income within a structured settlement from taxation by treating such income as part of the claimant’s damages. Although a personal injury lump-sum settlement itself is not taxable, the income from the investment of that lump sum in stocks, bonds, and certificates of deposit is taxable.\textsuperscript{16} Income derived from a lump-sum award is taxable even where the lump sum is retained in the court registry and invested there for the benefit of a minor claimant, the theory being that the minor has “received” the lump-sum award.\textsuperscript{17}  

Because of the tax-exempt status of periodic payments structured in accordance with Revenue Ruling 79-220, structured settlements can make a significant impact on the total disposable amount of the claimant’s award, even for taxpayers in the middle tax brackets. For example, a claimant in the 25% tax bracket needing $2,000 per month to meet his expenses requires a pre-tax monthly income of $2,667, or $32,000 annual gross income. If he were to receive structured settlement payments totaling $24,000 for the year, he would be in the same net financial position. Depending on the claimant’s age, a difference of $8,000 per year over the claimant’s lifetime could be substantial. As the claimant’s tax bracket increases, which generally occurs with the investment income from larger lump-sum settlements, that difference becomes

\textsuperscript{13} Rev. Rul. 79-220, 1979-2 C.B. 74, 75.  
\textsuperscript{14} Rev. Rul. 79-313, 1979-2 C.B. 75.  
\textsuperscript{15} Id. at 76.  
\textsuperscript{17} Rev. Rul. 76-133, 1976-1 C.B. 34.
even more substantial. 18

3. The Periodic Payment Settlement Tax Act of 1982

The capstone of the revenue rulings discussed above, The Periodic Payment Settlement Tax Act of 1982 [the Act], 19 was signed into law on January 14, 1983. The legislative history of the Act discusses the reasons for its enactment:

Despite several revenue rulings that indicate that the Internal Revenue Service considers that periodic payments as personal injury damages are excludable from the gross income of the recipient, the committee believes it would be helpful to taxpayers to provide statutory certainty in the area. Likewise, the committee believes that a person who undertakes an assignment of the liability for such payments from the person originally liable should not include amounts received for doing so in gross income to the extent that those amounts are used merely to purchase certain types of property to specifically cover the liability. 20

The Act amended section 104(a)(2) of the Internal Revenue Code to exclude from gross income damages resulting from personal injuries or sickness “whether by suit or agreement and whether as lump sums or as periodic payments.” 21

Prior to the Act, the Internal Revenue Code did not address the nature of structured settlements or their funding vehicles. The Act codified many of the considerations discussed in the prior revenue rulings when it established section 130 of the Internal Revenue Code, which defines those assets which qualify to fund structured settlements, 22 authorizes the assignment of tort liability, 23 and defines those tort liability assignments which qualify:

(c) QUALIFIED ASSIGNMENT. - For purposes of this section, the term “qualified assignment” means any assignment of a liability to make periodic payments as damages (whether by suit or

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18. An economic analysis which compares a tax-advantaged structured settlement to a lump-sum settlement is included infra at section III, subsection B.
22. I.R.C. § 130(d) (CCH 1984). Although the Code defines qualified funding assets as annuities or obligations of the United States, the great majority of structured settlements are funded by annuities. This article therefore focuses on structured settlements funded by annuities.
23. See infra, section V, subsection D, for further discussion of the importance of third-party assignments under I.R.C. § 130.
agreement) on account of personal injury or sickness—
(1) if the assignee assumes such liability from a person who is
a party to the suit or agreement, and
(2) if—
(A) such periodic payments are fixed and determinable
as to amount and time of payment,
(B) such periodic payments cannot be accelerated, de-
ferred, increased, or decreased by the recipient of such
payments,
(C) the assignee does not provide to the recipient of
such payments rights against the assignee which are greater
than those of a general creditor,
(D) the assignee’s obligation on account of the personal
injuries or sickness is no greater than the obligation of the
person who assigned the liability, and
(E) such periodic payments are excludable from the
gross income of the recipient under section 104(a)(2) [of the
Internal Revenue Code].

Because of the constructive receipt issues discussed herein, at-
torneys involved in drafting assignment agreements should con-
sider drafting their agreements in a manner which tracks section
130 of the Internal Revenue Code. Even in structured settlements
which do not involve assignment of contingent liability to a third
party, section 130 serves as a partial reference for prior revenue
rulings.

B. Other Advantages of Structured Settlements

The other advantages of a structured settlement might best be
discussed by example. Although there are many types of cases in
which a structured settlement might be advantageous, the follow-
ing survival/wrongful death case is used here for illustrative
purposes.

Assume that Mr. Smith was thirty-five years old, earning ap-
proximately $35,000 per year, and had the opportunity for in-
creased future earnings. His wife, also age thirty-five, is a home-
maker and cares for the couple’s two children, ages seven and nine.
Mr. Smith was killed in an accident for which the defendant alleg-
edly was at fault. The claimant’s attorney is demanding in excess
of $1,000,000 to settle the case while defendant’s insurer initially

24. I.R.C. § 130(c) (CCH 1984). See infra, section V, subsection D, for further discus-
sion of third-party assignments.
25. See infra, section V, subsection A, for a discussion of the kinds of cases in which
structured settlements are appropriate.
has established settlement authority at $400,000. The case could proceed towards trial, ultimately being settled (likely "on the courthouse steps") for a compromised lump sum of $600,000 to $650,000. Alternatively, the parties could attempt to negotiate a structured settlement, which if effected would result in substantially greater benefit for both the claimant and the insurer.

The needs of the claimant should be the primary factor when considering a structured settlement. In this case, Mrs. Smith needs monthly income. She still has two children to raise and has not been employed recently, having spent all of her time in the home with her children. There also is a potential need for educational funds for the Smith children. Usually, as here, up-front cash is needed for outstanding medical bills and other expenses associated with death or injury.26

Mrs. Smith’s settlement should allow for the possibility of future inflation and should provide a guarantee of monthly income for some period certain in the event of her premature death. Because she has young children, Mrs. Smith might wish to consider life insurance on herself, as well as demanding that the monthly income be guaranteed, even if Mrs. Smith were to die prematurely. The use of future lump sums is another alternative which she should consider. Future lump sums could serve as inflation stabilizers, opportunity lump sums, or simply as money which can be used for major purchases.

After considering Mrs. Smith’s financial needs, the parties settled the case as follows:

**STRUCTURED SETTLEMENT**

Mrs. Smith

<table>
<thead>
<tr>
<th>BENEFITS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section I</strong></td>
</tr>
<tr>
<td>Up Front Cash to Claimant</td>
</tr>
<tr>
<td>$ 35,000</td>
</tr>
</tbody>
</table>

| **Section II** |
| Monthly Life Income |
| (20 years guaranteed) |

26. Up-front cash also plays an important psychological role in establishing with the plaintiff a sense of accomplishment and satisfaction regarding the settlement.
Structured Settlements

$2,000/month for 5 yrs, then 120,000
$2,500/month for 5 yrs, then 150,000
$3,500/month for 5 yrs, then 210,000
$4,000/month for 5 yrs, then 240,000
$4,750/month for 5 yrs, then 285,000
$5,500/month for 5 yrs, then 330,000
$6,500/month for life thereafter 936,000

Subtotal 2,271,000

Section III
Education Fund
Beginning in 9 yrs, 60,000
$15,000/yr for 4 yrs
Beginning in 11 yrs, 60,000
$15,000/yr for 4 yrs

Subtotal 120,000

Section IV
Future Lump Sums
In 7 yrs, $ 10,000 10,000
In 14 yrs, $ 20,000 20,000
In 21 yrs, $ 35,000 35,000
In 28 yrs, $ 50,000 50,000
In 35 yrs, $100,000 100,000

Subtotal 215,000

Section V
Attorney Fees
$40,000/yr for 5 yrs 200,000

TOTAL BENEFITS $2,841,000

In addition to total benefits of $2,841,000 through Mrs. Smith's normal life expectancy, there are several advantages of this structured settlement. First, the $2,841,000 will be paid to Mrs. Smith in periodic installments according to her needs. There is adequate up-front cash to provide for final illness expenses, immediate purchases, or a protective cushion during the family's first few years of readjustment. The $2,000 monthly income will be in addition to social security benefits and will be increased every five years through age sixty-five to compensate for anticipated inflation. The monthly income has a twenty-year guarantee; if Mrs. Smith dies within the first twenty years, her heirs nevertheless will receive the monthly income through that first twenty years. The monthly income will continue to Mrs. Smith, however, as long as
she lives, even beyond her normal life expectancy. The guaranteed period is beneficial especially for the protection of dependents other than the primary claimant, usually the claimant's children. In addition to Mrs. Smith's regular increases in monthly income, a substantial increase in monthly income will occur after ten years. This increase is designed to coincide roughly with the discontinuance of her social security benefits as her children become independent.

An educational fund is planned for each of the Smith children. Beginning at age eighteen, each child will receive $15,000 per year during his or her anticipated four years of college. If either child postpones college, the funds can be put into savings pending college entrance. If a child does not attend college, the funds can be used in other constructive ways such as assisting in the purchase of a home or entering a business.

Future lump-sum payments are provided in seven-year increments. Although a more substantial future lump-sum package might have been included, Mrs. Smith preferred step increases in her monthly income. The structure nevertheless includes some future lump sums which are to be paid substantially after the trauma of the family's personal loss has passed. These lump sums can be used by Mrs. Smith to augment her investment portfolio or to make major discretionary purchases. All future lump sums are guaranteed: they will be paid either to Mrs. Smith or to her heirs.

Although Mrs. Smith's attorney has structured his fee over a five year period to take advantage of tax timing and to postpone the receipt of income not needed immediately, there certainly is no requirement that fees be structured. As with the claimant's settlement award, the attorney fees can be adapted to suit the needs of the recipient.

The significant payments tailored to fit the claimant's specific needs alone are often enough incentive for claimants to elect a structured settlement. There are additional advantages associated with the settlement, however, which must be considered. The first comes from the sharing of tax benefits by the claimant and defendant. Sharing of the tax benefits results in reduced total cost to the defendant and increased long-term benefits to the claimant. Specifically, the entire cost of the annuity to fund the structured settlement in this case is $542,000. This cost is beneficial to defendant, as it is less than the anticipated lump-sum settlement, and it is certainly less than the $1,000,000-plus potential jury award at trial. The claimant also benefits by avoiding the risk of a defense verdict. Moreover, the settlement provides annual after-tax income
to the claimant substantially in excess of what could have been provided by a lump-sum settlement of $600,000 to $650,000.

An economic analysis of the structured settlement demonstrates its advantage to the claimant over the lump sum. Assuming that the claimant could earn an annual, after-tax return of 8% over her entire life expectancy, she would need a lump sum of $752,554 to duplicate the payment scheme of her structured settlement. The sharing of tax advantages results in even more dramatic benefits to both claimants and defendants in larger cases, especially where the claimant’s injuries reduce life expectancy and therefore allow the annuity to be purchased at lower than standard rates.

Different assumptions regarding the interest rate used to discount the structured settlement will result in different present values. Specifically, the higher the after-tax interest rate assumed, the smaller the present value of the structured settlement. The 8% after-tax assumption is appropriate, however, even in light of arguments regarding the availability of tax-free municipal bonds and other “higher yield,” but taxable, investments.

A taxpayer in a 35% effective tax bracket would have to earn in excess of 12.3% annual interest on taxable investments to duplicate an 8% after-tax return. Taxpayers in higher tax brackets must earn increasingly greater returns to duplicate the 8% after-tax return. Additionally, the 12.3% return must be net of brokerage and management fees and must be earned consistently for the remainder of the claimant’s life. Finally, lump-sum investments must include some depletion of principal in order to duplicate the structured settlement payments. If the claimant invests in long-term assets to generate higher interest earnings, she is subject to the timing risk of liquidating those assets when higher market interest rates have depressed the value of her investments.

Regarding municipal bonds, the claimant again must allow for management and brokerage fees and state income taxes. Further, the bonds may be called due at a time when market interest rates are lower than those on the bonds. Finally, the claimant/investor must contend with the speculative risks including default, liquidity, and timing risks associated with municipal bonds and other corporate investments. It would be a rare investment advisor indeed who would guarantee a net, after-tax return of 8% per year over a young person’s entire lifetime, with systematic reduction of principal to parallel the structured settlement periodic lump-sum payment schemes, and with an investment safety guarantee com-
mensurate with that of an A+ rated life insurance company.\textsuperscript{27} This entire discussion of economic value, however, assumes that the average personal injury claimant will use the lump-sum settlement to systematically provide for the future financial needs that the settlement was intended to fulfill. Certainly some claimants are capable of successfully managing a lump sum settlement; but the proper investment of a lump sum to ensure adequate future income, whatever the economic conditions, is no simple task. Every attorney with experience in personal injury litigation has seen at least one case where the claimant simply did not reap the long-term benefits which the lump sum was intended to provide. One study shows that 90\% of the recipients of substantial lump sums of money, whether by settlement, sweepstakes, or lottery, dissipate the entire lump sum within five years of receipt.\textsuperscript{28} In light of this very real concern, the structured settlement takes on a greater value to the claimant than simply its estimated economic value.

By accepting a structured settlement, the claimant is relieved of investment responsibilities and concerns. Payments under the structured settlement are assured and the funds are managed by an A+ rated life insurance company, which sends the periodic payments directly to the claimant. With phenomenally large sums of money to invest, and a specialized investment staff, an A+ rated life insurance company usually can generate higher investment earnings than can the average claimant.

The periodic payments received from a structured settlement most naturally duplicate real life. People are paid wages periodically, and the income from a structured settlement duplicates that scheme. Claimants simply do not suffer all of their pain and suffering at once, nor do they realize all of their bills for all of their future needs in advance. Damages and losses occur periodically, and a structured settlement assists the claimant economically and psychologically by providing a natural, periodic-payment scheme. Experience indicates that it is a rare claimant who does not appreciate a secure,\textsuperscript{29} tax-free lifetime income void of investment management worries.

Finally, there are benefits beyond those to the parties directly involved in a structured settlement. Society has an interest in en-

\textsuperscript{27} See infra, section V, subsection B, this article, for a discussion of the financial strength of A+ life insurance companies.

\textsuperscript{28} JOURNAL OF COMMERCE, Mar. 1978.

\textsuperscript{29} See infra, section V, subsection B, of this article, for a discussion of the stability of structured settlement annuities provided by A+ rated life insurance companies.
suring that injured claimants do not receive more, or less, than is needed to replace damages. Lump-sum settlements are calculated to compensate the claimant for economic loss through normal life expectancy. If the claimant lives beyond normal life expectancy, the lump-sum settlement will result in a shortfall to the claimant; but if the claimant does not live to normal life expectancy, a windfall results. A structured settlement which provides income for the lifetime of the claimant will guard against both shortfalls and windfalls.

Additionally, by saving some of the cost of a lump-sum settlement, insurers and defendants can pass those savings on to their policyholders and customers, respectively. Society is further benefitted because the structure creates a win-win environment: as a result, many cases are settled rather than tried, thereby easing the burden on the courts. Furthermore, society benefits in those cases where a lump-sum settlement would not have provided its intended, long-term benefits, and the claimant eventually would have become an additional burden on the state.

IV. DISADVANTAGES OF STRUCTURED SETTLEMENTS

Since their inception in the late 1960's in the Thalidomide and other California medical malpractice cases, structured settlements which countermeasure the unpredictability of life expectancies have been "heralded as breakthroughs by both parties to the litigation." If, however, the parties do not consider certain factors in negotiating a structured settlement, the resulting structured settlement may be disadvantageous.

Upon implementation of a structured settlement, neither party can change the payment scheme. The claimant should fully understand the finality of the structured settlement. Those claimants who strongly wish to do as they please with their settlements, despite the risks, may not be candidates for a substantial structured settlement. In those cases, perhaps the best that the claimant's attorney can do is recommend that at least a part of the settlement be structured. If the claimant's expectations about what he can do with the money should prove unrealistic, then the structured settlement can provide a safety net of subsistence benefits.

Potential inflation is a second concern which arises because of the "fixed" nature of a structured settlement. If the structured settlement is to span a substantial period of time, that settlement should allow for potential inflation. The payments provided by a

structured settlement might be supplemented to allow for inflation in three ways. First, the claimant’s monthly income might be increased each year by incorporating an annual growth rate into the structured monthly income. That growth rate typically would be specified at 1% to 6% per year. A 5% annual growth rate on a $2,000 per month income would provide $24,000 the first year, $25,200 the next year, $26,460 the next year, $27,783 the next year, and so on, increasing each year for a period certain or through life expectancy.

A second method of allowing for inflation is to provide a step increase in the monthly income every five or ten years. An advantage to the step-rate approach is that the monthly income can be increased in a nonconstant manner to better address the needs of the claimant. In Mrs. Smith’s structure, for example, the monthly income will increase substantially at the time her social security benefits are discontinued.

The third method by which potential inflation can be factored into the structured settlement equation is through the use of future lump sums. Future lump sums, designed to serve as periodic inflation stabilizers, might be payable every five or ten years, for example, and should increase over time.

Finally, potential problems exist regarding attorney fees if the structured settlement agreement makes no provision for attorney fees or for guaranteed payments following the claimant’s death. Assume, for example, that the claimant’s lawyer has assisted the claimant in negotiating a structured settlement providing $2,000 per month for life to the claimant; but when the claimant dies, the payments cease. Assume further that claimant’s attorney earns a large contingency fee at the conclusion of the settlement negotiations. The claimant receives $2,000 per month for six months and then dies. Because the structured settlement was based on a lifetime-only annuity, the claimant’s estate receives no benefits. If the attorney has received his fee at the time of the claimant’s death, the claimant’s personal representative may be motivated to seek remedies against the attorney because no further benefits will be paid, and because the attorney’s fee now appears excessive. If, on the other hand, the attorney has not yet received full payment at the time of the claimant’s death, it is likely that the claimant’s estate will not have sufficient funds to pay the attorney the balance of his contingency fee. Inclusion of at least some guaranteed payments in the structured settlement may help insulate the claimant’s attorneys from both kinds of exposure.
V. QUESTIONS FREQUENTLY ASKED

The remainder of this article is devoted to those questions which often arise in structured settlement negotiations. Although this discussion certainly is not exhaustive, the author hopes that the discussion provided here will be of assistance to lawyers involved in structured settlement negotiations.

A. What Kinds of Cases Are Candidates for a Structured Settlement?

Because of the tax advantages which attend structured settlements in cases where damages result from personal injury or sickness, personal injury cases are prime candidates for structured settlements. Personal injury cases, however, are not the only cases where structures are appropriate. Structures also have been used to settle property damage claims, wrongful termination claims, and even to fund divorce settlements. A structured settlement should be considered in any case where periodic payments might benefit the claimant.

One of the areas in which the use of structured settlements has grown most rapidly is workers' compensation. Settlements and awards for personal injury or sickness in workers' compensation cases also are excluded from gross income. The same tax benefits which have been discussed in reference to personal injury actions also attend workers' compensation settlements.

One of the most significant cases in the workers' compensation area, and one which affects structured as well as lump-sum settlements, is Willis v. Long Construction Co. In Willis the Montana Supreme Court held that the question of whether a permanently and totally disabled claimant is entitled to a lump-sum settlement is to be determined by the trial court, based on the claimant's best interests. Moreover, when a lump sum is appropriate, it "cannot be discounted to present value."

Regarding the claimant's "best interests," Professor Larson's

31. See infra, section III, for discussion of the tax implications of structured settlements.
32. I.R.C. § 104(a) (CCH 1984) provides that "gross income does not include—(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness."
34. Id. at ___, 690 P.2d at 439.
35. Id. at ___, 690 P.2d at 438. At the time of this writing, the Montana Legislature was considering S.B. 281, 49th Leg. (1985), which would amend Montana's Workers' Compensation laws to permit discounting of lump-sum permanent and total disability awards to present value in certain limited situations. 

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Since compensation is a segment of a total income insurance system, it ordinarily does its share of the job only if it can be depended on to supply periodic income benefits replacing a portion of lost earnings. If a partially or totally disabled worker gives up these reliable periodic payments in exchange for a large sum of cash immediately in hand, experience has shown that in many cases the lump sum is soon dissipated and the workman is right back where he would have been if workmen’s compensation had never existed. . . . The only solution lies in conscientious administration, with unrelenting insistence that lump-summing be restricted to those exceptional cases in which it can be demonstrated that the purpose of the Act will best be served by a lump-sum award. Enough experience has been gained by now to prove that a broad statutory requirement such as that the granting of a lump sum must be in the best interest of the worker is no guarantee against abuse of the practice. The Council of State Governments’ committee examined this problem in depth, and concluded that both the substantive and administrative provisions of the typical act should be tightened. As to the substantive, its recommended draft limited lump sums to cases in which such payments would be in the best interest of the rehabilitation of the worker; and as to the administrative, it recommended that this should be allowed only when this course had been approved by a rehabilitation panel. 36

The author does not purport to thoroughly analyze Willis in this article. Nevertheless, a certain troubling aspect of the Willis decision must be addressed. Although Willis seems to have been decided on statutory grounds, the court’s rationale regarding present value is inconsistent with the fundamental economic theory commonly referred to as the “time value of money.” The present value of $500 per month for twenty years, for example, is not $120,000 unless that present value is incapable of earning investment income throughout the twenty year period. Yet $120,000 is the present value of those future benefits according to Willis. Money received today, however, can be invested to generate investment income. Assuming that the money received today can earn 5% interest per year, the present value of $500 per month for the next twenty years is $75,763. Even assuming this conservative interest rate, the economic present value is substantially less than the “Willis value.”

The practical effect of Willis is to significantly limit the use of

lump-sum settlements in workers’ compensation cases involving permanent and total disability. In most cases this is probably a good result, as receipt of a large lump sum generally is not in the claimant’s best interests. Insurers will be extremely reluctant to pay the total, nondiscounted value of all of claimant’s future benefits in one lump-sum. Moreover, significant numbers of nondiscounted lump-sum settlements could seriously threaten the long-term viability of the workers’ compensation system.

Willis, however, does not foreclose the opportunity to settle permanent and total disability workers’ compensation cases on a structured basis. Structured settlements should be considered in workers’ compensation cases, as they afford tax advantages which can be shared by both parties and provide periodic payments in the claimant’s best interests. In applying structured settlements to workers’ compensation situations, an annuity can be used either to duplicate or to enhance benefits under the workers’ compensation act. One form of enhancing the benefits is to provide guarantees of the periodic payments to protect the claimant’s dependents in the event of the claimant’s death. Additionally, it sometimes is possible to increase the claimant’s benefits because the injuries may justify lower than standard annuity rates, based on reduced life expectancy. A structured settlement which duplicates or enhances the benefits provided by law, in conjunction with some up-front cash, can bridge the gap between the economic present value and the “Willis value” in workers’ compensation cases, and can assist in effecting improved settlements.

B. How Secure Is a Settlement Funded by a Life Insurance Company Annuity?

Throughout this article the author has made a conscious effort to refer only to A+ rated life insurance companies when discussing the annuities which fund structured settlements. This and other ratings of life insurance companies have significance relative to the safety and stability of an annuity-funded settlement.

The A.M. Best Company, an independent company engaged in the analysis of financial size and management of life insurance companies, each year publishes ratings of over 1500 life insurance companies and is regarded as the authority in its field. A.M. Best’s rating classifications are: A+ (excellent), A (excellent), B+ (very good), B (good), C+ (fairly good), C (fair), and omitted. These ratings indicate the long-term ability of a company to discharge its obligations to policyholders based on: “(1) competent underwriting; (2) cost control and efficient management; (3) adequate
reserves for undischarged liabilities of all types; (4) net resources adequate to absorb unusual shock; and (5) soundness of investments.\textsuperscript{37} A.M. Best also categorizes life insurance companies according to financial size. The financial size categories are based on policyholders' surplus (roughly the equivalent of retained earnings), and range from Class I ($250,000 or less) to Class XV ($100,000,000 or more).\textsuperscript{38}

Although the structured settlement annuity market is rather small and specialized by insurance industry standards, there are several A+ rated life insurance companies in Class X or better which actively seek structured settlements annuity business. By purchasing a single-premium annuity from one of these larger A+ rated life insurance companies, the risk of nonfunding of the structured settlement can be minimized.

The issue of bonding arises occasionally regarding the safety and stability of the structured settlement. Bonding the performance of the life insurance company under the annuity contract typically costs 4% of the annuity premium. That is a substantial sum for "guaranteeing" the performance of the companies recommended here. It is this author's opinion that bonding a life insurance company which has several billion dollars in assets and millions, perhaps billions, in policyholders' surplus is an unnecessary expense. The money which could be spent purchasing a bond is better spent providing additional benefits for the claimant.

C. How Assured Are the Tax Benefits Associated with a Structured Settlement?

There certainly are no guarantees that tax laws will remain static. Perhaps at some time in the future municipal bond income will be taxable, Individual Retirement Account contributions will not be deductible, or damages resulting from personal injury will be included in gross income. The policy embodied by section 104(a)(2) of the Internal Revenue Code, which excludes personal injury compensatory damages from gross income, has been tested over time in American tax policy. Additionally, the revenue rulings promulgated in 1979 were codified in 1982 to provide "statutory certainty"\textsuperscript{39} regarding the exclusion from gross income of periodic payments of compensatory damages in personal injury actions. The

\textsuperscript{38} Id. at vi.
very strong trend is toward increased use of structured settlements, and every indication points in the direction of continued encouragement of periodic payment schemes.

It is not merely the soundness of the structured settlement concept which suggests continued tax-favored status. Reports from both the Senate Committee on Finance (submitted by Senator Robert Dole) and the House Committee on Ways and Means (submitted by Representative Dan Rostenkowski), in recommending passage of the Periodic Payment Settlement Tax Act of 1982, stated that the Act "will have a negligible revenue impact." The Senate report states that the "Treasury Department agrees with this statement." The Senate report further concludes that the Act "is not expected to have an inflationary impact on prices and costs in the operation of the national economy." The Senate and House reports are evidence of congressional assurance that the law of structured settlements will not be changed by efforts to generate additional taxes or to address inflation. Because structured settlements have negligible effect on these concerns, one logically could conclude that there is no reason to change the laws to the detriment of the sound public policies which those laws currently encourage. At the very least, one would expect that if the law ever were to change, a grandfather provision would be applicable to existing structured settlements.

D. What Is the Purpose of the Third-Party Assignment Under Section 130 of the Internal Revenue Code?

The third-party assignment authorized by section 130 of the Internal Revenue Code allows the defendant to assign contingent liability on the settlement to a third party. That third party is typically a life insurance reinsurer, or some other subsidiary or parent of the life insurance company issuing the annuity. The self-insured defendant or the defendant's liability or compensation insurer may wish to assign contingent liability to a third party so that the primary insurer can permanently close its file on the case. Without the assignment, the defendant would be contingently liable for the periodic payments if the life insurance company providing the annuity were unable to meet its obligations under the annuity contract. If the annuity is issued by a substantial, A+ rated life insurance company, this possibility is extremely remote.

42. Id. at 6.
The third-party assignment can protect the claimant as well in certain cases. Assume that the claimant is concerned about the financial future of the defendant, who is a self-insured, susceptible to substantial future liability claims from numerous other claimants or potential claimants.  

Assume further that the claimant's fears are warranted, and the defendant goes bankrupt. If there has been no assignment, the bankrupt defendant owns the annuity. There is a good possibility that a bankruptcy court could redirect the payments under the annuity as all of the general creditors of the defendant seek to share in defendant's unsecured assets. If the third-party assignment has been effected, the defendant's bankruptcy has no effect on the claimant. The assignee, rather than the bankrupt, owns the annuity, and the claimant will continue to benefit from the structured settlement.

As with other issues in structured settlements, the assignment decision must be made on a case-by-case basis. Whether an assignment should be utilized depends on several factors, primarily the goals of the claimant and the defendant, as well as the comparative financial strengths of the defendant and the potential assignee.

E. What Should Be Done to Ensure the Tax-Free Status of a Structured Settlement?

Lawyers involved in structured settlements should review the Internal Revenue Code sections, revenue rulings, and regulations previously discussed in this article. It is extremely important to be cognizant of constructive receipt issues at all times during the negotiation of a structured settlement. Once a claimant is in constructive receipt, the tax-favored status has been lost.

A common mistake is to specify in the settlement agreement that the claimant may change the beneficiary on the annuity. This may seem practical, but it does not comport with Revenue Ruling 79-220. The right to change the beneficiary can be construed as an ownership right or enough control to place the claimant in constructive receipt. The solution to this specific problem is to name the claimant's estate as the succeeding beneficiary, and then direct by will the periodic payments payable after the claimant's death.

Another issue which arises during structured settlement negotiations, and which may have constructive receipt significance, is the cost of the annuity. The most conservative argument suggests

43. Alternatively, the claimant may be concerned about the longevity of a liability carrier involved in writing policies in volatile areas of liability.
44. See supra, section III, subsection A.
45. See supra note 12 for the definition of "constructive receipt."
that to avoid any potential constructive receipt problems, the defendant and its insurer should not reveal to the claimant the cost of a structured settlement funding annuity. One can argue, however, that simply knowing the cost of a structured settlement, in and of itself, does not put the claimant in constructive receipt of the amount invested in the annuity.\textsuperscript{46} At the other extreme is the situation where the claimant is offered a choice between a cash settlement and the structured settlement which that exact amount of cash would purchase. In such case the claimant probably is in constructive receipt of the cash sum, whether it is actually received or is used to purchase the annuity, because he or she "could have drawn upon it during the taxable year."\textsuperscript{47}

Negotiating a structured settlement on the basis of cost has the potential of placing the claimant in constructive receipt. Where the line between the two scenarios discussed above will be drawn is subject to speculation until the courts address the issue. Perhaps extreme caution is appropriate until that time. It is not wholly unreasonable, however, for the claimant’s lawyer to want to know the cost of the structure, as his fee may be based on a percentage of the cost of the settlement. In those cases where cost is not disclosed, the claimant’s lawyer can engage the services of a consultant who can approximate the cost of the annuity.

\textbf{F. What Is the Minimum Settlement Below Which a Structured Settlement Is Not Feasible?}

Generally, structured settlements for less than $10,000 are not feasible. As with other structured settlement considerations, however, minimum premium determinations should be made on a case-by-case basis. One need that a smaller settlement can fill is an education fund for an injured minor. For example, a structured settlement funding annuity costing approximately $10,000 today can provide a child age ten with $7,500 per year for four years beginning at age eighteen. Moreover, the beneficiary of that college fund will take the $30,000 tax-free.

\textsuperscript{46} Private Letter Ruling 8333035 stated that knowledge of the cost of the annuity "is not determinative in deciding a question of constructive receipt, but that \textit{unqualified availability is decisive." (Emphasis added). In that particular taxpayer's situation, based on information submitted in a prior ruling request, Private Letter Ruling 8329054, knowledge of the cost of the annuity did not cause the taxpayer to be in constructive receipt of the amount invested in the annuity.

\textsuperscript{47} 26 C.F.R. § 1.451-2(a) (1984).
VI. Conclusion

Attorneys traditionally have been trained to evaluate cases in terms of lump-sum values. With the advent of structured settlements, however, attorneys have begun to analyze the needs of injured claimants and survivors, and to provide periodic payments to better meet those needs. This needs-oriented approach has resulted in widespread and ever-increasing use of the structured settlement as a settlement device. That success can be attributed only to the fact that structured settlements can provide real benefit to both claimants and defendants.

Claimants' attorneys who only a few years ago were cautious of this strange new settlement device are now making settlement demands in the form of structured settlements. Attorneys involved in structured settlement negotiations need to be sufficiently informed to properly evaluate structured settlement proposals. The lump-sum criteria is an insufficient measure of the value of structured settlements. Rather, those attorneys who settle cases on a structured basis should evaluate the structure in light of its ability to meet the claimant's needs, and its ability to insure that a claimant who has experienced the trauma and loss of a personal disaster not also be visited by a financial disaster resulting from inability to manage a lump-sum settlement. The structured settlement is a dynamic vehicle for providing that assurance, and in the process it provides real benefit to claimants, defendants, and society.