Unqualifying Qualified Structured Settlements?

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (http://www.woodporter.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (4th ed. 2009), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (4th ed. 2007), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

In this article, Wood dissects the qualifed structured settlement, comparing it to its nonqualifed cousin. Examining the tax risks that could cause a structure to move from one camp to another, Wood looks at prevailing practice in the structured settlement industry and asks whether that practice makes sense.

A structured settlement involves periodic payments rather than a lump sum. Section 104 confirms that a payment made on account of physical injuries or physical sickness is excludable from income. That is true whether the payment is made in a lump sum or in periodic payments over time. Classically, we think of structured settlements as tax free, but not all of them are.

Assuming a properly structured settlement of a personal physical injury case, the entire stream of payments is 100 percent excludable from income. In contrast, if the same case is settled for cash, the lump sum would be tax free, but the subsequent earnings on that sum would be taxed. The structure thus showcases the advantage of pretax versus post-tax investing. That is the essence of structured settlements.

An entire industry has grown up around this periodic payment rule. In fact, the structured settlement segment of the U.S. life insurance industry accounts for roughly $6 billion in annuity sales per year.[1] Related life insurance products have blossomed around the notion that periodic payments may be appropriate in other types of litigation despite a lack of physical injuries or physical sickness. These so-called nonqualified structures do not involve payments excludable under section 104 and do not involve qualified assignments.[2]

In a nonqualified case, every payment is taxable, the antithesis of the qualified structure. Yet the showcase of pretax investing is still present, because the lump sum that would otherwise go to the plaintiff is paid to purchase an annuity on a tax-deferred basis. In that case, there is no qualified assignment, which as we'll see is significant.

A. Qualified Prerequisites

What is a qualified assignment? The answer lies in section 130, which is closely connected to section 104. Although section 104 makes it clear that specific payments are excludable from the plaintiff's income if they are either paid in a lump sum or through periodic payments, just *how* are those periodic payments made?

Few plaintiffs would want to rely on a defendant to make payments for the next 20 or 30 years. Accordingly, the standard practice is for the defendant to pay a lump sum to an affiliate of a U.S. life insurance company (known in the industry as an assignment company). The assignment company receives the lump sum and assumes the obligation to pay the 20 or 30 years' worth of periodic payments.[3]

The assignment company then purchases an annuity from its parent life insurance company. Thereafter, it makes the payments for the next 20 or 30 years as called for under the annuity contract. Why have an assignment company at all? Someone must hold the annuity, and it may be necessary for the insurance company to issue the policy to someone other than itself.

Clearly, the plaintiff cannot own the annuity without having incidents of ownership. A plaintiff who receives a tax-free lump sum resolving his section 104(a)(2) damages could purchase an annuity on an after-tax basis. Yet this would be highly inefficient. The plaintiff would then be taxed on what you might think of as the interest element of each of the periodic payments. To exclude each periodic payment from income, the admittedly artificial qualified assignment architecture must be used.

It is worth once again contrasting qualified and nonqualified assignments. The plaintiff in a fully taxable case may still want a structure, even though he must include every periodic payment in income. Yet he can't own the annuity or have incidents of ownership. If he did, the entire amount would then be taxable.

---

[1] *See 2009 Annuity Fact Book* 59, Insured Retirement Institute, *available at* http://www.irionline.org/resources/article/id/24.

[2] For discussion, see Robert W. Wood, ''Structured Settlements in Non-Physical-Injury Cases: Tax Risks,'' *Tax Notes*, Aug. 2, 2004, p. 511, *Doc 2004-15135*, or *2004 TNT 142-59*.

[3] The duration is, of course, up to the plaintiff and varies widely. The payments may also be joint and survivor with the plaintiff's spouse.

For the qualified settlement and qualified assignment, the combination of sections 104 and 130 and the industry construct allow the plaintiff to be treated for tax purposes as not having an ownership interest in the policy. The plaintiff is merely a payee or beneficiary of the policy, but not its owner.

Furthermore, section 130 confirms that when the assignment company receives the lump sum payment from the defendant and then purchases a policy from the life insurance company parent, there is no taxable event.[4] According to the legislative history of the Periodic Payment Settlement Act of 1982, which enacted section 130, Congress believed that a person who undertakes an assignment of the liability to make periodic payments from the person originally liable shouldn't include amounts received for doing so in gross income if those amounts are used merely to purchase some types of property to specifically cover the liability.[5]

Thus, the assignment of the defendant's liability to make periodic payments in exchange for a lump sum can qualify as a nontaxable qualified assignment. To qualify, the assignment company must receive the obligation from a person who is a party to the suit, and the plaintiff-payee must not have rights to the periodic payments that would result in constructive receipt or economic benefit.[6]

In a typical personal injury structured settlement,[7] the tort-feasor defendant would assign to another company (the assignee) its liability to make the periodic payments to the plaintiff. In exchange for assuming its liability, the defendant would pay the assignee a lump sum, which the defendant could immediately deduct from its gross income. The assignee would then use the lump sum to purchase an annuity (from its life insurance company parent) to fund the periodic payments to the plaintiff.

If the transaction meets the requirements of section 130, the assignee would not have to report the lump sum as income until it received the annuity payments, at which time it would be entitled to an offsetting deduction for periodic payments made to the plaintiff. Assuming the plaintiff met the requirements of section 104(a)(2), he can exclude the periodic payments from his gross income, including any portion of the periodic payment that represents interest income generated by the annuity.

With nonqualified assignments, section 104 does not apply to the periodic payments, so section 130 can't apply either. Hence, the life insurance industry uses non-U.S. assignment companies for nonqualified assignments. A Barbados-based company (not doing business in the United States) that receives a lump sum from the defendant will buy the annuity (from its U.S. affiliate life insurance company). It won't need to worry about not being able to use a section 130 assignment. If it has no U.S. tax presence or filing status, it has no tax.

[4]*See* section 130(a).

[5]H.R. Rep. No. 97-832, 4 (1982).

[6]*See* section 130(c).

[7]*Liberty Life Assur. Co. v. Stone St. Capital, Inc.*, 93 F. Supp.2d 630, 634-635 (D. Md. 2000). Although this example lacks an assignment company, the taxability of the structure is the same.

B. Going Awry?

Returning to the qualified assignment, it is worth questioning what happens if something goes wrong. For instance, suppose that the parties *thought* this was a qualified assignment, but it turns out not to be? Recall that section 130 conditions qualified assignment treatment (among other things) on the excludability of the periodic payments under section 104. That means one must look to the plaintiff and the nature of the payments he is receiving.

What if it turns out the plaintiff was not actually injured in a car accident as had been represented, but instead was receiving lawsuit proceeds related to an action for wrongful termination of employment? Perhaps this is a silly example, because the life insurance company issuing the annuity will surely have some kind of underwriting criteria. Still, this could happen.

In any such situation, it is not merely the *plaintiff's* taxes on these periodic payments that is at stake. The eventual conclusion might be that some or all of the settlement payments are not excludable under section 104 after all. In turn, that means the ''qualified'' assignment turns out not to have been qualified.

C. Other Examples

If you don't think my example is likely to happen in real life, consider some of the other ways that this qualified versus unqualified issue might arise.

1. Maybe excludable, maybe not. What if the plaintiff's case is for wrongful imprisonment without any observable body harm or roughing up?[8] What if it is about sexual molestation that occurred years ago, and that may or may not have (ever) evinced observable bodily harm?[9] What if the case involved a mixture of claims, and some (but not all) of the damages are excludable, and the parties allocate more than they should to the section 104 claims?

In each of these cases, it does not strain credulity to suggest that the IRS might later nose around the settlement and have a different tax view of the particulars than the parties did. In my experience, the life insurance companies writing structured settlement annuities have differing levels of due diligence. Even within a particular company, there can be differing levels of adherence to their own practices.

Besides, no matter how careful any of the parties to a settlement or a life insurance company may be, many cases are not black and white. It cannot be gainsaid that in the real world of case resolution, it's often tough to say in an absolute fashion how something ''will'' be taxed, much less whether something is more likely than not to occur, has substantial authority, etc.

[8]*See* Wood, ''Why False Imprisonment Recoveries Should Not Be Taxable,'' *Tax Notes*, June 8, 2009, p. 1217, *Doc 2009-10767*, or *2009 TNT 108-10*; Wood, ''Why the *Stadnyk* Case on False Imprisonment Is a Lemon,'' *Tax Notes*, Apr. 5, 2010, p. 115, *Doc 2010-5747*, or *2010 TNT 67-3*.

[9]*See* Wood, ''IRS Allows Damages Exclusion Without Proof of Physical Harm,'' *Tax Notes*, Mar. 31, 2008, p. 1388, *Doc 2008-5734*, or *2008 TNT 63-31*.

2. Punitive damages or interest. Another possibility for derailing the structure train comes with punitive damages, interest, or both. Interest, in my experience, is particularly likely to be ignored. Suppose you have a catastrophic injury case, so that everyone acknowledges that the compensatory damages are for personal physical injuries and related emotional distress. That means there should be no issue about the applicability of section 104(a)(2) and section 130, right?

Not so fast. If this case settles on appeal and there were punitive damages or interest awarded, any compromise of those amounts in a settlement agreement may or may not ultimately be respected by the IRS. Depending on the facts and the procedural posture, there may be a strong case for respecting an agreement to eliminate (or more likely to compromise) punitive damages and/or interest.[10] However, there may also be a weak case. There may also be gradients.

In any of these situations, there is often no sure thing. If the resulting settlement proceeds are structured with a purportedly qualified assignment, it is easy to imagine this arrangement later being called into question. The life insurance company involved in issuing the annuities may or may not exercise appropriate due diligence in assessing the likelihood that a settlement compromise may later pass muster from a tax perspective. Whether it does or does not, there are issues beyond its control.

3. Structured attorney fees. And then there is the structuring of attorney fees, which itself might provide some interesting possibilities for the qualified-to-nonqualified transformation. Attorney fee structures are yet another invention of the life insurance industry. They involve a plaintiff attorney who agrees that his contingent fee will not be paid in cash on settlement, but rather through periodic payments over time. The practice gained prominence after the Tax Court and the Eleventh Circuit approved it.[11]

Since then, attorney fee structures have become garden variety, and the IRS no longer seems to mind.[12] Like structured settlements, this is an area of legal formalities and procedural subtleties that clients may be tempted to ignore.

One big assumption is that when the structure arrangement is contemplated and established, the lawyer has no right to demand his fee in cash. The lawyer, client, and defendant cooperate so that the lawyer effectuates the structure before the case triggers the lawyer's right to income. The attorney who structures fees in this way knows he will be subject to tax as he receives his installments. Fee structures can be a nice way of funding retirement, with the amount of consideration limited only by the size of the fees in question. But is this a qualified structure or an unqualified one?

Your initial reaction will probably be that this *must* be nonqualified. After all, how could the structure be the subject of a section 130 qualified assignment if the lawyer is taxable on the fees? Clearly, the fees are not excludable under section 104 to trigger section 130, correct? Once again, not so fast. It may be that few tax practitioners think about this, but at least some people in the structured settlement industry do.

Of the life insurance companies that write annuities for structured legal fees, some will do so as a qualified structure (meaning with a section 130 assignment). How can they do that, you might ask, since the lawyer's payments won't be excludable under section 104? Some of the life insurance companies adopt a piggyback theory, agreeing that they will use a qualified assignment to structure the annuities for the lawyer if the client was physically injured and is receiving damages excludable under section 104.

If the client structures those damages, they say, the lawyers can structure via a section 130 assignment, too. The insurance company may ask for the client to structure $1, or it may ask for the client to structure at least as much money as the lawyer. I am unsure where this piggyback theory started, but it was clearly in use before the Supreme Court decided *Banks*.[13]

Banks suggests that ordinarily, monies paid to a contingent fee lawyer will first be considered to have been paid to the client. If the client's share of the money is excludable under section 104, the theory presumably goes, the lawyer's money should be, too. Whatever the practice of these life insurance companies, it seems more than theoretically possible that the IRS might view this askance and seek to unqualify this purportedly qualified assignment. Plainly, the recipient of these structure payments is the lawyer, not the client. Axiomatically, the lawyer is not excluding the periodic payments under section 104.

Some of the life insurance companies view attorney fee structures as nonqualified by their very nature. To me, this makes more sense. After all, the fees are obviously not excludable since they represent payment for legal services rather than payment for personal physical injuries or physical sickness. The few life insurance companies that have nonqualified assignment companies also have qualified assignment companies (the qualified one being domestic, the nonqualified company being foreign). Such a life insurance company with sibling assignment companies can presumably decide if it wants to treat the attorney fee structure as qualified or not.

4. Qualified settlement funds. Finally, in our hit parade of potential problems that might unqualify a qualified

[10]*See* Wood, ''Should Prejudgment Interest Be Taxable?'' *Tax Notes*, Feb. 1, 1999, p. 719, *Doc 1999-4485*, or *1999 TNT 20-140*; Wood, ''Optimizing Tax Treatment of Interest: More Practical Advice,'' *Tax Notes*, Mar. 21, 2005, p. 1466, *Doc 2005-5360*, or *2005 TNT 54-33*.

[11]*See Childs v. Commissioner*, 103 T.C. 634 (1994), *Doc 94-10228, 94 TNT 223-15, aff'd*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-19540, 96 TNT 133-7*.

[12]Wood, ''Structuring Attorney Fees: Kingdom of Heaven?'' *Tax Notes*, Aug. 1, 2005, p. 539, *Doc 2005-15920*, *2005 TNT 142-28*; Wood, ''Legal Fee Structures, Law Firms, and Lawyers: Children of *Childs*?'' *Tax Notes*, Apr. 10, 2006, p. 173, *Doc 2006-6493*, *2006 TNT 69-20*.

[13]*Commissioner v. Banks*, 543 U.S. 426 (2005), *Doc 2005-1418, 2005 TNT 15-10*.

assignment, consider the qualified settlement fund (QSF). QSFs are wonderfully flexible vehicles that can facilitate additional time to properly plan structured settlements.[14] QSFs generally act as a bridge between defendants and plaintiffs. If a defendant pays all the money into a QSF, the defendant should receive a complete release. The QSF may later obtain a release from the plaintiff when funds are disbursed and structures are effected.

Ironically, a sizable segment of the structured settlement industry dislikes QSFs, viewing them like a demonic bad seed.[15] Some of this seems related to the belief that QSFs are used by plaintiffs and plaintiff brokers to take control of the structure process, freezing out the defendant and the defense insurance broker.[16]

Yet no matter which side in these unsettling QSF fisticuffs you take, you might end up having a purportedly qualified assignment under section 130 later attacked. Any qualified versus nonqualified issues that can arise outside the QSF context can occur with a QSF.

D. Savings Clause

A common structured settlement industry response to the potential problems presented by these situations is to insert a type of savings clause into the settlement or assignment documents that settle the case and establish the structure. The provision usually reads something like the following:

> In the event this [settlement agreement or qualified assignment] is declared terminated by a court of law, or in the event that section 130 of the Internal Revenue Code has not been satisfied, the assignee shall then assign ownership of any ''qualified funding asset'' purchased hereunder to the defendant, and assignee's liability for the periodic payments shall terminate.

There are many variations of this sort of provision, and despite those variations, for ease of reference, I'll call it the ''savings clause.'' Does it accomplish its desired purpose? The ''qualified funding asset'' is the annuity itself. If it later develops that section 104 did not apply to the payments, that means section 130 was not complied with, either. In that case, the annuity must be transferred to the defendants (or whoever is specified in the particular clause in question). That transferee will thereafter (presumably) make the payments.

Bear in mind, of course, that the defendants will have obtained a complete release from the plaintiff. It may not be crystal clear that the defendants' liability for the assignment springs back into place on this disqualifying event. Moreover, some courts have read settlement agreements and qualified assignment documents quite literally. For example, at least one court has enforced a nonassignment clause of a uniform qualified assignment, preventing the claimant of periodic payments under section 104 from assigning those payments to another payee.[17]

But to return to my question, if this problem has arisen, does the savings clause save anyone? The clause indicates that if section 130 was not complied with, the policy must be transferred. Recall that section 130 prevents the assignment company from being taxed on the lump sum it receives from the defendant, as long as it buys the annuity (the qualified funding asset). It is taxed only on any spread it gets to keep between the lump sum it receives from the defendant and the price it pays for the annuity.

If we assume (as we must to consider the actual operation of the savings clause) that section 130 turned out *not* to apply, doesn't it stand to reason that we would find out about the qualified assignment problem only later, possibly *many years* later? Consider the following example.

Example: Plaintiff was injured in the workplace in 2007 and thereafter faced discrimination from his employer. He sues Defendant, and the case eventually settles in 2010. The settlement agreement calls for periodic payments for Plaintiff's life, to be funded (if the Defendant elects) by a $1 million payment made by Defendant to an assignment company.

The settlement agreement characterizes all payments as for personal physical injuries. In fact, Plaintiff did not have a scratch, and suffered only headaches for which he did not seek treatment. Still, a structured settlement and purportedly qualified assignment are used.

Six years later, Plaintiff is audited and the IRS concludes that all of the payments are taxable. The IRS and/or Plaintiff contact the life insurance company to report what's happened. The life insurance company concludes (in 2016) that the qualified assignment in 2010 was defective. Because of the savings clause, the assignment company transfers the annuity policy back to the defendant.

Does the assignment company's transfer of the policy to the defendant correct the assignment company's tax problem? It is hard to see how it does. Section 130 exists to prevent the mismatch of gain and deduction. We now know that in 2010 a *taxable* assignment occurred, and that bell can't be unrung in 2016.

In 2010 the assignment company had $1 million of income (we learn of that in 2016 because it was *not* a qualified assignment). The assignment company may still be able to deduct the periodic payments it made to the plaintiff from 2010 to 2016, although some of those tax years are closed. Maybe the assignment company can deduct all of the six installments it has paid in 2016? In any case, these payments are probably small on an annual basis, probably one-twentieth or one-thirtieth annually of the total to be paid over the life of the

---

[14]Wood, '''Retroactive' Qualified Settlement Funds: 10 Things You Should Know,'' *Tax Notes*, Feb. 8, 2010, p. 793, *Doc 2010-1386*, *2010 TNT 28-1.*

[15]*Id.*

[16]*See* Wood, ''Single-Claimant Qualified (468B) Settlement Funds?'' *Tax Notes*, Jan. 5, 2009, p. 71, *Doc 2008-25804*, or *2009 TNT 2-60*.

[17]*See CGU Life Ins. Co. of Am. v. Metropolitan Mortg. & Secs. Co.*, 131 F. Supp.2d 670 (D. Pa. 2001). However, see also *W. United Life Assur. Co. v. Hayden*, 64 F.3d 833, 838 (3d Cir. 1995), in which the court did allow an assignment of periodic payments, based on ambiguities inherent in the settlement agreement.

annuity. The assignment company will be very unhappy if (statutes of limitation permitting) it has $1 million of income (six years earlier!), offset by, say, six small payments (let's assume $50,000 per year).

Of course, relying on the savings clause, the assignment company (in 2016) can tender the annuity policy to the defendant. That act presumably would trigger the assignment company being able to write off the rest of the $1 million. Yet the assignment company has a timing problem of significant proportions.

On these facts, it is fair to question how much the savings clause has helped. The act of transferring the annuity might be analogized to stemming the bleeding, but it certainly does not operate as a retroactive cure. After all, what the assignment company really wants is qualified assignment treatment. That is why the assignment company will almost surely want to be an ally in the taxpayer's fight with the IRS over the applicability of section 104.

E. Temporal and Conditional Aspects

I have already noted the statute of limitations point, which may be an enormous one. But there are additional temporal or conditional elements to this quagmire. The savings clause suggests that if there's a problem with the applicability of sections 104 and 130, the assignment company holding the annuity policy will act. If a court declares the assignment or the settlement agreement terminated, it says, the assignee will transfer the policy to the defendant. This seems clear.

But what if there's a dispute about the applicability of sections 104 and 130? The savings clause here isn't very specific. It doesn't mention a court decision, but refers only to the event that section 130 "has not been satisfied." Does that mean an IRS 30-day letter does the trick? An IRS 90-day letter? The decision of the Tax Court, a district court, or the Court of Federal Claims? Is it the assignee's right to decide when to pull the plug, meaning that it may do so after the IRS issues a 30-day letter, or possibly even an information document request? Is a phone call from the IRS enough?

Obviously, the particular savings clause should be examined as there are certainly variations. Moreover, most life insurance companies will negotiate on their own version. For example, a common change to the provision would have the annuity policy transferred to the plaintiff-payee rather than the defendant. Clearly, that would destroy any claim that the plaintiff did not have incidents of ownership. That would be bad from a tax perspective. Yet at least the plaintiff would know he would receive his annuity payments, and he might prefer this result to having the policy transferred to the defendant.

QSFs may add another wrinkle. Here, the savings clause might say that if section 130 turns out to not apply, the annuity will be transferred back to the QSF. QSFs eventually always terminate, and usually sooner rather than later. That means the QSF may no longer exist when the savings clause is triggered.

F. Summing Up

On a very practical level, if you are a plaintiff settling your personal physical injury case and your settlement involves a structure, you'll have to take some of it on faith. The documents and formalities can be daunting. At some point you'll likely watch as your advisers seem to pass a kind of magic wand over the inevitably confusing documents. They are important documents too, for they determine the nature of the annuity that will serve as the source of your monthly payments thereafter. If you read the fine print, you'll care about the savings clause.

Despite my examples, it seems likely that few people will ever have to consider a section 130 qualified assignment that goes bad. That is good. The structured settlement industry is finite, and in more or less lock step fashion, all the players tend to do the same things. There is also the perception that the industry is largely self-policing and conservative — an industry generally unlikely to push the envelope in the tax world.

Even so, the applicability of section 104 is inherently factual, and a lot of confusion remains. As National Taxpayer Advocate Nina Olson said in her most recent report to Congress, just look at the inventory of cases about section 104 in the Tax Court! There is a virtual epidemic of them. Jousting over what is and is not within the exclusion is practically a cottage industry.[18]

That sad fact alone should tell you that the qualified versus nonqualified assignment issue (which is inevitably linked to the applicability of section 104) is going to bubble to the surface. If I'm right about that, some U.S. life insurance companies that don't have nonqualified assignment companies might want to form them to use as needed. If there ever were a big problem, transferring the annuity from a qualified to a nonqualified assignment company would be preferable to transferring the policy to the defendant (or to the plaintiff).

In any event, the savings clause may not be a panacea. If a life insurance company has both qualified and nonqualified assignment companies, the savings clause might suggest moving the annuity from one assignment company to the other. Yet that still wouldn't retroactively fix the income recognition mismatch that will have already been created.

Hopefully the life insurance company that issues the annuities will have a stake in this, too. And with any luck, the annuity issuer would be the plaintiff's ally against the IRS if needed. Notably, the life insurance company is likely to view the dispute as not merely involving one case, but as potentially affecting other cases that it may have treated similarly. That suggests that the company may not readily agree with the IRS.

[18]*See* national taxpayer advocate, "2009 Annual Report to Congress," *Doc 2010-174, 2010 TNT 4-19*.