MICHIGAN LAWYERS WEEKLY
milawyersweekly.com
Vol. 32, No. 41
August 13, 2018

COMMENTARY

# Non-qualified structured settlements

## More cash for your clients — less for the IRS

**By Kelly Ramsdale**

How many times have we heard that we live in a litigious age? People are suing each other for just about everything. Some cases are sensationalized and ridiculous, but most are genuine cases where someone was physically, emotionally, or financially harmed. Settlements are never nearly enough to make the plaintiff "whole" in any way, especially financially, so handing a large chunk over to the IRS is especially painful.

**RAMSDALE**

Did you ever wonder how the plaintiffs of such cases are treated by the Internal Revenue Service? In cases where an actual "physical" injury where observable injury or sickness has occurred, any recovery they receive is treated as income tax-free per Internal Revenue Code § 104(a)(2).

On the other hand, cases of non-physical injury are fully taxable in the tax year received. Examples of non-physical injury cases are: employment cases (exclusive of lost wages), divorce, bad faith, discrimination (age/sexual/other) with or without retaliation, false arrest, breach of contract/contract disputes, sexual harassment/inappropriate touching (with or without retaliation), punitive damages, property damages, fraud, environmental claims, psychological/emotional distress/PTSD, coverage buyouts, property disputes, E&O/D&O claims, and whistleblower.

As I revise this previously released article, it's July 2018. Recent tax law changes have made the plaintiff's tax burden even greater. *Plaintiffs are no longer allowed to deduct attorney fees on non-physical injury cases.* Yes, that is correct, they may no longer take a deduction for attorney fees. There are few exceptions (whistleblower and employment cases mostly), meaning the majority of plaintiffs will not be allowed to deduct their attorney fees for tax years 2018-2025 (*'Tax Cuts' Mean Plaintiffs Pay Tax on 100%, Even Lawyer Fees*. May 2018. Robert Wood). I can't imagine how painful those discussions will be with your clients.

There is, however, a vehicle that may be used to defer taxes so the settlement funds can grow *before* having to pay the tax bill: *non-qualified structured settlements*. It is a powerful tool that has been around since 1999. Many, if not most, attorneys have never used one. Almost all of you have heard of or have used a qualified structured settlement for your clients. The basic idea behind either type of structured settlement is that, in a lawsuit, it is determined that the defendant has the obligation to pay the plaintiff. The concept of *obligation* is critical. The defendant *assigns* that obligation via the structured settlement annuity.

When the non-qualified structured settlement annuity is funded on behalf of the plaintiff, it *must be funded by the defendant*. The defendant also assigns the future payment obligation to the assignment company, who in turn purchases the structured settlement annuity from the life insurance company. The defendant has full and final release, and the plaintiff now has a stream of payments coming in for the length of the structured settlement term. The key to the tax-deferral is that the plaintiff at this point has not had what's called "constructive receipt" or "economic benefit" of the funds. This is also why the plaintiff cannot simply "go buy an annuity" with the settlement proceeds: they would have taken constructive receipt, so those funds would be fully taxable in that tax year.

The funds in the non-qualified structured settlement, however, grow *before* they reach the plaintiff, and are taxable only in the year they are received. So, if the plaintiff chooses to take half their settlement in cash and the other half in a non-qualified structured settlement annuity deferred for five years, paying for the rest of their life, they would pay tax *only* on the cash in the year they settle their case. The funds parked in the annuity are growing tax-deferred until they are paid out. So, the plaintiff wouldn't receive another 1099 for five years, and then, that annual 1099 would only include the amount paid out in that year. The rest of the money remains in the structure to grow tax-deferred.

There are very specific steps that must be followed. There is language that must be included in the settlement documents outlining the structure terms, and an additional document is required (a Non-Qualified Assignment and Release), which outlines the details of the assignment between the defendant (insurance carrier) and the assignment company. Constant communication between the plaintiff's attorney and the plaintiff-only structured settlement consultant is a must. If any of the steps are missed, it could be costly to the plaintiff, not to mention be a major headache to correct, if it's correctable at all.

Some of the rules that one must be aware of are:

- The plaintiff is not the owner of the annuity. This works out to be a good thing. They technically don't own it, therefore it is very difficult for creditors to attach, future ex-spouses to get to, or to go after in liability situations. With ownership/control comes taxation.
- Once the benefits are locked in, they're locked in. We advise our clients to pass the payment schedule by their personal tax advisor before we move forward. It is important to note that the tax-deferral passes on to the beneficiary, which can be very useful as an estate planning tool.
- None of the structured settlement payments may be accelerated, deferred, increased or decreased and may not be anticipated, sold, assigned or encumbered.

The non-qualified structured settlement annuity is not the same as the annuities that can be purchased from various life insurance agents and financial planners. They are specifically created and used in lawsuits. Most insurance agents and financial planners have never heard of either type of structured settlement annuity.

Parties from the defense often do not have any objection to using a non-qualified structured settlement annuity if they are given enough time to research it. I always advise my attorney clients to get the non-qualified structured settlement intentions out as early in the negotiations as possible. We have found that the later it is brought up, the less likely it is that the defense will agree to it. But, the defense gets their "full and final" release by the plaintiff, and, very importantly, they get the full tax write-off for having paid the settlement dollars in that year.

Another option to discuss with your client might be that, since they no longer get to deduct your fees, maybe it would make sense for you to also structure a portion of those fees. I had a taxable case recently where the attorney offered to structure his fees in such a way that it lessened the attorney fee now, allowing his client to have more cash in his pocket. He built his structure in such a way that it paid out roughly what he would have received at the time of settlement, but it was spread out over five years. He not only allowed his client more cash at settlement, but he deferred his taxable income for five years. Not a perfect solution, but with the new tax law, it might be one way of helping your cases to settle. It's worth a discussion with your own tax advisor.

With the recent tax law changes, you may discover your ability to settle cases just got much harder. I encourage you to investigate non-qualified structured settlements. You may really be doing a service to your client with the tax savings this product can deliver. The use of non-qualified structured settlements has been around for a long time. The tax deferral alone may make it an attractive option for those settling non-physical injury cases. More and more people are finding out how great they can be. Don't you and your clients already give the IRS enough?

*Kelly Ramsdale is president of Kelly Ramsdale & Associates, a national plaintiff-only structured settlement consulting firm in Denver. She has been involved in the Columbine High School cases, the 9-11 Victims' Compensation Fund and Pan Am Flight 103 (Lockerbie) cases.*