Overview of the Structured Settlement Tax Rules

Introduction

- In a structured settlement, a voluntary agreement is reached between the parties to a physical injury claim under which the injured person receives damages in the form of an assured stream of periodic payments tailored to his or her future medical expenses and basic living needs, often for the remainder of his or her lifetime, from a well-capitalized, secure financial institution.

- Congress adopted, with bipartisan support, a set of tax rules to encourage and govern the use of structured settlements. (Periodic Payment Settlement Act of 1982, P.L. 97-43). These structured settlement tax rules have worked effectively for three decades. In the Taxpayer Relief Act of 1997, Congress extended the structured settlement tax rules to worker's compensation to cover physical injuries suffered in the workplace.

- Under the structured settlement tax rules, the full amount of the periodic payments constitutes tax-free damages to the injured person, and the liability to make the periodic payments to the injured person may be assigned by the settling defendant to a structured settlement assignment company that will use a financially-secure annuity to fund the damage payments (I.R.C. §§ 104(a)(2) and (1), 130, 72(q),(s),(u)).

Tax Treatment of the Injured Claimant

- The tax benefit provided under the structured settlement tax rules goes to the injured claimant. (As discussed below, the life insurance company that issues the annuity to fund the payment stream pays tax on its profit from the sale of the annuity, just like on any of its other products.)

- This tax benefit to the injured claimant is in the form of the tax-free treatment of the time-value-of-money component of the periodic payment stream. If the injured claimant receives a lump sum as compensation, that lump sum constitutes tax-free damages under Code section 104(a)(2), but income produced by the claimant's investment of that lump sum is taxable. By contrast, to encourage injured claimants to accept compensation in the form of periodic payments to provide long-term financial security and avoid reliance on the social safety net, section 104(a)(2) excludes from the claimant's income compensatory damages received for physical injury or sickness "whether as lump sums or as periodic payments".

- In the case of physical injuries suffered in the workplace, section 104(a)(1) excludes the full amount of the compensation payments received by the injured claimant under the structured settlement of the worker's compensation claim.

Tax Treatment of the Other Parties to the Structured Settlement

- Under a structured settlement, the defendant and its liability insurer reach a settlement with the injured claimant under which the claimant's physical injury claim is extinguished in exchange for the defendant/liability insurer's agreement to pay a tailored periodic payment stream to the claimant. At this point, the defendant/liability insurer wants to pay up and close its books on the tort liability. The injured claimant wants a secure funding source for a lifetime of future payments. The issue then becomes what to do with the annuity that will fund the periodic payment stream. The defendant/liability insurer does not want to hold the annuity. If the annuity is given to the claimant to hold, that will be the equivalent of a lump sum recovery, upending the tax-free nature of the future periodic payments.

Structured Settlement Assignment Company

- To solve this dilemma over who would hold the annuity, Congress in the structured settlement tax rules in Code section 130 adopted the "assignment company" mechanism. Under this approach, the defendant/liability insurer assigns its periodic payment liability to a structured settlement assignment company in exchange for a lump sum payment to the assignment company. The assignment company is a single purpose affiliate of a life insurance company. The assignment company then purchases an annuity from its life company parent that exactly matches the payment stream due under the structured settlement. The assignment company's sole purpose is to hold these matched structured settlement obligations and annuity funding assets.

- Congress has prescribed detailed rules in Code sections 130(c) and (d) to govern this process. These rules ensure that the terms of the periodic payment obligation as assigned are the same as in the settling defendant's hands and that the amounts and timing of the payments under the annuity match the amounts and timing of the periodic payment obligation to the claimant.

- Since the assignment company is essentially a holder of convenience of the annuity and a "pass-through" to the claimant for the periodic payments under the annuity, Code section 130(a) provides that the assignment company will not be taxable on the lump sum received from the settling defendant that the assignment company uses to purchase the annuity from its life company parent. The assignment company's basis in the annuity is reduced to zero, so that "[a]lthough the assignee will have to include any amounts disbursed from the annuity. . .in gross income, the assignee will also be entitled to deduct the full amount when it is periodically paid as personal injury damages." (House Rept. No. 97-832, at 5; Senate Rept. No. 97-646, at 5).

- Congress at the same time adopted a series of conforming changes to the Code section 72 annuity tax rules, providing an exception for structured settlement annuities from the penalty tax on premature distributions prior to age 59-1/2 (sec. 72(q)(2)(G)), the distribution rule otherwise applicable upon death of the annuitant (sec. 72(s)(5)(D)), and the rule that generally does not recognize annuities held by persons other than natural persons (sec. 72(u)(3)(C)).

Life Insurance Company Issuing the Structured Settlement Annuity

- The life insurer issuing the structured settlement annuity is fully taxable on its income from the sale of the annuity, just like its sale of other types of annuities.

Defendant/Liability Insurer

- The defendant (or its liability insurer) may deduct the lump sum paid to the structured settlement assignment company to assume the periodic payment liability, in accordance with a specific Treasury Regulation. Treas. Reg. § 1.461-6(a).

Joint Tax Committee Revenue Estimate

The Joint Committee on Taxation staff has estimated that the structured settlement tax rules in Code sections 130 and 72 have a total five-year revenue loss that is "below the *de minimis* amount ($50 million)" for the fiscal years 2013 through 2017. (Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017* (JCS-1-13), February 1, 2013, at pp. 25-26, "Exclusion of investment income from structured settlement arrangements (secs. 72(u)(3)(C)) and 130)".)