

---

THE LAW FIRM OF  
**BOVE & LANGA**  
A PROFESSIONAL CORPORATION

---

TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108  
Telephone: 617.720.6040 – Facsimile: 617.720.1919  
www.bovelanga.com

## **A Dangerous Tax Trap in Structured Settlements**

**By Alexander A. Bove, Jr.**

[Published in the Massachusetts Lawyers Weekly, August 18<sup>th</sup>, 1997]

With the ever increasing size of personal injury settlements, the market for “structured settlements” (those where payments are made over a period of years in amounts - not necessarily equal - as negotiated by the parties) has virtually skyrocketed. And along with the increase in the amount of structured settlements comes a potential and not readily soluble tax trap thought about by all too few personal injury attorneys and covered by virtually none of the structured settlement arrangements.

In the typical structured settlement the defendant will contract with a settlement company to pay the negotiated settlement amount to the plaintiff. The settlement company then purchases an annuity from a life insurance company which assumes the defendant’s obligation to pay the settlement. The settlement company makes a profit by “selling” the plaintiff a package that in actuality costs less than it appears to cost, primarily by using different standards to calculate the present value of the payments. The insurance company makes a profit through its use of the defendant’s money over the structured payment period, paying the plaintiff an effective interest rate that is lower than the insurance company’s own rate of return on its investments. The plaintiff is often motivated to structure the settlement because payments received on account of personal injuries or sickness are free of federal income taxes under IRC section 104 (a)(2).

## **The Trap**

Although this tax-free treatment applies as well to a lump sum settlement, any interest, dividends, or other return produced by investing the lump sum will generally be taxable. Therefore, structuring the settlement has the effect of rendering the interest on the settlement free of income taxes. As a simple illustration (using a convenient set of numbers) say that Warren is offered a personal injury settlement (after legal fees) of \$100,000 lump sum, or \$25,000 per year for 5 years, for a total of \$125,000, both tax free. If he were to take the lump sum and invest it at 6 percent simple interest, and assuming he is in the 33 percent combined income tax bracket, he would have about \$120,000 at the end of 5 years as opposed to \$125,000 from the structured payments. Of course, the actual difference in after tax investment return is the key. Furthermore, if the plaintiff were able to invest the lump sum in tax free bonds with a return equal to or in excess of the actual rate on the structured settlement, he would likely be better off with the lump sum.

But there are other issues to consider. Many attorneys feel that the structured settlement arrangement offers protection against early dissipation of the funds or the risk of poor investment choices or performance. Accordingly, the clear income tax advantages combined with the protection against poor money management often make the structured settlement the better alternative. This might be so if it weren't for one other consideration: The estate tax to be paid on the early death of the plaintiff.

Although structured settlements enjoy a special income tax break, there is no corresponding estate tax relief. Our federal estate tax laws are very clear in their treatment of unpaid settlement proceeds to which the plaintiff is entitled - they are fully taxable to the extent of their present value on the death of the plaintiff. This is the trap.

To illustrate, say that Henry, a minor, is awarded a settlement payable over his life but no less than 40 years. The settlement has a present value of \$4 million. In year 5, Henry dies and at that time the settlement has a remaining present value of \$3.5 million. Assuming no other asset in

Henry's estate, the unpaid balance of the structured settlement is fully includible in Henry's estate and will generate a federal estate tax of about \$1.3 million. IRC section 2033 and Treas. reg. section 20.2031-7(a). How will these estate taxes be paid? Will the IRS agree to take a portion of each payment received by the beneficiaries?

If the estate tax liability is not paid by 9 months after the date of death, interest begins to run on the unpaid amount. IRC section 6601. And if reasonable cause does not exist for the failure to pay, a penalty will be added. IRC section 6651. Fortunately, IRC section 6161(a)(2) allows for an extension of time of up to ten years to pay the tax, if reasonable cause can be shown for the delay. Reasonable cause is deemed to include situations where a substantial part of the estate's assets includes rights to receive future payments AND the estate is unable to borrow the funds to pay the tax except at a rate which imposes a hardship on the estate. Treas. reg. section 20.6161-1(a), example (2). Note that even if the full ten years' extension is allowed, interest on the unpaid balance of the tax must also be paid, at a rate equal to the federal short term rate plus 3 points. IRC section 6621 (a)(2). Since this is virtually guaranteed to be a higher rate than that paid under the structured settlement, payment of the tax plus interest will consume a disproportionate part of the remaining settlement payments. In fact, in most cases the tax and interest will consume the settlement payments for years and the named beneficiaries will get nothing until the estate taxes (and interest) are paid in full.

As to the borrowing requirement, in most instances it would not be feasible (or desirable) to borrow the funds to pay the tax, as the interest payable to a commercial lender is unlikely to be any better than that which must be paid to the IRS. Whether this would be sufficient to be deemed a "hardship" to the estate is unclear. And remember, an inability to borrow the necessary funds except at hardship rates is a requirement to be eligible for the extension. Therefore, it may be necessary to produce evidence to the IRS of the results of attempts to borrow the funds.

An important planning possibility may exist in some cases if family circumstances are such that a loan could be made to the estate by a family member or by a family business. This could provide the opportunity for substantial tax savings if the loan is properly structured, since the

projected interest on the loan can be presently deductible to the estate, and that deduction in turn can reduce the estate tax. Estate of Graegin v. Commissioner Tax Court Memo 88-477.

### **No Way Out?**

Although the obvious solution to the tax problem would appear to be the purchase of life insurance on the life of the plaintiff, in most personal injury situations that generate sizable structured settlements, the plaintiff is likely to be uninsurable, or if insurable, only at prohibitive cost. Further, the amount of insurance necessary to pay the estate tax will vary depending upon the time of the plaintiff's death, although this is not the biggest problem. In the rare event that insurance is available, advisors must be careful to purchase it in a way that will avoid inclusion of the proceeds in the plaintiff's estate, typically by using an irrevocable life insurance trust to purchase the policy.

Speaking of trusts, many settlement advisors seem to believe that arranging the structured settlement payments to be made to a trust for the plaintiff's benefit (instead of directly to the plaintiff or his guardian) will allow the unpaid amounts to escape estate tax on the death of the plaintiff. We wish! Federal estate tax laws are abundantly clear on the complete taxation of such trusts for estate tax purposes, and it matters not whether the trust is revocable or irrevocable, or whether the trust is created by court order, or whether the trust is established and funded by the plaintiff's guardian, or even by the defendant as part of the settlement agreement. IRC section 2036, and TAM (IRS Tax Advice Memorandum) 9506004.

A relatively new option that has surfaced is the receipt of a lump sum cash payment to the plaintiff or the plaintiff's trust in return for the sale of the right to receive the remaining settlement payments. While at first glance this seems to offer a means of generating cash to pay the estate tax, it is by most measures a very questionable deal. The few companies that offer to purchase structured settlements generally do so at a price of about half of the present value of the remaining payments. Since the effective estate tax rates (starting with estates of \$1 million) range from 15 percent to 55 percent of the total, each case must be considered on its own. In the higher valued estates, however, at a 50 percent settlement buyout the plaintiff's beneficiaries

could be cashing in the settlement only to turn over the entire proceeds of the sale to the IRS for estate taxes. In a smaller estate, however, if there is absolutely no other way to deal with the tax, a sale could provide relief.

For instance, if the plaintiff died and the present value of the future payments was \$1 million, the estate tax would be \$153,000. A sale of the remaining payments for a cash price of \$500,000 would leave the family with \$347,000 after payment of the tax, or about 70 percent of the cash sales proceeds. Correspondingly, the larger the estate, the worse the result. Take a settlement with a present value of \$5 million. Assuming no other assets, the estate tax will be about \$2.2 million. If the settlement is sold for half its present value or \$2.5 million (to pay the tax), this will leave the family with only \$300,000, or about 12 percent of the sales proceeds.

Unfortunately, there is no ready solution to this problem, and although, in the author's opinion, the personal injury attorney would not be liable to the family for the lost payments in the case of a forced sale for half the value or for the interest on estate taxes, there is a professional duty if not a good faith obligation to advise the family of this potential problem in the event of the plaintiff's early death. Perhaps the best solution would be to have a provision in the settlement agreement calling for an acceleration of payments equal to the estate tax due on the plaintiff's death. In fact, the author has proposed to settlement companies the idea of adding just such a provision to the settlement contract to this effect: "In the event the plaintiff dies before receiving all of the payments under the guaranteed portion of the contract (those amounts called for under the term certain), and the inclusion of the present value of such remaining payments generates an estate tax in the plaintiff's estate, then the payor agrees to accelerate payments in an amount equal to the additional estate tax due attributable to the inclusion of such future payments in the plaintiff's estate, based on the ratio that the then present value of the remaining settlement payments bears to the value of the plaintiff's gross estate."

Understandably, settlement companies are reluctant to agree to such a proposal, since the risk and resulting loss to them is so difficult to measure. Nevertheless, it is measurable and as attorneys become more aware of the problem and push harder for such a provision in their

settlement negotiations, it could (and should) become a standard part of all structured settlement contracts.

Copyright © 1997 by Alexander A. Bove, Jr. All rights reserved.