Death, Taxes and the Successful Plaintiff

by Richard G. Halpern

Plaintiff's attorneys usually do not lose much sleep over the tax consequences to their clients of damages for personal injuries. The Internal Revenue Code is uncharacteristically friendly to victims of injury, excluding the money received as the result of a verdict or settlement from that most dreaded of all figures: taxable gross income.

So when a plaintiff receives a case verdict or settlement, the attorney typically collects his or her fee and arranges for the balance to go right to the plaintiff, tax free. No messy W-2, K-1, 1099, or H&R Block needed here: this income doesn't require reporting.

Similarly, periodic payments in properly set up structured settlements require no tribute to Uncle Sam. Lump sums or periodic payments; it doesn't matter. That's why periodic payment plans are useful to avoid taxation on what might otherwise look like investment income to the IRS.

But any good cynic knows there must be a cloud to this silver lining, and there is: the deadly duo of the tax collector and the Grim Reaper -- death taxes. At his or her death, every citizen or resident of the U.S. is subject to an estate tax. And the decedent's estate includes the value of all property and assets -- including the value of an annuity or other payment which the beneficiaries of the dearly departed may receive in the future.

Accordingly, when a plaintiff participates in a structured settlement and dies before receiving all the guaranteed payments, the current value of the payments due is included in the plaintiff's estate for federal tax purposes. It is added to all the other assets owned by the plaintiff, such as homes, bank accounts, insurance policies, and investments, and $600,000 of the total is excluded from the tax. Everything over that amount is subject to federal estate tax rates ranging from 37% to 55%.

This is a big hit by itself, but it's even worse than that. The tax is due within nine months of death! If the estate has assets other than the balance due on the structure, the family must use them to satisfy the estate tax liability. As a result, a plaintiff's family may be deprived of a substantial chunk of its current liquid assets; and if there are insufficient assets available to cover the tax, then the IRS can take all of each year's periodic payment as it is received -- plus interest!! This isn't some worst-case hypothetical. It happens all the time: a settlement structure turning into a nightmare for the very people it was designed to help.

This problem, like most, has solutions, but only if you anticipate it. First, you may be able to plan the estate so that taxable assets do not amount to $600,000 even when the value of the structured settlement is included. But assuming that that's not an option, the best solution is to give the plaintiff more control over the cash. And that means finding an alternative to traditional structured settlements.

Fortunately, there is such a beast: call it the settlement fund management trust. The plaintiff can directly control the funds, of course, and plan his or her estate to minimize death tax obligations. Even if their obligations cannot be eliminated entirely, the family would still have the funds immediately available to satisfy whatever tax liabilities might arise. But direct control by the plaintiff means that the income collected could be taxable at income tax rates of nearly 40 percent, so better still is for the plaintiff to assign the funds to a trustee. The trustee may then invest the funds in tax-exempt securities that will deliver tax-exempt income like a structure, and, at the same time, be sensitive to interest rate fluctuations.

Now the family is protected. The plaintiff has reaped the benefits of a structure (safety and tax free periodic payments), and by retaining some control over the money, has both permitted estate planning to take place and protected the family against death tax liability problems.

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