

THE USE OF IRC §1468B QUALIFIED SETTLEMENT FUNDS, IRC §130 QUALIFIED ASSIGNMENTS AND SPECIAL NEEDS TRUSTS IN SINGLE-PLAINTIFF PHYSICAL INJURY SETTLEMENTS

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I. INTRODUCTION

Internal Revenue Code (I.R.C.) § 104(a)(2) provides that the proceeds (except for punitive damages) from the settlement of a claim involving physical injury or sickness are not included in the taxable income of the plaintiff who receives these proceeds.^[1] However, if the settlement of the claim is paid in the form of a lump sum,^[2] any *income* earned by the recipient on the lump sum settlement is taxable.^[3] In addition to income tax concerns, there is an inherent risk that a lump sum settlement designed to provide for the plaintiff's lifetime medical and support needs may be dissipated prematurely. Unwise investments, poor money management or even the volatility of the economy can result in the exhaustion of the plaintiff's settlement funds, leaving the plaintiff with no means to provide for his or her care and support.^[4]

II. PERIODIC PAYMENT ACT OF 1982

In 1982, Congress passed the Periodic Payment Act (PPA),^[5] amending the Internal Revenue Code to grant statutory certainty to the tax-favored use of periodic payments in physical injury (PI) settlements.^[6] The PPA amended I.R.C. § 104(a)(2) to add parenthetical language which indicated that amounts received would be excluded from gross income whether received as "lump sums or as periodic payments."^[7] Most notably the Act created I.R.C. § 130, which provides a means whereby a defendant can fulfill a settlement obligation to make periodic payments of settlement proceeds through a qualified assignment of his or her liability to a third-party assignee.^[8] The defendant pays the assignee a lump sum, and the assignee purchases an annuity contract that will fund payment of the defendant's obligation to the plaintiff in the form of periodic payments.^[9] Under I.R.C. § 130, the amount received by the assignee is not included in that assignee's gross income unless that amount exceeds the cost of the annuity.^[10]

As a result, it is now common practice to structure all or part of a PI settlement with a qualified annuity and a qualified assignment under I.R.C. § 130. The advantages to the settling plaintiff are clear: proceeds received as annuity payments are not subject to income tax and the plaintiff has the security of a future stream of income to provide necessary funds for the plaintiff's lifetime.

I.R.C. § 130 requires that a qualified assignment be made by a "party to the suit or agreement" having liability to the plaintiff.^[11] In addition, if the plaintiff has actual or constructive receipt of the settlement funds, the ability to take advantage of the tax savings under I.R.C. § 130 is lost. Therefore, structured settlements under I.R.C. § 130 have traditionally been funded directly by the defendant or the defendant's insurance carrier.

Increasingly, settling plaintiffs and their attorneys have expressed serious dissatisfaction with the traditional arrangement in which the defendant has complete control over the purchase of the annuity that will fund the qualified assignment. Plaintiffs are forced to agree to a specified income stream rather than the lump sum amount with which the annuity will be funded. Defendants' insurance carriers often use "preferred" brokers who may be under an agreement to split commissions with the carrier. Fees, commissions and the actual commuted value of the annuity are seldom fully disclosed. Many times, the future payments the plaintiff will receive are less than what the plaintiff might have been able to obtain from another annuity issuer for the same premium payment. Plaintiffs may thus be deprived of the ability to enjoy the fullest benefit of the settlement and may even feel that they have been duped into settling for less than the agreed-upon amount. Further, there is at least a perceived conflict of interest involved where the plaintiff's financial settlement planning is in the hands of the opposing party.^[12]

Finally, in the context of PI settlements involving seriously or catastrophically injured plaintiffs, a primary goal is to provide funds for the support and care of the plaintiff while preserving eligibility for all available and appropriate governmental benefit programs, including Supplemental Security Income (SSI) and Medicaid. Typically, Medicaid eligibility is the first consideration because the need to ensure adequate medical care is

paramount. However, SSI is also an important benefit program that can provide much needed additional income, and sometimes more, to those who qualify.

For many years, Special Needs Trusts have been commonly used to preserve Medicaid eligibility for a settling plaintiff and have also been employed to preserve SSI eligibility since January 2000. Settling plaintiffs may require that the distribution of settlement proceeds be delayed to allow time to complete planning for SSI or Medicaid eligibility. At the same time, both the plaintiffs and defendants may wish to avoid delay in the execution and completion of the settlement itself. Plaintiffs in this situation will need a vehicle by which their settlements can be finalized without the proceeds being treated as available resources during the time necessary to create and fund an exempt Special Needs Trust.

As a result, many plaintiffs who are interested in receiving their settlements in the form of a structure are insisting on a different procedure that will allow them more control. Qualified Settlement Funds under I.R.C. § 468B and the corresponding IRS regulations provide an alternative to the traditional, defendant-directed structured settlement arrangement.

A. Qualified Settlement Funds under I.R.C. § 468B

In 1986, Congress enacted the Tax Reform Act,^[13] which added I.R.C. § 468B to allow a defendant to extinguish his or her liability by paying settlement proceeds into a “designated settlement fund” (DSF).^[14] Initially, DSFs were used in the settlement of large class action PI^[15] suits in which the individual shares of the settlement to the various class members had not yet been determined. However, I.R.C. § 468B contains no language that restricts the use of DSFs to the settlement of suits or claims involving multiple plaintiffs.

A DSF is defined as any fund:

(A) which is established pursuant to a court order and which extinguishes completely the tort liability [of the defendant or the defendant’s insurance carrier to the plaintiff],

(B) with respect to which no amounts may be transferred other than in the form of qualified payments,

(C) which is administered by persons a majority of whom are independent of the [defendant or the defendant's insurance carrier],

(D) which is established for the principal purpose of resolving and satisfying present and future claims against the [defendant] (or any related person or formerly related person) arising out of personal injury, death, or property damage,

(E) under the terms of which the [defendant] (or any related person) may not hold any beneficial interest in the income or corpus of the fund, and

(F) with respect to which an election is made by the defendant.^[16]

In 1992, the Secretary of the Treasury introduced regulations governing the treatment of DSFs.^[17] Under these regulations, the Secretary provided for the creation and use of “qualified settlement funds” (QSFs).^[18] Although QSFs are not specifically mentioned in I.R.C. § 468B, they are clearly intended to meet the definition of a DSF.

Under 26 C.F.R. § 1.468B-1, a fund, account or trust is a QSF if:

(1) It is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority;

(2) It is established to resolve or satisfy *one or more* contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to *at least one claim* asserting liability—

(i) Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (hereinafter referred to as CERCLA), as amended, 42 U.S.C. 9601 et seq.; or

(ii) Arising out of a tort, breach of contract, or violation of law; or

(iii) Designated by the Commissioner in a revenue ruling or revenue procedure; and

(3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).^[19]

Although the regulations define a QSF in broader terms than the statute's definition of a DSF, the regulations have been held to be valid.^[20]

The proceeds of a PI settlement used to fund a QSF continue to receive favorable tax treatment under I.R.C. § 104(a)(2), but income earned on the proceeds are taxable to the QSF for so long as the QSF continues to hold the funds.^[21] Under 26 C.F.R. § 1.468B-2, QSFs are taxed at the maximum rate applicable to trusts, but are otherwise treated as corporations under the I.R.C.^[22]

Like the governing statute, the regulations do not contain any language restricting the use of QSFs to settlement of suits or claims involving multiple plaintiffs. Moreover, the regulations state specifically that a QSF can be used to settle "one or more" claims.^[23] There can be little serious doubt that the regulations permit QSFs to be used in the settlement of single-plaintiff PI claims.^[24]

B. Qualified Assignments and Qualified Funding Assets under I.R.C. § 130

As noted above, the PPA amended I.R.C. § 104(a)(2), clarifying that the income from an annuity which makes periodic payments as part of a settlement of a PI claim for physical injury or sickness is not included in the gross income of the recipient.^[25] In addition, under I.R.C. § 130, amounts received for agreeing to a qualified assignment are not counted as income.

The assignment of the obligation to make periodic payments constitutes a "qualified assignment" if the following requirements are met:

(1) if the assignee assumes such liability from a person who is a party to the suit or agreement..., and

(2) if—

(A) such periodic payments are fixed and determinable as to amount and time of payment,

(B) such periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments,

(C) the assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability, and

(D) the periodic payments must be excludable from the gross income of the recipient under I.R.C. §§ 104(a)(1) & (2).^[26]

Further, the periodic payments must be funded with a commercial annuity issued by a life insurance company, and the annuity payments cannot be more than the periodic payments under the qualified assignment. Finally, the annuity must be purchased with settlement proceeds within 60 days before or after the qualified assignment and must be designated specifically to payment of the qualified assignment.^[27]

Once there is a qualified assignment of an annuity funding a structured PI settlement, the plaintiff cannot change the terms of the annuity, including the payment amounts or the payee. The annuity must be purchased directly by a party to the PI suit with liability to the plaintiff to avoid constructive receipt of the settlement funds by the plaintiff.^[28] The plaintiff will also be treated as having constructive receipt of the settlement funds if he or she has the option of receiving a lump sum in lieu of an annuity, or the ability to direct the use of the settlement proceeds to purchase an annuity.^[29]

As noted above, qualified assignments under I.R.C. § 130 are available in the settlement of both PI and workers' compensation claims, but only with regard to settlement proceeds that are exempt from taxation under I.R.C. §§ 104(a)(1) & (2).

C. QSFs and Qualified Assignments in Single-Plaintiff PI Settlements

The question still remains whether a QSF holding funds from a PI settlement involving a single plaintiff can accomplish a qualified assignment under I.R.C. § 130. Many defendants, liability carriers and structured settlement professionals have argued for years that it cannot, based upon the common law doctrine of "economic benefit," as defined in the landmark case of *Sproull v. Commissioner*.^[30]

In a nutshell, the *Sproull* case held that when a fund is placed irrevocably with a third party for the sole benefit of the taxpayer and the taxpayer has a vested, unconditional right to the fund, the taxpayer has received an economic benefit.^[31] This, the argument goes, is exactly what happens when a QSF is funded with the proceeds of a single-plaintiff PI settlement, since the amount to which the plaintiff's vested interest applies is immediately determinable.

Under *Sproull*, if the taxpayer has received an economic benefit, the fund is immediately includable in the taxpayer's gross income.^[32] Therefore, if the plaintiff has an economic benefit from PI settlement funds, the principal settlement amount is excludable under I.R.C. § 104(a)(2), but any *income* earned on the funds is includable in the plaintiff's gross income. This would arguably prevent the QSF from being able to accomplish a valid I.R.C. § 130 qualified assignment, since *all* of the periodic payments from the qualified funding asset, including the income portion, must be excludable from the plaintiff's gross income under I.R.C. § 104(a)(1) or (2).^[33]

Proponents of this argument often cite IRS Private Letter Ruling (P.L.R.) 200138006,^[34] as authority for the application of the economic benefit doctrine to single-plaintiff QSFs. While that particular PLR did involve an analysis of a QSF under the economic benefit doctrine, the QSF discussed in P.L.R. 200138006 was not funded with the proceeds of a PI settlement.^[35] Therefore, the case discussed in P.L.R. 200138006 did

not involve the issue of whether a QSF holding funds from a single-plaintiff PI settlement could accomplish a valid I.R.C. § 130 qualified assignment.

The real issue is whether the economic benefit doctrine applies to bar a single-plaintiff QSF, funded with PI settlement proceeds, from making a qualified assignment under I.R.C. § 130. To rely solely upon P.L.R. 200138006 as authority for the application of the economic benefit doctrine in such cases is to ignore the content of I.R.C. § 130, the Congressional intent and legislative history behind I.R.C. § 130, and IRS Rev. Proc. 93-34.

When I.R.C. § 130 was originally enacted in 1982, the statute provided that the party making a qualified assignment could not assign payment rights “greater than those of a general creditor.”^[36] The legislative history behind the original 1982 statute states Congress’ intent at the time that payments of damages from PI claims be “excludable from income only if the recipient taxpayer is not in constructive receipt of or *does not have the current economic benefit of* the sum required to produce the periodic payments.”^[37]

However, Congress amended I.R.C. § 130(c)(2)(C) in 1988^[38] by removing the “greater than a general creditor” language, so that “[r]ecipients of periodic payments under structured settlement arrangements should not have their rights as creditors limited by provisions of the tax law.”^[39] When Congress repealed I.R.C. § 130(c)(2)(C), it also added the following language to I.R.C. § 130(c):

The determination for purposes of this chapter of when the recipient is treated as having received any payment with respect to which there has been a qualified assignment shall be made *without regard to any provision of such assignment which grants the recipient rights as a creditor greater than those of a general creditor.*^[40]

The legislative history behind the 1988 revisions to I.R.C. § 130(c) states that “no amount is currently includable in the recipient’s income solely because the recipient is provided creditor’s rights that are greater than the rights of a general creditor.”^[41]

A settling plaintiff with vested rights to a settlement fund has rights “greater than those of a general creditor” and would normally be considered to have an “economic benefit” under *Sproull*.^[42] Thus, the effect of the 1988 amendments to I.R.C. § 130(c) was to make the “economic benefit” doctrine inapplicable to qualified assignments in PI settlements.

Whenever the parties to a PI case reach an agreement to settle for a specified amount, the plaintiff obtains a vested right to the settlement proceeds. When the defendant or the defendant’s insurance carrier provides the funds through a qualified assignment for the purchase of a qualified annuity, the funds are irrevocably placed with a third party for the sole benefit of the plaintiff. In spite of this, qualified assignments are routinely and successfully employed in structured PI settlements for individual plaintiffs.^[43]

It seems clear that the economic benefit doctrine is no longer applicable to bar a qualified assignment under I.R.C. § 130 after the 1988 revisions to that section. Indeed, the IRS has interpreted the 1988 revisions as allowing qualified assignments of periodic payment liabilities without regard to whether a plaintiff has the current economic benefit of the settlement proceeds or the qualified funding assets purchased with those settlement proceeds.^[44] Assuming the requirements of I.R.C. § 130 are met, the plaintiff’s economic benefit does not bar a successful qualified assignment.

Therefore, a party to the suit or agreement with liability to the plaintiff can accomplish a valid qualified assignment, regardless of whether the settlement proceeds are placed irrevocably with a third party in a separate fund, account or trust for the sole benefit of the plaintiff and the plaintiff has an unconditional, vested right in the fund, account or trust. So long as the plaintiff is not in constructive receipt of the settlement proceeds, a qualified assignment is still possible.

It is very important to note that I.R.C. § 130 requires only that the assignment be made by a “party to the suit or agreement” having liability to the plaintiff.^[45] That section does *not* require that the assignment be made by the original defendant or its insurance carrier. Thus, *any* party with liability to the plaintiff can make a valid qualified assignment.

In 1993, the IRS issued Revenue Procedure (Rev. Proc.) 93-34.^[46] This procedure “provides rules under which a designated settlement fund described in section 468B(d)(2) of the Internal Revenue Code or a qualified settlement fund described in section 1.468B-1 of the Income Tax Regulations will be considered ‘a party to the suit or agreement’ for purposes of section 130.”^[47]

Specifically, Rev. Proc. 93-34 provides that:

... a qualified settlement fund will be treated as “a party to the suit or agreement” within the meaning of section 130(c)(1) of the Code if each of the following requirements is satisfied:

(1) the claimant agrees in writing to the assignee’s assumption of the... qualified settlement fund’s obligation to make periodic payments to the claimant;

(2) the assignment is made with respect to *a claim* on account of personal injury or sickness (in a case involving physical injury or physical sickness) that is...:

(b) *a claim* [under CERCLA ; or arising out of a tort, breach of contract, or violation of law; or designated by the Commissioner in a revenue ruling or revenue procedure];

(3) each qualified funding asset purchased by the assignee in connection with the assignment by the designated or qualified settlement fund relates to a liability to a *single claimant* to make periodic payments for damages;

(4) the assignee is not related to the transferor (or transferors) to the designated or qualified settlement fund within the meaning of sections 267(b) or 707(b)(1); and

(5) the assignee is neither controlled by, nor controls, directly or indirectly, the designated or qualified settlement fund...^[48]

Rev. Proc. 93-34 does not contain any provisions that would restrict its application to settlements involving multiple plaintiffs. On the contrary, it speaks in terms of qualified

assignments relating to “a claim” and “liability to a single claimant.”^[49] This language, like the language of I.R.C. § 468B, itself, is consistent with situations involving either a single plaintiff or multiple plaintiffs.

The logical conclusion is that the provisions of I.R.C. §§ 130 and 468B, and Treas. Reg. §§ 1.468B-1 through 1.468B-5, as interpreted by the I.R.S., itself, permit QSFs in single-plaintiff PI settlements to make qualified assignments under I.R.C. § 130, so long as the QSF is made a “party to the suit or agreement” in compliance with Rev. Proc. 93-34.

III. STRATEGIES FOR USING QUALIFIED SETTLEMENT FUNDS

A. How Does a QSF Make a Valid Qualified Assignment?

It should not be difficult to comply with all of the applicable requirements of I.R.C. §§ 130 and 468B, I.R.S. Regulation §§ 1.468B-1 through 1.468B-5, and Rev. Proc. 93-34 when settling a PI claim. The parties could first petition the court with jurisdiction over the claim to create a QSF trust and appoint an independent trustee, with the court having continuing jurisdiction over the QSF trust until it terminates. The plaintiff would not have any rights to revoke or modify the terms of the QSF trust, or to compel any distributions from the QSF trust other than to fund a qualified assignment.

The parties could then enter into a “novation,”^[50] in which the plaintiff, defendant, the defendant’s insurance carrier and the QSF trustee would all agree that the defendant’s liabilities to the plaintiff be assigned to and fully assumed by the QSF. As consideration, the defendant and/or the defendant’s insurance carrier would agree to pay the QSF an agreed upon lump sum, to be used only to fund a qualified assignment.

The QSF could then be substituted for the original defendant as a party to the case; the QSF could be funded by the defendant or the defendant’s insurance carrier; and the defendant and/or its carrier could be granted a full release by all parties. The QSF trustee, now a party standing in the shoes of the original defendant, could then enter into a full and final, court-approved settlement agreement with the plaintiff. The settlement would extinguish all liabilities assumed from the original defendant and require payment

of the settlement proceeds through a qualified assignment. The plaintiff would not have the option of receiving any portion of the settlement in a lump sum and the obligation to make and fund the qualified assignment would fall solely to the QSF.

The QSF, as a “party to the suit or agreement,” should then be able to accomplish an I.R.C. § 130 qualified assignment, giving the plaintiff favorable income tax treatment of all income earned on the qualified annuity. Since the QSF would be funded with an agreed lump sum, representing the commuted value of the qualified annuity, the plaintiff would be assured of receiving the full value of the settlement.

The plaintiff would also have the ability to choose the structured settlement broker, to request that the trustee purchase a qualified annuity which would provide the most valuable income stream, and to ensure that all fees and commissions are fully disclosed. At the same time, the settlement would be protected from premature depletion and the plaintiff would be assured a secure, future stream of income for life to meet his or her needs for support and medical care. In short, the plaintiff would be able to enjoy all of the advantages of a tax-free structured settlement without the negative aspects of the traditional, defendant-directed structured settlement arrangement.

B. QSFs and Special Needs Trusts

Use of a QSF may be particularly useful in situations in which the distribution of settlement proceeds needs to be delayed to allow planning for the plaintiff’s SSI or Medicaid eligibility. The QSF’s prohibition on distributions other than to fund a qualified assignment and its restrictions on the plaintiff’s authority to compel distributions of principal or income prevent the assets in the QSF from being treated as available resources or income to the plaintiff for purposes of SSI and Medicaid. The qualified assignment may be drafted to name an SSI/Medicaid exempt Special Needs Trust as the payee (so long as all payments are made before the plaintiff reaches age 65).^[51]

The Omnibus Budget Reconciliation Act of 1993 (OBRA ‘93)^[52] established new Medicaid criteria for treatment of both revocable and irrevocable trusts created after

August 10, 1993. Specifically, OBRA '93 permits the use of a Special Needs Trust, funded with the assets of a Medicaid beneficiary, if the trust meets the following criteria set forth in the statute:

(A) A trust containing the assets of an individual under age 65 who is disabled (as defined in § 1382c(a)(3) of the Social Security Act) and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court if the State will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual by the state;.... ^[53]

In December 1999, Congress passed the Foster Care Independence Act (FCIA), ^[54]

which contained new anti-fraud provisions applicable to the SSI program. The FCIA specifically exempts OBRA '93 Special Needs Trusts from being considered available resources and provides that transfers to fund such trusts by individuals under age 65 will not incur a penalty period. ^[55] Thus, the FCIA provides that a trust will be exempt from the general rules regarding self-settled trusts if it complies with all of the criteria in 42 U.S.C.A. § 1396p(d)(4)(A) applicable to OBRA '93 Special Needs Trusts for Medicaid.

Even a trust that complies with all of the requirements of 42 U.S.C.A. § 1396p(d)(4)(A) might not be recognized as a valid exempt trust if it does not also comply with Social Security Administration policies, as set forth in the Program Operations Manual System (POMS) at POMS SI 01120.203. In particular, the trust must comply with all of the following key requirements: ^[56]

1. The trust will be established with the assets of the beneficiary, who is under age 65;
2. The beneficiary is disabled as that term is defined in the Social Security Act;

3. The beneficiary is the sole beneficiary of the trust and the trust must not allow any Prohibited Expenses or Payments under POMS SI 01120.203.B.3);^[57]

4. The trust was established by the beneficiary's parent, grandparent, legal guardian or a court, if the beneficiary is a minor. If the beneficiary is not a minor, the trust was established by someone who has legal authority to act with regard to the beneficiary's assets,^[58] which would mean that the trust must have been established by the beneficiary's legal guardian or a Court, or by the individual in the case of a pooled trust account;

5. The trust provides specific language providing that, upon the death of the

beneficiary, the trust must first reimburse the State for medical assistance paid for the beneficiary;

6. The trust will be fully funded before the beneficiary reaches age 65;

7. The trust is irrevocable. (The trust must contain a specific provision making the trust irrevocable; and, in states which still follow the common law *doctrine of worthier title*, the trust must name specific individuals as contingent beneficiaries upon the beneficiary's death, after repayment to the State for medical assistance benefits paid).

Failure of the trust to comply both with OBRA '93 and the requirements in the POMS will result in trust assets being considered an available resource for SSI purposes or in transfers to fund the trust being considered transfers without fair consideration, resulting in an SSI penalty period. The question arises, then, as to when the more restrictive SSI requirements will apply to the creation of a Special Needs Trust.

In 1999, the United States District Court in Colorado was presented with the issues of:
1) whether, in an SSI state^[59], a trust approved under the federal SSI eligibility criteria

could nonetheless be considered invalid under state Medicaid law; and 2) whether a Medicaid beneficiary in an SSI state can be denied Medicaid benefits under state Medicaid regulations if the individual continues to qualify for SSI.^[60] The court held that, in SSI states, Medicaid agencies cannot employ methodology or criteria more restrictive than that of SSI when evaluating trusts, because an SSI recipient automatically qualifies for Medicaid.^[61]

The court's holding in *Ramey* governs any situation in which state Medicaid regulations in an SSI state might impose more restrictive criteria for eligibility than those imposed by federal regulations governing SSI. In an SSI state, an individual who is eligible for SSI under the federal Social Security regulations cannot be denied Medicaid benefits by the application of a more restrictive state Medicaid law or regulation.

In SSI states, a trust that is approved by the Social Security Administration for an SSI beneficiary cannot also be required to comply with any additional requirements under state Medicaid law; and an individual who qualifies for SSI cannot be denied Medicaid under any state Medicaid law that might impose eligibility requirements stricter than those imposed by SSI. Thus, for a person whose Medicaid eligibility is due to eligibility for SSI, that person's Special Needs Trust must comply with SSI criteria, regardless of what criteria may exist under state Medicaid law. Further, if such an individual qualifies for SSI, even after consideration of all cash income and in-kind support and maintenance, that individual cannot be denied Medicaid benefits, even if a calculation of the individual's cash income and in-kind support and maintenance under state Medicaid regulations might otherwise result in ineligibility.

IV. SPECIAL FUNDING ISSUES

A. Medicaid Annuities under the Deficit Reduction Act of 2005

In many PI settlements, the plaintiff's future medical expenses may be expected to "spike" in later years. For example, a plaintiff may anticipate the need for surgery or replacement of certain durable medical equipment many years after the settlement. In these instances, it is not unusual for the structured settlement to include an annuity that

might pay out large payments in fixed amounts at 5 or 10 year intervals, specifically to provide extra funds in those years when unusually large medical costs are expected. By deferring payment for large and infrequent costs until needed, the defendant can reduce the costs of funding the settlement while still providing the plaintiff with sufficient settlement funds to meet his or her needs for future care.

The Deficit Reduction Act of 2005 (DRA)^[62] amended federal Medicaid law to provide that the purchase of an annuity from the assets of an annuitant who has applied for Medicaid (i.e., the Medicaid recipient or the recipient's spouse) is a transfer without fair consideration, unless the annuity: (1) is irrevocable, non-assignable, actuarially sound, and provides for substantially equal payments over the life of the annuity *with no deferral or balloon payments*; or (2) names the state as death beneficiary up to the amount of Medicaid benefits paid on behalf of the annuitant.^[63] However, the DRA does not provide for any further consequence in the treatment of deferred or balloon annuities. Thus, even a deferred or balloon annuity still should not be treated as a "resource" if it is annuitized, but rather, the payments should continue to be treated as income in the month received.

Under I.R.C. § 130, an annuity that funds a qualified assignment must be fixed as to the amount and time of periodic payments. However, those payments need not be made monthly or even annually. On the other hand, the DRA restrictions on annuities require that a Medicaid-exempt annuity must be actuarially sound and provide for substantially equal payments. The DRA specifically provides that the purchase of deferred annuities and balloon annuities by the Medicaid recipient or the recipient's spouse will result in a transfer penalty. Does this mean that only I.R.C. § 130 *immediate* annuities may be used in a structured settlement when the annuity will be used to fund a Medicaid Special Needs Trust for the plaintiff? Not necessarily.

As discussed above, a qualified annuity under I.R.C. § 130 must be purchased directly by a party to the case with liability to the plaintiff. The plaintiff cannot even have the *option* of receiving an annuity or a lump sum payment without having constructive receipt of the settlement funds and running afoul of I.R.C. § 130. In other words, any

annuity that would be used to fund a Special Needs Trust in the context of a PI settlement is purchased with assets of the party with liability to the plaintiff, and not with assets that could be considered “available” to the plaintiff/Medicaid recipient. Finally, the annuity would not be purchased with *assets of an annuitant who has applied for Medicaid*, since the Special Needs Trust would be the annuitant.

The DRA’s restrictions on the purchase of deferred or balloon annuities only apply to purchases of annuities with assets of an annuitant who has applied for Medicaid. Further, the DRA does not apply to SSI. Therefore, the DRA annuity provisions should not affect the ability to fund Medicaid or SSI Special Needs Trusts with I.R.C. § 130 deferred or balloon annuities as part of a PI settlement. In fact, the DRA annuity provisions arguably would not be applicable to this situation at all; thus, it should not be necessary for the I.R.C. § 130 annuity funding a Special Needs Trust to be actuarially sound or to name the state as remainder beneficiary.

B. Use of Annuities to Fund SSI and Medicaid Special Needs Trusts

SSI and Medicaid do not prohibit the use of either deferred or balloon annuities to fund exempt Special Needs Trusts if the annuities comply with I.R.C. § 130. If the plaintiff expects to incur future medical expenses on a fairly regular basis, an immediate annuity can be used to provide the necessary funding over time. If large expenses are expected periodically in the future, a deferred or balloon annuity may be appropriate as well. However, all annuity payments into an exempt Special Needs Trust must be completed before the plaintiff reaches age 65.^[64] Further, the Special Needs Trust should also be funded initially with a lump sum sufficient to provide immediate liquid funds for unexpected costs, the annuity payments should be large enough to ensure that funds in the trust will not be exhausted before the next payment date, and payments should be indexed to keep pace with inflation.

C. Naming the Trust as the Annuitant

Since both SSI and Medicaid eligibility are based partly upon the individual’s level of income, a structured annuity that makes periodic payments directly to the beneficiary

could prevent the individual from qualifying for those benefits for the lifetime of the annuity. Further, if the annuity is the subject of a qualified assignment, the individual will not be able to unilaterally amend the annuity at a later time to redirect payments into a Medicaid or SSI exempt trust.

Since there will virtually always be a qualified assignment of any annuities used to structure any PI settlement, careful planning is required to preserve the plaintiff's ability to qualify for Medicaid or SSI. In these cases, the annuity generally should not be set up with the individual plaintiff as payee. Rather, the annuity should pay out to the exempt Special Needs Trust.

V. CONCLUSION

Defendants, liability carriers and their structured settlement brokers have historically argued that QSFs cannot be used in single-plaintiff PI structured settlements involving qualified assignment. This argument, based on the theory that the economic benefit doctrine somehow bars the plaintiff from taking advantage of the favorable tax treatment in I.R.C. § 130, is not persuasive. It is based solely on a common law doctrine that has been superseded in this context by federal statutes and regulations; and upon a private letter ruling that is not on point.

An in-depth analysis of I.R.C. § 130 and its legislative history, I.R.C. § 468B and the corresponding IRS regulations, and Rev. Proc. 93-34 all support and lead to the opposite conclusion: the economic benefit doctrine is not applicable to the use of qualified assignments in PI settlements. The IRS' own interpretation of the law on this issue is in agreement.

The IRS has not said whether its stated position in this regard might somehow depend on the number of plaintiffs involved. Of course, it is possible that the IRS could draw a distinction and treat the economic benefit doctrine as a bar to use of qualified assignments by QSFs in single-plaintiff settlements only. However, this seems like a remote possibility at best.

There is simply no cogent basis in the Internal Revenue Code, the IRS regulations and procedures, or in the IRS' own previously stated interpretations of the law to support such a distinction. It is far more likely that the IRS will remain consistent and adopt the position that QSFs may successfully make qualified assignments in PI settlements regardless of the number of plaintiffs, so long as there is compliance with the requirements of I.R.C. § 130, I.R.C. § 468B; Treas. Reg. §§ 1.468B-1 through 1.468B-5; and Rev. Proc. 93-34.

Use of a QSF to purchase an I.R.C. § 130 qualified annuity to fund the exempt Special Needs Trust is a natural fit when a settling plaintiff seeks the most advantageous tax treatment of his or her settlement proceeds, needs to preserve SSI and/or Medicaid eligibility, and requires time to create an exempt Special Needs Trust without delaying the finalization of the settlement,. This process provides the necessary flexibility, while allowing the plaintiff to receive the maximum benefit from the settlement. However, the rules here are complex and the interplay of the various applicable statutes and regulations requires special care and knowledge. Finally, the circumstances in every settlement are unique. Practitioners are cautioned never to use a form QSF or Special Needs Trust, but rather to prepare the necessary documentation in a manner that is specific to the individual needs of each plaintiff in the context of this or her own settlement.

END NOTES

[1]. 26 U.S.C. § 104(a)(2) (2008) provides that gross income does not include “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal physical injuries or physical sickness.” 26 U.S.C. § 104(a)(1) (2008) excludes from gross income amounts received under workers’ compensation acts “for personal injuries or sickness.”

[2]. “Tort damages have traditionally been paid on a lump-sum basis.” Adam F. Scales, *Against Settlement Factoring? The Market in Tort Claims Has Arrived*, 2002 Wisc. Law Rev. 859, 862 (2002).

[3]. See Rev. Rul. 65-29, 1965-1 C.B. 59 (1965).

[4]. These concerns are described by Senator Max Baucus, one of the original sponsors of the Periodic Payment Act, at 144 Cong. Rec. S11499-01, (available at 1998 WL 684078).

[5]. Pub. L. No. 97-473, 96 Stat. 2605 (1982).

[6]. “Despite several revenue rulings that indicate that the Internal Revenue Service considers that periodic payments as personal injury damages are excludable from the gross income of the recipient, the committee believes it would be helpful to taxpayers to provide statutory certainty in the area.” S. Rep. 97-646, 97th Cong. 2d. Sess. 1982, 1982 U.S.C.C.A.N. 4580, 4583.

[7]. Pub. L. No. 97-473, § 101, 96 Stat. 2605 (1982).

[8]. 26 U.S.C. § 130 (1997). “Typically, the assignee is an affiliate of an insurance company, and its only business is to accept for a fee qualified assignments of liabilities to make periodic payments to tort claimants.” *Letter from Skadden Arps lawyers to Pamela Olson, Assistant Secretary (Tax Policy)* (requesting I.R.S. clarification on whether an assignment by a qualified settlement fund is a “qualified assignment”) (June 19, 2003), (available at 2003 WL 22662008) (I.R.S. Misc.) (hereinafter “Skadden Arps Letter”).

[9]. This annuity is referred to in I.R.C. § 130 as the “qualified funding asset.” 26 U.S.C. § 130(d) (1997).

[10]. *Id.*

[11]. 26 U.S.C. § 130(c)(1) (1997).

[12]. *See generally* Richard B. Risk, Jr., *A Case for the Urgent Need to Clarify Tax Treatment for a Qualified Settlement Fund Created for a Single Claimant*, 23 VA Tax Rev. 639, 642-44 (2004) (describing these concerns in detail).

[13]. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[14]. 26 U.S.C. § 468B (2008).

[15]. DSFs may be used to settle PI claims, but may not be used to settle workers' compensation claims. 26 U.S.C. § 468B(e) (2008).

[16]. 26 U.S.C. § 468B(d)(2) (2008).

[17]. 26 C.F.R. §§ 1.468B-1-1.468B-5 (2008).

[18]. A QSF, like a DSF, may be used to settle a PI claim, but not a workers' compensation claim. 26 C.F.R. § 1.468B-1(g)(1) (2008).

- [19]. 26 C.F.R. § 1.468B-1(c) (2008) (emphasis added).
- [20]. *U. S. v. Brown*, 348 F.3d 1200, 1217 (10th Cir. 2003).
- [21]. 26 U.S.C. § 468B(b) (2008) and 26 C.F.R. § 1.468B-2(a) (2008).
- [22]. 26 C.F.R. § 1.468B-2(a) (2008).
- [23]. 26 C.F.R. § 1.468B-1(c)(2) (2008).
- [24]. However, the I.R.C. and the Treasury Secretary have as yet refused to clarify the validity of this use of QSFs. *See Risk, supra* n. 11 at 673-82. *See also* Skadden Arps Letter, *supra* n. 6.
- [25]. 26 U.S.C. § 130 (1997).
- [26]. 26 U.S.C. § 130(a) (1997).
- [27]. 26 U.S.C. § 130(d) (1997).
- [28]. Rev. Rul. 79-313, 1979-2 C.B. 75 (1979).
- [29]. Rev. Rul. 65-29, 1965-1 C.B. 59 (1965); Rev. Rul. 76-133, 1976-1 C.B. 34 (1976).
- [30]. *Sproull v. Commr.*, 16 T.C. 244 (1950), *aff'd*, 194 F.2d 541 (6th Cir. 1952).
- [31]. *Id.* at 247-248.
- [32]. *Id.*
- [33]. 26 U.S.C. § 130(c)(2)(D) (1997).
- [34]. P.L.R. 200138006 (May 7, 2001).
- [35]. The settlement discussed in this Private Letter Ruling was the settlement of a malpractice lawsuit against a law firm.
- [36]. 26 U.S.C. § 130(c)(2)(C) (1982).
- [37]. S. Rep. No. 97-646; H.R. Rep. No. 97-832, 97th Cong., 2d Sess. 4 (1982) (emphasis added).
- [38]. Pub. L. 100-647, 102 Stat. 3342, Title VII, § 6079(b)(1).
- [39]. H.R. Rep. No. 100-795, at 541 (1988).

[40]. I.R.C. § 130(c) (emphasis added).

[41]. H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. at II-171(1988).

[42]. 16 T.C. 244 (1950), *aff'd*, 194 F.2d 541 (6th Cir. 1952).

[43]. To prevent constructive receipt, the settlement terms will not permit the plaintiff the option to receive the settlement in a lump sum, and will provide that the assignment will be made directly by the defendant or the defendant's insurance carrier.

[44]. P.L.R. 9703038 (Jan. 17, 1997).

[45]. 26 U.S.C. § 130(c) (1997).

[46]. Rev. Proc. 93-34, 1993-28 C.B. 49 (1993).

[47]. Rev. Proc. 93-34, § 1.

[48]. Rev. Proc. 93-34, § 4 (emphasis added).

[49]. *Id.*

[50]. A “novation” is a “mutual agreement among all parties concerned for the discharge of a valid existing obligation by the substitution of a new valid obligation on the part of the debtor or another, or a like agreement for the discharge of a debtor to its creditor by the substitution of a new creditor.” 58 Am. Jur. 2d *Novation*, § 1 (2008).

[51]. 42 U.S.C. § 1396p(d)(4)(A) (2008); 42 U.S.C. § 1382b(e)(5) (2008).

[52]. Pub. L. No. 103-66, 107 Stat. 312 (1993).

[53]. 42 U.S.C.A. § 1396p(d)(4)(A) (1984).

[54]. Foster Care Indep. Act of 1999, Pub. L. 106-169, 113 Stat. 1822.

[55]. 42 U.S.C.A. § 1382b(e)(5) (1984).

[56]. Social Security Online, POMS SI 01120.203,
<https://secure.ssa.gov/apps10/poms.nsf/lnx/0501120203!opendocument> (accessed Feb. 18, 2008).

[57]. Examples of Prohibited Expenses and Payments include: “Payments of debts owed to third parties; Funeral expenses; and Payments to residual beneficiaries.” Social Security Online, POMS SI 01120.203.B.3(b),
<https://secure.ssa.gov/apps10/poms.nsf/lnx/0501120203!opendocument> (accessed April 18, 2008).

[58]. *Id.* at POMS SI 01120.203.B.1(e).

[59]. There are 39 SSI states, consisting of 32 “§1634 states”: Alabama, Arizona, Arkansas, California, Colorado, Delaware, Georgia, Florida, Kentucky, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Montana, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, Washington, West Virginia, Wisconsin, Wyoming and Washington D.C.; and 7 “SSI criteria states”: Alaska, Idaho, Kansas, Nebraska, Nevada, Oregon and Utah. The “§ 1634 states” have entered into an agreement, as authorized by §1634 of the Social Security Act, 42 U.S.C. § 1383c, that the Social Security Administration will determine Medicaid eligibility. The “SSI criteria states” make their own Medicaid determinations, using the SSI criteria. Social Security Online, POMS SI 01120.203.B.3(b), POMS SI 01715.010, <https://secure.ssa.gov/apps10/poms.nsf/lnx/0501715010!opendocument> (accessed Feb. 18, 2008). *See generally* John J. Campbell, *Basic Strategies for SSI Planning*, 1 NAELA Q. 311, 321 (Fall 2005).

[60]. *Ramey v. Rizzuto*, 72 F. Supp.2d 1202 (D.C. Colo. 1999), *aff'd*, *Ramey v. Reinertson*, 268 F.3d 955 (10th Cir. 2001).

[61]. 268 F.3d at 962, *citing Herwig v. Ray*, 455 U.S. 265, 268, 102 S.Ct. 1059, 1063 (1982).

[62]. Pub. L. No. 109-171, 120 Stat. 4 (2005).

[63]. Pub. L. No. 109-171, § 6012(b) & (c), amending 42 U.S.C. § 1396p(c)(1)(F) & (G).

[64]. 42 U.S.C. § 1396p(d)(4)(A) (2008).

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**The State of Colorado does not certify attorneys as experts in any field.*

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