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Structured Settlement Annuities and Special Needs Trusts

by Carol S. Battaglia

This article discusses the use of structured settlement annuities and Special Needs Trusts as means of managing settlement or judgment funds from personal injury actions. Traditionally, the single recovery rule required that all damages for an injury must be recovered in a single action. In situations in which a settlement was reached between the parties outside of trial, alternative arrangements began to arise involving periodic payment of funds. Several tax issues made these early periodic payment settlement agreements problematic. See, Daniel W. Hindert et al., Structured Settlements and Periodic Payments, § 1-7 (2007).

In 1982, Congress passed the Periodic Payment Act ("PPA") which provided statutory certainty to the tax issues arising from periodic payments in physical injury settlements. See, Pub. L. No. 97-473, 96 Stat. 2605 (1982). As a result, payments received by a claimant in a personal injury case, whether received as a lump sum or as periodic payments, would be free from federal income tax assuming specific requirements are met. See, Internal Revenue Code §104(a)(2). Furthermore, a defendant could now assign his or her liability to a third party assignee without tax consequences. Subsequently, the next two decades saw an increase in the use of structured settlements, but something was needed to help safeguard the annuitant's eligibility for government benefits.

The Omnibus Budget Reconciliation Act of 1993 ("OBRA-93") addressed this issue by specifically providing that settlement and award monies held in properly created Special Needs Trusts would not cause loss of eligibility for Supplemental Security Income ("SSI"), Medicaid, or other government benefits. See, 42 USC 1396p(d)(4)(A). Another significant part of OBRA-93 is the "payback provision" which requires that, immediately upon the beneficiary's death, Medicaid be reimbursed for funds spent on the beneficiary. In fact, Special Needs Trusts drafted after August 11, 1993, must contain a "payback provision" in order to be valid.

Advantages of Special Needs Trusts

Structured settlement annuities and Special Needs Trusts can both satisfy many of the basic needs of a beneficiary; however, the flexibility of a Special Needs Trust does provide some advantages in certain cases

Stream of Income Over Time

During the course of a personal injury law suit a life care plan is often created. This plan will attempt to assess as accurately as possible the funds that will be needed to support the beneficiary for the rest of his or her lifetime. Insurance companies will use the dollar amount that has been predicted to structure a payment plan for the annuitant's life. The amount of the payments may be steady or may be set to adjust at certain times, so while there is clearly some flexibility in the set-up of a structured settlement, the schedule generally cannot be changed once set in motion.

When a Special Needs Trust is utilized, there is more flexibility. The trustee can reevaluate the beneficiary's needs annually and make adjustments for additional expenditures if needed or for retention and investment of currently unneeded funds. In addition, the trustee of a Special Needs Trust may approve expenditures for unusual or infrequent purchases.

Investment Guidance

In the event that there are excess monthly funds in a structured settlement, an annuitant will likely need professional help in order to manage and invest those funds appropriately. Under the guidance of the Uniform Prudent Investor Act ("UPIA"), within a Special Needs Trust, the trust's investment manager can invest any excess funds so as to maximize the beneficiary's benefits. The UPIA follows the modern portfolio theory and provides that a fiduciary's primary concern should be balancing the tradeoff between risk and return, and that diversification so as to reduce the risk is a required duty. See, UPIA §2, Standard of Care; Portfolio Strategy; Risk and Return Objectives and UPIA Section 3. Diversification (1992). A Special Needs Trust usually needs to be funded with approximately $300,000 or more in order to justify the services of an investment manager.

Preventing Funds from Being Spent All at Once

To a certain extent, both structured settlement annuities and Special Needs Trusts protect against funds being spent too quickly by making payments monthly rather than paying out a lump sum up front. However, within a month an annuitant is still able to immediately spend all of the funds he or she receives thus potentially ending up short of funds before the next payment. There are more protections available through a Special Needs Trust, since the trustee has the discretion to make an annual budget which will protect most of the funds while retaining the ability to make supplemental distributions as the need arises.

Tax Concerns

Income earned by investments made with funds held in a Special Needs Trust is subject to federal income tax. Typically, such income will be taxed at a relatively low tax rate due to the fact that such trusts are usually grantor trusts, meaning that the beneficiary's tax rate will apply. Beneficiaries who receive public benefits are usually in the lowest tax bracket so they will pay little or no income taxes. If taxes are owed, then the Special Needs Trust can pay them.

Beyond the Basics

There are certain situations in which an injured party might need additional protection and/or flexibility that is not offered by an annuity alone. Factors to consider in determining whether an individual's needs might be better by use of a Special Needs Trusts are discussed below.

<u>Protection of Certain Public Benefits</u>

A crucial consideration for an individual receiving a settlement is that the settlement not make him or her ineligible for needs-based public benefits such as SSI, Medicaid (Medi-Cal) and Regional Center. Receipt of direct payments from an annuity could cause ineligibility, whereas benefits may be protected if an annuity and other investments are held within a Special Needs Trust.

<u>Inheritance for Heirs</u>

It may also be important to an injured party to have the opportunity to leave any funds remaining upon death to the heirs. Payments under an annuity may be limited to the term of the annuitant's life, so there may be no possibility of leaving money to heirs. In contrast, funds remaining in a Special Needs Trust may be left to heirs, subject to federal laws requiring that funds first be used to reimburse Medicaid for monies spent on the beneficiary during his or her lifetime.

<u>Insurance Company Failure</u>

One other factor to consider is that it is possible for an insurance carrier that is providing all of the annuities within a structured settlement to fail. While this is not commonplace, it creates a risk of total loss to the injured party if all of the annuities in a structured settlement are provided by one company.

<u>Use of an Annuity With an Investment Portfolio</u>

A good option for individuals who want regular payments but also want the opportunity to grow their income is to combine an investment portfolio with an annuity. Investments would be made with funds received in an initial lump sum payment to a Special Needs Trust; a structured settlement annuity, which would be payable to the Special Needs Trust, could also be created. Combining these vehicles would allow beneficiaries to receive regular monthly payments from the annuity while also providing the potential through the managed investment portfolio to increase their quality of life and have funds available for unexpected changes to their condition.

Conclusion

When determining how to invest proceeds from a personal injury settlement, both the current and future needs of the injured party should be considered. In many cases, either a structured settlement annuity or a Special Needs Trust will meet those needs, especially as compared to receiving a single lump sum payout. When greater flexibility, protection, and investment opportunities are desired, a Special Needs Trust, either alone or combined with a structured settlement annuity, may be the best solution.