Taxable damage awards and the use of structured settlements

Structured settlements can reduce the tax burden by distributing the taxable income over a period of years

BY DAN FINN

Although the vast majority of Americans will not be dramatically impacted by the passage of California's Proposition 30 or the American Taxpayer Relief Act of 2012 (ATRA), two particularly unique groups of taxpayers most certainly will: Californians receiving taxable damage awards or settlements stand to be disproportionately and adversely affected by recent changes to the income tax rates. The same holds true for their contingency-fee lawyers, who often earn their incomes unevenly.

Consider:

• The top Federal Income Tax Rate recently increased from 35 percent to 39.6 percent – *a 13.1 percent tax hike.*

• The California State Income Tax Rate, including the one percent Proposition 63 Mental Health Services Act tax for incomes over $1 million and the recently passed "temporary" Proposition 30 tax increase, increased at the high end from 10.3 percent to 13.3 percent – *a 29.1 percent tax hike.*

Combined, top California taxpayers now send about *fifty-three cents of every dollar* earned over this threshold to the United States Treasury or Franchise Tax Board, earning California the dubious distinction of having the highest marginal tax rate in the country.

This doesn't even take into account the new 3.8 percent Section 1411 Medicare Surtax on certain income, the Alternative Minimum Tax (AMT) modifications and phase-outs, changes to capital gains income, etc., all of which combine to create an even greater sense of financial urgency for some.

History will ultimately pass judgment on the wisdom of these new tax laws, but when applied to an individual award or settlement the unintended disparity caused by their passage becomes abundantly clear.

The challenge of cash awards

Whether for punitive damages, bad faith, wrongful termination, discrimination, defamation or any one of a variety of taxable damage possibilities, the new tax rates present a major challenge for attorneys negotiating settlements and trying cases.

For starters, many gross cash settlements will need to be larger going forward in order for attorneys to net their clients the same amount of money they may have achieved for them in years past.

This could serve as an impediment to settlement talks since an otherwise agreeable gross settlement figure might be rejected once the plaintiff determines the net recovery will not yield enough money, after taxes, to render settlement viable.

As a result, an otherwise resolvable dispute might be forced to trial, further straining the state's already financially challenged civil justice system.

In addition, a settlement or judgment intended to compensate the plaintiff for loss extending into the future, often for a lifetime, may never come to fruition when paid in cash. That's because a large, one-time payment can create tax inequity by forcing the taxpayer into a "millionaire" tax bracket one year, only to be followed by normal tax status in subsequent years.

This extraordinary tax burden in a single year, instead of a more reasonable tax obligation spread out over time, seems an unfair and unintended consequence of the new tax laws since tax parity cannot be easily accomplished.

Fortunately, there is a solution.

Non-physical injury structured settlements

Before finalizing any negotiated settlement or concluding any judgment, the parties should explore the possibility of arranging for a portion of the settlement, or the attorney's fee, to be paid over time utilizing what's commonly called a taxable or non-physical injury structured settlement.

Unlike traditional structured settlements, which pay future periodic payments, principal and interest, on a 100 percent income tax-free basis when properly implemented and paid on account of personal, physical injury, taxable structured settlements for non-physical injury claims are fully taxable.

However, because the payments are made over time, cash flows can often be coordinated so they are received in a future year when the recipient's anticipated tax bracket will be more reasonable.

In addition to being consistent with acceptable tax planning strategies as old

as the Tax Code itself, this serves the dual purpose of ensuring the settlement proceeds fulfill their intended purpose – properly compensating the plaintiff for a loss – and fairly satisfying one's tax obligations.

A thorough discussion about the tax implications of various settlement options also helps insulate the plaintiff attorney from any potential legal malpractice challenge which could arise absent such a conversation.

Since very few financial advisors are familiar with the unique sub-specialty of taxable structured settlements and structured attorney fees, it is vital that practitioners seek out an experienced, credentialed individual familiar with implementing them. They should further encourage their clients to seek out independent tax counsel who can work in tandem with this chosen expert.

Case study

Fifty-one-year-old Emma Gudwerkur's boss called her into the office one day to tell her that she was being let go from her job as a marketing representative because she was getting "a little long in the tooth," and the company needed to make way for someone who projected "a more youthful exuberance." He praised her for her many years of dedicated service as one of the company's top performers and wished her all the best for the future.

Not surprisingly, a wrongful termination and age discrimination lawsuit ensued and the parties eventually commenced settlement negotiations.

At mediation a few weeks before trial, Ms. Gudwerkur was offered a package to settle her claim that would net her approximately $1million in cash. Because of the nature of her claim, the entire amount would be taxable.

Since her firing, Emma and her husband had been living on $75,000 – about half of the couple's customary income. While this results in a very manageable 17.6 percent combined federal and state average tax bracket for the couple, they find it ever harder to maintain their customary standard of living with Emma's loss of income.

By contrast, because of the progressive nature of our nation's tax system, her $1million cash settlement would end up being taxed at 46.7 percent, – more than two-and-a-half times the couple's current tax rate – for one year only. The following year, their tax rate would revert back to a more normal range in the low-to-mid-twenties.

Since nearly half of her proposed settlement ($467,000) will be owed in taxes this year, she rejects the cash offer.

Seeking an alternative arrangement, the parties consult with a taxable structured settlement expert who is able to show that Ms. Gudwerkur, for the same $1 million cost to the defense, could receive a payout of $70,000 per year, her customary salary, over the next 17 years. In addition to spreading out her tax burden, this arrangement adds $190,000 in pre-tax interest to her original offer.

While the total payout of $1.19 million (19 percent more than the cash offer albeit paid over time) is part of the appeal, because her anticipated combined tax bracket will be much lower over that span, the couple's average tax bracket drops from 44.7 percent to a far more reasonable 25.4 percent in the year of settlement where they expect it to remain.

The structured arrangement reduces her total tax liability over time to only $403,000 saving her a minimum of $64,000. Her CPA points out the clear advantage of paying total taxes of $403,000 over 17 years versus $467,000 in year one and enthusiastically recommends she structure her settlement.

Perhaps even more important than the superior tax advantage, structuring fills the void left by the termination and allows her to resume her customary lifestyle for the remainder of her normal working life expectancy.

While this hypothetical scenario is predicated on tax brackets and income levels remaining constant over time – far from a sure thing – it demonstrates the value of finding tax-friendlier, needs-based solutions to settlement challenges on taxable damage claims.

In practice, each case is unique and readers should not rely solely on the figures used in this case study. Instead, a thorough analysis is in order before making any decisions as tax laws can be complex.

Conclusion

Large cash settlements and judgments can undermine the entire settlement process by disproportionately and adversely affecting the very individuals the settlements are designed to help in the first place. Since many taxable damage plaintiffs never were and never will be the high-wage earners originally targeted by Proposition 30 and ATRA, they shouldn't be taxed as if they were.

Instead, by implementing a carefully crafted, non-physical injury structured settlement, tax fairness can be restored, leaving litigants and their counsel with a better chance of resolving their disputes pre-trial.

There will always be many valid reasons for passing up opportunities to structure taxable settlements, awards or attorney fees. But for those who qualify and are able to take advantage of this unique planning strategy, the benefits should be fully explored.


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