Best's Insurance Law Podcast

Understanding Nonphysical Injury Structured Settlements - Episode #123

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John Czuba: Welcome to the "Insurance Law Podcast", the broadcast about timely and important legal issues affecting the insurance industry. I'm John Czuba, Managing Editor of *Best's Recommended Insurance Attorneys and Adjusters, including Expert Service Providers*.

We're pleased to have with us today Dan Finn, the owner of Finn Financial Group, a structured settlement and specialty income planning firm based in Newport Beach, California.

Dan has a Master's Certificate in Structured Settlement Consulting. He's a past president of the National Structured Settlements Trade Association, has his CPC Designation, and is also a Retirement Income Certified Professional.

Dan, we're very pleased to have you with us today.

Dan Finn: Thanks, John.

John: Today, we're going to be discussing Dan's recent article that was published for the claims industry entitled, "Understanding Nonphysical Injury Structured Settlements. Why this under-used claims resolution technique deserves a fresh look."

Dan, let me begin with this question today. Can you define for us a nonphysical injury and how does a structured settlement for this type of claim differ from a traditional structured settlement?

Dan: I'd be happy to, John. A nonphysical injury structured settlement would be one that doesn't qualify for the preferential tax treatment afforded by the Internal Revenue Code under Section 104(a)(2), which is the basis of the structured settlements industry when it originated.

Mechanically, nonphysical injury structured settlements and traditional physical injury structured settlements work almost identically, but the tax treatment of the cash flows is where the difference comes into play.

Traditional structured settlements have cash flows that are one hundred percent income-tax free whereas nonphysical injury structured settlements pay cash flows that are one hundred percent taxable with taxes due in the year of receipt of the funds.

John: Now, Dan, your article actually gives an excellent summation of the history of structural settlements. It references some ambiguity in the original structured settlement laws that require the industry to modify its approach to handling claims involving nonphysical injuries. Can you tell us a little bit about that?

Dan: Sure. It was an unintentional ambiguity, I should add, that the law originated the way it did. When structured settlements first came into existence in the '70s they were used with the intent of resolving medical malpractice claims, products liability cases, etc. all of which involved obvious physical injuries.

When people talked about personal injuries, it was assumed this referred to personal physical injuries, so there was no obvious need to add the word physical. Well, along the way, as you might expect, once you create a tax code section that gives preferential tax treatment to certain types of cases, every practitioner tries then to have every type of case that they file included under the tax-free laws.

We started seeing then employment disputes, which typically don't have a physical component, filed with the expectation that damages would be treated as tax free cash flows when that wasn't what the original law intended.

In the mid '90s, the Small Job Protection Act of 1996 culminated in putting an end to that ambiguity. They then added the word "physical" to the code to make sure that any claim that was going to receive tax-free treatment had to have a physical component and anything else was going to be taxable.

That left all doubt behind us. The good news about this law was that it did create the need for a nonphysical injury structured settlement option, which is when usage of this option began.

John: Dan, some types of physical injuries are obvious like a broken arm, cuts and abrasions, or dislocations, but what about something like emotional distress? Can this be considered a physical injury?

Dan: Emotional stress is a perfect one to talk about because emotional distress can be part of a physical injury, but it depends on the origin of the claim. When I mentioned the Small Job Protection Act of 1996, the framers of that act actually went out of their way to make clear that emotional distress, on its own, is not automatically tax free. It is a taxable event when arising from a nonphysical injury tort.

Going back to the wrongful termination lawsuits, a person is fired from their job and that action causes them emotional distress. The way the law is written today, that emotional distress is considered fully taxable, except to the degree that there are any medical expenses not previously deducted.

On the other hand, if you have a car accident that leads to a broken arm, cuts or abrasions that you mentioned, and then that leads to ensuing emotional distress, then the emotional distress is considered one hundred percent income tax free because it originated from a physical injury.

It's like a chicken and the egg, which came first? You have to determine which comes first, the physical act that causes emotional distress or nonphysical act that leads to emotional distress which causes physical symptoms.

John: Dan, you described nonphysical injury structured settlements as an under-used claims resolution technique. Can you comment on why you believe this is an option that isn't more widely considered?

Dan: It's probably the way this originated, to be honest. Most of the practitioners in the structured settlement world and in the claims departments and the plaintiff bar understand that structured settlements for tax-free claims, the physical injury claims, are used regularly. Every top firm, plaintiff attorney firm, I know uses them regularly as do most every insurance carrier that's out there.

But they don't usually think of them on these types of cases, probably because it's still relatively new. We're only 20 years into it. It doesn't seem like it's new, but it's because that distinction was only made 20 years ago and I guess we haven't caught up to it yet. We've got to do a better job of educating everybody that this is a possibility and something that should be explored.

John: Dan, do you feel the value of nonphysical injury structured settlement is easier or harder to quantify than that of a traditional structured settlement?

Dan: It's much easier. Tax-free money that is paid in cash is fantastic. Tax-free money that is paid in a structured settlement is fantastic as well. What's not to like about it? It's guaranteed money, tax free, safe and secure over time, but cash isn't always a terrible option, if you can take one hundred percent of your cash and have it paid tax free.

But a taxable settlement, particularly on larger settlements are different. You now have an individual who , let's say, falls into a normal tax bracket of 20 to 30 some percent and now they get a large cash taxable lump sum that might be taxed at 40, 45, even 55 percent or more in one year only.

The following year, they go back to their normal tax bracket. It's easier to quantify by saying, "What if we spread this cash out over a number of years and, instead of paying a big lump sum and being taxed like a millionaire in one year, let's spread this lump sum out over a number of years and stay in a normal tax bracket?"

Those are savings that then go to the individual instead of going unnecessarily to the IRS. By the way, the IRS isn't against this type of thing. They have all types of laws in place that promote tax avoidance which is very legal and a very sensible strategy that many of us use when we contribute to our 401(k)s and similar retirement plans.

Nonphysical injury structured settlements are designed to put more parity into a transaction that could otherwise be considered unfair.

John: Dan, is it accurate to say nonphysical injury structured settlement negotiations could result in fairer outcomes all the way around for both parties trying to resolve a claims dispute?

Dan: Absolutely. Let's go back to the wrongful termination case. If you've got an individual who is used to earning an income and they pay taxes as they earn the income, they file a lawsuit. Let's say that the jury determines that the defendant is guilty of wrongful termination.

Now, all of a sudden, they're going to pay this individual one time, instead of the income that they would have received over the rest of their working life at a normal tax bracket. Now they're going to be taxed inappropriately in that one year instead of having it spread out evenly, which would seem fairer.

From the defendant’s perspective, it is fair because now you’re trying to resolve a conflict or dispute and pay an individual according to what the intent of the settlement was meant to resolve anyway. Paying damages over time instead of all at once is more consistent with what the basis of the lawsuit usually was originally.

John: Dan, thank you so much for joining us today.

Dan: My pleasure. Thanks, John.

John: That was Dan Finn, owner of Finn Financial Group in Newport Beach, California. Special thanks to today’s producer, Frank Vowinkel.

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I’m John Czuba, and now this message.

Transcription by CastingWords

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