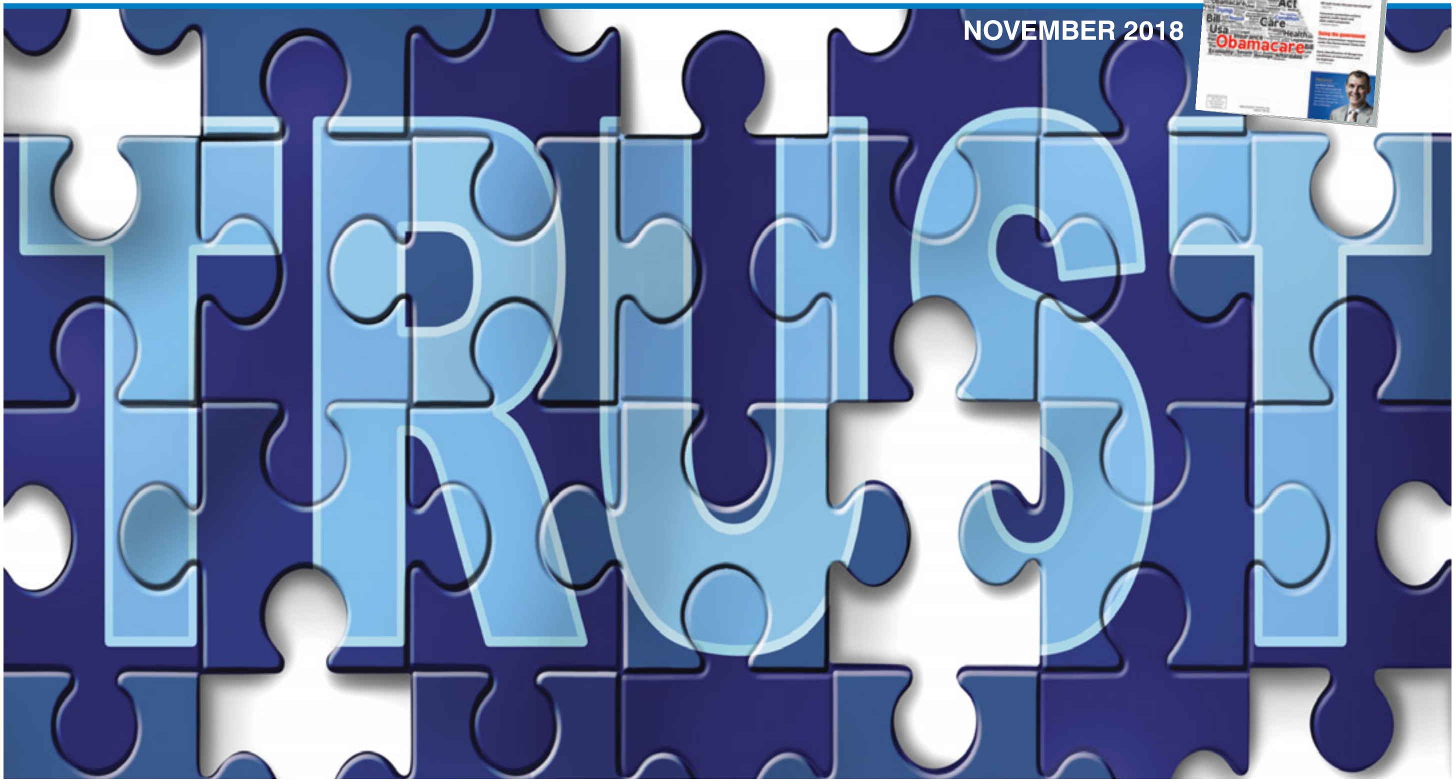

Are you too trusting?

All-cash trusts are speculative puzzles with missing pieces. Blending structured settlements with trusts can lower costs and mitigate risk

By Dan Finn

Congress enacted laws in 1982 to encourage the use of structured settlements which permit injured parties to arrange for their settlement funds to be paid out over time to help better meet their anticipated future needs. If properly implemented in accordance with section 104(a)(2) of the Internal Revenue Code, all cash flows, principal and any accumulated interest, are paid out 100 percent income tax-free provided the settlement represents compensation for a *physical* injury or *physical* illness.

Funds stemming from personal, *non-physical* injury litigation can still be structured; however, settlement proceeds from these types of conflicts, principal and interest, are fully taxable. Implementing taxable structured settlements still allows plaintiffs to more efficiently satisfy their tax obligation on these types of lawsuits, however, and should be explored.

Structured settlements have been used successfully to help resolve hundreds of thousands of lawsuits since their inception decades ago and are favored by many judges and numerous disability advocacy groups. While their tax-preferred nature and zero out-of-pocket cost makes them an ideal choice for those seeking secure, guaranteed income, they do present some flexibility challenges since terms cannot be modified once established.

Trusts

When the plaintiff needs or desires to have settlement proceeds overseen by a third-party fiduciary, a trust might be established to preserve rights to public benefits or to further the goal of conserving funds and protecting the individual from others. These trusts fall into two general categories and may go by varying names:

Special Needs Trusts (SNT): Also called Supplemental Needs Trusts, these vehicles are useful for individuals with qualifying disabilities who may need access to care and support beyond what they might otherwise be able to afford on their own given the needs-based limitations on government benefits to which they may be entitled;

Non-SNT Grantor Trusts: This is the general, catch-all description of a type of trust designed to accomplish several objectives and may go by varying trademarked names emphasizing settlement preservation, support for minors and such. In addition to permitting a professional fiduciary to make investment recommendations and decisions, these

trusts can be useful to those who need or prefer their financial affairs managed by someone more experienced in doing so. With built-in spendthrift protection, it also places a gatekeeper between the trust beneficiary and predatory friends, relatives and companies seeking to separate them from their sudden money.

In addition to the cost of establishing the trust itself, the beneficiary can expect to see their corpus reduced by ongoing management fees, expenses and taxes, not to mention any diminution in value of assets under management when they occur. Ideally, costs will be offset by the increase in value of the trust assets which hopefully grow over time. A predictable outcome is far from guaranteed, however.

Structure + Trust = Best of both worlds

When combined, these dual instruments offer incomparable advantages neither can accomplish independent of the other. While not every case is well suited for either or both, an optimal outcome can usually be expected when the two are used in concert with each other, especially on higher dollar cases.

By establishing the trust with cash sufficient to meet immediate and shorter-term needs plus achieve any speculative future goals, the structured settlement can be created to pour into the trust, providing steady tax-free cash flow (in physical injury cases) to help more efficiently meet the continuing needs of the beneficiary – nursing care, prescriptions, transportation costs, rent, mortgage payments, housekeeping services, utilities, insurance premiums, property taxes, and the like.

For the same reason manufacturing companies sometimes use what's called a "just-in-time" (JIT) inventory strategy to reduce waste and lower inventory costs by scheduling raw material arrivals to coincide with production schedules, the structured settlement is designed to pay into the trust at the time it's most likely to be needed. This JIT approach minimizes the trust management fees and taxes significantly. By timing the influx of funds from the structure to meet expected ongoing needs when they arise, this JIT approach has the added benefit of helping the trustee meet its security income obligation to the trust more efficiently.

According to Christi Fried of Continental Trust Services, LLC in Boston, "Structured settlements are extremely valuable due to the lifetime tax-free income they provide, the rated age underwriting advantage and the commutation riders. I like them feeding a trust because they act like a bond investment guaranteeing income we can rely on to budget expenses."

Fried goes on to extol their benefits as a hedge against undesirable market outcomes. "We want structured settlements to protect the trust funds against sequence-of-returns risk, the worst-case scenario of negative returns. Having a guaranteed stream of deposits helps offset losses during market downturns, provides cash for continuing growth and allows for dollar cost averaging."

One academic research paper concluded that a life insurer's superior ability to manage mortality risk across large numbers of people enables them to provide guaranteed, secure lifetime income for "25 percent to 40 percent less money than can be achieved using traditional means." ("Rational Decumulation," Babell & Merrill, Wharton Financial Institutions Center Working Paper No. 06-14, July 2006). Coupled with the tax-free nature of the structured settlement, the annuity advantage becomes even more pronounced.

Tax consequences

Structured settlements can improve the trustees' ability to lower taxes as well. According to Fried, "Taxes for a trust are very individualized and we're pretty successful in lowering them or eliminating them altogether since they can be offset by expenses. The structured settlement helps here because it is purchased outside the trust corpus and pays benefits with no tax consequences. This is a big advantage for the client."

Will Lindahl, Executive Director of CPT Institute in San Marcos, California adds his perspective as one who manages a pooled trust. "All Special Needs Trusts, individual or pooled, protect eligibility for Supplemental Security Income (SSI), and/or Medicaid (Medi-Cal in California). The primary difference between the two is that the trustee of a pooled SNT is a charity or non-profit association which generally enables them to dramatically reduce fees associated with managing the trust."

Like Fried, Lindahl perceives the steady cash flow from a structure as a major advantage. "Our trust beneficiaries benefit by having a budget they must adhere to. This plan of action ensures they do not spend their settlement funds too quickly, making for a more secure future. When used together (SNTs and structured settlements), there is greater protection from market changes and they are receiving guaranteed tax-free income which does not count against their benefit eligibility."

All-cash trusts: an irresponsible trend

In recent years, as the stock market has rebounded from its 2009 nadir, a false sense of security has emboldened some advisors and attorneys to recommend forgoing the use of structured settlements altogether in favor of all-cash trusts, presumedly due to the allure of superior, if nonguaranteed, projected returns from the stock market. All-cash trusts have their place in some instances, but this dangerous trend can leave unsuspecting plaintiffs unaware of what they missed out on and the unnecessary costs they incur and risks they face as a result.

When fees are charged as a percentage of assets, spreading funds out over time can save the client money. "We could definitely make more money on an all-cash trust, but it simply isn't the right

thing to do," Fried continues. "Structured settlements are unique in their ability to provide tax-free guaranteed lifetime income to those with physical injuries, something we cannot guarantee otherwise. We encourage all our eligible clients to select a structured settlement."

All-cash trusts for minors are especially worrisome for a couple reasons. Unlike adults who may voluntarily take risks with their settlement proceeds if they choose, the court's expectation is that a child's settlement be preserved at all costs. For this reason, they historically have favored blocked bank accounts and structured settlements as the preferred "no risk" options.

Because preservation trumps rate of return in most judges' eyes, trustees should only be recommending ultra-conservative investments to ensure no loss of settlement proceeds. If trustees stick to the most conservative of allocations, it's unlikely they can ever outperform the guaranteed cash flows structured settlements can generate over time given the impact of fees and taxes. To the extent any funds are invested in stocks, this would seem to fly in the face of the court's expectation anyway, calling into question the trustee's recommendation.

Lindahl, too, cautions against all-cash trusts since the funds can be depleted too quickly. "Very often we see individuals who decide to take their settlement funds in cash and within a year or two, they are in the same situation they were prior to receiving the funds. A structured settlement protects them from these tragic outcomes."

Comparing returns: All-cash trust vs. structured settlement

To help illustrate the impact of fees and taxes on one's settlement proceeds in a trust when compared to a structured settlement, it's helpful to analyze a hypothetical deposit and compare the outcomes of both. To simplify the process, assume the following conditions exist:

- Plaintiff needs to dedicate one portion of her settlement to *guarantee* a single lump sum of $500,000 (plus whatever interest it might accrue) is available in five years;
- Because loss of principal is not an option, the trustee recommends placing these funds in a 5-year jumbo CD, currently paying 3.0 percent (bankrate.com), with all interest income reinvested at the same rate;
- Trustee management fees are 1.0 percent;
- Trust taxes on earnings within the trust are 15 percent.

The trust results reveal a competitive guaranteed rate of return offset by fees and taxes owed. CDs generate a 1099-INT for interest earned every year since it is considered taxable income to the trust. Unless offset, taxes are owed on this sum even though the original lump sum is tax-free. Fees paid out over the five-year term total $26,545, or 5.3 percent of the original total deposit.

The net rate of return on the deposit within the trust is 1.51 percent, negating the 3.0 percent the CD pays. (See Exhibit A above)

On the other hand, because structured settlements earn interest which is 100 percent income tax-free, the net result to the plaintiff is a final lump sum

Exhibit A: Without Structure

Year	Deposit	Interest	(Fees)	(Taxes)	Balance
1	$500,000	$15,000	($5,150)	($2,250)	$507,600
2	$507,600	$15,228	($5,228)	($2,284)	$515,316
3	$515,316	$15,459	($5,308)	($2,319)	$523,148
4	$523,148	$15,694	($5,388)	($2,354)	$531,100
5	$531,100	$15,933	($5,470)	($2,390)	$539,173
	Total:	$77,315	($26,545)	($11,597)	**$539,173**

Net Internal Rate of Return (IRR): 1.51%

Exhibit B: With Structure

Year	Deposit	Interest	(Fees)	(Taxes)	Balance
1	$500,000		$0	$0	$500,000
2	$500,000		$0	$0	$500,000
3	$500,000		$0	$0	$500,000
4	$500,000		$0	$0	$500,000
5	$500,000	$53,670	$0	$0	$553,670
	Total:	$53,670	$0	$0	**$553,670**

Net Internal Rate of Return (IRR): 2.04%

enhanced by about $15,000, or 2.7 percent. The elimination of management fees and taxes makes this result possible.

The net rate of return on the structured settlement deposit is 2.04 percent, about 35 percent better than the cash trust outcome.
(See Exhibit B on previous page)

In this example, the trust earns more interest, but the initial apparent advantage is cancelled out by fees and taxes. While different assumptions would lead to different outcomes, this exercise highlights the importance of understanding how costs can impact the total trust portfolio and shows how integrating structured settlements can help offset them.

Conclusion

Combining structured settlements with trusts to accomplish post-settlement income and preservation goals oftentimes leads to an optimum outcome for the plaintiff whose life is affected by the decisions made at this critical stage.

With a decided tax advantage and demonstrable ability to significantly lower the fees associated with managing a trust, structured settlements should always be considered for that portion of the settlement dedicated to helping meet basic living expenses plus any additional funds the injured party simply cannot afford to lose. The spendthrift, public benefit protection and accumulation goals can be better accomplished using an appropriate trust established for this purpose. Together, the combination can result in the most advantageous of outcomes.

Fried sums it up best. "Structured settlements provide the foundation for a successful trust plan. Clients need these funds to last for the rest of their lives. Having the annuity, along with market investments, cash, real estate and vehicles, allows for a well-balanced plan of spending and earning."


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