

# Structured Settlement Planning for Trial Attorneys: The Benefits of Using Qualified Settlement Funds and Private Placement Insurance Products

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*Trial attorneys who receive contingency fee income have “spiked” income, and face income taxation on contingency fee income, depending upon the jurisdiction, of 39.6 percent to over 50 percent. This article outlines strategies that attorneys who receive healthy contingency fees can use to achieve tax reduction and tax deferral. The strategies utilize the qualified settlement fund (QSF), a highly flexible structure with no limitations on duration or amount of contribution, in combination with split dollar life insurance and private placement life insurance to allow the trial attorney to convert compensation income that would be taxed at the highest marginal rates into tax-free benefits during lifetime as well as at death.*

## Overview

Trial attorneys are extremely vulnerable to a tax landscape that is becoming hostile territory. The result of the American Taxpayer Relief Act of 2013 (ATRA)<sup>1</sup> is that earned income continues to be taxed at substantially higher rates than investment income. That is not how most high income taxpayers spell “R-E-L-I-E-F.” The top marginal income tax rate increased to 39.6 percent.<sup>2</sup> The phase out of personal exemptions and miscellaneous

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<sup>1</sup> P.L. 112-240, 126 Stat. 2313.

<sup>2</sup> See ATRA § 101.

itemized deductions could effectively add another 2 percent to the marginal bracket.<sup>3</sup> State marginal tax brackets can increase taxation 7 to 10 percent to a total marginal bracket of 50 percent.

The long-term capital gains rate increased to 20 percent<sup>4</sup> and most states tax capital gains as regular income. Additionally, as a result of the 2010 health care legislation, many high-income attorneys in 2013 will face the impact of a new Medicare 3.8 percent tax on investment income.<sup>5</sup> Fortunately, the estate tax changes provided some solace. Although the top rate rises from 35 to 40 percent, a still higher 55 percent rate would otherwise have come back into effect, and ATRA leaves the exemption equivalent at \$5.2 million per taxpayer.<sup>6</sup> All in all, however, high-income attorneys have plenty of incentive to try to reduce the taxes they will owe when they earn large contingency fees.

Qualified retirement plans are minimally beneficial to high-income trial attorneys. Allowable contributions are based on a maximum annual salary of \$255,000.<sup>7</sup> The limit on contributions to defined contribution plans is \$51,000, which is not much for an attorney who has \$10 million of income due to a settlement. The maximum allowable deferral into a 401(k) plan is \$17,500 in 2013, with an additional available catch-up contribution of \$5,500 for a taxpayer age 50 or older.<sup>8</sup> Again, these amounts are relatively meaningless to the high-income trial attorney. Similarly, the controlled group rules of Sections 414(b) and 414(c) and affiliated service group rules of Section 414(m) that apply to qualified retirement plans limit the ability of the trial attorney to work around “rank and file” employees in the firm in order to increase contributions for himself.

I have previously written on the use of private placement variable annuities (PPVAs) as a more flexible solution for trial attorneys who elect to defer contingency fees in structured settlement annuities.<sup>9</sup> A PPVA is an institutionally priced variable deferred annuity that provides for much greater

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<sup>3</sup> See IRC §§ 68, 151(d)(3), as amended by ATRA §§ 101(b)(2)(A), 101(b)(2)(B). References herein to Section(s) are to the Internal Revenue Code of 1986 (as amended) (the “Code” or “IRC”), unless otherwise specifically indicated.

<sup>4</sup> ATRA § 102(b) (amending IRC § 1(h)(1)).

<sup>5</sup> See IRC § 1411, added by the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, 124 Stat. 1029, § 1402.

<sup>6</sup> See ATRA § 101(a) (striking title IX of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTTRA) and § 304 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA), P.L. 111-312, 124 Stat. 3296).

<sup>7</sup> IRC § 415(d).

<sup>8</sup> See IRC § 414(v).

<sup>9</sup> Gerald R. Nowotny, “Income Tax Reduction and Deferral Strategies for Trial Attorney Contingency Fee Income—Part I,” *A.B.A. Sec. Tax’n News Q.* (Summer 2012).

investment flexibility than a retail fixed or variable annuity. Additionally, I have written about the use of captive insurance as an integrated risk management and tax planning solution for plaintiff law firms.<sup>10</sup> In this article, I focus on a new concept, structured settlement life insurance, for the reduction and deferral of contingency fee income.

The structured settlement life insurance strategy combines the advantages of qualified settlement funds under Section 468B, private placement life insurance (PPLI) and annuities, and split dollar life insurance. The strategy delivers planning results that are more powerful than any of the other structured settlement arrangements for trial attorneys in the marketplace.

### **Using the Qualified Settlement Fund as a “Holding Tank” for Settlement Funds**

Qualified settlement funds (QSFs) came into being in 1993. The congressional intent in passing Section 468B was to allow defendants to make payment to settle a case while multiple plaintiffs sorted out the details of their payment as part of settlement discussions. In many respects, it is a tax-free way station. The defendant is able to receive an immediate tax deduction, while the plaintiffs avoid recognizing taxable income until the funds are paid to them from the QSF.

These unique attributes provide plaintiffs and their trial attorneys with flexible planning options. The discussion throughout the balance of this article will focus on how the QSF can be effectively combined with PPVAs and PPLI to provide powerful tax planning results for the trial attorney with contingency fee income.

**What Is a QSF?** QSFs are trusts that are designed to resolve litigation and satisfy claims even if they are not the subject of litigation. The QSF is authorized and governed by the provisions of Section 468B.<sup>11</sup> Depending on the complexity of a case, the number of plaintiffs or defendants, and the level of uncertainty regarding distributions, the QSF may last for only a few weeks or for a few years. The key point is that no statutory time limit exists within Section 468B or the Treasury regulations in regard to how long a QSF may be kept in place.

**Benefits for Both Defendants and Plaintiffs.** From a defendant’s perspective, the ability to transfer assets to a QSF can resolve the claim and release the defendant from further liability while at the same time achieving

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<sup>10</sup> Gerald R. Nowotny, “Income Tax Reduction and Deferral Strategies for Trial Attorney Contingency Fee Income- Part II” A.B.A. Sec. Tax’n News Q. (Winter 2013).

<sup>11</sup> See IRC § 468B.

an immediate tax deduction—regardless of when claimants actually receive their distributions.<sup>12</sup> This is a significant tax point for the defendant.

Plaintiffs are able to achieve several benefits:

- Claimants can use the QSF to time the receipt of their income.
- Plaintiffs are not taxed until they actually receive distributions from the QSF.
- The QSF allows the plaintiffs and their attorney to take their time in working out the details of their distribution; if distribution is delayed, there will be no tax liability until after payments are made.

**Requirements to Establish a QSF.** QSFs generally have three requirements:

1. The QSF must be established by court order and administered under the jurisdiction of that court.<sup>13</sup> The court need not be in the same jurisdiction as the legal action. In fact, a probate court in the trial attorney’s home jurisdiction could have jurisdiction over the QSF trust.
2. The QSF must be established “to resolve or satisfy one or more contested or uncontested claims that have resulted or may arise from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability.”<sup>14</sup>
3. The QSF must be a trust under state law.<sup>15</sup>

**Taxation of the QSF.** Once established, a QSF is a taxpayer in its own right. The QSF is not taxed on contributions to the QSF trust. Any inclusion will not occur until the date of distribution. The trust is taxed on its investment income at the top federal marginal rate, along with any state taxation that might apply.<sup>16</sup>

A QSF is taxed on its modified gross income at the maximum income tax rate for estates and trusts. The top marginal rate for trusts in 2013 will be 39.6 percent, not including state taxation, which can easily add another 4 to 10 percent to the rate. If that weren’t enough, the new Medicare tax on investment income also applies to trust income, adding an additional 3.8 percent of taxation on that income.<sup>17</sup>

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<sup>12</sup> See IRC § 468B(a).

<sup>13</sup> See IRC § 468B(d)(1).

<sup>14</sup> See IRC § 468B(d)(2)(C).

<sup>15</sup> See Treas. Reg. § 1.468B-1(b)(1).

<sup>16</sup> See Treas. Reg. § 1.468B-1(b).

<sup>17</sup> See IRC § 1411.

Taxable amounts transferred to the QSF do not include amounts transferred to resolve the claim for which the QSF was established. The investment income from public utilities and federal and municipal securities under Section 115 is also excluded.<sup>18</sup> The amount transferred to the QSF by the defendant is not taxable income to the QSF, and the QSF may take deductions for its administrative costs and investment losses. Distributions of cash or property are excluded from the QSF's gross income.<sup>19</sup>

When a QSF makes a distribution to a claimant, the QSF obtains a release from that claimant. The QSF must file an annual tax return on or before March 15 of the year following the close of its taxable year.<sup>20</sup>

**QSF Administration.** A QSF needs an administrator and a trustee. The two roles can be accomplished by the same organization. The trustee may be either an individual or a trust company. The administrator has the responsibility of accounting for and administering the QSF. These tasks include obtaining the employer identification number and preparing and filing QSF tax returns. The trustee has all of the traditional fiduciary obligations of a trustee under state trust law.

## Using Nevada as a Jurisdiction for the QSF

One of the hallmark features of any deferred compensation arrangement is the avoidance of constructive receipt of the funds. The trade-off for satisfying this requirement is that the funds must be available to creditors. Instead, I would recommend establishing a QSF in a jurisdiction that has asset protection legislation. The passage of Section 409A eliminated the ability to use offshore trusts.

It remains to be seen whether domestic self-settled trusts can withstand a constitutional challenge when a creditor from one state attempts to collect against an asset protection trust in Nevada, Delaware, or South Dakota, which were the initial states to enact spendthrift trust legislation. While a number of domestic jurisdictions have since adopted trust legislation that provides for asset protection, in my view, Nevada has the strongest legislation. Nevada's asset protection has several things going for it:

- *Statute of limitations:* Nevada has a two-year statute of limitations.<sup>21</sup> For pre-existing creditors, the statute of limitations is the longer of two years from the date of the transfer to the trust or six months

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<sup>18</sup> See IRC § 115(1).

<sup>19</sup> Treas. Reg. § 1.468B-2(b)(1).

<sup>20</sup> Treas. Reg. § 1.468B-2(j).

<sup>21</sup> See Nev. Rev. Stat. § 166.170(1)(a).

from the date the creditor discovered the transfer, or reasonably should have discovered the transfer.<sup>22</sup>

- *Tacking*: If a trust is moved from another jurisdiction to Nevada, the statute of limitations does not restart.<sup>23</sup>
- *Last-in, first-out*: For purposes of determining the statute of limitations, and multiple transfers to the trust, a transfer that is within the statute will not taint the entire trust for prior transfers where the statute has already expired.<sup>24</sup>
- *Decanting*: A trustee may form another spendthrift trust without restarting a new statute of limitations period.<sup>25</sup>
- *Exceptional creditors such as spousal and governmental claims*: Nevada law does not exempt exceptional creditors from the favorable laws outlined above.<sup>26</sup>
- *Income tax*: Most important, Nevada does not tax trust income.<sup>27</sup>

## In What Types of Cases May QSFs Be Used?

Most disputes can use a QSF. Generally any claims under the Superfund legislation<sup>28</sup> can use a QSF, as well as any claims arising out of a tort, breach of contract, or other violation of law. However, the Treasury regulations exclude workers' compensation claims and bankruptcy or general creditor claims from using a QSF.<sup>29</sup>

Some practitioners wonder whether a QSF can be used for a single claimant. Assuming the government means what it says, the answer should be "Yes." The plain statutory and regulatory language answers this question in the affirmative.<sup>30</sup> Regulations under Section 468B provide that a QSF may be "established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event that has occurred and that has given rise to at least one claim asserting liability."<sup>31</sup> The concern deals with the tax doctrine of constructive receipt and economic benefit. The author's view on the matter is straightforward: If Congress wanted to limit the ability to use QSFs for a single claimant, it would have written the statute differently.

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<sup>22</sup> See *id.*

<sup>23</sup> See Nev. Rev. Stat. § 166.180(2)(a).

<sup>24</sup> See Nev. Rev. Stat. § 166.170(7)(b).

<sup>25</sup> See Nev. Rev. Stat. § 163.553.

<sup>26</sup> Nev. Rev. Stat. 166.1 (Mar. 7, 2011).

<sup>27</sup> *Id.*

<sup>28</sup> See Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), P.L. 96-510 (codified at 42 U.S.C. §§ 9601 et seq.).

<sup>29</sup> Treas. Reg. § 1.468B-1(g)(1).

<sup>30</sup> IRC § 468B; Treas. Reg. § 1.468B-1(c)(2).

<sup>31</sup> Treas. Reg. § 1.468B-1(c)(2).

## QSFs, Structured Settlements, and PPVAs

QSFs can be used to facilitate structured settlement distributions. As stated earlier, this article focuses on structured settlement arrangements for attorneys rather than for plaintiffs. Funds transferred to a QSF will include attorney fees, and the plaintiff's attorney can also be thought of as a beneficiary of the QSF. The QSF's gross income will exclude the amount that the defendant contributes to the QSF to resolve or satisfy liabilities. (This exclusion applies regardless of whether the amounts transferred to the QSF include attorney fees.)

The QSF can be used as a repository to make structured payments to attorneys. The attorney may receive structured payments even if the claimants do not. The QSF may serve as a repository for both qualified and non-qualified assignments.<sup>32</sup> If the QSF vehicle is chosen, PPVAs are an ideal asset to be owned by the trust or an assignment company as part of a structured settlement annuity arrangement. The QSF is taxed at the maximum tax rate for trusts—39.6 percent. As a practical matter, the QSF will have a combined marginal tax rate of 43.4-50 percent. The PPVA is an institutionally priced variable deferred annuity that provides for customized investment options. The cost of the PPVA contract will be under one percent per annum.

The open architecture of the PPVA has an unlimited array of investment choices, which can include investment management by the attorney's investment advisor who is appointed to manage a portfolio for the life insurer within the policy. The PPVA provides for tax deferral until such time as distributions are made to the attorney.

## Why a QSF Is a Better Option for Trial Attorneys Than a Qualified Retirement Plan

**Higher Benefit Levels at Lower “Plan” Cost.** As noted earlier, qualified retirement plans are limited in benefit for high-income trial attorneys. The maximum allowable annual contributions/deferrals do not make much of a dent for retirement purposes for the trial attorney living in luxury and intending to remain there in retirement.<sup>33</sup> At any rate the maximum annual retirement benefit is only \$205,000, which is not much if your lifestyle is \$1 million per year.<sup>34</sup> Not only do defined benefit plans have limits, they are generally too expensive at the firm level, because of the contribution requirements for firm employees and associates. The affiliated service group rules

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<sup>32</sup> Non-qualified assignments are used to facilitate periodic payments involving tort claims that do not involve personal physical injuries such as racial discrimination, wrongful termination, or violations of the Americans With Disabilities Act (ADA) or the Employee Retirement Income Security Act (ERISA).

<sup>33</sup> See discussion in text *supra* at notes 7-8.

<sup>34</sup> See IRC § 415(b).

of Section 414(m) limit the ability of the highly compensated trial attorney to circumvent contributions for firm employees and attorneys.<sup>35</sup> Congress created sophisticated rules and testing requirements designed to prevent discrimination in benefit levels and contributions in favor of the highly compensated. Other rules prevent the creation of new entities in an attempt to bypass contributions for firm employees or the creation of multiple plans.

**Flexibility.** The highly compensated trial attorney does not have to worry about the application of any of the qualified retirement plan rules to the QSF. Unlike a qualified retirement plan arrangement, the QSF with respect to the trial attorney does not have a cap on contributions to the QSF or a limit on the amount of trial attorney income that can be considered. There are no minimum contribution or participation rules for other employees of the law firm. The QSF arrangement does not have early withdrawal penalties for distributions made before age 59½, nor are there minimum distribution requirements at age 70½. The QSF rules are not statutorily restricted in the length of time they can exist. The costs of operating and administering the QSF are miniscule in comparison to the tax advantages to the trial attorney.

Adding to the flexibility, the trial attorney (or his firm) can inexpensively create and maintain multiple QSFs in regard to different cases and settlements. The trial attorney can allocate a percentage of each case in a manner similar to a defined contribution, such as 25 percent of his compensation into a structured settlement arrangement within the QSF. In the same manner, a pension actuary can easily replicate a defined benefit design in order to determine the level of annual commitment necessary to fund a fixed retirement benefit (including a benefit designed to increase by an inflation factor) at retirement age.

**Deductibility.** Like a pension plan contribution, the defendant's transfer of insurance proceeds to the QSF is tax deductible. The use of the PPVA creates the same tax deferral as a qualified retirement plan. The significant difference is the lack of limits on contributions and benefits along with an absence of contribution and non-discrimination requirements.

In the current tax environment, this is the time for trial attorneys and plaintiffs' law firms to incorporate the use of the QSF as a retirement plan and deferred compensation vehicle.

**The Strategy in Action.** To understand the advantages of a QSF, consider the following example:

*Example 1:* Joe Smith, age 50, is a partner in a plaintiffs' law firm. Joe has a professional corporation with four partners. The

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<sup>35</sup> See IRC § 415(m).

firm's partnership agreement provides that the partner who wins a trial gets a 60 percent compensation credit on the contingency fee, with the remaining partners getting a 20 percent compensation credit. The firm allocates the remaining 20 percent to cover the firm's fixed expenses and to fund future cases.

Joe's combined marginal tax bracket for federal, state, and city purposes is 40 percent. Joe recently settled a product liability case for \$60 million. The fee agreement provides for a \$19.8 million contingency fee to the firm. Joe receives a compensation credit equal to \$11.88 million. The other partners receive compensation credits of \$1.32 million each.

*The QSF:* During the course of settlement discussions, the firm, claimant, and defendant agree to create a QSF. The defendant likes the fact that it can take a deduction for its transfer of insurance proceeds to the QSF rather than waiting to take a deduction when the claimant receives payment. The firm petitions the probate court in Henderson County, Nevada, to issue an order authorizing the creation of the QSF. Southwestern Trust Company will serve as the trustee.

The QSF trust document does not limit the term of the QSF. The trustee enters into a structured settlement arrangement with Acme Life, a specialty life insurer issuing private placement insurance products. Acme owns an assignment company that is a qualified assignment company under Section 130. The assignment company purchases a PPVA contract issued by Acme.

*The PPVA:* The PPVA features an insurance dedicated fund managed by Good Investments, a registered investment advisor. Good Investments manages Joe's investment portfolio and those of several of the other partners, along with the firm's retirement plans. The investment mandate of the PPVA's fund allows the investment manager a large degree of investment discretion and authority to invest in a wide range of asset classes, including alternative investments.

*Annuity Provisions:* The annuity provisions in Joe's contracts provide for distributions in five years for a five-year period when his daughter enters college. She plans to attend graduate school and the estimated cost is \$250,000 (i.e., \$50,000 per year). Beyond those interim annuity payments, the annuity settlement provisions provide for a joint and survivor annuity beginning at age 70.

The annuity payout provides for variable payouts based upon an assumed interest rate of 5 percent. If the investment performance within the PPVA exceeds this benchmark, annual

annuity payments will increase. The annuity payments will cease at the death of the joint annuitant.

The projected value of the annuity in 20 years, assuming an investment return of 8 percent per year, is \$53.37 million. The projected joint and survivor annuity is \$3.03 million per year. Nothing is included in the taxable estate for federal estate tax purposes.

Each of Joe's partners is also age 50. Their projected value of their annuities at age 65 is \$4.2 million. The projected joint and survivor annuity for each partner and the partner's spouse is approximately \$244,000 per year.

The QSF plan assets are segregated from the claims of the firm's creditors and personal creditors. Under state law, annuity payments are also exempt from the claims of creditors. The joint and survivor payout will also result in no inclusion for federal estate tax purposes.

## Getting the Best Tax Result From QSFs and Structured Settlement Life Insurance

The previous discussion outlined the special tax attributes of the QSF. Without additional tax structuring, however, the QSF has several negative attributes:

- Trusts as a separate taxable entity reach the top marginal tax bracket at low levels of taxable income.
- Annuity income creates income in respect of a decedent (IRD) in a manner similar to qualified retirement plans and non-qualified retirement plans. Where such income is high, as in our Example 1, the resulting tax bite may have a painful sting. This deferred income is subject to both income and estate taxation. The combined income of the two taxes could erode 70 to 75 percent of the account value.
- Many trial attorneys are personally wealthy and may not require additional retirement income. The ability to convert the contingency fee proceeds into a tax-free asset that creates an estate asset on an income- and estate-tax-free basis might be more attractive to them.

The QSF combined with PPLI and the use of split dollar life insurance provides a unique opportunity to deliver these benefits to the trial attorney. The author refers to this technique as structured settlement life insurance.

**Tax Advantages of Life Insurance.** Life insurance agents and attorneys have one thing in common: people seem to harbor animosity toward both, except

for their own.<sup>36</sup> Life insurance agents motivate clients to take action in an area of their lives that they would rather avoid—their own mortality. Nevertheless, life insurance agents have the best game in town from a tax perspective.

Life insurance is the most tax-advantaged investment vehicle available. The inside build-up of the policy's cash value is tax-free, meaning that investment earnings within the policy are not taxed.<sup>37</sup> The policyholder also has the ability to access those investment gains during lifetime on a tax-free basis, by using low cost policy loans and partial surrenders of the policy cash value.<sup>38</sup> The policy death benefit receives income-tax-free treatment and may also receive estate-tax-free treatment if it is owned by a third party such as a family trust.<sup>39</sup>

PPLI is a state of the art, institutionally priced, variable universal life insurance policy that allows for customized investment options, including hedge funds and private equity funds. The policy is effectively a low-load or no-load life insurance policy, making it very efficient, but that is also the primary reason it isn't sold as often as it might be.<sup>40</sup>

**The QSF-Structured Settlement Life Insurance Strategy.** The thrust of the structured settlement life insurance (SSLI) strategy is use of the QSF as a source of funds to invest in a PPLI contract owned by the trial lawyer's family trust using a split dollar life insurance arrangement. The plan also has a death-benefit-only component paid to the trustee of the QSF for the benefit of the trial attorney's family.

**Split Dollar Overview.** Split dollar life is a contractual arrangement between two parties to share the benefits of a life insurance contract. In a corporate setting, split dollar life insurance has been used for 58 years as a fringe benefit for business owners and corporate executives. Generally speaking, two forms of classical split dollar arrangements exist, the endorsement method and collateral assignment method.

The earliest authoritative reference in the tax law to split dollar is Revenue Ruling 55-713.<sup>41</sup> The seminal split dollar ruling is Revenue Ruling

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<sup>36</sup> Recall that in Woody Allen's film "Take the Money and Run," imprisonment is made more onerous by one's having to spend it with a life insurance agent.

<sup>37</sup> See IRC §§ 7702, 817(h).

<sup>38</sup> See IRC § 72(e)(5).

<sup>39</sup> See IRC §§ 101(a), 2042.

<sup>40</sup> See Gerald R. Nowotny, "Using Private Placement Insurance Products to Achieve Tax Efficiency for High Net Worth Investors," 29(4) J. Tax'n Invs. 49 (Summer 2012). This article discusses the reasons why private placement insurance products have not captured a larger percentage of market share in spite of their obvious advantages.

<sup>41</sup> 1955-2 CB 23.

64-328.<sup>42</sup> The IRS issued final split dollar regulations in September 2003.<sup>43</sup> These regulations were intended to terminate the use of a technique known as equity split dollar. The consequence of these regulations is to categorize equity split dollar into two separate regimes—the economic benefit regime and the loan regime.

Section 409A, which dealt with the requirements for deferred compensation arrangements, was added to the Internal Revenue Code in 2004. Treasury issued its “Guidance on Deferred Compensation” on December 21, 2004. The FAQ Section of the IRS notice provides that the limitations of Section 409A do not extend to attorney fee deferral arrangements.<sup>44</sup> Furthermore, Section 409A does not apply to non-equity split dollar arrangements such as that described in this article.<sup>45</sup>

*Split Dollar Under the Economic Regime.* Under the economic benefit regime, the employee or taxpayer is taxed on the “economic benefit” of the coverage paid by the employer. The tax cost is not the premium but the term insurance cost of the death benefit payable to the taxpayer. The economic benefit regime usually uses the endorsement method but may also use the collateral assignment method.<sup>46</sup>

In the endorsement method within a corporate setting, the company is the applicant, owner, and beneficiary of the life insurance policy insuring a company executive. The company pays all or most of the policy’s premium. The company has an interest in the policy cash value and death benefit equal to the greater of the policy’s premiums or cash value. The company contractually endorses the excess death benefit (the amount of death benefit in excess of the cash value) to the employee who is authorized to select a beneficiary for this portion of the death benefit.

The economic benefit is measured using the lower of the Table 2001 term costs or the insurance company’s cost for annual renewable term insurance. This measure is the measure for both income and gift tax purposes. Depending on the age of the taxpayer, the economic benefit tax cost is a very small percentage of the actual premium paid into the policy—1 to 3 percent. See Figure 1.

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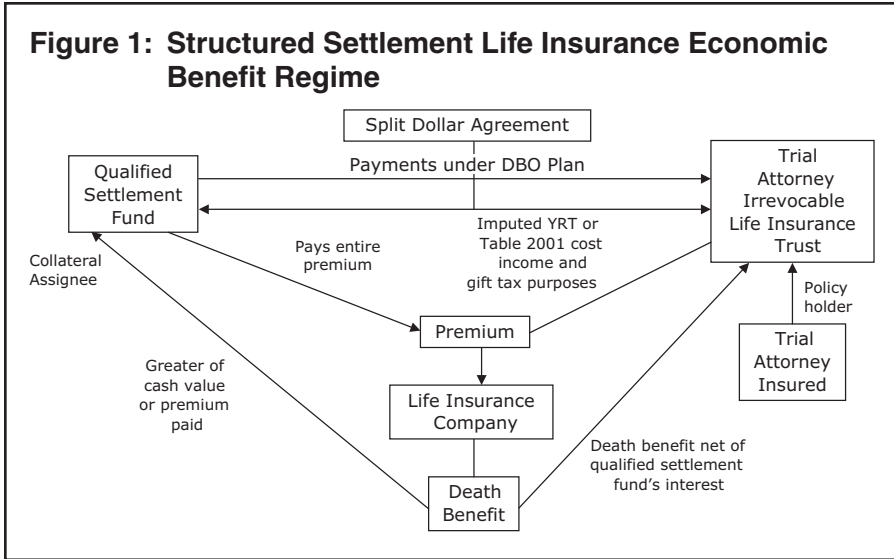
<sup>42</sup> 1964-2 CB 11.

<sup>43</sup> Treas. Reg. § 1.468B-1(c)(2).

<sup>44</sup> Notice 2005-1, 2005-1 CB 274.

<sup>45</sup> Notice 2007-34, 2007-1 CB 996.

<sup>46</sup> Treas. Reg. § 1.61-22(d).

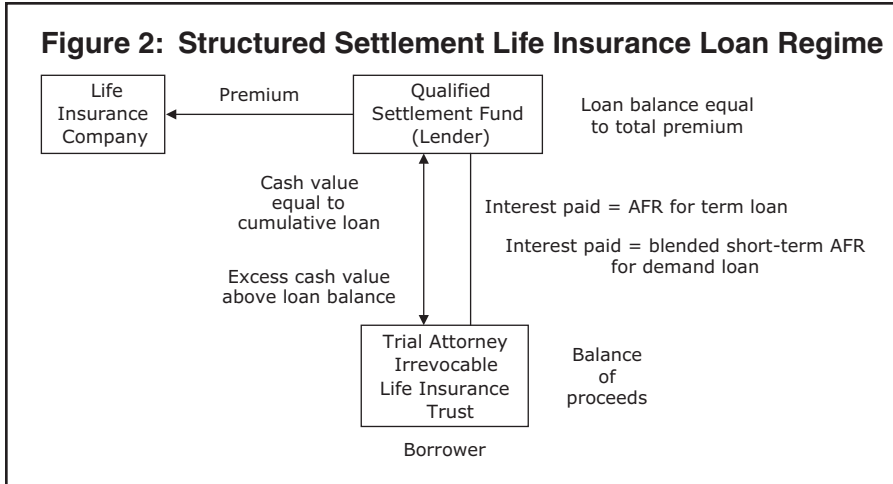


*Split Dollar Under the Loan Regime.* The loan regime follows the rules specified in Section 7872, under which the employer's premium payments are treated as loans to the employee. If the interest payable by the employee is less than the applicable federal rate, the forgone interest payments are taxable to the employee annually. In the event the policy is owned by an irrevocable trust, any forgone interest (less than the applicable federal rate (AFR)) would be treated as a gift imputed by the employee to the trust. The loan is non-recourse. The lender and borrower (i.e., employer and employee respectively) are required to file a Non-Recourse Notice with their tax returns each year, representing that a reasonable person would conclude under all the relevant facts that the loan will be paid in full.<sup>47</sup>

Split dollar under the loan regime generally uses the collateral assignment method of split dollar. In a corporate split dollar arrangement under the loan regime, the employee or a family trust is the applicant, owner, and beneficiary of the policy. The employer loans the premiums in exchange for a promissory note in the policy cash value and death benefit equal to its premiums plus any interest that accrues on the loan. The promissory note can provide for repayment of the cumulative premiums and accrued interest at the death of the employee.<sup>48</sup> See Figure 2.

<sup>47</sup> Treas. Reg. § 1.7872-15(d).

<sup>48</sup> Treas. Reg. § 1.7872-15(b)(1)-(3).

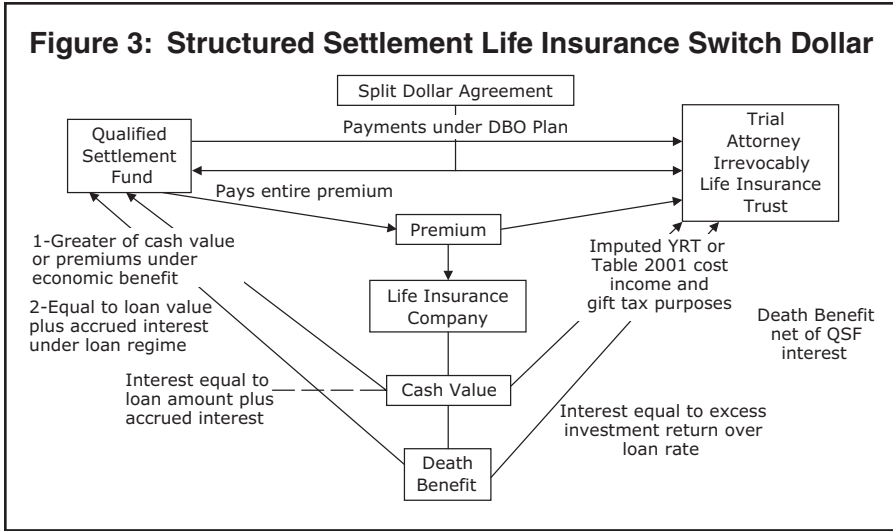


*Switch Dollar Life Insurance.* Switch dollar starts out as a traditional split dollar arrangement using the economic benefit regime under the final split dollar regulations promulgated in September 2003. As the economic benefit tax cost to the trial attorney increases, the arrangement is switched to a split dollar arrangement under the loan regime.

The four stages of the arrangement are as follows:

1. *Economic benefit phase:* The QSF funds the entire policy premium. The trial attorney has a tax cost equal to the value of the economic benefit (term insurance cost) for the trial attorney's (family trust) interest in the policy. This measurement is used for both income and gift tax purposes.
2. *Switch:* The split dollar agreement terminates. The family trust issues a promissory note to the QSF. The initial premium is equal to the cumulative premiums. The note has no interest rate and is a demand note. The trial attorney has reportable income equal to the long-term applicable rate.
3. *Loan phase:* The loan interest accrues and is added to the principal of the loan. The family trust owns the policy in its entirety. The trustee is able to take a partial surrender of the cash value and policy loans and make tax-free payments each year to the trial attorney or his spouse.
4. *The end:* The loan and any accrued interest are repaid at the trial attorney's death to the QSF. The trustee of the QSF uses the repaid loan proceeds to make the payments on a taxable basis to the trial attorney's estate or beneficiaries under a death benefit only (DBO) Plan.

For a diagram of the arrangement, see Figure 3.



*Death Benefit Only (DBO) Plan.* Under the typical DBO plan, a contractual arrangement between a corporation and an employee or contractor is executed. The corporation agrees that if the contractor or employee dies, the corporation will pay a specified amount to the employee or contractor’s spouse or other designated class of beneficiaries’ children. Payments can be made on an installment basis or in a lump sum.

The payments are taxable income but can be structured so that they are estate-tax-free. If the payments are made to a designated beneficiary who does not provide the employee with the ability or right to change or revoke the designation, the payments can avoid estate taxation.

In structured settlement life insurance, the QSF takes the place of the corporation. The reimbursement to the QSF at the death of the insured provides the source of funds for the trustee to make payments under the DBO plan.

**The Strategy in Action.** Example 2 illustrates how the QSF SSLI strategy works.

**Example 2:** Assume Joe Smith’s situation is the same as set out earlier in Example 1, but that instead of the strategy outlined there he uses a QSF SSLI approach.

*The Family Trust’s PPLI:* The Smith family trust is an irrevocable trust designed to provide multi-generational benefits to Joe’s wife, children, and grandchildren. The trustee of the family trust is the applicant, owner, and beneficiary of a PPLI policy insuring Joe’s life. The policy will have premiums of \$2.5 million

per year for four years, for a total of \$10 million. The policy will pay a death benefit of \$40 million.

*The PPVA.* The balance of the contingency fee, \$1.88 million, is invested in a PPVA contract. The annuity is structured so that Joe's two-year-old grandson is the measuring life under the annuity contract. The non-natural person rule of Section 72(u) provides that deferred annuities lose the benefit of tax deferral when the owner of the deferred annuity is a non-natural person. In Year 30, the projected account value, assuming a net return of 7 percent, is \$14.3 million. The death benefit under the annuity tax rules will not be triggered by Joe's death but rather by his grandson's.<sup>49</sup>

*The Split Dollar Economic Benefit Arrangement.* The policy will be funded by the trustee of the QSF. The trustee of the QSF enters into a collateral assignment split dollar arrangement with the trustee of the Smith family trust. During the first four years of the arrangement, the split agreement will use the economic benefit arrangement and then switch to the loan regime. The average annual economic benefit (tax) cost during the first five years to Joe is \$28,000. This is the cost for both income and gift tax purposes each year. During that time, the QSF has an interest in the policy cash value and death benefit equal to the greater of the policy premiums or cash value.

*The Split Dollar Loan Regime Switch.* At the end of Year 4, the trustees agree to switch to the loan regime. The trustees terminate the collateral assignment agreement in exchange for a promissory note equal to the cumulative premiums paid to date, \$10 million. The cash value in the policy at the end of Year 10 is \$10 million.

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<sup>49</sup> The legislative history of IRC § 72(u) and IRC § 72(u)(1)(B) provides an exception for annuities that are "nominally owned by a non-natural person but beneficially owned by an individual." See Conf. Comm. Rep., Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647. This rule describes the typical arrangement in a personal trust. The IRS has reviewed this issue with respect to trusts at least eight times in Private Letter Rulings (e.g., PLR 9204014 (Oct. 24, 1991); PLR199905015 (Nov. 5, 1998); PLR 199933033 (May 25, 1999)) and has ruled favorably for the benefit of the taxpayer in each instance.

IRC § 72(s)(6) deals with the distribution requirements of an annuity that is owned by a non-natural person (e.g., a trust). It provides that the death of the primary annuitant is the triggering event for required distributions from the annuity contract. The primary annuitant must be an individual. Distributions must begin within five years following the death of the primary annuitant for the trust-owned annuity. At death, the annuity account balance may be paid out over the life expectancy of the beneficiary, providing additional deferral.

The interest rate on the loan is the short-term blended AFR, which is currently 0.22 percent per year. The interest is capitalized and added to the promissory note. The annual interest charge added to the policy is \$22,000 in Year 1. Ultimately, a portion of the death benefit equal to the accumulated principal and interest will be repaid to the QSF. The loan can be restructured as a long-term loan in the event interest rates begin to move upward. (The long-term AFR in January 2013 is 2.31 percent.)

*The DBO Plan.* These repayments to the QSF at Joe’s death will be paid to Joe’s wife and family in a lump sum or in installments pursuant to a DBO plan. Assuming death in year 30, this payment is projected to be \$19.3 million. The tax-free proceeds payable to the Irrevocable Life Insurance Trust (ILIT) in Year 30 is approximately \$85 million, assuming a net return of 8 percent, and \$505 million assuming a return of 15 percent.

The trustee of the Smith family trust takes a tax-free policy loan of \$1 million per year beginning in Year 10 and distributes the proceeds to Mrs. Smith, who is a discretionary beneficiary of the trust. The distribution is also tax-free.

In the event of Joe’s death, the death proceeds (\$40 million) are income- and estate-tax-free. At death, the trustee of the family trust will reimburse the trustee of the QSF an amount equal to \$10 million (cumulative premium) plus any accrued interest. Lastly, Joe’s estate will be paid \$10 million in a lump sum as payment for the original compensation paid to the QSF, the contingency fee. This payment is taxable income to the estate. See Figure 4.

**Figure 4: Structured Settlement Life Insurance Switch in Year 5**

| QSF |               |            |           | TRIAL ATTORNEY   |                  |                 |               |
|-----|---------------|------------|-----------|------------------|------------------|-----------------|---------------|
| YR  | CUM. NET PMTS | LOAN       | INTEREST  | ECONOMIC BENEFIT | LOAN COLLATERAL  |                 |               |
|     |               |            |           |                  | TOTAL CASH VALUE | ILIT CASH VALUE | DEATH BENEFIT |
| 1   | 2,500,000     | -----      | -----     | 28,800           | 2,500,000        | ---             | ---           |
| 5   | 10,000,000    | 10,222,000 | 222,000   | 24,400           | 10,000,000       | ---             | 37,500,000    |
| 10  | 10,000,000    | 11,160,000 | 1,160,000 |                  | 36,500,000       | 25,100,000      | 37,800,000    |
| 20  | 10,000,000    | 13,900,000 | 3,900,000 |                  | 136,500,000      | 123,900,000     | 144,000,000   |
| 30  | 10,000,000    | 19,300,000 | 9,300,000 |                  | 525,000,000      | 505,000,000     | 505,000,000   |

## Summary

Trial attorneys who receive contingency fee income have “spiked” income. In some years income can be very substantial. In other years, income can be flat. Unfortunately, recent tax changes treat earned income harshly. Trial attorneys face income taxation on contingency fee income, depending upon the jurisdiction, of 39.6 percent to 50 percent or more. Trial attorneys have not availed themselves of structured settlement annuities due to the fixed rate structure in the current low interest environment. Planning in this area requires a variety of strategies that allow the attorney to have greater access and control over the funds in the short term. The strategies outlined in this article provide tax reduction and tax deferral. The strategies utilize the QSF which had been in favor and has fallen into disfavor largely because of structured settlement broker disagreement.

The QSF is a highly flexible structure and of far greater utility to the trial attorney than any qualified retirement plan trust could ever hope to be. The structure does not have any limitations on duration and the amount of contribution. Furthermore, the QSF could be restructured in a favorable jurisdiction such as Nevada. The introduction of life insurance and split dollar dramatically enhances the tax treatment for the trial attorney. Life insurance is the most tax-advantaged investment vehicle. A customized product such as PPLI provides great investment flexibility with institutional pricing and tax advantages.

The introduction of split dollar life insurance into the planning equation adds another dimension to the planning. The combination of the QSF, PPLI, and split dollar allows the trial attorney to convert compensation income that would be taxed at the highest marginal rates into tax-free benefits during lifetime as well as death.



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