



Henderson Structured Settlements





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## **FOREWORD**

A good deal of “literature” has been produced about structured settlements since their inception here in Canada *circa* 1980. Most of this originates with structured settlement firms, and most amounts to little more than advertisement. Essentially, all of this literature makes the same point: structured settlements are, in many circumstances, preferable to lump-sum settlements. While explanations and illustrations are offered in support of this, most of us are, unfortunately, probably still no better able to make informed decisions about structured settlements now than we were prior to being exposed to this literature.

The foregoing, then, points out a deficiency not in structured settlements -- the virtues of which are indisputable -- but rather the manner in which the story is told. Clearly, there is a need for literature that is written from the perspective and in the language of the consumer.

This guide is intended to serve this need. The terms of reference stipulated that it be both objective in the information presented and useful to those claims personnel and lawyers who would have a real interest in reading it. Consequently, the success of the material that follows should be judged principally in reference to these terms.





## INTRODUCTION

In keeping with the remarks made in the foreword, information of a historical or highly technical nature will be kept to a minimum. For example, while the complete history of structured settlements may be of academic interest, a knowledge of this does not really assist in the process of deciding whether a given situation is amenable to settlement by structure or not. Likewise, it is not essential that the “user” be intimately familiar with the mathematics of annuities. In other words, the tack taken here will be, to the greatest extent possible, practical, rather than theoretical.

The manual itself has been organized on the basis of a series of fundamental questions. These are:

1. What are structured settlements?
2. Why use structured settlements?
3. Which cases can be structured?
4. When should a structured settlement consultant be contacted, and what can a structured settlement consultant do?
5. How do you negotiate using structured settlements?

Each of these questions translates into chapters. In addition to these, Canada Revenue Agency’s *Interpretation Bulletin IT-365R2*, the bulletin pursuant to which structured settlement income is deemed tax-free, has been appended.





## CHAPTER 1 - WHAT ARE STRUCTURED SETTLEMENTS?

### Definition

The term *structured settlement* has been defined in a variety of ways. The judicial definition offered by the Supreme Court of Ontario in *Yepremian v. Scarborough General Hospital (No. 2)* is perhaps the simplest and easiest to understand: “Structured settlements are a means whereby all or part of the damages are paid to a claimant by means of periodic payments rather than by means of a lump sum.”

Structured settlements, then, represent an alternative to the conventional lump-sum settlement; that is, they replace the traditional single payment with, primarily, a series of periodic payments. This is not to say, however, that structured settlements do not allow for lump-sum payments. The term *structure* comes from the idea that a settlement can be shaped to meet the needs of the situation. As we shall see, structured settlements can be formulated to allow “up-front” lump-sum payments, to allow income to be varied from year to year, to allow certain elements of income to be deferred, to allow for lump-sum payments at various times in the future, and to allow for the escalation of payments (i.e., indexation) in an effort to offset the effects of inflation.

### History<sup>2</sup>

Structured settlements were first employed in Sweden, France, West Germany, Australia, and New Zealand in the early 1950s. They first appeared in the United States in 1958 in the form of a structured judgment. Since then, structures have been used extensively on a voluntary basis in the United States, and some states have gone so far as to enact legislation to allow the courts to impose structured judgments. Some of the more notable American cases in which structured settlements have been employed are the thalidomide cases of the 1960s and the Ford Pinto cases of the 1970s.

In fact, structured settlements were introduced to Canada in 1968 by virtue of the American thalidomide cases. They did not, however, gain widespread popularity in this country until the 1980s, when the tax-free status of structures was finally confirmed by Revenue Canada (now Canada Revenue Agency). This, combined with an influx in the number of million dollar awards during this period, served to make structured settlements an attractive alternative to the lump sum.<sup>3</sup> In fact,



some Canadian jurisdictions have enacted legislation that allows the courts to impose structured judgments in certain circumstances.<sup>4</sup>

### **Anatomy of a Structured Settlement**

As defined above, structured settlements are a means whereby all or a part of the damages paid to a claimant are by way of periodic payments. In particular, structured settlements are usually composed of two distinct elements: a cash portion paid “up-front” and an annuity payment plan. The former is intended to pay for out-of-pocket expenses and wage loss incurred prior to settlement, as well as any necessary capital expenditures, such as home and vehicle modification, legal fees, and the like, whereas the latter is designed specifically to provide a stream of payments (usually monthly) to meet the claimant’s future financial needs.

An annuity is defined generally as “a contract ... for the payment of periodic amounts during the lifetime of a particular person, or for a fixed or guaranteed period ....”<sup>5</sup> More specifically, an annuity policy is a “contract between an issuer and an owner, whereby the issuer, in return for a premium, agrees to pay a specific amount of money on a regular periodic basis at fixed intervals, to begin on a designated date and continue for life or such shorter or longer period as agreed by the owner and issuer.”<sup>6</sup> Any annuity payment plan used in the context of a structured settlement will consist of a combination of features of each of the following categories:<sup>7</sup>

#### **1. Payment of the purchase price:**

(a) *Single Premium*: One-premium policy whereby no further premiums are due or payable beyond the large single payment at the beginning of the contract.

#### **2. Benefit distribution period:**

(a) *(Straight) life*: Benefit payments continue as long as the measuring life lives; that is, they cease upon death. There is no guarantee that any particular number of periodic payments will be made, and benefits could cease (because of the death of the measuring life) after as little as one payment being made by the life insurer.<sup>8</sup> This form of annuity is generally not popular for use in structured settlements, notwithstanding that it produces the largest individual periodic payment.



(i) *Joint and last survivor*: Policy provides that payments will be made to more than one individual, but will cease at the death of the last surviving measuring life.

(ii) *Standard*: No anticipated deviation from the life expectancy set out in the tables.<sup>9</sup>

(iii) *Non-Standard (impaired, rated-up)*: Anticipated deviation from the life expectancy set out in the tables in the form of “the early death” of the particular measuring life, derived from an assessment of his or her current and projected state of health. A non-standard assessment generally results in a substantial premium savings and/or benefit enhancement compared to a standard-rated individual because of the anticipated shorter payout period.

(b) *Guaranteed term certain*: Fixed number of periodic benefit payments are made to the injured claimant, and his or her beneficiary or estate as the case may be, without reference to the life or death of any individual. The premium cost for any particular benefit level will vary directly with the length of the guarantee to beneficiary period.

(c) *Life plus minimum guaranteed term certain*: Most common form of structured settlement annuity, by which benefit payments cease at either the death of the measuring life or the conclusion of the guarantee to beneficiary period, whichever comes last. The optimum guaranteed period depends upon the settlement funds available, the immediate needs of the claimant, and his or her life expectancy.

### **3. Commencement of benefit payments:**

(a) *Immediate*: Payments begin immediately upon payment of the full premium.

(b) *Deferred*: Commencement of the benefit payments is delayed. On a deferred basis, benefits do not start until a specified time in the future, notwithstanding that the entire premium has already been paid in full. For example, payments may be deferred for five, ten, or fifteen years, or until the measuring life attains the age of majority or until retirement.



#### 4. Nature of the payments:

(a) *Fixed level payments*: Providing one specified dollar amount, which does not increase or decrease throughout the entire payment period, under any circumstance.

(b) *Variable payments*: Such payments are employed in an effort to protect the purchasing power and value of the benefits from inflation during the payout period. This feature is frequently used in structured settlement annuities. The amount of variation can be determined in a number of ways. The most common are:

(i) *Indexed-Variable*: Automatic cumulative cost-of-living adjustments in accordance with changes in a specified index; for example, the Consumer Price Index (CPI).

(ii) *Indexed-Fixed*: Payments are automatically increased each year on a cumulative basis by a specified percentage or dollar amount. This is the most common form of variation in the structured settlement context.

(c) *Combination periodic (fixed or variable) payments and lump sum(s)*: Annuity payments are, by definition, strictly periodic in nature. An annuity policy may, however, include one or more lump-sum payments to be made on an ascertained or ascertainable future date. This is, again, a very common form of structured settlement annuity policy.

#### 5. Miscellaneous provisions:

(a) *Custom provisions*: Some of the custom provisions utilized with structured settlements include: beneficiary designation; non-assignable (neither the policy nor any proceeds therefrom are capable of being assigned by the owner or the annuitant, collaterally or otherwise); non-commutable (a provision that prevents the owner, annuitant, or, most importantly, any of their creditors from collapsing the policy for its present-value lump-sum equivalent); non-transferable (neither the policy nor any proceeds therefrom are capable of being transferred by the owner or the annuitant, collaterally or otherwise).

(b) *Boilerplate*: Fine print provisions inserted to provide protection for both the annuity issuer and the owner or annuitant.

The foregoing, then, constitutes the “menu” of options from which the annuity portion of a structured settlement is formulated. To illustrate, a relatively uncomplicated structured settlement might begin with an “up-front” lump-sum payment (to pay past lost income and legal fees, for example) and be followed by an annuity policy featuring (in the order of the foregoing categories):

1. a single premium;
2. a standard life plan with a minimum guaranteed (to a beneficiary) term certain;
3. an immediate start time;
4. a combination of periodic (variable, indexed-fixed) and lump-sum payments; and
5. the non-assignable, non-commutable, and non-transferable provisions.

Of course, the size and timing of both periodic and lump-sum payments, the guaranteed period, and the rate of inflation protection are all variables that would be determined ultimately by the size of the loss or premium available and the financial needs and expectations of the claimant.

### **Notes to Chapter 1:**

1. (1981), 31 O.R. (2d) 384 (Ont. H.C.) at 387.
2. For a more complete history of structured settlements, see Leanne Todd, “Structured Settlements and Structured Judgments: Do They Work and Do We Want Them?” *Dalhousie Law Journal* 12 (November 1989): 448-51.
3. The increase in million dollar awards was to a significant degree attributable to the principles of damage assessment established in “The Trilogy” cases handed down by the Supreme Court of Canada in 1978. In particular, see *Andrews v. Grand & Toy Alberta Ltd.*, 2 S.C.R. 229 (S.C.C. 1978); *Thornton v. School District No. 57* (Prince George), 2 S.C.R. 267 (S.C.C. 1978); *Arnold v. Teno*, 2 S.C.R. 287 (S.C.C. 1978).



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4. For example, see *Courts of Justice Act*, R.S.O. 1990, c.C.43, ss. 116 and 116.1, *Insurance (Vehicle) Act*, R.S.B.C. 1996, c. 231, s. 99, and *Judicature Act*, R.S.A. 2000, c.J-2, s. 19.1.
5. D. Norwood, *The Uniform Life Insurance Law of Canada* (Toronto: Life Insurance Institute of Canada, 1974), 18, quoted in John P. Weir, *Structured Settlements* (Toronto: Carswell Legal Publications, 1984), 40.
6. *Ibid.*, 43.
7. This material was synthesized primarily from the table and text presented by Weir, *ibid.*, 48-52.
8. Please note that all structured settlement payments are guaranteed to the measuring life or recipient for the term of the plan (e.g., life in this case). In addition, a structured settlement might be guaranteed to a beneficiary for a period of time. If the recipient were to die within this guaranteed period, the beneficiary would then receive the payments, tax free, for the balance of the guaranteed period.
9. The tables referred to here are the life expectancy tables published by Statistics Canada.

## CHAPTER 2 - WHY USE STRUCTURED SETTLEMENTS?

The most obvious motivation for settling injury claims, in whole or in part, by means of a structured settlement is found in the income tax treatment of lump-sum damages received in personal injury or fatal accident cases in Canada. In general, compensatory damages for personal injury are not subject to tax. However, the income derived from the investment of these damages is. Only income generated by way of investment in a structured settlement is, in effect, tax free. In order to invest in and derive the tax benefits of a structured settlement, the following conditions must be met:<sup>1</sup>

1. The damages to be invested must be in reference to a claim for personal injury or death.
2. The claimant and the casualty insurer must agree to settle by way of a structure.<sup>2</sup>
3. The casualty insurer must purchase a single premium annuity policy to produce the periodic payments stipulated in the settlement agreement.
4. The casualty insurer must be both the owner and annuitant (beneficiary) of the annuity policy.
5. The annuity policy must be non-assignable, non-commutable, and non-transferable.
6. The casualty insurer must irrevocably direct that the payments be made to the claimant.
7. The casualty insurer must remain liable to make the periodic payments required by the settlement agreement in the event the life insurer defaults.

While the casualty insurer, as owner and annuitant/beneficiary of the annuity policy, is taxed on the income generated for the claimant, this tax exposure ultimately amounts to nothing, because the settlement is treated as a deductible expense. Moreover, while it was once necessary to obtain an “advance ruling” from Canada Revenue Agency (CRA) to ensure the tax-free status of any given structured settlement, this is generally no longer required.<sup>3</sup>

Structured settlements, then, can, because of the foregoing tax arrangement, produce more income for less investment cost. Consequently, both the claimant and the casualty insurer “win.” The only



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potential “loser”, given the tax revenue foregone, is CRA. However, this loss is mitigated by the elimination of the potential for lump-sum dissipation and the burden of support this invariably imposes on government.<sup>4</sup>

Structured settlements offer *advantages* beyond the basic tax-induced advantages of a *higher rate of income return for claimants* and *lower loss payments for casualty insurers*. In particular, structured settlements offer *claimants* the equally important additional *advantages* of:

1. *security* in the form of regular, guaranteed payments, received in the same periodic way that income and expenses are generally received;
2. *flexibility* (at least at inception) in that a structured settlement can be, by reference to the “menu” of annuity options, tailored to the anticipated needs of the claimant;
3. the *elimination of the risk of dissipation* and thereby the risk of becoming dependent on government assistance; and
4. *financial management* without a fee.

Similarly, structured settlements offer *casualty insurers* the additional *advantages* of:

1. *earlier settlements* and therefore savings realized in terms of reduced legal costs and prejudgment interest, because of the attractiveness of structured settlements; and
2. *elimination of bad faith potential* by facilitating settlement within policy liability limits.

Nonetheless, there is a “down” side to structured settlements. For the claimant, the principal disadvantage is, ironically, the *inflexibility* of structured settlements. Once in place, a structure cannot be altered in response to a change in the claimant’s needs.<sup>5</sup>

For the casualty insurer, there are essentially two disadvantages to structured settlements. First, there are *administrative costs* associated with the tax that the annuity portion of the structure attracts and the attendant need to retain a claim file (albeit a retired claim file). Second, there is a *contingent liability* that the casualty insurer assumes when it guarantees the payments made from the life insurer to the claimant.<sup>6</sup>



**Notes to Chapter 2:**

1. The tax treatment of structured settlements is set out in *Interpretation Bulletin IT-365R2*, issued by Revenue Canada (now Canada Revenue Agency) on May 8, 1987. Please see the appendix.
2. While structured settlements usually involve casualty insurers, Canada Revenue Agency does permit others (e.g., self-insurers) to settle damage claims by structured settlement, subject to the same conditions. However, it should be noted that a structured settlement cannot be obtained without the consent of the insurer, casualty or otherwise; that is, a structure cannot be purchased unilaterally by the claimant.
3. Some still insist upon “advance rulings” as a matter of procedure. However, notwithstanding cases involving more unique fact situations (e.g., extraterritorial cases), these are generally not necessary.
4. CRA’s “loss” is further mitigated by the tax revenue that structured settlement companies generate through their operations.
5. This inflexibility is, of course, also a virtue; that is, the inflexibility of a structured settlement eliminates the potential for lump-sum dissipation.
6. The potential insolvency of a life insurer would appear to be a disadvantage in theory only; that is, no life insurer in Canada has ever failed to meet its financial obligations. Nonetheless, if on-going administration and contingent liability were a concern to a casualty insurer, the ownership of a structured settlement could be assigned.



## CHAPTER 3 - WHICH CASES CAN BE STRUCTURED?

Structured settlements represent an alternative to, rather than a replacement for, lump-sum settlements; that is, they are not appropriate in all cases. For example, a structured settlement may not be appropriate in the case of a claimant who would like to purchase a business, particularly if the business is within the claimant's ability and would assist in his or her rehabilitation to a productive life.

Nonetheless, there are a wide variety of circumstances in which structures are a most appropriate means of settlement. These circumstances can be categorized by reference to the nature of both the claim and the claimant:<sup>1</sup>

### Claim Types Amenable to Structured Settlements

#### 1. Excess of \$50,000

Although structured settlements can be devised on the basis of any principal, \$50,000 is generally considered the point at which the additional administrative cost of designing and negotiating a structured settlement is justified by the tax and loss payment savings produced. Infants and claimants in high tax brackets, however, are clear exceptions to this rule. In the case of infants, given that payments are deferred often ten to fifteen years, the investment of even a small amount in a structured settlement can result in substantial payments eventually being generated. Similarly, in the case of claimants who are either in a high tax bracket to begin with or would be pushed into a higher tax bracket by the interest from a lump sum, the investment of, again, even a small amount in a structured settlement can produce significant tax savings.

#### 2. Serious Bodily Injury

The more serious the injury, the greater the damages and therefore the greater the tax and loss payment savings structured settlements have to offer. Moreover, the more serious the injury, the greater the future care costs and, as will be explained below, the greater, again, the benefits structures have to offer.



### **3. Fatal Injury and Dependency**

Fatal injury or wrongful death claims in tort are intended to compensate the surviving dependants for their future loss of support. This type of loss is assessed on the basis of after-tax dollars in most Canadian jurisdictions and subsequently “grossed-up” for the tax that investment of this amount would attract. A structured settlement allows the casualty insurer to avoid the expense of “gross-up” and return some of these savings to the claimant(s) by way of enriched benefits. Moreover, regardless of “gross-up”, structured settlements still offer, as explained above, tax and loss payment savings in proportion to the size of the loss.

### **4. Future Care**

Like fatal injury claims, future care claims in tort are assessed on the basis of after-tax dollars in most Canadian jurisdictions and subsequently “grossed-up” for taxes. Consequently, for the reasons cited above, this type of claim is also amenable to a structured settlement.<sup>2</sup>

### **5. Future Lost Income**

Future lost income claims in tort are assessed on a pre-tax basis in most Canadian jurisdictions and therefore there are no “gross-up” savings associated with the use of structured settlements. Nonetheless, a structure can still produce tax and loss payment savings for claimants and casualty insurers, respectively, in proportion to the size of the loss.

### **6. Excess Limits**

Lump-sum damages often exceed the liability limits of the casualty policy in question. This can result in the personal assets of the liable insured being placed at risk, the claimant being confronted with the expense of collecting against the personal assets of the liable insured, and, ultimately, a “bad faith” suit being launched by the liable insured against the casualty insurer.<sup>3</sup> These cases can, however, often be resolved within the liability limits by taking advantage of the tax and loss payment savings that structured settlements offer.



## **7. Multiple Parties**

As in the case of excess limits claims, structured settlements can be used to resolve claims in which there are multiple claimants and/or casualty insurers and limited compensatory funds.

## **8. Questionable Liability or Quantum**

Structured settlements offer a compromise solution to claims in which liability or quantum is inconclusive and the potential loss payment is significant. Again, by virtue of the tax and loss payment savings offered by structured settlements, the risk of an “all or nothing” outcome can be avoided and replaced by an outcome acceptable to both claimant and casualty insurer.

## **9. Punitive Damages**

The tax and loss payment savings realized through structured settlements provide an effective means of minimizing both the size and attendant adverse publicity of punitive or exemplary damage claims.

## **10. First Party Claims (Accident Benefits)**

Because first party Accident Benefits payments are made directly by the casualty insurer on a tax-free, periodic basis to begin with, there is no tax advantage to structured settlements in this context. Nonetheless, the fact that Accident Benefits and structured settlements both produce tax-free income makes structured settlements a most appropriate means of evaluating and settling Accident Benefits claims.

### **Claimant Types Amenable to Structured Settlements**

#### **1. Infants**

Structured settlements are almost invariably appropriate in the case of infants. As explained above, virtually no principal amount is too small for investment in a structure if the claimant is relatively young. The rate of return on investment in a structured settlement usually exceeds the interest earned on a lump sum paid into court or held in trust. Moreover, although investment income from a



lump sum is usually tax exempt until an infant reaches the age of twenty-one, a structure can extend the tax exemption period beyond twenty-one and thereby produce the tax and loss payment savings cited above. Finally, a structured settlement, because of its periodic nature, can provide protection against premature dissipation, which is invariably a large risk, particularly at age of majority.

## **2. Financially Unsophisticated**

Most injured claimants have neither the ability nor the desire to manage an investment portfolio of significance. Structured settlements are guaranteed and self-managing and therefore preclude the risk of premature dissipation and the need and expense associated with financial management.<sup>4</sup>

## **3. Reduced Life Expectancy**

Structured settlements almost invariably provide higher rates of return than conventional investments for claimants who, by virtue of their injury or life conditions, have a shorter than normal life expectancy.

## **4. Compensation Neurosis**

Structured settlements, because they tend to produce earlier settlements in a less adversarial fashion, may be of therapeutic value in the context of claimants suffering from, or likely to suffer from, compensation neurosis.

## **5. Marginal Rate of Income Taxation**

As explained above, claimants who are either in a high income tax bracket to begin with, or would be pushed into a higher income tax bracket by the interest earned on the investment of a lump sum, would derive a larger benefit from tax-free structure income.



**Notes to Chapter 3:**

1. Weir, *Structured Settlements*, 13.
2. In Ontario, pursuant to section 116.1 of the *Courts of Justice Act*, structured settlements are mandatory in reference to damages for future care in excess of \$250,000.00 arising out of a medical malpractice action.
3. In this regard, see *Pelky v. Hudson Bay Insurance Co.*, I.L.R. 720 (Ont. H.C. 1982).
4. According to an oft-cited American study (see Weir, *Structured Settlements*, 18), the dissipation rate among settlement recipients is such that 25% of them have nothing left within two months, 50% have nothing left by the end of the first year, 70% have nothing left within two years, and 90% have nothing left within five years.





## **CHAPTER 4 - WHEN SHOULD A STRUCTURED SETTLEMENT CONSULTANT BE CONTACTED, AND WHAT CAN A STRUCTURED SETTLEMENT CONSULTANT DO?**

A structured settlement consultant might be called upon at any time during the claim settlement process. In the past the convention was to call a structured settlement consultant when a claim was settled and some or all of the damages were to be structured. Increasingly, the practice has evolved so that contact is earlier. Structured settlement consultants are now often employed, to good advantage, for pre-settlement evaluative purposes; that is, to evaluate, *via* structured settlement costs, the present value of various future damage scenarios and provide structured settlement illustrations in reference to various potential settlement amounts (thereby demonstrating how and whether these amounts invested in a structured settlement might underwrite the claimant's future needs).

The structured settlement consultant's role is non-partisan. The assumptions underlying the assessment of damages and the negotiation over these assumptions is something left to the parties involved in negotiation. The structured settlement consultant's role is simply to assist in both the assessment and investment of these damages.

The services provided by the structured settlement consultant can be categorized generally in terms of education and consultancy (both pre- and post-settlement). The educational services provided by the structured settlement consultant might include publications, seminars, and meetings intended to encourage familiarity with the concept of structured settlements.

In the area of consultancy, the structured settlement consultant's services would include the review and analysis of all material relevant to evaluating damages and designing structured settlement proposals (e.g., medical and rehabilitation reports, future lost income analyses, future care cost analyses, etc.), the production of evaluative reports and structured settlement proposals, attendance at a variety of meetings (e.g., mediations, settlement meetings, pre-trials/trials, individual meetings with claimants and their representatives, etc.), the provision of income tax information, opinions and rulings from CRA, if and when necessary, and assistance in the execution of closing documentation.

The qualifications required of a structured settlement consultant exceed mere knowledge of and licensing in the life insurance business and contracts with all the producing life insurance companies. In particular, any "shopping list" of qualifications should include:



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1. Knowledge of the conduct of a civil action, including procedural aspects;
2. Working knowledge of legislative provisions, including those concerning taxation, insurance and dependency;
3. Detailed knowledge of damages assessment procedures;
4. Intimate familiarity with annuities, including brokerage abilities;
5. Knowledge of casualty insurance reserving methods and policy details;
6. Substantial experience in arranging structures; and
7. Personal coverage in the form of comprehensive errors and omission insurance.<sup>1</sup>

A structured settlement consultant is paid on the basis of the commission earned in reference to the structured annuities purchased from the various life insurance companies with which he or she is licensed.<sup>2</sup> Consequently, the services of a structured settlement consultant are offered to both claimants (and their representatives) and casualty insurers (and their representatives) free-of-charge.

**Notes to Chapter 4:**

1. Weir, *Structured Settlements*, 145.
2. The conflict of interest that could exist between the commission earned by the consultant and the best interests of the claimant is obviated by the fact that most life insurance companies offer competitive rates of commission. Moreover, structured settlement companies should be prepared to pledge, formally, that they place structured settlements by reference to what is in the best interest of consumers (as opposed to where the commissions earned are the highest).

## CHAPTER 5 - HOW DO YOU NEGOTIATE USING STRUCTURED SETTLEMENTS?

Whether and when structured settlements are used during the course of the claim settlement process (i.e., for evaluative or illustrative purposes) depends, to a large degree, on the philosophy embraced and the type of claim under consideration (i.e., tort or first party). However, as stated in the last chapter, the use of structured settlements has increasingly become a regular practice in the course of settling both tort and Accident Benefits claims.

### Tort Claims

Recall that structured settlements, relative to lump-sum settlements, can make “winners” of both claimants and casualty insurers. The most obvious reason for this is that the income generated through a structured settlement is received by the claimant tax free. This tax savings makes it possible to generate, again relative to a lump-sum investment, more income on the basis of a smaller principal or loss payment. Consequently, both claimant and casualty insurer “win.”

How then, specifically, might structured settlements be used to arrive at a “win-win” outcome? What constitutes a “win-win” outcome; that is, how much more income should the claimant reasonably expect to receive by virtue of a structured settlement, and how much savings can the casualty insurer reasonably expect in terms of a reduced loss payment?

The following stepwise procedure is reflective of what takes place in most successful negotiations involving structured settlements in the context of a tort claim.

#### 1. Claim and/or Claimant Type Identification

The first step is the identification of appropriate claim/claimant types or heads of damages (see chapter 3).

#### 2. Structured Settlement Consultant Contact

The next step is to contact a structured settlement consultant. Whether for evaluative or illustrative purposes, early contact allows the consultant to take the necessary preparatory measures; for example, the submission of medical documentation for life impairment ratings.



### 3. Lump-Sum Parameter

The third step in the process is usually the determination of a point of comparison; namely, the lump-sum claim potential. This usually means calculating, mathematically, the present value of the future heads of damages being claimed.<sup>1</sup>

### 4. Offer/Counter-offer

The fourth step is the preparation and exchange of offers. Offers involving structured settlement costs are usually arrived at in one of two ways: "top-down" or "ground-up."

A "top-down" offer begins with the present value of the claimant's full lump-sum loss. This amount is then broken down in terms of what is to be paid "up-front" and what is to be invested in the structured settlement. The amount to be invested in the structured settlement is discounted in recognition of the fact that the casualty insurer has no obligation to agree to a structure and, therefore, should share in the tax benefit that it produces for the claimant.<sup>2</sup> The discount employed, conventionally, has been in the range of 10% to 15%.<sup>3</sup>

A "ground-up" offer is based on the claimant's loss assessed on a periodic basis, rather than by reference to a lump sum. The principal amount to be invested in a structured settlement is calculated in reference to what would be necessary to replace the claimant's periodic loss; for example, the amount invested in a structure needed to produce the claimant's net annual future lost income. If this amount is not increased by some percentage factor, the claimant gets merely what he has lost, on a net basis, and the casualty insurer enjoys the full benefit of the tax savings through a significantly lower (relative to a present value calculation) loss payment. There is no convention associated with the percentage increase that may be applied to this "ground-up" figure; that is, this is a matter of negotiation.

### 5. Legal Fees

The fifth step in the process is legal fees. Legal fees are usually covered by the "up-front" payment. While always negotiable, the amount paid usually approximates what would have been paid had the loss been settled by a lump sum.



## 6. Settlement Documentation

The final step is the settlement documentation. The documentation associated with structured settlements is usually some combination of the following:

- a. Minutes of Settlement
- b. Release/Consent Judgment
- c. Partial Satisfaction Piece
- d. Certified Copy of the Annuity Contract(s)

The Minutes of Settlement may embody the Settlement Agreement and the Release. Alternatively, the Release may be a stand-alone document, particularly in cases where no action has been commenced. In the event that the structured settlement is negotiated in the context of a lawsuit, there may be a need to obtain a Consent Judgment (which would incorporate the Minutes of Settlement) and file a Partial Satisfaction Piece in relation to any initial “up-front” lump-sum payment.

The manner in which this documentation is worded is important to ensuring the tax-free status of the structured settlement. A structured settlement consultant should be able to assist with closing documentation. This would, at minimum, include the provision of precedent wording and an ability to determine and formally “sign off” on whether the closing documentation complies with CRA’s guidelines for structured settlements.

### **Accident Benefits Claims**

A first party Accident Benefits claim is a claim in contract. Consequently, unlike a tort claim (which, at some point, will be settled, speculatively, into the future), there is no legal obligation to settle an Accident Benefits claim into the future. All the casualty insurer will ever owe here are benefits to the present in accordance with the terms and conditions of the policy contract. Disputes may arise over compliance with these terms and conditions, but not over the present value of benefits that may or may not be owed in future.



*The User's Guide to Structured Settlements*

Nonetheless, so as to bring final resolution to Accident Benefits claims, both casualty insurers and claimants often voluntarily engage in settlement negotiations, and structured settlement costs are now, for the reasons stated in chapter 3, the generally accepted means of evaluation and settlement.

### **Settlement Options**

In the case of a claim for Accident Benefits, the disposition options available to casualty insurers are:

- A. Pay the benefits on an incremental/incurred basis, as prescribed by contract;
- B. Obtain a present value of the contractual obligation to benefits and negotiate a cash settlement on the basis of this; or
- C. Purchase a structured annuity to offload the contractual obligation to pay benefits in whole or in part.

*Option A:*

This option is self-explanatory and simply requires ongoing administration of the contractual entitlement(s).

*Option B:*

This option is attractive in that a successful settlement will bring claim closure to both the casualty insurer and the claimant.

In order to negotiate a settlement, the first step is to quantify the future entitlement. The valuation of a future entitlement can be done by means of a mathematical “present value” calculation or a structured annuity cost.

The structured annuity cost or “market valuation” approach is appealing in that it avoids any adversarial discussions as to the proper discount rate(s). A structured annuity cost is a real present value of future benefits in that it represents the cost that a life company or companies would require to assume a casualty insurer’s contractual obligation to pay benefit(s).



Once the value of the future entitlement is determined, the matter of contingencies or discounts can be negotiated to ultimately arrive at the cash settlement value. A portion of this then may be structured, depending on whether this has been agreed to by the parties to the settlement.

*Option C:*

*In lieu* of making payment directly, an insurer may wish to discharge its first party contractual obligation through the purchase of a structured annuity. This may be done unilaterally, so long as what is being replaced by the annuity is beyond dispute (e.g., the payment of a maximum monthly benefit). The principal advantage of this option to the insurer is the elimination of the administrative costs associated with an open file. Furthermore, the purchase of a structured annuity may result in a reserve savings, in that the annuity cost may reflect an impaired life expectancy rating, for example, whereas reserves usually do not. The advantage of this option to the claimant is that it usually eliminates the contingency of disentitlement and the involvement of the insurer in the claimant's day-to-day life.

If opted for, a guarantee to beneficiary or reversionary interest will usually form part of the structured annuity contract under both Option B and Option C. A guarantee to beneficiary/reversionary interest is a guarantee term that ensures that the beneficiary (i.e., invariably the insurer in the circumstances of Option C) receives, upon the death of the claimant, the payments (on a commuted basis if the beneficiary named is an insurer) within the guarantee to beneficiary/reversionary interest term.

### **Settlement Procedure**

Notwithstanding legal fees and closing documentation, the settlement procedure for an Accident Benefits claim can be inferred on the basis of the foregoing options.

The matter of legal fees in an Accident Benefits case is very much subject to negotiation. At times this issue is dealt with in a manner much like it would be in the context of a tort claim. However, if nothing is in dispute and negotiation has been entered into voluntarily, it may be (and is often argued by those representing the casualty insurer) that nothing or a significantly lesser amount (relative to what might be paid in a tort case) is owed in legal fees. Again, this is very much a negotiable issue, depending on the circumstances of the case.



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Accident Benefits closing documentation is case specific. If required (and it is likely not with Option C), a qualified structured settlement consultant will have available properly vetted precedents and be willing and able to assist in drafting of closing documentation.

**Notes to Chapter 5:**

1. The calculation of a present value can be a highly contentious issue in that a dispute often arises over the appropriate discount rate to be employed. So as to avoid this, many jurisdictions have mandated a discount rate for tort claims.
2. As pointed out in chapter 2, structured settlements impose contingent liability and administrative costs on casualty insurers. This provides further rationale for a discount. And without a discount of some sort, the claimant is, by virtue of the tax-freedom a structure provides, likely to be indemnified well in excess of, perhaps, his or her before-tax loss and, certainly, his or her after-tax loss.
3. See Justice R. E. Holland, "Structured Settlements in Injury and Wrongful Death Cases," *Advocates' Quarterly* 8 (1987): 191.





## **CONCLUSION**

Structured settlements are certainly not new. Moreover, at least conceptually, structured settlements are not complex. They represent an alternative means of evaluating and receiving compensatory damages for personal injury. If used in the appropriate circumstances, they can be of great advantage to all parties to a claim. The key is early recognition of what circumstances are appropriate, followed by contact with a qualified structured settlement consultant; that is, someone properly equipped to provide assistance throughout the claim settlement process.



**APPENDIX**

Canada Revenue Agency    Agence du revenu  
du Canada

**INTERPRETATION BULLETIN**

NO: IT-365R2

DATE: May 8, 1987

SUBJECT: INCOME TAX ACT

**Damages, Settlements and Similar Receipts**

REFERENCE: Section 3 (also section 6, subsections 5(1), 12.2(1) and (3), 14(1), 16(1), 56(1), and 248(1), paragraphs 81(1)(g.1) and (g.2) and subparagraphs 14(5)(a)(iv) and 56(1)(a)(ii)).

This bulletin replaces and cancels IT-365R dated March 9, 1981 and the Special Release to IT-365R which was issued on May 25, 1984. Current revisions are designated by vertical lines.

1. This bulletin deals with the treatment for tax purposes of amounts received
  - (a) out of claims for damages for personal injury or death,
  - (b) as compensation for the loss of property or income,
  - (c) as crime compensation awards, and
  - (d) on termination of employment.

Amounts received as Damages in Respect of Personal Injury or Death

2. Amounts in respect of damages for personal injury or death may be received by an injured taxpayer or by a dependant of a deceased taxpayer on account of:



- (a) Special damages - examples are compensation for
  - (i) out-of-pocket expenses such as medical and hospital expenses, and
  - (ii) accrued or future loss of earnings and
- (b) General damages - examples are compensation for:
  - (i) pain and suffering,
  - (ii) the loss of amenities of life
  - (iii) the loss of earning capacity,
  - (iv) the shortened expectation of life and
  - (v) the loss of financial support caused by the death of the supporting individual.

All amounts received by a taxpayer or the taxpayer's dependant, as the case may be, that qualify as special or general damages for personal injury or death will be excluded from income regardless of the fact that the amount of such damages may have been determined with reference to the loss of earnings of the taxpayer in respect of whom the damages were awarded. However, an amount which can reasonably be considered to be income from employment rather than an award of damages will not be excluded from income. The tax treatment of an award of compensation, as adjudicated by a compensation board or commission in Canada, which is received as a result of a worker having suffered injury, disability or death while performing the duties of employment, is explained in IT-202R2.

#### Awards Not Considered to be Annuities

3. An award of damages for personal injury or death that decrees that it be paid in periodic payments is not, despite such periodic payments, considered to be an annuity contract for the purposes of subsections 12.2(3) and 56(1) and the periodic payments themselves are not considered to be annuity payments. However, an annuity contract purchased by a taxpayer or a



taxpayer's representative with proceeds of a lump sum award received for damages for personal injury or death will be an annuity contract for all purposes of the Act and will, except in the circumstances described in 6 below, give rise to income in the taxpayer's hands.

#### Interest Element of Awards for Personal Injury or Death

4. Where an amount in respect of damages for personal injury or death has been awarded by a Court or resolved in an out-of-court settlement, no part of such amount will be income to the recipient even though the amount includes or is augmented by an amount which, pursuant to the terms of the Court order or the settlement agreement, is referred to as interest. However, where an amount that has been awarded for damages is held on deposit, the amount of interest earned will be included in the income of the injured taxpayer unless paragraph 81(1)(g.1) or (g.2) has application (see 6 below). Where an amount that has been awarded for damages is held in trust, any interest earned on the amount is income of the trust or of the beneficiary, depending on the circumstances.

#### Structured Settlement

5. A "structured settlement" is a means of paying or settling a claim for damages, usually against a casualty insurer, in such a way that amounts paid to the claimant as a result of the settlement are free from tax in the claimant's hands. To create such a structured settlement the following conditions must be complied with:

- (a) a claim for damages must have been made in respect of personal injury or death,
- (b) the claimant and the casualty insurer must have reached an agreement under which the latter is committed to make at least periodic payments to the claimant for either a fixed term or the life of the claimant,
- (c) the casualty insurer must:
  - (i) purchase a single premium annuity contract which must be non-assignable, non-commutable, non-transferable and designed to produce payments equal to the amounts, and at the times, specified in the agreement referred to in (b),



(ii) make an irrevocable direction to the issuer of the annuity contract to make all payments thereunder directly to the claimant, and

(iii) remain liable to make the payments as required by the settlement agreement (i.e., the annuity contract payout).

As a consequence of compliance with the foregoing conditions, the casualty insurer is the owner of, and annuitant (beneficiary) under, the annuity contract and must report as income the interest element inherent in the annuity contract while the payments received by the claimant represent, in the Department's view, non-taxable payments for damages.

Income from Property that was Received by a Taxpayer Under 21 Years of Age as an Award of Damages for Personal Injury

6. For the 1984 and subsequent taxation years, paragraphs 81(1)(g.1) and (g.2) exempt from tax the income of a taxpayer from particular sources for taxation years during any part of which the taxpayer was under 21 years of age. To qualify for this exemption the income must, during the particular taxation years, be derived from one or more of the following sources:

- (a) property received by or on behalf of a taxpayer who is under 21 years of age as an award of, or pursuant to an action for, damages in respect of the taxpayer's physical or mental injury,
- (b) property substituted for property described in (a),
- (c) a capital gain derived from the disposition of property described in (a) or (b), or
- (d) invested income that was, by virtue of paragraph 81(1)(g.1) or (g.2), not required to be included in the taxpayer's income for a particular taxation year described above.

For the purposes of paragraphs 81(1)(g.1) and (g.2) income will include income received and receivable and income accrued (i.e., earned but not received) up to, but not beyond, the end of the taxation year in which the taxpayer attains the age of 21 years.

7. For taxation years ending after 1971 and before 1984, former paragraph 81(1)(g.1)
- (a) caused the exempt period to end on the day immediately preceding the day on which the injured taxpayer attained the age of 21 years, and
  - (b) restricted exempt income to income that was actually received while the injured taxpayer was under 21 years of age.

#### Receipts in Respect of Non-Performance of Business Contracts

8. An amount received by a taxpayer in lieu of the performance of the terms of a business contract by the other party to that contract may, depending on the facts, be either an income or capital receipt. If the receipt relates to the loss of an income-producing asset, it will be considered to be a capital receipt; on the other hand, if it is compensation for the loss of income, it will constitute business income. Again, while it is a question of fact as to whether a receipt is an income or capital amount, the following factors are important in making this distinction:

- (a) if the compensation is received for the failure to receive a sum of money that would have been an income item if it had been received, the compensation will likely be an income receipt,
  - (b) “where for example, the structure of the recipient’s business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no more than a surrogatum for the future profits surrendered, the compensation received is in use to be treated as a revenue receipt and not a capital receipt”, and
  - (c) “when the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient’s profit-making apparatus, involving the serious dislocation of the normal commercial organization and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilization of a capital asset and is therefore a capital and not a revenue receipt.”
- ((b) and (c) above are quotations from the judgment in *Commissioner of Inland Revenue v. Fleming and Co. (Machinery) Ltd.*, 33TC57 (House of Lords)).



9. Where an amount received by a taxpayer as compensation for a breach of a business contract is a capital amount according to the comments in 8 above, that amount would relate either to a particular asset of the taxpayer or to the whole structure of the taxpayer's profit-making apparatus. If, on the basis of the facts of the case, such as the terms of a contract, settlement or judgment, the amount received relates to a particular asset (tangible or intangible) which is sold, destroyed or abandoned as a consequence of the breach of contract, it will be considered proceeds of disposition of that asset or a part thereof, as the case may be. Where the amount of compensation relates to a particular asset that was not disposed of, the amount will serve to reduce the cost of that asset to the taxpayer. On the other hand, where the amount of compensation is of a capital nature but it does not relate to a particular asset as indicated above, the amount will be considered as compensation for the destruction of, or as damages to, the whole profit-making apparatus of the taxpayer's business. Such compensation may result in an "eligible capital amount" for the purpose of subsection 14(1) and subparagraph 14(5)(a)(iv).

#### Compensation for Loss of Business Income or Business Properties

10. Amounts received by a taxpayer with respect to the loss of business income or business property may fall into one of the following categories:

- (a) a non-taxable receipt,
- (b) an income receipt,
- (c) a receipt resulting from the disposition of a capital property, or
- (d) an eligible capital amount.

See IT-182 for a discussion of the factors that determine the tax status of a given receipt.

#### Crime Compensation Awards and Similar Receipts

11. A number of provinces make crime-compensation awards pursuant to the authority of criminal-injury compensation laws. The Department considers that such crime-compensation awards are non-taxable.





12. A taxpayer who is a victim of a crime may receive compensation from a source other than the person who committed the crime or a crime-compensation board. For example, a male employee of a bank is kidnapped and upon his release the bank pays the employee an amount to compensate for “damages” inflicted on him. Where the amount of money or benefit received is compensation for damages the Department will normally consider the amount to be a non-taxable receipt even if the damages are computed with reference to the victim’s salary. To qualify as a non-taxable receipt, the amount must not be in excess of a fair evaluation of the damages suffered by the employee having regard to all relevant facts of the case. The amount of the receipt will ordinarily be accepted as a fair evaluation unless there are indications (such as the employer and employee not dealing at arm’s length) that the receipt includes an amount for services rendered by the employee to the employer. Any part of an amount received by a taxpayer from his employer, or former employer, that is compensation for loss of earnings (e.g., an amount paid in lieu of regular wages or benefits) resulting from a disability of short duration will be included in the income of the taxpayer.

13. Where a taxpayer, other than an employee, is in receipt of an amount that has not been awarded by a court or a crime-compensation board (a payment by a bank to a customer, for example) for “damages” inflicted as a result of a crime, the total amount is considered to be a non-taxable receipt.

#### Amounts Received on Termination of Employment

14. Applicable with respect to the termination of an office or employment occurring after November 12, 1981, the defined term “termination payment” was repealed by S.C. 1980-81-82-83, c.140. The definition of “retiring allowance” in subsection 248(1) was amended concurrently so that amounts that were previously included in the definition of a termination payment are now fully included in income as retiring allowances under subparagraph 56(1)(a)(ii). Retiring allowances are dealt with in IT-337R2.

15. Where a taxpayer receives an amount pursuant to the terms of an employment contract, the amount is to be included in computing the taxpayer’s income under subsection 5(1) or section 6, whichever may be applicable, as income from an office or employment, whether or not it is received on termination of the employment. Such an amount would include, for example, salary, wages, accrued vacation pay, and an amount paid in lieu of notice of termination.