

# **“Special Needs” Trusts Under the Texas Property Code and The Texas Probate Code**

Written By:  
Helen B. Wils  
Crain, Caton & James  
1401 McKinney, Suite 1700  
Houston, Texas 77010  
(713) 658-2323

## **I. INTRODUCTION.**

A severely injured person often will require Medicaid assistance in order to pay for continuing medical care. Proceeds from the settlement of a lawsuit, whether structured or not, may disqualify an individual from Medicaid eligibility. Individuals whose resources exceed certain limits cannot qualify for Medicaid. Certain assets, however, will not count as resources in determining Medicaid eligibility. For example, assets placed in a “special needs” or “supplemental needs” trust created on behalf of a disabled individual, and funded with assets of that individual, will maintain the individual’s eligibility for governmental benefits. A “special needs” or “supplemental needs” trust may be funded with proceeds of a personal injury settlement, including periodic payments from a structured settlement. The terms “special needs” and “supplemental needs” are often used interchangeably.

Section 141.002 of the Texas Civil Practice and Remedies Code defines a structured settlement as “an arrangement for periodic payment of damages for personal injuries or sickness established by settlement or judgment in resolution of a tort claim or for periodic payments in settlement of a workers' compensation claim.” Tex. Civ. Prac. & Rem. Code §141.002(13). Such payments may be made to the trustee of a special needs trust for the sole benefit of the beneficiary of the trust.

There are two types of “special needs” or “supplemental needs” trusts: (i) those which are “self-settled”; and (ii) those which are created by a third party.

The assets of a self-settled trust are assets which belonged to the beneficiary or which the beneficiary had a right to receive, such as, for example, the proceeds of a personal injury settlement. Special needs trusts also are created by third parties for the benefit of the beneficiary from funds belonging to the third party. For example, a grandparent may make provisions for a special needs trust for a grandchild in his or her will to avoid disqualifying a disabled grandchild from SSI and Medicaid benefits. This paper will deal primarily with self-settled special needs trusts. Self-settled special needs trusts must provide for the reimbursement of any Medicaid payments made on behalf of the beneficiary of the self-settled special needs trust. Third party special needs trusts need not contain such a requirement.

## II. DEFINITIONS.

Ordinarily, a trust created with an individual’s own assets count as a resource in determining Medicaid eligibility, but 42 U.S.C. 1396p(d)(4)(A) provides an exception for trusts containing assets of certain disabled individuals. Such trusts commonly are referred to as “(d)(4)(A)” trusts or “special needs” trusts. What constitutes “disability” for Medicaid purposes differs significantly from the definition of “incapacity” under the Property Code and under the Probate Code.

A. **Disability.** To be the beneficiary of a special needs trust, the individual must be disabled within the meaning of 42 U.S.C. §1392p(d)(4)(A). Under 42 U.S.C. §1396p(d)(4) (A) the individual must be unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months (or, in the case of a child under the age

of 18, if he suffers from any medically determinable physical or mental impairment of comparable severity. 42 U.S.C. §1382c(a)(3)(A)(C).

**B. Incapacity Under the Texas Property Code.** The definition of disability under 42.U.S.C.§1382c(a)(3)(A)(C) differs substantially from the definition for “incapacity” found in Texas Property Code §142.007. Section 142.007 provides that an

“‘incapacitated person’ means a person who is impaired because of mental illness, mental deficiency, physical illness or disability, advanced age, chronic use of drugs, chronic intoxication, or any other cause except status as a minor to the extent that the person lacks sufficient understanding or capacity to make or communicate responsible decisions concerning his person.”

Tex. Prop. Code §142.007.

**C. Incapacity Under the Texas Probate Code.** The Texas Probate Code provides a definition of incapacity.

"Incapacitated person" means:

- (A) a minor;
- (B) an adult individual who, because of a physical or mental condition, is substantially unable to provide food, clothing, or shelter for himself or herself, to care for the individual's own physical health, or to manage the individual's own financial affairs; or
- (C) a person who must have a guardian appointed to receive funds due the person from any governmental source.”

Tex. Prob. Code §601(14).

**III. CREATION OF SPECIAL NEEDS TRUSTS.** In Texas, special needs trusts are established pursuant to either §142 of the Texas Property Code or §867 of the Texas Probate Code in conjunction with 42 U.S.C. §1396p(d)(4)(A).

**A. 42 U.S.C. 1396p(d)(4)(A) Trusts**

1. **Purpose.** The purpose of a “special needs” trust is to provide for the beneficiary’s supplemental needs only; it may *not* be used for the beneficiary’s basic

support, including basic food, clothing, shelter, health, support, maintenance and education.

2. **Requirements.** A trust created under 42 U.S.C. 1396p(d)(4)(A) must meet certain requirements as follows:

- a. the trust must contain assets of an individual;
- b. the individual must be under 65 when the trust is created;
- c. the individual must be disabled in accordance with the definition provided in 42 U.S.C. §1396p(d)(4)(A);
- d. the trust must be established by a parent, grandparent, legal guardian or court; and
- e. the trust must provide for repayment to the state of trust funds equal to the amount paid by Medicaid for the beneficiary upon the termination of the trust.

42 U.S.C. 1396p(d)(4)(A).

**B. Requirements for Texas Property Code Section 142 Trusts**

Section 142 Special Needs Trusts are created in suits where a minor has no legal guardian or an incapacitated person is represented by a next friend or guardian ad litem. These trusts are generally created out of proceeds resulting from a settlement or judgment in personal injury suits. A special needs trust qualifying under 42 U.S.C. 1396p(d)(4)(A) may be created by filing an application to the court in which the lawsuit is pending for an order creating a trust under Texas Property Code §142. Attach the proposed trust agreement as an exhibit to the application.

Mandatory provisions of a §142 trust are as follows:

1. The minor or incapacitated person must not have a legal guardian. Tex. Prop. Code § 142.001. If there is a legal guardian, the appropriate trust is a trust established under § 867 of the Texas Probate Code.

2. The applicant must be the next friend or the court-appointed guardian ad litem. Tex. Prop. Code § 142.005(a).

3. The trustee must be a trust company or state or national bank having trust powers in Texas. Tex. Prop. Code §142.005(a)

4. The trust must provide that the corporate trustee serve without bond. Tex. Prop. Code §142.005(b)(5) .

5. The minor or incapacitated person must be the sole beneficiary of the trust. Tex. Prop. Code §142.005(b)(1).

6. The trust must provide for distributions of principal, income or both as the trustee determines is reasonably necessary for the health, education, support and maintenance of the beneficiary, with any income not distributed added to principal. Tex. Prop. Code §142.005(b)(2), 142.005(b)(3).

**If distributions are made using the distributive standard described in the paragraph above, the beneficiary will not qualify for state Medicaid assistance.** A departure from this language is permitted to incorporate special needs language necessary to maintain government benefits.

Texas Property Code §142.005(g) provides:

“Notwithstanding any other provision in this chapter, if the court finds that it would be in the best interests of the minor or incapacitated person for whom a trust is created under this section, the trust may contain certain provisions determined by the court to be necessary to establish a special needs trust as specified under 42 U.S.C. §1396p(d)(4)(A).”

Tex. Prop. Code §142.005(g).

7. The trust must provide that the trustee receive reasonable compensation upon application to and approval of the court. Tex. Prop. Code §142.005(b)(6).

8. The trust terminates (i) on the death of the beneficiary; (ii) if the beneficiary is a minor, when the beneficiary reaches the age stated in the trust or the beneficiary's 25th birthday, whichever occurs first; or (iii) if the beneficiary is incapacitated, on the death of the beneficiary prior to attaining capacity. Tex. Prop. Code §142.005(b)(4).

9. Upon termination, the remaining trust estate is distributed to the beneficiary, or if the beneficiary is deceased, to his representative. Tex. Prop. Code 142.005(e). **However, if the trust is to qualify as a special needs trust under 42 U.S.C. 1396p(d)(4) (A), the trust must provide for repayment to the state for Medicaid benefits paid on behalf of the beneficiary prior to distribution of assets to the beneficiary or the beneficiary's representative.** Therefore, the practitioner should take care to provide for repayment as mandated by 42 U.S.C. 1396p(d)(4)(A) and permitted by Tex. Prop. Code §142.005(g).

10. An exculpatory clause in the trust is not enforceable unless

“ the provision is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust; and the court creating or modifying the trust makes a specific finding that there is clear and convincing evidence that the inclusion of the provision is in the best interest of the beneficiary of the trust.”

Tex. Prop. Code §142.005(j).

11. In 1999, §§142.008 and 142.009 were added to the Probate Code. These sections set out the requirements for structured settlements. Section 142.008 provides as follows:

“(a) In a suit in which a minor or incapacitated person who has no legal guardian is represented by a next friend or an appointed guardian ad litem, the court, on a motion from the parties, may provide for a structured settlement that:

(1) provides for periodic payments; and

(2) is funded by:

(A) an obligation guaranteed by the United States government; or

(B) an annuity contract that meets the requirements of Section 142.009.

(b) the person obligated to fund a structured settlement shall provide to the court:

(1) a copy of the instrument that provides funding for the structured settlement; or

(2) an affidavit from an independent financial consultant that specifies the present value of the structured settlement and the method by which the value is calculated.

The structured settlement must be solely for the benefit of the beneficiary. Tex. Prop. Code §142.008(c).

12. Section 142.009 establishes the requirements for an annuity contract for a structured settlement. The insurance company providing the annuity contract must be (i) licensed in Texas to write annuity contracts; (ii) have a minimum of \$1,000,000 in capital and surplus; and (iii) be approved by the court and comply with any court requirements to ensure the funding to satisfy the periodic payments. The court may consider whether the company holds industry ratings equivalent to at least two of the following rating organizations:

- a. A. M. Best Company: A++ or A+;
- b. Duff & Phelps Credit Rating Company Insurance Company Claims Paying Ability Rating: AA-, AA, AA+, or AAA;
- c. Moody's Investors Service Claims Paying Ability Rating: Aa3, Aa2, Aa1, or aaa; or
- d. Standard & Poor's Corporation Insurer Claims-Paying Ability Rating: AA-, AA, AA+, or AAA.”

Tex. Prop. Code § 142.009.

**C. Texas Probate Code § 867 Management Trusts.** To establish a trust under § 867 of the Texas Probate Code, there must be an existing guardianship. If there is an existing guardianship, the guardian, the attorney ad litem, or the guardian ad litem for the Ward may apply to the court in which the guardianship is pending to create a trust pursuant to Section 867 of the Texas Probate Code. The requirements of an 867 Management Trust are as follows:

1. With certain exceptions, the trustee must be a financial institution. Tex. Prob. Code §867(b).

a. If, however, the value of the trust's principal is \$50,000 or less, the court may appoint a person to serve as trustee if the court finds the appointment to be in the ward's best interests. Tex. Prob. Code §867(c).

b. If the value of the trust's principal is greater than \$50,000, the court may appoint a person to serve as trustee only if (i) no financial institution is willing to serve as trustee; and (ii) the appointment is in the ward's best interests. Tex. Prob. Code §867(d). Prior to the court's making a finding that no financial institution is willing to serve, the court has to check a list of corporate fiduciaries in Texas. The list is available from the office of the presiding judge of

statutory probate courts or from the principal office of the Texas Bankers Association. Tex. Prob. Code §867(e).

2. **Best Interests.** The establishment of the trust must be in the ward's best interests. Tex. Prob. Code Ann. §867(b). Section 867 does not define "best interests" or address factors the court may consider in determining "best interests."

a. If the applicant seeks to establish a § 867 "special needs" trust, the ward's best interests will be served by preserving the ward's SSI/Medicaid eligibility.

b. If the trust is not a "special needs" trust, it is presumptively in the ward's best interests to save court costs and legal fees of the guardianship and obtain the advantage of the professional management and broader investment options available to a corporate trustee.

3. **Sole Beneficiaries.** The ward must be the sole beneficiary of the trust. Tex. Prob. Code Ann. §868(a)(1).

4. **Distributive Standards.** The trust must provide that the Trustee may disburse as much principal or income as the trustee determines is necessary for the ward's health, education, support and maintenance and any income not distributed shall be added to principal. Tex Prob. Code Ann. §868 (a)(2)<sup>1</sup>. **If the trust instrument uses this distributive standard, however, it will not qualify as a "special needs" trust.** When creating or modifying the

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<sup>1</sup> The statute also permits the trust instrument to allow for distributions "for the health, education, support or maintenance of . . . another whom the Ward is legally obligated to support." Tex. Prob. Code § 868(b). *Do not* include this provision if you want the trust to qualify as a "special needs" trust. *Do not* use this provision in a trust for a minor beneficiary. The parents have a legal obligation to support the minor ward; the minor ward does not have a legal obligation to support the parent.

trust, the court may modify terms required by §868(a)(1) and (2) only if the court determines modification or omission is necessary and appropriate for the ward to receive public benefits or assistance under a state or federal program not otherwise available to the ward and it is in the ward's best interests. Tex. Prob. Code Ann. §868(d). If it is desirable to establish a "special needs" trust, the ad litem should assure that the trust agreement does not permit disbursement for the ward's basic health, education, support, and maintenance if the ad litem wants the trust to qualify as a (d)(4)(A) special needs trust.

5. **No Bond if Corporate Trustee.** If the trustee is a corporate fiduciary, the trustee serves without bond. Tex. Prob.Code Ann. §868 (a)(4).

6. **Bond Required of Trustee an Individual.** If the trustee is a person rather than a corporate trustee, the trustee must file a bond in an amount equal to the value of the trust principal and protected annual income and in accordance with any other conditions that the court determines are necessary. Tex. Prob. Code §868B.

7. **Compensation.** Upon annual application to the court and the court's approval, the trustee may receive reasonable compensation from the trust estate determined in the same manner as compensation of a guardian under Section 665 of the Probate Code. Tex. Prob. Code Ann. §868 (a)(5). Section 665 permits the guardian a fee of 5% of the estate's gross income and 5% of all money paid out upon a finding that the guardian has prudently managed the estate. Tex. Prob. Code §665. However, if the court

finds that compensation is unreasonably low, the court may review and modify the amount of compensation. Tex. Prob. Code §665. As a general rule, the probate courts in Harris County approve corporate trustees' fees to be paid in accordance with the trustees' published fee schedule. *Practice Tip*. In the application to create a §867 trust, the practitioner should request that fees be permitted in accordance with the trustees' published fee schedule. A payment provision permitting such payment should be incorporated into the trust agreement and the fee schedule should be attached to the trust agreement for the court's approval.

8. **Exculpatory Provisions.** The 2003 legislature amended §867 to provide that an exculpatory clause in the trust is not enforceable unless

“(1) the provision is limited to specific facts and circumstances unique to the trust property of that trust and is not applicable generally to the trust; and

(2) the court creating or modifying the trust makes a specific finding that there is clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.”

Tex. Prob. Code §868( c).

9. **Termination – Minors.** If the ward is a minor, the trust terminates (i) on the death of the ward or the ward's 18th birthday, whichever is earlier; or (ii) on a date selected by the court but not later than the ward's 25th birthday. Tex. Prob. Code §870. Some courts will not permit a §867 trust to extend beyond the Ward's 18th birthday, assuming the Ward is not

incapacitated. If the Applicant wants the trust to extend beyond the Ward's 18th birthday, check with the Court in which the guardianship is pending.

10. **Termination – Incapacitated Persons.** If the ward is incapacitated, the trust terminates on the date the court determines that continuing the trust is no longer in the ward's best interests or on the death of the ward. Tex. Prob. Code §870.

11. **Annual Account.** The trustee must prepare an annual account in the same manner required of a guardian; the annual account shall be provided to the guardian of the Ward's person or estate. Tex. Prob. Code §871.

12. **Final Account.** Upon termination, the trustee prepares a final account in the same manner as a guardian under §749 and after court approval, distributes the remaining trust assets to the ward, when the trust terminates on its own terms, to the successor trustee, or to the personal representative of the deceased ward's estate. Tex. Prob. Code Ann. §873.

13. **Discharge of Guardian.** In the 2003 legislative session, §868A was amended to provide that on or at the time of the creation of the trust, the court may discharge the guardian of the estate if the court determines that the discharge is in the ward's best interest. (Prior to the change, §868A required that a guardian of the person remain in place.)

14. **Amendment.** The court may amend, modify or revoke the trust at any time before the trust terminates but the Ward or the guardian of the Ward's estate may not revoke the trust. Tex. Prob. Code § 869.

15. **Successor Trustee.** The court may appoint a corporate fiduciary as successor trustee if the trustee resigns, becomes ineligible, or is removed. Tex. Prob. Code § 869A.

16. **Liability.** The guardian of the person or estate is not liable for the acts or omissions of the trustee. Tex. Prob. Code § 872.

**D. Caveats.**

1. Parents' Duty to Support Child. If the beneficiary is a minor, the parents still have a duty to support the child, the existence of a trust notwithstanding. Section 777 of the Code provides that a parent who is the guardian of a ward may not use income or corpus from the ward's estate for the ward's support, education or maintenance unless the guardian presents clear and convincing evidence that the parents are unable to support the ward without unreasonable hardship.

2. Taxes. These trusts are considered grantor trusts under IRC §§ 671-678. Taxes due and the costs of preparation may come out of trust proceeds. Income is taxable to the beneficiary. Make sure the appropriate tax returns are filed!

## **E. Structured Settlement Basics.**

1. What is it? A structured settlement is a settlement in which there is a lump-sum payment and a series of periodic payments to the plaintiff in the future. These future payments are generally funded by an annuity purchased with a portion of the settlement.<sup>2</sup>

A structured settlement can be an attractive alternative for all parties involved. The plaintiff can enjoy favorable tax treatment concerning receipt of payments from the annuity while the amount payable by the defendant for the purchase of the annuity is generally less than the defendant would pay in a lump-sum settlement. Cases which qualify for the use of a structured settlement involve lost future income and/or future medical expenses.

The structured settlement requires attorneys to act not only as their clients' counsel, but also as their investment advisor. Considerations of the structured settlement negotiating process include: valuation of the settlement, determining the needs of the plaintiff, the tax aspects of the structure, the safety of the expected future payments, and the attorney fees.

The value of the structured portion of the settlement is determined by the cost to the defendant. Normally, the defense will not provide the plaintiff with the cost of the annuity. In determining the cost, the following factors are utilized to calculate annuity premiums: interest rates, mortality, uniform periodic payments, future lump sum payments, and growth of future payments.

Just as every case is distinct, so are the needs of each plaintiff. For this reason, it is not possible to have a standard structured settlement upon which to rely. There are general provi-

<sup>2</sup> The case of A. v. D., 482 A.2d 531 (N.J. Super. Ct. App. Div. 1984), exemplifies how structured settlements are utilized. Of the settlement approved by the court, \$275,000 was allotted to a structured settlement for the plaintiff. Id. at 533. Of this amount, \$225,000 was used to purchase an annuity that provided both monthly and lump-sum payments. Id. The annuity was written for \$400 per month immediately, increasing to \$750 per month in 1989, and increasing again in 1996 to \$2,500 per month plus four percent annual increases. Id. at 535-36, exhibit III. The lump-sum provisions of the annuity provided for payments of \$10,000 per year for 12 years starting in 1990, then two lump-sum payments: one of \$200,000 in 2000 and another of \$154,166.67 in 2011. Id. E.g., Gayla R. Harrison, The Ethics of Structuring Settlements, 34 Drake L. Rev. 1045, 1045 n.1 (1985).

sions that fit most cases, but there are also needs which do not fit the standard mold. The plaintiff's needs must be considered in light of his or her personal circumstances.

In order for the structured settlement to receive the specific tax advantages available, the payments must be properly structured. The primary support for excluding amounts from the income of a particular recipient is § 104 of the Internal Revenue Code ("IRC"). That section grants an exclusion from gross income of various amounts including "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or sickness." IRC § 104(a)(2)

The advantages of the structured settlement are negated unless the necessary precautions are taken to help insure the safety of the expected future payments. Generally, an increased rate of return directly correlates to an increased risk of failure. Attorneys negotiating structured settlements must look into the financial stability of the life insurance company issuing the annuity and attempt to get additional guarantees to back up a potential failure of the annuity. Even the most carefully considered settlements are of no value if the annuity is placed with a company that fails and the attorney has not established any additional safeguards.

2. Reasons for Selecting Structured Settlements. In a majority of cases, the option of selecting a lump sum payment or a structured settlement is in the hands of the ad litem.

a. Plaintiff's Perspective. The ad litem must weigh the benefits of a structure against the benefits of individual management. While a structured settlement is not the most lucrative investment tool available to yield income, the key word is **risk**. Does the potential yield through stock investment justify risking dissolution of the ward's principle and incurring malpractice claims of mismanagement? Does the conservative yield of an annuity

justify diminution of purchasing power possibly available through growth in trust assets available through stock investments and individual management?

There are two aspects to the advantages of the tax-free status of a structured settlement. The first is the receipt of the award free from federal income taxes. This obviously is an important factor. If the plaintiff is in the 28 percent marginal tax bracket, and the award is in the amount of \$500,000, the fact that it is received tax-free means the difference between receiving \$500,000 and \$360,000. The second factor is the tax-free accumulation of the funds. Assume an award of \$500,000, a marginal tax rate of 28 percent, an interest rate of 7 percent, and the deferral of the annuity for 20 years. If the plaintiff received a tax-free lump sum payment of \$500,000 and invested it at 7 percent for 20 years, but was required to pay federal income tax at the marginal rate of 28 percent on the interest income, the award would increase to \$1,335,793. If, however, a structured settlement were employed, and there was not federal income tax levied on the interest income earned during the 20-year period, the award would increase to \$1,934,842. This is a difference of \$598,049, or 45 percent more than would have accumulated under the taxable plan. The higher the tax rate, the greater the advantage the structure has for the plaintiff.<sup>3</sup> Against this the ad litem should weigh the potential growth of investments in stock, taking into account income tax and capital gains tax liability and evidence the risk to the ward.

b. Defendant's Perspective. In order for an ad litem to properly carry out his duties to the ward, it is necessary to discuss the advantages structured settlements hold for the defendant insurance company. These considerations can help safeguard the settlement from abuse by the defendant.

One reason the insurance industry advocates structured settlements is the fact that they provide a market for annuity companies. The liability carrier will not be the same firm that

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<sup>3</sup> James R. Eck & Jeffrey L. Ungerer, Structuring Settlements 43-44 (Shepard's/McGraw-Hill, Inc. 1987).

writes the annuity due to regulations concerning the types of insurance a single company may write. However, these regulations do not prevent an affiliate firm from providing such coverage. It is common for a liability carrier to be a member of a fleet of companies where one of the affiliates will be licensed to write life insurance and another affiliate will be licensed to write annuities. Individual insurers would rather have a structured settlement placed with an affiliate company rather than allow these large sums of money slip away to be invested with some other industry.

The tax advantages available to the plaintiff are also advantages to the defendant insurance company. As was exemplified in the plaintiff's perspective, the accumulation of funds under a structured settlement hinges on the tax advantages. For the defendant insurance company, this means the money needed to fund a structured settlement is up to forty percent less than the money needed to satisfy a plaintiff with a lump sum award.

Assuming a structured settlement is appropriate, the attorney should focus on preparing a life needs analysis for the client and should discuss the client's needs with appropriate experts in medicine, rehabilitation, finance, and structured settlements.

The analysis should include considerations of future medical needs, cost of living increases, educational expenses, the effect of inflation over the annuity period, rehabilitation costs and the effect of the client's injury on his entire family. Only after an independent evaluation of pertinent factors will the ad litem be in a position to negotiate intelligently and in the interest of the ward and estate.

### 3. Tax Considerations.

In order to minimize taxes and maximize the client's recovery, attorneys must properly structure the settlement. A miscue here or there can easily red-flag the IRS to impose an income tax on all or part of the settlement. This section will outline the general rules governing

the taxation of settlements and the methods of structuring such settlements to allow the injured party to enjoy the greatest tax advantages.

a. General Rules. Two sections of the IRC determine federal income taxation of amounts received as injury damages. Section 61(a) and the regulations thereunder provide the general rule that gross income includes all income from whatever source derived except as otherwise provided by law. Section 104(a)(2) of the IRC is a specific statutory exclusion from gross income within the “except as otherwise provided” clause of § 61(a). Section 104(a)(2) excludes the amount of any damages received, except punitive damages (whether by suit or agreement and whether as lump sums or as periodic payments), on account of personal injuries or sickness.

Any of six different issues determine whether damages, including lump sums or periodic payments, are excludable from gross income:

- (1) Is the underlying claim or cause of action based upon tort or tort-type rights? If not, IRC § 104(a)(2) does not apply.
- (2) Are damages received “on account of personal injuries”? If not, IRC § 104(a)(2) does not apply.
- (3) Is there a linkage between the “personal injury” suffered and the damages being paid? If not, IRC § 104(a)(2) may not apply.
- (4) Are any of the damages specifically designated as or potentially allocable to “punitive damages”? If so, to the extent that damages are punitive, they are not excludable under IRC § 104(a)(2).

- (5) Are damages received as “periodic payments” within the meaning of I.R.C. §104(a)(2)? If not, only the present value of the periodic payments is excludable.<sup>4</sup>
- (6) Are any damages attributable to medical expenses that were deducted in a prior taxable year? If so, damages are not excludable to the extent such deductions were allowed for any prior taxable year.<sup>5</sup>

The United States Supreme Court recently reiterated the two independent requirements that a taxpayer must meet before a recovery may be excluded under the Code. First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is “based upon tort or tort type rights”. See Commissioner v. Schleier, 132 L.Ed.2d 294 (1995). In making said demonstration, particular attention should be given to the primary characteristic of an action based upon tort-type rights: the availability of compensatory remedies. Id. at 306. Second, the taxpayer must show that the damages were received “on account of personal injuries or sickness.” Essentially, a causal link must be established between the recovery and the personal injury to fall within §104(a)(2)’s exclusion. Id. at 302-303.

b. Structuring Settlements for Nontaxability. In the area of structured settlements, there is no decision more important than Revenue Ruling 79-220, 1979-2 C.B. 74. In pertinent part, Revenue Ruling 79-220 states:

where damages are to be paid periodically and the injured person has no right to the discounted present value of the payments or any control over investment of the present value, the entire amount of cash periodic payment is excludable, including earnings on the fund.

Full exclusion for all parties is only guaranteed by following the guidelines in I.R.C. § 130.

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<sup>4</sup> See DANIEL W. HINDERT ET AL, STRUCTURED SETTLEMENTS AND PERIODIC PAYMENT JUDGMENTS § 2.03[2] at 2-18.8 (1996) (discussing analysis of receipt for purposes of exclusion under § 104(a)(2)).

<sup>5</sup> See DANIEL W. HINDERT ET AL, STRUCTURED SETTLEMENTS AND PERIODIC PAYMENT JUDGMENTS § 2.03[3] at 2-33 (1996) (discussing conditions pertaining to non-exclusion of damages due to prior medical deductions).

The typical arrangement under I.R.C. § 130 involves the assignment by a defendant to a third party licensed to issue an annuity of its liability to make periodic payments to the injured party. In order for the assignment to qualify under Code § 130, certain criteria must be satisfied. IRC § 130(c). If properly structured, a qualified assignment: 1) allows the defendant to fully deduct the amount paid in exchange for a release of liability (Prop. Treas. Reg. § 1.461-6(a), 55 Fed. Reg. 23235-02 (1990)), 2) does not affect the injured party's ability to exclude from gross income all amounts paid pursuant to the qualified assignment (Treas. Reg. § 1.451-2 (as amended in 1979)), and 3) allows the assignee of the qualified assignment to exclude the amount received for agreeing to such qualified assignment to the extent such amount does not exceed the aggregate cost of the qualified funding assets. 27 U.S.C. § 130(a) (1988); See Mark A. Coel, Tax Aspects of Personal Injury Awards and Structured Settlements, Florida Bar Journal, May 1992, at 81.

In conclusion, structured settlements can provide great benefits over traditional lump sum settlements. However, advisors must be cautious not to violate the fiduciary obligations due to the incapacitated person in using structured settlements. Analyze long term needs of the incapacitated person. Seek an independent analysis from individuals dealing in annuities and other experts to properly serve your client. Used appropriately, structured settlements can provide advantages for all parties involved.



**“SPECIAL NEEDS” TRUSTS UNDER  
THE TEXAS PROPERTY CODE AND  
THE TEXAS PROBATE CODE**

Written By:  
Helen B. Wils  
Crain, Caton & James, P.C.  
1401 McKinney, Suite 1700  
Houston, Texas 77010  
Phone: 713-658-2323  
Fax: 713-658-1921

**Civil Court Ad Litem Institute**  
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Presented By:  
Robert A. Higley