

Over the last few weeks I have been diligently outlining tax planning strategies for trial attorneys with contingent fee income. These strategies have ranged from structured settlement arrangements using private placement variable deferred annuities (PPVA), captive insurance, and Qualified Settlement Funds (QSFs) combined with private placement variable annuities. In my last installment I introduced structured settlement life insurance, a new concept for trial attorneys.

Structured settlement life insurance is a powerful tool that combines the benefits of a Qualified Settlement Fund (QSF) and private placement life insurance (PPLI) to provide a powerful combination of deferred compensation along with tax-free income and benefits for the trial attorney and his family. The same benefits are achievable for the claimant such as the UBS Whistleblower.

In Part 5, I focused on the utility of the QSF from an investment funding perspective to illustrate how private placement life insurance can be used in a split dollar life insurance funding format in order to create a scenario where the trial attorney is able to create a retirement fund that exploits the tax advantages of life insurance – (1) Tax-free inside buildup of the policy cash value (2) Tax-free lifetime distributions from the policy through policy loans and withdrawals. (3) Income and Estate-tax free death benefit.

I thought it would be useful to focus on the case of the UBS Whistleblower (Brad Birkfeld) situation to illustrate what could have been accomplished in structuring the tax consequences of his record \$104 million settlement award from the IRS in conjunction with his role as a whistleblower. Unlike cases that involve physical injury that result in tax-free treatment for the plaintiff, a Whistleblower case results in taxable treatment at ordinary rates for both the Whistleblower and his attorney.

Through sophisticated tax planning, the UBS Whistleblower would have demonstrated clearly to his employer (UBS) that there was never a need to hide the money under a rock! Additionally, the law firm representing the UBS Whistleblower could have structured their \$30 million fee. Perhaps, the Government and UBS (and affected clients) might not like the result, but the difference here is the fact that is legally supported by the Book (Internal Revenue Code) and case law. It's how you connect the dots!

The latest installment will also illustrate the flexibility of structure settlement life for the UBS Whistleblower.

III Qualified Settlement Funds (QSF)- A Quick Review

QSFs are trusts that are designed to resolve litigation and satisfy claims of the litigation even if they are not the subject of litigation. The QSF is authorized and governed by the provisions of IRC Sec 468B. A QSF has no statutory time limit within IRC Sec 468B or the treasury regulations in regard to how long a QSF may be kept in place.

The QSF has benefits for both plaintiffs and defendants. From a defendant's perspective, the ability to transfer assets to a QSF can resolve the claim and release the defendant from further liability while achieving an immediate tax deduction regardless of when claimants actually receive distributions. This is a significant tax planning point for the defendant particularly for non-physical injury tort cases.

The plaintiff is able to achieve numerous benefits. Claimants can use the QSF to time the receipt of their income. Plaintiffs are not taxed until they actually receive distributions from the QSF. The QSF provides the plaintiff and their attorney with the ability to work out the details of their distribution.

IV Tax Advantages of Life Insurance A Quick Summary

A few of the tax benefits:

1. Tax-free inside buildup of cash
2. Tax-free loans and withdrawals during lifetime.
3. Income Tax-free death benefit.
4. Estate tax-free death benefit if owned by an irrevocable trust.

V Private Placement Life insurance – A Quick Summary?

PPLI is a security under federal securities law and is limited to accredited investors and qualified purchasers. PPLI is a state of the art institutionally priced variable universal life insurance policy that allows for customized investment options including a wide range of investment options such as hedge funds and private equity funds.

VI Structured Settlement Life Insurance

a. The Basics

The thrust of the structured settlement life insurance strategy is use of the QSF as a source of funds to invest in a PPLI contracted owned by the trial lawyer's family trust using a split dollar life insurance arrangement. The objective is to provide the taxpayer (hereinafter "Whistleblower") with tax-free insurance benefits, tax-free income along with deferred compensation payments. Not a bad combination, right

The Whistleblower's family trust is the applicant, owner and beneficiary of a PPLI contract insuring the Whistleblower's life. The policy is funded over several years so that the policy is treated as a non-modified endowment contract (Non-MEC). Non-MEC status is a technical acronym to label the policy as one that is eligible for all of the tax benefits that I outlined above.

The trustee of the family trust enters into a split dollar arrangement with the trustee of the QSF. Split dollar is a contractual arrangement that provides for the co-ownership and sharing of benefits of a life insurance contract between two or more parties. In the typical split dollar arrangement, the QSF would have an interest in the policy cash value and death benefit equal to its premium payments. The excess portion of the cash value and death benefit would inure to the benefit of the family trust.

The big "take away" regarding split dollar is how it is taxed to the Whistleblower. The participant (Whistleblower or his attorney) is not taxed on the QSF trustee's premium payments. Final Treasury regulations (Treas Reg 1.61-22) provide two different methods of taxation.- the economic benefit method or the loan method.

Under the economic benefit method, the taxpayer is taxed on the value of the death protection provided under the policy. The economic benefit is valued using term insurance costs. The term insurance cost is determined using the lesser of the Table 2001 rates or the insurer's cost for annual renewable term.

The loan method of split dollar treats the premium payments as loans to the taxpayer. The minimum interest rate is the applicable federal rate (AFR). If the loan rate is a below market rate loan, the rules of IRC Sec 7872 apply. The forgone interest is treated as taxable income and treated as an imputed gift by the taxpayer if the policy is owned by a trust. Interest payments can accrue and be repaid at the insured's death.

b. Variations on a Theme

The UBS Whistleblower case facts provide a good example for the different planning methods of Structured Settlement Life Insurances.

VII Strategy Example

A. The Facts

Brad Best, age 42, is a former private banker with a well-known Swiss Bank. He recently was awarded \$104 million for his role in the IRS Whistleblower Program for reporting the Bank's role in assisting American taxpayers in hiding assets and income that were reportable under American tax law. Best's efforts allowed the IRS to recover \$800 million in tax revenues.

Brad will have to serve a minimum sentence for his own involvement at Club Fed, a minimum security prison and will be released to a "half way" house for six months. He is currently single but plans to remain in New England and eventually marry and raise his children in a small New England town. Brad plans to write a book and serve as an advocate for whistleblowers such as himself. Brad would like to have an annual payment of at least \$3 million per year that has some degree of inflation protection.

The award is more than he will need for the next five lifetimes but he would like to defer taxation and pass as much wealth as he can to future generations as he can as well as endow the National Whistleblower Center, a 501(c)(3) organization.

Solution

During the course of settlement discussions, the U.S. Government agrees to place the entire amount of the Whistleblower award into a QSF. The amount of the award is \$104 million. Brad's fee agreement with the Whistleblower law firm, The Justice Law Center, provides for a 30 percent contingency fee - \$31.2 million. The balance of the fee is \$72.8 million. The Government acquiesced to this arrangement as the QSF is authorized by IRC Sec 468B.

Both Brad and the law firm plan to structure their payout.

1. Distribution for Personal Expenses

Brad takes an initial distribution of \$10 million. Brad plans to purchase a \$2.5 million home in cash with the after-tax proceeds and place the balance in an investment portfolio that will not be managed by his former bank.

2. Private Placement Immediate Annuity-

The trustee of the QSF purchases a single premium private placement variable immediate annuity (SPIA) issued by Acme Life. The initial premium is \$25 million. The projected annual annuity payment is \$1 million. The annuity payment will adjust each year based upon the policy's investment performance. Payments will increase each year to the extent that investment performance exceeds 3.5 percent per year. Payments will continue for the balance of Brad's lifetime. Additionally, the QSF will not be taxed on any of the SPIA investment income.

3. Structured Settlement Life Insurance –

The QSF trustee allocates another \$25 million of the Whistleblower award to a structured settlement life insurance arrangement. The QSF enters into a split dollar agreement with the trustee of Brad's family trust. The family trust is the applicant, owner, and beneficiary of a policy insuring Brad's life. The policy has a death benefit of \$70 million and premiums of \$5 million per year for five years. The policy uses the increasing death benefit option so that the minimum net amount payable to the trust is a minimum of \$70 million.

The split dollar arrangement is initially structured using the economic benefit regime. The QSF collateral assignment interest in the policy cash value and death benefit is equal the greater of the policy's cumulative premiums or cash value. The excess death benefit is payable to the family trust. Brad's annual tax cost for both income and gift tax purposes in Year 1 is \$29,400; Year 10- \$56,000; Year 20- \$107,800; and Year 30-\$290,000. The death benefit payable to the family trust income, estate, and generation skipping transfer tax free in the event of death is \$70 million.

In Year 30, the trustee decides to switch the split dollar method to the loan method. The collateral assignment is terminated and the family trust provides a promissory note to the QSF equal to the cumulative premiums- \$25 million. The loan provisions provide for the accumulation of interest that will be recovered at Brad's death. The interest rate is equal to the long-term applicable federal rate at that time. At that point in time, the policy has a net death benefit of \$70 million and cash value of \$50 million. The trustee of the QSF has an interest in the policy equal to its cumulative premiums- \$25 million. The trustee of the family trust has the discretion to access the policy cash value to distribute income to trust beneficiaries on a tax-free basis..

At Brad's death, the QSF will receive a portion of the death benefit equal to the accumulated principal and interest. One half of these payments will be made to Brad's private foundation in a lump sum. The balance will be paid to a second family trust established for Brad's grandchildren.

4. Structured Settlement Life Insurance – Freeze Life Insurance Partnership

The balance of the QSF proceeds - \$22.1 million – is invested into a Freeze Investment Partnership with the family trust. The QSF trustee invests \$22.1 million in exchange for the preferred interests in a new partnership. The family trust purchases all of the common equity (non-frozen) interests in the partnership for \$500,000.

The partnership invests all of its assets in a Frozen Cash Value life insurance policy. This policy is a specialty private placement life insurance policy that is intentionally designed to violate the U.S. tax law definition of life insurance. The policy provides that the initial premium plus the investment growth on this policy constitute a mortality reserve that is paid on an income tax-free basis at death. The policy's cumulative premiums are accessible during lifetime on a tax-free basis.

Under the partnership agreement, preferred partners are entitled to a cumulative preferred return of four percent along with a liquidation preference equal to its investment capital - \$22 million. The preferred partner also has the voting rights. The common equity partner is entitled to the excess growth above the preferred partner's interest.

In year 20, the policy has a projected death benefit of \$125 million. The preferred partnership interest with its cumulative preference return is valued at \$50 million. The excess value of \$75 million has accrued for the benefit of the common equity holder – the family trust.

In the event that Brad dies in Year 20, the partnership would be liquidated and the family trust would receive an additional \$75 million income and estate tax-free. The QSF would receive \$50 million upon liquidation of the partnership. The amount received by the QSF would be paid in a single lump sum to Brad's estate in order to fund several charitable bequests along with Brad's private foundation.

Summary

Any day you receive \$104 million from the Government after so much pain and suffering, is a blessed day and beautiful thing. Assuming no planning, the initial proceeds after income taxes payable to Brad would have been worth \$47 million. Assuming his death 15 years later and growth in his estate of five percent, Brad's estate would be left with approximately \$52 million.

The techniques outlined in this article provide long-term tax deferral and the conversion of tax-deferred assets into tax-free assets while providing a lifetime income. The benefits of structured settlement annuity and life insurance arrangements (using private placement insurance contracts) provide benefits that produce results that are 5-8 times greater (if not more) than the "Take Your Money and Run" strategy. Only the strategy that was the source of the UBS Whistleblower case is capable of producing similar results (at least until you get caught).

The structured arrangements – life insurance and annuities – are in effect tax deferral plans similar to an IRA or qualified plan but without limits and restrictions. Life insurance due to its special tax consequences is capable of producing even stronger benefits than structured settlement annuity arrangements. Private placement insurance contracts are the “jet fuel” to turbo-charge the results. The next time that you are settling a case, give serious consideration for yourself as well as your client so that you can be whistling Dixie.

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