VOL. 52, NO. 3 WINTER 2026

Employee Relations LAW JOURNAL

Employment Settlements Should Not Default to Lump Sums

By Dan Finn

Employment settlements are overwhelmingly taxable – wage allocations, emotional distress damages, and attorney fee inclusions under Commissioner v. Banks combine to make the lump sum default among the most expensive choices a plaintiff can make. However, the author explains, too few attorneys realize that non-qualified structured settlements, long established in physical injury practice, are equally available for employment and whistleblower recoveries. The author notes that PLR 200836019 confirms that periodic payments defer income until received, with no constructive receipt. The author concludes that the tax savings can be substantial – with additional benefits that extend well beyond the settlement itself.

Most litigators know structured settlements as a fixture of the personal physical injury bar, where Section 104(a)(2) of the Internal Revenue Code allows periodic payments to arrive income-tax-free. Far fewer realize that a parallel option exists for taxable recoveries – employment, whistleblower and other non-physical-injury claims – where the stakes are arguably higher. In situations like this, when every dollar is taxable, timing drives the tax bill.

The current landscape gives plaintiff counsel ample reason to take a fresh look at their taxable settlement inventory for opportunities that can meaningfully improve their clients' after-tax recoveries. Interest rates remain well above the levels of the 2010s, which has materially improved the pricing of periodic payment arrangements. Employment litigation volume remains heavy – nearly 90,000 discrimination charges were filed

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with the U.S. Equal Employment Opportunity Commission[1] in fiscal year 2024, and roughly three-quarters of federal employment cases resolve in likely settlements.[2] And the workforce is aging: workers 55 and over make up a growing share of the labor force, and therefore of wrongful termination plaintiffs. For these plaintiffs, termination is often followed by years of diminished earnings – which makes compressing a multi-year recovery into a single tax year especially costly. For this subset of clients, the lump sum should be a deliberate choice, not a default, because the default is often the most expensive option the tax code allows.

THE TAX LANDSCAPE OF EMPLOYMENT RECOVERIES

Employment recoveries are overwhelmingly ordinary income. The wage portion is paid through payroll, subject to income and employment tax withholding and reported on Form W-2. The non-wage portion – typically emotional distress and similar non-economic damages – is reported on Form 1099 and is fully taxable in nearly all cases: under the 1996 amendments to Section 104(a)(2), emotional distress unaccompanied by physical injury or physical sickness does not qualify for exclusion.

The recovery being taxable is only half the problem, however. Under *Commissioner v. Banks*,[3] a plaintiff's gross income includes the entire recovery, contingent fee and all. That's the bad news. The good news is that for claims of unlawful discrimination – a term the statute defines broadly enough to cover the majority of employment claims – Section 62(a)(20) allows an above-the-line deduction for attorney fees, and Section 62(a)(21) provides parallel treatment for certain whistleblower awards. For qualifying claims, the fee inclusion and the deduction largely offset, and the client's taxable income tracks the net recovery. Claims falling outside those provisions face a far harsher result – the client can be taxed on money the attorney keeps – which is one more reason characterization and allocation deserve attention at settlement rather than at tax time.

Even with an above-the-line deduction, a large taxable cash settlement produces an outsized single-year tax burden. One lever remains to address it: timing – and it is bigger than most practitioners realize.

WHAT TIMING IS WORTH

Consider a 58-year-old wrongful termination plaintiff, a single filer in California. Her settlement allocates $150,000 to W-2 wages, paid through payroll at closing, and $750,000 in non-wage proceeds – both net of attorney fees. The wage allocation alone already places her at a combined federal and California marginal rate of roughly 33% in the settlement year. Every additional dollar received that year starts there, and most of her $750,000 lump would climb through the 35% and 37% federal brackets plus California rates exceeding 11%. If, instead, she elects a periodic payment arrangement that defers the entire non-wage amount one year, she could receive a guaranteed income stream from a highly rated life insurer specializing in these arrangements. Over a 10-year period, she could expect to receive $7,833 per month. That's a total payout of $940,000, consisting of the original $750,000 deferred plus $190,000 of tax-deferred internal growth. The payments run from roughly age 59 to age 69, bridging her to a maximized Social Security claim.

The comparison with a lump sum is stark, as shown in Table 1.

Taken as a lump sum, the $750,000 stacks on top of her wages, pushing her into the top federal bracket and California's highest bands. Adding the tax on her wages, her total tax bill comes to approximately $374,000 when taken as a lump versus $201,000 if structured – leaving her with $526,000 or $889,000 respectively, a difference of nearly $364,000 driven by nothing more than payment timing and the tax-deferred growth it makes possible.[4]

Two points keep the comparison honest. First, the pure timing savings – before counting any growth – is roughly $174,000, produced by nothing more than when the money arrives. The additional $190,000 of tax-deferred internal growth on the structured side – net of the tax paid on it as it arrives – accounts for the rest of the nearly $364,000 after-tax difference.

Second, the lump-sum client could certainly invest her after-tax proceeds, but she would begin with $526,000 of post-tax principal, with future earnings taxed annually. For the client who structures, the full $750,000 compounds pre-tax, and the $190,000 of growth reaches her taxed at the lower bracket as it arrives.

The math of catching up is daunting. To match the structure's after-tax annual income from her $526,000 starting point, she would need to earn roughly 8% annually on a risk-free basis – returns that haven't been available for more than a generation – and around 10% if those earnings are modestly taxed, every year for a decade, without a losing year. Although the periodic payment arrangement produces a yield of just under 4%, the favorable outcome it achieves has nothing to do with investment performance – and everything to do with starting principal and tax treatment.

The income bridge also does quiet double duty for her retirement. It makes delaying Social Security affordable: delayed retirement credits add roughly 8% per year past full retirement age, and claiming at 70 rather than 62 increases the monthly benefit by roughly three-quarters – for life. And it spares any 401(k), IRA, or other retirement account from forced withdrawals during the gap years, including the 10% early-withdrawal penalty that would apply before age 59½, leaving those accounts to keep compounding tax-deferred. The structure does not just lower the tax on the settlement; it protects the growth of everything else she owns.

THE AUTHORITY

The Internal Revenue Service addressed this arrangement directly in PLR 200836019, released on September 5, 2008.[5] There, an employment discrimination plaintiff agreed to receive periodic payments through a non-qualified assignment – that is, an assignment falling outside Section 130, which is reserved for excludable physical injury and workers' compensation recoveries. The Service ruled that the plaintiff was not in actual or constructive receipt of the deferred amounts, and that each payment is includible in income under Section 451 only as received.

The ruling's reasoning has solid lineage. It drew on Rev. Rul. 2003-115, which reached the same conclusion for September 11 Victim Compensation Fund claimants who irrevocably elected periodic payments, and on the longstanding principle of *Reed v. Commissioner*[6] that a taxpayer is not in constructive receipt merely because deferral was negotiated as part of a settlement, provided the taxpayer never held a present right to the funds. The conditions the ruling turned on are instructive: the claimant had no right to accelerate, defer, increase or decrease the payments, and no ability to anticipate, sell, assign or encumber them; the obligation would be funded by an annuity owned by the assignment company, with the claimant holding no rights in that annuity beyond those of a general creditor.

The customary caveat applies – a private letter ruling binds the Service only as to the taxpayer who requested it. But it reveals the IRS's analytical framework, and the Service has shown no appetite for challenging properly executed arrangements in the years since. The related question of structuring the attorney's own contingency fee, blessed in *Childs v. Commissioner*,[7] is a companion topic deserving its own treatment.

THE MECHANICS – AND WHY TIMING IS UNFORGIVING

The sequence matters more than anything else. The structure must be designed and documented before the release is executed. In the typical arrangement, the settlement agreement obligates the defendant to make future periodic payments; the defendant then assigns that obligation to an assignment company through a non-qualified assignment and funds it, typically with an annuity; the claimant receives payments on the agreed schedule and pays tax on each as it arrives.

Done out of order, the planning fails – permanently. Boilerplate release language reciting consideration "receipt of which is hereby acknowledged" can place the client in constructive receipt before a dollar moves, collapsing the deferral in a fully taxable case. There is no fixing it afterward. The practical takeaway for counsel is simple: the structured settlement conversation belongs at the term-sheet stage, before settlement documents are drafted, not after.

One question sophisticated readers will ask: what about Section 409A, which governs nonqualified deferred compensation arrangements? A properly executed transfer to a third-party assignment company places the obligation outside the employer's deferred compensation framework that would otherwise complicate employer-paid installments. That is one of several reasons the assignment architecture – rather than a simple installment agreement with the former employer – is the standard approach.

"I CAN'T WAIT THAT LONG"

A common objection has little to do with the tax math: "I understand I'll pay more in taxes, but I can't wait that long." The answer is that structures are not all-or-nothing. The client who needs a portion of the settlement now – for debt, housing, a cushion – takes it in cash and structures the remainder. The question shifts from "cash now versus waiting" to "how much do you actually need now?" That is a planning conversation rather than a tax lecture, and one worth having before the release is signed.

WHEN IT DOES NOT FIT

Candor requires acknowledging the limits. On smaller settlements, where the recovery lands mostly in modest brackets anyway, the timing benefit may not justify the commitment. Where immediate needs will consume most of the recovery, cash is the right answer. The screening is straightforward: the larger the net taxable recovery, the higher its taxable proportion, and the longer and more uncertain the client's path back to earnings, the stronger the case for periodic payments. Put differently, the cases where structures help most are precisely the ones where lump sums are most dangerous – a large taxable recovery delivered to someone whose earning years ended early. The tax problem and the dissipation problem are the same problem.

ONE DEVELOPMENT WORTH WATCHING

The National Structured Settlements Trade Association (NSSTA), together with the National Consumers League and the American Association of People with Disabilities, is actively seeking IRS guidance that would recognize clinically diagnosed PTSD as a physical injury qualifying for tax-free treatment under Section 104(a)(2). In May 2025, NSSTA submitted a formal request to the Treasury and IRS to include this issue in the 2025–2026 Priority Guidance Plan, prompted in part by the Tax Court's 2024 decision in *Estate of Finnegan v. C.I.R.*,[8] which declined to allocate any portion of a $25 million civil rights settlement to PTSD but

Table 1: Lump Sum vs. Structured Settlement Comparison

	Lump Sum	Structured
Income recognized in year one	$900,000 (wages + non-wage)	$150,000 (wages only)
Total income, years 2–11	–	$940,000
Total income, all years	$900,000	$1,090,000
Total tax	~$374,000	~$201,000
Client net recovery	~$526,000	~$889,000

left the underlying tax question unresolved. As of June 2026, the IRS has not issued a revenue ruling or chief counsel advice in response, leaving the question open and ripe for future guidance.

If that guidance is issued favorably, a portion of certain employment recoveries – particularly those involving workplace harassment, hostile work environment, or other traumatic circumstances – could qualify for the Section 104(a)(2) exclusion. For now, however, most of those damages remain taxable, and the planning strategies discussed here apply in full. Where a recovery includes both taxable and non-taxable components – as when physical injury claims are joined with discrimination or retaliation claims – careful allocation between the two becomes essential, and a structured settlement can be designed to address each portion appropriately.

CONCLUSION

For the right client, the difference between a lump sum and a well-designed periodic payment arrangement can run to hundreds of thousands of dollars, produced by nothing more exotic than payment timing – supported by published IRS reasoning and decades of practice. As the workforce ages and employment recoveries grow, settlement planning in taxable cases is moving from nicety toward standard of care. The lump sum will remain the right answer for many clients. It should simply stop being the automatic one.

NOTES

1. https://www.eeoc.gov/newsroom/eeoc-publishes-annual-performance-and-general-counsel-reports-fiscal-year-2024.

2. https://www.prnewswire.com/news-releases/lex-machina-releases-2023-employment-litigation-report-301896257.html.

3. Commissioner v. Banks, 543 U.S. 426 (2005).

4. Figures computed using 2026 federal single-filer tax brackets and standard deduction, and current California tax rates; tax figures rounded to the nearest $1,000. Assumes no other material income during the payment years. Social Security benefits, if claimed during the payment period, would add taxable income. Future rate changes could raise or lower these results. Payment figures are based on quotes available at the time of writing and are subject to change before publication.

5. https://www.irs.gov/pub/irs-wd/0836019.pdf.

6. Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983).

7. Childs v. Commissioner, 103 T.C. 634 (1994), aff'd, 89 F.3d 856 (11th Cir. 1996).

8. Estate of Finnegan v. C.I.R., T.C. Memo. 2024-42 (April 10, 2024).

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