Structured Settlements: Are Factoring and Commuting Different?

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Claimants in personal injury cases often structure their settlements, choosing periodic payments rather than a lump sum. If claimants who take a structured settlement later realize that they need some or all of the funds earlier than scheduled, they may turn to a factoring company. Factoring occurs under an agreement between the claimant (i.e., the payee) and a third party. The payee usually assigns future payment rights to a factoring company in return for a lump sum. Subsequently, the payer of the annuity continues making periodic payments, but to the factoring company.

Factoring companies are not insurance companies, nor do they issue annuities. However, some insurance companies are entering the factoring business. If an insurance company factors periodic payments under an annuity it issued, this is not factoring, but rather, "commuting."

Commuting is similar to factoring, in that the payee receives a lump sum for giving up future periodic payments. However, in a commutation, the payee is not paid by a third party. From a payee's viewpoint, factoring and commuting both produce cash, but the factual differences are significant. Although these two vehicles may both get cash to the payee, it is unclear whether an insurance company can commute periodic payments under its own annuity policy and still comply with Federal income tax law.

Periodic Payments

A structured settlement begins with a tax-free personal physical injury or workers' compensation recovery. The plaintiff may want a structure to control spending, conserve assets or enhance eligibility for public benefits. Because structuring a settlement also makes otherwise-taxable interest tax free, the tax benefits alone can be enormous.

Mechanically, the defendant assigns its obligation to make periodic payments (a qualified assignment) to a third party (the qualified assignee), by paying it a lump sum. The qualified assignee purchases an annuity to fund the periodic payments, often from a related insurance company. Although the qualified assignee receives a lump sum, this payment is not included in its gross income (up to the purchase price of the funding annuity), provided several requirements are met.

Perhaps most important, under Sec. 130(c)(2)(B), the periodic payments cannot be accelerated, deferred, increased or decreased by the recipient. Settlement agreements and qualified assignment and annuity contracts often contain anti-assignment clauses designed to prohibit payees from assigning rights to receive future periodic payments to third parties. Although the enforceability of anti-assignment clauses is beyond this item's scope, such clauses typically do not prevent a payee from factoring, especially if the transfer or assignment is approved by a court order issued under an applicable state transfer statute.

Excise Tax

While no Code sections specifically regulate commutations, Sec. 5891 levies a 40% excise tax on certain structured-settlement factoring transactions.

To avoid the excise tax, the factoring transaction must be approved by a "qualified order," defined by Sec. 5891(b)(2) as a final order, judgment or decree finding that the transfer of structured-settlement payment rights does not contravene any statute. (Many state laws also require court orders before structured settlements can be factored or commuted.) In addition, the periodic payments must be (1) fixed and determinable, and not accelerated, deferred, increased or decreased by the recipient (per Sec. 130(c)(2)(A) and (B)); and (2) payable by a person who is a party to the suit, agreement or workers' compensation claim, or by a person who has assumed the liability for these periodic payments under a qualified assignment in accordance with Sec. 130.[1]

[1] See Sec. 5891(c)(1)(B).

Of course, focusing unduly on timing should not obscure the fact that *any* acceleration (increase, deferral, etc.) is contrary to Sec. 130.

Because payments in a factoring transaction do not change and the annuity remains outstanding, it is generally accepted that these payments meet Sec. 130(c)(2)'s requirements. However, when an issuer commutes its own annuity, it makes no further payments.

From the payee's perspective, both factoring and commuting arguably involve acceleration, because in either event, the payee receives funds earlier than specified. From the issuer's perspective, an acceleration arguably occurs only in a commutation; it continues to make scheduled annuity payments after a factoring. From the qualified assignee's perspective, a commutation is arguably an acceleration, while factoring is not. The qualified assignee is the annuity's legal owner and has the right and power to change its terms.

Timing

Another matter is timing. If Sec. 130 was met when the structured settlement was entered into, subsequent factoring does not affect it (i.e., the qualified assignee's Sec. 130 tax break is not affected by later factoring). It is unclear whether a subsequent commutation fares as well. Even if a commutation does not trigger an excise tax, an "acceleration" could violate Sec. 130, particularly if the time between issuance and commutation is minimal.

For example, if an issuer commutes an annuity in close proximity to the qualified assignment, it might be deemed to have had a prearranged plan to commute. If it contacts all payees receiving periodic payments and actually solicits the commutation of its own annuities, this could conceivably invoke constructive-receipt issues for payees, even if they must meet some requirement to receive the money.

Of course, focusing unduly on timing should not obscure the fact that *any* acceleration (increase, deferral, etc.) is contrary to Sec. 130. Still, if an insurance company offers to issue structured-settlement annuities and simultaneously seeks to commute them, is the commutation bona fide (even without an express link between a particular issuance and a particular commutation)? It seems hard to reconcile this with Sec. 130's "no acceleration" mandate.

Court Order Ramifications

To avoid the excise tax, an acquirer of structured-settlement payment rights must obtain a final order, judgment or decree of a state court or responsible administrative authority ruling that the transfer-of-payment rights do not contravene any Federal or state statute, or the order of any court or responsible administrative authority. Under Sec. 5891(b)(5), this qualified order is "dispositive" for purposes of avoiding the excise tax.

Although such an order plainly means no excise tax, it probably means no more than that. Under traditional Federal income tax principles, a ruling by a state or Federal court is not binding on the Service or the courts.[2] When trial courts rule that a payment has particular tax consequences, the IRS often disagrees.[3] Even a trial court's ostensibly factual findings (e.g., that a plaintiff's recovery is for personal physical injuries) are not binding on the Service or the courts.[4] A court ruling that no statute is violated—a precondition to avoiding the excise tax—surely cannot, by itself, determine for Federal tax purposes that an assignment qualifies under Sec. 130.

There is no clear answer as to whether annuity issuers can commute payments due under their own policies without adverse tax consequences.

Conclusion

Although the Code appears to permit factoring, there is no clear answer as to whether annuity issuers can commute payments due under their own policies without adverse tax consequences. Considering Sec. 130's ban on acceleration, deferral, increase and decrease, factoring and commuting seem different. Factoring does not violate these four requirements, while commuting seems to.

If issuers risk violating Sec. 130 when they commute their own annuities (with or without a qualified order under Sec. 5891), the consequences could be quite severe. Without Sec. 130, the assignment company could face a crushing tax mismatch, paying tax on the initial payment it receives to fund the annuity, but deducting payments to the payee only over time. Until this issue is clarified, this is a risk that seems too big to take.

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[2] See *Edward E. Robinson,* 102 TC 116 (1994), aff'd and rev'd in part, 70 F3d 34 (5th Cir. 1995).

[3] See *Bill E. McKay, Jr.,* 102 TC 465 (1994), vacat'd on other grounds, 84 F3d 433 (5th Cir. 1996), and IRS Letter Ruling 8437084 (6/13/84).

[4] See *Robinson,* note 2 supra.