Structured Settlements: Factor vs. Commute?

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (http://www.woodporter.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. Tax Institute 2005 with 2006 Update) *available at* http://www.damageawards.org. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Long a staple of personal injury cases, structured settlements allow plaintiffs to receive a stream of payments over time in lieu of a lump sum settlement payment. Significantly, assuming the case is based on physical injury, each periodic payment will be 100 percent tax-free, including payments for the time value of money (aka interest), even if the payments continue for 30 years or more. In many cases, that makes structures a good deal for plaintiffs, and it is one reason they are so popular. Other benefits include asset protection, enforced savings, and enhanced eligibility for public benefits.

Nevertheless, claimants receiving periodic payments often face unforeseen events and may need all or a portion of the funds earlier than scheduled. Unexpected personal and family expenses include medical bills, specialized housing needs, school tuition, and so on. Factoring is a logical answer to meet those unexpected demands. Factoring structured settlements caught the eye of Congress, which added section 5891 to the IRC in 2002.[1]

That section requires the parties to a factoring transaction to obtain state court approval or face a 40 percent excise tax. Interestingly, section 5891 and concomitant state court oversight has evidently not destroyed demand. Indeed, there continues to be demand for factoring structured settlements. That demand has created a vibrant and active secondary market for structured settlement payments, and has led to the somewhat unorthodox situation in which issuers of structured settlement annuities themselves are also entering the factoring business.

A Rose by Any Other Name?

I should define what I mean by factoring and commuting. Factoring involves a third party paying a discounted lump sum to the original recipient of the structured settlement periodic payments (the payee) in return for the transfer or assignment of the right to receive future structured settlement payments. Thereafter, the payer continues making periodic payments, but there is a change in the recipient.

Commuting is similar in that the payee receives a discounted lump sum. The difference is that in a commutation the payee receives payment from the payer of the periodic payments, not from a third party.[2] The payer substitutes a lump sum for all or a portion of specified future periodic payments, causing all or a portion of the payments to be paid in a current lump sum. That factual difference between a commutation and a factoring transaction is significant and should prompt serious questions about whether different tax rules should apply.

From the payee's viewpoint, whether he factors or commutes is immaterial. He just wants the lump sum now. Under section 5891 and applicable state transfer statutes, he'll be asked to show why he needs it. A payee may want to factor or commute all (or only a portion) of his remaining periodic payments.[3] For convenience, I assume (perhaps unrealistically) that each payee factors or commutes *all* remaining periodic payments. (In fact, both commuting and factoring most typically involve payment on only part of the future payment stream.)

I also assume that the original recipient of the structured settlement annuity payments is entitled to exclude the entire amount of each payment from gross income under section 104, and that the funding annuity has been the subject of a qualified assignment meeting the terms of section 130.[4] In other words, these are 100 percent physical injury cases.

Factoring occurs under an agreement between the payee and a third party. The defendant in the underlying personal physical injury action, the annuity issuer, and the qualified assignee[5] are not parties to the factoring transaction. Typically, the payee assigns or pledges future payment rights to a factoring company in return for a lump sum. After factoring, the annuity issuer continues to make periodic payments on precisely the same schedule and in the same amounts as originally required by the structured settlement agreement and annuity contract, but payments are made to the factoring company instead of to the original claimant.

Because the structured settlement payments are unchanged in a factoring transaction and the funding

[1]P.L. 107-134 (Jan. 23, 2002). All references are to the Internal Revenue Code of 1986, as amended. For further discussion of section 5891, see Robert W. Wood, "Structured Settlements and Factoring: Never the Twain Shall Meet?" *Tax Notes*, Mar. 14, 2005, p. 1278, *Doc 2005-4839*, or *2005 TNT 46-98*.

[2]*Black's Law Dictionary* (8th Edition, 2004) defines "commutation of payments" as a substitution of lump sum compensation for periodic payments.

[3]A payee could factor or commute any or all future payments, or only a particular percentage of any or all remaining payments.

[4]For a discussion of the use of structured settlements outside of section 104, see Robert W. Wood, "Structured Settlements in Non-Physical-Injury Cases: Tax Risks?" *Tax Notes*, Aug. 2, 2004, p. 511, *Doc 2004-15135*, or *2004 TNT 142-59*.

[5]A qualified assignee will be discussed in more depth below. Generally speaking, in a case to which section 104 applies, a defendant pays a qualified assignee to assume its liability to make periodic payments to the claimant. The qualified assignee then purchases an annuity (often from a related insurance company) to fund its periodic payment liability.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

annuity remains outstanding in full, it is generally accepted that no payments are ''accelerated, deferred, increased, or decreased.'' Those four words are tax terms of art found in section 130. Although they have plain English meanings, too, I use them here only in their technical tax sense, discussed below.

The companies that factor structured settlements are not insurance companies (or affiliated with insurance companies), and they do not issue annuities. However, some insurance companies (that do issue annuities) also provide liquidity for structured settlements. That is confusing, and I should clarify what I mean by insurance company. Unlike factoring companies, insurance companies issue structured settlement annuities in personal physical injury cases. As it is used in this article, the term ''insurance companies'' also includes companies that do not actually issue structured settlement annuities but are wholly owned by companies that do. That may include a qualified assignee.

An insurance company may factor periodic payments due under an annuity it issued *itself*, and on which it is then making periodic payments. For example, Western Insurance Company could issue an annuity to fund structured settlement payments due and owing to a payee, and then later pay out a lump sum in lieu of the payments due under that annuity. I believe this transaction should not be viewed as factoring but rather as a commutation.

Variations of that fact pattern occur among insurance company affiliates. For example, one entity in the Eastern Insurance Company group might commute an annuity issued by a related Eastern group company. Again, I view that as distinct from factoring and classify it as a commutation. When an insurance company commutes its own structured settlement annuity payments (or those of a related company), no further periodic payments will generally be made. The issuing insurance company's commutation of its own payment obligations terminates those obligations under the annuity.

Factoring structured settlement payments has become commonplace, and section 5891 provides a framework for those transactions. Commutations are less common, and section 5891 does not expressly speak to them. Because of that, and more significantly because of the factual differences between factoring and commuting, this article questions whether an insurance company can commute periodic payments due under its own annuity policy (or that of an affiliate) and still comply with federal income tax law.

Robert Frost once wrote of two paths diverging in the forest. Taking the path ''less traveled by,'' he said, was a decision that made all the difference. With apologies to Robert Frost, I think there is a difference between factoring and commuting, and that those two paths of reaching what may on the surface appear to be the same place, may yield very different — and unexpected and adverse — tax results.

Primer on Periodic Payments

A structured settlement begins with a lawsuit settlement in which there has been a personal physical injury or workers' compensation recovery excludable from the plaintiff's income under section 104(a)(2) or section 104(a)(1). During settlement negotiations, the parties may have different financial goals. The defendant may wish to make a lump sum payment to extinguish its liability, but the plaintiff may desire a stream of periodic payments.

The plaintiff may have many reasons for wanting a structure. The payee may want (or need) the discipline of periodic payments, need to protect Medicare or Social Security eligibility, and so on. Since a structure protects what would otherwise be taxable interest from tax, the tax benefits alone can be enormous to the payee. To meet those goals, the defendant pays a qualified assignee to undertake the obligation to make periodic payments to the payee. Invariably, the assignment company buys an annuity, so an insurance company guarantees the periodic payments.

The federal income tax treatment of structured settlements was crystallized in Rev. Ruls. 77-230,[6] 79-220,[7] and 79-313.[8] In those rulings, the IRS made clear that a payee who could have received a tax-free lump sum settlement could instead receive periodic payments free from federal income tax, including the amount of each payment that might be viewed as interest.[9] Section 130, added to the code by the Periodic Payment Settlement Act of 1982,[10] codifies those rulings. Section 130 brought widespread acceptance to structured settlements, blessing the tax mismatch that always occurs when a defendant makes (and deducts) a lump sum settlement while the payee receives periodic payments.

The settlement agreement may call for periodic payments, but will generally allow the defendant to assign the obligation to make those payments to a third party. Mechanically, the defendant making a qualified assignment of its periodic payment liability to a third party (the qualified assignee) pays a lump sum to the qualified assignee in exchange for the agreement to assume that liability. On receiving the assignment and the lump sum payment, the qualified assignee purchases an annuity to fund the periodic payments, often from a related insurance company.

Here, tax rules are critical. Although the qualified assignee receives a lump sum, that payment is *not* included in the qualified assignee's gross income (up to the purchase price of the funding annuity), if several requirements are met.[11] To receive the ''no tax'' benefit of section 130, the qualified assignee must assume the liability from a party to the suit or settlement agreement.[12] A qualified assignment also must meet the following four requirements:

---

[6]1977-2 C.B. 214.

[7]1979-2 C.B. 74.

[8]1979-2 C.B. 75.

[9]For a detailed review of those rulings, see Wood, note 4 *supra*.

[10]P.L. 97-473 (Jan. 14, 1983).

[11]Section 130(a).

[12]Section 130(c)(1). The IRS has granted some leeway here, allowing a qualified assignee to assume the liability from a qualified settlement fund. *See* Rev. Proc. 93-34, 1993-2 C.B. 470, *Doc 93-8638, 93 TNT 167-9*.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

1. the periodic payments must be fixed and determinable as to amount and time of payment;

2. the periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient;

3. the assignee's obligation on account of the personal injuries or sickness cannot be greater than the obligation of the person who assigned the liability; and

4. the periodic payments must be excludable from the gross income of the recipient under either section 104(a)(2) on account of personal physical injury or physical sickness or section 104(a)(1) on account of a workers' compensation claim for personal injuries or sickness.[13]

Antiassignment Provisions

Although section 130 provides predictable income tax consequences, it does not answer all pertinent questions. One area of uncertainty is the payee's ability to assign rights to periodic payments to third parties. That is not a simple subject. True, settlement agreements, qualified assignment contracts, and annuity contracts often contain antiassignment clauses intended to prohibit payees from assigning to third parties the right to receive future periodic payments. The enforceability of antiassignment clauses is complex, and is beyond the scope of this article.

Still, a couple points are worth noting in passing. There is little uniformity among the courts, and state law can play an important role. For example, the Fourth Circuit has held that under Virginia law, a payee cannot assign his rights under a structured settlement annuity policy.[14] The court reasoned that the qualified assignee, not the payee, owned the annuity policy, and the payee could not assign (sell, hypothecate, and so on) what he did not own. The same rationale arguably applies to a payee's ability to assign rights under a qualified assignment.

Some courts have held antiassignment language to limit the payee's rights to effect an assignment, but not to limit the payee's *power* to assign.[15] Thus, the qualified assignee would be limited to damages if a payee assigns his rights to receive periodic payments despite antiassignment language. Other courts have flatly prohibited assignments.[16]

Depending on the jurisdiction, payees may have the ability to assign rights under settlement agreements.[17] Section 130's prohibition on acceleration, deferral, increase, or decrease in payments may not be sufficient to prevent an assignment.[18] In other words, an assignment may not violate section 130. Also, the absence of an express prohibition on assignment (or other transfer) in a settlement agreement arguably supports the conclusion that an assignment is not prohibited by section 130.[19]

Despite all that, antiassignment clauses typically do not prevent a payee from *factoring* periodic payments, especially when the transfer or assignment is approved by a court order rendered in accordance with an applicable state transfer statute. An annuity issuer or owner may not object to the assignment. Besides, many assignments are upheld even if annuity issuers or owners object. Thus, even though some courts have upheld antiassignment language, factoring structured settlement annuity payments still occurs with regularity.

Section 5891 Excise Tax

As payees began assigning rights to periodic payments with increasing frequency, Congress took notice and responded in 2002[20] with section 5891, which levies a 40 percent excise tax on some structured settlement factoring transactions.[21] The tax does not apply when the transfer is approved in advance in a "qualified order."[22] Many state laws also require court orders before structured settlements can be factored or commuted.[23]

There is little available data on that excise tax. Indeed, I understand that virtually no structured settlement factoring transaction incurs the tax (because in each case, a qualified order is obtained). Section 5891 applies only to structured settlements, defined as arrangements (1) established by suit or agreement for the periodic payment of damages that are excludable from gross income of the recipient under section 104(a)(2); or (2) established by agreement for the periodic payment of compensation under any workers' compensation law excludable from gross income of the recipient under section 104(a)(1).[24]

To avoid the excise tax, the periodic payments must be (1) of the character described in section 130(c)(2)(A) (the periodic payments must be fixed and determinable regarding the amount and time of payment) and section 130(c)(2)(B) (the periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of the payments); and (2) payable by a person who is a party to the suit or agreement, or to the workers' compensation claim, or by a person who has assumed the liability for the periodic payments under a qualified assignment in accordance with section 130.[25]

Factoring vs. Commuting

Following a section 130 assignment, the payee will receive periodic payments from an annuity purchased

[13]Section 130(c)(2).

[14]*See Allstate Insurance Co. v. American Bankers Insurance Company of Florida*, 882 F.2d 856 (4th Cir. 1989) (decided before enactment of the Virginia Structured Settlement Transfer Statute).

[15]*See Rumbin v. Utica Mutual Insurance Company*, 254 Conn. 259, 757 A.2d 526 (Conn. 2000).

[16]*See Liberty Life Assurance Company v. Stone Street Capital*, 93 F. Supp.2d 630 (D. Md. 2000); *Grieve v. General American Life Insurance Company*, 58 F. Supp.2d 319 (D.Vt. 1999).

[17]*See Wonsey v. Life Insurance Company of North America*, 32 F. Supp.2d 939 (E.D. Mich. 1998).

[18]*Id.* at 1363.

[19]*See Settlement Funding v. Jamestown Life Insurance Company*, 78 F. Supp.2d 1349, 1358 (N.D. Ga. 1999).

[20]P.L. 107-134 (Jan. 23, 2002).

[21]Section 5891(a).

[22]Section 5891(b)(1).

[23]For a more in-depth review of state requirements, see Wood, note 1 *supra*.

[24]Section 5891(c)(1)(A).

[25]*Id.*

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

and owned by the qualified assignee. The payee may later need liquidity (relative to the remaining periodic payments), and the market addresses those liquidity needs. Because the factual distinctions between factoring and commuting are critical, bear with me as I briefly revisit the mechanics.

A factoring company typically has the payee assign or pledge future payment rights to it in exchange for a lump sum. Thereafter, the annuity issuer continues to make periodic payments, but now to the factoring company. If the requirements of section 5891 are met (including a qualified order), no excise tax is due.

Alternatively, a payee may transact with the annuity issuer itself to receive currently the discounted value of the remaining periodic payments. The insurance company that issued the structured settlement annuity (or a related company that owns the annuity) makes the lump sum payment in return for the payee's relinquishment of future payment rights. I refer to that transaction with the issuer as a commutation.

With factoring, the annuity issuer still makes all scheduled structured settlement annuity payments over the full term, even though the payments thereafter go directly to the factoring company. In contrast, a commutation contemplates a cessation of structured settlement annuity payments. Before discussing the relevant tax authorities, I note one type of commutation that is technically distinct, and that, despite its moniker, should not be viewed as a commutation for tax purposes.

I refer to those as automatic commutations, since they are determined by events outside the payee's control and, for that matter, outside the defendant's, qualified assignee's, or annuity issuer's control. Typically, those commutations occur on the death of the payee before the termination of all periodic payments. The commutation is usually not mandatory, but gives the payee's beneficiaries a right to commute if they wish.

Referring to such a right as a commutation is unfortunate terminology because even the IRS views those transactions as not violating the "no acceleration" mandate of section 130.[26] Presumably that is due to the express trigger on death. Thus, although such a clause in a policy may, in common parlance, be regarded as a commutation right, I don't include automatic commutations in my definition of commutation in this article. After all, those automatic commutations are evidently not even troubling to the IRS.

IRS Pronouncement

Before enactment of section 5891, the IRS made at least one foray into the realm of commutations with LTR 9812027. Its value to the discussion is limited because it deals solely with automatic commutations. However, the paucity of authorities makes even that tangentially relevant ruling interesting.

As part of a settlement agreement in which the defendant agreed to make periodic payments, the defendant in LTR 9812027 made a section 130 assignment of its liability to a third-party assignment company. Notably, the settlement agreement contained a commutation clause providing that if the payee died within 10 years, a percentage of each remaining periodic payment would be paid in a lump sum to the payee's beneficiary. The settlement agreement provided for a mechanical calculation to determine the lump sum, based on the prevailing discount factor the annuity issuer would use in comparable transactions at the payee's death.

The qualified assignee purchased an annuity from an insurance company that allowed for a commutation on the payee's death. However, the commutation provision was effective only if the settlement agreement irrevocably provided for the current payment of some or all of the remaining guaranteed periodic payments at the payee's death. Under those facts, the IRS found the payments to be "fixed and determinable" as to the time and amount under section 130(c)(2)(A).

Yet the IRS reaches a much broader conclusion, noting that the commutation provisions in the settlement agreement and the annuity contract did not "cause the assignment to fail to comply with Section 130(c)." Implicit in that conclusion is the assumption that the automatic commutation provisions did not cause an acceleration, since section 130(c)(2)(B) prohibits acceleration, deferral, increase, or decrease of the periodic payments.

Interestingly, the IRS did not expressly address whether an automatic commutation (or any other type of commutation) causes an acceleration for section 130 purposes. Even so, LTR 9812027 is important, suggesting that the IRS believes an acceleration does not occur if the automatic commutation is contemplated in the original structured settlement documents and funding annuity and caused by events outside the payee's control. It is possible that none of that bothered the IRS, because of the formulaic nature of the commutation.

In any case, LTR 9812027 apparently has limited application for most commutations, since automatic commutations are factually quite different. In LTR 9812027, the commutation seed was planted in both the settlement agreement and the annuity contract, and the commutation occurred through events outside the payee's control. The payee had no ability to affect whether a commutation might occur, and the commutation was made to the payee's beneficiaries, not to the payee.

Turning from automatic commutations back to garden-variety ones, I have found that commutations are typically not even mentioned in settlement agreements, in section 130 assignments, or in annuity contracts. A commutation contract typically comes into being only well after the settlement agreement has been executed and the annuity contract has been issued. Perhaps more important, payees control the occurrence and timing of commutations. Indeed, the payee actually enters into the commutation contract with the annuity issuer, annuity owner, or a related entity.

Whose Accelerations?

The IRS has provided virtually no guidance on commutations, although there are glimpses of guidance in sections 5891 and 130. No code section overtly regulates those transactions, yet factoring and commuting are both economically unattractive if the section 5891 excise tax

[26] *See* LTR 9812027, *Doc 98-9967, 98 TNT 55-16*.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

applies. Given the virtually penal nature of its excise tax, section 5891 implicitly forces all parties to comply with its requirements.

On its face, section 5891 provides a 40 percent excise tax only when a person acquires structured settlement payment rights. However, section 5891 enables acquirers of those rights to avoid imposition of the excise tax if they meet certain requirements. Notably, the excise tax does not apply if the factoring transaction is approved by a qualified order or defined as a final order, judgment, or decree finding that the transfer of structured settlement payment rights does not contravene any federal statute. Of course, section 130 specifies that structured settlement annuity payments cannot be accelerated, deferred, increased, or decreased — and that arguably occurs when an annuity issuer commutes its annuity. Indeed, after such a commutation, the annuity issuer will make no further payments.

Regarding section 130, it provides only an exclusion from gross income for the qualified assignee; without it, an assignment creates taxable income for the qualified assignee. Section 130 does not address the income tax treatment of any other party. Although the code does not define an acceleration, dictionaries define it as "the shortening of the time for vesting in possession of an expected interest,"[27] or the act or process of bringing something about at an earlier time.[28]

Of course, those definitions do not address the perspective from which to assess whether an acceleration has occurred. Indeed, they appear to presume that acceleration is a bilateral event, involving action by both payer and payee. Could there be an acceleration for one party (the payee), but no acceleration for the other (the annuity issuer or qualified assignee)? After all, from the payee's perspective, both factoring and commuting arguably involve acceleration, since in either event, the payee receives money earlier than the settlement agreement or annuity contract specifies. However, from the issuer's perspective, an acceleration arguably occurs only in a commutation. The issuer continues to make the scheduled annuity payments after a factoring.

It seems consistent with the scope of section 130 to view its requirements (for example, no acceleration) from the perspective of the qualified assignee. The qualified assignee is the legal owner of the annuity and has the right and power to change its terms. From the qualified assignee's perspective, a commutation is arguably an acceleration, while factoring is not.

After all, if the payee negotiates with a third party to change the manner of payment, the issuer continues to make payments according to the original schedule. There is no acceleration from the viewpoint of the qualified assignee (or the annuity issuer), even though the payee receives a lump sum. In contrast, however, in a commutation there certainly seems to be an acceleration of payments from the viewpoint of the qualified assignee (and of the annuity issuer).

[27]*Black's Law Dictionary*, 8th Edition, 2004.

[28]*See* the Merriam-Webster Online Dictionary at http://www.webster.com/dictionary/acceleration.

Section 130's prohibition on acceleration, deferral, increase, or decrease appears to be absolute, yet there has been no statutory pronouncement on whether a commutation contravenes section 130. Although the annuity payments are accelerated (or increased) vis à vis the payee in a commutation, is that the kind of acceleration section 130 prohibits? That invites distinctions between factoring, in which there is no acceleration to the qualified assignee (or the annuity issuer) but to the payee there is, and a commutation, in which *everyone* experiences acceleration.

Coordination

Congress addressed at least some potential conflicts in this area. Section 5891(d), entitled "Coordination With Other Provisions," provides that if section 130 is satisfied when the structured settlement was entered into, a later factoring transaction does not affect the application of section 130 to the parties to the structured settlement, including the qualified assignee. Moreover, the statute says that section 5891 has no effect on section 130 "in any taxable year."

That suggests that the taxation of a qualified assignee under section 130 is not affected by later factoring. The legislative history supports that interpretation, stating that a factoring transaction:

> does not affect the application of certain present-law rules, if those rules were satisfied at the time the structured settlement was entered into. The rules are Section 130 (relating to an exclusion from gross income for personal injury liability assignments).[29]

There is also judicial support for that interpretation. In *Settlement Funding v. Jamestown Life Insurance Company*,[30] the defendant claimed that an assignment of structured settlement rights could result in an acceleration of payments to the payee. The court found that argument "pure speculation," noting that the Third Circuit had rejected the argument that a later assignment would cause a settlement company to retroactively lose the exclusion provided by section 130.[31] If section 130 was satisfied when a defendant (or its insurance company) assigns its liability to make periodic payments, later factoring should not violate it.

However, one can argue that section 130's four-pronged mandate is prospective in nature, prohibiting an acceleration, deferral, increase, or decrease not only on the execution of the qualified assignment, but at times thereafter. The existence of the section 5891(d)(1) safe harbor supports that interpretation, for the safe harbor seems meaningless if this requirement is not prospective.

Temporal Proximity

Even if a commutation does not trigger an excise tax under section 5891, it may violate section 130, particularly when the time between issuance and commutation

[29]Joint Committee of Taxation report JCX-93-01, *Doc 2001-31590, 2001 TNT 247-10*.

[30]78 F. Supp.2d 1349 (N.D. Ga. 1999).

[31]*See Settlement Funding* at 24, *paraphrasing Western United Life Assurance Co. v. Hayden*, 64 F.3d 833, 840 (3d Cir. 1995).

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

is minimal or other indices suggest that the events should be stepped together. Section 130 prohibits the acceleration, deferral, increase, or decrease of payments. Although section 130 does not allow acceleration after six months, a year, or even five years, it is reasonable to think timing may be relevant and may expose particularly egregious situations.

For example, if an issuer commutes an annuity in close proximity to the qualified assignment, the issuer might be deemed to have had a prearranged plan to commute the annuity. Such an arrangement could be viewed as part and parcel of the qualified assignment contract, going against the very underpinnings of section 130. It would presumably violate the spirit, if not the letter, of section 130's prohibitions. Moreover, temporal proximity could invoke the step transaction or substance-over-form doctrines, prompting a court to find section 130 violated.

Also, what if an issuer contacts all payees receiving periodic payments and actually solicits commutations of its own annuities? If the issuer says it is willing to commute the periodic payments of any and all payees, does that give the payee an option to commute? An open-ended invitation to commute could conceivably invoke constructive receipt issues for payees, even if they must jump through some hoops to get the money.

Of course, focusing unduly on timing should not obscure the fact that any acceleration (increase, deferral, and so on) flies in the face of section 130. Still, timing (and other circumstances) may add insult to injury. Indeed, if an insurance company offers to issue structured settlement annuities and to simultaneously commute them, one may question the bona fides (and tax effects) of a commutation, even with no express link between a particular issuance and a particular commutation. It seems awfully hard to square that with the ''no acceleration'' mandate of section 130.

Effect of Court Order

To avoid the imposition of 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. The order must find that the transfer of payment rights does not contravene any federal or state statute, or the order of any court or responsible administrative authority. Thus, the order would implicitly state that no federal or state statute (including section 130) has been contravened.

The qualified order is ''dispositive'' for purposes of avoiding the excise tax.[32] Although that plainly means no excise tax, it is curious to contemplate whether the effect of the court order goes beyond that. Under traditional federal income tax principles, a ruling by a state or federal court is not binding on the IRS or the courts.[33] Indeed, ''the relevance of a state court's judgment to the resolution of a federal tax question will vary, depending on the particular tax statute involved as well as the nature of the state proceedings that produced the judgment.''[34]

When trial courts rule that a payment has particular tax consequences, the IRS often disagrees.[35] Even a trial court's ostensibly factual findings that a plaintiff's recovery is for personal physical injuries are not binding on the IRS or the courts.[36] A court ruling that no statute is violated —- which is a precondition to the nonapplicability of section 5891 —- surely cannot by itself determine for federal income tax purposes that an assignment qualifies under section 130.

Although the court ruling avoids the excise tax, it may beg the question of whether a particular commutation (or factoring) transaction violates section 130. Here again, factoring and commuting seem fundamentally different. The Joint Committee on Taxation noted that payees would be ''willing to accept discounted lump sum payments from certain 'factoring' companies in exchange for their payment streams.''[37] The drafters did not address whether payees might accept lump sum payments from the issuers themselves.

The Road Less Traveled By

I find no clear answer to whether an annuity issuer or owner can commute annuity payments due under its own policy without adverse tax consequences. In a world in which many transactions are cut and dried, and in which one doesn't expect uncertainty, that is unnerving. Factoring *someone else's* annuity is clearly okay, but a *commutation* appears to accelerate payments. Section 130 flatly prohibits acceleration, deferral, increase, or decrease, and it is difficult to see how an issuer's commutation is not thoroughly ensnared.

Also, the appropriate weight to be given to a qualified order is questionable. Given the preponderance of federal income tax authorities discounting the value of state court orders as controlling (or even bearing on) federal income tax consequences, a court order surely cannot prevent (or cure) a violation of section 130. Although I haven't seen the IRS take that position on exactly those facts, I've certainly seen the argument made by the Service in many other contexts.

Considering the unequivocal mandate of section 130 and its prohibition on acceleration, deferral, increase, and decrease, it seems logical and appropriate to view factoring and commuting differently. Factoring does not violate those four requirements, while commuting seems to. Neither Congress nor the IRS may have considered the distinctions between factoring and commuting that I have attempted to draw here.

However, if I am right that issuers risk violating section 130 when they commute their own annuities (with or without a qualified order under section 5891),

[32]Section 5891(b)(5).

[33]*See Robinson v. Commissioner*, 102 T.C. 116, *Doc 94-1439, 94 TNT 23-18* (1994), *aff'd in part, rev'd in part*, 70 F.3d 34, *Doc 95-10932, 95 TNT 238-7* (5th Cir. 1995).

[34]*Brown v. United States*, 890 F.2d 1329, 1342 (5th Cir. 1989).

[35]*See McKay v. Commissioner*, 102 T.C. 465, *Doc 94-3399, 94 TNT 60-9* (1994), *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996); LTR 8437084 (June 13, 1984).

[36]*See Robinson*, 102 T.C. 116 (1994), *aff'd in part, rev'd in part*, 70 F.3d 34 (5th Cir. 1995).

[37]*See* JCX-93-01, *supra* note 29.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

what are the consequences? Without section 130, the assignment company has a crushing tax mismatch, paying tax on the upfront payment it receives to fund the annuity, and then deducting payments to the payee only over time. That tax mismatch is precisely why nonqualified assignment companies (involving structures of settlements in employment suits and other recoveries not excludable under section 104)[38] are formed offshore. Suffice it to say that falling outside of section 130 could be very bad.

[38]For discussion of nonqualified assignments, see Wood, note 4 *supra*.

Moreover, that commutation trap could be sprung regardless of the payee's reasons for needing cash or the manner in which the commutation is concluded. Although the paucity of authority prevents me from stating that a commutation violates section 130, I have serious concerns that it may. As a result, I believe those transactions should not be recommended by prudent tax practitioners.

Put more poetically, given the ambiguities I've described, it seems to me that insurance companies that are risk-averse (and aren't they all?) should not be taking the road less traveled by. After all, unexpected taxes may lurk in the woods.

(C) Tax Analysts 2006. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.