

**EXCISE TAX ON STRUCTURED SETTLEMENT  
FACTORING TRANSACTIONS AUDIT TECHNIQUE  
GUIDE**

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## Chapter One - Introduction

The following background information is excerpted (with permission) from an article that appeared in the ABA Judges' Journal, Spring 2005 Vol. 44, No. 2 pp. 19-31, "Transfers of Structured Settlement Payment Rights : What Judges Should Know About Structured Settlement Protection Acts", authored by Daniel W. Hindert and Craig H. Ulman.

Structured settlements have enjoyed widespread acceptance and have become an established part of our legal landscape over the past twenty-five years. More than \$6 billion is now paid each year to fund new structured settlements in the United States, and an estimated \$100 billion or more has been paid in the aggregate to fund structured settlements that are in force today. Little controversy attended the development of structured settlements. Much controversy has accompanied the development of a secondary market, in which structured settlement "factoring" companies acquire from settlement recipients their rights to receive future payments.

Since 1997, the controversy surrounding structured settlement factoring has led thirty-eight states to enact statutes that make transfers of payment rights under structured settlements ineffective unless those transfers receive advance court approval. Since 2002, the Internal Revenue Code (IRC) has reinforced the state statutes by imposing a 40 percent federal excise tax if a transfer of structured settlement payment rights does not receive the required court approval.

Because of this unusual combination of state law requirements and federal tax sanctions, state courts throughout the country are being asked to rule on growing numbers of applications for approval of transfers of payment rights under state structured settlement protection acts (SSPAs).

\* \* \*

### Structured Settlements And The Rise Of Factoring

Structured settlements are settlements of tort claims involving physical injuries or physical sickness, and workers' compensation claims, under which settlement proceeds take the form of periodic payments, including scheduled lump sum payments. Structured settlements generally are funded by single-premium annuity contracts held by the party that is contractually obligated to make the future settlement payments. Under federal tax rules designed to encourage the use of structured settlements, the full amount of each periodic payment, including the amount attributable to earnings under the annuity contract, is excludable from the settlement recipient's income under IRC section 104(a)(1) or (2). Congress has endorsed the use of structured settlement as a means of assuring continuing income to injury victims and minimizing the risk that lump sum recoveries will be dissipated, leaving victims of disabling injuries to fall back on public assistance.

Consistent with the congressional policy favoring the use of structured settlements, and for reasons linked to their tax treatment, structured settlement agreements typically provide that a settlement recipient's rights to receive future payments may not be assigned or otherwise transferred. In some cases, transfers of payment rights are also restricted or prohibited under applicable statutes or court orders. Notwithstanding these restrictions, an active secondary market in structured settlement payment rights developed in the early 1990s. Through aggressive advertising, specialized finance companies – now commonly referred to as factoring companies – began persuading structured settlement recipients (referred to herein as "payees") to trade future payments for present cash.

To circumvent the restrictions on assignment of payment rights, factoring companies arranged for payees to redirect their payments to factoring company addresses. The factoring companies would then collect the payments (endorsing checks in the payee's names, using powers of attorney and signature stamps) without informing insurers that payment rights had been assigned.

Many payees who dealt with factoring companies were exploited. By fashioning transactions as purchases of future payment rights or as loans originated in states with generous usury laws, factoring companies often charged sharp discounts to payees who were ill equipped to appreciate the value of their future payments or to understand the onerous terms of factoring agreements. In some cases, factoring companies charged discounts equivalent to annual interest rates as high as 70 percent. Payees who defaulted often were sued in remote forums specified in the factoring companies' form contracts. In many cases, these actions commenced with entry of confessed judgments against payees. Insurers responsible for making ostensibly nonassignable settlement payments became embroiled in collection actions brought by factoring companies. Insurers also faced uncertain tax consequences and risks of multiple liability when assigned settlement payments became subject to competing claims.

## **Enactment Of State SSPAs**

Beginning in 1997, state legislatures recognized the need to protect structured settlements against the abuses of factoring. As explained by legislators in New Jersey:

Structured settlements provide strong public policy benefits. They provide long-term protection for injury victims and their families. They provide against the loss or dissipation of lump sum recoveries. Factoring companies, commonly using phone banks, advertising and high-pressure sales to "buy" a settlement for a small lump-sum, undermine these benefits and may exploit an injured person at a time when they need cash.

\* \* \*

Although they are not uniform, all of the SSPAs are derived from the same model legislation, and they all reflect the same basic legislative scheme. Under each of the SSPAs:

- The transferee – that is, the factoring company – is required to make a series of disclosures designed to highlight the value of transferred payments and to contrast that value with the net amount that a payee stands to receive in exchange for the transferred payments. In most states, the transferee is required to disclose the discounted present value of the transferred payments, as determined by using the "Applicable Federal Rate" most recently published by the Internal Revenue Service for purposes of valuing annuities.

- The effectiveness of any transfer of structured settlement payment rights is conditioned on advance court approval of the transfer, based on findings that the transfer (1) will serve the best interests of the payee and the payee's dependents and/or is necessary to enable them to avoid hardships, and (2) will not contravene "applicable law" or, more specifically, applicable statutes or orders.

- At least some aspects of the procedure for seeking approval of proposed transfers are spelled out. For example, the statutes identify the categories of “interested parties” that are entitled to receive notice of a proposed transfer, the contents of the notice, and the minimum notice period that must elapse before an application can be heard.

Key terms – e.g., “structured settlement, “structured settlement payment rights,” and “transfer” – are defined.

[END OF SUBJECT MATTER EXCERPTED FROM ARTICLE.]

IRC section 5891(a) imposes a tax equal to 40% of the factoring discount on any person who acquires directly or indirectly structured settlement payment rights in a structured settlement factoring transaction that does not qualify for exemption under conditions that are specified in section 5891(b). The tax was implemented by the Victims of Terrorism Tax Relief Act of 2001, December 21, 2001, Public Law 107-134. The new law was a part of the tax relief and assistance package for the victims of the September 11 terrorist attacks. Temporary Regulation 157.5891-1T was issued and effective February 19<sup>th</sup>, 2003, and contained temporary regulations relating to the manner and method of reporting and paying the 40-percent excise tax imposed on any person who acquires structured settlement payment rights in a structured settlement factoring transaction that does not qualify for exemption. On July 8<sup>th</sup>, 2004, the IRS issued final regulations, Treasury Regulation Section 157.5891-1, which substantially adopted and replaced the temporary regulation provisions.

In general, section 5891 applies to structured settlement factoring transactions entered into on or after February 22, 2002. The amount of the excise tax is 40% of the excess of (1) the aggregate undiscounted amount of the payments being acquired, over (2) the total amount actually paid to acquire them. The 40% excise tax does not apply, however, if the transfer is approved in advance in a final order, judgment or decree that: (1) finds that the transfer does not contravene any Federal or State statute or the order of any court or responsible administrative authority, (2) finds that the transfer is in the best interest of the payee, taking into account the welfare and support of the payee’s dependents; and (3) is issued under an applicable State statute by an applicable State court or, if applicable, by a “responsible administrative authority” with exclusive jurisdiction over the claim or proceeding resolved by the structured settlement. Rules are provided for identifying the applicable State statute and the applicable State court.

The new Excise Tax provision also provides that a factoring transaction does not affect the tax treatment of the parties to a structured settlement under the structured settlement tax rules, if those rules were satisfied at the time the structured settlement was entered into. The rules are IRC section 130 (relating to an exclusion from gross income for amounts received in connection with “qualified assignments” of liability for periodic payments, as damages or as workers compensation, on account of personal physical injury or physical sickness), IRC section 72 (relating to annuities), IRC sections 104(a)(1) and (2) (relating to an exclusion for amounts received under workers’ compensation acts or as damages on account of personal physical injuries or physical sickness), and IRC section 461(h) (relating to the time of economic performance in determining the taxable year of deduction).

The purpose of IRC section 5891, is to deter the purchasers of payment rights under structured settlements from taking advantage of recipients who are entitled to receive tax free settlement payments, including payments under settlements received by victims of the 9/11 terrorist attack. The tax is basically a penalty tax imposed on purchasers of payment rights under structured settlements. The practical effect of section 5891 is to compel such purchasers to comply with State structured protection acts (“SSPAs”), which require that transfers of structured settlement payment rights receive advance court (or administrative authority) approval. Absent an

appropriate court or administrative authority order, a party acquiring structured settlement payment rights must pay, up front, a tax equal to 40% of its expected gross profit on the transaction (i.e., the difference between the total undiscounted amount of the future payments it acquires and the amount that it pays to acquire them). In conjunction with the SSPAs, section 5891 should make structured settlement recipients much less vulnerable to predatory factoring transactions. This new law not only benefits the individual that sells payment rights under his or her structured settlement but also makes clear that insurers involved in structured settlements will suffer no adverse tax consequences as a result of structured settlement factoring transactions. Prior to enactment of section 5891, the tax consequences of these transactions for insurers were uncertain. See, e.g., *Liberty Life Assurance Co. v. Stone Street Capital, Inc.*, 93 F. Supp.2d 630 (D. Md. 2000). Section 5891 does not affect the tax treatment of structured settlement payments that are acquired by factoring companies. Those payments will continue to be subject to income tax in the hands of factoring companies.

As of June 2006, the following states had enacted SSPAs requiring that transfers of structured settlement payment rights receive advance court (or, in some cases, administrative authority) approval. (Since July 1, 2002, every transfer of payment rights has required such approval in order to avoid the federal excise tax.)

<u>State</u>	<u>Citation For SSPA</u>	<u>Prior Court or Admin. Approval Required?</u>	<u>Best Interest/Hardship Finding Required?</u>	<u>Miscellaneous</u>
Alabama Eff Date: 07/01/2006	Act 2006-628	Yes	Yes	Payee be given detailed financial and legal disclosures before transferring payment rights
Alaska Eff. Date: 08/12/2003	Alaska Code Sections 09.60.200 & .09.60.230	Yes	Yes	Disclosure of Key Terms to payee required. <sup>1</sup> Payee must receive independent professional advice regarding implications of the transfer.
Arizona Eff. Date: 05/20/2002	Arizona Code Sections 12-2901 to 12-2904	Yes	Yes	Payee must be advised in writing to seek independent professional advice.
Arkansas Eff. Date: 08/12/2005	Ark. Code Ann Section 23-81-701 through 23-81-707	Yes	Yes	
California Eff. Date: 01/01/2000	California Insurance Code Sections 10134 to 10141	Yes	Yes	Transferee required to advise payee of right to seek counsel in connection with transfer petition and to advise that transferee will pay fees of payee's counsel up to \$1500. Copy of transfer agreement must

<sup>1</sup> Every SSPA requires disclosure of key terms to the payee.

				be filed with state Attorney General's Office. Cannot factor structured settlements of claims for workers comp. benefits.
Colorado Eff. Date: 07/01/2004	Colorado Statutes Sections 13-23-102 to 13-23-108	Yes	Yes	Payee must be advised in writing to seek independent professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Connecticut Eff. Date: 10/01/1998	Connecticut Statute Section 52-225f	Yes	Yes	Payee must be advised in writing to seek independent professional advice.
Delaware Eff. Date: 07/26/2000	Delaware Code, title 10, Sections 6601 & 6602.	Yes	Yes	Payee must receive independent financial advice.
Florida  Eff. Date: 10/01/2001	Florida Statute Section 626.99296	Yes	Yes	Payee must receive independent financial advice. Cannot factor structured settlements of claims for workers comp. benefits.
Georgia Eff. Date: 07/01/1999	Georgia Code Sections 51-12-70 to 51-12-77	Yes	Yes	Payee has 21 days to cancel.
Hawaii Eff. Date: 05/26/2006	HB1977 HD1 SD2	Yes	Yes	Disclosure of Key terms to payee.
Idaho Eff. Date: 07/01/2001	Idaho Code Section 28-9-109	Yes	Yes	Transferee must advise payee to seek professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Illinois Eff. Date: 01/01/1998	Illinois Statute Section 153 (215 ILL)	Yes	Yes	Transferee must advise payee to seek professional advice.
Indiana Eff. Date: 06/30/2001	Indiana Code Sections 34-50-2-1 to 34-50-2-11	Yes	Yes	Cannot factor structured settlements of claims for workers comp. benefits.
Iowa Eff. Date: 07/01/2001	Iowa Code Ann Section 682.1 through 682.7	Yes	Yes	
Kansas Eff. Date: 07/01/2005	2005 House Bill no.2160	Yes	Yes	Cannot factor structured settlements of claims for workers comp. benefits.

Kentucky Eff. Date: 07/15/1998	Kentucky Rev. Statute Sections 454.430 to 454.435	Yes	Yes	Disclosure of Key Terms to Consumer required. <sup>2</sup> Cannot factor structured settlements of claims for workers comp. benefits.
Louisiana Eff. Date: 08/15/2001	Louisiana Sess. Law Serv. Section 9.2715	Yes <sup>3</sup>	No. However, this omission does not prevent the transfer of structured settlements as long as the order contain the necessary findings of a qualified order.	Court must find that Payee received independent professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Maine Eff. Date: 09/18/1999	Maine Rev. Statute Ann. Title 24A Sections 2241 to 2246	Yes	Yes	Payee required to receive independent professional advice. Interested parties must consent to transfer if settlement documents bar assignment of payments.
Maryland Eff. Date: 10/01/2000	Maryland Courts and Judicial Sections 5- 1101-5-1105	Yes	Yes	Payee must receive independent professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Massachusetts Eff. Date: 01/12/2001	Massachusetts Ann. Laws chapter 231C section 2	Yes	Yes	Payee must receive independent professional advice.
Michigan Eff. Date: 01/14/2001	Michigan Comp. Laws Section sections 691.1191 to 691.1197	Yes	Yes	Payee must receive independent professional advice. Interested parties must consent to transfer if settlement documents bar assignment of payments. Discount/interest cannot exceed 25% per year. Cannot factor structured settlements of claims for workers comp. benefits.

<sup>2</sup> The Kentucky SSPA includes this requirement, but it effectively is a nullity, because any payee who enters into a factoring transaction will inevitably have consented to the transaction.

<sup>3</sup> The Louisiana SSPA provides for authorization of a transfer by ex parte order.

Minnesota Eff. Date: 08/01/1999	Minnesota Statute Sections 549.31 to 549- 34	Yes	Yes	Payee must receive independent professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Mississippi Eff. Date: 08/01/2002	Mississippi Code Ann. Sections 11-57- 1 to 11-57-15	Yes	Yes	Factor must advise payee in writing to seek professional advice.
Missouri Eff. Date: 08/28/1999	Missouri Rev. Statute Sections 407.1060 to 407.1068	Yes	Yes	Court must find that payment to be made to payee equals "the fair market value of the structured settlement rights being transferred." Cannot factor structured settlements of claims for workers comp. benefits.
Montana Eff. Date: 10/01/2005	Mont. Code Ann. Section 33-20-1401 through 33-20- 1412	Yes	Yes	Cannot factor structured settlements of claims for workers comp. benefits.
Nebraska Eff. Date: 01/01/2002	Nebraska Rev. Statute Sections 25.3101 to 25-3107	Yes	Yes	Cannot factor structured settlements of claims for workers comp. benefits. Payee must be notified of right to professional advice. Discount/finance charge cannot exceed maximum interest rate for a consumer loan.
New Jersey Eff. Date: 08/02/2001	New Jersey Statute Ann. Sections 2A:16-63 to 2A:16-69	Yes	Yes	Payee must be notified of right to professional advice.
New Mexico Eff. Date: 07/01/2005	New Mexico Stat. Ann. Section 44-9-1 through 44-9-7	Yes	Yes	
New York Eff. Date: 09/17/2002	New York General Obligation Sections 5- 1701 to 5-1709	Yes	Yes	Payee must be notified of right to professional advice. Transfer agreement may not require payee to pay (i) the transferee's attorneys' fees or costs if a transfer is not completed, or (ii) any federal tax liability (other than the

				payee's own tax liability). Cannot factor structured settlements of claims for workers comp. benefits.
Nevada Eff. Date: 05/29/2003	N.R.S. Section 42.030	Yes	Yes	
North Carolina Eff. Date: 10/01/1999	North Carolina General Statute Sections 44B- 1-543.10 to 44B-1-543.15	Yes	Yes	Payee must receive professional advice. Discount/interest rate cannot exceed prime + 5%; fees cannot exceed 2% of net amount payable to payee. Cannot factor structured settlements of claims for workers comp. benefits.
North Dakota Eff. Date: 08/01/2009	2009 Bill Tracking ND H.B. 1205 2009 Bill Text ND H.B. 1205 chapter 32-03.4 of the North Dakota Century Code	Yes	Yes	Court must also determine whether the transaction is fair and reasonable.
Ohio Eff. Date: 10/27/2000	Ohio Rev. Code Ann. Sections 2323.58.1 to 2323.58.7	Yes	Yes	Payee must receive professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Oklahoma Eff. Date: 11/01/2001	Oklahoma Statute Title 12 Sections 3228 to 3245	Yes	Yes	Transferee must advise payee in writing to seek professional advice.
Oregon Eff. Date: 01/01/2006	Ch 173 Oregon Laws 2005 (2005 S.B. 645)	Yes	Yes	
Pennsylvania Eff. Date: 04/11/2000	40 Pennsylvania Statute Sections 4001 to 4009	Yes	Yes	Transferee must advise payee to seek professional advice or sign waiver of advice.
Rhode Island Eff. Date: 08/13/2001	Rhode Island Code R. Sections 27- 9.3-1 to 27-9.3-7	Yes	Yes	Transferee must advise payee to seek professional advice.

South Carolina Eff. Date: 06/13/2002	South Carolina Code Ann. Sections 15-50- 10 to 15-50-70	Yes	Yes	Transferee must advise payee in writing to seek professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
South Dakota Eff. Date: 07/01/2001	South Dakota Codified Laws sections 21-3B- 1 to 21-3B-12	Yes	Yes	Transferee must advise payee to seek professional advice.
Tennessee Eff. Date: 06/23/2000	Tennessee Code Ann. Sections 47-18- 2601 to 47-18- 2607	Yes	Yes	Factor must advise payee to seek professional advice. Cannot factor structured settlements of claims for workers comp. benefits.
Texas Eff. Date: 09/01/2001	Texas Civ. Prac. & Rem. Sections 141.001 to 141.009	Yes	Yes	Transferee must advise payee in writing to seek professional advice.
Utah Eff. Date: 05/06/2002	Utah Code Ann. Sections 78-59-101 to 78-59-108	Yes	Yes	Transferee must advise payee in writing to seek professional advice.
Vermont Eff. Date: 07/01/2012	Vermont Code Section 1. 9 V.S.A Ch 63, subchapter 5	Yes	Yes	Factoring company must file additional documents with the court.
Virginia Eff. Date: 07/01/1999	Virginia Code Ann. Sections 59.1:475 to 59.1:477.1	Yes	Yes	Factor must advise payee in writing to seek professional advice.
Washington Eff. Date: 07/22/2001	Washington Rev. Code Sections 19.205.010 to 19.205.900	Yes	Yes	Transferee must advise payee in writing to seek professional advice.
Wisconsin Eff. Date: 11.13.2015	Wisconsin Statute subchapter III of chapter 895	Yes	Yes	Transferee must advise payee in writing to seek professional advice.
West Virginia Eff. Date: 06/11/1999	West Virginia Code Statute R. Sections 46A- 6H-1 to 46A- 6H-8	(ii) the transferred payment rights total more than \$40,000.00 or (iii) the settlement agreement	Yes	Cannot factor workers' compensation claims. Court approval only for: lump sum payment exceeds 40,000. Settlement payments to infant or incompetent, Personal injury payments, and others.

		contains a provision restricting assignment of payments. rights.		
Wyoming Eff. Date: 07/01/2006	Senate File 0099	Yes	Yes	

New Hampshire is the only states that do not have an SSPA.

***Tax Reported on:***

For transactions that do not meet the conditions for exemption under section 5891(b), the 40% excise tax is reported on Form 8876; with the first return due date of no later than May 20<sup>th</sup>, 2003 for all structured settlement payment rights received before February 20<sup>th</sup>, 2003 and after February 21<sup>st</sup>, 2002. After February 19<sup>th</sup>, 2003, the Form 8876 must be filed by the 90<sup>th</sup> day following the receipt of structured settlement payment rights in a structured settlement factoring transaction. Extensions can be obtained by filing Form 7004, Application for Automatic 6-Month Extension of Time to File Certain Business Income, Information, and Other Returns, by the due date of Form 8876. Form 7004 does not extend the time for payment of the tax.

Procedures for processing of Form 8876 at the Cincinnati Campus are contained in IRM Section 3.17.46.5.39. Procedures for Cincinnati Campus Returns and Document Analysis of Form 8876 are contained in IRM Section 3.11.23.30.1. Filings are posted to non-master file, abstract code 234, activity code for AIMS purposes 034, MFT 27.

***Law:***

Imposition of the tax - Internal Revenue Code section 5891 imposes on any person who acquires directly or indirectly structured settlement payment rights in a structured settlement factoring transaction a tax equal to 40 percent of the factoring discount as determined under subsection (c)(4) with respect to such factoring transactions. Section 5891(c)(3) defines structured settlement factoring transaction to mean a transfer of structured settlement payment rights made for consideration by means of sale, assignment, pledge or other form of encumbrance or alienation for consideration. Sub-section (c)(4) defines the factoring discount as an amount equal to the excess of (1) the aggregate undiscounted amount of structured settlement payments being acquired in the structured settlement factoring transaction, (IRC section 5891(c)(4)(A)) over (2) the total amount actually paid by the acquirer to the person from whom such structured settlement payments are acquired (IRC section 5891(c)(4)(B)).

The excise tax on structured settlement factoring transactions does not apply in the case of a structured settlement factoring transaction in which the transfer of the structured settlement payment rights is approved in advance in a qualified order. A “qualified order” is defined as a final order, judgment or decree (A) that finds that a transfer of structured settlement payment rights (i) does not contravene any Federal or State statute or the order of any court or responsible administrative authority, and (ii) is in the best interest of the payee, taking into account the welfare and support of the payee’s dependents, and (B) is issued (i) under the authority of an applicable State statute by an applicable State court, or (ii) by the responsible administrative authority (if any) which has exclusive jurisdiction over the underlying action or proceeding which was resolved by means of the structured settlement. IRC section 5891(b)(2).

An “applicable State statute” is defined as a statute that provides for entry of an order, judgment or decree described in clause (A) above and has been enacted by (I) the state in which the payee of the structured settlement is domiciled, or (II) if there is no such statute in the state in which the payee is domiciled, then the State in which a party to the structured settlement (including an assignee under a qualified assignment under section 130) or the person issuing the funding asset for the structured settlement is domiciled or has its principal place of business. IRC section 5891(b)(3).

An “applicable State court” means a court of the State that enacted the “applicable State statute.” If the payee is not domiciled in the state that enacted the statute, then the “applicable State court” may be a court of the State in which the payee is domiciled. IRC section 5891(B)(4). If a structured settlement factoring transaction is approved in advance in a final judgment, order or decree that satisfies these conditions, the excise tax under section 5891(a) does not apply. The definitions of “qualified order,” “applicable State statute” and “applicable State court” generally are intended to assure that a decision to approve or disapprove a structured settlement factoring transaction is made by a court in the payee’s home state.

When a structured settlement factoring transaction occurs, and the applicable requirements of Internal Revenue Code Sections 72, 104(a)(1), 104(a)(2), 130, and 461(h) were satisfied at the time the original structured settlement was entered into, the factoring transaction does not affect the application of the provisions of such sections to the parties to the structured settlement in any taxable year. In other words, a structured settlement factoring transaction will not disturb the original tax treatment of the settlement for the parties to the settlement. IRC Section 5891(d).

When structured settlement payments become subject to a structured settlement factoring transaction, the person making the payments will not be required to withhold tax under IRC section 3405.

### ***Definitions:***

The following definitions of terms used in section 5891 are not in alphabetical order, but are in an order where the succeeding definition helps to explain terminology in the prior definition:

1. Structured Settlement - The term “structured settlement” means an arrangement which is established by
  - (1) suit or agreement for the periodic payment of damages excludable from the gross income of the recipient under Section 104(a)(2), or
  - (2) agreement for the periodic payment of compensation under any workers’ compensation law excludable from the gross income of the recipient under Section 104(a)(1), and
  - (3) under which the periodic payments are of the character described in subparagraphs (A) and (B) of Section 130(c)(2), and 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 such periodic payments under a qualified assignment in accordance with Section 130. (IRC section 5891(c)(1)).

**Note: IRC section 5891 applies only to transfers of payment rights under settlements providing for payments that are tax-free to the settlement recipient. Taxable structured settlement payments are rare, but if they were to become the subject of a structured settlement factoring transaction, the excise tax under IRC section 5891(a) would not apply.**

2. Excludable from gross income under IRC Section 104(a)(2) - Section 104(a)(2) generally provides that gross income for income tax purposes does not include the amount of any damages (other than punitive damages) received (whether by suit of agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.
3. Excludable from gross income under Section 104(a)(1) – Section 104(a)(1) generally provides that gross income for income tax purposes does not include amounts received under workmen’s compensation acts as compensation for personal injuries or sickness.
4. Under which the periodic payments are of the character described in subparagraphs (A) and (B) of Section 130(c)(2) - Section 130(c)(2)(A) refers to periodic payments that “are fixed and determinable as to amount and time of payment.” Section 130(c)(2)(B) states that “such periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments.”
5. Qualified assignment in accordance with Section 130 – Section 130(c) states, “For purposes of this section, the term ‘qualified assignment’ means any assignment of a liability to make periodic payments as damages (whether by suit or agreement), or as compensation under any workmen’s compensation act, on account of personal injury or sickness (in a case involving physical injury or physical sickness) – (1) if the assignee assumes such liability from a person who is a party to the suit or agreement, or the workmen’s compensation claim, and (2) if (A) such periodic payments are fixed and determinable as to amount and time of payment, (B) such periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments, (C) the assignee’s obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability, and (D) such periodic payments are excludable from the gross income of the recipient under paragraph (1) or (2) of section 104(a). (Note that the requirement set forth in clause D is also included in the definition of “structured settlement” in section 5891(c)(1).)
6. Structured settlement payment rights – means rights to receive payments under a structured settlement. (IRC section 5891(c)(2))
7. Structured settlement factoring transaction – means “a transfer of structured settlement payment rights (including portions of structured settlement payments) made for consideration by means of sale, assignment, pledge, or other form of encumbrance of alienation for consideration.” Section 5891(c)(3)(A). It does not include (i) “the creation or perfection of a security interest in structured settlement payment rights under a blanket security agreement entered into with an insured depository institution in the absence of any action to redirect the structured settlement payments to such institution or otherwise to enforce such blanket security interest against the structured settlement payment rights,” or (ii) “a subsequent transfer of structured settlement payment rights acquired in a structured settlement factoring transaction.” Section 5891(c)(3)(B). In other words, section 5891, including the 40% excise tax, does not apply to a transaction in which a bank lender acquires a security interest that extends to a borrower’s structured settlement payment rights as part of a blanket security arrangement covering other collateral, until and unless the lender seeks to collect the borrower’s structured settlement payments or otherwise to enforce its security interest in the structured settlement payment rights. Section 5891 also does not apply to secondary transactions in which structured settlement payment rights that have already been the subject of a structured settlement factoring transaction are reassigned (e.g., if a structured settlement factoring company securitizes payment rights that it previously acquired). Section 5891 applies only to transfers of structured settlement payment rights made by settlement recipients, not to subsequent transfers made by structured settlement factoring companies.
8. Factoring Discount – means an amount equal to the excess of the aggregate undiscounted amount of structured settlement payments being acquired in the structured settlement factoring transaction, over the total amount actually paid by the acquirer to the person from whom such structured settlement payments are acquired. For example, John Doe, the payee under a structured settlement is entitled to receive \$50,000 a year in structured settlement payments

for a period of 10 years. After one year, XYZ Factoring Company offers to buy the rights to the remaining 9 years of payments for \$200,000.00. The Factoring Discount would be \$250,000, the excess of the structured settlement payments (\$450,000) due to John Doe in the transaction over the amount paid (\$200,000) by XYZ. (IRC section 5891(c)(4))

9. Responsible Administrative Authority – means the administrative authority which had jurisdiction over the underlying action or proceeding which was resolved by means of a structured settlement. (IRC section 5891(c)(5))
10. State – The term state includes the Commonwealth of Puerto Rico and any possession of the United States. (Treas. Reg. 157.5891-1(c)(1)(6))
11. Qualified Funding Asset – If the structured settlement involves an IRC section 130 assignment, annuities or U. S. Obligations are the only permissible funding assets. Most, if not all, structured settlements that become the subject of factoring transactions are funded by annuities.

## **Examination Reports for Audit Results**

The Excise Tax examiner uses a report as the record of findings and recommendations concerning the examination of Structured Settlement Factoring Transactions. Like most excise taxes, this Report Form is the Form 5384, Excise Tax Examination Changes and Consent to Assessment & Collection, for agreed cases, and Form 5385, Excise Tax Examination Changes, for Unagreed Cases. The use of these report forms for this excise tax is detailed in IRM Section 4.24.10 which covers Excise Tax Examination Reports.

### ***Appeal Rights and Assessments:***

Like many other Excise Taxes, the appeal rights and assessment procedures for the Excise Tax on Structured Settlement Factoring Transaction are different from the appeal rights and assessment procedures for Income tax. Internal Revenue Code Section 5891, which imposes the excise tax, is under Subtitle E, (Alcohol, Tobacco, and Certain other Excise Taxes), Chapter 55 of the Internal Code (Title 26). Under Internal Revenue Code Section 6211, the term “deficiency” is defined, and is restricted to income, estate, and gift taxes imposed by subtitles A and B, and excise taxes imposed by chapters 41, 42, 43, and 44 of the Internal Revenue Code. As the new Excise Tax on Structured Settlement Factoring Transactions, like other excise taxes such as foreign insurance, does not fall under the definition of a deficiency, deficiency procedures such as a statutory notice would not apply. Therefore, the jurisdiction of the Tax Court would also not apply to the new Excise Tax on Structured Settlement Factoring Transactions, as the deficiency and overpayment provisions that confer jurisdiction to the Tax Court are not applicable. The lack of jurisdiction for Excise taxes was upheld in Phillips Petroleum Co. (92 TC 885, Dec. 45667).

## **Chapter Two – Audit Techniques**

### **1. Background Audit Information**

Prior to starting an assigned examination of a taxpayer for structured settlement factoring transactions, the examining officer should review all original case documents to familiarize him/her self with taxpayer’s business. The transcripts should be reviewed to see what types of income tax returns are filed. Research should be conducted on Accurint and the internet to see how the taxpayer is involved with structured settlement factoring. For example, does the company enter into factoring transactions for its own account or as a broker utilized to set up transactions that are referred to and consummated by other, larger entities that have greater resources? By becoming familiar with the taxpayer’s business prior to contact, the examiner will be better to understand the answers to the initial interview, and have a better idea of exactly what type of records should be used to determine the correct excise tax liability.

## 2. The Initial Interview

After the examiner has established who the responsible person is to talk to for the taxpayer's business, the following questions should be used as a guide for an initial interview with the taxpayer for the Excise Tax on Structured Settlement Factoring Transactions:

1. Background of Business:
  - a) Type of Business, e.g. C-Corp, Sub-S
  - b) Date organized
  - c) Date Business began
  - d) Explanation of Business Activities
  - f) Explanation of all related entities
2. Excise Tax Activity:
  - a) Has this entity, an affiliate or any predecessor entity ever filed excise tax returns, such as a Form 720, 2290, or 8876?
  - b) If so, are copies of the returns available along with the related workpapers used to prepare the returns?
  - c) How was the reported excise tax calculated?
  - d) What other back-up workpapers are prepared when determining the tax due?
3. If no return has been filed, who is the person in the company responsible to determine that excise tax is not due?
4. Structured settlement factoring transactions
  - a) What are the major sources of revenue for the company related to structured settlement factoring transactions?
  - b) How are these items accounted for in the books and records?
  - c) Do you specialize in factoring payment rights under any particular type of structured settlement agreements? Do you specialize in acquiring any particular category of payments (e.g., life-contingent payments)?
  - d) Do you maintain a separate folder or deal package for each structured settlement factoring transaction the company is involved in?
  - e) How does the company report income from structured settlement factoring transactions for income tax purposes and GAAP accounting purposes?

## 3. Financial Statements

Large Public Business Organizations, which include most of the Coordinated Industry Cases, publish public annual reports containing Financial Statements. All other companies must create financial statements to obtain loans and financing, and these Financial Statements contain the Income report, Balance Sheet and Cash Flow statements. The first step of the audit process is to review the Business Financial Statements, and determine the sources of income and cash for the business. For large businesses, the sources of cash and income may have to be traced to a smaller business component, and then to detailed workpapers used provide detail showing the source of income or cash for the business. A business involved in purchasing structured settlement payment rights would show income and/or a cash flow from the previously purchased payment rights, and an expense and/or cash outflow for the structured settlement payment rights acquired during the current year or period reflected in the Financial Statements. These Financial Statements should contain figures which can be reconciled to the income tax returns filed by these businesses.

#### 4. Coordination with other Examination Specialists

In examining a case for the Excise Tax on Structured Settlement Factoring Transactions, the Excise Tax Specialist should coordinate this issue with the Coordinated Industry Case Team Coordinator (if the case is a CIC case). Before submitting an Information Document Request for records relating to Structured Settlement Factoring Transactions, a meeting should be held with the Team Coordinator to make sure the same records have not already been requested by the Team Coordinator or another Specialist assigned to the case.

#### 5. Initial Requests for Information

If based on the above actions and procedures, it appears that the taxpayer is involved in structured settlement factoring transactions, an initial Information Document Request should be issued. An example of an initial IDR is shown below in Exhibit A-1.

##### Exhibit A-1 – IDR Example

<b>Form 4564</b>	<b>Department of the Treasury Internal Revenue Service Information Document Request</b>	<b>Request Number EX – 02</b>
<b>To: (Name of Taxpayer and Company, Division or Branch)</b> Example Corporation EIN #??-????????	<b>Subject: Excise Taxes</b>	
<b>Attn: Mr. Tax Contact Person</b>	<b>Submitted to:</b>	
	<b>Dates of Previous Requests:</b>	

**Description of Documents Requested:**

RE: Structured Settlements – IRC 5891(a)

In general, Section 5891(a) applies to structured settlement factoring transactions entered into on or after February 22, 2002.

Please answer the following questions:

1. What is the main business purpose of the company? Provide detailed response to the question.
2. Is the company involved in structured settlement factoring transactions? If so, explain.
3. Does the company broker the purchase or sale of any structured settlement agreements? If so, explain.
4. If involved in structured settlement factoring transactions, provide copies of the structured settlement, the factoring/transfer agreements along with the final court order approving such transfers during the period \_\_\_\_\_ through \_\_\_\_\_.
5. Provide a list of the clients and entities which participated in structured settlement factoring transactions involving the company during the period \_\_\_\_\_ through \_\_\_\_\_.

# Chapter Three –Determining Taxability

## 1. How to Apply the Law to the Documents

After the audit techniques have identified Structured Settlement Factoring Transactions by the taxpayer under audit, a determination must be made as to whether the Excise Tax applies, and if it does, how the amount of tax due is computed. The following questions should be applied to each structured settlement factoring transaction:

- Do the future payments to be made under the structured settlement agreement consist of income tax free periodic payments which are fixed and determinable as to the amount and time of payment.? If yes, go to next question. If not, stop. The transfer is not subject to excise tax.
- Was the factoring transaction approved in advance in a court order or an order of an administrative authority? If not, the transfer is subject to tax. No exceptions.
- If the factoring transaction was approved in advance in a court order, does the order satisfy the conditions for a “qualified order” under IRC section 5891(b)(2)? In particular:
- Does the order contain findings that the factoring transaction (i) does not contravene any Federal or State statute or the order of any court or responsible administrative authority, and (ii) is in the best interest of the payee, taking into account the welfare and support of the payee’s dependents? If not, the order plainly fails to satisfy the conditions for a “qualified order.” Further analysis of the order is not indicated. The factoring transaction is subject to excise tax.
- If the order contains the necessary findings, further analysis is appropriate, in order to determine whether the order was issued (i) “under the authority of an applicable State statute by an applicable State court” (IRC section 5891(b)(2)(B)(i)) or (ii) by a “responsible administrative authority” which had “exclusive jurisdiction over the underlying action or proceeding” that was resolved by the structured settlement (IRC section 5891(b)(2)(B)(ii)).
- If the order was entered by a court (as distinguished from an administrative authority):
  - What is the state of domicile for the payee (the person transferring his structured settlement payment rights) in the factored structured settlement?
  - Does the state in which the payee is domiciled have a structured settlement protection act (“SSPA”) providing for entry of an order, judgment, or decree that contains the findings necessary under IRC section 5891(b)(2)(A), i.e., a “qualified order”? If so, then (i)that SSPA is the “applicable State statute” under which a “qualified order” approving the factoring transaction must be entered; and (ii) the “qualified order” must be entered by a court (the “applicable State Court”) of the same state. If the state in which the payee is domiciled does not have an SSPA the “applicable State statute” can be an SSPA in a state in which either the party to the structured settlement or the issuer of a qualified funding asset (“insurers”)<sup>4</sup> involved in the structured settlement is domiciled or has its

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<sup>4</sup> For convenience this document uses the term “insurers.” However, in many cases, the company with the obligation to make periodic payments under a structured settlement is not an insurance company, although it may often be part of a group of companies that include insurance companies.

principal place of business, and the “applicable State court” can be either a court of that state or a court of the state in which the payee is domiciled. (A state court of general jurisdiction in a payee’s home state may be willing to rule on a transfer application based on the SSPA of another State.)

- If the payee is domiciled in a state that has an SSPA that provides for entry of an order containing the necessary findings, but the order (i) has been entered by a court in another state and/or (ii) does not indicate that it has been entered under the authority of the SSPA in the payee’s home state,<sup>5</sup> the order fails to satisfy the conditions for a “qualified order.” The factoring transaction is subject to excise tax.
- If the payee is domiciled in a state that does not have an SSPA that provides for entry of an order containing the necessary findings, has the order been entered (i) under the authority of an SSPA enacted in a state in which one of the insurers is located, and (ii) either by a court of that state or by a court of the payee’s home state? If the answer is negative, the order fails to satisfy the conditions for a “qualified order.” The factoring transaction is subject to excise tax.
- Was the underlying action or proceeding (i.e., the action or proceeding that was resolved by the structured settlement) subject to the exclusive jurisdiction of an administrative authority? (For example, many workers’ compensation acts and other statutes providing compensation for occupation-related injuries and illnesses give administrative agencies exclusive jurisdiction over claims brought under those acts.) If so, the order of a court does not (and cannot) satisfy the conditions for a “qualified order,” because in order to satisfy those conditions an order must be issued by the administrative authority.<sup>6</sup>
- If the order was entered by an administrative authority, did that administrative authority have exclusive jurisdiction over the underlying claim or proceeding? If not, the order does not (and cannot) satisfy the conditions for a “qualified order.”

Note that a court order approving a factoring transaction normally will have been drafted by the factoring company, and it may include self-serving findings indicating that the transaction qualifies for exemption from excise tax under IRC section 5891(b). Such findings are not binding on the Internal Revenue Service.

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<sup>5</sup> Court orders approving factoring transactions under SSPAs often refer to multiple statutes, because, depending on the circumstances, such transactions may be subject to several SSPAs, including, for example, the SSPA in the payee’s home state, the SSPAs in the states in which the annuity owner and annuity issuer are located, and the state in whose courts the underlying claim was heard. The fact that one SSPA is designated as the “applicable State statute” for purposes of the definition of “qualified order” in IRC section 5891(b)(2) does not mean that other SSPAs do not continue to apply.

<sup>6</sup> Most workers’ compensation acts prohibit or sharply restrict assignment of workers’ compensation, including compensation payable under workers’ compensation settlements. In conditioning exemption from the federal excise tax, in the case of factoring transactions involving workers’ compensation settlements, on approval of such transactions by the “responsible administrative authorities,” IRC section 5891 does not imply that such transactions can or should be approved. In most cases they presumably should not be approved, because they contravene applicable statutes (i.e., workers’ compensation laws) and/or orders of responsible administrative authorities (i.e., the workers’ compensation commission orders approving the settlements). IRC section 5891 simply establishes the standards that must be met in those cases in which payment rights under workers’ compensation settlements can be transferred, consistent with applicable workers’ compensation law restrictions.

For any structured settlement factoring transaction that was not approved in advance in an order that satisfies the conditions for a “qualified order” under IRC section 5891(b)(2) the following questions should be addressed:

- What was the aggregate undiscounted amount of structured settlement payments acquired in the transaction?
- What net amount was actually paid by the factoring company to the payee? This should be the net amount actually remitted to the payee (or paid for his account), not the gross purchase price identified in the factoring agreement or the disclosure statement given to the payee. (Factoring companies often deduct various fees and expenses from the amounts that they have otherwise agreed to pay in exchange for future structured settlement payments; so the net amount received by a payee may be substantially smaller than the gross amount reflected in the documents.)

In order to be subject to the Excise Tax imposed on the factoring transactions, structured settlement payments must be tax-free to the recipient under IRC Section 104, as described in Chapter 1. Although applicability of the excise tax depends on the character of the structured settlement payments as tax-free payments in the hands of the payee, that will very seldom be an issue, because (i) the vast majority of structured settlements are carefully documented to assure that the periodic payments will not be taxable; (ii) payees under the rare structured settlements that are taxable are not likely to resort to factoring transactions, and factoring companies have never been known to show any interest in acquiring payment rights under taxable settlements ; and (iii) in most cases in which factoring companies have sought court (or administrative authority) approval for factoring transactions, the factoring companies are likely to be estopped from questioning the tax-free character of factored payments. Other factoring transactions, like the sale of future payments of lottery winnings, would not be subject to the excise tax. While some of the same companies factor both structured settlement payment rights and rights to future lottery payouts, lotteries should not be confused with structured settlements, and factoring of lottery payouts should not be equated with factoring of structured settlements, many of whose recipients rely on their structured settlement payments to meet their basic living expenses and/or to pay for continuing medical treatment.

Once again, in order to comply with the conditions for exemption from the excise tax of IRC Section 5891, the Court approving the factoring of structured settlement payment rights must be located in the State in which the payee of the structured settlement is domiciled, or if that State has not enacted an “applicable State statute,” then in the state in which one of the insurers involved in the structured settlement is domiciled or has its principal place of business. Structured settlement factoring companies may sometimes be trying to avoid an unfavorable SSPA or an unfavorable forum in the payee’s home state. For example, if a factoring company seeks to acquire structured settlement payment rights from a payee domiciled in North Carolina (which limits the discounts and fees that factoring companies can charge), the factoring company may seek to have its transaction approved under the SSPA, and in the courts, of another state. If that occurs, the resulting order is not a qualified order for purposes of section 5891(b), and the factoring company is liable for the excise tax.

An examiner should always plan to review court orders and the applications pursuant to which they were granted. Note, however, that there is no issue of court “jurisdiction.” A court of general jurisdiction in State A may technically have jurisdiction to approve a transfer of structured settlement payment rights by a payee domiciled in State B; but that does not imply that the court in State A is an “applicable State court” under IRC section 5891(b)(4).

**Exercise Problem** – Mr. John sustained physical injuries in an automobile accident. His subsequent claims for compensatory damages were resolved in 1998 through a structured settlement, under which Mr. John is entitled to receive \$2,000.00 per month for life, plus a series of lump sum payments totaling \$400,000.00, payable at ten-year intervals starting in 2008. The obligation to make the future settlement payments is assigned, through a qualified assignment in accordance with IRC section 130, to X Corporation. The future settlement payments are funded by an annuity contract issued by X Life Insurance Company, an affiliate of X Corporation. Both X Corporation and X Life Insurance Company are domiciled and headquartered in Washington State. Mr. John is domiciled in North Carolina. The settlement payments to Mr. John are excludable from his income under IRC section 104(a)(2).

In September 2004, J Corporation, a structured settlement factoring company, agrees to purchase from Mr. John his rights to receive the lump sum settlement payments. J Corporation agrees to pay Mr. John \$160,000, less various fees and expenses. J Corporation makes required disclosures to Mr. John and applies for approval of the transaction by a state court in Washington, under the Washington Structured Settlement Protection Act (the Washington Act<sup>®</sup>). J Corporation’s application is not contested, and in November 2004 the court enters an order finding that the transfer (i) is in Mr. John’s best interest, taking into account the welfare and support of his dependents, and (ii) does not contravene any Federal or State statute or the order of any court or responsible administrative authority. On December 1, 2004, J Corporation and Mr. John complete their transaction. J Corporation pays Mr. John \$157,500.00 – the agreed \$160,000.00 purchase price less \$2,500.00 in fees.

Is J Corporation subject to excise tax under IRC section 5891(a)? If so, what is the amount due for the excise tax and when was the return due?

**Answer to Exercise Problem** – J Corporation is liable for the excise tax on its structured settlement factoring transaction with Mr. John. The transaction was approved in advance in a court order containing the findings specified in IRC section 5891(b)(2)(A), but the order was not entered under the authority of an “applicable State statute” or by an “applicable State court.” Because Mr. John is domiciled in North Carolina, which has a structured settlement protection act that provides for entry of an order containing the findings contemplated in IRC section 5891(b)(2)(A), the “applicable State statute” is the North Carolina act (not the Washington Act) and the “applicable State court” would be a court in North Carolina (not in Washington). Thus, the Washington court order is not a “qualified order” under IRC section 5891(b)(2).

The amount of the tax is 40% of the remainder obtained by subtracting \$157,500.00 (the amount actually paid to Mr. John) from \$400,000.00 (the aggregate undiscounted amount of the transferred payments):

$$\begin{array}{r} \$400,000.00 \\ - \quad \underline{157,500.00} \\ \$242,500.00 \\ \quad \underline{\times 40\%} \\ \$ 97,000.00 \end{array}$$

The return, on Form 8876, should have been filed by J Corporation by March 1, 2005, the 90<sup>th</sup> day following J Corporation’s receipt of structured settlement payment rights in the structured settlement factoring transaction.

## Chapter Four – Sources of Information

### Sources for Classification

Many structured settlement factoring companies advertise for customers through websites that can be located by searching for references to structured settlements, structured settlement purchasing or the National Association of Settlement Purchasers, a trade organization to which most of the largest structured settlement factoring companies belong. (They do not generally call themselves “factoring companies.”) Some companies also advertise extensively on cable television and in magazines and newspapers. Reported court decisions involving factoring transactions, including decisions approving or disapproving transactions under SSPAs, can be useful sources of information. Those decisions are readily located by searching Westlaw and Lexis databases for cases referring to “structured settlements.”

In two states, Maine and West Virginia, the SSPAs require that structured settlement factoring companies obtain special licenses. See Me. Rev. Stat. Ann. Tit. 24-A § 2242 (requiring that factoring companies register with the Superintendent of Insurance); W. Va. Code § 46A-6H-8 (requiring that factoring companies register with the Secretary of State). Information about factoring companies that have done business in those states should be available from their registrations. However, these appear to be sites maintained by factoring brokers, not factoring companies per se, and they may not be very helpful.

**A final source of information may be the National Structured Settlements Trade Association (NSSTA). The NSSTA is headquartered in Washington D.C. This Association lobbied hard for the law which created Section 5891 imposing the Excise Tax on the structured settlement factoring transactions, and has a direct interest in the enforcement of the new excise tax. In this regard, the Trade Association may be in a position to provide technical support and information.**

### Sources of Legal Information

Internal Revenue Code Section 5891

Treasury Regulation 157.5891-1

Internal Revenue Code Section 130

Internal Revenue Code Section 72

Internal Revenue Code Section 104

Internal Revenue Code Section 461

Internal Revenue Code Section 6211

Phillips Petroleum Co. (92 TC 885, Dec. 45667)