

“VICTIMS OF TERRORISM TAX RELIEF ACT OF 2001”

Joint Committee on Taxation Explains New Law

Following is an excerpt from the technical explanation of the “Victims of Terrorism Tax Relief Act of 2001,” pertaining to the 40 percent excise tax imposed on the purchase of future payments from structured settlements without first obtaining advance approval of a court or administrative agency. This document, which was prepared by the staff of the congressional Joint Committee on Taxation, may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the “Victims of Terrorism Tax Relief Act of 2001,”* as Passed by the House and the Senate on December 20, 2001 (JCX-93-01), December 21, 2001. The date of enactment was January 23, 2002, when the president signed it into law.

5. Treatment of purchase of structured settlements (sec. 115 of the bill and new sec. 5891 of the Code).

Present Law

Present law provides tax-favored treatment for structured settlement arrangements for the payment of damages on account of personal injury or sickness.

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee’s obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(1) or (2) as workers’ compensation for personal injuries or sickness, or as damages on account of personal physical injuries or physical sickness.

A qualified funding asset means an annuity contract issued by an insurance company licensed in the U.S., or any obligation of the United States, provided the annuity contract or obligation meets statutory requirements. An annuity that is a qualified funding asset is not subject to the rule requiring current inclusion of the income on the contract which generally applies to annuity contract holders that are not natural persons (e.g., corporations) (sec. 72(u)(3)(C)). In addition, when the payments on the annuity are received by the structured settlement company and included in income, the company generally may deduct the corresponding payments to the injured person, who, in turn, excludes the payments from his or her income (sec. 104). Thus, neither the amount received for agreeing to the qualified assignment of the liability to pay damages, nor the income on the annuity

that funds the liability to pay damages, generally is subject to tax.

The exclusion for recipients of the periodic payments received under a structured settlement arrangement as damages for personal physical injuries or physical sickness can be contrasted with the treatment of investment earnings that are not paid as damages. If a recipient of damages chooses to receive a lump sum payment (excludable from income under sec. 104), and then to invest it himself, generally the earnings on the investment are includable in income. For example, if the recipient uses the lump sum to purchase an annuity contract providing for periodic payments, then a portion of each payment under the annuity contract is includable in income, and the balance is excludable under present-law rules based on the ratio of the individual’s investment in the contract to the expected return on the contract (sec. 72(b)).

Present law provides that the payments to the injured person under the qualified assignment cannot be accelerated, deferred, increased, or decreased by the recipient (sec. 130). Consistent with these requirements, it is understood that contracts under structured settlement arrangements generally contain anti-assignment clauses. It is understood, however, that injured persons may nonetheless be willing to accept discounted lump sum payments from certain “factoring” companies in exchange for their payment streams. The tax effect on the parties of these transactions may not be completely clear under present law.

Explanation of Provisions

The bill generally imposes an excise tax on any person who acquires certain payment rights under a structured settlement arrangement from a structured settlement recipient for consideration. The amount of the excise tax is 40 percent of the excess of (1) the undiscounted amount of the payments being acquired, over (2) the total amount actually paid to acquire them.

The 40-percent 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 a court or is issued by the responsible administrative authority. Rules are provided for determining the applicable State statute.

The provision also provides that the acquisition 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), section 72 (relating to annuities), sections 104(a)(1) and (2) (relating to an exclusion for amounts received under workers’ compensation acts and for damages on account of personal physical injuries or physical sickness), and section 461(h) (relating to the time of economic performance in determining the taxable year of a deduction).

Effective Date

The provision generally is effective for acquisition transactions entered into on or after 30 days following enactment. A transition rule applies during the period from that date to July 1, 2002. Under the transition rule, if no applicable State law (relating to the best interest of the payee) applies to a transfer during that period, then the exception from the 40 percent excise tax is available without the otherwise required court (or administrative) order, provided certain disclosure requirements are met. Under the transition rule, the person acquiring the structured settlement payments is required to disclose in advance to the payee: (1) the amounts and due dates of the payments to be transferred; (2) the aggregate amount to be transferred; (3) the consideration to be received by the payee; (4) the discounted present value of the transferred payments; and (5) the expenses to be paid by the payee or deducted from the payee’s proceeds.

The provision providing that the acquisition transaction does not affect the application of certain present-law rules is effective for transactions entered into before, on or after the 30th day following enactment. □

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