

The following is general information and should not be considered tax advice. Please consult your own tax professionals.

Structured settlement payments are typically tax free payments for the original annuitant, per 26 U.S. Code § 104, and carriers do not issue IRS Form 1099. But just because there is no 1099 does not mean that these assigned structured settlement payments (DCF Income Payments) are tax-free. Income received that is in excess of the purchase price is subject to tax for the purchaser of a payment stream.

The income is typically considered 'ordinary' and recognized for tax purposes only when it is received, leaving unrealized income to defer, accrue, and compound. The portion of a payment that is reportable as income (and not principal) is ultimately determined by the taxpayer, but below are three methodologies you and your tax advisor may discuss.

PAYMENT TABLE METHODOLOGY:

DCF Exchange obtained guidance from a well-recognized nationwide accounting firm, which we make available to our clients. This guidance states that the income portion of a payment is (1) the amount received minus (2) the price of purchase for that payment. That allows for substantial deferral as early payments have proportionally less taxable income, and later payments have more. This is shown on the Payments Table in the closing book.

The 'Payments Table' treats each individual payment in a series of payments as its own discounted cash flow event.

For example, using 100 monthly payments of \$1000 starting in 1 month, the first payment will have very little interest and almost all principal. It requires \$995.10 today to grow to \$1000 in 1 month at a 6% annual rate. Because it only had 1 month to accrue and grow, you only recognize that \$4.90 as interest income on that first payment. The second monthly payment will have a little more interest, and so on. By the end, the 100th payment has had 100 months to grow. It requires \$615.34 today to grow to \$1000 in 100 months at 6%, and therefore the last payment of \$1000 has \$384.66 of interest.

In sum, the 'payments table' is an approach that allows you to defer the recognition of income until later years.

EXCLUSION RATIO METHODOLOGY:

Some purchasers choose to compute taxes based on an "exclusion ratio" applied to the whole payment stream so as to obtain a consistent ratio of income vs. principal across all payments. This ratio is also shown on the Payments Table and while DCF has not obtained tax advice regarding this method, your tax advisors may choose to utilize this approach.

For example, a single lump sum that costs \$50,000 and pays out \$100K has a 50% exclusion ratio. Half of the payment, when received, would be taxable income. Likewise, 100 monthly payments of \$1000 that costs \$50,000, also has a 50% exclusion ratio. Half of each monthly payment would be recognized as interest when it is received.

AMORTIZATION SCHEDULE METHODOLOGY:

The amortization schedule is a traditional method of allocating principal and interest in a loan or a stream of payments, that results in recognizing more interest in the early years of a payment stream.

By its nature, an amortization schedule reflects the accrual of interest on the entire investment at every compounding period. At the end of that compounding period, the schedule 'posts' accrued interest to principal, whereupon the now-larger amount of principal accrues in the next compounding period. DCF Payments are typically computed using monthly compounding and the amortization schedule can be downloaded from our calculator, but calculating Internal Rate of Return (XIRR) in MS Excel, for example, uses a daily compounding method by default.

In an amortization schedule, payments early on in the schedule contain large amounts of interest and relatively small amounts of principal. You see this most commonly in a mortgage- when you borrow to buy a house, your early years of the mortgage pay down principal very slowly.

Following the amortization schedule, you will recognize more taxable income early on in a payment stream, and less interest in later years.

TAXATION INFORMATION SUMMARY:

It's important to note that in all three methods, the exact same amount of interest is recognized- they just vary as to when you recognize it. Different clients use different approaches, and we typically include the payments table in the closing book.

Please note, if a DCF Income Payment is owned by your IRA then the tax treatment above does not apply, as IRA distributions trigger taxes for IRA holders, not the income from IRA owned assets.

Again, DCF Exchange, LLC does not offer tax advice, and this page is for general information only, so please be sure to consult your own tax adviser for more information.