

Part 1

Section 61.—Gross Income Defined

26 CFR 1.61-1: Gross income.
(Also § 104, 130, 139, 451; 1.451-2)

Rev. Rul. 2003-115

ISSUES

(1) Are periodic payments made to a claimant of the September 11th Victim Compensation Fund of 2001 (Fund) pursuant to an Award Determination Agreement among the claimant, the Special Master, and an assignment company (Agreement) excluded from the gross income of the claimant under §§ 139(f) and 104(a)(2) of the Internal Revenue Code?

(2) Is the amount transferred by the United States to an assignment company pursuant to an Agreement and in exchange for the assignment company's assuming the United States' obligation to make periodic payments to a claimant excluded from the gross income of the assignment company under § 130(a)?

FACTS

On September 11, 2001, terrorist-related airline crashes occurred in New York, Virginia, and Pennsylvania. Following the attacks, the United States Government, under Title IV of the Air Transportation Safety and System Stabilization Act (Act), Pub. L. No. 107-42, 115 Stat. 230 (2001), created the Fund. The Act authorizes an award of compensation to any individual physically injured and to the personal representative of any individual killed as a result of the September 11th terrorist-related airline crashes.

To receive an award, a claimant must file a claim with the Fund no later than December 22, 2003. The Special Master, appointed under section 404 of the Act to administer the Fund, reviews the claim and notifies the claimant of any additional information needed to process the claim. Once the Special Master receives sufficient information to make an initial evaluation of the claim, the Special Master determines the claim to be substantially complete and notifies the claimant by letter. When a claim is determined to be substantially complete, the claimant is deemed to have waived any right to file a civil action or be a party to an action in any federal or state court for damages sustained as a result of the September 11, 2001, airline crashes, except to recover collateral-source obligations or to recover from a person who is a knowing participant in a conspiracy to hijack an aircraft.

The Special Master, within 120 days of his determination that the claimant's application is substantially complete, must determine (1) whether the claimant is entitled to an award and (2) the amount of the award. Once the Special Master makes an award determination, the claimant is notified in writing. The claimant then has 21 days to either accept the award determination or appeal it by requesting a hearing before the Special Master. Alternatively, a claimant, following the submission of a claim, may proceed directly to a hearing process for purposes of determining the award amount.

The amount of an award is affected by a number of factors including whether the claimant received an insurance or workers' compensation award as a result of either injuries incurred by, or the death of, the victim from the attack; the income of the victim; the nature, severity and duration of the victim's injuries resulting from the attack; the size of the victim's household, including the number of surviving dependents; and the victim's age. The particular needs of a claimant also may be taken into account in determining the award amount.

The Special Master allows a claimant to make an election to receive an award in the form of periodic payments instead of a lump sum payment. The claimant, however, must elect periodic payments before the Special Master issues the letter notifying the claimant that his or her claim is substantially complete. If a claimant who applies for advance benefits as provided by the Fund desires periodic payments, the claimant must elect periodic payments when he or she files the form applying for advance benefits. An election may not be revoked by the claimant.

When electing to receive periodic payments, the claimant may choose to receive the entire award in periodic payments, or only a portion of the award in periodic payments with the remainder to be received as a single payment. Further, at the time the claimant elects periodic payments, the claimant must choose the period of time over which the payments are to be made and the frequency of payments during that period. For example, a claimant may choose to receive his or her award in monthly payments over twenty years or in monthly payments over the claimant's lifetime. Finally, all periodic payments must be of an equal amount unless the claimant specifies otherwise at the time he or she elects to receive periodic payments.

If a claimant chooses to receive all or a portion of the award in periodic payments, and if the Special Master determines that the claimant is entitled to an award, then the terms of the award are set forth in an Agreement. Each Agreement sets forth the amount to be paid and the frequency and duration of the payments. In addition, an Agreement may state that, if the claimant dies before the entire interest is distributed, the remaining payments are payable to the claimant's estate or to a secondary beneficiary duly designated by the claimant during the claimant's lifetime. Each Agreement provides that no payee or beneficiary shall have the right or power to transfer, mortgage, encumber or anticipate the periodic payments, by assignment or otherwise.

Each Agreement also includes an assignment by the Special Master of the United States' periodic payment obligation to, and an assumption of that obligation by, an assignment company in exchange for a payment from the United States to the assignment company. Each Agreement provides that the assignment company's periodic payment obligation is equal to the periodic payment obligation of the United States prior to the assignment, and that the periodic payments cannot be accelerated, deferred, increased, or decreased by the claimant or any beneficiary or payee. Each Agreement allows the assignment company to fund its obligation to make periodic payments through the purchase of an annuity contract that complies with the requirements set forth in § 130(d) for a qualified funding asset. Under an Agreement, the assignment company is the owner of the annuity, which is subject to claims of the general creditors of the assignment company.

LAW AND ANALYSIS

Issue 1

The first issue concerns whether periodic payments made to a claimant of the Fund pursuant to an Agreement are excluded from the gross income of the claimant under § 139(f) and § 104(a)(2).

Section 61 provides that, except as otherwise provided by the Code, gross income includes all income from whatever source derived.

Section 139(f) provides that gross income does not include "any amount received as payment under section 406 of the Air Transportation Safety and System Stabilization Act." The § 139(f) exclusion applies to amounts paid to claimants in the form of a lump sum or periodic payments.

Section 104(a)(2) provides that gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as a lump sum or as periodic payments) on account of personal physical injuries or physical sickness.

Neither § 139(f) nor § 104(a)(2) excludes from gross income amounts that are earned from the investment by the claimant of a lump sum amount received as either payment under section 406 of the Act or damages on account of personal physical injuries or physical sickness, respectively. If such a lump sum payment is invested for the benefit of a claimant who has actual or constructive receipt, or the economic benefit, of the lump sum payment, only the lump sum payment is excluded from gross income, and none of the income from the investment of the lump sum payment is excludable from the claimant's gross income. Rev. Rul. 65-29, 1965-1 C.B. 59.

Section 1.451-2 of the Income Tax Regulations provides rules relating to constructive receipt. Under § 1.451-2(a), an amount is constructively received in the taxable year in which such amount is credited to a taxpayer's account, set apart for the

taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time if notice of intention is given. Income is not constructively received if the taxpayer's control of receipt of the amount is subject to substantial limitations or restrictions. Section 1.451-2(a).

The economic benefit doctrine, developed in case law, provides that if a promise to pay an amount is funded and secured by the payor, and the payee is not required to do anything other than wait for the payments, an economic benefit is considered to have been conferred on the payee and the amount of such benefit is considered to have been received. In *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd.*, 194 F.2d 541 (6th Cir. 1952), the court found that an economic benefit had been conferred on a taxpayer when the taxpayer's employer established a trust to compensate the taxpayer for past services. In 1945, the employer transferred money to the trust to be paid to the taxpayer in 1946 and 1947. The taxpayer was the trust's sole beneficiary. The court held that the taxpayer received compensation in 1945 in an amount equal to the value of the amount transferred to the trust for the taxpayer's benefit because such transfer to the trust provided the taxpayer with an economic benefit.

Not all rights to receive periodic payments, however, trigger application of the economic benefit doctrine. Rev. Rul. 79-220, 1979-2 C.B. 74, concludes that a right to receive certain periodic payments under the facts of the ruling does not confer an economic benefit on the recipient. In Rev. Rul. 79-220, a taxpayer entered into a settlement with an insurance company for the periodic payment of nontaxable damages for an agreed period. The taxpayer was given no immediate right to a lump sum amount and no control of the investment of the amount set aside to fund the insurance company's obligation. The insurance company funded its obligation with an annuity payable directly to the taxpayer. The insurance company, as owner of the annuity, had all rights to the annuity and the annuity was subject to the claims of the general creditors of the insurance company. The ruling concludes that all of the periodic payments are excluded from the taxpayer's gross income under § 104(a)(2) because the taxpayer did not receive, or have the economic benefit of, the lump sum amount used to fund the annuity. Further, the ruling holds that if the taxpayer dies before the end of the agreed period, the payments made to the taxpayer's estate under the settlement agreement are also excludable from the gross income of the estate under § 104(a)(2).

With respect to a claimant of the Fund, the award claim procedure requires the claimant to make an irrevocable election relating to periodic payments while the claimant's control of receipt of payments is subject to substantial limitations or restrictions. Consequently, the claimant is not in constructive receipt of a lump sum amount. Further, no economic benefit of a lump sum has been conferred on the claimant by the Agreement. The assignment company making the periodic payments to the claimant may fund its obligation with an annuity to which the assignment company has all rights and that it continues to own. The periodic payments under the Agreement are, therefore, amounts "received as payment under section 406 of the Air Transportation Safety and System Stabilization Act" and thus excluded from the

claimant's gross income under § 139(f). Moreover, the payments are excluded from the claimant's gross income under § 104(a)(2) as damages received on account of personal physical injuries or physical sickness. Finally, any payments to a successor beneficiary pursuant to the Agreement are excludable from the gross income of the successor beneficiary under §§ 104(a)(2) and 139(f).

Issue 2

The second issue concerns whether the amount transferred by the United States to an assignment company in exchange for the assignment company assuming the United States' obligation to make periodic payments to a claimant is excluded from the assignment company's gross income under § 130(a). Section 130 provides tax-favored treatment to certain structured settlement arrangements. Under § 130(a), any amount received for agreeing to a qualified assignment is excluded from the gross income of the assignee to the extent such amount does not exceed the aggregate cost of any qualified funding assets. Section 130(c) defines a qualified assignment as any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of 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 the following requirements--

- (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 of such payments;
- (3) the assignee's obligation on account of the personal injuries or sickness must be no 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 § 104(a)(1) or (2).

Under § 130(d), a qualified funding asset means any annuity contract issued by an insurance company licensed in the United States, or any obligation of the United States, meeting the requirements set forth in § 130(d)(1) through (4).

Each Agreement meets the requirements set forth in § 130(c)(1) through (4). Moreover, the Special Master is considered a person who is a party to a suit or agreement because the Fund was created to compensate the victims of the terrorist attack. Accordingly, any payment by the United States to the assignment company for agreeing to a qualified assignment is excluded from the assignment company's gross income under § 130 to the extent such amount does not exceed the aggregate cost of any qualified funding assets purchased by the assignment company to fund the payment obligation assumed by it.

HOLDINGS

Under the facts of this revenue ruling:

(1) Periodic payments made to a claimant of the Fund pursuant to an Agreement are excluded from the gross income of the claimant under §§ 139(f) and 104(a)(2). Similarly, any payments to an estate or secondary beneficiary pursuant to an Agreement are excluded from the gross income of the successor beneficiary under §§ 104(a)(2) and 139(f).

(2) The amount transferred by the United States to an assignment company pursuant to an Agreement and in exchange for the assignment company's assuming the United States' obligation to make periodic payments to a claimant is excluded from the gross income of the assignment company under § 130(a) to the extent the amount transferred does not exceed the aggregate cost of any qualified funding asset purchased by the assignment company to fund the periodic payment obligation.

GRACE PERIODS FOR CERTAIN CLAIMANTS

Any claimant of the Fund who has been notified by the Special Master that his or her claim is substantially complete (or who has applied to receive advance benefits) but who has not made an election relating to periodic payments (including specifying the period of time over which the payments are to be made, the frequency of such payments, and, if the claimant so desires, a periodic-payment stream other than equal payments) may make such election and rely on this revenue ruling provided the claimant makes his or her election before the earlier of (1) December 17, 2003, or (2) the date the Special Master issues the claimant's award determination letter.

In addition, a claimant may rely on this revenue ruling if: (1) before issuance of the claimant's award determination letter, the claimant informed the Special Master of the claimant's wish to receive periodic payments but provided no information regarding the period or frequency of such payments (and, if desired, a periodic-payment stream other than equal payments); (2) before October 28, 2003, the Special Master confirmed in writing that the claimant so informed the Special Master; and (3) the claimant provides the additional information required to perfect his or her election by December 2, 2003.

DRAFTING INFORMATION

The author of the revenue ruling is Shareen S. Pflanz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, please call Shareen Pflanz or Stephen Toomey at (202) 622-4920 (not a toll-free call).