

Internal Revenue Service

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, ID No.

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PLR-150850-07

Date:
June 2, 2008

LEGEND:

taxpayer =

Employer =

Assignee =

Annuity =

Issuer

Date a =

Date b =

Dear

This responds to your letter dated November 13, 2007, requesting a ruling on the proper federal income tax treatment for certain periodic payments the taxpayer will receive in settlement of various claims against Employer.

REQUESTED RULINGS:

- (1) The taxpayer will not be in actual or constructive receipt of periodic payments until she receives the applicable cash payment.
- (2) The taxpayer will include each of the periodic payments in her income in the year in which she receives such payment.

APPLICABLE FACTS:

The taxpayer files her federal income tax return on a calendar year basis under the cash receipts and disbursements method of accounting.

The taxpayer has asserted that from Date a to Date b , while employed by Employer she was subjected to a pattern of hostile employment practices. Taxpayer filed a complaint seeking damages arising from alleged lost overtime wages (the "Wage Claim") and from alleged non-physical injuries, including emotional distress and mental anguish (the "Non-Wage Claim" and, together with the Wage Claim, the "Claims").

As a result of negotiations, taxpayer and Employer (the "Parties") agreed to settle taxpayer's Claims. Under a proposed Settlement Agreement and Release, Employer agrees to pay taxpayer an initial lump sum of cash (the "Lump Sum Payment") in settlement of her Wage Claim, together with a specified schedule of periodic payments (the "Periodic Payments") in settlement of her Non-Wage Claim.

In the Settlement Agreement and Release, taxpayer will agree that she may change neither the timing nor the amount of the Periodic Payments in order to accelerate, defer, increase or decrease such payments. Taxpayer further will agree that she may not sell, mortgage, encumber or anticipate all or any portion of the Periodic Payments by assignment or other means.

The Settlement Agreement and Release reserves the right of the Employer to enter into a "Non-Qualified Assignment," under which the Assignment Company ("Assignee") will make the Periodic Payments directly to the taxpayer. Furthermore, as part of the Settlement Agreement and Release, taxpayer will agree to allow Employer to enter into a Non-Qualified Assignment with Assignee and acknowledges that upon the Assignee's acceptance of a Non-Qualified Assignment, the Assignee will become the sole obligor with respect to the specified Periodic Payments. Under the Nonqualified Assignment Agreement, the Assignee agrees, for good and valuable consideration, to make the Periodic Payments to taxpayer.

Under the Non-Qualified Assignment Agreement, the Assignee will make the Periodic Payments directly to the taxpayer. The Assignee's obligation to make the Periodic Payments is no greater than that of Employer; however, the Assignee's obligation to make the Periodic Payments will continue regardless of the subsequent bankruptcy or insolvency of the Employer.

The Non-Qualified Assignment will be an irrevocable contract requiring the Assignee to make the specified Periodic Payments to the taxpayer. Under no circumstances can the taxpayer elect to receive the commuted value of the remaining Periodic Payments.

The Assignee's obligation under the Non-Qualified Assignment to make Periodic Payments will be discharged by transmitting, by the due date for each payment, a valid check or its electronic equivalent in the specified sum for the taxpayer. Similar to the Settlement Agreement and Release, the Non-Qualified Assignment prohibits changes to the timing or the amount of the Periodic Payments and prohibits the taxpayer from accelerating, deferring, increasing or decreasing the scheduled Periodic Payments. In addition, the taxpayer may not sell, assign, encumber or anticipate all or any portion of the Periodic Payments by assignment.

The Non-Qualified Assignment further specifies that the taxpayer has no rights against the Assignee other than those of an unsecured general creditor. The Non-Qualified Assignment states that all rights of ownership with respect to any annuity contract purchased by the Assignee belong exclusively to the Assignee; taxpayer will not be a third party beneficiary of any such annuity contract.¹ The Non-Qualified Assignment also states that no assets have been set aside to secure the Periodic Payments.

By settling her Non-Wage Claim for an agreed schedule of Periodic Payments and permitting Employer to assign its obligation to make such payments to the Assignee (the "Assignment Transaction"), the taxpayer can address her desire to use the settlement as a source for meeting future needs, including retraining and financial planning.

The Taxpayer has represented that:

1. The Periodic Payments represent compensation to the taxpayer for non-physical personal injuries and sickness she incurred during the course of her employment with Employer.
2. The Periodic Payments represent payments made by Employer to settle taxpayer's Non-Wage Claim and are not wages for federal income tax purposes.
3. Employer's Periodic Payments in settlement of the taxpayer's Non-Wage Claim will constitute a taxable recovery to the taxpayer pursuant to section 61 of the Internal Revenue Code and are not exempt from federal income tax under section 104(a)(2).

LAW AND ANALYSIS:

¹ Pursuant to the Non-Qualified Assignment Agreement, the Assignee will fund the Periodic Payments by purchasing an annuity contract issued by the Annuity Issuer. All rights of ownership and control of such annuity contact shall be and remain vested in the Assignee.

Section 451 of the Code provides that an item of gross income shall be included in a taxpayer's gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations, provides, in part, that gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.

Section 1.451-2(a) of the Regulations, provides, in part, income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Rev. Rul. 66-45, 1966-1 C.B. 95 states that the phrase 'or otherwise made available' was added to section 1.451-2(a) of the Regulations to make it clear that it is a right of withdrawal during the taxable year, rather than the formal setting apart or crediting of income, which causes income to be constructively received.

In Rev. Rul. 67-203, 1967-1 C.B. 105, a winner of the Irish Sweepstakes reported his income on the cash receipts and disbursements basis, and, by reason of being a minor his winnings were to be held by the Irish court until he reached majority. Rev. Rul. 67-203 holds that the economic benefit doctrine applies and requires the inclusion of the present value of the sweepstakes winnings in the minor's gross income at the time the funds are paid over to the Irish court.

Rev. Rul. 2003-115, 2003-2 C.B. 1052, holds that neither the constructive receipt doctrine nor the economic benefit doctrine applied to a claimant regarding the settlement of a claim under the September 11 Victim Compensation Fund where (i) the claimant irrevocably elected to receive periodic payments while the claimant's control of receipt of payment was subject to substantial restrictions; (ii) the Fund assigned its obligation to make such periodic payments to an assignment company pursuant to a "qualified assignment" described in section 130; and (iii) the assignment company funded its obligation to make periodic payments by purchasing an annuity contract described in section 130(d).

Williams v. U.S., 219 F.2d 523 (5th Cir. 1955) holds that a seller is in constructive receipt of income where the buyer agrees to pay the full purchase price and the seller

self imposes limitations on an escrow, which does not make the sales proceeds any less available to the seller.

In Commissioner v. Brooklyn Gas Co., 62 F.2d 505 (2d Cir. 1933), a gas company engaged in rate litigation and obtained an interlocutory order staying reduced rates and directing that money collected in excess be impounded. The gas company was permitted to withdraw the impounded money upon issuing a bond. The court held that the money was taxable in years earned, not in the year litigation was finally terminated, because the taxpayer had dominion and control over the money without any restriction

In Childs v. Commissioner, 103 T.C. 634 (1994, *aff'd* without op. 89 F.3d 856 (11th Cir. 1996)), the taxpayer received a structured settlement agreement, which provided that the defendant's insurance company assigned its obligation to Assignee, who then purchased an annuity from its subsidiary. Assignee remained the owner of the annuity policy, maintained the right to change the beneficiary without the consent of the taxpayer; and the taxpayer's rights under the annuity policy were not greater than those of a general creditor. The Tax Court held that the fair market value of taxpayer's right to receive payments under the settlement agreement was not includable income in the year in which the settlement agreement was effected because the promise to pay was neither fixed nor secured. The court further held that the doctrine of constructive receipt was not applicable because the taxpayer did not have a right to receive payment before the time fixed in the settlement agreement.

In Sproull v. Commissioner, 16 T.C. 244 (1951), *aff'd*, 194 F. 2d 541 (1952), the Tax Court held that an economic benefit or financial benefit is conferred to the taxpayer, and as a result, the taxpayer recognizes income under the economic benefit doctrine where money is placed in trust for the taxpayer, taxpayer is not required to do anything to earn such funds, and the trust contained no restriction on taxpayer's right to assign or otherwise dispose of the money placed in trust.

Under Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961), and Rev. Rul. 68-606, 1968-C.B. 42, a freely transferable, readily marketable right to a future payment stream, not subject to setoffs, is equivalent to cash and therefore is taxed at its fair market value when the right to such payment is received by a cash basis taxpayer.

Timing of Income for Federal Income Tax Purposes

Generally, the taxpayer's method of accounting determines when an amount is treated as received for Federal income tax purposes. In the instant case, Taxpayer reports on the cash receipts and disbursements method of accounting for Federal income tax purposes.

Under the cash receipts and disbursements method of accounting, all items which constitute gross income (whether in the form of cash, property, or services) are to be

reported as income in the taxable year in which such items are actually or constructively received, or where the taxpayer is conferred an economic benefit.

A. Actual Receipt

Income is actually received when it is reduced to the taxpayer's possession, dominion, or disposition. See Brooklyn Gas. Under the Non-Qualified Assignment, taxpayer will not receive, nor in any way possess or control, the amount paid to the Assignee by the Employer. Nor will taxpayer receive any property at the time the Employer enters into the Non-Qualified Assignment, other than the contractual promise of the Assignee to make the scheduled payments. A mere unfunded, unsecured promise to pay does not result in income to a taxpayer on the cash receipts and disbursements method of accounting. Rev. Rul. 60-31, 1960-1 C.B. 174, and U.S. v. Christine Oil & Gas Co., 269 F. 458 (Cir. 1920). Thus, the taxpayer shall not be viewed as being in actual receipt of cash or property when she enters into the Settlement Agreement and Release with the Employer or when the Employer and the Assignee enter into the Non-Qualified Assignment.

B. Cash Equivalency

Under the "cash equivalency" doctrine, a cash basis taxpayer may be treated as being in receipt of income if that taxpayer receives a promise or other contractual obligation that can readily be converted into cash by the taxpayer. Cowden v. Comm'r, 289 F.2d 20, 24 (5th Cir. 1961), *rev'g and rem'g* 32 T.C. 853 (1959), *on remand*, 20 T.C.M. 1134 (1961). The taxpayers in Cowden were lessors under an oil, gas, and mineral lease who were entitled under the lease to deferred payments. Shortly after entering into the lease, the taxpayers assigned their rights to the deferred payments in exchange for an amount which represented a normal market discount from the amount of future payments they otherwise would have received. The Court stated:

We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

289 F.2d at 24.

Under the Non-Qualified Assignment, the taxpayer will not be able to assign, encumber or otherwise transfer her right to receive the Periodic Payments. Both the Settlement

Agreement and Release, executed by the Employer and the taxpayer, and the Non-Qualified Assignment, executed by the Employer and the Assignee, will provide that the taxpayer will have no right to modify the schedule of Periodic Payments, or to accelerate, defer, increase, decrease, anticipate, sell, assign, or encumber any payment.

Based upon the fact that the taxpayer's right to payments under the Non-Qualified Assignment will be neither assignable nor transferable, the taxpayer's limited right to payments shall not be treated as equivalent to cash. Although the Non-Qualified Assignment between the Employer and the Assignee will provide for the Assignee to fund its obligations by acquiring an annuity contract, the taxpayer will have no rights in the annuity contract and thus will continue to possess only an unsecured and unfunded promise to pay. The Assignee's purchase of an annuity contract, under which the Assignee has all rights of ownership does not create a "cash equivalent" right that ripens into a benefit of the taxpayer.

C. Constructive Receipt

A cash basis taxpayer is in constructive of income, as opposed to actual receipt, when income although not actually reduced to a taxpayer's possession "is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." Section 1.451-2(a) of the Regulations. The phrase "or otherwise made available" was added to the Regulation to make it clear that a taxpayer's right to draw on income during the taxable year, even if it is not formally set apart or credited, causes income to be constructively received. Rev. Rul. 66-45, 1966-1 C.B. 95. A taxpayer will not have current income under the constructive receipt doctrine merely because he seeks deferral of payments as part of a negotiated settlement. See Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983). If, however, the taxpayer has a current right to receive all of the funds before a deferral mechanism is established, current income cannot be avoided. Williams v. United States.

Under the Non-Qualified Assignment, the taxpayer will not have a right to draw on or otherwise accelerate her receipt of the Periodic Payments scheduled to be made by the Assignee. The amounts to be paid by the Assignee will come from its general assets, which are subject to claims of the creditors of the Assignee. The Non-Qualified Assignment specifically provides that "None of the Periodic Payments may be accelerated, deferred, increased or decreased and may not be anticipated, sold, assigned, or encumbered. Any attempts to do so will be void."

Thus, under the Non-Qualified Assignment, the taxpayer will have no ability to receive any Periodic Payment (either partially or in full) before the time the Assignee is scheduled make any payment. The Non-Qualified Assignment will be entered into only after a Settlement Agreement and Release is negotiated between taxpayer and the

Employer. During these negotiations, the taxpayer's payment rights will be established. The negotiated Settlement Agreement and Release will fix the taxpayer's rights prior to the time when she has an unqualified right to demand immediate payment. She will therefore not have a current right to receive a settlement payment before her right to receive Periodic Payments under the Settlement Agreement is established. Under the Settlement Agreement and Release and the Non-Qualified Assignment, taxpayer will be entitled to specified payments only at specified times, and the taxpayer will be prohibited from altering either the timing or the amount of any payments. Accordingly, the taxpayer shall not be viewed as constructively receiving any of the applicable payments at any time before the Assignee makes the Periodic Payments in cash pursuant to the schedule set forth in the Settlement Agreement and Release. Furthermore, Assignee's purchase of an annuity contract to fund its obligations under the Non-Qualified Assignment does not amount to a setting apart or crediting of funds for the taxpayer's benefit given that she will possess no rights under the annuity contract. Childs. (No constructive receipt where settlement agreement stipulated that attorney's rights under annuity policies, acquired by assignment company to fund obligation to make periodic payment of attorney's contingent fee arising from client's settlement, were no greater than rights of a general creditor.)

D. Economic Benefit

Under the "economic benefit doctrine," a taxpayer on the cash method of accounting may be treated as having received income in a year prior to actual or constructive receipt in certain limited circumstances. See, e.g., Sproull v. Comm'r, 16 T.C. 244, 247 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952). A cash-basis taxpayer is taxed currently on the value of the economic benefit conferred when the taxpayer is assured the benefit of future payments, even though such payments will not be made or made available to the taxpayer until subsequent taxable years. A taxpayer is treated as receiving the current economic benefit of future payments when a payor unconditionally and irrevocably establishes a separate fund or trust of assets exclusively for the taxpayer's benefit. Sproull, 16 T.C. at 248 *supra* (the economic benefit doctrine requires current inclusion in income of an amount irrevocably transferred to a trust to be paid, with earnings, to an employee over the following two years, or to his estate should he die earlier); Pulsifer v. Commissioner, 64 T.C. 245, 247 (1975) (Irish Sweepstakes winnings irrevocably deposited with an Irish court for the benefit of a minor sweepstakes winner are currently includible in income under the economic benefit doctrine); Rev. Rul. 67-203, 1967-1 C.B. 105.

Neither the execution of the Non-Qualified Assignment nor the purchase of an annuity contract by the Assignee to fund its obligation to the taxpayer shall be viewed as conferring a current economic benefit on the taxpayer. After the execution of the Non-Qualified Assignment, the taxpayer will possess only a mere promise to be paid (although the identity of the promisor will have changed). Moreover, no amount will be set aside from which to make the scheduled payments, nor will a separate fund be

irrevocably and unconditionally set aside for the benefit of the taxpayer. Furthermore, taxpayer has no rights against the Assignee other than that of a general creditor.

Based on the above, neither the “constructive receipt” doctrine, the “cash equivalency” doctrine, nor the “economic benefit” doctrine shall apply to the taxpayer’s facts regarding the Periodic Payments.

RULINGS:

Based solely on the facts and representations submitted, we conclude and rule as follows:

- (1) The taxpayer will not be in actual or constructive receipt of the Periodic Payments until she receives the applicable cash payment.
- (2) The taxpayer will include each of the Periodic Payments in her income in the year in which she receives such payment.

DISCLAIMERS AND LIMITATIONS:

This ruling is based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed or implied regarding the deductibility of any amounts by Employer under section 1.461-4 of the Regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
Associate Chief Counsel
(Income Tax & Accounting)

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