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Hagner Mister
Secretary, Maryland Department of Agriculture
50 Harry S. Truman Parkway
Annapolis, MD 21401

Dear Secretary Mister:

This letter responds to a telephone inquiry from Peter Tropp of your office regarding the federal income tax consequences of proposed legislation that would give tobacco farmers in Maryland two new options for payment under Maryland's tobacco buyout program. This letter is an "information letter" as defined in section 2.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 8. An information letter is advisory only and has no binding effect on the Internal Revenue Service. Section 2.04 of Rev. Proc. 2001-1.

As we understand the proposed legislation, Maryland will offer two new options for farmers to participate in its tobacco buyout program. Tobacco farmers are not required to participate in the program. Under the existing tobacco buyout program, Maryland will pay $1 per pound to eligible tobacco growers for each of the next ten years. The current program is funded by 5% of the available annual revenues from Maryland's share of the national tobacco settlement agreement. Under the proposed legislation, Maryland will sell approximately $65 million in bonds, backed by proceeds from the national tobacco settlement. Combined with $10 million currently available, the new program will make $75 million available for tobacco buyouts and a targeted agricultural land preservation initiative. Two new options for buyouts will be available for each eligible applicant: 1) Maryland will pay an up-front lump-sum payment currently estimated to be $6.74 per pound (the present value of 10 annual payments of $1 per pound), or 2) Maryland will purchase an annuity from private financial providers guaranteeing an annual $1 per pound payment. The proposed legislation is subject to approval by the Maryland General Assembly.

In a telephone conversation between Peter Tropp of your office and Kim Koch of my office, Mr. Tropp asked for advice on the federal income tax consequences of the annuity option to cash method farmers who elect that option under the proposed legislation.[1] Under the general rule for taxpayers using the cash method of accounting, income is included in gross income for the tax year in which it is actually or constructively received. With the annuity option, the farmer will not have actual receipt of the entire amount in the year the annuity is issued. Thus, the question is whether the farmer will have constructive receipt of the income in the year the annuity is issued. An additional issue is whether the farmer must include the income in the year of the annuity under either of two doctrines created by the courts, the cash equivalency doctrine or the economic benefit doctrine.

Section 1.451-2 provides that income is constructively received by a taxpayer in the tax year in 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 tax year if notice of intention to withdraw had been given. In the case of an annuity under the proposed legislation, the issue of constructive receipt potentially arises because the farmer can choose between the annuity and a lump-sum payment. In situations where a taxpayer has already earned an amount of income, a taxpayer choosing an annuity over a lump-sum payment of that income may have constructive receipt of the lump-sum amount. In such a case, the taxpayer is essentially turning his back on income that is currently available. However, in situations such as this one where the farmer has not "earned" the income prior to choosing a buyout option, the mere fact that the farmer can choose from several options, including a lump-sum payment, does not mean that each of the options will give rise to income under the constructive receipt doctrine. In this situation, the farmer is not turning his back on the lump-sum payment because that payment is not currently available to the farmer unless the farmer chooses the lump-sum option. For farmers who do not choose the lump-sum option (including farmers who choose not to participate at all in the buyout program), the possibility of participating in the program and choosing a lump-sum does not give rise to income under the constructive receipt doctrine.

The courts have also created two doctrines that require taxpayers to recognize income upon the receipt of certain promises to pay in the future. Under the first of these doctrines, the cash equivalency doctrine, a taxpayer is treated as having income when he receives a promise to pay that is the "equivalent of cash." In Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961), the court described the doctrine as follows:

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[1] A cash method farmer who chooses the lump-sum payment must include the payment in income in the tax year in which received. See § 451(a) of the Internal Revenue Code and § 1.451-1(a) of the Income Tax Regulations. A farmer that uses an accrual method of accounting and chooses either the lump-sum payment or the annuity option must include the amount in income in the tax year in which the farmer has a fixed right to receive the income and the amount of the income can be determined with reasonable accuracy. See § 1.451-1(a).

> 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.

In this case, it appears that Maryland's promise to pay will not be of a kind that is frequently transferred to lenders or investors. If that is the case, the cash equivalency doctrine will not require a farmer to include the amount of the annuity in income in the year the annuity is issued.

The other court-created doctrine that requires taxpayers to recognize income upon the receipt of a certain type of promise to pay in the future is the economic benefit doctrine. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for a taxpayer's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 195 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174 (Situation 4). In Sproull, the court set forth the current elements of the economic benefit doctrine. At issue in Sproull was the taxability of amounts paid by the taxpayer's employer to an interest bearing trust as compensation for the taxpayer's past services. In finding that the taxpayer obtained an economic benefit in the year the trust was established, the court noted that the funds were placed in trust irrevocably for the taxpayer's sole benefit and that the taxpayer had to do nothing further to establish his right to the funds.

In the instant case, it is unclear at this point exactly how the annuity will be established. However, if Maryland purchases an annuity (or sets up a trust fund, escrow account, etc.) and irrevocably names a particular farmer as the beneficiary of the annuity, the economic benefit doctrine likely will apply to require the farmer to include the amount of the annuity in gross income in the year the annuity is issued. On the other hand, if Maryland purchases an annuity to fund its promise to make annual payments to farmers generally over a number of years, and the farmers receive no present economic benefit from the annuity, fund, or account, the farmers will not be required to include the amount of the annuity in income until payments are actually received.

For example, in Rev. Rul. 72-25, 1972-1 C.B. 127, the Service ruled that amounts payable to an employee under a deferred compensation arrangement are not includible in gross income until received where the employee does not acquire a present interest in the employer's annuity contract used as a funding method. In that ruling, the taxpayer and his employer executed a deferred compensation agreement to be funded by an annuity contract purchased by the employer. The employer was the applicant, owner, and beneficiary of the annuity contract. The annuity contract was subject to the general creditors of the employer. The benefits under the agreement were not subject to anticipation, alienation, sale, transfer, assignment, pledge, or encumbrance by the employee or his beneficiary. Thus, the Service concluded, because the employee had no present interest in the annuity contract, compensation payable under the agreement was not required to be reported upon issuance of the annuity.

Similarly, in Rev. Rul. 79-220, 1979-2 C.B. 74, the Service ruled that a plaintiff was not required to recognize income as a result of an insurance company's purchase of an annuity contract to fund monthly damage payments. In that ruling, the insurance company was the owner of the annuity contract and had all the rights of ownership, including the right to change the beneficiary. The plaintiff could rely only on the general credit of the insurance company for collection of the monthly payments. See also Rev. Rul. 68-99, 1968-1 C.B. 193 (an employee was not required to recognize income as a result of his employer's purchase of an insurance contract where the employee did not receive a present economic benefit therefrom).

Another situation similar to the annuity option in this case arises when a state sets up a lottery fund to pay out lottery prizes over a period of years. In one common fact pattern, whenever a jackpot is won, the lottery immediately purchases Treasury bonds in an amount that, together with the accrued interest thereon, will be sufficient for the state to meet its obligation to pay the installments as they become due. The bonds purchased to pay each jackpot, with their accrued interest, are placed into the reserve account for the payment of the jackpot prize and are not set aside for any specific winner or winners. The lottery names itself rather than the winner as the owner and beneficiary of the annuity. The lottery uses the payments received under the annuity contracts to fund payments to the lottery winner. Under these facts, the funds are merely a financial investment by the lottery that will enable it to meet its payment obligations to the winner. Accordingly, the winner does not receive a present economic benefit from the reserve account and is not required to report the installments until they are actually received.

In summary, the federal income tax consequences to cash method farmers who choose the annuity option under the proposed legislation will depend on how the "annuity" is structured. If the farmer does not receive a present economic benefit from the annuity option, he will not be required to include the total amount of the annuity in gross income when the annuity is established. Instead, the annuity payments should be reported as they are actually received.

I hope this information is helpful. If we can be of further assistance, please contact Kim Koch (ID # 50-04024) of my office at (202) 622-4950.

Sincerely,

Douglas Fahey
Acting Chief, Branch 5
Associate Chief Counsel
(Income Tax & Accounting)