

Internal Revenue Service

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Person To Contact: _____, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-144239-12

Date:
April 08, 2013

Fund =
Company =
State X =
Insurance =
Regulator
Court =
Entity 1 =
Entity 2 =
Plan =

Newco =
Fund Claims =
Administrator
Year 1 =
Date u =
Date v =
Q =
R =
\$a =
\$b =
\$c =
\$d =

Dear _____ :

This responds to your letter dated October 10, 2012, and subsequent correspondence, submitted on behalf of Fund, requesting a ruling that its payments to certain Fund beneficiaries are not subject to information reporting under § 6041 of the Internal

Revenue Code because the payments are excluded from their gross income under § 104(a)(2).

FACTS

Fund was formed under the laws of State X as a not-for-profit, non-stock corporation. Fund was established in connection with the liquidation of Company and was formed in order to replace, in hardship situations, some of the benefits due to Company payees, which are being reduced due to Company's insolvency. Fund's annual accounting period is a calendar year and its method of accounting is an accrual method.

Company is a life insurance company domiciled in State X and since Year 1 has been under the direction of Insurance Regulator as receiver, pursuant to the orders of Court.

Company's sole remaining in-force policies are annuity contracts (Contracts). You represent that the Contracts consist of the following types:

- Structured settlement annuities (SSAs), the payments under which are excludable from the recipients' gross income pursuant to § 104(a)(2).¹
- Individual certificates delivered under group annuity contracts issued by Company in connection with the terminations of defined benefit plans (i.e., pension termination annuities), and other single premium immediate annuities not included in the above categories (together, Other Annuities).

Company's assets as of Date u totaled \$a, but the value of Company's liabilities as of that date was approximately \$b. Accordingly, Company cannot continue to pay 100 percent of the benefits on all Contracts.

Insurance Regulator worked with representatives from, and counsel for, various interested parties, including among others Entity 1 and Entity 2, various state life and health insurance guaranty associations with statutory coverage obligations under the Contracts (the participating guaranty associations or PGAs), and certain life insurance companies to reach a consensus on the Plan that is in the best interests of Company payees and creditors, avoids disruption of annuity payments, and increases the amount of funds available for Company payees and creditors. Insurance Regulator petitioned Court to, among other things, declare Company to be insolvent; approve the provisions, terms and conditions of the Plan; appoint Insurance Regulator and its successors in office as liquidator of Company; and to direct Insurance Regulator to liquidate the business and affairs of Company. On Date v, Court approved the Plan.

Pursuant to the Plan, Insurance Regulator and Entity 1 will determine an implied account value for each Contract equal to the present value of Company's projected

¹ We have assumed, but do not decide, that the payments made under the currently existing SSAs are excluded from recipients' gross income under § 104(a)(2).

liabilities due and payable under each Contract as of the date of liquidation (Liquidation Value). The Liquidation Value assigned to each Contract will then be reduced to a pro rata amount that could be supported by Company's assets as of the date of entry of an order of liquidation (Restructured Value). The Restructured Value of Contracts as so restructured (Restructured Contracts) is expected to reduce benefit payments to approximately Q percent of their pre-Restructured Value.

The order approving the Plan will reduce the liabilities under each Contract to its Restructured Value, and the difference between the Liquidation Value assigned to a Contract (i.e., its pre-Restructured Value) and the Restructured Value for the Contract will be deemed to be an indebtedness of Company to Company payees. Under the Plan, Company will transfer a substantial portion of its assets to Newco and will cede and assign to Newco its liability to make the reduced benefit payments under the Restructured Contracts. Company will not cede or assign to Newco the obligations it retains under the Plan in respect of the Restructured Contracts (Retained Liabilities). The Retained Liabilities may be discharged only by a future court order closing Company's liquidated estate.

The Plan provides that benefits under the Restructured Contracts shall be immediately enhanced, upon Newco's assumption of the Restructured Contracts, from a variety of funding sources. The PGAs will provide financial support to supplement benefit payments, up to the maximum amount allowable by their respective state laws, with respect to the Restructured Contracts eligible for guaranty association coverage. In addition, Insurance Regulator and Entity 1 have negotiated with certain life insurance companies for the provision of supplemental benefit enhancements (Supplemental Benefit Enhancements). A Restructured Contract that is subject to a benefit reduction after application of all of the other benefit enhancements under the Plan would receive Supplemental Benefit Enhancements to increase the total benefits to be paid by Newco in respect of such Contract to the lesser of (a) total benefits with a present value of \$C and (b) total benefits under the terms of the pre-Restructured Contract.

Company's estate will retain some of Company's remaining assets, which will be used to pay secured claims, administrative expenses, and other remaining liabilities of Company. When no longer needed, any remaining funds will be transferred to Newco and allocated on the same basis as all other transferred assets. In addition, the Plan contemplates that, at defined points in the future, Newco will attempt to transfer all of Newco's liabilities to a commercial life insurer and remit the proceeds (if any) of such transfer to Company's estate. Such later recoveries by Company, with the approval of Court, will be used to satisfy Company's Retained Liabilities in accordance with the priorities set forth in the State X insurance law and the Plan.

Even after the funding from other sources, including the PGAs and the Supplemental Benefit Enhancements discussed above, approximately R percent of Company payees will not receive the full amounts due under their pre-Restructured Contracts. A

consortium of insurance companies has committed to contribute \$d to Fund for payment to Company payees whose policy benefits have been reduced and who will not receive from other sources the full amounts due under their pre-Restructured Contracts and who otherwise qualify for Fund benefits (Fund Beneficiary or Beneficiaries). These companies are not required to make any additional contributions to Fund, and Fund will hold \$d in a general account until the amount is distributed to Fund Beneficiaries. You represent that Court considered the payments Fund will make to Fund Beneficiaries to be an integral part of the overall plan for replacing amounts due to Company payees under the Contracts, along with other Contract enhancements. Fund's making of the payments depended on Court's approval of the Plan.

Payments from Fund will be administered by Fund Claims Administrator. Fund Claims Administrator has sole discretion regarding the award of financial assistance, the amount of an award, and the form of the award (i.e., lump sum or periodic payments). A Company payee must apply to Fund in order to receive payments from Fund. The application Fund Claims Administrator has developed requires information regarding the circumstances leading to the creation of a Contract; the amount of the annuity benefit thereunder; the current monthly annuity benefit payments; a Fund Beneficiary's life expectancy, financial status, and medical history; and certain other relevant information.

Fund Claims Administrator will make determinations regarding payments from Fund based on individual needs. The \$d will be allocated among Fund Beneficiaries. After such allocations, Fund Claims Administrator will pay benefits from Fund assets in one of two ways:

- (1) Fund Claims Administrator will make a lump sum payment of benefits to a Fund Beneficiary; or
- (2) Fund Claims Administrator will purchase an annuity to fund periodic payments to a Fund Beneficiary.

Fund has represented that it (or a third-party assignee that is unrelated to any Fund Beneficiary) will remain the owner of any annuity, including both SSA and Other Annuities, purchased to fund periodic payments to a Fund Beneficiary and that payments under the annuity will be made to a Fund Beneficiary at the direction of Fund (or a third-party assignee that is unrelated to any Fund Beneficiary). A Fund Beneficiary will have no interest in an annuity and will have no ability to assign the rights to the annuity. Fund has also represented that a Fund Beneficiary will have no right to change the payee or to alter or accelerate the payments under the annuity, which as noted above, will be made by the issuer of the annuity to the beneficiary at the direction of Fund. A Fund Beneficiary will have no right to demand payment of any amount either from the insurance company that issues the annuity or from Fund before amounts are due and payable under the terms of the annuity. Fund will not create any separate escrow or trust account for any Fund Beneficiary with respect to any annuity or the

payments to be made thereunder. Fund will hold the annuities in Fund's general account. A Fund Beneficiary will have no interest in the assets of Fund.

The payments Fund makes to a Fund Beneficiary will not exceed (on a present value basis) the amount of the Fund Beneficiary's shortfall under his or her Restructured Contract. Fund will be subrogated to any amount that a Fund Beneficiary recovers in excess of the amount the Fund Beneficiary would have received under his or her pre-Restructured Contract. If a Fund Beneficiary receives a payment of any amount to which Fund is subrogated, the Fund Beneficiary will be obligated to make payment of such amount to Fund. You represent that it is erroneous to assume that the value of the rights that the Company payees retain against Company (and correspondingly, Fund's subrogation rights) are de minimis because there are at least three different potential sources of payments written into the Plan. For example, Company's retained assets that exceed secured claims and expenses would be transferred to Newco to Company payees through additional pro rata distributions to each Company payee who does not receive a full payment under the Plan. In addition, the contracts that Newco is administering could have significant profit potential due to historically low interest rates. Thus, an insurer may be willing to purchase Newco's business, and Newco would be required to remit the sale proceeds to Company for payment to Company payees. In addition, the owners of the SSAs still have contractual obligations to Company payees under the underlying structured settlement agreements.

LAW

Section 6041 requires every person engaged in a trade or business to: (1) file an information return for each calendar year in which the person makes in the course of its trade or business payments to another person of fixed and determinable income aggregating \$600 or more, and (2) furnish a copy of the information return to that person. See § 6041(a) and (d); § 1.6041-1(a)(1) and (a)(2) of the Income Tax Regulations.

Section 61(a) provides that, except as otherwise provided in subtitle A, gross income means all income from whatever source derived.

Section 104(a)(2), as in effect prior to the amendments made by § 1605(a) of the Small Business Job Protection Act of 1996 (1996 Act), provided, in general that gross income does not include the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.² For amounts to which the 1996 Act applies, § 104(a)(2) provides, in general, that gross income does not include the amount of any damages (other than punitive

² Section 1605(d)(2) of the 1996 Act provides that the amendments made by § 1605(a) to § 104(a)(2) do not apply to any amount received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

Generally, the taxpayer's method of accounting determines when an amount is treated as received for federal income tax purposes. Fund Beneficiaries report 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 an economic benefit has been conferred on the taxpayer. If a Fund Beneficiary receives title to, constructive receipt of, or an economic benefit from the assets used to fund future periodic payments, then some portion of the future periodic payments may not be excludable from income. See Rev. Rul. 79-220, 1979-2 C.B. 74.

Section 451(a) 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 1.451-2 provides that income, although not actually reduced to a taxpayer's possession 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 during the taxable year if notice of intention to withdraw had been 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). Under the constructive receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment and the obligor is ready, willing, and able to make payment. *Martin v. Commissioner*, 96 T.C. 814, 823 (1991).

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. See *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd* 194 F.2d 541 (6th Cir. 1952). In *Sproull*, 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, and the trust agreement contained no restrictions on taxpayer's right to assign or otherwise dispose of the trust interest created. Further, the trustee's only duties were to hold, invest, accumulate and shortly pay over the funds to the taxpayer. 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. *Sproull*, 16 T.C. at 247-248.

Not all rights to receive periodic payments, however, trigger application of the economic benefit doctrine. Rev. Rul. 79-220 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 personal injury 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 notes that the insurance company's purchase of an annuity was merely an investment by the company to provide a source of funds to satisfy its obligation to the payees. 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 have actual or constructive receipt of, or have the economic benefit of, the lump sum amount used to fund the annuity.

A similar result was reached in Rev. Rul. 72-25, 1972-1 C.B. 127. An employer purchased an annuity contract to fund its deferred compensation liability. Since the employee had no present interest in the annuity contract and the agreement created no separate account or trust fund for the benefit of the employee, the compensation payable to the employee was not includible in the employee's income until the earlier of taxable year that the employee actually received it or it was otherwise made available to the employee.

Amounts that are not taxable under constructive receipt principles or the economic benefit doctrine nevertheless may satisfy the requirements for inclusion in income under the doctrine of cash equivalency. Under the cash equivalency doctrine, taxpayers may be taxed currently if a promise for payment by a solvent obligor is unconditional and assignable, and readily exchangeable for cash. See *Cowden v. Commissioner*, 289 F.2d 20, 24 (5th Cir. 1961); *Ennis v. Commissioner*, 17 T.C. 465, 470 (1951); *Johnston v. Commissioner*, 14 T.C. 560, 565 (1950).

ANALYSIS

In this case, a Fund Beneficiary will not be in constructive receipt of the periodic payments from Fund. Fund (or a third-party assignee that is unrelated to any Fund Beneficiary) will own any annuities Fund Claims Administrator decides should be purchased to fund benefit payments for a Fund Beneficiary. The Fund Beneficiary will have no right to demand payment of any amount either from the insurance company that issues the annuity or from Fund before amounts are due and payable under the terms of the annuity. Fund will not create any separate escrow or trust account for any

Fund Beneficiary with respect to any annuity or the payments to be made thereunder. Fund will hold the annuities in Fund's general account. The Fund Beneficiary will have no interest in the assets of Fund.

Any annuity that Fund purchases to fund benefits for a Fund Beneficiary will not confer an economic benefit on the Fund Beneficiary. The Fund Beneficiary will have no interest in the annuity that will be unconditionally set aside for the Fund Beneficiary's benefit. Fund will not create any separate escrow or trust account for any Fund Beneficiary with respect to any annuity or the payments to be made thereunder. Similar to the annuities in Rev. Rul. 79-220, any annuity Fund acquires would be solely as a matter of convenience to Fund, so Fund has a continuing source of assets from which to make periodic payments to Fund Beneficiaries. The Fund Beneficiary will have no rights in the annuity other than a right to payments thereunder at the time they are due and payable under the annuity contract. The Fund Beneficiary will have no interest in the assets of Fund.

Also, in this case, the doctrine of cash equivalency does not apply to a Fund Beneficiary's rights to collect periodic payments from Fund. The Fund Beneficiary will not own the annuity or be able to assign or transfer his or her rights to the annuity. Fund's commitment to make payments to a Fund Beneficiary over time is not the type of promise that is readily exchangeable for cash.

Based on Fund's representations and the analysis above, a Fund Beneficiary who receives a benefit from Fund in the form of an SSA will not be in constructive receipt of or receive an economic benefit from the assets used to fund the future periodic payments at any time before the Fund Beneficiary actually receives the applicable cash payment. In addition, the doctrine of cash equivalency does not apply to a Fund Beneficiary's rights to collect periodic payments from Fund with respect to an SSA.

In addition, given the totality of the facts and circumstances, any lump sum benefit payments and any the periodic payments that Fund makes to Fund Beneficiaries will retain their character as payments that are excludable from gross income under § 104(a)(2).

Therefore, because the amounts Fund Beneficiaries receive from Fund in respect of SSAs are excludable from gross income under § 104(a)(2), they are not income under § 6041. Thus, Fund is not subject to any information reporting obligations under § 6041 with respect to the payments.

CONCLUSION

Based solely on the information submitted and representations made, we conclude that Fund does not have any information reporting obligations under § 6041 for benefits paid with respect to SSAs, because (i) any lump sum benefit payment made to a Fund

Beneficiary with respect to an SSA will retain its character as a payment that is excludable from the Fund Beneficiary's gross income under § 104(a)(2), and (ii) any periodic payments made to a Fund Beneficiary with respect to an SSA, which the beneficiary does not recognize until received, under his or her method of accounting, will retain their character as payments that are excludable from the Fund Beneficiary's gross income under § 104(a)(2). Thus, Fund is not required to file or furnish information returns under § 6041 for benefits paid with respect to SSAs. Similar analysis and conclusions also apply to payments Fund makes with respect to Other Annuities regarding (i) the classification of payments based on the payments that are being replaced and (ii) the timing for recognizing a payment.

Except as expressly provided in the preceding paragraph, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced herein. For example, we do not express any opinions under §§ 501(c)(6) and 5891.

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.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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.

In accordance with the Power of Attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)