

REVENUE RULING 79-220 (explanation)

Revenue Ruling 79-220, issued in 1979, lists the conditions in which a Plaintiff under a 104(a)(2) case qualifies for tax-exempt benefits.

The issue at hand when writing this revenue ruling was whether the exclusion from gross income provided by Section 104(a)(2) of the Internal Revenue Code of 1954 applied to the full amount of monthly payments received in settlement of a damage suit or only to the discounted present value of such payments. To resolve this question, the IRS responded positively by means of Revenue Ruling 79-220 stating under what conditions the periodic payments would be excludable from gross income. A revenue ruling, as opposed to a private letter ruling, can be applied to all similar cases.

The guidelines of 79-220 are as follows:

- 1) The plaintiff has a right only to the future periodic payments and does not have actual or constructive receipt of the lump sum amount used to fund the periodic payments.
- 2) The plaintiff has no right to the discounted present value of the payments or the investment.
- 3) The owner purchased a single premium annuity.
- 4) The owner has all rights over the annuity.
- 5) The owner must have a continuing obligation to pay the benefits to the plaintiff. The policy is merely a source of funds to satisfy the obligation.
- 6) The plaintiff's rights are no greater than those of a general creditor.
- 7) The benefits to the estate will also flow tax-free.

(&6731) Revenue Ruling 79-220, I. R. B. 1979-30,5.
(Code Sec. 104. Also, Code Secs. 61 and 451)

Compensation for injuries or sickness: Damages: Monthly payments: Amount excludable. An insurance company purchased and retained exclusive ownership in a single premium annuity contract to fund monthly payments stipulated in settlement of a damage suit. The recipient may exclude the full amount of the payments from gross income under Section 104 (a)(2) of the Code rather than the discounted present value. Payments made to the estate after the recipient's death are also fully excludable. Back references: &680.086, 1020.02 and 2830.66.

ISSUE

Does the exclusion from gross income provided by section 104 (a)(2) of the Internal Revenue Code of 1954 apply to the full amount of monthly payments received in settlement of a damage suit or only to the discounted present value of such payments?

FACTS

A, an individual, sued B for damages for personal injuries. B is insured by M, an insurance company. Before trial, A accepted M's offer to settle the suit for a lump-sum payment of \$8,000 and M's agreement to provide A with monthly payments of \$250 for A's lifetime or 20 years, whichever is longer, the payments to be made to A's estate after A's death if A should die before the end of 20 years. A had no right to the discounted present value of the monthly income (the present value of which, at date of settlement, was less than the total monthly payments to be provided) or to control the investment of the amount.

To provide the monthly payments for A, M purchased a single premium annuity contract from O, another insurance company. M advised O to make payments directly to A. However, M is the owner of the annuity contract and has all rights of ownership, including the right to change the beneficiary. A can rely on only the general credit of M for collection of the monthly payments.

LAW AND ANALYSIS

Section 61(a) of the Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

Section 104(a)(2) of the Code provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical and dental expenses) for any prior taxable year, gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.

Section 1.104-1(c) of the regulations provides, in part, that the term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

However, if a lump-sum damage 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 received as damages within the meaning of section 104(a)(2) of the Code, and none of the income from the investment of such payment is excludable under section 104. See Rev. Rul. 65-29, 1965-1 C. B. 59, relating to damages awarded a claimant for tortious injuries in a lump-sum payment of 416x dollars over which claimant had unfettered control. The 416x dollars represented the discounted value of 520x dollars, which was found to be the reasonable cost of care, medicine, and medical attention for the injured person over a 10-year period. Rev. Rul. 65-29 holds that only the lump-sum payment, 416x dollars, is received as damages within the meaning of section 104(a)(2). See also Rev. Rul. 76-133, 1976-1 C. B. 34, which reaches a similar conclusion with regard to a court approved settlement awarded a minor and transmitted by the clerk of the court, in the name of the minor, to a savings and loan association for deposit in certificates of deposit.

In the instant case, there is a continuing obligation by M to pay \$250 per month to A for the agreed period. M's purchase of a single premium annuity contract from the other insurance company was merely an investment by M to provide a source of funds for M to satisfy its obligation to A. See Rev. Rul. 72-25, 1972-1 C. B. 127, which relates to a similar arrangement made by an employer to provide for payment of deferred compensation to an employee. In Rev. Rul. 72-25, as here, the arrangement was merely a matter of convenience to the obligor and did not give the recipient any right in the annuity itself.

HOLDINGS

The exclusion from gross income provided by section 104(a)(2) of the Code applies to the full amount of the monthly payments received by A in settlement of the damage suit because A had a right to receive only the monthly payments and did not have the actual or constructive receipt or the economic benefit of the lump-sum amount that was invested to yield the monthly payments. If A should die before the end of 20 years, the payments made to A's estate under the settlement agreement are also excludable from income under section 104.

&G731 1979, Commerce Clearing House, Inc.