

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Identifying Number:

Telephone Number:

Refer Reply To:
CC:DOM:IT&A:2 – PLR-119273-97
Date: June 10, 1999

Legend:

Claimant =

Assignee =

Factor =

State M =

State N =

date 1 =

date 2 =

date 3 =

u =

v =

w =

x =

y =

z =

Dear

This letter is in response to a ruling request submitted on behalf of Claimant regarding the application of § 104(a)(2) of the Internal Revenue Code to certain payments received by Claimant in a factoring transaction.

FACTS. Claimant is an individual residing in State M. Claimant uses the cash receipts and disbursement method of accounting for filing his federal income tax returns. In May 1995, Claimant negotiated a Settlement Agreement with a defendant to recover damages on account of personal injuries that provides for periodic payments of \$y per month beginning on date 1 for the longer of a u-year period (the Guaranteed Period) or

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Claimant's life. You represent that amounts payable under the Settlement Agreement are excludable from Claimant's gross income under § 104(a)(2). Pursuant to the Settlement Agreement, the defendant made an assignment of its periodic payment liability to Assignee in what you represent was a "qualified assignment" under § 130(c). The Settlement Agreement states that Claimant has no right "accelerate or defer said future payments, ... receive the present discounted value of future payments or ... have the power to sell, mortgage, encumber, or anticipate the future payments or any part thereof by assignment or otherwise."

After receiving monthly periodic payments of \$y from Assignee for about 18 months, Claimant entered into a contract with Factor to transfer \$w per month of his rights in the remaining monthly payments during the Guaranteed Period beginning on date 2 to Factor for a lump sum payment of \$x. This \$w per month is equal to approximately 80% of the \$y monthly payments. This transfer ("Factoring Transaction") closed during date 3 with Factor issuing checks to Claimant for \$y, because Claimant, not Factor, received the date 2 payment and the three succeeding monthly payments.

As part of the Factoring Transaction, Factor notified Assignee that it was to make the \$y monthly payments to Claimant at a new address in care of banks appointed by Factor to receive those payments. Claimant also executed a power of attorney authorizing Factor or its assignee to cash the monthly periodic payment checks issued by Assignee. Thus, after the Factoring Transaction, Factor was to receive the \$y monthly payments from Assignee, retain from each full monthly payment the \$w per month it acquired in exchange for its lump sum \$x payment and then send a check to Claimant in the amount of the \$z portion of each monthly payment that Claimant did not transfer to Factor.¹

The \$y lump sum that Claimant received is equal to approximately 26 percent of the face amount of the payments acquired by Factor, resulting in a return to Factor of about 20 percent. You represent that Factor has engaged in other factoring transactions and that each of them is individually structured and highly negotiated, both as to the amounts being assigned at each payment interval and the discount rate applied thereto.

You represent that the Factoring Transaction is governed by and is enforceable under the law of State N, and that a court in State M would look to State N law in determining whether the Factoring Transaction is enforceable. For purposes of this ruling we have *assumed* but do not *decide* that the Factoring Transaction is enforceable under applicable state laws.

¹ Assignee has advised Claimant and Factor that it will not honor the assignment of the periodic payments to Factor absent a court order. Thus, Assignee has not made any periodic payments to Claimant or Factor after it made the date 2 payment and the three succeeding monthly payments.

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Specifically, you request the following two rulings:

1. Lump sum payments paid by Factor to Claimant in exchange for the right to receive a portion of the future payments due to Claimant under the Settlement Agreement constitute damages received on account of personal injuries under former § 104(a)(2).
2. Periodic payments paid to Claimant under the Settlement Agreement in excess of the amount assigned by Claimant to Factor will constitute damages received on account of personal injuries under former § 104(a)(2).

LAW. 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. Section 1605(d)(2) of the 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.

Section 451 provides that the amount of any item of gross income shall be included in the gross income of the taxpayer for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be accounted for as of a different period. Section 1.451-1(a) of the Income Tax Regulations likewise provides that under the cash receipts and disbursements method of accounting, income must be included in gross income when actually or constructively received.

Rev. Rul. 79-220, 1972-2 C.B. 74, involves an insurance company that had a continuing obligation to pay an amount monthly to an individual for an agreed period of time in settlement of a suit for personal injuries. The insurance company purchased a single premium annuity from another insurance company as an investment to provide a source of funds to satisfy its obligation to the individual. The ruling holds that the exclusion from gross income provided by § 104(a)(2) applies to the full amount of the monthly payments received by the individual because the individual 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. In support of its holding, Rev. Rul. 79-220 cites to 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 and concludes that the employee

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includes the compensation in income in the taxable year in which it is actually received or otherwise made available, whichever is earlier.

Amounts that are not taxable under actual or constructive receipt principles, nevertheless, may satisfy the requirements for inclusion in income under the doctrine of cash equivalency. Under this doctrine a taxpayer is treated as having income when the taxpayer receives property that is the "equivalent of cash." Decisions in cases involving cash equivalency have been based on the facts and circumstances of particular cases. In situations where a contract provided for deferred payments and no notes or other evidences of indebtedness were given, the contract rights, which in the situations described were not of a type commonly sold or given as part of a purchase price, were held not to be property and, therefore, not a cash equivalent. Ennis v. Commissioner, 17 T.C. 465 (1951); Johnson v. Commissioner, 14 T.C. 560 (1950). *Compare* Rev. Rul. 68-606, 1968-2 C.B. 42 (obligor's payments to make future installment payments is a cash equivalent, even though contained only in a contract if the rights under the contract are freely transferable and readily saleable.)

Under § 1.83-7(a) if a nonqualified stock option provided to an employee for services has no readily ascertainable fair market value when granted, the employee defers income realization until the option is exercised or the option is sold or otherwise disposed of at which time the employee realizes *compensation* income. See also Rev. Rul. 72-25, *supra*.

DISCUSSION. Claimant settled his personal injury claim in exchange for defendant's obligation to make periodic payments, which was then assumed by Assignee. Claimant has not actually or constructively received the full damage amount. In addition, Claimant did not receive the discounted value of Assignee's future periodic payment obligation because under these facts that payment obligation was in no proper sense the equivalent of cash. Thus, Claimant excluded from gross income the full amount of each monthly payment as Assignee made each payment.

As a result of the Factoring Transaction, Claimant received a \$y lump sum payment in exchange for the sale of his right to receive \$w of each of the remaining monthly periodic payments for the Guaranteed Period, thereby closing the transaction as to that portion of Assignee's periodic payment obligation. In the context of deferred compensation, an employee's sale of a nonqualified stock option without a readily ascertainable fair market value to a third party closes a transaction created when the employer granted the option to the employee and results in income of the same character (*i.e.*, *compensation* income) to the employee in the year of the sale. Similarly, Claimant's receipt of Factor's lump sum payment in exchange for the sale of his right to \$w of each of the remaining monthly periodic payments closes the May 1995 transaction attributable to that portion of Assignee's periodic payment obligation and results in income of the same character as would have been received absent the

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Factoring Transaction. Thus, the \$y that Factor paid to Claimant in the Factoring Transaction is considered received on account of personal injuries under former § 104(a)(2). The fact that the \$y lump sum was paid by Factor does not affect its character under § 104(a)(2) in this case in which the Settlement Agreement was not readily saleable and Claimant uses the cash method of accounting. See Rev. Rul. 72-224, 1972-1 C.B. 30 (cash method seller excludes from income as tax-exempt interest under § 103 that portion of proceeds received from purchaser of state or local governmental obligation attributable to interest accrued prior to sale). See also Rev. Rul. 70-151, 1970-1 C.B. 116.

In addition, Claimant did not transfer to Factor its right to receive \$z per month out of each monthly payment during the Guaranteed Period. However, pursuant to the Factoring Transaction, this \$z of the monthly \$y payment will be sent to Claimant in care of a designated bank. Factor will retain \$w of the monthly payment and will direct that the remaining \$z be remitted to Claimant. Thus, Factor is merely Claimant's agent with respect to the \$z per month of the periodic payments that are paid by Assignee under the Settlement Agreement.

CONCLUSION. Accordingly, based strictly on the information submitted and representations and assumptions made, we conclude that:

1. The \$y lump sum payment received by Claimant from Factor pursuant to the Factoring Transaction is damages received on account of personal injuries or sickness under former § 104(a)(2).
2. The \$z monthly periodic payments paid by Assignee and remitted to Claimant by Factor, which were not assigned by Claimant to Factor in the Factoring Transaction are damages received on account of personal injuries or sickness under former § 104(a)(2). Similarly, periodic payments made after the Guaranteed Period, which were not assigned by Claimant to Factor in the Factoring Transaction and that are received by Claimant from Assignee are damages received on account of personal injuries or sickness under former § 104(a)(2).

Except as expressly set forth in the preceding paragraph, no opinions are expressed concerning the tax consequences of the transaction described in this letter under any provision of the Internal Revenue Code. As noted above we have *assumed* but not *decided* that the Factoring Transaction is valid under applicable state law. Thus, this ruling shall be considered of no effect retroactively if the Factoring Transaction is not valid under applicable state law.

For two reasons we decline to rule on Claimant's request concerning whether the Factoring Transaction adversely affected Assignee's exclusion under § 130 of amounts it received from defendant to assume the liability to make periodic payments. First,

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under § 2.02 of Rev. Proc. 99-1 1999-1 I.R.B. 6, 12 the Service issues rulings applying the tax laws to a taxpayer's specific set of facts. The tax consequences under § 130 do not pertain to Claimant, the taxpayer who is requesting this ruling. Second, the Service may decline to issue a ruling when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts and circumstances of a particular case.

A copy of this letter should be attached to any income tax return to which it is relevant. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Deputy Assistant Chief Counsel
(Income Tax & Accounting)

By _____
Michael J. Montemurro
Senior Technician Reviewer, Branch 2