

INTERNAL REVENUE SERVICE

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August 7, 2002

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Dear Xxxxx:

This letter is in response to your request for information on behalf of a tax-exempt organization formed to assist the victims of the terrorist attacks that occurred on September 11, 2000. The organization plans to purchase annuities for the children that would be paid out over the four years that correspond to the years the will be . You ask whether the entire amount of the annuity payments to the children would be excluded from their gross income under section 139 of the Internal Revenue Code.

Our understanding of the facts is as follows: The organization is a tax-exempt public charity. It was formed to assist the in New York City. No employer monies fund this organization and there is no employer control of the organization. The general public funds the charity. We assume that grants paid in the form of annuities will be distributed in a charitable manner, as explained in IRS Publication 3833, *Disaster Relief: Providing Assistance through Charitable Organizations*.

Under Code section 61, gross income means all income from whatever source derived, including compensation for services. Other Code sections specifically exclude certain payments from gross income. The three exclusion sections that are most pertinent to your situation are Code section 102, pertaining to gifts, Code section 117, pertaining to qualified scholarships, and Code section 139, pertaining to qualified disaster relief payments. Section 72 pertains to the taxation of annuities.

Code section 102(a) provides that gross income does not include the value of property acquired by gift. The most critical factor in determining whether a payment is a gift is the transferor's intent in making the payment. *Commissioner v. Duberstein*, 363 U.S. 278 (1960). In *Duberstein*, the Supreme Court stated that a gift proceeds from a "detached and disinterested generosity," and is made "out of affection, respect, admiration, charity or like impulses." If the payment proceeds primarily from "any moral or legal duty" or from "the incentive of anticipated benefit" of an economic nature, it is not a gift. Further, "where the payment is in return for services rendered, it is irrelevant that the donor derives no

economic benefit from it.” Thus, under *Duberstein*, a factual analysis of the circumstances surrounding the transfer in each particular case is necessary to determine the dominant reason for the transfer and whether the circumstances support a finding of donative intent. Insight into a transferor’s intention can be gained by examining the factors (such as the economic need of the recipient) that the transferor considered in deciding whether to make the transfer and the form of assistance. See *United States v. Kaiser*, 363 U.S. 299 (1960).

If the annuity payments are unrestricted as to use, they may be excludable from a recipient’s gross income as a gift under section 102(a) if the transfers are motivated primarily by charitable or similar impulses and not by moral or legal obligations or anticipation of economic benefit, and are not in return for services. If, however, the annuity payments are restricted for education expenses, the gift exclusion under section 102(a) will not apply; however, the payments may be excludable from the recipient’s gross income under section 117.

Section 117(a) provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization that is a school with a regular faculty and enrolled students that attend the school. A qualified scholarship means an amount received as a scholarship or fellowship grant to the extent the amount was used for qualified tuition and related expenses, such as tuition and fees, books, supplies, and equipment required for courses. Amounts received for room, board, and travel are not related expenses.

Scholarship or fellowship grant receipts that exceed expenses for tuition, fees, books, supplies, and certain equipment are not excludable from a recipient’s gross income as a qualified scholarship under section 117.

Under section 1.117-3 of the Income Tax Regulations a scholarship is an amount paid or allowed to, or for the benefit of, a student whether an undergraduate or a graduate, to aid such individual in pursuing his studies. A fellowship grant generally is an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. A scholarship or fellowship grant may also be in the form of a reduction in the amount owed by the recipient to an educational organization for tuition, room and board, or any other fee.

The provisions of section 117 override those of section 102. In enacting section 117, Congress intended to subject to income taxation scholarship and fellowship grants to the extent they exceed the limitations on the exclusion provided in that section, notwithstanding section 102. Thus, a scholarship or fellowship grant that exceeds the limitations of section 117 is includible in gross income, even though it may otherwise qualify as a gift under Code section 102. See Treas. Regs. section 1.117-1.

Section 139(a) excludes from gross income any amount received by an individual as a qualified disaster relief payment. Section 139(b)(1) provides that the term “qualified disaster relief payment” means any amount paid to or for the benefit of an individual to

reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster. Therefore, the applicability of section 139 depends on whether annuity payments would defray such reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster.

The taxation of the annuity payments may also depend on whether the tax-exempt organization or the child has the actual or constructive receipt or the economic benefit of the annuity contract. If the tax-exempt organization purchases the annuity and transfers it to the child, only the amount equal to the fair market value of the annuity at the time of the transfer could qualify for any applicable exclusion from income under section 102 or section 117. In such a case the income on the annuity would not be excludable from gross income. See Rev. Rul. 65-29, 1965-1 C.B. 59, and Rev. Rul. 76-133, 1976-1 C.B. 34.

If the tax-exempt organization owns the annuity and pays the proceeds of the annuity to the child, the child would not have actual or constructive receipt of the annuity contract. Accordingly, all of the annuity payments would be excludable from the gross income of the child to the extent such payments qualified for exclusion under section 102 or section 117. See, e.g., Rev. Rul. 79-220, 1979-2 C.B. 74, and Rev. Rul. 79-313, 1979-2 C.B. 75.

In general, the cost of an annuity can be recovered tax-free over the period that an annuitant is to receive the payments. The amount of each payment that is more than the part that represents the annuitant's cost is taxable. Section 72 of the Code addresses the taxation of annuities.

We hope you will find this discussion helpful. However, in accordance with section 3.06 of Rev. Proc. 2002-4, 2002-1 I.R.B. at 127, this information letter is advisory only and has no binding effect on the Internal Revenue Service. The information provided herein cannot be relied upon as a ruling on the matters discussed. If you have any questions regarding this discussion or we can be of further assistance, please feel free to call me at xxx-xxx-xxxx or xxxxxxxxxxxxxxxx at xxx-xxx-xxxx.

Sincerely,
xxxxxxx xxxxxxxxxxxx
Manager, Exempt Organizations
Technical Group x