

Rev. Rul. 77-230

1977-2 C.B. 214

Section 104 -- Damages Awards/Sick Pay
Section 213 -- Medical Expense Deduction
Section 677 -- Income for Grantor's Benefit

IRS Headnote

Trust income for benefit of the U.S. as grantor; individual's medical expenses paid by trust. The U.S. is considered the owner of a trust established as a result of an individual's suit for injuries sustained at a Government facility under a settlement agreement requiring payment of the individual's future medical expenses from the trust, accumulation of net income in excess of medical expenses, and reversion of trust corpus to the U.S. on the individual's death. Income earned by the trust will not be subject to tax. Distributions from the trust to pay medical expenses are excludable from the individual's gross income and no deduction may be taken for medical expenses paid by such distributions.

Full Text

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Advice has been requested concerning the treatment, for Federal income tax purposes, of payments made for an individual's medical expenses by a trust established by the United States of America.

An individual sued the United States of America for damages for injuries suffered in the course of a physical examination at a medical facility operated by the United States Government. Pursuant to a court-approved settlement, a trust was established by the United States of America and funded in the amount of \$100,000 to pay for the individual's future medical expenses for any physical or mental condition arising from, or related to, or that may have been contributed to by the injury sustained. The settlement agreement also provided that the net income of the trust, and the corpus if necessary, would be distributed in payment of incurred medical expenses, and that net income in excess of incurred medical expenses would be accumulated and added to the corpus. Upon the individual's death, the remaining trust estate (if any) as well as undistributed income (if any) would revert to the United States. If the trust assets are depleted by payment of the individual's medical expenses, the United States is not required to make further contributions to the trust or otherwise pay subsequently arising medical expenses of the individual.

Section 671 of the Internal Revenue Code of 1954 provides the general rule that in cases where the grantor or another person is regarded as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of the grantor or person who is regarded as the owner those items of income, deductions, and credits against the tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account in computing the taxable income or credits against the tax of an individual. The circumstances under which the grantor is regarded

as the owner of a portion of the trust are set forth in section 673 (reversionary interests), section 674 (power to control beneficial enjoyment), section 675 (administrative powers), section 676 (power to revoke), and section 677 (income for benefit of grantor).

Section 677(a)(2) of the Code provides that the grantor shall, in general, be treated as the owner of any portion of a trust, whether or not treated as such owner under section 674, whose income, without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be held or accumulated for future distribution to the grantor or the grantor's spouse.

In this case, the trust agreement provides that any trust assets remaining, including any net income in excess of the incurred medical expenses that had been accumulated and added to the trust corpus, will revert to the United States upon the individual's death. Accordingly, the United States of America is considered the owner of the entire trust pursuant to section 677(a)(2) of the Code.

However, because the owner of the trust, the United States of America, is not subject to Federal income tax, any income earned by the trust will not be subject to income tax, whether the income is distributed to the individual, retained by the trust, or distributed on termination of the trust.

In addition, benefits received by the individual through distributions made from the income or corpus of the instant trust in payment of the individual's medical expenses are amounts received through a settlement agreement entered into in lieu of prosecution of a legal suit based upon tort or tort type rights and are, therefore, excludable from the individual's gross income under section 104(a)(2) of the Code.

To the extent medical expenses arising from or related to the injury are compensated for by the United States and not by the individual, the individual is not entitled to a medical expense deduction for such expenses under section 213 of the Code.