Part I

Section 102.–Gifts and Inheritances

26 CFR 1.102-1: Gifts and inheritances
(Also § 170; 1.170A-1.)

Rev. Rul. 99-44

ISSUES

(1) Is interest earned on funds deposited in the personal account of an Individual Development Account (IDA) project participant includible in the participant's gross income under § 61 of the Internal Revenue Code?

(2) May a project participant exclude, as a gift under § 102, parallel funds paid for a qualified expense of the project participant?

(3) May a donor deduct under § 170 a contribution to a qualified entity for an IDA project?

ASSETS FOR INDEPENDENCE ACT

Congress established a demonstration program to determine the effects of Individual Development Accounts ("IDAs") on low-income individuals and their families. Assets for Independence Act, Pub. L. No. 105-285, Title IV (Oct. 27, 1998)("Act"). The Act's purposes include stabilizing families and enabling individuals and families with limited means to increase their economic self-sufficiency. Section 403 of the Act.

IDAs are accounts created under the Act for use by eligible low-income individuals ("project participants") for qualified expenses, which are postsecondary

educational expenses (i.e., amounts paid for tuition, fees, books, supplies, and equipment), first-time home purchases, business capitalization, or the transfer of IDA funds directly into another IDA for the benefit of an eligible family member. Section 404(8) of the Act. Under § 408 of the Act, only individuals whose net worth and incomes are below certain levels are eligible to be selected as project participants. Project participants deposit earned income into a personal account, and a qualified entity provides matching contributions (or "parallel funds" as defined below) using Federal and non-Federal funds. "Qualified entity" includes an organization described in § 501(c)(3) of the Code. If a state or local government agency or tribal government submits an application jointly with the § 501(c)(3) organization, the state or local government agency or a tribal government is also a qualified entity. Section 404(7) of the Act.

A qualified entity other than a State or local government agency or tribal government must establish a Reserve Fund to hold all Federal and non-Federal funds received for the project and any investment income generated by the funds. Section 407 of the Act. The Reserve Fund is used to provide parallel funds for project participants, provide training and information to participants as necessary to their achieving economic self-sufficiency, administer the IDA demonstration project, and provide a research organization with relevant information.

An IDA for a project participant consists of two types of funds: "personal funds," and parallel funds. Under the IDA program, a separate custodial bank account ("personal account"), for which the qualified entity is the custodian, holds the deposits

of the project participant. Personal funds consist of these deposits and any interest earned on the funds in the personal account. Periodically, the qualified entity will note the amount of recent deposits made by a project participant into the participant's personal account. On the qualified entity's books for the Reserve Fund, the qualified entity will then allocate parallel funds to that participant. Parallel funds consist of (1) a matching amount that corresponds to the amount of the participant's recent deposits, and (2) interest.

Parallel funds remain in the complete control of the qualified entity until they are disbursed. They may be disbursed only for a qualified expense and only upon written request of the project participant and written approval of a responsible official of the qualified entity. Disbursements of parallel funds are made by the qualified entity directly to the "payee," which is the educational institution, the home seller, the business capitalization account, or the family member's IDA, as appropriate. Section 404(8) of the Act.

Personal funds may be withdrawn for a qualified expense upon written request of the project participant and written approval of a responsible official of the qualified entity. Personal funds may also be withdrawn for certain emergency uses specified in § 404(3) of the Act. Further, a project participant may withdraw personal funds for an expense that is not a qualified expense or an emergency use. However, such a withdrawal will terminate the participant's involvement in the IDA program, in which case any bookkeeping allocations of parallel funds to that participant will be reversed

on the qualified entity's books. In all circumstances, personal funds (including all interest) are the property of the participant.

Under very limited circumstances described in section 413(b)(5)(B) of the Act, funds not distributed to project participants may be remitted to their sources pro rata. This would occur only if: (1) the Secretary of Health and Human Services ("HHS Secretary") determines that a qualified entity has not operated a project in accordance with its application or the requirements of the Act (and has not implemented any corrective recommendations directed by the HHS Secretary); and (2) the HHS Secretary has not, within a 1-year period, found another qualified entity to conduct the project.

FACTS

The HHS Secretary selects O, a qualified entity under the Act and an entity described in § 170(c)(2) of the Code, to operate a demonstration project under the Act. O previously received a commitment of funds for the project from non-Federal sources. One such source is DR, a corporation, which contributes cash to O for the project. At the time of DR's contribution, and throughout the life of the project, O operates the project in accordance with O's application and the requirements of the Act. Pursuant to the Act, O receives funds for the project from the Federal government. O establishes a Reserve Fund to hold the Federal and non-Federal funds O receives for the project.

A, an individual, applies and is selected to be a project participant. As required by the project, A opens a personal account. A deposits earned income into the interest-bearing account each month. Every three months, O determines the total of

A's deposits for the preceding three months. On its books, O then allocates to A from the Reserve Fund a matching amount that corresponds to A's deposits during the preceding three months and interest. Under the applicable state and local law, the parallel funds are beyond the reach of A's creditors.

After participating in the project for three years, A incurs qualified expenses. A makes a written request to O for payment of the parallel and personal funds, and a responsible official of O gives written approval. A's personal funds and the parallel funds allocated to A are paid directly to the payee. O's payment on behalf of A to the payee was made with the intent to help stabilize A's family and enable A to increase A's economic self-sufficiency.

LAW AND ANALYSIS

Issue (1)

Section 61 of the Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Section 61(a)(4) specifically includes interest in gross income.

As a general rule, interest earned by a taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits. Section 1.61-7(a) of the Income Tax Regulations.

In the instant case, interest will be earned on the funds in A's personal account. Those funds, including the interest, remain the property of A in all circumstances. The interest on funds in A's personal account is currently includible in A's gross income under § 61.

Issue (2)

Section 102 provides that the value of property acquired by gift is excluded from gross income. A gift "proceeds from a 'detached and disinterested generosity,' ... 'out of affection, respect, admiration, charity or like impulses.'" Commissioner v. Duberstein, 363 U.S. 278, 285 (1960) (citations omitted). On the other hand, payments that proceed primarily from "the constraining force of any moral or legal duty" are not gifts. 363 U.S. at 285.

A determination of whether a transfer proceeds from detached and disinterested generosity requires an inquiry into the transferor's intention in making the payment. 363 U.S. at 285-86. Insight into a transferor's intention can be gained by examining the factors that the transferor considered in deciding whether to make the transfer and the form of the assistance. See United States v. Kaiser, 363 U.S. 299, 304 (1960). In general, a payment made by a charity to an individual that responds to the individual's needs, and does not proceed from any moral or legal duty, is motivated by detached and disinterested generosity.

In the instant case, A was eligible to participate in the project in part because A's net worth and income were below levels set forth in the Act. Further, payments pursuant to the Act are designed to stabilize families and to enable individuals and families of limited means to increase their economic self-sufficiency. These facts indicate that O selected A to be a project participant and paid the parallel funds on behalf of A out of charitable and like impulses, and detached and disinterested

generosity. Therefore, O's payment of the parallel funds is excluded from A's gross income as a gift under § 102.

Issue (3)

Section 170(a) allows as a deduction, subject to certain limitations, any charitable contribution, as defined in § 170(c), payment of which is made in the taxable year.

If a charity's ownership of property would be defeated by the subsequent happening of some event, but on the date of the gift the possibility of the event occurring appears to be so remote as to be negligible, the deduction is allowable. See § 1.170A-1(e).

In the instant case, DR contributed cash to O, an organization described in § 170(c)(2). At the time DR made this contribution, it was fully expected that O would operate the project in accordance with its application and the requirements of the Act. If O was unable to do so, the Secretary was permitted, within a 1-year period, to find another qualified entity to conduct the project. Therefore, at the time of the contribution, the possibility of any funds being returned to DR under § 413(b)(5)(B) of the Act was so remote as to be negligible.

Thus, DR may deduct under § 170 a contribution to O for O's IDA demonstration project, subject to the limitations of that section.

HOLDINGS

(1) Interest earned by an IDA project participant on funds deposited in the participant's personal account is currently includible in the participant's gross income under § 61.

(2) A project participant may exclude, as a gift under § 102, parallel funds paid for a qualified expense of the project participant.

(3) A donor may deduct under § 170 a contribution to a qualified entity for the qualified entity's IDA project, subject to the limitations of that section.

DRAFTING INFORMATION

The principal author of this revenue ruling is Karin Gross of the Office of the Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling contact Karin Gross at (202) 622-4930 (not a toll-free call).