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Date:

March 22, 2000

Legend

State X =
Amount 1 =
Date 1 =
Relevant Period =

Dear :

This is in response to your ruling request, dated September 21, 1999, regarding the federal income tax consequences of amounts paid pursuant to the settlement of a class action, including state income tax refunds and interest thereon, administration costs, and attorneys' fees.

Facts

Prior to Date 1, retirement benefits paid to state and local government retirees of State X were exempt from the income tax of State X. Federal government retirees living in State X did not enjoy this same exemption with respect to their federal retirement benefits. In 1989, the United States Supreme Court ruled in Davis v. Michigan Dept. of Treasury, 489 U.S. 803 (1989), that a state cannot tax state and local government retirees differently than it taxes federal retirees.

In response to Davis, the legislature of State X extended the exemption from tax to all government retirees (state, local, and federal). However, the legislature capped the exemption at \$4,000 of annual retirement benefits. Three opt out class actions were filed in State X in the wake of the legislative response to Davis: two by state and local retirees and one by federal retirees. The suits by the state and local retirees challenged the imposition of the \$4,000 cap on the exemption. In all three lawsuits, the retirees sought recoveries of state income tax previously paid.

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One of the class actions by state and local retirees obtained a favorable ruling in the trial court with respect to the imposition of the \$4,000 cap. The trial court's ruling that the legislation was unconstitutional as an impairment of contract and a taking of property without just compensation was affirmed on appeal. The decision led to negotiations and a global settlement between the legislative leaders of State X and all class counsel. The global settlement was achieved by the consolidation of the three class actions and the trial court's approval of a consent order.

Pursuant to the consent order, State X was released from the claims against it, and the class members received a permanent exemption from State X income tax. In addition, the consent order provided for monetary relief to class members for the taxation of their retirement benefits during the Relevant Period. A settlement fund (Settlement Fund or Fund) was established and amounts from the Fund will be used to satisfy the liability of State X. Also pursuant to the consent order, attorneys' fees and administration costs will be determined by the trial court and paid from the Fund. The legislature of State X appropriated Amount 1, which was payable to the Settlement Fund to be administered by class counsel under the supervision of the trial court. The consent order provides that the trial court shall retain continuing jurisdiction over the cases to oversee the execution of the terms of the order and to enter other orders as may be necessary to carry out the provisions of or to resolve issues that may arise in carrying out the terms of the order.

A Fund administrator is charged with paying individual awards to class members by relying, in part, on their prior year state income tax returns. Class members who are state and local retirees are expected to receive a payment, subject to deductions for administration costs, attorneys' fees, and expenses, equal to 95% of their state income taxes paid on retirement benefits during the Relevant Period together with interest thereon. Class members who are federal retirees are expected to receive a payment, subject to deductions for administration costs, attorneys' fees, and expenses, equal to 70% of their state income taxes paid on retirement benefits during the Relevant Period together with interest thereon.

After the consent order was approved, the trial court ordered the creation of a so-called Reserve Fund, which is a sub-account of the Settlement Fund. The Reserve Fund is 15% of the Settlement Fund and was set aside for administration costs and attorneys' fees. In the event the Reserve Fund proves to be greater than necessary to cover these expenses, the trial court has the authority to distribute the remainder to the class members.

In order to receive monetary relief from the Settlement Fund, class members were required to submit claim forms to the settlement administrator by December 31, 1999. Class members were also permitted to opt out of the settlement and pursue their claims individually.

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Rulings Requested

You have asked for rulings on the following issues:

(1) Does the Settlement Fund have a reporting obligation under § 6050E of the Internal Revenue Code with respect to payments it makes to class members?

(2) Does the Settlement Fund have a reporting obligation under § 6041 with respect to payments it makes to class members?

(3) Does the Settlement Fund have reporting obligations to the class members under §§ 6041, 6049, or 6050E with respect to amounts paid from the Reserve Fund for administration costs and for attorneys' fees paid directly to class counsel?

Relevant Authorities

Section 61 provides that, except as otherwise provided, gross income means all income from whatever source derived.

Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form.

Gross income is an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207.

Rev. Rul. 80-364, 1980-2 C.B. 294 (Situation 3), held that, with respect to the settlement of a lawsuit brought by a union against an employer to enforce a collective bargaining agreement, the portion of the settlement paid by the union for attorneys' fees was a reimbursement for expenses incurred by the union and was not includible in the gross income of the union members.

Section 111 provides that gross income does not include income attributable to the recovery during the taxable year of an amount deducted in a prior taxable year to the extent such amount did not reduce the federal income tax imposed. Conversely, gross income includes income attributable to the recovery during the taxable year of an amount deducted in a prior taxable year to the extent such amount reduced the tax imposed. See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983), 1983-1 C.B. 50 (tax benefit rule).

Rev. Rul. 70-86, 1970-1 C.B. 23, considered the federal income tax consequences of a program in the State of California to refund real property tax. The ruling held, in relevant part, that (i) if the recipient of a refund had not claimed a federal income tax deduction for the real property tax in the year paid, the refund would be excludible from

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the recipient's gross income in the year received; and (ii) if the recipient of a refund had claimed a deduction for the real property tax in the year paid, under the tax benefit rule the refund would be includible in the recipient's gross income in the year received, but only to the extent the deduction of real property tax reduced the federal income tax imposed.

Section 468B(g) provides that nothing in any provision of law will be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

Section 1.468B-1(c) generally provides that a fund, account, or trust is a qualified settlement fund if –

(1) it is established pursuant to an order of, or is approved by, a court of law or other governmental authority and is subject to the continuing jurisdiction of such authority;

(2) it is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability arising out of a tort, breach of contract, or violation of law; and

(3) it is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related parties).

Section 1.468B-2(l)(2)(i) provides that, in general, payments and distributions by a QSF are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Code, and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C of the Code.

Section 1.468B-2(l)(2)(ii) provides that a QSF must make a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant. For purposes of §§ 6041(a) and 6041A, if a QSF makes a payment or distribution on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business. In such a situation, the QSF is also deemed to have made the distribution or payment to the transferor or claimant.

Section 6041 requires all persons engaged in a trade or business and making payment in the course of that trade or business to another person of fixed or determinable gains, profits, and income (other than payments to which § 6049(a) applies) of \$600 or more in a calendar year to file an information return.

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Section 1.6041-1(c) provides that income is “fixed” when it is to be paid in amounts definitely predetermined. Income is “determinable” when there is a basis of calculation by which the amount may be ascertained.

Rev. Rul. 80-22, 1980-1 C.B. 286, holds that crop insurance proceeds paid to farmers that had informed the payor insurance company that they were required to capitalize certain farming expenses were not fixed and determinable income under § 6041 because the payor could not require the farmers to disclose their bases in the destroyed crops, which information was required to determine the portion of the insurance proceeds constituting “gains, profits and income” under that section. Thus, the payment of the insurance proceeds was not subject to reporting under § 6041.

Section 6049(a) requires every person who makes payments of interest (as defined in § 6049(b)) aggregating \$10 or more to any person during a calendar year to file an information return. Section 6049(b)(1)(A) states, in part, that “interest” means interest on any obligation issued in registered form, or of a type offered to the public, other than any obligation with a maturity (at issue) of not more than one year held by a corporation. Section 6049(b)(1)(E) provides that “interest” also includes interest on deposits with brokers (as defined in § 6045(c)).

Section 1.6049-5(b)(iv) provides, in general, that for purposes of § 6049 the term “interest” does not include interest that a governmental unit pays with respect to a tax refund.

Section 6050E requires that every person who makes payments with respect to any individual of refunds of State or local income taxes aggregating \$10 or more during any calendar year shall file a return. Section 6050E(c) defines “person” as the officer or employee having control of the payment of the refunds (refund officer).

Analysis

Before we consider the rulings requested, we must consider the classification of the Settlement Fund as a qualified settlement fund (QSF). The Fund is a QSF because it satisfies the three requirements under §1.468B-1(c). As required under §1.468B-1(c)(1), the Fund was created by a consent order issued by a court. Also, the court has continuing jurisdiction over the Fund as evidenced in the consent order. Next, as required under §1.468B-1(c)(2), the Fund was created to satisfy claims arising out of a tort, breach of contract, or violation of law. Finally, as required under §1.468B-1(c)(3), the consent order and the plan of settlement administration specify that the Fund must be segregated from the other assets of the transferor. The fact that the Settlement Fund is a QSF (and not, for example, a grantor trust) means that reporting obligations to the class members are governed by §1.468B-2.

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We are asked in the first and second rulings requested whether the Settlement Fund has reporting obligations with respect to the distributions to class members. In each of the three class actions filed by the federal, state, and local retirees, State X awarded refunds of the state income tax paid on retirement benefits during the Relevant Period and interest thereon. The portions of the distributions that are properly allocable as refunds of state income tax paid on retirement benefits are not gross income to class members who did not claim itemized deductions for the tax on their federal income tax returns in the years when the tax was paid; however, such distributions may be gross income to class members who itemized and deducted the tax on their federal returns. Under the tax benefit rule, class members must include in gross income the refunds of state income tax if the tax was deducted in the years paid, but only to the extent that a deduction reduced the federal income tax imposed. To the extent that a deduction did not reduce the tax imposed for an individual class member, the state income tax refund is not includible in the class member's gross income.

As stated above, the portions of the distributions that are properly allocable as refunds of state income tax paid on retirement benefits during the Relevant Period are not gross income to class members who did not claim itemized deductions for the tax on their federal income tax returns in the years when the tax was paid. With respect to class members who claimed itemized deductions for the tax on their federal income tax returns, the Fund does not know whether these class members derived a tax benefit from their deductions and the Fund cannot require them to disclose that information. As in Rev. Rul. 80-22, the Fund cannot determine whether such class members have gross income upon receipt of a refund of state income tax paid on retirement benefits during the Relevant Period. Thus, no payments from the Fund that are allocable as refunds of state income tax are subject to reporting under § 6041. However, payments of such amounts to a class member are subject to reporting by the Fund under § 6050E if such payments to the class member aggregate \$10 or more during a calendar year.

Distributions that are properly allocable as interest on the class members' claims for previously paid state income tax are an accession to wealth and are not excludible from gross income under any provision of law. Interest paid to the class members is not "interest" under § 6049(b). The interest is based on claims and distributions related to class actions challenging the imposition of State X income tax on government retirement benefits. Consequently, the interest payments relate neither to registered obligations (under § 6049(b)(1)(A)), nor to deposits made with brokers (under § 6049(b)(1)(E)). In addition, interest paid by a governmental unit with respect to tax refunds is not interest under § 6049(b), and the distributions are not interest under any other provision of § 6049. Accordingly, the Settlement Fund has no reporting obligation under § 6049. Interest paid to a class member is, however, fixed and determinable income under § 6041 and therefore is subject to reporting by the Fund under that section if the interest paid to the class member is \$600 or more during a calendar year.

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In the third ruling requested, we are asked whether the Settlement Fund has a reporting obligation to the class members with respect to amounts paid (other than amounts that may be paid to class members) out of the sub-account of the Fund called the Reserve Fund. In order to make this determination, we must consider whether these amounts constitute gross income to the class members.

As for amounts paid from the Reserve Fund to compensate class counsel, we conclude that these amounts are not income to the class members in this opt out class action where the members have not personally agreed to compensate class counsel. The result is similar to the result in Rev. Rul. 80-364 (Situation 3), which held that the portion of a settlement paid by a union for attorneys' fees was a reimbursement for expenses incurred by the union and was not includible in the gross income of the union members. Class actions are employed by the judicial system to consolidate in one lawsuit a group of common claims against the same defendant(s). Class actions frequently come about as representative litigation in which the claims of a great many similarly interested individuals are pursued by class representatives who share those interests. In opt out class actions, it is often the case that a number of class members are not identified until after the conclusion of the lawsuit. A class member obtains the benefits of an opt out class action merely by coming within the definition of the class, unless the member affirmatively excludes himself from the lawsuit, i.e., "opts out." Our decision that the amounts paid to compensate class counsel are not income to the class members is specific to the facts of this case. Cf. Sinyard v. Commissioner, T.C. Memo. 1998-364 (settlement of opt in class action pursuant to Age Discrimination in Employment Act where class members had contingency fee agreements with counsel); Frederickson v. Commissioner, T.C. Memo. 1997-125, aff'd in unpub. opinion, 97-71051 (9th Cir.1998) (settlement of mandatory, Title VII class action where class members personally signed settlement agreements providing for compensation of counsel).

Next, we address amounts paid from the Reserve Fund to satisfy administration costs. Administration costs and other incidental expenses incurred in connection with the operation of a QSF are not a payment or distribution on behalf of the claimants and therefore are not gross income to the claimants. The costs are deductible by the QSF. See §1.468B-2(b)(2). These principles apply to the administration costs in the present case.

In summary, with respect to payments from the Reserve Fund for administration costs and attorneys' fees, which are not income to the class members, the Settlement Fund has no reporting obligations to the class members under §§ 6041, 6049, or 6050E. In the event the Reserve Fund proves to be greater than necessary to cover these expenses and the excess amount is paid to the class members, such amounts will be characterized as either refunds of state income tax paid on retirement benefits during the Relevant Period or as interest thereon.

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Based on the facts and information submitted and the representations made, we rule as follows:

(1) The Settlement Fund is subject to the information reporting requirement of § 6050E with respect to payments to a class member of amounts that are properly allocable as refunds of state income taxes paid on retirement benefits during the Relevant Period, if such payments aggregate \$10 or more during a calendar year.

(2) The Settlement Fund is subject to the information reporting requirement of § 6041 with respect to payments to a class member of amounts that are properly allocable as interest on the foregoing state income taxes, if the payments aggregate \$600 or more during a calendar year. Such payments are reported on Form 1099-INT.

(3) The Settlement Fund does not have reporting obligations under §§ 6041, 6049, or 6050E with respect to amounts paid from the Reserve Fund for administration costs and attorneys' fees paid to class counsel.

No opinions are expressed under any provision of the Internal Revenue Code regarding the tax consequences of the transaction described in this letter except as specifically set forth in this letter. No opinion is expressed concerning the proper allocation between amounts paid as refunds of state income taxes and amounts paid as interest. See § 4.02(1) of Rev. Proc. 2000-3, 2000-1 I.R.B. 103, 111.

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

Sincerely,

Assistant Chief Counsel
(Income Tax and Accounting)

By: /s/ Judith A. Lintz
JUDITH A. LINTZ
Reviewer, Branch 4

cc: