

Internal Revenue Service

Department of the Treasury

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November 10, 1999

Legend

Company =

State 1 =

State 2 =

Plan =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

x =

y =

Court =

Trust =

This letter is in response to the letter dated June 28, 1999, submitted on behalf of Company, requesting the following rulings:

(1) the Trust that will be established upon approval of the Plan qualifies as a qualified settlement fund within the meaning of section 468B of the Internal Revenue Code and the regulations thereunder;

(2) the Trust will be subject to tax on its modified gross income as defined in section 1.468B-2(b) of the Income Tax Regulations, at a rate equal to the maximum

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rate in effect for that taxable year under section 1(e) of the Internal Revenue Code;

(3) the transfer of the Company stock into the Trust and the transfer of cash and other assets into the Trust on behalf of the Company to resolve the liability that the Trust will be created to assume, will not constitute gross income to the Trust; and

(4) the Company will be entitled to deduct transfers made to the Trust consisting of income of the Company, less a sufficient amount of capital to maintain business operations.

Facts

Based upon the facts submitted and the representations made, Company is a small family-owned company located in State 1. Formed in Date 1, Company is in the business of manufacturing y. Company uses the accrual method of accounting for both tax and financial accounting. The Company's fiscal year ends in August.

Company has been a named party to numerous tort claims resulting from Company's use of x in y. The cumulative outcome of all past, pending, and anticipated future claims stemming from Company's use of x was the declaration of bankruptcy by Company. On Date 2, Company filed a petition for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. Taxpayer initially filed an earlier version of a plan of reorganization on Date 3, but the plan was met with such serious objections that it was determined that confirmation of the plan was not possible. Therefore, Company has submitted Plan on Date 4 for confirmation and approval of Court. Due to issues not related to the portion of the Plan that is relevant to this request, the Company is currently awaiting a formal docketing of the Plan in the Court.

In accordance with the Plan, the Trust will be established under State 2 law to settle liability resulting from the production and sale of y made with x. While the Trust will be established under State 2 law, it will remain under the continuing jurisdiction of the Court in compliance with the Plan's provisions. According to the Plan, the Trust would be funded with: (a) all of the common stock of Company, (b) remaining insurance proceeds relating to bodily injury claims, (c) all of the income of Company minus an amount deemed sufficient to maintain successful business operations, and (d) the obligations of Company's liability insurance carrier to pay property damage claims up to the appropriate limits. After dividing all creditors and claimants into eight different classes, the Plan authorizes the assets of the Trust to be used for the settlement of claims of members of classes six and seven, Allowed x Bodily Injury Claims Against Debtor and Allowed x Property Damage Claims Against Debtor respectively.

In addition to a plan for funding the Trust, the proposed Plan contains a trust agreement requiring the appointment of two trustees to administer and oversee the Trust in accordance with State 2 law and granting them such necessary and traditional powers as to fulfill such duties. Finally, the Plan provides for the termination of the Trust upon

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certain conditions. Any remaining funds will be transferred to charitable organizations described in section 501(c)(3) of the Code.

Requested Ruling 1

Section 468B(g) of the Internal Revenue Code provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority granted to the Secretary under section 468B(g) of the Code, the Secretary has published sections 1.468B-1 through 1.468B-5 of the Income Tax Regulations regarding the taxation of qualified settlement funds.

Section 1.468B-1(c) of the Income Tax Regulations provides that a fund, account, or trust is a qualified settlement fund if it meets the following three requirements:

- (1) It is established pursuant to an order of, or it is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continual jurisdiction of that governmental 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 (i) under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended, 42 U.S.C. 9601 *et seq.*, or (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the Commissioner in a revenue ruling or revenue procedure; and
- (3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

In this case, the Plan creating the Trust will be approved by the Court and the Court will retain continuing jurisdiction over the Trust. Furthermore, the Trust will settle liability derived from tort claims that either are or will be filed against Company in the future as a result of Company's use of x. Finally, the Trust will be formed and administered in accordance with State 2 law.

Requested Rulings 2 and 3

Section 1.468B-2(a) provides that a qualified settlement fund is a United States person and is subject to tax on its modified gross income for any taxable year at a rate equal to

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the maximum rate in effect for that taxable year under section 1(e).

Section 1.468B-2(b) of the Income Tax Regulations defines “modified gross income” of a qualified settlement fund as its gross income, as defined in section 61 of the Code, computed with the following modifications-

(1) In general, amounts transferred to the qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income. However, dividends on stock of a transferor (or related person), interest on debt of a transferor (or a related person), and payments in compensation for late or delayed transfers, are not excluded from gross income.

(2) A deduction is allowed for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund that would be deductible under Chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and other actuarial fees relating to the operation of the qualified settlement fund, and expenses arising from the notification of claimants and the processing of their claims. Administrative costs and other incidental expenses do not include legal fees incurred by, or on behalf of claimants.

(3) A deduction is allowed for losses sustained by the qualified settlement fund in connection with the sale, exchange, or worthlessness of property held by the fund to the extent the losses would be deductible in determining the taxable income of the corporation under section 165(f) or (g), and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of a net operating loss of the qualified settlement fund to the extent the loss would be deductible in determining the taxable income of the corporation under section 172(a). For purposes of this paragraph (b)(4), the net operating loss of a qualified settlement fund for the a taxable year is the amount by which the deductions allowed under paragraph (b)(2) and (b)(3) of this section exceed the gross income of the fund computed with the modifications described in paragraph (b)(1) of this section.

The Trust will be funded by transferring to the Trust what are essentially two types of assets, securities and cash. These assets will be transferred to the Trust to satisfy liabilities that the Trust was created to assume. According to the proposed Plan, the Trust will be set up with common stock in Taxpayer, profits, if any, from the annual operation of the Company, and the remaining insurance proceeds from both bodily and

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property claims yet to be paid by the insurance carrier. Furthermore, there is no transfer of interest on debt of the company, nor are there provisions for late payments or dividends from the common stock.

Requested Ruling 4

Section 162(a) of the Code provides, in relevant part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Furthermore, even though a particular taxpayer may incur an expense only once in the lifetime of its business, the expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure. Commissioner v. Tellier, 383 U.S. 687 (1966); Deputy v. du Pont, 308 U.S. 488 (1940).

Section 461(a) of the Code states that the amount of any deduction shall be taken in the taxable year that is the proper taxable year under the method of accounting used by the taxpayer in computing taxable income. Additionally, section 1.461-1(a)(2) of the Income Tax Regulations provides that an accrual method taxpayer may deduct an expense in the taxable year in which all events have occurred that establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h)(1) of the Code provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. The Code goes on, in part, to further clarify in section 461(h)(2)(C) that if the liability of the taxpayer requires a payment to another person and arises out of any tort, economic performance occurs as the payments to such person are made.

Section 1.468B-3(c)(1) of the Income Tax Regulations generally provides that for purposes of section 461(h), economic performance occurs with respect to a liability described in section 1.468B-1(c)(2) (determined with regard to sections 1.468B-1(f) and (g)) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

Conclusions

Based solely on the information provided and the representations made, and conditioned on the approval of the Plan by the Court, we conclude as follows:

(1) Upon approval of the Plan by the Court and the creation of the Trust, the Trust will constitute a qualified settlement fund under section 1.468B-1(c) of the Income Tax Regulations. The Trust satisfies the three requirements outlined in the regulations regarding qualifications for a fund to be classified as a qualified settlement fund. First,

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the proposed Plan, which contains provisions for the establishment of the Trust, must be approved by the Court and the Trust will be subject to the continuing jurisdiction of the Court. Second, the Trust will be established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from a related series of events that has occurred (i.e., the sale, supply or production of products containing x) and has given rise to at least one claim arising out of a tort, breach of contract, or violation of law. Third, the Trust will be formed and administered in accordance with State 2 law.

(2) The Trust will be subject to tax on its modified gross income as defined in section 1.468B-2(b) of the Income Tax Regulations at a rate equal to the maximum rate in effect for that taxable year under section 1(e) of the Internal Revenue Code.

(3) The transfer of the Company stock into the Trust and the transfer of cash and other assets into the Trust on behalf of the Company to resolve the liability that the Trust will be created to assume, will not constitute gross income to the Trust. However, any dividends paid on the stock will be taxable to the Trust. Section 1.468B-2(b)(1) of the Income Tax Regulations.

(4) The Company will be entitled to deduct transfers to the Trust consisting of income of the Company, less a sufficient amount of capital to maintain business operations.

Except as specifically ruled above, no opinion is expressed as to the federal tax treatment of any issue addressed in this ruling under other provisions of the Internal Revenue Code and Regulations that may be applicable. In addition, no opinion is expressed or implied as to whether the Company is entitled to any deduction for the stock transferred to the Trust or regarding the valuation of the stock under section 1.468B-3(b) of the Income Tax Regulations.

This ruling is directed only to Company. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file in this office, the original of this letter is being sent to you as the Company's authorized representative.

Sincerely,
/s/ David B. Auclair
Senior Technician Reviewer, Branch 1
Office of Assistant Chief Counsel
(Income Tax and Accounting)

Enclosures (2):

Copy of this letter
Copy for section 6110 purposes