

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

September 30, 1999

LEGEND:

Operating Fund =

Settlement Agreement =

Litigation =

X =

Product =

Date 1 =

Date 2 =

Court =

State =

Dear

This letter responds to your request for a ruling on whether the Operating Fund is a qualified settlement fund under section 1.468B-1 of the Income Tax Regulations and a ruling on whether the Operating Fund is a grantor trust under Subpart E, Part I, Subchapter J, Chapter 1 of the Internal Revenue Code.

Facts

On Date 1, an amended and consolidated class action complaint was filed in the Court. The complaint alleged that X and other companies placed into the stream of commerce a defective Product, resulting in personal injury to class members. The settlement class members and defendants, including X, entered into the Settlement Agreement to resolve claims related to the Litigation. On Date 2, the Court granted Initial Approval of the Settlement Agreement. The Settlement Agreement defines "Initial Approval" as the Court's conditional certification of the settlement class pursuant to Fed. R. Civ. P. 23(c)(1) and Rule 23 (e), and entry of the orders provided for in the Settlement Agreement.

The Settlement Agreement provides for the establishment of four escrow funds: the Patient Benefit Fund, the Operating Fund, the Litigation Fund, and the Reserve Fund. The Patient Benefit Fund will be used to pay Product-related claims and other expenses pursuant to the Settlement Agreement. The Operating Fund will be used to pay X's operating expenses, except for those expenses paid from the Litigation Fund and the Reserve Fund. The Litigation Fund will be used by X to pay expenses associated with other disputes. The Reserve Fund will be used by defendants and related parties to pay expenses associated with Product-related claims that are prosecuted or attempted to be prosecuted after the date of the Settlement Agreement.

The Court appointed a Special Master/Trustee to administer the Patient Benefit Fund and the Operating Fund. The Special Master/Trustee was assigned duties and powers that include the following: to administer the settlement proceeds in escrow; and to advise the Court whether the funds are invested in securities issued by the United States or in securities backed by the full faith and credit of the United States and upon such terms as the Special Master/Trustee, with the approval of the Court, deems to be in the best interests of the class members consistent with the purposes of the Settlement Agreement. According to representations by the Special Master/Trustee, the Operating Fund qualifies as a trust under State law.

The Settlement Agreement requires X and other defendants to contribute a stated amount to the Patient Benefit Fund ten days after the Initial Approval of the Settlement Agreement. The Settlement Agreement provides that this contribution and any

reversions of other monies to the Patient Benefit Fund from the Operating Fund, the Litigation Fund, and the Reserve Fund will be used to satisfy all Product-related claims.

The Settlement Agreement also requires X to contribute a stated amount to the Operating Fund ten days after the Initial Approval of the Settlement Agreement. Between that date and the Final Approval of the Settlement Agreement, the Settlement Agreement provides that X, in its discretion, may withdraw funds from the Operating Fund to meet its operating expenses, but only if it has first completely exhausted the funds retained by it to meet its general operating expenses, and only after it has obtained the approval of the Special Master/Trustee, which approval shall not unreasonably be withheld. The Settlement Agreement defines "Final Approval" as that time when all conditions precedent to the settlement shall have been satisfied, and the order and final judgment approving the Settlement Agreement has been entered, any appeals have been exhausted, and no further appeal may be taken.

The Settlement Agreement provides that within ten days of Final Approval of the Settlement Agreement, X will deposit the balance of the cash held by it into the Operating Fund and will file with the Special Master/Trustee a copy of its current budget and a report showing year-to-date expenditures against the budget. In each year following the financial year in which Final Approval of the Settlement Agreement occurs, X must prepare and submit to the Special Master/Trustee and counsel for the settlement class a budget for the next financial year, which estimates the financial impact of X's legally enforceable obligations for that financial year. Counsel for the settlement class may file with the Special Master/Trustee any objections they have to X's budget. The Special Master/Trustee shall have absolute discretion to resolve any dispute resulting from such an objection.

The Settlement Agreement provides that on the liquidation of X, any funds remaining in the Operating Fund after payment of the expenses of liquidation, shall revert to the Patient Benefit Fund.

Trust Classification

Section 301.7701-4(a) of the Regulations on Procedure and Administration provides that, in general, the term "trust" as used in the Code refers to an arrangement created either by a will or by an intervivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually, the beneficiaries of a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries may be the persons who created the trust and the trust will be recognized as a trust under the Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the

protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 301.7701-6(b) of the regulations provides that the term “fiduciary” applies to a person who occupies a position of peculiar confidence toward others, such as a trustee, an executor, or an administrator.

The Operating Fund is a trust under section 301.7701-4(a) of the regulations and the Special Master/Trustee is a fiduciary under section 301.7701-6(b) of the regulations.

Qualified Settlement Fund

Section 1.468B-1(a) of the regulations provides that a qualified settlement fund is a fund, account, or trust that satisfies all the requirements of section 1.468B-1(c). First, section 1.468B-1(c)(1) requires that the fund, account, or trust is established pursuant to an order of, or 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 continuing jurisdiction of that governmental authority. Second, section 1.468B-1(c)(2) requires that the fund, account, or trust 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, 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. Third, section 1.468B-1(c)(3) provides that the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).

The Operating Fund does not meet the requirement stated within section 1.468B-1(c)(2). Although a portion of the Operating Fund may revert to the Patient Benefit Fund on the liquidation of X and be used to satisfy Product-related claims, the principal purpose of the Operating Fund is to provide a fund for X to meet stated operating expenses, not to satisfy Product-related claims.

Grantor Trust

Section 677(a) of the Code provides that a grantor is treated as the owner of any portion of a trust whose income (1) is distributed to the grantor without the approval or consent of any adverse party, or (2) in the discretion of the grantor or a nonadverse party or both, may be distributed to the grantor without the approval or consent of any adverse party.

Section 1.677(a)-1(d) of the Income Tax Regulations provides, in general, that a grantor is treated as the owner of a portion of a trust whose income (1) is applied in discharge of a legal obligation of the grantor, or (2) in the discretion of the grantor or a nonadverse party or both, may be applied in discharge of a legal obligation of the grantor.

Section 671 of the Code provides that when the grantor is treated as the owner of any portion of a trust, the grantor's taxable income, deductions, and credits include those items of the trust's income, deductions, and credits attributable to the portion of the trust that the grantor is treated as owning.

Section 1.671-2(c) of the regulations provides that an item of income, deduction, or credit included in computing a grantor's taxable income, deduction, or credit is treated as if the grantor had received it or paid it directly.

Section 1.671-3(a)(1) of the regulations provides that if the grantor is treated as the owner of an entire trust, the grantor takes into account in computing income tax liability all items of income, deduction, and credit to which the grantor would have been entitled if the trust had not been in existence during the period the grantor is treated as the owner.

Section 1.671-2(e) of the regulations provides that the term "grantor" includes a corporation.

Section 672 (a) of the Code defines an "adverse party" as any person having a substantial beneficial interest in a trust that would be adversely affected by the exercise or nonexercise of a power that the party possesses respecting the trust. Section 672(b) defines a "nonadverse party" as any person who is not an adverse party.

Section 1.672(a)-1(a) of the regulations provides that a trustee is not an adverse party merely because of his interest as trustee.

Before Final Approval of the Settlement Agreement, X may withdraw amounts from the Operating Fund to meet stated operating expenses with the approval of the Special Master/Trustee, which approval may not be unreasonably withheld. After Final Approval, X must submit annually its budget to the Special Master/Trustee and counsel for the settlement class. Counsel for the settlement class may object to items in the budget, however, the Special Master/Trustee has sole discretion to resolve any dispute resulting from such an objection. The Special Master/Trustee is not an adverse party under section 672(a) of the Code and section 1.672(a)-1(a) of the regulations. As all funds in the Operating Fund/Trust may be used to pay stated operating expenses of X and, on liquidation of X, any remaining funds will revert to the Patient Benefit Fund, in the discharge of X's legal obligation, X is treated as the owner of the entire Operating Fund under section 677 of the Code and section 1.677(a)-1(d) of the regulations. Therefore, the Operating Fund is a grantor trust and the items of income, deductions, and credits attributable to the Operating Fund will be taken into account in computing

X's taxable income, deductions, and credits under section 671 of the Code and accompanying regulations.

No opinion is expressed about the federal tax consequences of the formation or operation of the Operating Fund or any other issue under the provisions of any other section of the Code.

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

Sincerely,

David B. Auclair
Senior Technician Reviewer
Branch 1

Office of Assistant Chief Counsel
(Income Tax & Accounting)

Enclosures(2)

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