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## Department of the Treasury

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, ID No.

Telephone Number:

Refer Reply To:

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Date:

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### Legend:

Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
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Date 9	=
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State A	=
\$a	=
\$b	=
\$c	=
\$d	=
\$e	=
\$f	=
\$g	=
\$x	=
\$y	=
\$z	=
Fund	=

W =  
Product a =  
Product b =  
Court =  
h =  
i =  
k =

Dear :

This responds to your letter dated April 25, 2007, requesting a private letter ruling concerning the application of § 468B of the Internal Revenue Code to the Fund. In particular, you requested rulings addressing the following issues:

1. Is the Fund a qualified settlement fund under § 1.468B-1 of the Income Tax Regulations?
2. Does the Fund's modified gross income include pre-judgment interest, post-judgment interest, or amounts paid by W to the Fund for damages, including attorney fees and costs and disbursements related to litigation?
3. Will the class members have gross income when the Fund makes payments to third-parties for costs and disbursements related to litigation, costs of Fund administration, and the portion of the common fund awarded to class counsel?
4. Does the Fund have a reporting obligation under § 6041 of the Internal Revenue Code to class members for amounts paid to third-parties for costs related to the litigation, costs of Fund administration, or the portion of the common fund awarded to class counsel?
5. Does the Fund have a reporting obligation under § 6041 for payments, other than payments of pre-judgment and post-judgment interest, made to class members?
6. Does the Fund have a reporting obligation under § 6049 for payments made to class members?

### Conclusions

1. The Fund is a qualified settlement fund under § 1.468B-1.
2. The pre-judgment interest, post-judgment interest, and amounts paid by W to the Fund for damages, including attorney fees and costs and disbursements related to litigation, are not included in the Fund's modified gross income.

3. Class members will not have gross income when the Fund makes payments to third-parties for costs and disbursements related to litigation, costs of Fund administration, or the portion of the common fund awarded to class counsel.
4. The Fund does not have a reporting obligation under § 6041 to class members for amounts paid to third-parties for costs related to the litigation, costs of Fund administration, or the portion of the common fund awarded to class counsel.
5. The Fund does not have a reporting obligation under § 6041 for payments made to class members that are attributable to compensatory damages; however, to the extent that the amount of a payment to a class member is attributable to punitive damages, such amount is reportable under § 6041. Moreover, the Fund has a § 6041 reporting obligation for the amount of the incentive award paid to each class representative.
6. The Fund does not have a reporting obligation under § 6049 for payments made to the class members.

## FACTS

W is a corporation engaged in the manufacturer of Products a and b. In Date 10, a group of W's customers filed a class action lawsuit with the Court alleging that W committed a common law tort violation as well as several violations of state law (i.e., under state consumer fraud, false advertising and deceptive trade practices statutes) when it marketed the same h as two different products, Product a and Product b. The class sought damages to sanction W for its misconduct and to deter similar future misconduct.

The class representatives entered into contingency fee arrangements with attorneys when the lawsuit was commenced. The lawsuit was certified as a nationwide consumer fraud class action, i.e., an "opt-out" class action, meaning that all persons damaged by the defendant's conduct were automatically members of the class ("class members") unless they affirmatively opted-out. Under state and federal class action practice, the damages awarded in an opt-out class action are paid into a common fund in which both the class members and class counsel have a legal interest. The amounts of those respective interests are determined by the court which would consider a variety of facts, including the risk, effort and success of class counsel. As is typical in opt-out class actions, when the class was certified in the class action, the Court assumed jurisdiction over the percentage of the common fund that would be awarded to class counsel and preempted the contingency fee retainer agreements that class representatives had signed with class counsel when the lawsuit commenced.

On Date 2, a jury returned a verdict in favor of the class finding that W had breached consumer fraud statutes. The Court entered a money judgment on Date 3.

The verdict became final on Date 4, when W's final appeals were denied. W was required under the laws of State A and by order of the Court to pay the Date 2 judgment ("Date 2 judgment") on Date 7, which was j days after Date 4. The Date 2 judgment required W to pay \$x, which comprised of: (1) \$a in damages, consisting of \$d of compensatory damages, \$e in punitive damages, and \$f of attorney fees and other litigation costs that were approved by the District Court and the appellate courts; (2) \$b of pre-judgment interest; and (3) \$c of post-judgment interest. W transferred \$x to the Fund on Date 7.

The prejudgment interest was calculated from Date 1, a date before the jury verdict, until Date 3, the date the Court entered the money judgment. The post-judgment interest was calculated from Date 3 until Date 7.

The Fund was established to resolve a lawsuit arising from the national class action against W. The Fund was designed to pay compensatory and punitive damages to the claimants for W's breach of consumer fraud laws. On Date 5, the Court approved the establishment of the Fund to hold the money judgment plus interest for the class. The Court retained jurisdiction over the case and the Fund. The escrow account was established on Date 6. The Fund is an interest-bearing escrow account which is segregated from the assets of W (and related parties).

The Court awarded \$y to class counsel, and \$z to class members. The class members share will be divided among those claimants that file valid claims, in proportion to the amount of Product a purchased between Date 8 and Date 9. The amount actually paid to each claimant exceeds compensatory damages because of the trebling of damages, and the existence of pre-judgment and post-judgment interest. Also, the amount paid to each claimant depends upon the amount of valid claims filed with the Fund.

The Court also approved the Fund's payment of money for the expenses and costs of litigation, incentive fees to the class representatives, claims administration, claims notice program, and other legal and administrative costs. The Court approved an incentive award of \$g to each of the k class representatives. This incentive award was not a reimbursement for expenses incurred for out-of-pocket expenses.

The Fund's taxable year is the calendar year and it uses an accrual method of accounting. The Fund does not know which or whether any of the class members derived a tax benefit from payments for Product a.

## LAW AND ANALYSIS

### Classification as Qualified Settlement Fund

The Fund's first requested ruling is that the Fund is a qualified settlement fund under § 1.468B-1 for federal income tax purposes. Section 468B(g) 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. Section 468B(g) authorizes the issuance of regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise. Sections 1.468B-1 through 1.468B-5 regarding qualified settlement funds were issued pursuant to § 468B(g).

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account or trust that satisfies the three requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the fund, account or trust be established pursuant to an order of, or be 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 continuing jurisdiction of the governmental authority. Second, § 1.468B-1(c)(2) provides that the fund, account or trust be established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event that has occurred and has given rise to at least one claim asserting liability: (i) under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA); (ii) arising out of tort, breach of contract, or violation of law; or (iii) designated by the Commissioner in a revenue ruling or revenue procedure. Third, § 1.468B-1(c)(3) requires that the fund, account, or trust must be a trust under applicable state law, or have its assets segregated from other assets of the transferor (and related persons). Finally, § 1.468B-1(h)(2) provides that if a fund, account, or trust is established to resolve or satisfy claims described in § 1.468B-1(c)(2) as well as other types of claims (i.e., non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund.

Based on the facts represented by the Fund, the three requirements of § 1.468B-1(c) are satisfied, and as such, the Fund is a qualified settlement fund for Federal income tax purposes. First, the Fund was approved by the District Court in state A in date 1 and remains subject to the continuing jurisdiction of the Court. See § 1.468B-1(c)(1). Second, the Fund is established to resolve or satisfy claims, that were litigated, and judgment was entered, against W for violating consumer fraud statutes. See § 1.468B-1(c)(2). Third, the Fund is an escrow account that is completely segregated from other assets of W, or W's related parties. See § 1.468B-1(c)(3). Finally, the fact that other claims will be paid by the Fund (e.g., class counsel fees) does not prevent the Fund from being classified as a qualified settlement fund because these non-allowable claims arise from the same event or related series of events. Section 1.468B-1(h)(2).

#### The Fund's modified gross income.

The Fund's second requested ruling is that the Fund's modified gross income does not include payments made by W to the Fund for satisfaction of the damages (compensatory and punitive damages), pre-judgment interest, and post-judgment

interest. Section 1.468B-2(b) provides that the modified gross income of a qualified settlement fund is its gross income, as defined in § 61, computed with certain modifications. Under § 1.468B-2(b)(1), 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 the gross income of the fund. However, payments in compensation for late or delayed transfers are not excluded from gross income.

Based on the facts presented, the amount of damages paid by W (compensatory and punitive damages) is excluded from the modified gross income of the Fund under § 1.468B-2(b)(1) because payment was to resolve or satisfy a liability for which the Fund was established. Also, the prejudgment interest is excluded from the Fund's modified gross income under § 1.468B-2(b)(1). The Court entered the money judgment, consisting, in part, of prejudgment interest, on Date 3. W's payment to the Fund was not due or made until Date 7, a date after Date 3. Therefore, the prejudgment interest is an amount transferred to the Fund by W to resolve or satisfy a liability for which the Fund was established, and is not a payment in compensation for late or delayed transfers. See § 1.468B-2(n) (Ex. 1).

Finally, the post-judgment interest is also excluded from the modified gross income of the Fund under § 1.468B-2(b)(1) because it was to resolve or satisfy a liability for which the Fund was established. The post-judgment interest was calculated from Date 3 through Date 7, the date of payment. W was not required to pay the Date 2 judgment until Date 7. W made a timely payment on Date 7. Therefore, no portion of this post-judgment interest was a payment in compensation for late or delayed transfers under § 1.468B-2(b)(1).

#### Fund payments to third-parties and gross income to class members.

The Fund's third ruling request is that payments from a money judgment in an "opt-out" class action to third parties for costs and disbursements related to the litigation, costs of Fund administration, and the portion of the common fund awarded to class counsel will not constitute gross income to class members.

Section 61 provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived. The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). When a payment is made to satisfy the obligation of a taxpayer to a third party, the amount of the payment is generally includible in the taxpayer's gross income. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). Even though the taxpayer never actually receives such payment, the taxpayer receives the benefit of the payment, and the amount is therefore gross income. Under the rationale of *Old Colony Trust Co.*, a prevailing litigant must

generally recognize gross income when another party pays attorneys' fees for which the litigant is liable.

The rationale of *Old Colony Trust Co.* is not applicable in certain opt-out class action lawsuits where, although the class members may receive a benefit from the litigation, no express contractual liability for a fee exists between the class members and litigating counsel. In such cases where there is no contractual agreement and someone other than the class members is liable for payment of attorneys' fees incurred in connection with such litigation, the attorneys' fees are generally not includible in a class member's gross income.

In Rev. Rul. 80-364, 1980-2 C.B. 294, Situation 3, a union filed claims on behalf of its members against a company due to breach of a collective bargaining agreement. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, providing that the company would pay the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for attorneys' fees and returned 34x dollars to the employees for back-pay owed to them. The ruling concluded that the portion of the settlement paid by the union for attorneys' fees was a reimbursement for expenses incurred by the union and not includible in the gross income of the union members. *But cf. Sinyard v. Commissioner*, T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001), *cert. denied sub nom, Sinyard v. Rossotti*, 536 U.S. 904 (2002) (holding that attorney's fees recovered in an opt-in class action pursuant to Age Discrimination in Employment Act are includible in the gross income of a class member who had a contingency fee agreement with class counsel); *Fredrickson v. Commissioner*, T.C. Memo. 1997-125, *aff'd in unpub. opinion*, 166 F.3d 342 (9th Cir. 1998) (holding that a class member's gross income includes attorney's fees awarded in Title VII (opt-out) class action where class member personally signed a settlement agreement providing for compensation of counsel).

In the instant case, attorneys' fees will not be awarded or paid to class counsel pursuant to any specific fee or retainer agreement between such counsel and the class members, including the class representatives. No provision of the statement signed by each class member imposes an obligation on any class member to compensate class counsel for services rendered to the class. Rather, the attorneys' fees were, or will be, paid by the Fund to class counsel in an amount approved by the Court. Because the action was certified as a class-action lawsuit, no separate agreements remained or became operative, and no amounts of attorneys' fees will be paid pursuant to any separate contingency fee or retainer agreement with a class member or class representative. Thus, the payment of attorneys' fees to class counsel by the Fund is similar to Situation 3 in Rev. Rul. 80-364 and does not constitute income to the respective class members or the class representatives.

Similarly, amounts paid for costs and disbursements related to the litigation and costs of Fund administration are not payments or distributions on behalf of the class members and, therefore, are not gross income to the respective class members or the class representatives.

Based on the facts presented, the amounts paid for costs and disbursements related to the litigation, costs of Fund administration, and the portion of the common fund awarded to class counsel by the Fund do not constitute gross income of the class members.

#### Information Reporting for Fund Payments to Third-Parties

The Fund's fourth requested ruling is that the Fund does not have a reporting obligation under § 6041 to class members for costs and disbursements related to the litigation, costs of Fund administration, or the portion of the common fund awarded to class counsel.

Section 1.468B-2(l)(2)(ii)(A) provides, in part, that a qualified settlement fund must make information returns for a distribution to a claimant if one or more transferors would have been required to make a return had that transferor made the distribution directly to the claimant.

Section 1.468B-2(l)(2)(ii)(C) provides, in part, that for purposes of § 6041(a), if a qualified settlement fund 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.

Section 6041(a) provides, in part, that all persons engaged in a trade or business and making payments in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more in any taxable year shall render a true and accurate return to the Secretary, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment. Under § 6041, interest payments are not covered by § 6041 if the payment is subject to the information reporting requirements of § 6049(a).

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.



As used in § 6041, the term “gains, profits, and income” means gross income and not gross amounts paid. A payor is generally not required to make a return under § 6041 for payments that are not includible in the recipient’s income, and a payor is not required to make a return if the payor does not have a basis to determine the amount of a payment that is required to be included in the recipient’s gross income.

The facts provided indicate that certain payments made by the Fund may equal or exceed \$600. The Fund will have an income tax reporting requirement as to these payments if the Fund possesses the information necessary to determine whether or how much of a payment will be includible as income in the gross income of a recipient. Section 6041(a) reporting requirements are conditioned on a payor knowing that a payment to a payee is in the nature of income and the amount of income. If a payor cannot determine either that a payment is in the nature of income or in what amount, then the payor is not required to file an information return under § 6041.

Based on the information provided and the representations made and the fact that these amounts are not gross income to the class members, as discussed in the third ruling request above, the Fund will not have a reporting requirement under § 6041 as to the class members for the payments made by the Fund to third parties for costs and disbursements related to the litigation, costs of Fund administration, or the portion of the common fund awarded to class counsel.

#### Information Reporting for Payments Made to Class Members

The Fund’s fifth ruling request is that, with the exception of pre-judgment and post-judgment interest, the Fund does not have a reporting obligation under § 6041 for payments made to the class members.

Section 61(a) and the regulations thereunder define gross income to mean all income from whatever source derived. Section 1.61-1(a). The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. Thus, under § 61, any receipt of funds or other accessions to wealth is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

In spite of the broad scope of § 61 and the regulations thereunder, it does not apply to a receipt of a refund or return of capital because it is not an “accession to wealth.” For payments made in settlement or judgment of a lawsuit by a party to restore a taxpayer to the position he or she was in before the taxpayer’s loss was incurred, are not generally includible in the taxpayer’s gross income because there is no economic gain to the taxpayer. See *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944) (stating if a recovery is treated as a replacement of capital, the damages received from the lawsuit are treated as a return of

capital and are taxable only to the extent that the damages exceed the basis of the property replaced).

Based on the facts presented, the payments of the money judgment consist, in part, of compensatory damages. Payments from the Fund to the class members that are properly allocable to compensatory damages constitute a return of capital and are not gross income to the class members, unless the class members derived tax benefits in a prior taxable year from such amount. The Fund represents that it does not know which class members, if any, derived tax benefits in a prior taxable year from such amounts.

The punitive damages are not specifically excluded from the class members' gross income by the Code. The punitive damages represent accessions to wealth, clearly realized, over which the class members have complete dominion. Accordingly, such payments are gross income to the class members.

Furthermore, the class representatives were awarded incentive payments of \$g each by the Court for their work during the litigation and trial testimony. Consequently, the incentive payments constitute clear accessions to the wealth of the class representatives and no other section of the Code excludes such payments from gross income of the class representatives. *Berst v. Commissioner*, T.C. Memo. 1997-137. The incentive payments are includible in the gross income of the class representatives.

The Fund requested a ruling on the reporting obligations for payments, other than payments of pre-judgment and post-judgment interest, to the class members. To the extent a distribution from the Fund to a claimant is attributable to compensatory damages, such amount is not reportable under § 6041; however, to the extent that the amount of the distribution is attributable to punitive damages, such amount is reportable under § 6041.

Moreover, the Fund will have a reporting obligation under § 6041 for the incentive award payments to the class representatives. The incentive award payments to the class representatives are fixed and determinable gains, profits, or income of \$600 or more. In this case, the incentive award payments are not reimbursements for costs and expenses incurred by the class representatives over the course of the class action litigation.

#### Information Reporting under § 6049 for Payments Made to Class Members

The Fund's sixth ruling request is that the Fund does not have a reporting obligation under § 6049 for payments made to the class members.

Section 6049(a) provides that every person who makes payments of interest aggregating \$10 or more to any person during any calendar year, or receives payments of interest as a nominee and who makes payments aggregating \$10 or more during any calendar year to any other person with respect to the interest so received, shall make a return according to the forms or regulations prescribed by the Secretary setting forth the aggregate amount of such payments, and the name and address of the person to whom paid.

Section 6049(b)(1) provides that the term “interest” includes 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 a year or less which is held by a corporation. Pursuant to § 6049(b)(1)(E), “interest” also includes interest on deposits with brokers (as defined in § 6045(c)). This is so even though interest earnings have accrued on the funds to be paid to Fund claimants.

Distributions made by the Fund do not relate to deposits with brokers or obligations issued in registered form, and do not otherwise qualify as interest within the meaning of § 6049(b). Accordingly, the Fund has no information reporting obligation under § 6049 for its distributions to the class members.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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 must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

John P. Moriarty  
Senior Technician Reviewer, Branch 7  
(Income Tax & Accounting)