

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Identifying Number:

Telephone Number:

Refer Reply To:

CC:DOM:IT&A:4 – PLR-105180-99

Date:

September 3, 1999

In Re:

Legend:

Company =

Subsidiary =

Plan =

Trust =

Restricted Trust Account =

Products =

Court =

District Courts =

Date 1 =

Date 2 =

Date 3 =

S =

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T =

U =

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X =

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Dear

This is in response to a ruling request submitted on behalf of Company dated March 4, 1999, and supplemental letters dated May 6, 1999; June 25, 1999; July 29, 1999; and August 26, 1999. You have requested the following rulings: (1) the Trust will constitute a "qualified settlement fund" under § 468B of the Internal Revenue Code and § 1.468B-1 of the Income Tax Regulations, and (2) Company's payments to the Trust will be deductible by Company under §§ 162 and 461 when they are made.

FACTS

Company is a corporation using the accrual method of accounting. Company previously manufactured and sold the Products, which led to the filing of numerous personal injury and product liability lawsuits against Company. Faced with mounting litigation, Company filed a bankruptcy petition on Date 1 in the Court. After lengthy

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negotiations, the Plan, which provides for the reorganization of Company, was filed on Date 2.

The Plan provides two alternative claim resolution methods for those claimants with claims related to the manufacture and sale of the Products. Claimants meeting specific criteria may resolve their claims by accepting one or more settlement payments provided under the Plan. Claimants who wish to litigate their claims instead of settling may elect to do so.

As an integral part of the Plan, Subsidiary is being established as a wholly owned subsidiary of Company to assume liability for, defend, and resolve litigated claims. This will accomplish a major objective of the Plan by assuring claimants the opportunity to litigate claims related to the Products and freeing Company from the distraction of actually conducting the litigation. Subsidiary will not engage in any trade or business other than the resolution of litigated claims. Subsidiary will be managed exclusively for the benefit of Company and Company's shareholders. Subsidiary will have a single officer and a board of directors selected by Company, subject to the approval of the Court. Subsidiary will have nominal assets. Your letter of July 29, 1999, includes a representation by Company that its initial basis in its Subsidiary's shares under §§ 351 and 358 will be equal to Company's basis in the assets it transfers to Subsidiary at the time of its incorporation. Company also represented that, for basis purposes, any Company liabilities resolved by Subsidiary under the plan of reorganization will be ignored.

Claimants who elect to litigate will either initiate suit against Subsidiary or continue existing litigation against Subsidiary instead of Company. Settlements for litigated cases will be recommended by Subsidiary and subject to the approval of Company. Company also retains the authority to approve defense costs over a certain amount. One of the District Courts will appoint an individual to assist it in the administration of the litigated claims, and the individual's assigned duties will include review of proposed settlements and defense costs. If a litigated claim is settled or reduced to final judgment, it will be presented for payment from the funds in the Trust, and payment will be made directly from the Trust to the litigating claimant and generally his or her counsel. Similarly, defense costs will be paid directly from the Trust to the persons performing the defense work. Subsidiary will receive amounts from the Trust only for the salary of Subsidiary's manager, the salaries of approximately Z employees who will monitor the defense work and maintain information on the lawsuits, the leasing of office space and equipment for the employees, and certain incidental costs such as postage, utilities, and office supplies.

In order to satisfy settling and litigated claims, Company will establish the Trust, an irrevocable trust under state law. The Plan provides that Company, in full release, satisfaction, and discharge, of all claims, will execute and deliver the Trust instrument and other documents. The Court will maintain continuing and exclusive jurisdiction over

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the Trust and its assets. The District Courts do not have jurisdiction over the Trust but will exercise jurisdiction or supervision over matters arising in the settlement and litigation of claims that affect the timing and amount of payments received by claimants.

Under the Plan, Company will be required to pay a maximum of \$S to the Trust in a series of payments. Company will be required to make an initial payment on the effective date of the Plan or, under certain circumstances, at a time prior to the effective date. Even after the Plan has been confirmed, the effective date will not occur until certain conditions are satisfied or are waived by Company and certain other parties. One of these conditions concerns the resolution of any appeal filed from the Court's confirmation order that challenges the schedule of payments or releases from liability. The Plan provides that even if that specific type of appeal is filed, and if the confirmation order is not stayed pending resolution of such an appeal, Company will be required to make an initial payment of \$T as well as subsequent payments of insurance proceeds shortly after Company receives such amounts. The Plan provides that these funds are to be paid to the Trust, which will retain these payments in the Restricted Trust Account pending the outcome of the appeal. Your letter of August 26, 1999, provides that this Restricted Trust Account will be a trust account within the Trust pursuant to the Trust agreement rather than a separate entity. Additionally, the Restricted Trust Account will be administered by the trustee of the Trust rather than by a separate fiduciary. You have represented that the Trust agreement submitted with your letter dated April 9, 1999, will be modified to incorporate the escrow arrangement contained in the Plan through the use of the Restricted Trust Account. Accrued interest is to be retained in the Restricted Trust Account. Investment decisions will not be made by Company. During the pendency of the appeal, funds may be withdrawn from the Restricted Trust Account for certain administrative expenses that the Trust incurs related to settling and litigating claims. Company will not control the withdrawal of funds to meet Trust expenses. Expenditures of the Restricted Trust Account funds will be overseen by the District Courts through annual budgets during the pendency of any appeal. If the appeal does not result in a reversal of the confirmation order, the funds held in the Restricted Trust Account will either be transferred to an unrestricted account within the Trust or retained in the same account without any special restrictions, and settlement and litigation of claims will commence. If the appeal results in the reversal of the confirmation order, the funds in the Restricted Trust Account will be forwarded to Company.

If Company is required to make the initial payment on the effective date, Company will pay either \$U or \$V to the Trust, depending on when the effective date occurs. After a specified time measured from the effective date, Company will be required to make subsequent payments to the Trust on an "as needed" basis to pay claims and expenses as well as to maintain a specified amount for a reserve. Company will receive periodic notices concerning the subsequent payments it is required to make to the Trust. Unless the Court orders otherwise, Company must pay the amount stated in a notice shortly after the notice is received. The subsequent payments are subject to

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an annual liability limit of \$W, and the first annual period begins on Date 3. In any year for which Company's payments are less than the annual liability limit, the next succeeding annual liability limit is increased to reflect the difference. A notice may not be submitted to Company if it will cause Company's payments to exceed the applicable annual liability limit. Company will generally be required to transfer insurance proceeds to the Trust shortly after Company receives such amounts. This requirement may result in the modification of the annual liability limits. Certain other limited circumstances may also result in the modification of the annual liability limits.

The Plan specifies a dollar limit on the maximum amount payable from the Trust for litigated claims and related expenses. This limit is \$X. Similarly, there is a limit on the maximum amount payable from the Trust for settled claims and related expenses. This limit is \$Y, plus Trust earnings. There are other dollar limits on the maximum amounts payable from the Trust for particular types of settled claims. No separate funds or accounts will be maintained within the Trust for litigated claims, settled claims, or particular types of settled claims. Thus, payments will be made to the Trust, rather than to separate funds or accounts.

Upon termination of the Trust, any Trust funds allocable to the settlement of claims will be distributed, if cost effective, to the holders of allowed claims. If such a distribution would not be cost effective, these funds will be distributed to a medical research institute or university. No amount in the Trust allocable to the settlement of claims will revert to Company.

Upon termination of the Trust, any amounts allocable to litigation of claims will be distributed to Company. However, Company represents that upon termination, it expects to receive no assets or nominal assets in this manner.

Company maintains products liability insurance. Company's insurers have to date paid substantial amounts pursuant to several insurance policies. Company expects to receive additional insurance proceeds from these insurers over time. Your letters of May 6, 1999, and June 25, 1999, include representations by Company that it will include in gross income all insurance proceeds received by it or paid by an insurer to the Trust on its behalf.

FUND CLASSIFICATION

Section 468B(g) of the Code 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. Pursuant to the authority of section 468B(g) of the Code, the Secretary has published §§ 1.468B-1 through 1.468B-5 of the regulations regarding qualified settlement funds.

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Section 1.468B-1(a) of the regulations provides that a qualified settlement fund is a fund, account, or trust that satisfies all three requirements of § 1.468B-1(c). First, § 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, § 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, § 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 (or related persons).

Based on the facts represented, the Trust meets all three requirements of § 1.468B-1(c) of the regulations. First, the Trust will be established pursuant to an order of the Court and will be subject to the Court's continuing jurisdiction. Second, the Trust was established to resolve or satisfy one or more claims that have resulted 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. Third, the Trust will be a trust under state law and the Trust's assets will be segregated from other assets of Company (and related persons). Additionally, we conclude that the Restricted Trust Account is part of the Trust.

DEDUCTION OF PAYMENTS

Section 162(a) provides the general rule 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. See also § 1.162-1(a).

Section 1.468B-3(d) provides that no deduction is allowed to a transferor for a transfer to a qualified settlement fund to the extent the transferred amounts represent amounts received from the settlement of an insurance claim and are excludable from gross income. If the settlement of an insurance claim occurs after a transferor makes a transfer to a qualified settlement fund for which a deduction has been taken, the transferor must include in income the amounts received from the settlement of the insurance claim to the extent of the deduction.

Section 461(a) provides the general rule that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

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Section 461(h)(1) provides the general rule 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.

Section 461(h)(4) provides that the all events test is met with respect to any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.461-1(a)(2) provides in part that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.468B-3(c)(1) provides the general rule that, for purposes of § 461(h), economic performance occurs with respect to a liability described in § 1.468B-1(c)(2) (determined with regard to § 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. Section 1.468B-3(c)(2) and (3) provide exceptions to the general rule.

Section 461(f) provides in part that if (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of § 461(h), then the deduction shall be allowed for the taxable year of the transfer. See also § 1.461-2(a)(1).

Section 1.461-2(b)(1) provides in part that the term “asserted liability” means an item with respect to which, but for the existence of any contest in respect of such item, a deduction would be allowable under an accrual method of accounting.

Section 1.461-2(b)(2) provides in part that any contest which would prevent accrual of a liability under § 461(a) shall be considered to be a contest in determining whether the taxpayer satisfies § 461(f)(1). A contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability.

Section 1.461-2(c)(1) provides in part that a taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee

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pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.

Section 1.461-2(d) provides in part that in order for a contest with respect to an asserted liability to exist after the time of transfer, such contest must be pursued subsequent to that time. Thus, the contest must have been neither settled nor abandoned at the time of the transfer. A contest may be settled by a decision, judgment, decree, or other order of any court of competent jurisdiction which has become final, or by written or oral agreement between the parties.

Initially, we note that the analysis under § 162 could be affected by the form of the Plan because it uses Subsidiary as a nominal defendant in the litigation, and Subsidiary will assume liability for the litigated claims and associated expenses. It is a well established principle that a taxpayer may not deduct a voluntary payment of another person's liability as an "ordinary and necessary" business expense. However, the tort and product liability lawsuits and potential lawsuits arise from Company's manufacture and sale of the Products, which was one of its principal business activities. Moreover, Company will make the payments to the Trust to satisfy and discharge the claims related to the manufacture and sale of the Products, which includes both settling and litigated claims. Furthermore, Company will be legally obligated to make the payments to the Trust. The Court will retain jurisdiction over Company's performance, and the Court may impose such remedies as it determines to be necessary and appropriate to remedy any breach of Company's obligation to make the payments and to deter or protect against any subsequent breach. Additionally, Subsidiary will have only nominal assets. The litigated claims, whether settled or reduced to final judgment, will be presented for payment from the funds in the Trust, and payment will be made directly from the Trust to the litigating claimants and generally their counsel. Accordingly, based on the facts represented, Company's payments to the Trust will be for "ordinary and necessary" business expenses.

Under the Plan, there are two types of circumstances where Company's liability could remain contested in litigation at the time it makes payments. The first set of circumstances concerns payments Company makes to the Trust on or after the effective date of the Plan. Even after the Plan has been confirmed, the effective date will not occur until certain conditions are satisfied or are waived by Company and certain other parties. One of these conditions concerns the resolution of any appeal filed from the Court's confirmation order that challenges the schedule of payments or releases from liability. Consequently, if this condition is waived and the remaining conditions are satisfied or waived, Company's liability to make payments on and after

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the effective date could be contested in litigation when such payments are made during a pending appeal.

The second set of circumstances concerns a special provision in the Plan that may require Company to make payments before the effective date. The Plan provides that even if the specific type of appeal described above is filed, and if the confirmation order is not stayed pending resolution of such an appeal, Company is still required to make an initial payment as well as subsequent payments of insurance proceeds shortly after Company receives such amounts. Under these circumstances, Company will make the payments to the Trust, which will be required to retain these payments in the Restricted Trust Account pending the outcome of the appeal. The Restricted Trust Account will be an account within the Trust. The Trust agreement submitted with your letter dated April 9, 1999, will be modified to incorporate the escrow arrangement contained in the Plan through the use of the Restricted Trust Account. Accrued interest is to be retained in the Restricted Trust Account. Investment decisions will not be made by Company. During the pendency of the appeal, funds may be withdrawn from the Restricted Trust Account for certain administrative expenses that the Trust incurs related to settling and litigating claims. Company will not control the withdrawal of funds to meet Trust expenses. Expenditures of the Restricted Trust Account funds will be overseen by the District Courts through annual budgets during the pendency of any appeal. If the appeal does not result in a reversal of the confirmation order, the funds held in the Restricted Trust Account will either be transferred to an unrestricted account within the Trust or retained in the same account without any special restrictions, and settlement and litigation of claims will commence. If the appeal results in the reversal of the confirmation order, the funds in the Restricted Trust Account will be forwarded to Company.

Under these two types of circumstances, all the events that establish the fact of the liability may not have occurred at the time Company will make certain payments because Company's liability will remain contested in litigation. In the case of claims contested in litigation, the fact of the liability and the amount do not become fixed until the judgment of the court becomes final and nonappealable. See United States v. Consolidated Edison Co., 366 U.S. 380, 385-87, motion for leave to file petition for reh'g as amicus curiae denied, 368 U.S. 884 (1961). However, § 461(f) provides a narrow exception to the general rule that the amount of a contested liability cannot be taken into account by an accrual method taxpayer.

Based on the facts represented, the requirements of § 461(f) will be met with respect to both sets of circumstances described above. The possible appeal concerning the schedule of payments and releases from liability will be a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. Also, under the first set of circumstances described above, Company will transfer money beyond its control to the Trust. Under the second set of circumstances described above, the money will be

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transferred beyond Company's control to the Restricted Trust Account, which is part of the Trust. Moreover, the Court will approve both the Plan and the Trust agreement, which will be executed by Company, the trustee of the Trust, and authorized representatives of the claimants. Additionally, the contest with respect to the asserted liability will exist after the time of the transfer. Finally, but for this contest, a deduction would be allowed for the taxable year of the transfer because Company will make the transfer to the Trust to resolve or satisfy a liability described in § 1.468B-1(c)(2) and the amount of the liability can be determined with reasonable accuracy no later than the time each payment will be made.

Based on the facts represented, including that Company will include in gross income all insurance proceeds received by it or paid by an insurer to the Trust on its behalf, we conclude that:

- (1) if Company is required to make the initial payment prior to the effective date, such payment is deductible under § 162 at the time such payment is made to the Trust;
- (2) if, prior to the effective date, Company is required to make subsequent payments that are attributable solely to insurance proceeds received during a pending appeal, such payments are deductible under § 162 at the time such payments are made to the Trust;
- (3) if Company is required to make the initial payment on the effective date, such payment is deductible under § 162 at the time such payment is made to the Trust; and
- (4) Company's subsequent payments to the Trust after the effective date on an "as needed" basis in response to the notices (which are not permitted to cause payments to exceed the annual liability limits, as modified) are deductible under § 162 at the time such payments are made to the Trust.

A copy of this letter must be attached to any income tax return to which it is relevant. 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) provides that it may not be used or cited as precedent.

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Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

By _____
Michael L. Gompertz, Jr.
Assistant to Branch Chief, Branch 4

Enclosures (2):

Copy of this letter

Copy for section 6110 purposes

cc: