

Internal Revenue Service

Department of the Treasury

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LEGEND

year 1 =

Parent =

Fund A =

Fund B =

State =

Corporation =

Facility =

date 1 =

date 2 =

Agency =

Regulation =

Permit =

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Act =

Dear :

This is in reply to a letter dated October 31, 2002, and subsequent correspondence, requesting a ruling that Fund A and Fund B will be treated as Qualified Settlement Funds (QSF) under § 1.468B-1 of the Income Tax Regulations and that the income of Fund A and Fund B is excludible from gross income under § 115(1) of the Internal Revenue Code.

FACTS

Prior to year 1, Corporation operated Facility, a hazardous waste treatment, storage and disposal facility that included a hazardous waste landfill. A dispute arose between, Agency, Parent and Corporation concerning liabilities from operating, closure, and post-closure care of Facility. Corporation, along with Parent and other subsidiaries of Parent, filed voluntary petitions for bankruptcy relief in year 1. At that time the parties submitted a settlement agreement to the bankruptcy court for approval as part of a reorganization plan. The settlement agreement includes two proposed trust agreements (including the amendments on date 1), each of which creates an irrevocable trust fund (Fund A and Fund B). State, through Agency, is the sole beneficiary of both funds. The trustee of each fund must be approved by Agency. Subsequent to the adoption of the reorganization plan, the bankruptcy court will retain jurisdiction over this matter, enforcing the terms of the settlement agreement and resolving any disputes arising thereunder, until the bankruptcy proceedings are closed.

Under the settlement agreement Corporation will transfer ownership of Facility to Fund A along with a specified cash amount and a single payment annuity. The settlement agreement provides that the funds transferred by Corporation to Fund A will satisfy, in full, Fund A's financial assistance obligations for closure and post-closure care of Facility pursuant to the requirements of Permit, Regulation and Act. According to the trust agreement, the purpose of Fund A is to maintain Facility in an environmentally protective manner and in accordance with applicable law. To accomplish this purpose the trustee will receive and maintain custody of the Facility, manage the trust funds and effect closure and post-closure care of Facility in accordance with State law, other applicable laws, and the terms of the settlement agreement. The settlement agreement also requires Corporation to transfer a specified amount of money to Fund B. According to the trust agreement, the purpose of Fund B is to pay for the costs of (i) clean-up, (ii) restoration of environmental impairment and (iii) addressing other environmental concerns associated with Facility.

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The Fund A and Fund B trust documents can only be amended with the written approval of Agency and the fund's trustee. The original trustees of Fund A and Fund B are selected by Parent, subject to the approval of Agency. Thereafter, Agency can petition the bankruptcy court or other court of competent jurisdiction to remove a trustee and nominate a successor trustee. Fund A is required to submit an annual budget for the coming year to Agency. Fund B is required to submit to Agency an annual statement listing the beginning and ending value of its assets. Agency has unrestricted access to the books and records of Fund A and Fund B. The settlement agreement and trust agreements provide that the assets of Funds A and B and any income generated by the funds must be used for the benefit of Agency for the purposes described in the trust agreements.

According to the proposed trust agreements, if at any time no funds or assets remain in the fund, the fund will terminate at that time. Unless terminated for lack of funds or assets, Fund A and Fund B will continue in effect until date 2. After date 2 each fund will remain in effect until Agency determines that Facility presents no future risk to public health, and the fund is no longer necessary for the restoration of the environmental impairment and addressing other environmental concerns associated with Facility. Pursuant to the amendments to the proposed trust agreements described in the letter of date 1, upon termination, any money and or assets remaining in either Fund A or Fund B will be distributed to Agency or to another agency of State designated by Agency.

LAW AND ANALYSIS

Section 468B

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

- (1) It 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;
- (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

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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).

Section 1.468B-2(a) provides that a QSF is a United States person subject to tax on its “modified gross income” for any taxable year at a rate equal to the maximum rate in effect for that taxable year under § 1(e). The term “modified gross income” means gross income as defined in § 61 computed with certain modifications not relevant here. Section 61 provides, in part, that except as otherwise provided in subtitle A of the Code, gross income means all income from whatever source derived. Section 115(1) is an exception to § 61. Therefore, to the extent that the income of a QSF is described in § 115(1), that income is excluded from the QSF’s modified gross income under § 1.468B-2.

To be treated as a QSF, Fund A and Fund B must satisfy all three requirements of § 1.468B-1(c).

Section 1.468B-1(c)(1) is satisfied if the fund is established pursuant to an order of, or is approved by, any agency or instrumentality (including a court of law) of the United States and is subject to the continuing jurisdiction of that governmental authority. The settlement agreement provides for the establishment of Fund A and Fund B. The settlement agreement creating these funds is subject to the approval of the bankruptcy court. The bankruptcy court is an agency or instrumentality of the United States. The settlement agreement states that the bankruptcy court will retain jurisdiction over matters contained in the settlement agreement. Therefore, Fund A and Fund B satisfy §1.468B-1(c)(1).

Section 1.468B-1(c)(2) is satisfied if the fund 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 violation of law. A qualified settlement fund may be established to resolve claims described in § 1.468B-1(c)(2) as well as other types of claims (non-allowable claims) arising from the same event or series of events. See § 1.468B-1(h)(2). However, under § 1.468B-3(c), economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims. Fund A and Fund B will be established to resolve or satisfy a variety of claims made against Parent by Agency. At least some of these claims relate to civil penalties imposed as the result of violations of the Act. Because Fund A and Fund B are being established to resolve or satisfy liabilities that arose out of violations of law, the funds satisfy §1.468B-1(c)(2). Parent has not requested a ruling as to whether, or to what extent, economic performance will occur upon the transfer of money or property to

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Fund A or Fund B. Therefore, the extent to which the underlying claims are non-allowable and the extent to which transfers to Fund A and Fund B will satisfy the economic performance requirement of § 461(h) is not addressed in this letter.

Section 1.468B-1(c)(3) is satisfied if the fund is segregated from other assets of the transferor (and related persons). The property to be transferred to Fund A and Fund B will be segregated from the transferors' other assets and from the assets of related persons. Therefore, Fund A and Fund B satisfy §1.468B-1(c)(3).

Accordingly, Fund A and Fund B will qualify as QSFs under § 468B and the regulations thereunder. Because both Funds are qualified settlement funds under § 1.468B-1(c) of the regulations, they are separate taxable entities, the income of which may be excluded from gross income under § 115(1) if the provisions of that section are satisfied.

Section 115(1)

Section 115(1) provides, in part, that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, is excludable from gross income for federal income tax purposes under § 115(1). The ruling reasons that the investment of cash balances by a state or political subdivision thereof in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and other revenue to fund government expenses. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115(1). In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

By funding the remediation of a contaminated and polluted site, Funds A and B perform an essential governmental function

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The income of Funds A and B will be used solely for purposes related to the remediation of a contaminated site. No part of either Fund's income will be distributed to a private party other than as payment for goods or reasonable compensation for services rendered. The trust documents of both Funds provide that upon dissolution, each Fund's assets shall be distributed to State, through Agency or another agency of State.

Based on the information and representations submitted by Corporation, and provided that the proposed amendments to the trust agreements described above are adopted, we hold that the income of both Funds A and B are derived from an essential governmental function and accrue to a state, a political subdivision of a state or to an entity the income of which is excludable from gross income under § 115(1).

CONCLUSIONS

Fund A and Fund B are Qualified Settlement Funds within the meaning of § 468B of the Code and the regulations thereunder.

The incomes of Fund A and Fund B are excludable from gross income under § 115(1) of the Code.

Except as specifically provided otherwise, no opinion is expressed on the federal tax consequences of any particular transaction.

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

Sincerely,

Elizabeth Purcell, Chief
Exempt Organizations
Branch 2
Division Counsel/Associate
Chief Counsel
(Tax Exempt and Government
Entities)

Enclosures