

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

March 21, 2003

LEGEND

A =

AA =

AAA =

B =

BB =

C =

D =

E =

F =

G =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Dear :

This letter responds to your submission of September 10, 2002, and supplemental correspondence dated October 16, 2002, requesting rulings on behalf of a proposed entity to be established by court order to resolve or satisfy certain legal claims.

FACTS

BACKGROUND

In Year 1, A and AAA (collectively "A") filed petitions under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the D. On Date 1, the Bankruptcy Court confirmed A's Chapter 11 reorganization plan (the "Initial Plan"). The Initial Plan became effective on Date 2. The Initial Plan provided for establishing, effective Date 2, F under the laws of the state of C. The Initial Plan further provided for the Bankruptcy Court's continuing jurisdiction over E. On Date 3, the Internal Revenue Service issued a letter ruling holding, in pertinent part, that F constituted a qualified settlement fund under section 468B of the Internal Revenue Code ("the Code") and section 1.468B-1 of the Income Tax Regulations ("the regulations").

Pursuant to the Initial Plan, F received all of the stock of A, which changed its name to B to permit transfer of A's name to AA. F also received the stock of a subsidiary of A, a limited sum of cash, and the right to receive certain insurance proceeds concerning E injury and property damage claims. F manages certain assets of A as a settlement fund to resolve or satisfy claims against A for bodily injury and property damage arising from exposure to products containing E.

The Initial Plan provided for the formation of AA. On Date 2, AA acquired various trademark rights, operating assets, and businesses of A. The original owners of AA were creditors of A that were not E claimants. In exchange for their claims against A, these creditors received debt and equity interests in AA. On Date 4, the Internal Revenue Service issued a private letter ruling holding, in pertinent part, that the Initial Plan constituted a reorganization under section 368(a)(1)(G) of the Internal Revenue Code.

Concurrent with its Confirmation Order, on Date 1, the Bankruptcy Court issued a permanent injunction barring forever all cognizable E claimants at that time from filing claims against AA. In addition, the Bankruptcy Court included in the Confirmation Order a "Channeling Order," temporarily enjoining any then-unknown E claimants from suing any entity, including AA, until remedies provided by F were exhausted.

The Bankruptcy Court subsequently concluded that the number of known and potential E claimants significantly exceeds the estimates contained in the Initial Plan, and that E's assets are inadequate to pay all existing claims without an infusion of funds from AA. Accordingly, on Date 5, the Bankruptcy Court issued a Memorandum Opinion holding that it would lift the Channeling Order unless AA funded F with a specified amount by Date 6. AA appealed to the District Court.

B, F, and E claimants' representatives subsequently negotiated an agreement with AA. Because of the progress of the parties' negotiations, the Bankruptcy Court issued a stay of the portion of its Memorandum Opinion that lifted the Channeling Order. Additionally, on Date 7, the District Court approved a stipulation by the parties to stay indefinitely the termination of the Channeling Order, and to close the appeal, subject to its being reopened upon good cause. On Date 8, B filed a new Chapter 11 petition, together with a new Chapter 11 reorganization plan, (the "New Plan"), to implement this agreement.

G

The New Plan will establish G, a trust under C state law, as a qualified settlement fund under Treas. Reg. § 1.468B-1, to assume all liabilities of B and F resulting from E claims, and to provide for payment of E claims pursuant to a court-approved procedure. As prescribed by the Bankruptcy Court pursuant to confirmation of the New Plan, G will receive all of the stock of the BB, plus cash and other available assets, including insurance proceeds, from E, plus a settlement contribution from AA, consisting of cash and a note. The New Plan will provide for continuing supervision by the Bankruptcy Court.

RULINGS REQUESTED

- (1) G will constitute a “qualified settlement fund” under section 468B or the Internal Revenue Code and section 1.468B-1 of the Income Tax Regulations.
- (2) The cash and property transferred to G as contemplated by the New Plan will be excluded from G’s gross income pursuant to section 1.468B-2(b)(1) of the Regulations.
- (3) Pursuant to sections 162, 461(h), and 468B(a) of the Code, AA may deduct its payments to G in the year of payment. Pursuant to section 1.468B-3(c)(3) of the Regulations, the “year of payment” regarding any note issued by AA to G will be the year payments are made on the note, not the year of delivery of the note to G.

LAW AND ANALYSIS

Section 468B(g) of the Internal Revenue Code states 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.” The same section provides that the Secretary “shall prescribe regulations providing for the taxation of any such account or fund” To that end, the Secretary has published sections 1.468B through 1.468B-5 of the regulations regarding qualified settlement funds.

Section 1.468B of the regulations reconciles the term “qualified settlement fund” in the regulations with the term “designated settlement fund” in the Code. The regulation states:

§ 1.468B. Designated Settlement Funds. - A designated settlement fund, as defined in section 468B(d)(2), is taxed in the manner described in § 1.468B-2. The rules for transferors to a qualified settlement fund described in § 1.468B-3 apply to transferors to a designated settlement fund. Similarly, the rules for claimants of a qualified settlement fund described in § 1.468B-4 apply to claimants of a designated settlement fund. A fund, account, or trust that does not qualify as a designated settlement fund is, however, a qualified settlement fund if it meets the requirements of a qualified settlement fund described in § 1.468B-1.

FIRST REQUESTED RULING

Section 1.468B-1(c) of the regulations provides, in pertinent part, that a fund, account, or trust is a qualified settlement fund if:

- (1) it is established pursuant to an order of, or is approved by, a court of law or other governmental authority and is subject to the continuing jurisdiction of such authority;
- (2) it is established to resolve or satisfy one or more contested or uncontested claims that have arisen 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 tort, breach of contract, or violation of law; 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 parties).

We conclude that under the facts represented in this request, G meets the qualifications prescribed in the regulation. G will be established pursuant to a Bankruptcy Court order, and will remain under the continuing jurisdiction of the Bankruptcy Court. The purpose of G will be to resolve or satisfy both actual and anticipated tort claims. G will be created under C law. Accordingly, G will be a qualified settlement fund under section 1.468B-1 of the regulations.

SECOND REQUESTED RULING

Section 1.468B-2(b)(1) provides that in general, transfers to a qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability comports with the purpose of the fund are excluded from the fund's gross income. However, the regulation does not exclude the following categories of transfers from the fund's gross income:

- (a) dividends on stock of a transferor (or a related person);
- (b) interest on debt of a transferor (or a related person); or
- (c) payments in compensation for late or delayed transfers.

We conclude that under the facts represented in this request, cash and property transferred to G as contemplated by the New Plan will be transferred by, or on behalf of, a transferor to resolve or satisfy a liability for which G will be established. Accordingly, those transfers will be excluded from G's gross income pursuant to section 1.468B-2(b)(1) of the regulations to the extent that such transfers do not fall within the exceptions specified by the regulation.

THIRD REQUESTED RULING

In general, payments to settle lawsuits or potential lawsuits are deductible under section 162(a) of the Code if the acts giving rise to the litigation were performed in the ordinary course of the taxpayer's trade or business. See Rev. Rul. 80-211, 1980-2 C.B. 57, and authorities cited therein.

Section 461(h) of the Code states that for purposes of claiming a deduction under section 162(a), the "all events test" of deductibility of an item is not satisfied until economic performance has occurred. Section 461(h)(2)(c) states that economic performance of a tort liability occurs when payments are made. Section 1.468B-3(c)(1) of the regulations provides that, except in situations where a transferor contributes debt or retains a reversionary interest in the contribution, economic performance is deemed to occur when a transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

G is a qualified settlement fund established for the purpose of resolving or satisfying potential tort claims under state law against AA and other potential tort defendants. G's status as a qualified settlement fund makes AA's contributions to it deductible in the year made, pursuant to the interaction of sections 162(a), 461(h), and 468B of the Code and regulations. Accordingly, we conclude that under the representations made in this request, AA may deduct contributions to G in the year of the transfer, and payments on the note in the years that payments are made.

CAVEATS:

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. This office has not verified any of the material submitted in support of the request for rulings. Therefore, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

GERALD M. HORAN
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)

cc: