



Dear \_\_\_\_\_ :

This is in reply to your joint request for rulings dated July 22, 2005, concerning the establishment of Trust pursuant to a confirmation order of the Court in connection with a plan of reorganization under Chapter 11 of the U. S. Bankruptcy Code to resolve or satisfy certain corporate fraud and related securities law claims brought against Company. Specifically, you have requested the following rulings:

1. Trust will be classified as a qualified settlement fund within the meaning of section 1.468B-1 of the Income Tax Regulations for federal income tax purposes;
2. Attorneys' fees paid with respect to the settlement of the Class Action will not constitute gross income of the Class Members or the Trust; and
3. Trust does not have a reporting obligation with respect to payments it makes to the Class Members.

#### FACTS

Company was a publicly-held corporation. Sometime prior to Year 1, certain former senior officers of Company allegedly perpetrated a massive fraud on the shareholders. Specifically, the senior officers caused Company to inflate artificially the value of its stock by issuing false and misleading public statements that overstated earnings and reporting streams of income that did not exist. It is alleged that during the period of these misrepresentations, the officers sold hundreds of millions of dollars worth of their stock and secreted the proceeds offshore.

In Year 1, the shareholders of Company learned of the alleged fraud and filed lawsuits in federal court seeking to recover damages for violations of the antifraud provisions of the Securities and Exchange Act of 1934. The lawsuits were subsequently consolidated into one opt-out class action lawsuit in the Court. In light of the class action lawsuit, Company filed for bankruptcy protection from its creditors under chapter 11 of the Bankruptcy Code to avoid protracted litigation and to settle the claims of the class action plaintiffs (the "Class Members").

Pursuant to the plan of reorganization, Trust was created under the laws of State and evidenced by a liquidating trust agreement dated as of Date 1. The trust agreement provides, in part, that Trust "is organized for the primary purpose of litigating the Trust Claims, distributing the proceeds of the Trust Claims and the Proceed Assets to the Class Members and liquidating its assets for the benefit of the Class Members, all in accordance with Treasury Regulation § 301.7701-4(d), with no objective to continue or engage in the conduct of a trade or business except to the extent reasonably necessary to, and consistent with, the liquidating purposes of the Trust." In other words, according to the parties, "[t]he primary purpose of the Trust is to recover as much cash

as possible from Company's causes of action and assets contributed to the Trust in order to distribute the proceeds to the Class Members in satisfaction of their claims against Company and other parties." Under the terms of the plan of reorganization, the Class Members would assign to Trust their causes of action that could have been asserted under the class action lawsuit and all of their claims against Company arising from the purchase of Company stock during the period of the alleged fraudulent activity (the "Class Period"). The Class Members consist of all persons and entities with securities claims on account of any transaction during the Class Period that choose not to opt out of the class action settlement.

On Date 1, the Court entered a confirmation order confirming Company's plan of reorganization. In accordance with the plan, the representatives of the Class Members, on behalf of the Class Members, received approximately A of the stock of Subsidiary, a wholly-owned subsidiary of Company, and B of the beneficial interest in Trust that was established to liquidate and/or recover on assets transferred to it by Company. The plan of reorganization also provided that class counsel fees, in an amount ultimately approved by the Court, are to be paid from the assets of Trust. The remaining C of stock in Subsidiary was distributed to Company's shareholders of record as of the business day prior to the confirmation date in complete liquidation of Company (outside of Trust).

On Date 2, the Court entered its order and final judgment approving the settlement of the class action lawsuit as provided in the plan of reorganization, awarding attorneys' fees and out-of-pocket costs of class counsel, and retaining jurisdiction of the case pending the complete administration of Trust in accordance with the plan of reorganization, among other appropriate relief.

As contemplated by the plan of reorganization and the Court's order and final judgment, Trust operations consist of the receipt of litigation recoveries and settlement proceeds and the payment of its administrative and operating expenses, legal fees and distributions to the Class Members.

In addition to the property received by Trust in Year 1, in Year 4, in excess of \$ W of additional proceeds were recovered by Trust from one of Company's former officers. On Date 3, Trust distributed approximately \$ X to the Class Members, \$ Y to Subsidiary, and approximately \$ Z in legal and trustee fees.

### LAW AND ANALYSIS

#### 1. Classification of Trust as a Qualified Settlement Fund

Section 468B(g) of the Code 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. Pursuant to the authority of section 468B(g), the

Secretary has published sections 1.468B-1 through 1.468B-5 of the regulations regarding qualified settlement funds.

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account, or trust that satisfies all three 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 it 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 continued 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; (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).

Section 1.468B-1(b) provides, in part, that if a fund, account, or trust that is a qualified settlement fund could be classified as a trust within the meaning of section 301.7701-4, it is classified as a qualified settlement fund for all purposes of the Code.

Section 1.468B-1(h)(2) provides that if a fund, account, or trust is established to resolve or satisfy claims described in section 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, the three requirements of section 1.468B-1(c) are satisfied, and as such, Trust is a qualified settlement fund for federal income tax purposes. First, Trust is established pursuant to an order of the Court dated Date 1 over which the Court retains jurisdiction during Trust's complete administration. See § 1.468B-1(c)(1). Second, Trust is established to resolve or satisfy claims brought by the Class Members against Company for damages allegedly sustained as a result of securities fraud and related securities law claims. See § 1.468B-1(c)(2). Third, Trust is a trust under the laws of State evidenced by a validly executed liquidating trust agreement. See § 1.468B-1(c)(3). The fact that the trust agreement stated that the trust is a trust as described in section 301.7701-4 (regarding the classification of a grantor trust) is not determinative, since Trust is a qualified settlement fund within the meaning of section 1.468B-1(a), Trust is a qualified settlement for all purposes of the Code. See § 1.468B-1(b). Finally, the fact that other claims have been paid by, or will be paid by, Trust (e.g., attorneys' fees and distributions to Subsidiary) does not prevent Trust from being treated as a qualified settlement fund, since the other types of claims arise from the same event or related series of events. See § 1.468B-1(h)(2).

## 2. Attorneys' Fees Paid by Trust Not Income to Class Members or Trust

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived. Section 1.61-1(a) provides that gross income includes income realized in any form. Gross income is an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion. See Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955); 1955-1 C.B. 207.

Generally, a taxpayer must include in gross income that portion of taxable damages paid to his or her attorney as attorneys' fees, even if the defendant makes the payment directly to the taxpayer's attorney. See Comm'r v. Banks, 125 S.Ct. 826 (2005); Alexander v. Comm'r, 72 F.3d 938 (1<sup>st</sup> Cir. 1995); Baylin v. U. S., 43 F.3d 1451 (Fed. Cir. 1995). However, this rule does not apply to payment of attorneys' fees to class counsel resulting from settlement of an opt-out class action lawsuit. Payments made to class counsel in an opt-out class action are not income to the class members. In opt-out class actions, a class member obtains the benefits of an opt-out class action merely by coming within the definition of the class, unless the member affirmatively excludes himself from the lawsuit. The Service has consistently ruled that this result is in line with situation 3 of Rev. Rul. 80-364, 1980-2 C.B. 294. In situation 3 of Rev. Rul. 80-364, a union filed claims on behalf of its members against a company due to a breach of a collective bargaining agreement. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, that provided 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 union for attorney's fees was a reimbursement for expenses incurred by the union and not includible in the gross income of the union members.

Based on the above, amounts paid, or to be paid, by Trust to compensate class counsel are not gross income to the Class Members in this opt-out class action where the members have not personally agreed to compensate class counsel. Note that this conclusion is limited to the particular facts of this case. See cf. Sinyard v. Comm'r, T.C. Memo 1998-364, aff'd, 268 F.3d 756 (9<sup>th</sup> Cir. 2001), cert. denied sub nom, Sinyard v. Rossotti, 536 U.S. 904 (2002) (settlement of opt in class action pursuant to Age Discrimination in Employment Act where class members had contingency fee agreements with counsel); Fredrickson v. Comm'r, T.C. Memo 1997-125, aff'd in unpub. opinion, 97-71051 (9<sup>th</sup> Cir. 1998) (settlement of mandatory, Title VII class action where class members personally signed settlement agreements providing for compensation of counsel).

Similarly, amounts paid, or to be paid, by Trust to compensate class counsel are not gross income to Trust. Section 1.468B-2(b)(1) provides that 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 gross income. However, dividends on stock of a transferor (or a related person), and payments in compensation for late or delayed transfers, are not excluded from gross income. It should be noted that Trust is not entitled to deduct the attorneys' fees for class counsel as administrative costs and other incidental expenses incurred in connection with the operations of the Trust. See § 1.468B-2(b)(2).

### 3. No Reporting Obligations With Respect to Payments to the Class Members

Section 1.468B-2(l)(2)(i) provides that payments and distributions by a qualified settlement fund are subject to the information reporting requirements in sections 6031 through 6060 of the Code.

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 section 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.

Except as otherwise provided, section 6041(a) requires information reporting from all persons engaged in a trade or business who make payments in the course of the trade or business to another person, of rent, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, or other fixed or determinable gains, profits, and income of \$600 or more. Section 1.6041-1(c) provides that income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. Where the determination of the recipient's gross income inclusion of an amount is based on the knowledge of the recipient's basis and the payer lacks such information, the amount to be paid is not a payment of fixed or determinable amount of gains, profits, or income. See e.g., Rev. Rul. 80-22, 1980-1 C.B. 286 (payment of insurance proceeds not a payment of a fixed or determinable amount of gains, profits, or income, where the determination of the recipients gross income inclusion of the insurance proceeds is based on the knowledge of the recipient's basis and the insurance company lacks such information). In addition, section 111(a) of the Code provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of federal income tax imposed.

Section 6045(a) requires every person doing business as a broker to make a return, disclosing gross proceeds, when required by the Secretary and in accordance with the regulations as the Secretary may prescribe.

Section 6045(c) defines broker as a dealer, a barter exchange, and any other person who (for a consideration) regularly acts as a middleman with respect to property or services. Pursuant to section 1.6045-1(a)(1), the term broker means any person that in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others. The term "sale" means any disposition of securities, commodities, regulated futures contracts, or forward contracts for cash, and includes redemptions of stock, retirements of indebtedness, and entering into short sales. See § 1.6045-1(a)(9).

Section 6045(f) requires any person engaged in a trade or business and making a payment in the course of such trade or business to file information returns with respect to any payment to an attorney in connection with legal services, unless such payment is reportable under section 6041(a) or section 6051.

Section 1.6041-1(d)(2) provides that fees for professional services paid to attorneys are required to be reported in returns of information if paid by persons engaged in a trade or business and paid in the course of such trade or business.

Based on the facts represented, Trust does not have a reporting obligation with respect to payments it makes to the Class Members. The payments from Trust to the Class Members are not payments of rent, salaries, wages, premiums, annuities, compensation, remunerations, and emoluments. Moreover, the payments from Trust to the Class Members are not payments of fixed or determinable gains, profits, and income of \$600 or more. A distribution from Trust may be includible in the gross income of a Class Member to the extent that the Class Member derived any federal income tax benefit from a previous deduction taken by the Class Member. However, Trust is unaware of whether a Class Member took a deduction in a previous year and the amount by which such a deduction reduced the Class Member's federal income tax liability. In addition, Trust does not know a Class Member's basis in the stock. Thus, Trust is unable to determine if a distribution to a Class Member is includible in the gross income of the Class Member and the amount of the gross income inclusion, if any.

Finally, distributions from Trust to the Class Members are not reportable under section 6045 because Trust is not a broker within the definition of section 6045(c)(1) and regulations 1.6045-1(a)(1).

### CONCLUSIONS

Based solely on the information provided and the representations made, we conclude as follows:

1. Trust will be classified as a qualified settlement fund within the meaning of section 1.468B-1 of the Income Tax Regulations for federal income tax purposes;

2. Attorneys' fees paid with respect to the settlement of the Class Action will not constitute gross income of the Class Members or the Trust; and

3. Trust does not have a reporting obligation with respect to payments it makes to the Class Members.

The rulings contained in this letter are based upon information and representations submitted by Taxpayers and accompanied by a penalty of perjury statement executed by the appropriate parties. 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.

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 taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

Sincerely,

Jeffery G. Mitchell  
Branch Chief, Branch 6  
(Income Tax & Accounting)

cc: