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Private Letter Ruling 200602017

Designated Settlement Funds

September 28, 2005

Release Date: 1/13/2006

In Re: * * *

LEGEND:

Fund = * * *

Life Insurance Co. = * * *

Department = * * *

citation = * * *

Court = * * *

Year 1 = * * *

Date 1 = * * *

Date 2 = * * *

Date 3 = * * *

Date 4 = * * *

Dear * * *:

This is in reply to your letter dated May 17, 2004, as supplemented with additional information provided on November 16, 2004, September 19, 2005, and September 23, 2005, submitted on behalf of the Fund, requesting the following rulings:

- (1) That the Fund is a qualified settlement fund (QSF) under section 1.468B-1(a) of the Income Tax Regulations (Regulations).
- (2) That the distributions from the QSF received by claimants will be characterized as long term capital gain under section 1222 of the Internal Revenue Code (Code).
- (3) That the Fund is not a transferor for purposes of Code section 6041.
- (4) That the released alleged tortfeasors (insured parties) are the transferors for purposes of Code section 6041.

(5) That the primary carriers of the alleged tortfeasors' insurance policies (insurers) are not the transferors for purposes of Code section 6041.

(6) That [*2] the payments made by the Fund to claimants on behalf of the transferors are payments made in the course of a trade or business to which Code section 6041 applies.

(7) That the Fund is subject to reporting on any payment to a claimant in any taxable year only to the extent the aggregate pro-rata payments made by each insured party to any one claimant during that taxable year are \$ 600 or more.

(8) That the Fund must backup withhold under Code section 3406 on any particular distribution to any one claimant only if the claimant has not previously provided a certified TIN to Life Insurance Co. (acting on behalf of Fund, another settlement fund and itself) and the aggregate pro-rata payment to such claimant for the taxable year is \$ 600 or more.

(9) That the Fund is not subject to reporting under Code section 6041, or backup withholding under Code section 3406, on any amounts held in the QSF for missing Claimants unless and until such amounts are actually distributed to a Claimant.

(10) That the Fund is not required to report or backup withhold with respect to Claimants for the attorneys' fees paid by the Fund from the assets in the QSF.

FACTS

The rulings contained in this letter are based upon information [*3] 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. The material information submitted is summarized below.

In Year 1, a liquidity crisis forced Life Insurance Co., a mutual holding company, to seek protection from State X's Department of Insurance which resulted in Life Insurance Co. being placed in receivership and subsequently in liquidation. Under the laws of State X, once an insurance company is placed in liquidation status, the state appoints a liquidator. As provided under the citation, the liquidator is granted the authority to (1) prosecute any action which may exist on behalf of the creditors, members, policyholders or shareholders of Life Insurance Co. against any officer of the company, or any other person, and (2) exercise and enforce all rights, remedies, and power of any creditor, shareholder, policyholder or member.

Pursuant to the authority granted under the laws of State X, the state appointed liquidator sent demand letters stating that the [*4] liquidator intended to file suit alleging malfeasance and misfeasance by some of the persons whose wrongdoing and/or misfeasance resulted in the

liquidity crisis or hindered discovery of the causes or preliminary indications of the liquidity crisis (the alleged tortfeasors). On Date 1, prior to the filing of such a suit, some of the alleged tortfeasors and their insurers entered into a settlement agreement with the liquidator. On or about Date 2, the liquidator deposited the amounts received pursuant to the settlement agreement into a separate account belonging to a trust formed under the laws of State X. On Date 3, the Court issued an order approving the establishment of a qualified settlement fund (QSF), subject to the Court's continuing jurisdiction, for the purpose of resolving or satisfying the claims of the victims of the alleged wrongdoing committed by the alleged tortfeasors who were released from liability as set forth under the terms contained in said settlement agreement.

On or about Date 4, utilizing a portion of the assets held in the Fund, the liquidator paid attorneys' fees [*5] related to the settlement. The liquidator paid the attorney fees to counsel as part of the liquidator's statutory duties to acquire and preserve the assets available to Claimants and none of the Claimants personally agreed to compensate counsel chosen by the liquidator.

The Fund anticipates distributing a portion of the settlement amount, less operating expenses and attorneys' fees, to each Claimant in one payment. Notwithstanding the efforts of the liquidator, Life Insurance Co., and the Fund, a large number of Claimants have not been located. The Fund will maintain records and will distribute amounts owed to these missing Claimants as they are located. However, it is likely that some of the assets held by the Fund will escheat and be paid over to and held by Department pursuant to State X's unclaimed property laws.

LAW AND ANALYSIS

Qualified Settlement Fund/Transferors (Issues #1, #3, #4 & #5)

Section 468B(g) provides that "[n]othing 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 Secretary shall prescribe regulations providing for taxation of any such account or fund whether as [*6] a grantor trust or otherwise." Pursuant to such authority, the Secretary has published sections 1.468B-1 through 1.468B-5 of the Regulations regarding QSFs.

Under sections 1.468B-1 (a) and (c), a fund, account, or trust is a QSF if:

(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 arising out of a 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 persons).

Under section 1.468B-1(d) of the Regulations, a "transferor" is a person that transfers (or on behalf of whom an insurer or other person transfers) money or property [*7] to a QSF to resolve or satisfy the claim or liability.

On Date 3, the Fund met the first and second requirements of section 1.468B-1(c). On that date, the Court issued an order approving the establishment of the QSF, subject to the Court's continuing jurisdiction, for the purpose of resolving or satisfying the claims of the victims of the alleged malfeasance and misfeasance of some of the former officers and directors of Life Insurance Co. and its former subsidiaries (the alleged tortfeasors). On or about Date 2, the Fund, a trust formed under the laws of State X, met the third requirement of section 1.468B-1(c) when the liquidator deposited into the Fund's separate account, the amounts received pursuant to the settlement agreement executed on Date 1. Therefore, as was asked in issue #1, the Fund is a QSF.

Since, under section 1.468B-1(c), the assets of a QSF must be segregated from the assets of a transferor, a QSF cannot be a "transferor" to itself. Further, although the insurers of some of the alleged tortfeasors transferred monies to the Fund in order to secure the release of these alleged tortfeasors pursuant to the settlement agreement, the released alleged tortfeasors (and not [*8] the insurers) are the "transferors" by definition under section 1.468B-1(d), since the monies were transferred on their behalf. Therefore, as was asked in issues #3, #4 and #5, respectively, the Fund is not the transferor; the insured parties are the transferors; and the insurers are not the transferors.

Distributions or Payments to Claimants

Characterization (Issue #2)

Section 1.468B-4 of the Regulations provides that whether a distribution is includible in the income of a recipient is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor.

Section 6.06 of Rev. Proc. 2005-1, 2005-1 I.R.B. 1, 14, provides that the Service generally does not issue letter rulings where the request does not address the tax status, liability, or reporting obligations of the requester. Under this provision, we decline to rule on whether the distributions received by claimants will be characterized as long term capital gain under section 1222 of the Code (issue #2) because the requester (the Fund) is not a claimant.

Information Reporting (Issues #6, #7 & #9)

Section 1.468B-2(l)(2)(i) provides that, in general, [*9] "[p]ayments and distributions by a qualified settlement fund are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code (Code), and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C of the Code." Section 1.468B-2(l)(2)(ii) of the Regulations provides that, for purposes of sections 6041(a) and 6041A, if a QSF makes a distribution or payment on behalf of a transferor or a claimant, the QSF is deemed to make the distribution or payment in the course of a trade or business.

Section 6041 of the Code requires all persons engaged in a trade or business and making payment in the course of such trade or business (the "payor") 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 (the "reporting threshold"), to file an information return with the Service and to furnish an information statement to the payee.

Section 1.6041-1(c) of the Regulations provides that payments are fixed when they are paid in amounts definitely predetermined. Income is determinable [*10] whenever there is a basis of calculation by which the amount to be paid may be ascertained. Section 1.6041-1(a)(2) of the Regulations requires a payor to report section 6041 amounts on Form 1099.

Section 1.6041-1(h) of the Regulations provides:

When payment deemed made. For purposes of a return of information, an amount is deemed to have been paid when it is credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and is made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

Therefore, because the Fund is a QSF (for the reasons set forth hereinabove with respect to issue #1), the distributions or payments it makes on behalf of a transferor or claimant are deemed made in the course of its trade or business, as was asked in issue #6.

Section 1.468B-2(l)(1) of the Regulations provides that, in general, payments and distributions by a QSF are subject to the information reporting requirements. As more fully described in the preamble to the final regulations, this rule was not intended to impose a greater burden with respect [*11] to information reporting than existed before the enactment of section 468B. See, T.D. 8459, 58 F.R. 11537, as corrected by 58 F.R. 13706 (February 26, 1993), and reprinted at 1993-1 C.B. 69, 71-2 (1993). During the notice and comment period preceding finalization of the rule, the Service was asked to clarify the extent of a QSF's reporting obligation if some, but not all, of its multiple transferors would have a reporting obligation had each transferor made a payment directly to the claimant. Id. In response, and intended to simplify the administrability of the rule, section 1.468B-2(l)(2)(ii) of the final Regulations provides that if even one of the transferors would have been subject to the information reporting requirements had that transferor been the payor (instead of the QSF), then the QSF is subject to the information reporting requirements. However, section 1.468B-2(l)(2)(ii) was not intended to and does not permit a QSF to avoid the information reporting requirements by first allocating the amount of the payment amongst the multiple transferors, next deeming each of them to be a separate and distinct payor, and then testing each deemed payor's payment against the \$ 600 [*12] reporting threshold. Therefore, for purposes of determining whether the \$ 600 reporting threshold has been met (issue #7), the Fund is treated as the sole payor and the \$ 600 reporting threshold is measured at that (the Fund's) level.

With respect to issue #9, the Fund has no reporting obligation with regard to missing claimants until amounts are distributed to a missing claimant because, until a missing claimant is located, there remains a substantial limitation or restriction as to the time or manner of payment.

Backup Withholding (Issues #8 & #9)

Section 3406(a) of the Code provides that, in the case of any reportable payment and where certain circumstances exist (e.g., the payee fails to furnish the payor a taxpayer identification number (TIN) in the required manner), the payor shall deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under section 1(c) and such payment.

Section 3406(b)(1) provides that the term "reportable payment" means any reportable interest or dividend payment, and any other reportable payment. Section 3406(b)(3) defines other reportable payments as any payment of a kind, and to a payee, required to be [*13] shown on a return required under Code sections 6041, 6041A, 6045, 6050A, or 6050N. Section 3406(b)(6) provides:

Other reportable payments include payments described in section 6041(a) or 6041A(a) only where aggregate for calendar year is \$ 600 or more.--Any payment of a kind required to be shown on a return required under section 6041(a) or 6041A(a) which is made during any calendar year shall be treated as a reportable payment only if --

(A) the aggregate amount of such payment and all previous payments described in such sections by the payor to the payee during such calendar year equals or exceeds \$ 600,

(B) the payor was required under section 6041(a) or 6041A(a) to file a return for the preceding calendar year with respect to payments to the payee, or

(C) during the preceding calendar year, the payor made reportable payments to the payee with respect to which amounts were required to be deducted and withheld under subsection (a).

The backup withholding rules of section 3406 apply to distributions to the claimants if they are reportable under any one of the subsections listed in section 3406(b). As discussed above, the Fund may be required to report the payments it will make to Claimants. [*14] However, the Fund will not have either a filing requirement or a backup withholding obligation for the preceding year, so neither section 3406(b)(6)(B) nor (C) is applicable. Thus, as asked in issue #8, only to the extent that payments to a claimant are reportable under section 6041 and the claimant fails to furnish a TIN to the Fund, the Fund will be required to backup withhold pursuant to section 3406.

Further, as asked in issue #9 and as discussed above, the Fund has no reporting obligation with regard to a missing claimant until amounts are distributed to a missing claimant. A fortiori, the backup withholding rules of section 3406 do not apply to missing claimants unless and until such claimants receive a payment.

Payment of Attorneys' Fees (Issue #10)

Section 61 of the Code 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, 75 S. Ct. 473, 99 L. Ed. 483, 1955-1 C.B. 207 (1955); 1955-1 C.B. 207.

When a payment is made to satisfy the obligation [*15] of a taxpayer to a third party, the amount of the payment is generally includible in the taxpayer's gross income. *Old Colony Trust v. Commissioner*, 279 U.S. 716, 49 S. Ct. 499, 73 L. Ed. 918, 1929-2 C.B. 222 (1929). Even though the taxpayer never actually receives such payment, he receives the benefit of the payment, and the amount is therefore gross income to him (or her). Under the rationale of *Old Colony Trust*, a prevailing litigant must generally recognize gross income when another party pays attorneys' fees for which the litigant is liable.

Where a taxpayer may receive a benefit of litigation but is not liable for payment of attorneys' fees incurred in connection with such litigation, a different result may obtain, e.g., certain opt-out class action lawsuits where no contractual liability for a fee exists between the class member and litigating counsel.

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 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 [*16] the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for attorney's 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 attorney's fees was a reimbursement for expenses incurred by the union and was not includible in the gross income of the union members.

The expenses incurred in the instant case by the state appointed liquidator were incurred as part of that official's statutory duties to prosecute actions on behalf of the creditors, members, shareholders, and policyholders of Life Insurance Co., and to marshal, acquire, preserve and liquidate assets on behalf of such members, etc. The state appointed liquidator has the exclusive power to exercise rights of the insurance company's members, including assertions of any causes of action that would otherwise have belonged to such members. The liquidator incurred the liability for such fees and none of the member/claimants personally agreed to compensate counsel chosen by the liquidator.

Therefore, payments for attorneys' fees made by the Fund to counsel retained by the state appointed liquidator [*17] in the settlement of the subject litigation are not income to the member/claimants on whose behalf the action was prosecuted. The retention and payment of counsel by chosen by the liquidator is analogous to Situation 3 in *Rev. Rul. 80-364*, 1980-2 C.B. 294. Our conclusion that the attorneys' fees paid by the Fund are not income to the Claimants is specific to the facts of this case. See *cf. Sinyard v. Commissioner*, T.C.M. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001), *cert. denied sub nom, Sinyard v. Rossotti*, 122 S.Ct. 2357 (2002), and *Fredrickson v. Commissioner*, T.C. Memo 1997-125, *aff'd in unpub. Opinion*, 97-71051 (9th Cir. 1998).

Therefore, as to issue #10, because the payment for attorneys' fees is not income to the Claimants, the Fund has no reporting obligation under section 6041 and no backup withholding obligation under section 3406 with respect to these payments.

CONCLUSION

Accordingly, based strictly on the information submitted and representations made, we conclude:

- (1) The Fund is a qualified settlement fund under section 1.468B-1.
- (2) The Fund is not eligible to receive a ruling on the characterization of the distribution(s) in the hands of the claimants.
- (3) The Fund is not the transferor [*18] under section 1.468-2 for purposes of Code section 6041.
- (4) The released alleged tortfeasors are the transferors under section 1.468-2 for purposes of Code section 6041.
- (5) The insurers are not the transferors under section 1.468-2 for purposes of Code section 6041
- (6) The Fund is the payor subject to reporting as provided in section 6041 on any payment or distribution to a Claimant.
- (7) The payments made by the Fund to Claimants on behalf of the transferors are payments made in the course of a trade or business to which Code section 6041 applies.
- (8) The Fund must backup withhold under Code section 3406 on any payment or distribution to a Claimant if that Claimant has not previously provided a certified TIN.
- (9) The Fund is not subject to either reporting under Code section 6041 or backup withholding under Code section 3406 on any amounts held by it for missing Claimants unless and until such amounts are actually distributed to the Claimant.
- (10) The Fund is not required to report or backup withhold with respect to Claimants for the attorney's fees paid by the Fund from the assets in the QSF.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of [*19] 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.

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

Sincerely,

George Baker
Branch Chief, Branch 7
(Income Tax & Accounting)

cc: * * *