You requested advice concerning the characterization of gain or loss from the sale of securities reported on Forms 1120-SF, U.S. Income Tax Return for Settlement Funds (Under Section 468B), filed by (the Trust), a qualified settlement fund (QSF). On its original Form 1120-SF, the Trust reported capital gain from the sale of securities. On its Form 1120-SF, the Trust treated losses from the sale of securities as ordinary losses and included them in the calculation of its net operating loss (NOL). The Trust subsequently amended its Form 1120-SF and recharacterized as ordinary income the amount originally reported as capital gain income. The Trust also claimed a NOL carryback from the taxable year ended on its amended Form 1120-SF. This advice has been coordinated with the Associate Office of Chief Counsel, Income Tax & Accounting.

This opinion is based on the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts herein are determined to be incorrect, this opinion should not be relied upon. This memorandum should not be cited as precedent.
1. Whether the Trust may include ordinary losses from the sale of securities in the calculation of its NOL on its Form 1120-SF.

2. Whether the Trust correctly treated the sales of its securities on its Form 1120-SF and its amended Form 1120-SF as producing ordinary losses/income instead of capital gains/losses.

Conclusions

1. Treasury Regulation § 1.468B-2(b) does not permit a QSF to deduct any ordinary losses nor does it permit ordinary losses to be included in a NOL of a QSF. Therefore, if the Trust treats the sales of its securities as sales producing ordinary losses, it should not include those purported losses in the calculation of its NOL on its Form 1120-SF.

2. The Trust should have treated the sales of its securities on its Form 1120-SF and its amended Form 1120-SF as producing capital losses/gains instead of ordinary losses/income.¹

Facts

We understand the relevant facts here to be as follows:

The Trust was established by order of the U.S. , as a result of a submitted by .

The Trust assumed the tort liabilities of relating to damage attributable to .

The (the Trust Agreement), dated provides that:

1. The Trust is to use its assets and/or income to liquidate and pay claims against .

¹ Please note that this memorandum does not address: (1) the specific amount of any NOL or capital loss carryback allowable in the taxable year; and, (2) the specific amount of any NOL or capital loss allowable in the taxable year.

² In the was sued by over plaintiffs alleging .
2. The Trust is intended to qualify as a designated settlement fund or a qualified settlement fund and receive the benefits under the Internal Revenue Code of providing for payment of claims.

3. The purposes of the Trust are to: (a) assume the liabilities of and (b) use the Trust’s assets and income to pay holders of valid claims.

4. is to transfer and assign to the Trust certain assets.\(^3\)

5. The Trustees’ powers include:
   a. taking any and all actions as in their judgment are necessary or convenient to effectuate the Trust’s purposes;
   b. transferring, exchanging, or selling any or all of the Trust’s assets as the Trustees consider proper; and,
   c. selling all or any part of the securities included in the Trust’s assets.

6. Article provides:
   a. When the Trust has at least in or should the Trustees conclude it is highly unlikely the Trust will ever have that amount of funds created (the , collectively “the Funds”);
   and,
   b. That the funds held in the Trust are to be invested in the manner in which individuals of ordinary prudence, discretion, and judgment would act in the management of their own affairs.

7. Generally, Trust investments are subject to these limitations:
   a. No more than % or % of the equity in any entity or business enterprise may be acquired;
   b. Only long-term debt securities rated A or higher by Moody’s Investors Service, Inc., securities rated AA or higher by Standard & Poor’s Corporation, securities given an equivalent investment grade rating by another nationally recognized statistical rating agency, or issued or fully guaranteed by the United States or any agency thereof may be acquired or held;
   c. Only commercial paper rated at least Prime-1 by Moody's, rated at least A-1 by S&P, or given an equivalent investment grade may be held more than days;
   d. Only securities traded on a national securities exchange, major international exchange, or on the NASDAQ may be acquired or held;

\(^3\) According to several provided by the Trust, on transferred to the Trust assets totaling . The total assets consisted of the amount of .
e. Only preferred stock rated B or higher by Moody’s, B+ or higher by S&P, or given an equivalent investment grade may be acquired or held; and, 
   f. Only debt securities or other instruments (other than debt securities issued by 
      the United States or any agency thereof), issued by any entity if the aggregate market 
      value of all securities and instruments issued by such entity is less than % or % of 
      the aggregate value of the Trust assets, may be acquired.

8. All payments in respect to claims are to be paid solely out of Trust Assets.

9. The Trust is to terminate after the first occurrence of: (1) the Trustees, in their sole 
   discretion, decide to terminate the Trust because they deem it unlikely that new 
   claims will be filed and all such claims duly filed have been satisfied; 
   or, (2) the Trustees judge that continued administration of the Trust is uneconomic or 
   inimical to the best interests of the claimants and the Court orders that termination of 
   the Trust will not expose to any increased risk of having claims filed against it.

On the Trust engaged to process related claims. 

further below state that the Trust began processing these claims in .

Income Tax Returns, Forms 1120-SF

The Trust produced a copy of a Schedule D, Capital Gains and Losses, for the taxable 
year claiming a net short-term capital loss in the amount of $ and a net long-term capital loss in the amount of $. We have no knowledge of whether any ordinary income was reported on this return.

On its Form 1120-SF for the taxable year, the Trust reported capital gain of $ .

taxable interest in the amount of $. Modified gross income was reported as No was reported and the return included no indication that any ordinary or trade or business income was received in .

The Form 1120-SF for the taxable year reported capital gain in the amount of $ , income in the amount of $ , Modified gross income of , and direct or indirect distributions to claimants in the amount of $. On Schedule L, Balance Sheets, the beginning balance of was $ and the ending balance was $ .

According to this return, the Trust received a Schedule K-1 for . The return contains no indication that any ordinary or trade or business income was received in from the operation of the Trust itself.
The Trust filed its original Form 1120-SF for the taxable year on . That Form 1120-SF:

1. Reported capital gain net income on line 3 in the amount of $ .

2. Claimed a NOL deduction on line 12 in the amount of $. This NOL deduction was calculated by including losses and amounts utilized from the taxable year ended through the taxable year ended . No carryforward to was reported.

3. Reported the amount of $ as Modified gross income, line 14.

4. Reported in the amounts of $ and $ at the beginning and end of the year, respectively.

5. Reported Total assets in the amounts of $ and $ at the beginning and end of the year, respectively.

The Trust filed its Form 1120-SF for the taxable year on . This return: (1) reported capital gain net income of $ on line 3; (2) reported Income of ($ ) on line 5; (3) reported the amount of ($ ) as Modified gross income on line 14; (4) claimed a NOL deduction in the amount of $ on line 12; (5) reported in the amounts of $ and $ at the beginning and end of the year, respectively. The end of year amount consisted of ; and, (6) reported Total assets in the amounts of $ and $ at the beginning and end of the year, respectively.

The Trust’s Form 1120-SF for the taxable year reported: (1) capital gain net income of $ ; (2) income in the amount of ($ ); (3) Modified gross income in the amount of ($ ); (4) a NOL of $ ; (5) of $ at the beginning of the year and $ at the end of the year; and (6) Total assets of $ at the beginning of the year and $ at the end of the taxable year.

On , the Trust filed an amended income tax return, Form 1120-SF, for the taxable year . That amended Form 1120-SF:

1. Characterized the amount of $ on line 5, income, as

2. Claimed a NOL deduction on line 12 in the amount of $. This NOL was related to a NOL in the amount of $ in the taxable year that the Trust carried back to the taxable year in the amount of $. The amended
return showed the amount of $ as available for carryforward to the taxable year.

3. Reported the amount of $ on Line 14, Modified gross income.

4. line 3, capital gain net income.

5. Reported in the amounts of $ and $ at the beginning and end of the year, respectively.

6. Reported Total assets in the amounts of $ and $ at the beginning and end of the year, respectively.

The Note to the amended Form 1120-SF stated, “This tax return is being amended due to a Net Operating Loss Carryback from .”

Trust Financial Information

The Trust received Schedules K-1 as a partner as of the taxable years in the following partnerships:

Each of the Schedules K-1 included short-term capital gain(loss), long-term capital gain(loss), and Other income(loss) that included short-term and long-term capital gain(loss). The Schedule K-1 from for the taxable year

That Schedule K-1 also

Schedule K-1 from

, citing Treas. Reg. §§ 1.469-1T(e)(6) and 1.469-2T(C)(3)(ii)(D). The same Schedule K-1 includes or from taxable income. Neither Schedule K-1 from includes ordinary business income(loss).

According to

for the periods through
Accordingly, pursuant to such investment criteria and recommendations, investments in securities were held in as follows:

According to information provided by the Trust, it held accounts at accounts at and account at . The Trust also held investments in/accounts at

The Trust’s position

Amended Form 1120-SF

In summary, the Trust takes the position that:

1. The Trust is an association taxable as a corporation since it carries on a business under Rev. Rul. 58-442. The Trust further notes that a QSF is subject to I.R.C. § 468B even if a QSF is classified as an association for tax purposes.

2. When assets are held for sale in connection with a trade or business and the proceeds of such assets are less than the tax basis, there is negative gross income. The Trust cites I.R.C. §§ 468B and 61(a)(1) in support of its position, as well as Davis v. United States, 87 F.2d 323 (2d Cir. 1937), cert. denied, 301 U.S. 704 (1937).
3. Treasury Regulation § 1.468B-2(b) provides that a QSF is allowed a NOL deduction to the extent the loss would be deductible in determining the taxable income of a corporation under I.R.C. § 172(a). According to the Trust, that regulation is the only one applicable to trade or business losses of an entity taxable as a corporation (other than the possibility that such losses are administrative costs described in Treas. Reg. § 1.468B-2(b)(2)).

4. The Trust is entitled to the NOL described in I.R.C. § 172(b)(1)(A) unless the election under § 172(b)(1)(H) is made. The Trust claims the amended return reflects such rules.

1. The sale or exchange of Trust assets is not a sale or exchange of capital assets. The Trust notes that it is in the business of holding money and securities it is required to sell in the ordinary course of its trade or business each time a claimant must be paid. Due to the losses from the sale of assets, the Trust incurred losses from the sale of assets.

Accordingly, the Trustees:

The sale of securities was motivated by the Trustees' determination that Just as receipt of property is a necessary incident to the Trust's conduct of its business, so was the decision.

2. The determination of the Trust's “modified gross income” depends upon the aggregate of the Trust’s gross income items from all sources. Such determination of modified gross income considers as one such item a negative amount resulting from the failure to recover the tax basis of assets sold during the taxable year.

According to the Trust, gross income is not the same as gross receipts. A fundamental tax principle in the calculation of gross income is the recovery of the tax basis of assets. Thus, the manner of the securities' losses are to be taken into account in calculating the Trust's modified gross income. “Gross income” can be a negative figure when reduced by such necessary amounts as the tax basis of assets.

3. To the extent the Trust has negative modified gross income, the negative modified gross income, as adjusted for allowed expenses, is a deductible NOL to the same extent as such loss would be allowable to a corporation under I.R.C. § 172(a).

The Trust argues that § 172(a) allows corporate taxpayers a deduction for a taxable year in the amount equal to the aggregate of NOL carryovers to such taxable year plus...
NOL carrybacks to such taxable year. However, for noncorporate taxpayers, the amount deductible for capital losses cannot exceed the amount includible as capital gains. The Trust contends that the provisions of Treas. Reg. § 1.468B-2(b)(4) supersede the definition of a NOL found in § 172(c). Treasury Regulation § 1.468B-2(b)(4) recognizes that incurring business-related losses can result in negative gross income and merits amelioration of the annual accounting impact of such negative amount provided by the NOL rules. For the Trust, the availability of a NOL to a QSF is consistent with the NOL provisions and the regulations relating to the taxation of a QSF that appear to be to maximize the amounts available to fund claimants.

The Trust’s

In support of these three contentions, the Trust variously cites I.R.C. §§ 468B, 61, 165(f) and (g), 1211(a), 1212(a), 172(a), 1(e), and 1001(a), and Treas. Reg. §§ 1.468B-2(a) and (b) and § 1.61-6. It also cites a number of court cases in the alleged to be pertinent to and supportive of the main issues.

Service Actions

By letter dated , the Service advised the Trust that its carryback claim for the taxable year was rejected on . The claim was returned because the original loss year return was not available. The letter further advised the Trust that a timely new claim with supporting information had to be received by . To our knowledge, the Trust did not file any such new claim. The only information available to us regarding this Service action is a copy of the letter sent to the Trust on . We do not have a copy of the referenced “carryback claim” unless the , the original and amended Form 1120-SF, and the amended Form 1120-SF constitute the “carryback claim.” Neither do we know why this letter states that the original loss year return was not available as of the date of the letter. Should this request for advice pertain to reconsideration of a previously rejected refund claim, please promptly advise this office. Further coordination with the Office of Chief Counsel will be needed if LB&I is asking for advice on a previously rejected refund claim.
The Trust’s submission (the submission) raised arguments concerning Treas. Reg. § 301.7701-4(a) and Rev. Rul. 58-442 (that is, the Trust is engaged in business since it would be classified as a business entity treated as an association). In further support of those arguments, the Trust relied on Sears, Roebuck & Co. Employees’ Savings and Profit Sharing Fund v. Commissioner, 45 F.2d 506 (7th Cir. 1930). This submission also discussed the business of , and cites Brooklyn Trust Co. v. Commissioner, 80 F.2d 865 (2d Cir. 1936), Rev. Rul. 74-159, Gerard Trust v. Corn Exchange Bank, 22 T.C. 1343 (1954), Guardian Industrial Corp. v. Commissioner, 97 T.C. 308 (1991), aff’d, 73 A.F.T.R.2d 1903 (6th Cir. 1994), and Goldsmith v. Commissioner, 143 F.2d 466 (2d Cir. 1944)(concurring opinion).

As to its trade or business, the Trust states: (1) the assignment of the obligation to deal with mass tort liabilities with the creation of a trust to which assets were transferred to dispose of such claims is that entity’s business; (2) the business of the Trust is to manage a complex and long-lived claims administration process; (3) the Trustees hold assets for disposition in connection with the Trust’s business of meeting current and anticipated claims over a significant period of time; (4) the Trust’s assets were acquired with the intention of their sale and investment in order to meet payment obligations; and, (5) the assets of the Trust were acquired for and were held for sale to customers in the ordinary course of the Trust’s business of managing and paying tort claims. The Trust also states that it is important to determine whether asset sales are made in the ordinary course of a business to customers under I.R.C. § 1221(l).

**IDR response dated**

In its response to IDR No. 3, the Trust stated:

1. It did not hold itself out to any third party as a dealer in securities or a trader in securities. Securities were sold on a public exchange as part of the Trust’s legal obligation to utilize all assets in its business of administering the disposition of claims.

2. The Trust engaged various brokerage firms to manage certain of its assets received in to meet its obligations to pay claims in accord with .

3. The Trust first engaged in the trade or business of holding money and securities as of .

4. The Trust devoted full time to its obligation to administer and pay claims.

5. In order to obtain a return that would enhance its ability to make payments to tort victims, the Trust invested its assets.
IDR response dated

In response to IDR No. 4, the Trust stated: (1) the Trustees review the investment and the relationship of the investment return assumptions to the payment percentage; (2) attention is paid at Board of Trustee meetings as necessary to asset allocations and the performance of investment managers within such allocations; (3) the Trustees decide the allocation of Trust assets among asset classes; (4) the Trustees decided whether to make a particular investment in particular securities; (5) in cases involving the selection of funds available for investment in the asset class; (6) the choice of the particular security within that asset class is made by the; (7) the Trustees continually and on a monthly basis review performance; (8) was engaged to advise with respect to each performance; (9) the Trust does not choose the Trust’s purpose is dealing with current and anticipated emerging claims and all assets are held to meet these obligations; and, (11) the Trust may buy and sell assets to maximize its ability to deal with emerging claims. Further, the Trust’s management business and management of the funds is dictated by the requirements of the. The Trust also stated that it will eventually terminate as provided for in the Trust Agreement, but does not expect claims and assets to be exhausted until.

Documents provided confirm that the Trustees reviewed and decided asset allocations, reviewed performance of the, decided whether to invest in, and determined the amount of funds available for investment in any particular asset class. The documents also show that the Trust’s choose particular securities and the Trust did not choose the actual investment. The Trust further advised that it held several accounts at due to

According to the information provided by the Trust, since those

According to the Trust’s, the Trustees: (1) are responsible for hiring managers and investment advisors and reviewing recommended asset mix or allocations; (2) are responsible for setting long term goals and objectives; (3) shall adopt an Asset Allocation Model which provides for its investment advisors to diversify investments in cash, fixed income securities, equity securities, and alternative investments to provide a balanced positive total return without having undue risk; (4) review quarterly the investment performance and asset allocations; and, (5) review portfolio performance. Most importantly, the Statement provides that the
In support of its position that the Trust is an association or an insurance company for tax purposes and not a trust, the Trust cites Rev. Rul. 83-132, several private letter rulings issued in the 1960s pertaining to trusts treated as insurance companies for tax purposes, cases decided by the Board of Tax Appeals reaching the same conclusion, and a series of General Counsel Memoranda issued in the 1970s on the subject of self-insured employer-provided life insurance.

Analysis:

1. The Trust may not include losses from the sale of securities in the calculation of its NOL on its Form 1120-SF.

The Trust is a QSF under I.R.C. § 468B

Treasury Regulation § 1.468B-1(a) provides that a QSF is a fund, account, or trust that satisfies the requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the 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, § 1.468B-1(c)(2) requires that the 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, § 1.468B-1(c)(3) provides that the 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).

The facts here show the Trust meets the three requirements of Treas. Reg. § 1.468B-1(c) and therefore is a QSF. First, the Trust was established by court order and is subject to the continuing jurisdiction of the court. Second, per the Trust Agreement, the acknowledged purpose of the Trust was to use its assets and/or income to liquidate and pay claims against . Thus, the Trust was established to resolve or satisfy contested or uncontested claims that have resulted or may result from a related series of events that have occurred and that have given rise to at least one claim asserting liability arising out of a tort. Third, the contributed funds are physically segregated from other assets of (and related persons). The contributed funds are held in the accounts noted above separate from other assets.
In addition, the Trust filed Forms 1120-SF and the Trust Agreement states responses that the Trust acknowledges that it is a QSF.

The taxation of a QSF under the § 468B regulations

Treasury Regulation § 1.468B-2(a) provides that a QSF is a United States person and is subject to tax on its modified gross income for any taxable year at a rate equal to the maximum rate in effect for the taxable year under I.R.C. § 1(e). Treasury Regulation § 1.468B-2(b) provides that the modified gross income of a QSF is its gross income, as defined in I.R.C. § 61, computed with certain modifications.

Treasury Regulation § 1.468B-2(b)(2) allows a deduction for administrative costs and other incidental expenses incurred in connection with the operation of the QSF that would be deductible under Chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operation of the QSF, and expenses arising from the notification of claimants and the processing of their claims.

Treasury Regulation § 1.468B-2(b)(3) allows a deduction for losses sustained by a QSF from the sale, exchange, or worthlessness of property to the extent the losses would be deductible in determining the taxable income of a corporation under I.R.C. §§ 165(f) or (g), and under §§ 1211(a) and 1212(a). Section 165(f) provides that losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in §§ 1211 and 1212, and § 165(g) provides rules applicable when securities that are capital assets become worthless during the taxable year. Section 1211(a) provides that, in the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from sales or exchanges. Section 1212(a) provides, in relevant part, that corporate taxpayers can carry net capital losses back to the three taxable years preceding the loss year and then forward to the five taxable years succeeding the loss year. Also, the carryback of a net capital loss cannot increase or produce a NOL (as defined in I.R.C. § 172(c)) for the taxable year to which it is being carried back. I.R.C. § 1212(a)(1)(A)(ii).

Treasury Regulation § 1.468B-2(b)(4) allows a deduction for the amount of a NOL of a QSF to the extent the loss would be deductible in determining the taxable income of a corporation under § 172(a). For this purpose, the NOL of a QSF for a taxable year is the amount by which the deductions allowed under §§ 1.468B-2(b)(2) and 1.468B-2(b)(3) exceed the gross income of the fund. Ordinary losses that arise from the sale, exchange, or worthlessness of property are not deductible under § 1.468B-2(b)(2) or (3); as described above, § 1.468B-2(b)(2) allows a deduction for certain administrative costs and other incidental expenses, and § 1.468B-2(b)(3) allows a deduction for
capital losses. Thus, ordinary losses are not taken into account in calculating a NOL under Treas. Reg. § 1.468B-2(b).

The treatment of the Trust’s losses from the sale of securities in

In taxable years prior to the Trust’s sales of securities resulted in overall gains. The Trust reported these as sales producing capital gains/losses on its original Forms 1120-SF.

Starting with its Form 1120-SF, however, the Trust reported the sales of securities as sales producing ordinary losses/income. The Trust incurred losses in from selling securities because of . The Trust used these purported ordinary losses in the calculation of its NOL for A NOL has a longer carryforward period (20 years) than a capital loss carryforward (5 years). On the Trust’s amended Form 1120-SF, it carried back part of the NOL and accordingly increased its NOL deduction.

As discussed in the preceding section, Treas. Reg. § 1.468B-2(b) does not permit ordinary losses from the sales of securities to increase a NOL of a QSF. Consequently, if the Trust treats the sales of its securities as sales producing ordinary losses, it may not include these sales in its NOL calculation.

The Trust’s arguments that ordinary losses can increase a QSF’s NOL are meritless

In spite of the plain language of Treas. Reg. § 1.468B-2(b), the Trust asserts that it may increase a NOL by ordinary losses because (1) it could be classified as an association taxable as a corporation and thus allowed a larger NOL under the provisions of I.R.C. § 172 and (2) it has a negative modified gross income that permits the claimed larger NOL.

With respect to the first argument, Treas. Reg. § 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 301.7701-4 of this chapter, it is classified as a qualified settlement fund for all purposes of the Internal Revenue Code (Code). If a fund, account, or trust, organized as a trust under applicable state law, is a qualified settlement fund, and could be classified as either an association (within the meaning of § 301.7701–2 of this chapter) or a partnership (within the meaning of § 301.7701–3 of this chapter), it is classified as a qualified settlement fund for all purposes of the Code.

Although the Trust admits it is a QSF, it argues that absent this classification, it would be classified as an association taxable as a corporation and therefore entitled to a NOL carryback as claimed on the amended Form 1120-SF. This argument is meritless.

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As noted previously, the Trust recharacterized the sales of its securities from sales producing capital gain to sales producing ordinary income on its amended Form 1120-SF.
under the plain language of Treas. Reg. § 1.468B-1(b). Additionally, as noted above, if an association meets the three requirements of a QSF pursuant to Treas. Reg. § 1.468B-3(c), it is subject to taxation as a QSF under Treas. Reg. § 1.468B-2; application of the QSF rules are not elective. See Preamble to T.D. 8459. Thus, the Trust’s argument that it is classified as a QSF but taxed as a corporation is meritless under the plain language of the I.R.C. § 468B regulations and the Preamble to these regulations; there is no authority for the Trust’s proposed hybrid classification.

The Trust’s second argument is that it has negative modified gross income resulting from the failure to recover the tax basis of assets sold during the taxable year and that permits it to claim a larger NOL under Treas. Reg. § 1.468B-2(b)(4). Treasury Regulation § 1.468B-2(b) provides that the modified gross income of a QSF is its gross income, as defined in I.R.C. § 61, computed with certain modifications.

Section 61(a) provides generally that gross income means all income from whatever source derived, except as otherwise provided in subtitle A. Section 61(a)(3) provides that gross income includes “gains derived from dealings in property.” See also Treas. Reg. § 1.61-6. Internal Revenue Code § 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in I.R.C. § 1011, and the loss shall be the excess of the adjusted basis over the amount realized. See also Treas. Reg. § 1.1001-1(a). Section 1001(c) provides that, except as otherwise provided in subtitle A of the Code, the entire amount of the gain or loss on the sale or exchange of property shall be recognized.

As a general matter, I.R.C. § 1 imposes a tax on “taxable income.” Section 63 provides that the term “taxable income” means gross income minus the deductions allowed under chapter 1 of the Code. One of those deductions is I.R.C. § 165. Section 165(a) provides the general rule that a deduction is allowed for any loss sustained during the taxable year and not compensated for by insurance or otherwise. As discussed above, § 165(f) provides that losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in §§ 1211 and 1212, and § 165(g) provides rules applicable when securities that are capital assets become worthless during the taxable year.

It is clear under the plain language of the Code that gross income under § 61(a)(3) is never a negative amount. That section plainly states that gross income includes “gains derived from dealings in property.” Also, under the statutory structure of the Code, losses from the sale or other disposition of property are accounted for through deductions under § 165, not through negative adjustments under § 61(a)(3). Treasury Regulation § 1.468B-2(b)(3) provides for the deduction of only capital losses, which are allowed only to the extent of gains from sales or exchanges of capital assets. Ordinary losses that arise from the sale, exchange, or worthlessness of property are not deductible under Treas. Reg. § 1.468B-2(b); thus, ordinary losses are not taken into account in calculating a NOL under Treas. Reg. § 1.468B-2(b)(4).

The Trust cites various court cases in support of its argument. However, those cases are inapplicable and irrelevant because they do not show that gross income under §
61(a)(3) could ever be a negative amount. For example, in Davis v. United States, 87 F.2d 323 (2d Cir. 1937), cert. denied, 301 U.S. 704 (1937), the court recognized the distinction between gross receipts and gross income and the items constitutionally required to reduce gross receipts to gross income. However, the Second Circuit’s discussion pertained only to calculating the amount of gross receipts. Similarly, in support of the proposition that a fundamental tax principle in calculating gross income is recovery of an asset’s tax basis, the Trust cites The Pittsburgh Milk Company v. Commissioner, 26 T.C. 707 (1956), nonacq., 1959-2 C.B. 8. Once more, this fundamental tax principle does not answer the question here. In support of the proposition that gross income can be a negative figure when reduced by the tax basis of assets, the Trust cites Eisner v. Macomber, 252 U.S. 189 (1920). The issue before the Court was whether undivided profits in the form of stock dividends extraordinary in amount were taxable income. Thus, the Court decided a different issue than the issue here.

2. The Trust should have treated the sales of its securities on its Form 1120-SF and its amended Form 1120-SF as producing capital losses/gains instead of ordinary losses/income.

As explained above, the Trust treated the sales of its securities as sales producing capital gains/losses on its original Forms 1120-AF for taxable years prior to . Starting with its Form 1120-SF, the Trust treated the sales of securities as sales producing ordinary losses/income. The Trust filed an amended Form 1120-SF based on a claimed NOL carryback from . It also recharacterized the sales of its securities during from sales producing capital gain to sales producing ordinary income. As discussed below, we think the sales of the Trust’s securities in and produced capital gains/losses, not ordinary income/losses.

Definition of capital asset

Internal Revenue Code § 1221(a) provides that the term “capital asset” means property held by the taxpayer (whether or not connected with the taxpayer’s trade or business), with the exception of the items listed in §§ 1221(a)(1) through 1221(a)(8). Section 1221(a)(1) includes stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. 5

The Trust is not engaged in a business

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5 Section 1221(a)(2) includes property, used in the taxpayer's trade or business, of a character that is subject to the allowance for depreciation provided in I.R.C. § 167, or real property used in the taxpayer's trade or business. This exception clearly cannot apply because the securities are not depreciable or real property.
Although the term “trade or business” is used throughout the Internal Revenue Code, neither the Code nor the Income Tax Regulations provide any explicit, general definition of the term. Cf. I.R.C. § 7701(a)(26) (the term “trade or business” includes the performance of the functions of a public office). The Supreme Court has stated that to be engaged in a “trade or business” for purposes of I.R.C. § 162 “the taxpayer must be involved in the activity with continuity and regularity,” and “the taxpayer’s primary purpose for engaging in the activity must be for income or profit.” Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987). Determining whether a taxpayer is carrying on a trade or business requires an examination of the facts in each case. Id. at 36.

It appears that the Trust argues that the activity of being a QSF is in itself a business. However, the Trust Agreement clearly shows that the purposes of the Trust are to: (a) assume the and (b) use the Trust's assets and income to pay holders of valid claims. The primary purpose for the Trust's activity as a QSF is not for income or profit, as required by Groetzinger. Consequently, the Trust is not engaged in a business of being a QSF. Additionally, it is important to keep in mind that the Trust and are separate taxpayers, and the activities of cannot be attributed to the Trust. See Whipple v. Commissioner, 373 U.S. 193 (1963); Broz v. Commissioner, 137 T.C. 46, 65-66 (2011) (“The determination of whether an entity is actively engaged in a trade or business must be made by viewing the entity in a standalone capacity and not in conjunction with other entities.”), aff’d, 2013 U.S. App. LEXIS 17636 (6th Cir. 2013).

It appears that the Trust also argues that it is somehow in a business involving the purchase and sale of securities. It is well-settled that a taxpayer who purchases and sells securities falls into one of three distinct categories: dealer, trader, or investor. Arberg v. Commissioner, T.C. Memo. 2007-244 (citing King v. Commissioner, 89 T.C. 445, 457-459 (1987)). A dealer is engaged in the business of buying and selling securities, and such a business involves sales to customers. King v. Commissioner, 89 T.C. at 457. Dealers purchase securities with the expectation of realizing a profit not because of a rise in value, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. Marrin v. Commissioner, 147 F.3d 147, 150-152 (2d Cir. 1998). Securities in the hands of dealers are excluded from the definition of a capital asset, falling within the exception for "property held by the taxpayer primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business" under § 1221(a)(1). A trader is engaged in the business of buying and selling securities, but traders do so for their own account. Arberg v. Commissioner, T.C. Memo. 2007-244. Hence, their securities are not excluded from the definition of a capital asset due to the absence of customers, and sales thereof produce capital gains and losses unless they make a mark-to-market election pursuant to I.R.C. § 475(f), with the consequence that gains and losses are treated as ordinary in character under §§ 475(d)(3)(A)(i) and (f)(1)(D). Id. Traders seek to profit from short-term market swings and receive income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. King v. Commissioner, 89 T.C. at 457-459. An investor is someone who makes purchases for capital appreciation and income, usually without regard to short-term developments that
would influence prices on the daily markets, and who seeks profits through dividends, interest, or long-term gains. Id. Investors buy and sell securities for their own account, but they are not considered to be in a trade or business no matter how much time or resources they expend on the activity. Id. at 459. Their sales produce capital gains and losses.

In its response to IDR No. 3, the Trust stated that it did not hold itself out to any third party as a dealer in securities or a trader in securities. Moreover, the Trust has not identified any “customers” to whom it sold securities. Dealers purchase securities with the expectation of realizing a profit not because of a rise in value, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. Marrin v. Commissioner, 147 F.3d at 150-152. The Trust is clearly not engaged in the business of being a dealer in securities.

Similarly, the Trust is clearly not engaged in the business of being a trader in securities. Traders seek to profit from short-term market swings and receive income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. King v. Commissioner, 89 T.C. at 457-459. “In distinguishing a trader from an investor, courts consider the following nonexclusive factors: (1) The taxpayer's intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's securities transactions.” Van der Lee v. Commissioner, T.C. Memo. 2011-234, aff'd, 501 Fed. App’x 30 (2d Cir. 2012). The Trust did not seek to profit from short-term market swings and receive income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. Furthermore, even if the Trust were in the business of being a trader, its sales of securities would produce capital gains and losses unless it made a mark-to-market election pursuant to I.R.C. § 475(f), which it did not do.

We think the facts clearly show that the Trust was not engaged in any business and that it bought and sold the securities as an investor. Therefore, the sales produced capital gains and losses.

The Trust’s other arguments

The Trust also argues that because QSFs are subject to a uniform flat tax rate there is no apparent reason to distinguish between gains and losses from the sale or exchange of capital assets and ordinary gains and losses. This argument regarding the tax rate does not provide guidance on whether the Trust is engaged in a trade or business.

In support of its position that it is in the trade or business of paying tort claims and asset sales are made in the ordinary course of that business to customers, the Trust includes a discussion of the business of

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are irrelevant to determining whether, for federal income tax purposes, the Trust is engaged in a trade or business. Neither does the general discussion provided by the Trust nor assist in making that determination.

Please contact at with any questions.

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Area Counsel

By: ________________________________

General Attorney
(Large Business & International)