

Instructions for Form 1120-SF

(Rev. Sept. 1996)

U.S. Income Tax Return for Settlement Funds

Section references are to the Internal Revenue Code unless otherwise noted.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . 17 hr., 56 min.

**Learning about the
law or the form . . .** 3 hr., 5 min.

Preparing the form . . . 6 hr., 19 min.

**Copying, assembling, and
sending the form to the IRS . . .** 48 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001.

DO NOT send the tax form to this office. Instead, see **When and Where To File** on this page.

A Change To Note

• For certain qualified settlement funds, the IRS has allowed the use of the cash method of accounting and a fiscal tax year for tax years beginning before January 1, 1996. However, beginning January 1, 1996, all qualified settlement funds must use the accrual method of

accounting and a calendar tax year. See Regulations section 1.468B-5.

How To Get Forms and Publications

By personal computer.—If you subscribe to an on-line service, ask if IRS information is available and, if so, how to access it. Tax forms, instructions, publications, and other IRS information are available through the Internal Revenue Information Service (IRIS), on FedWorld, a government bulletin board. The IRIS menus offer information on available file formats and software needed to read and print files. You must print the forms to use them; the forms are not designed to be filled out on-screen.

IRIS is directly accessible by modem at 703-321-8020. On the Internet, telnet to iris.irs.ustreas.gov or, for file transfer protocol services, connect to ftp.irs.ustreas.gov. If you are using the World Wide Web, connect to http://www.irs.ustreas.gov. FedWorld's help desk offers technical assistance on accessing IRIS (not tax help) during regular business hours at 703-487-4608.

Tax forms, instructions, and publications are also available on CD-ROM, including prior-year forms starting with the 1991 tax year. For ordering information and software requirements, contact the Government Printing Office's Superintendent of Documents (202-512-1800) or Federal Bulletin Board (202-512-1387).

By phone or in person.—To order forms and publications, call 1-800-TAX-FORM (1-800-829-3676). You can also get most forms and publications at your local IRS office.

General Instructions

Purpose of Form

Form 1120-SF is used by designated and qualified settlement funds to report transfers received, income earned, deductions claimed, tax due, and distributions made.

Who Must File

All section 468B designated and qualified settlement funds must file an annual income tax return on Form 1120-SF.

When and Where To File

File Form 1120-SF by the 15th day of the 3rd month after the end of the fund's tax year. File Form 1120-SF with the Internal Revenue Service Center, Philadelphia, PA 19255.

If the due date falls on a Saturday, Sunday, or legal holiday, file on the next business day.

Extension of time to file.—File **Form 7004**, Application for Automatic Extension of Time To File Corporation Income Tax Return, to request a 6-month extension of time to file.

Who Must Sign

The return must be signed and dated by the administrator of the fund.

If the fund administrator completes Form 1120-SF, the Paid Preparer spaces should remain blank. Anyone who prepares Form 1120-SF but does not charge the fund should not sign the return. Generally, anyone who is paid to prepare the return must sign it and fill in the Paid Preparer's Use Only area.

The paid preparer must complete the required preparer information and—

- Sign the return, by hand, in the space provided for the preparer's signature (signature stamps and labels are not acceptable).
- Give a copy of the return to the administrator.

Tax Year and Accounting Method

A qualified settlement fund's tax year is the calendar year and the fund must use the accrual method of accounting.

Rounding Off to Whole Dollars

The fund may show amounts on the return and accompanying schedules as whole dollars. To do so, drop any

amount less than 50 cents and increase any amount from 50 cents through 99 cents to the next higher dollar.

Depository Method of Tax Payment

The fund must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year. Some funds (described below) are required to electronically deposit all depository taxes, including fund income tax payments.

Electronic deposit requirement.—If the fund's total deposits of social security, Medicare, and withheld income taxes were more than \$50,000 in 1995, it must make electronic deposits for all depository tax liabilities that occur after June 30, 1997. If the fund was required to deposit by electronic funds transfer in prior years, it must continue to do so in 1997. The Electronic Federal Tax Payment System (EFTPS) must be used to make electronic deposits. If the fund is required to make deposits by electronic funds transfer and fails to do so, it may be subject to a 10% penalty. Funds that are not required to make electronic deposits may voluntarily participate in EFTPS. For information on EFTPS, call 1-800-945-8400 or 1-800-555-4477. (These numbers are for EFTPS information only.)

Form 8109, Federal Tax Deposit Coupon.—If the fund does not use EFTPS, deposit fund income tax payments (and estimated tax payments) with Form 8109. Do not send deposits directly to an IRS office. Mail or deliver the completed Form 8109 with the payment to a qualified depositary for Federal taxes or to the Federal Reserve bank (FRB) servicing the fund's geographic area. Make checks or money orders payable to that depositary or FRB. To help ensure proper crediting, write the fund's EIN, the tax period to which the deposit applies, and "Form 1120-SF" on the check or money order. Records of these deposits will be sent to the IRS.

A penalty may be imposed if the deposits are mailed or delivered to an IRS office rather than to an authorized depositary or FRB. For more information on deposits, see the instructions in the coupon booklet (Form 8109) and **Pub. 583**, Starting a Business and Keeping Records.

Caution: If the fund owes tax when it files Form 1120-SF, do not include the payment with the tax return. Instead, mail or deliver the payment with Form 8109 to a qualified depositary or FRB, or use EFTPS, if applicable.

Estimated Tax Payments

Generally, a fund must make installments of estimated tax if it expects its estimated tax to be \$500 or

more. The installments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. If any date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.

Use **Form 1120-W**, Estimated Tax for Corporations, as a worksheet to compute estimated tax. The following instructions refer to the 1996 Form 1120-W. Enter expected modified gross income on line 1 of Form 1120-W. Skip lines 2 through 20 and enter 39.6% of the estimated modified gross income for the tax year on line 21. Complete the rest of Form 1120-W in accordance with its instructions. Use deposit coupons (Form 8109) to make deposits of estimated tax or use the EFTPS, if applicable.

For information on penalties that apply if the fund fails to make required payments, see the instructions for line 18 on page 4.

If the fund overpaid estimated tax, it may be able to get a "quick refund" by filing **Form 4466**, Corporation Application for Quick Refund of Overpayment of Estimated Tax. The overpayment must be at least 10% of expected income tax liability and at least \$500. To apply for a quick refund, file Form 4466 before the 16th day of the 3rd month after the end of the fund's tax year but before the fund files its income tax return. Do not file Form 4466 before the end of the fund's tax year.

Interest and Penalties

Interest.—Interest is charged on taxes not paid by the due date even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, gross valuation overstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Penalty for late filing of return.—A fund that does not file its tax return by the due date, including extensions, may have to pay a penalty of 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or \$100. The penalty will not be imposed if the fund can show that the failure to file on time was due to reasonable cause. Funds that file late must attach a statement explaining the reasonable cause.

Penalty for late payment of tax.—A fund that does not pay the tax when due may have to pay a penalty of $\frac{1}{2}$ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the fund

can show that the failure to pay on time was due to reasonable cause.

Trust fund recovery penalty.—This penalty may apply if certain excise, income, social security, and Medicare taxes that must be collected or withheld are not collected or withheld, or these taxes are not paid to the IRS. These taxes are generally reported on Forms 720, 941, 943, or 945. (See **Other Forms That May Be Required** below.)

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax. See the instructions for Form 720 or **Pub. 15** (Circular E), Employer's Tax Guide, for details, including the definition of responsible persons.

Other penalties.—Other penalties can be imposed for negligence, substantial understatement of tax, and fraud. See sections 6662 and 6663.

Other Forms That May Be Required

The fund may have to file any of the following:

Form W-2, Wage and Tax Statement.

Form W-3, Transmittal of Wage and Tax Statements.

Form 940 or **Form 940-EZ**, Employer's Annual Federal Unemployment (FUTA) Tax Return. The fund may be liable for FUTA tax and may have to file Form 940 or 940-EZ if it paid wages of \$1,500 or more in any calendar quarter during the calendar year (or during the preceding calendar year) or one or more employees worked for the fund for some part of a day in any 20 different weeks during the calendar year (or the preceding calendar year).

Form 941, Employer's Quarterly Federal Tax Return. Employers must file this form quarterly to report income tax withheld and employer and employee social security and Medicare taxes. Also see **Trust fund recovery penalty** above.

Form 945, Annual Return of Withheld Federal Income Tax. File Form 945 to report withholding from nonpayroll distributions or payments. Nonpayroll payments include pensions, annuities, IRAs, military retirement, gambling winnings, Indian gaming profits, and backup withholding. Also see **Trust fund recovery penalty** above.

Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

Forms 1099-DIV, INT, and MISC. These information returns are for reporting certain dividends and distributions, interest payments, and miscellaneous income.

When reporting taxable distributions to claimants, use the appropriate information return to report the

distribution. For example, if the distribution is for wages, report the distribution on Form W-2.

For more information, see the instructions for Forms 1099, 1098, 5498, and W-2G, and Regulations section 1.468B-2(l).

Attachments

Attach schedules in alphabetical order and forms in numerical order to Form 1120-SF.

Complete every applicable entry space on Form 1120-SF. Do not write "See attached" instead of completing the entry spaces. If you need more space on the forms or schedules, attach separate sheets. Use the same size and format as the printed forms. Show the totals on the printed forms. Attach these separate sheets after Form 1120-SF or, if applicable, Schedule D (Form 1120). Be sure to put the fund's name and EIN on each sheet.

Definitions

Administrator.—The term "administrator," which may include a trustee if the qualified settlement fund is a trust, is, in order of priority:

1. The person designated or approved by the governmental authority that ordered or approved the fund.

2. The person designated in the escrow agreement, settlement agreement, or other similar agreement governing the fund.

3. The escrow agent, custodian, or other person in possession of the fund's assets.

4. The transferor or, if there are multiple transferors, all of the transferors unless an agreement is signed by all of the transferors that designates a single transferor as the administrator.

Transferor.—The term "transferor" is a person who transfers (or on whose behalf an insurer or other person transfers) money or property to a settlement fund to resolve or satisfy claims against that person.

Related person.—The term "related person" is any person who is related to the transferor within the meaning of section 267(b) or section 707(b)(1).

Qualified Settlement Fund

A fund, account, or trust (hereafter referred to as a fund) is a qualified settlement fund if it meets the governmental order or approval requirement, the resolve or satisfy requirement, and the segregation requirement. These requirements are discussed below.

Governmental order or approval requirement.—To meet this requirement, the fund must be established pursuant to an order of, or must be 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.

A fund is "ordered by" or "approved by" a governmental authority when the authority issues its initial or preliminary order to establish, or grants its initial or preliminary approval of, the fund even if that order or approval may be subject to review or revision. Generally, a governmental authority's order or approval has no retroactive effect and does not permit a fund to be a qualified settlement fund prior to the date the order is issued or the approval is granted. See, however, **Relation-back rule** below.

Arbitration panels.—An arbitration award that orders the establishment of or approves a fund is an order or approval of a governmental authority if:

- The arbitration award is judicially enforceable.
- The arbitration award is issued pursuant to a bona fide arbitration proceeding in accordance with rules approved by a governmental authority (such as self-regulatory organization-administered arbitration proceedings in the securities industry).
- The fund is subject to the continuing jurisdiction of the arbitration panel, the court of law that has jurisdiction to enforce the arbitration award, or the governmental authority that approved the rules of the arbitration proceedings.

Resolve or satisfy requirement.—To meet this requirement, a fund must be established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or a series of related events) that has occurred and that has given rise to at least one claim asserting liability:

- Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended,
- Arising out of a tort, breach of contract, or violation of law, or
- Designated by the Commissioner in a revenue ruling or revenue procedure.

Generally, a fund does not meet the resolve or satisfy requirement if it is established to resolve or satisfy a liability to provide property or services unless the transferor's obligation to provide property or services is extinguished by a transfer or transfers to the fund. An exception exists for liabilities to provide property or services if the liabilities are under CERCLA.

Segregation requirement.—To meet this requirement, the fund must (a) be a trust under applicable state law or (b) keep its assets segregated from other assets of the transferor (and related persons). For example, cash held by a

transferor in a separate bank account satisfies the segregation requirement.

Classification of fund prior to meeting all three requirements.—If a fund meets the resolve or satisfy requirement, the assets of the fund are treated as owned by the transferor of those assets until the fund also meets the governmental order and the segregation requirements. On the day the fund meets all three requirements, the transferor is treated as transferring the assets to a qualified settlement fund.

Relation-back rule.—If a fund meets the resolve or satisfy requirement and the segregation requirement before it meets the governmental order or approval requirement, the transferor and the administrator (defined above) may jointly elect the "relation-back election" (defined below) to treat the fund as coming into existence as a qualified settlement fund on the later of (a) the date the fund meets the resolve or satisfy requirement and the segregation requirement or (b) January 1 of the calendar year in which all three requirements are satisfied. If a relation-back election is made, the assets held by the fund on the date the qualified settlement fund is treated as coming into existence are treated as transferred to the qualified settlement fund on that date.

Relation-back election.—Make the relation-back election by attaching a copy of the election statement to Form 1120-SF for the tax year in which the qualified settlement fund is treated as coming into existence. The statement must be signed by each transferor and the administrator. File Form 1120-SF and the election statement by the due date of Form 1120-SF, including extensions. The election statement must contain the following:

1. The words "Regulations section 1.468B-1 Relation-back election" at the top of the first page.
2. The name, address, and identifying number of each transferor.
3. The name, address, and employer identification number of the qualified settlement fund.
4. The date on which the qualified settlement fund is treated as coming into existence.

5. A schedule describing each asset treated as transferred to the fund on the date the fund is treated as coming into existence. The schedule of assets does not have to identify the amount of cash or the property transferred by a particular transferor.

Qualified settlement fund treated as a corporation.—Except as otherwise provided in Regulations section 1.468B-5(b), for purposes of subtitle F of the Internal Revenue Code, a qualified settlement fund is treated as a corporation and any tax imposed under Regulations section 1.468B-2(a) is

treated as a tax imposed by section 11. See Regulations section 1.468B-2(k) for more information.

Designated Settlement Fund

A fund, account, or trust is a designated settlement fund if it meets the following six requirements:

1. It is established by a court order and completely extinguishes the taxpayer's tort liability.
2. No amounts may be transferred to the fund other than in the form of a qualified payment (defined below).
3. The fund must be administered by persons a majority of whom are independent of the taxpayer.
4. It is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer arising out of personal injury, death, or property.
5. The taxpayer may not hold any beneficial interest in the income or corpus of the fund.
6. The taxpayer elects to have the fund treated as a designated settlement fund.

A **qualified payment** is any money or property that is transferred to a designated settlement fund under a court order other than—

1. Any amount that may be transferred from the fund to the taxpayer (or any related person).
2. The transfer of any stock or indebtedness of the taxpayer (or any related person).

Note: A designated settlement fund is taxed in the same manner as a qualified settlement fund. In addition, if a fund does not meet the requirements of a designated settlement fund but does meet the requirements of a qualified settlement fund, the fund is treated as a qualified settlement fund.

Specific Instructions

Employer identification number (EIN) of fund.—Show the correct EIN in the space provided on page 1 of Form 1120-SF. If the fund does not have an EIN, the administrator should apply for one on **Form SS-4**, Application for Employer Identification Number. Form SS-4 can be obtained at most IRS or Social Security Administration (SSA) offices. If the fund has not received its EIN by the time the return is due, write "Applied for" in the space for the EIN. See Pub. 583 for more information.

Address.—Include the suite, room, or other unit number after the street address. If a preprinted label is used, include this information on the label.

If the Post Office does not deliver mail to the street address and the fund or the administrator has a P. O. box, show the

box number instead of the street address.

Final Return, Change of Address, Amended Return

If the fund ceases to exist, file Form 1120-SF and check the "Final return" box. If the fund is correcting a previously filed Form 1120-SF or Form 1120-DF, check the "Amended return" box.

If the fund has changed its address since it last filed a return, check the box for "Change of address."

Income

Note: Amounts transferred to the fund by or on behalf of a transferor are generally excluded from income.

Line 1—Taxable interest.—Enter total taxable interest received or accrued during the tax year, including original issue discount. Do not include any tax-exempt interest here. Report tax-exempt interest on page 2 under **Additional Information**, line 2, as an item of information.

Do not offset interest expense against interest income.

Line 3—Capital gain net income.

Every sale or exchange of a capital asset must be reported in detail on Schedule D (Form 1120), Capital Gains and Losses, even though no gain or loss is indicated.

Line 5—Other income.—Enter other taxable income not reported on lines 1 through 4. List the type and amount of income on an attached schedule. If the fund has only one item of other income, describe it in parentheses on the dotted part of line 5.

Deductions

Note: Do not deduct:

- Expenses allocable to tax-exempt income (see section 265).
- Payments of claims made by the fund.
- Expenses incurred by, or on behalf of, claimants or transferors.

Line 11—Items of loss, deduction, or credit from a partnership interest.

For tax years ending before 2003, a fund that holds a partnership interest it acquired before February 15, 1992, is allowed a deduction for its distributive share of that partnership's items of loss, deduction, or credits, described in section 702(a) that would be deductible in determining taxable income (in the case of a tax credit, the income tax liability) of a corporation. The deduction is allowed only to the extent of the fund's distributive share of that partnership's items of income and gains described in section 702(a) for that tax year. If the fund has an interest in more than one partnership, attach a schedule showing each partnership's items of loss, deduction, and credit, and that partnership's items of income or gain.

Credits against tax are treated as deductions by dividing the amount of the credit by 39.6%.

Note: Limitations on changes in partnership agreement and capital contribution—Changes in a qualified settlement fund's distributive share of items of income, gain, loss, deduction, or credit, are disregarded if:

1. They result from a change in the terms of the partnership agreement after December 17, 1992, or from a capital contribution to the partnership after December 17, 1992, unless the partnership agreement as in effect prior to December 18, 1992, requires the contribution, and

2. A principal purpose of the change in the partnership agreement or capital contribution is to circumvent the limitations on deductions.

Line 12—Other deductions.—Enter the total of other deductions not entered on lines 7 through 11. List the type and amount of deduction on an attached schedule. If the fund has only one item of other deduction, describe it in parentheses on the dotted part of line 12.

Line 13—Net operating loss deduction (NOL).—Enter the total NOL carryovers from prior tax years, but do not enter more than the fund's taxable income. See **Pub. 536**, Net Operating Losses, and Regulations section 1.468B-2(b)(4) for more details.

Part II.—Tax Computation

Line 15—Modified gross income.

Modified gross income of a qualified settlement fund is its gross income, as defined in section 61, computed with certain modifications. See Regulations section 1.468B-2(b) for more information.

Line 17—Credits and payments.—No credits or payments are allowed other than those on lines 17a through 17e.

Line 18—Estimated tax penalty.—A fund that does not make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. Generally, a fund is subject to the penalty if its tax is \$500 or more, and it did not timely pay the smaller of (a) 100% of its tax liability or (b) 100% of its prior year's tax. See section 6655 for details and exceptions, including special rules for large funds.

Use **Form 2220**, Underpayment of Estimated Tax by Corporations, to see if the fund owes a penalty. Generally, the fund does not have to file this form because the IRS can figure the amount of any penalty and bill the fund for it.

If you attach Form 2220, be sure to check the box on line 18 and enter the amount of any penalty on that line.

See Form 2220 for other information that may apply.

