

**Office of Chief Counsel
Internal Revenue Service**

Memorandum

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to: Marion K. Mortensen
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(Small Business/Self-Employed)

from: Tiffany P. Smith
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(Procedure & Administration)

subject: Interest Imposed on Qualified Settlement Funds

This Chief Counsel Advice responds to your request for assistance dated April 1, 2005, regarding the application of the increased interest rate for large corporate underpayments to a qualified settlement fund. This advice may not be used or cited as precedent.

LEGEND

Fund =

\$A =

ISSUE

Whether the increased interest rate for large corporate underpayments provided in section 6621(c) of the Internal Revenue Code (Code) applies to a qualified settlement fund?

CONCLUSIONS

Section 1.468B-2(k) of the regulations generally provides that, for purposes of subtitle F of the Code, a qualified settlement fund is treated as a corporation. A qualified settlement fund is not treated as a corporation for purposes of subchapter S of the Code and cannot qualify as an S corporation. The Internal Revenue Service (Service), therefore, is required to treat a qualified settlement fund as a C corporation for purposes of subtitle F of the Code and to impose the increased underpayment rate provided in

section 6621(c) of the Code on a qualified settlement fund's underpayment of tax that exceeds \$100,000.

FACTS

The Fund underpaid its tax liabilities by more than \$A. The Service calculated interest due on the underpayment at the increased rate imposed for large corporate underpayments pursuant to section 6621(c) of the Code. The Fund is contesting the Service's imposition of the increased interest rate, asserting that it is a settlement trust fund and not a corporation. You state that the public information on the Fund makes clear that the Fund qualifies as a court created trust to satisfy claims arising from class action litigation.

LAW AND ANALYSIS

Section 6601(a) of the Code provides that if a tax is not paid on or before the last date prescribed for payment, interest will accrue on the underpaid amount at the underpayment rate established under section 6621 of the Code. Section 6621(a)(2) provides that the standard interest rate imposed on underpayments equals the Federal short-term rate plus 3 percentage points. However, section 6621(c)(1) provides that the underpayment rate for large corporate underpayments equals the Federal short-term rate plus 5 percentage points. Section 6621(c)(3) defines "large corporate underpayment" as any underpayment by a C corporation for any taxable period that exceeds \$100,000.

Section 468B(b)(5) of the Code provides that for purposes of subtitle F, a designated settlement fund shall be treated as a corporation. The term "designated settlement fund" is defined in section 468B(d)(2) of the Code. However, the concept of a designated settlement fund has been subsumed into that of a "qualified settlement fund" because a designated settlement fund is taxed in the same manner as a qualified settlement fund. See section 1.468B of the Income Tax Regulations (regulations).

Section 468B(g) of the Code 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 a grantor trust or otherwise." Pursuant to this authority, the Secretary issued sections 1.468B-1 through 1.468B-5 of the regulations relating to qualified settlement funds.

Under sections 1.468B-1(a) and (c) of the regulations, a fund, account, or trust (emphasis added) is a qualified settlement fund 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) it is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

Section 1.468B-1(b) of the regulations provides 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 of the Regulations on Procedure and Administration, it is classified as a qualified settlement fund for all purposes of the Code. Section 1.468B-1(b) also provides that 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 section 301.7701-2) or a partnership (within the meaning of section 301.7701-3), it is classified as a qualified settlement fund for all purposes of the Code. Therefore, if the Fund is either a designated settlement fund or a qualified settlement fund, it is irrelevant whether the Fund could also be classified as a trust because it is taxed as a qualified settlement fund pursuant to the regulations issued under the authority granted to the Secretary under section 468B(g) of the Code. See United States v. Brown, 348 F.3d 1200, 1218 (10th Cir. 2003).

Section 1.468B-2(k) of the regulations generally provides that, for purposes of subtitle F of the Code, a qualified settlement fund is treated as a corporation. Based on the facts you have provided, we conclude that the Fund is a qualified settlement fund, and that the Service should treat the Fund as a corporation for purposes of the subtitle F rules pursuant to section 1.468B-2(k). However, the increased underpayment rate provided in section 6621(c) of the Code applies only to large corporate underpayments of a C corporation. Section 1361(a)(2) defines the term "C corporation" as a corporation that is not an S corporation.

For the Fund to qualify as an S corporation, section 1361(a)(1) requires that the Fund be a small business corporation and make the required S corporation election. To satisfy the definition of a "small business corporation" under section 1361(b)(1), the Fund must be a domestic corporation (among other requirements). A qualified settlement fund that could be classified as an association and thus a corporation under section 301.7701-2(b)(2) is classified as a qualified settlement fund for all purposes of the Code. As a qualified settlement fund, the Fund is treated as a corporation under section 1.468B-2(k) only for purposes of subtitle F. No provision of the Code or regulations treats a qualified settlement fund as a corporation for purposes of subtitle A, which contains in subchapter S the requirements for being an S corporation. Because the Fund is not treated as a domestic corporation for purposes of subtitle A, the Fund cannot qualify as an S corporation under subchapter S. The Service, therefore, is required to treat the Fund as a C corporation for purposes of subtitle F of the Code and

to impose the increased underpayment rate provided in section 6621(c) of the Code on the Fund's underpayment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions.