

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200804016**
Release Date: 1/25/2008

[Third Party Communication:
Date of Communication: Month DD, YYYY]
Person To Contact:
, ID No.
Telephone Number:

Index Number: 108.01-00, 108.04-00, 162.00-00, 162.00-00, 172.00-00, 172.01-00, 172.01-05, 461.00-00, 468B.00-00, 468B.01-00, 468B.04-01, 1001.00-00

Refer Reply To:
CC:ITA:B07
PLR-152832-06
Date:
October 18, 2007

Legend:

- X =
- IR =
- b =
- c =
- d =
- e =
- f =
- g =
- A =
- B =
- \$w =
- \$y =
- \$z =
- date 1 =
- date 2 =

date 3 =
 date 4 =
 date 5 =
 date 6 =
 date 7 =
 Bankruptcy Court =
 Court =

Dear :

This responds to your letter dated November 10, 2006, requesting certain rulings concerning the application of various sections of the Internal Revenue Code to transfers made by X to TR. By letter dated February 2, 2007, TR joined your request for ruling number one. Specifically, you requested the following rulings concerning the Federal income tax treatment of certain transfers of assets to TR:

1. Is TR a qualified settlement fund under § 1.468B-1 of the Income Tax Regulations?
2. Does X realize gain or loss upon the transfer to TR of a promissory note (Note), tax refund benefits, certain refund proceeds deriving from settlement agreements (CCR Funds), certain insurance recoveries (Recovery Trust Accounts), insurance settlement proceeds, certain rights derived from resettlement of multi-party claims (Shortfall Claims), or X's transfer of all rights, claims or causes of action, or rights to proceeds that arise out of any e-related claim or demand?
3. Does X realize gain or loss upon the transfer of its preferred stock to TR?
4. Does X realize gain or loss, or other income, upon X's transfer of \$z million to TR in exchange for the return of the preferred stock?
5. Is X allowed a deduction for the transfer to TR of \$y, the Note, the tax refund benefits, the CCR Funds, the Recovery Trust Accounts, insurance settlement proceeds, the Shortfall Claims, rights to proceeds that arise out of any e-related claim or demand, cash payment made for the return of X's preferred stock, and any payments made to TR under employment agreements?
6. Does X realize cancellation of indebtedness income under § 108(b) when X's present and future e-related claims are channeled to TR pursuant to the Bankruptcy Court order?
7. Do X's payments directly to TR, in performance of X's obligations under the Plan of Reorganization (the "Plan") to transfer and deliver to TR the following assets, including any associated income and proceeds (collectively, the "Segregated Funds"), qualify as "specified liability losses" within the meaning of § 172(f)(1): \$y, the Note, the CCR Funds, the Recovery Trust Accounts, cash in the amount of X's tax refund benefits, and the obligation collateralized with preferred stock?

STATEMENT OF FACTS

X represents the facts to be as follows. X uses an accrual method of accounting, with a taxable year ending on date 7. X is an f contractor that provides goods and services to businesses dealing in c. X specializes in b and d. For many years, X has been a specialty contractor engaged in the sale, installation, maintenance, repair, removal and handling of e-containing product, including g, and d services. X does not manufacture e-containing products. By date 1, X was named as a defendant or co-defendant in e-related personal injury, wrongful death or property damage suits in numerous states.

On date 2, X filed for bankruptcy protection under Chapter 11 of Title 11 of the United States Code. On date 3, X submitted the Plan with the Bankruptcy Court. The Plan was amended on date 4. The Court approved the amended Plan on date 6.

In accordance with § 524(g) of the Bankruptcy Code, a trust was established to pay both current e-related claims and future demands against X that arise out of the same or similar conduct or events that gave rise to the e-related claims. Under the Plan, TR will assume all liability and responsibility for all e-related claims and demands against X, trust expenses, and \$w in pre-bankruptcy e-related defense costs. TR will satisfy these claims by making distributions to claimants in accordance with the Plan, the trust agreement, and other relevant documents. X will have no further financial or other liability for these claims.

X represents that it previously claimed a \$w deduction for the pre-bankruptcy defense costs prior to funding TR.

X represents that TR is a trust established pursuant to the laws of state B. TR remains under the continuing jurisdiction of the Bankruptcy Court. X will fund TR with the following assets for the purpose of satisfying e-related tort claims, and certain e-related defense costs: (1) \$y, (2) the Note, (3) cash from the future tax refund benefits, (4) the CCR Funds, (5) the Recovery Trust Accounts, (6) the insurance settlement proceeds, (7) the Shortfall Claims, (8) all rights, claims or causes of action, or rights to proceeds that arise out of any e-related claim or demand, (9) the cash payments in an amount that match bonus payments paid to executives, and (10) an obligation collateralized by preferred stock. All assets were transferred to or issued by X in consideration of TR's assumption of X's e liabilities. TR will segment these assets in order to assure that a specified amount of TR's funds will be allocated to pay only X's liability for damages arising from X's sale, or X's installation and sale, of e-containing product, which damages arose after X sold, or installed and sold, and relinquished possession of e-containing product.

X makes the following additional representations:

In accordance with X's confirmed Plan of Reorganization, the Trust Agreement and the e-Related Claims and Demands Trust Distribution Procedures, the Trustee for

the Trust (established pursuant to the Trust Agreement) has established a policy that provides for the following:

- a) the segmentation of all funds that X pays directly to TR in performance of X's obligations under the Plan to transfer and deliver to TR the following assets, as defined in the Plan, and including any associated income and proceeds (collectively, the "Segregated Funds"): the Note; \$y; the obligation collateralized by preferred stock; the CCR Funds; the Recovery Trust Accounts; and cash in the amount of the Tax Refund Benefits;
- b) each payment (hereinafter referred to as a Company Product Personal injury and Property Damage Payment) that TR will make from the Segregated Funds directly to each claimant meets each of the following requirements:
 - (i) It is a payment of compensatory damages on account of physical injury to an individual that manifests itself before the date TR makes that payment (or interest on such damages) or compensatory damages for damage to or loss of use of property; and
 - (ii) The payment is being made to satisfy X's liability for damages arising from X's sale, or installation and sale of e-containing product, which damages arose after X sold, or installed and sold, and relinquished possession of e-containing product.

LAW AND ANALYSIS

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

1. Classification of TR as a qualified settlement fund.

X's first requested ruling is that TR is a qualified settlement fund under § 1.468B-1 for federal income tax purposes. Section 468B(g) provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority of section 468(g), the Secretary has published §§ 1.468B-1 through 1.468B-5 regarding qualified settlement funds.

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account, or trust that satisfies the three requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the fund, account, or trust be 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 continuing jurisdiction of the

governmental authority. Second, § 1.468B-1(c)(2) provides that the fund, account, or trust be established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event that has occurred and has given rise to at least one claim asserting liability: (i) under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA); (ii) arising out of 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) requires that the fund, account, or trust must be a trust under applicable state law, or have its assets segregated from other assets of the transferor (and related persons).

Section 1.468B-1(h)(2) provides that if a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section as well as other types of claims (*i.e.*, non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund. However, under § 1.468B-3(c), economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims.

Based on the facts presented and representations made, the three requirements of § 1.468B-1(c) are satisfied, and as such, TR is a qualified settlement fund for Federal income tax purposes. First, TR was approved by the Bankruptcy Court on date 5. TR remains subject to the continuing jurisdiction of the Bankruptcy Court. See § 1.468B-1(c)(1). Second, TR was established to resolve or satisfy one or more claims brought by claimants against X for injuries allegedly sustained from X's e-related business activities. See § 1.468B-1(c)(2). Third, X has represented that TR is a trust under the law of state B. See § 1.468B-3(c)(3).

Finally, the fact that other claims will be paid by TR (*e.g.*, defense costs incurred by X prior to bankruptcy) does not prevent TR from being classified as a qualified settlement fund because these non-allowable claims arise from the same event or related series of events. Section 1.468B-1(h)(2). However, X does not have economic performance with regard to these claims upon transfer to the trust. See §§ 1.468B-1(h)(2) and 1.468B-3(c)(2).

2. X's transfer of certain obligations and assets to TR.

X's second requested ruling is whether X realizes gain or loss upon the transfer to TR of the Note, tax refund benefits, CCR Funds, Recovery Trust Accounts, insurance settlement proceeds, Shortfall Claims, or its transfer of all rights, claims or causes of action, or rights to proceeds that arise out of any e-related claim or demand.

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) generally provides that gain or loss from the sale or other disposition of property is the difference between the amount realized and the adjusted basis of the property.

Section 1001(c) states that, except as otherwise provided in Subtitle A, the entire amount of gain or loss realized on the sale or exchange of property shall be recognized.

Section 1.468B-3(a)(1) provides that a transferor must treat a transfer of property to a qualified settlement fund as a sale or exchange for purposes of § 1001(a). The amount realized by the transferor is the fair market value of the property on the date the transfer is made to the qualified settlement fund. However, the issuance of a transferor's debt, obligation to provide services or property in the future, or obligation to make a payment described in § 1.461-4(g) is generally not a transfer of property by the transferor, and generally does not result in gain or loss to the transferor under § 1.468B-3(a)(1).

A payment described in § 1.461-4(g)(2) includes a payment or series of payments to another person and arising under any worker's compensation act or out of any tort, breach of contract, or violation of law. A liability arising out of tort, breach of contract, or violation of law includes a liability arising out of the settlement of a dispute in which a tort, breach of contract, or violation of law, respectively, is alleged. See § 1.461-4(g)(2)(ii).

Based on the facts presented and the representations made, X does not realize gain or loss when it issues the Note to TR because X's issuance of Note is the issuance of its own debt. Section 1.468B-3(a)(1).

In addition, under § 1.468B-3(a)(1), X will not realize gain or loss by entering into an obligation to make future cash payments to TR deriving from the Recovery Trust Accounts, the insurance settlement proceeds, the CCR Funds, or the future tax benefits. X's obligation to transfer these assets to TR is based on its e-related tort liability. These assets are types of payment liabilities described in § 1.461-4(g). In addition, X represents that any Recovery Trust Account, insurance settlement proceeds, CCR Funds, or future tax benefit proceeds will be transferred to TR in the form of cash payments. X will not realize gain or loss when actual cash payments, in satisfaction of these obligations, are made to the TR.

Finally, pursuant to § 1.468B-3(a)(1), X's transfer of certain rights derived from the Shortfall Claims, and X's transfer of all the rights, claims or causes of action, or rights to proceeds that arise out of any e-related claim or demand, are transfers of property to TR within the meaning of § 1.468B-3(a)(1). Therefore, X must treat the transfers as a sale or exchange of that property for purposes of § 1001. X realizes gain to the extent the fair market value of these assets, at the time of transfer, exceeds X's adjusted basis in these assets. X has the burden of establishing the value of the

transferred property. No opinion is expressed regarding the value of any property transferred to TR.

3. X's transfer of its preferred stock to TR.

X's third requested ruling is whether X realizes gain or loss upon its transfer of the preferred stock to TR. As stated above, § 1.468B-3(a)(1) states that a transferor must treat a transfer of property to a qualified settlement fund as a sale or exchange for purposes of § 1001(a). However, this section also provides that a transferor generally does not realize gain or loss upon the issuance of a transferor's debt, obligation to provide services or property in the future, or obligation to make a payment described in § 1.461-4(g).

Although X has entered into a series of transactions that places possession of the preferred stock with TR, the stock acts as collateral for X's future promise to pay \$z to TR. Based on the facts presented and the representations made, X does not realize gain or loss with respect to its pledge of the preferred stock, as no transfer of the preferred stock within the meaning of § 1.468B-3(a)(1) has occurred. No opinion is expressed or implied regarding the tax ownership of the preferred stock or whether the preferred stock is stock for Federal income tax purposes.

4. Transfer of \$z to TR.

X's fourth requested ruling is whether X realizes gain or loss, or other income, upon X's transfer of \$z million to TR in exchange for the return of the preferred stock. Based on the facts presented and the representations made, X will not realize gain or loss, or other income, when a future payment of \$z is transferred to TR, which coincides with the time TR returns the collateral (preferred stock) to X. No opinion is expressed or implied regarding the tax ownership of this preferred stock or upon whether this preferred stock is stock for Federal income tax purposes.

5. Deductions for the property and cash transferred to TR.

X's fifth requested ruling is whether X is allowed a deduction for the transfer of \$y, the tax refund benefits, the Note, CCR Funds, Recovery Trust Accounts, insurance settlement proceeds, cash payment made for the return of X's preferred stock, any payments made to TR under the employment agreements, and the transfer of all rights, claims or causes of action, or rights to proceeds that arise out of any e-related claim or demand to TR.

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, § 162 permits deductions in settlement of lawsuits or

potential lawsuits if the acts that gave rise to the litigation were performed in the ordinary course of the taxpayer's business.

Section 1.468B-3(d) provides that no deduction is allowed to a transferor for a transfer to a qualified settlement fund to the extent the transferred amounts represent amounts received from the settlement of an insurance claim and are excludable from gross income.

Section 461(a) provides that a deduction shall be taken for the taxable year which is the proper taxable year under the accounting method used in computing taxable income.

Section 1.461-1(a)(2) provides that, under an accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.468B-3(c)(1) provides that, except as otherwise provided in § 1.468B-3(c), for purposes of § 461(h), economic performance occurs with respect to a liability described in § 1.468B-1(c)(2) (determined with regard to § 1.468B-1(f) and (g)) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

Section 1.468B-3(c)(3) states that economic performance does not occur when a transferor transfers to a qualified settlement fund its debt (or the debt of a related person). Instead, economic performance occurs as the transferor (or related person) makes principal payments on the debt. Similarly, economic performance does not occur when a transferor transfers to a qualified settlement fund its obligation (or the obligation of a related person) to provide services or property in the future, or to make a payment described in § 1.461-4(g). Instead, economic performance occurs as services, property or payments are provided or made to the qualified settlement fund or a claimant.

Based on the facts presented and representations made, X is allowed a deduction under § 162 for amounts in excess of \$w that were transferred to TR to resolve or satisfy e-related liabilities that arose from the conduct of its business. In the case of the Shortfall Claims and the transfer of all rights, claims or causes of action, X may deduct the fair market value of these assets at the time of transfer. X has the burden of establishing the value of the transferred property. No opinion is expressed regarding the value of any transferred property. Also, no deduction is permitted for amounts attributable to insurance settlement proceeds that were excluded from X's gross income under § 1.468B-3(d). X represents that X previously deducted \$w and that it will not claim an additional deduction.

X may deduct these liabilities if the all-events test is otherwise satisfied, in the taxable year that economic performance occurs. To the extent that the transfers are allocable to allowable claims, under § 1.468B-3(c)(1), economic performance occurs in the taxable year or years in which X transfers cash or property to TR within the meaning of § 1.468B-3(a)(1). First, with regard to the \$y, the Shortfall Claims, and X's transfer of all rights, claims or causes of action, economic performance occurs, under § 1.468B-3(c)(1), at the time X transfers these assets to TR. Second, with respect to X's transfer to TR of the tax refund benefits, the CCR Funds, the Recovery Trust Accounts, and any payments made to TR under employment agreements, economic performance occurs in the taxable year X makes an actual cash payment to TR in satisfaction of these obligations. See § 1.468B-3(c)(3). Third, with respect to the Note, under § 1.468B-3(c)(3) economic performance occurs when X makes principal payments on the Note. Finally, with regard to the obligation collateralized by preferred stock, under § 1.468B-3(c)(1), economic performance occurs when X pays \$z to TR. Economic performance does not occur to the extent X makes a transfer to TR to satisfy non-allowable claims (*i.e.*, the \$w in pre-bankruptcy defense costs). Section 1.468B-1(h)(2).

6. Cancellation of indebtedness income under § 108(b).

X's sixth ruling request is whether X realizes cancellation of indebtedness income under § 61(a)(12) when the e-related claims and demands against X (and parties related to X) or against various insurance companies entering into settlements approved by the Bankruptcy Court were channeled to and became a claim against TR, rather than against X, its related parties or the insurance companies, pursuant to the Supplemental Agreement.

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness. Such income (also known as cancellation of indebtedness income, or COD income) is ordinary in nature and equals the difference between what is owed and what is actually paid to satisfy the liability. The debtor must generally report COD income in the year the discharge occurs.

Section 108(e)(2) provides that no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

Although X may have otherwise realized discharge of indebtedness income under § 61(a)(12) to the extent that liquidated e-related claims and demands were discharged pursuant to the Plan for amounts that were less than their face value, the § 108(e)(2) exception applies to the extent that payment of the liquidated e-related claims and demands would have given rise to a § 162(a) deduction. *Preslar v. Commissioner*, 167 F.3d 1323, 1327-1328 (10th Cir. 1999). Accordingly, X does not realize discharge of indebtedness income with respect to any liquidated e-related claims

and demands that were discharged under the Plan to the extent that X's payment of such claims would have given rise to a deduction under § 162(a).

The settlement of unliquidated e-related claims and demands brought against X by claimants for injuries allegedly sustained by X's e-related business activities do not give rise to discharge of indebtedness income under § 61(a)(12). Rather, if the dispute concerning the amount of the debt is in good faith, settlement of the dispute is "treated as the amount of debt cognizable for tax purposes." *Preslar, supra*, at 1327, quoting from *Zarin v. Commissioner*, 916 F.2d 110, 115 (3rd Cir. 1990).

Accordingly, based on the information submitted and representations made, X did not realize discharge of indebtedness income when the unliquidated e-related claims and demands described in this paragraph were channeled to TR.

7. Specified liability losses within § 172(f)(1).

X's seventh ruling request is whether X's payments directly to TR, in performance of X's obligations under the Plan to transfer and deliver to TR the following assets, including any associated income and proceeds (collectively, the "Segregated Funds"), qualify as "specified liability losses" within the meaning of § 172(f)(1): the Note, \$y, the obligation collateralized with preferred stock, the CCR Funds, the Recovery Trust Accounts, and cash in the amount of X's tax refund benefits.

Section 172(a) allows a deduction for the taxable year an amount equal to the aggregate of the (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.

Section 172(b)(1)(C) provides that in the case of a taxpayer that has a specified liability loss (as defined in § 172(f)) for a taxable year, such specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the year of such loss.

Section 172(f)(1)(A) defines a specified liability loss to mean the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year: Any amount allowable as a deduction under §162 or 165 that is attributable to (i) product liability or (ii) expenses incurred in investigating, settling, and opposing claims against the taxpayer on account of product liability.

Section 172(f)(4) provides that the term "product liability" means (A) the liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product that is manufactured, leased, or sold by the taxpayer but only if (B) such injury, harm or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

Section 1.172-13(b)(2)(ii) provides that the term “product liability” does not include liabilities arising under warranty theories relating to repair or replacement of the property that are essentially contract liabilities.

The amounts that X paid and will pay to TR that TR will use to make a Company Product Personal Injury and Property Damage Payment relate to “product liability” claims because they arose out of the settlement of claims for physical injury to individuals, or damage to or loss of the use of property, due to exposure to e in items that X sold, or installed and sold, and which injuries arose after X relinquished control of the items.

Accordingly, based on the facts presented and representations made, X's payments to TR are “specified liability losses” as defined in § 172(f) to the extent that: (i) X may deduct such payments under § 162; and (ii) TR uses such payments to make Company Product Personal Injury and Property Damage Payments (except interest payments) to claimants. X may carryback such payments to each of the 10 taxable years proceeding the year of the loss. See § 172(b)(1)(C).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

The rulings contained in this letter are based upon information 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.

Sincerely,

George Baker
Senior Technician Reviewer, Branch 7
Office of Associate Chief Counsel
(Income Tax & Accounting)