

Internal Revenue Service

Number: **201803005**

Release Date: 1/19/2018

Index Number: 468B.02-00, 162.00-00,
461.00-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:ITA:B06

PLR-114222-17

Date:

October 20, 2017

LEGEND

Business Entity =

Defendant 1 =

Defendant 2 =

Owners =

State 1 =

Partnership A =

Business =

Litigation =

Court =

Plaintiffs =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Trust 1 =
Trust 2 =
Trustee =
Z =
Dollar Amount A =
Dollar Amount B =

Dear :

This letter responds to your letter dated April 26, 2017, requesting certain rulings concerning the application of various sections of the Internal Revenue Code and the Income Tax Regulations to Defendant 1 and Partnership A (“Taxpayers”) and Trust 2. You have requested the following rulings that:

1. Trust 2 will constitute a qualified settlement fund upon its establishment under Treas. Reg. § 1.468B-1.
2. Taxpayers will be entitled to deduct the amounts transferred to Trust 2 under §§ 162, 461(h) and 1.468B-3(c) in the years Taxpayers transfer those amounts to Trust 2.

FACTS

Defendant 1 is a Business Entity that is owned by Owners. Defendant 2 is a State 1 limited liability company, all of the interests in which are owned by Partnership A. Defendant 2 is treated as a disregarded entity for Federal income tax purposes. Partnership A is a State 1 limited partnership, all of the interests in which are owned, directly and indirectly, by Owners. Defendant 1 and Defendant 2 are collectively referred to as “Defendants.” Taxpayers share common ownership by Owners. Taxpayers both have an annual accounting period ending on March 31, and both maintain their accounting books on the basis of the accrual method of accounting.

Owners, through the Defendants, operate the Business. On Date 1, the Litigation was established in the Court. The Litigation arose from the alleged effects of personal injuries purportedly suffered by Plaintiffs in connection with their employment in the Business, and through which Plaintiffs sought to hold Defendants responsible for their alleged injuries under various theories of tort liability. On Date 2, Defendants and Plaintiffs entered into a class action settlement agreement (the “Settlement Agreement”), which Settlement Agreement was approved by the Court on Date 3, as amended on Date 4, and became effective on Date 5.

The Settlement Agreement is intended to fully resolve, discharge and settle all claims by qualifying members of the settlement class ("Settlement Class Members") related to the Litigation against Defendants. In relevant part, the Settlement Agreement requires Defendants to pay certain cash settlement awards ("Settlement Awards") to Settlement Class Members. Defendants are jointly and severally liable for amounts to be paid to Settlement Class Members under the Settlement Agreement. The Defendants' obligation to make such payments extends over a period of Z years from the effective date of the settlement.

TRANSACTIONS REQUIRED UNDER THE SETTLEMENT AGREEMENT

Under the Settlement Agreement, Defendants are required to establish Trust 1. Trust 1 will be used to fund the Defendants' monetary obligations under the Settlement Agreement, including payment of Settlement Awards. The Court approved the agreement for Trust 1 on Date 6. The Settlement Agreement requires Defendants, over the Z-year term of Trust 1, to make periodic contributions to Trust 1. The Settlement Agreement further requires that Trust 1's funds are to be invested conservatively, in a manner designed to assure timely availability of funds, protection of principal and avoidance of concentration of risk.

Taxpayers intend that Trust 1 will be structured and operated in a manner so that it qualifies a qualified settlement fund under § 1.468B-1, and are not seeking such a ruling with respect to Trust 1.

Under the Settlement Agreement, Defendants are also required to establish Trust 2, prior to Date 7. Trust 2 is intended to serve both as a funding source and as security for Defendants' obligations to pay Settlement Awards from Trust 1. Specifically, Defendants are obligated to fund Trust 2 with sufficient amounts so that as of Date 7, Trust 2 will contain funds that, in the reasonable belief of Defendants and taking into account reasonably expected investment returns, will be sufficient to satisfy Defendants' remaining anticipated payments of Settlement Awards as they come due over the remainder of the Z-year term of the Settlement Agreement. Contributions to Trust 2 will be transferred to Trust 1 by Trustee as needed to satisfy such payment obligations. It is possible that some portion of Defendants' contributions to Trust 2 may be attributable to amounts recovered by Defendants under existing liability insurance policies. Although the funds in Trust 2 are intended to serve, in part, as security for Defendants' funding obligations with respect to payment of Settlement Awards, the Settlement Agreement makes clear that Defendants' obligations to meet their funding requirements are absolute, and not limited to the amounts that eventually will be held in Trust 2.

Trust 2 will be managed by Trustee and will be subject to the continuing jurisdiction of the Court. However, the terms of Trust 2 will permit Defendants to direct how the funds of Trust 2 are to be invested. This investment discretion was granted to enable

Defendants to use their investment expertise to generate returns on the funds contributed to Trust 2 that are anticipated to exceed the returns that would be realized if the conservative investment guidelines of Trust 1 were applicable.

Defendants anticipate that, over the Z-year term of the settlement, they will be required to make payments to Settlement Class Members and for administrative costs and expenses with a face value in excess of Dollar Amount A and a present value as of Date 3 in excess of Dollar Amount B. Although Defendants are not required to contribute funds to Trust 2 until Date 7, Defendants intend to begin making contributions shortly following the date of this ruling, in order to maximize investment returns on contributed funds and to build toward the amounts required to be held in Trust 2 as of Date 7.

Once funds are paid into Trust 2, Defendants will not retain any control over the amounts so deposited, other than their discretion with respect to investment decisions. Defendants' investment decisions will at all times be subject to the supervision of the Court and Trustee. The terms of Trust 2 will provide that Defendants have no right to pledge or assign property of Trust 2 to a third party, and creditors of Defendants will have no rights or remedies with respect to the property held in Trust 2.

Trustee will be permitted to make withdrawals from Trust 2 for the purposes of (1) transferring funds to Trust 1 to satisfy Defendants' monetary obligations under the Settlement Agreement to pay Settlement Awards, and (2) paying costs and expenses of Defendants relating to Trust 2.

With prior approval of the Court, Trustee is also permitted to make withdrawals of funds from Trust 2 to (1) return excess funds to Defendants based on the Trust 2 investments having attained investment returns beyond the amount necessary to satisfy Defendants' remaining anticipated payment obligations under the Settlement Agreement, (2) return excess funds to Defendants based on reductions to the remaining anticipated payment obligations of Defendants, and (3) return remaining funds in Trust 2 to Defendants upon completion of their payment obligations. The Settlement Agreement requires the Court to grant approval for these withdrawals unless there has been a material default on Defendants' payment obligations within the 30 days prior to the request for withdrawal, or there is a showing by clear and convincing evidence that the requested withdrawal would materially impair the Settlement Agreement.

REPRESENTATIONS

Taxpayers make the following representations with respect to Trust 2:

1. Trust 2 will be established under state law.

2. Trust 2 will be established to resolve or satisfy one or more tort claims for Settlement Awards under the Settlement Agreement.
3. Trust 2 will be established pursuant to the Court's final approval order of the Settlement Agreement, and will be subject to the continuing jurisdiction of the Court.
4. In the event that Defendants contribute amounts to Trust 2 that were previously received as settlement of insurance claims and which amounts were excluded from gross income of Taxpayers when received, Taxpayers will comply with the provisions of § 1.468B-3(d) and will not claim a deduction for the contribution of such amounts to Trust 2.
5. In the event that Defendants settle an insurance claim after they have contributed amounts to Trust 2 for which a deduction has been claimed by Taxpayers, Taxpayers will comply with the provisions of § 1.468B-3(d) and include in income the amounts received from the settlement of the insurance claim to the extent of the deduction.
6. Defendants will not, except as expressly otherwise set forth herein, have refund or reversion rights in Trust 2's assets or income.
7. In the event that Defendants receive a distribution of funds after they have contributed amounts to Trust 2 for which a deduction has been claimed by Taxpayers, Taxpayers will comply with the provisions of § 1.468B-3(f) and include in income amounts so received to the extent required by the tax benefit rule, as provided in § 111(a).

REQUESTED RULINGS

1. Trust 2's Status as a Qualified Settlement Fund

Taxpayers' first requested ruling is that Trust 2, upon its establishment, will be a qualified settlement fund under § 1.468B-1 for Federal income tax purposes.¹

Section 468B(g)(1) 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

¹ Ordinarily, the Service does not issue letter rulings regarding the tax consequences of a taxpayer who is not directly involved in the request if the requested letter ruling would not address the tax liability of the requester. See section 6.06 of Rev. Proc. 2017-1, 2017-1 I.R.B. 2017-1, 20. Although Trust 2 is not a party to this ruling request, the characterization of Trust 2 as a qualified settlement fund affects the timing of economic performance with respect to assets transferred by Taxpayers to Trust 2, and, therefore, affects the timing of Taxpayers' deductions for amounts transferred to the trust (see Taxpayers' second requested ruling, below).

subject to current income tax. Pursuant to the authority of § 468B(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 requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the fund, account, or 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 fund, account, or 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 fund, account, or 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).

Based on the facts presented and the representations provided herein, Trust 2, upon its establishment, will be a qualified settlement fund for Federal income tax purposes. First, Trust 2 will be approved by the Court, and the trust will be subject to the continuing jurisdiction of the Court. See § 1.468B-1(c)(1). Second, Trust 2 will be established to resolve or satisfy tort claims brought against Defendants for damages allegedly sustained by Plaintiffs in connection with their participation in activities related to the Defendants' Business. Defendants are obligated to fund Trust 2 with sufficient amounts so that as of Date 7, Defendants can satisfy their remaining anticipated obligations regarding payment of Settlement Awards as they come due over the remainder of the Z-year term of the settlement. Defendants' contributions to Trust 2 will be transferred to Trust 1 by Trustee as needed to satisfy such payment obligations. See § 1.468B-1(c)(2). Third, Trust 2 will be a trust under state law. See § 1.468B-1(c)(3). Thus, the three requirements of § 1.468B-1(c) will be satisfied.

2. Taxpayers' Deductions for Transfers to Trust 2

Taxpayers' second requested ruling is that Taxpayers may deduct the amounts transferred to Trust 2 under §§ 162, 461(h), and 1.468B-3(c) in the years Taxpayers transfer those amounts to Trust 2.

Section 162(a) provides the general rule that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See *also* § 1.162-1(a). Payments made in settlement of lawsuits are deductible under § 162 if the acts which gave rise to the litigation were performed in the ordinary conduct of a taxpayer's business. See U.S. v.

Gilmore, 372 U.S. 39 (1963); Rev. Rul. 80-211, 1980-2 C.B. 57, and the authorities cited therein.

Section 461(a) provides the general rule that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting 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 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to the item occurs.

Section 461(h)(4) provides that the all events test is met with respect to any item if all events have occurred which determine the fact of the liability and the amount of such liability can be determined with reasonable accuracy.

Section 1.468B-3(c)(1) provides that, except as otherwise provided in that section, 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)(2)(i)(A) and (B) provide that economic performance does not occur to the extent the transferor (or a related person) has a right to a refund or reversion of a transfer if that right is exercisable currently and without the agreement of an unrelated person that is independent or has an adverse interest (e.g., the court or agency that approved the fund, or the fund claimants), or money or property is transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur, such as the passage of time, or if restrictions on its refund or reversion are illusory.

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. If the settlement of an insurance claim occurs after a transferor makes a transfer to a qualified settlement fund for which a deduction has been taken, the transferor must include in income the amounts received from the settlement of the insurance claim to the extent of the deduction.

Section 1.468B-3(f)(1) provides that a transferor must include in gross income any distribution it receives from a qualified settlement fund.

Section 1.468B-3(f)(3) provides that a distribution described in § 1.468B-3(f)(1) or (f)(2) is excluded from the gross income of a transferor to the extent provided by § 111(a) (regarding the recovery of tax benefit items).

Based on the facts represented, the amounts to be transferred to Trust 2 will be used to satisfy the Defendants' anticipated obligations regarding payment of Settlement Awards, which are liabilities described in § 1.468B-1(c)(2). These liabilities arose as a result of Taxpayers' principal business activities. Thus, such amounts will be deductible under § 162(a) as ordinary and necessary business expenses.

To the extent that the all events tests under § 1.461-1(a)(2), including economic performance, are met, the amounts transferred to Trust 2 will be deductible in the taxable year of the transfer. With respect to Taxpayers' transfers of funds to Trust 2, Taxpayers' liability is fixed and determinable with reasonable accuracy, and economic performance will occur at the time the cash is transferred to Trust 2. Furthermore with respect to economic performance, Taxpayers will meet the requirements of § 1.468B-3(c)(2)(i)(A) and (B). Under the Settlement Agreement, the Defendants do not have a currently exercisable right to reversion of any funds contributed to Trust 2. The circumstances permitting reversion of Trust 2 funds to Defendants are restricted and dependent upon events that are not certain to occur and are not illusory, and in all cases are subject to the approval of the Court.

Therefore, we conclude that Taxpayers may deduct under § 162 the amount of cash they transfer to Trust 2 in the taxable year or years of the transfers, but only to the extent that (i) the transfers are made to resolve or satisfy a liability described in § 1.468B-1(c)(2) and (ii) the transferred amounts do not represent amounts received from the settlement of an insurance claim which is excludable from Taxpayers' gross income.

PROCEDURAL MATTERS

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 Taxpayers 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 representatives.

A copy of this letter must be attached to any Federal income tax return to which it is relevant. Alternatively, Taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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,

Roy A. Hirschhorn
Branch Chief, Branch 6
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: