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SELECTED FEDERAL INCOME TAX CONSEQUENCES RESULTING FROM THE UTILIZATION OF LIQUIDATING TRUSTS, SETTLEMENT TRUSTS, FUNDS AND ACCOUNTS, DISBURSING AGENTS, AND OTHER ASSIGNMENTS TO THIRD PARTIES, TO SATISFY DEBTOR CLAIMS AND LIQUIDATE THE DEBTOR'S ASSETS

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I. INTRODUCTION.

A. Liquidating trusts, settlement funds, trusts and accounts, disbursing agents, escrows, disputed ownership funds, assignment for the benefit of creditors, receiverships and other arrangements utilizing the services of a third party to administer, preserve, hold, protect, reorganize, liquidate or otherwise resolve liability claims and/or to dispose of the debtor's assets for the benefit of creditors and equity holders are commonly utilized in and outside of bankruptcy.

B. In most cases, the formation, funding, operation and liquidation of a liquidating trust, settlement fund, trust or account, escrow or third party assignment for the benefit of creditors and/or equity holders will have federal income tax consequences to one or more of the following parties: (1) the debtor/transferor; (2) the liquidating trust and trustee, fund or account administrator; (3) third party assignee; (4) creditor claimant, or (5) equity holders. Federal income tax consequences potentially include but are not limited to (a) recognition of gains and losses or other income by the debtor transferor, the creditor claimants, the liquidating trust or the settlement fund or account, (b) imposition of tax reporting and withholding tax obligations, and (c) imposition of personal liability for taxes for third party trustee, administrators or assignees.

1. The federal income tax consequences to the debtor, the creditor, the shareholder/equity owner (if applicable), the trust, settlement fund and account, claimant, receiver, or other third party assignor or assignee with respect to (1) the formation, funding and operation of a liquidating trust, settlement fund, trust or account, or (2) the assignment of assets to a disbursing agent or other assignee, depend on numerous factors, including but not limited to the terms and intent of the trust, settlement fund or account, escrow or other assignment, the origin of the claims/liabilities to be satisfied, the type of assets to be transferred, held and/or liquidated, the method of formation and funding of the trust, fund or account, and the powers granted to the third party trustee or assignee. See, for example, In re Shank, 240 B.R. 216 (Bankr. D. Md. 1999), U.S. v. Brown, 334 F.3d 1197 (10th Cir. 2003); Internal Revenue Code Section 468B; Internal Revenue Code Section 641; Internal Revenue Code Section 671; Treasury Regulations Section 301.7701-4; IRS Revenue Procedure 94-45, 1994-2 C.B. 684. [1]

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[1] Unless otherwise indicated, all section references to (a) "IRC" or "Code" are to the sections of the Internal Revenue Code of 1986, as amended, and (b) the "Regulations" or "Regs." are to the Treasury Income Tax Regulations promulgated under the Internal Revenue Code.

C. The formation, funding, operation and liquidation of a liquidating trust, settlement trust, fund or account, escrow or other third party assignment may result in different state tax consequences including income tax consequences and sales tax consequences.

1. Many state income tax laws are based upon, but are not identical to federal income tax laws. This may result in significantly different federal and state income tax consequences to the debtor, or to the creditor claimants, as a result of the debtor's transfer of assets to the trust, fund or account. For example, unlike federal income tax laws, California income tax laws currently prohibit the carryback of net operating losses by the debtor and limit certain net operating loss carryforwards by the debtor. The application of these rules can cause a mismatching of income and deductions that may result in significant California income tax liability to an insolvent or bankrupt debtor.

II. FEDERAL INCOME TAX CLASSIFICATION AND TAXATION OF LIQUIDATING FUNDS, ACCOUNTS AND OTHER THIRD PARTY ARRANGEMENTS.

A. The federal income tax consequences with respect to the formation, funding, operation and liquidation of a liquidating trust, settlement fund or account, or other transfer to a third party assignee will depend on the classification and taxation of the legal arrangement.

B. The Internal Revenue Code and the Treasury Regulations provide for the classification and taxation of legal entities, contractual arrangements and organizations for federal income tax purposes, including liquidating trusts, settlement funds and accounts, disputed ownership funds and other third party liquidating arrangements. Whether an organization, trust, fund, account or legal arrangement is an entity separate from its owners (separate taxable entity) or a non-taxable pass-through entity for federal income tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local or bankruptcy laws or the legal characterization of the entity or contractual relationship under local law or bankruptcy laws. See Treas. Reg. Section 301.7701-1(a); Treas. Reg. Section 301.7701-4; IRS Rev. Rul. 69-300, 1969-1 C.B. 167.

C. IRC Section 468B and the Treasury Regulations thereunder address the federal income taxation of certain trusts, funds, accountants, escrows and other legal organizations and arrangements, including but not limited to Qualified Settlement Funds ("QSF"), Designated Settlement Funds ("DSF"), and Disputed Ownership Funds ("DOF"). IRC Section 468B(g)(1) provides that (1) except as provided in Treasury Regulations and (2) except for certain funds created for the receipt of settlement payments directed by a government entity to satisfy claims asserting liability under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"), escrow accounts, settlement funds or similar funds are subject to current income taxation. The purpose of this section is to insure that all income earned under these legal arrangements is currently subject to federal income taxation.

D. IRS Revenue Procedure 94-45 sets forth the IRS' guidelines to obtain a tax ruling with respect to a bankruptcy liquidating trust that is not subject to IRC Section 468B.

E. The term "trust" as used in the Internal Revenue Code generally refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries. Ordinarily the beneficiaries of such a trust do no more than accept the benefits of the trust and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally, an arrangement will be treated as a trust under the Internal Revenue Code the purpose of the arrangement is to vest in the trustee responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. See Reg. Section 301.7701-4(a).

F. Liquidating trusts in and outside of bankruptcy are treated as trusts for federal income tax purposes. An organization or entity will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for federal income tax purposes if it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation is lost or abandoned, the status of the organization will fail to qualify as a liquidating trust for federal income tax purposes. Bondholders' protective committees, voting trusts, and other agencies formed to protect the interests of security holders during insolvency, bankruptcy, or corporate reorganization proceedings are analogous to liquidating trusts so long as they are not utilized to further the control or profitable operation of a going business on a permanent continuing basis. See Reg. Section 301.7701-4(d). See Rev. Proc. 94-45 discussed below; IRS Rev. Rul. 63-245, 1963-2 C.B. 144; IRS Rev. Rul. 72-137, 1972-1 C.B. 101; IRS Rev. Rul. 75-379, 1975-2 C.B. 505; IRS Rev. Rul. 80-150, 1980-1 C.B. 316; IRS PLR 200509019; IRS PLR 9603013.

G. The IRS takes the position that for federal income tax purposes, the term "trust" is not confined to technical trusts under local law. Legal arrangements or relationships that resemble trusts or contain the characteristics of a trust qualify as a trust, for federal income tax purposes, even though there are technical reasons that cause the relationship to fail to qualify as a trust under local law. See Rev. Rul. 69-300, 1969-1 C.B. 167; IRS General Counsel Memorandum 39368; IRS Field Service Advice dated May 1, 1992.

1. In Rev. Rul 69-300, the IRS held that a bank appointed by a court as a custodian of property was a fiduciary for federal income tax purposes with respect to the property. Consequently, the bank was required to file trust federal income tax returns in its fiduciary capacity with respect to the custodial assets. The IRS held that the mere appointment of a bank or an individual as a custodian does not cause the custodian to be taxed as a fiduciary. However, fiduciary status exists where the custodian is granted broad discretionary powers of administration and management.

H. A liquidating trust can be taxed for federal income tax purposes in a variety of different ways:

1. A "grantor trust" with creditors as the grantors. See IRS Rev. Proc. 94-45, 1994-28 C.B. 124; PLR 200326015;

2. a "grantor trust" with the debtor as the grantor. See Rev. Rul. 77-230, 1977-2, C.B. 214; see Johnson v. Comm'r, 108 T.C. No. 22 (1997);

3. a separate taxable trust entity with creditors as beneficiaries of the trust. See IRC Section 641; PLR 8848019; GCM 32368;

4. a tax partnership with the creditors/beneficiaries as partners;

5. a taxable corporation with creditors/beneficiaries as shareholders; or

6. a Qualified Settlement Fund, Designated Settlement Fund, Disputed Ownership Fund, Escrow, or other fund or trust account within the meaning of IRC Section 468B and the Treasury Regulations thereunder (discussed below).

I. A grantor trust is a pass-through tax entity for federal income tax purposes. The trust does not pay federal income tax. Rather, the trust files information returns with the IRS which reports the trust's tax items such as income, deductions, gains and losses. The grantor(s) of the trust, rather than the beneficiaries of the trust, is required to report and pay federal income tax on the trust's tax items. See IRC Sections 671-679; PLR 200128001. In the case of a bankruptcy liquidating trust that is not subject to IRC Section 468B, the creditor/claimants are treated as the grantors of the trust for federal income tax purposes and are required to pay federal income tax on their share of the trust's income. See Rev. Proc. 94-45 (discussed below).

J. The establishment and funding of a trust in which the debtor is treated as the grantor for federal income tax purposes is not an immediate taxable event to either the debtor or the creditor beneficiaries. The debtor as grantor is treated as continuing to own all of all of the trust assets for federal income tax purposes and is treated for federal income tax purposes as if the trust doesn't exist except for information reporting purposes. See IRC Section 671 and the Regulations thereunder.

K. The establishment and funding of a grantor trust in which the creditors are treated as the trust grantors for federal income tax purposes is an immediate taxable event to both the debtor and to the creditor beneficiaries. The debtor is treated for federal income tax purposes as transferring to the creditors those assets which the debtor uses to fund the trust in satisfaction of the creditors' claims. The transfer of assets by the debtor is a taxable sale by the debtor of assets in satisfaction of debt. The sale may result in (i) gain or loss to the debtor, and/or (ii) cancellation of debt income to the debtor. The deemed receipt of the assets by the creditors is potentially taxable to the creditors. The creditors may realize gain or loss with respect to the satisfaction of their claims equal to the difference between their share of the fair market value of the assets transferred by the debtor and the creditors' tax basis in their claims. See Rev. Proc. 94-45. IRC Section 108, IRC Section 1001 and the Treasury Regulations thereunder.

III. FEDERAL INCOME TAXATION OF BANKRUPTCY LIQUIDATING TRUSTS OTHER THAN QUALIFIED SETTLEMENT FUNDS AND DESIGNATED SETTLEMENT FUNDS.

A. IRS Rev. Proc. 94-45 sets forth a safe harbor for structuring bankruptcy liquidating trusts that do not qualify as Qualified Settlement Funds, Designated Settlement Funds, or certain electing Disputed Ownership Funds under IRC Section 468B (see discussion below). The Internal Revenue Service takes the position that liquidating trusts that satisfy the criteria under Rev. Proc. 94-45 or otherwise qualify as bankruptcy liquidating trusts that are not subject to IRC Section 468B are taxed as creditor grantor trusts for federal income tax purposes. The federal income tax characterization and treatment of the formation and operation of bankruptcy liquidating trusts that is set forth in Rev. Proc. 94-45 (creditor grantor trust) is consistent with the IRS' long standing position with respect to non bankruptcy liquidating trusts.

B. Under Rev. Proc. 94-45, the formation and funding of the trust is treated for federal income tax purposes as a (1) a fictitious deemed direct transfer of assets by the debtor to the creditors in satisfaction of the creditors' claims against the debtor, immediately followed by (2) a fictitious deemed direct transfer of the assets by the creditors to the trust, as settlors/ grantors of the liquidating trust. The establishment and funding of the grantor trust in which the creditors are treated as the trust grantors for federal income tax purposes is an immediate taxable event to both the debtor and to the creditor beneficiaries. The debtor is treated, for federal income tax purposes, as transferring to the creditors those assets which the debtor uses to fund the trust. The deemed tax transfer of assets by the debtor to the creditors in satisfaction of claims is treated for federal income tax purposes as a taxable sale by the debtor of assets in satisfaction of debt. The receipt of the assets by the creditors, in satisfaction of claims, is a taxable transaction to the creditors. See Rev. Proc. 94-45.

C. The transfer of assets by the debtor to the liquidating trust (i.e. the deemed fictitious transfer of assets to creditors in satisfaction of their claims) is treated as a taxable sale for federal income tax purposes. Consequently, the debtor will recognize gain or loss with respect to the transfer. In addition, the debtor may realize cancellation of debt income ("CODI") to the extent the fair market value of assets transferred by the debtor to fund the trust is less than the amount of debt/creditor claims satisfied by the transfer. The CODI may qualify for one or more of the cancellation of debt income exclusions under IRC Section 108 such as the bankruptcy or insolvency exclusion. See Rev. Proc. 94-45; IRC Section 1001 and the Regulations thereunder; and IRC Section 108.

D. The deemed trust's fictitious transfer by the debtor to the creditors/beneficiaries in satisfaction of their claims against the debtor is also a taxable event to the creditors for federal income tax purposes. The creditors may recognize an immediate gain or loss for federal income tax purposes measured by the difference between the fair market value of their share of the trust's assets and the creditors' tax basis in their claims.

E. As a result of the fictitious transactions described above whereby the creditors (rather than the debtor) are deemed to settle the trust for federal income tax purposes, the liquidating trust is treated as grantor trust for the benefit of the creditors.

Consequently, the liquidating trust is treated as a nontaxable pass-through tax entity. The trust does not pay federal income tax. The trust reports its share of tax items of income, gain, loss, deduction and credits to the IRS and to the creditor beneficiaries who report, and if necessary, pay federal income tax on their share of the trust's tax items.

F. Rev. Proc. 94-45 specifies conditions under which the Internal Revenue Service will consider issuing rulings classifying entities created pursuant to bankruptcy plans under chapter 11 of the Bankruptcy Code as liquidating trusts under Treas. Reg. Section 301.7701-4(d). It also outlines the income reporting requirements for the trust. In cases where an IRS ruling under Rev. Proc. 94-45 will not be sought, the bankruptcy plan, disclosure statement and legal documentation regarding the formation, funding, operation, distribution and liquidation of the liquidating trust should be drafted to satisfy the safe harbor requirements of the Rev. Proc.

1. Under Rev. Proc. 94-45, a ruling generally will be issued that an entity is classified as a liquidating trust if the following conditions are met:

a. The trust is or will be created pursuant to a confirmed plan under Chapter 11 of the Bankruptcy Code for the primary purpose, as stated in its governing instrument, of liquidating the assets transferred to it with no objective to continue or engage in the conduct of a trade or business, except to the extent reasonably necessary to, and consistent with, the liquidating purpose of the trust;

b. The bankruptcy plan and disclosure statement are required to explain how the bankruptcy estate will treat the transfer of its assets to the trust for federal income tax purposes. A transfer to a liquidating trust for the benefit of creditors is required to be treated for all purposes of the Code as a transfer to creditors (e.g., IRC Sections 61(a)(12), 483, 1001, 1012 and 1274). The transfer will be treated as a deemed transfer to the beneficiary-creditors followed by a deemed transfer by the beneficiary-creditors to the trust. To the extent that the liquidating trust is being created for the benefit of equity interest holders in the debtor, the transfer to the trust should be treated as a transfer to the equity interest holders. The ruling request is required to explain whether the debtor or the bankruptcy estate will incur any tax liability from the transfer and, if so, how that liability will be paid.

c. The bankruptcy plan, disclosure statement, and any separate trust instrument is required to provide that the beneficiaries of the trust will be treated as the grantors and deemed owners of the trust. See Bixby v. Commissioner, 58 T.C. 757 (1972), acq., 1975-2 C.B. 1, and IRC Section 677 of the Code. The trust instrument (which may be the plan if there is no separate trust instrument) must require that the trustee file returns for the trust as a grantor trust pursuant to Treas. Reg. Section 1.671-4(a).

d. The bankruptcy plan, disclosure statement, and any separate trust instrument are required to provide for consistent valuations of the transferred property by the trustee and the creditors (or equity interest holders), and those valuations are required to be used for all federal income tax purposes.

e. Whether or not a reserve is established for disputed claims, all of the trust's income is required to be treated as subject to federal income tax on a current basis, and the ruling request is required to explain, in accordance with the plan, how the trust's taxable income will be allocated and who will be responsible for payment of any tax due.

f. The trust instrument must contain a fixed or determinable termination date that is generally not more than 5 years from the date of creation of the trust and that is reasonable based on all the facts and circumstances. If warranted by the facts and circumstances provided for in the bankruptcy plan and trust instrument, and subject to the approval of the bankruptcy court with jurisdiction over the case upon a finding that the extension is necessary to the liquidating purpose of the trust, the term of the trust may be extended for a finite term based on its particular facts and circumstances. The trust instrument must require that each extension be approved by the court within 6 months of the beginning of the extended term.

g. If the trust is to hold any operating assets of a going business, a partnership interest in a partnership that holds operating assets, or 50% or more of the stock of a corporation with operating assets, the ruling request is required to explain why it is necessary to retain these assets.

h. If the trust is to receive transfers of listed stocks or securities or other readily marketable assets, the ruling request is required to explain the necessity for doing so. The trust is not permitted to receive or retain cash or cash equivalents in excess of a reasonable amount to meet claims and contingent liabilities (including disputed claims) or to maintain the value of assets during liquidation.

i. The investment powers of the trust, other than those reasonably necessary to maintain the value of the assets and to further the liquidating purpose of the trust, are required to be limited to powers to invest in demand and time deposits, such as short-term certificates of deposit, in banks or other savings institutions, or other temporary, liquid investments, such as Treasury bills.

j. The trust is required to distribute at least annually to the beneficiaries its net income plus all net proceeds from the sale of assets, except that the trust may retain an amount of net proceeds or net income reasonably necessary to maintain the value of its assets or to meet claims and contingent liabilities (including disputed claims).

k. The ruling request is required to contain representations that the trustee will make continuing efforts to dispose of the trust assets, make timely distributions, and not unduly prolong the duration of the trust.

G. Holywell Corp. v. Smith, 503 U.S. 47, 112 S.Ct. 1021 (1992).

1. Pursuant to a bankruptcy reorganization plan of the debtors which included four corporations and one individual, a trust administered by a court-appointed trustee was established to liquidate property of the five estates and distribute the proceeds to creditors. The trustee sought a declaratory judgment that he had no duty to file federal income tax returns or pay income tax, which was granted by the bankruptcy court and affirmed by the district and appellate courts. The U.S. Supreme Court reversed, holding that trustee did in fact have a duty to file tax returns and pay income tax. With respect to the corporate debtors, the court held that respondent was an "assignee" of corporate property according to IRC Section 6012(b)(3), who was required to file tax returns, regardless of whether the assignment was in connection with the winding up of a dissolving corporation. Additionally, the trustee had a duty to file returns and pay taxes with respect to the individual debtor, pursuant to IRC Section 6012(b)(4), as the fiduciary of a non-grantor liquidating trust, since the bankruptcy estate's property never reverted to the individual.

H. IRS's View of the Holywell case.

1. See footnote 1 of Rev. Proc. 94-45. "The tax consequences associated with the creation of a bankruptcy liquidating trust were not addressed in Holywell Corp. v. Smith, 112 S.Ct. 1021 (1992)."

2. IRS Field Service Advice ("FSA") dated April 29, 1997. In this FSA, the IRS sets forth its interpretation of the U.S. Supreme Court's decision in the Holywell case as applied to liquidating trusts. The IRS determined that the Holywell decision does not change the tax treatment of liquidating trusts set forth in Rev. Proc. 94-45, and that the decision does not mandate that every liquidating trust is a separate taxable entity.

a. Excerpts from FSA dated April 29 , 1997.

"IV. Applicability of Holywell.

Recently, the Supreme Court held that the trustee of a post-confirmation liquidating trust had to file returns and pay taxes for the trust under Sections 6012(b)(3), 6012(b)(4), and 6151(a). Holywell Corp. v. Smith. It appears that the Court viewed the case as a simple matter of statutory application; therefore, the issues discussed in this memorandum were not addressed by the Court.

Holywell involved both corporate and individual debtors. In the case of the corporate debtors, the Court held that the trustee was, at a minimum, an assignee within the meaning of Section 6012(b)(3), and thus subject to a duty to file returns and pay taxes. The Court did not address the issue of whether the trustee might be required to file returns as the trustee of a trust. It did not need to resolve this issue to hold that the trustee had a return filing obligation.

In the case of the individual debtor, the Court held that the trustee was the fiduciary of the trust of an individual and therefore required to file returns and pay taxes under Sections 6012(b)(4) and 6151(a). Based on the language of the debtor's plan of reorganization, the Court held that the trust was not a continuation of the bankruptcy estate. Instead, a new taxable entity – a trust – was created by the confirmation of the plan.

Once the Court decided that a trust existed, it ceased its analysis. Thus, the opinion does not address the question of how the trust is to be taxed under subchapter J (i.e., as a simple, complex, or grantor trust), nor does it define the relationship between the creditors and the trust. As a result, it leaves open the possibility that the creditors are merely the beneficiaries of these types of trusts, and not the grantors.

We do not believe that the bankrupt's creditors can ever be merely the beneficiaries of a bankruptcy liquidating trust. Section 301.7701-4(a) explains that the beneficiaries of a trust usually do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. In bankruptcy cases, the creditors will be responsible for the creation of the equity if they vote to accept the plan of reorganization; their role is more active than that of a mere beneficiary.

In addition, the Court never considered the question of whether the transfer to the trustee was a taxable event. As we have explained above, it is our opinion that the transfer to the Trust for the benefit of the creditors does not differ from a transfer directly to the creditors. See H.R. Rep. No. 96-833, 96th Cong., 2d Sess. 39; Rev. Rul. 63-245, 1963-2 C.B. 144; Dannenberg v. Commissioner, 73 T.C. 370 (1979), acq. 1980-2 C.B. 1. It is well settled that a transfer directly to the creditors in return for debt relief is a taxable event. See, e.g., United States v. Davis, 370 U.S. 65 (1962); Bialock v. Commissioner, 35 T.C. 649 (1961); Section 1.1001-2.

The Court's failure to address these vital issues makes it appropriate to apply the opinion mechanically to any set of facts. However, the Holywell Court gave the Service one holding that should prove useful in future cases – failure to object to the reorganization plan because it lacks instruction for the trustee to report and pay taxes does not relieve the trustee of his duty to do so. It would be prudent, however, to continue to insist that the trustee's reporting requirements be made explicit in the Plan, to ensure that the parties are aware of their duties and of the tax ramifications of the agreement.

Conclusion.

The Trust Agreement indicates that the Trust is intended to be treated as a grantor trust, with the debtors as the sole grantors. Notwithstanding the Trust's statements, the Trust should be classified a s grantor trust owned by the creditors. (If the debtor's reversionary interest in the Trust is likely to have substantial value, then the debtor may be treated as owning a portion of the Trust as well. See Trust Agreement.

The transfer of the real properties to the Trust will be a taxable exchange of those properties for debt relief. Consequently, the debtor will recognize gain on the difference between the amount realized from the exchange and the adjusted tax bases of the transferred properties. The amount realized from the exchange is the lesser of the fair market value of the transferred properties or the amount of debt outstanding."

3. IRS Chief Counsel Advice Memorandum 200149006 (August 10, 2001 DTR 12/10/2001.

4. IRS Chief Counsel Advice Memorandum 200228003 (March 5, 2002).

IV. FEDERAL INCOME TAXATION OF QUALIFIED SETTLEMENT FUNDS (IRC SECTION 468B).

A. As discussed above, Rev. Proc. 94-45 does not apply to a QSF or a DSF under IRC Section 468B. The federal income taxation of a QSF, DSF and a DOF, including the tax consequences to the transferor, the fund and distributions to claimants are set forth in IRC Section 468B and the Treasury Regulations thereunder. See Treas. Reg. Sections 1.468B-1, 1.468B-2, 1.468B-3, 1.468B-4, 1.468B-5 and 1.468B-9.

B. A QSF is defined as a fund, account or trust that satisfies all of the following criteria:

1. it is established pursuant to an order of, or is approved by the United States government, any state, territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) and is subject to the continuing jurisdiction of that governmental authority; and

2. it is established to resolve or satisfy one or more contested or uncontested liability claims that arose:

a. under CERCLA;

b. out of a tort, breach of contract, or violation of law; or

c. under circumstances designated by the IRS in a revenue ruling or revenue procedure; and

3. The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

a. If the fund, account or trust is not a trust under applicable state law, then the fund, account, or trust satisfies the segregation requirements described above if its assets are physically 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.

C. The following liabilities are excluded for purposes of the QSF qualification rules (i.e., are non-allowable QSF claims):

1. A liability for the provision of services or property unless (a) the transferor's obligation to provide services or property is extinguished by a transfer to the fund, account or trust, or (b) in the case of a transferor's liability under CERCLA to provide services or property if, following its transfer to a fund, account, or trust the transferor's only remaining liability to the Environmental Protection Agency (if any) is a remote, future obligation to provide services or property;

2. A liability that arises under a workers compensation act or a self-insured health plan;

3. A liability that is an obligation to refund the purchase price of, or to repair or replace, products regularly sold in the ordinary course of the transferor's trade or business;

4. a liability that is an obligation of the transferor to make payments to its general trade creditors or debt holders with respect to a title 11 or similar case, or a workout; or

5. a liability that is designated by the IRS in a revenue ruling or a revenue procedure.

   a. A "transferor" is a person that transfers (or on behalf of whom an insurer or other person transfers) money or property to a qualified settlement fund to resolve or satisfy qualifying claims described against that person.

D. If a fund, account, or trust is established to resolve or satisfy qualifying claims and liabilities as well as other types of claims (i.e., non-allocable claims) arising from the same event or related series of events, the fund is a qualified settlement fund. However, economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims.

E. Taxation of Qualified Settlement Funds.

1. For federal income tax purposes, absent a grantor trust election (discussed below) 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 trust tax rate in effect for that taxable year (IRC Section 1(e)). The "modified gross income" of a QSF is its gross income, computed with the following adjustments:

   a. In general, amounts transferred to the QSF by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income. Income earned by the QSF with respect to QSF assets such as dividends on stock of a transferor (or a related person) transferred to the QSF or interest on debt of a transferor (or a related person) transferred to the QSF are taxable. Payments to compensate for late or delayed transfers, are not excluded from gross income and are taxable for federal income tax purposes.

   b. A deduction is allowed to the QSF for:

      (1) administrative costs and other incidental expenses incurred in connection with the operation of the QSF that would be deductible in determining the taxable income for federal

income tax purposes of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operation of a QSF, and expenses arising from the notification of claimants and processing of their claims. Administrative costs and other incidental expenses do not include legal fees incurred by, or on behalf of, claimants;

(2) losses sustained by the QSF in connection with the sale, exchange, or worthlessness of property held by the fund to the extent the losses would be deductible in determining the taxable income of a corporation for federal income tax purposes; and

(3) the amount of a net operating loss of the QSF to the extent the loss would be deductible in determining the taxable income of a corporation. The net operating loss of a QSF for a taxable year is the amount by which the deductions allowed exceed the gross income of the fund computed with modifications.

c. Amounts that are distributed by a QSF to (or on behalf of) a transferor or a claimant are not deductible by the fund.

d. A QSF's initial tax basis in property it receives from a transferor (or from an insurer or other person on behalf of a transferor) is the fair market value of that property on the date of transfer to the fund.

e. A QSF is required to treat a distribution of property to a claimant as a sale or exchange of that property for federal income tax purposes. In computing gain or loss, the amount realized by the QSF is the fair market value of the property on the date of distribution.

f. The federal income tax imposed on the modified gross income of a QSF is not reduced or offset by certain tax credits.

g. A QSF is not subject to the alternative minimum tax (IRC Section 55), the accumulated earnings tax (IRC Section 531), the personal holding company tax (IRC Section 541), or the maximum capital gains rate (IRC Section 1(h)). A QSF is, however, subject to taxes that are not imposed on the income of a taxpayer.

h. The taxable year of a QSF is the calendar year. A qualified settlement fund is required to use the accrual method of accounting.

i. For purposes of subtitle F of the Internal Revenue Code, a qualified settlement fund is treated as a corporation and any tax imposed is treated as a tax imposed by IRC Section 11.

j. A QSF is required to file an income tax return with respect o the tax imposed for each taxable year that the fund is in existence, whether or not the fund has gross income for that taxable year. The income tax return of the QSF is required to be filed on or before March 15 of the year following the close of the taxable year of the QSF unless the fund is granted an extension of time for filing.

2. The administrator of a QSF is required to obtain an employer identification number for the fund.

3. Payments and distributions by a QSF are subject to the tax information reporting requirements and the withholding requirements of the Internal Revenue Code. A QSF is required to file a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant;

4. A QSF is eligible to request a prompt assessment of tax under IRC Section 6501(d). For this purpose, a QSF is treated as dissolving on the date the fund no longer has any assets (other than a reasonable reserve for potential tax liabilities and related professional fees) and will not receive any more transfers.

5. If a QSF has only one transferor, the transferor may make an election (grantor trust election) to treat the qualified settlement fund as a trust all of which is owned by the transferor for federal income tax purposes under IRC Section 671 and the Regulations thereunder (i.e., a grantor trust for the benefit of the debtor or other transferor). A grantor trust election may be made whether or not the QSF would otherwise be classified as a grantor trust owned by the transferor.

a. If a grantor trust election is made, then:

(1) the qualified settlement fund is treated for federal income tax purposes as a trust all of which is treated as owned by the transferor under IRC Section 671 and the regulations thereunder;

(2) the transferor must take into account in computing the transferor's federal income tax liability all items of income, deduction, and credit (including capital gains and losses) of the qualified settlement fund in accordance with Treasury Regulation Section 1.671-3;

(3) the reporting obligations imposed by Treasury Regulation Section 1.671-4 on the trustee of a trust apply to the administrator of the QSF; and

(4) certain provisions of the QSF Regulations will continue to apply to the QSF.

F. Taxation of Transferor to QSF.

1. A transferor is required to treat a transfer of property to a QSF as a sale or exchange of that property for federal income tax purposes. In computing the gain or loss, the amount realized by the transferor is the fair market value of the property on the date the transfer is made (or is treated as made) to the QSF. The issuance of the transferor's debt obligation to provide services or property in the future, or obligation to make a payment to a QSF is generally not treated as a taxable transfer of property by the transferor, (i.e. does not generally result in gain or loss to the transferor).

a. A transferor must obtain a qualified appraisal to support a loss or deduction it claims with respect to a transfer to a QSF of the following types of property:

(1) Nonpublicly traded securities issued by the transferor (or a related person); and

(2) interests in the transferor (if the transferor is a partnership) and in a partnership in which the transferor (or a related person) is a direct or indirect partner.

2. For purposes of determining deductibility of payments and transfers to the QSF, under IRC Section 461(h), economic performance occurs with respect to a qualifying liability to the extent the transferor makes a transfer to a QSF to resolve or satisfy the liability. Exceptions to economic performance may apply if the transferor (or a related person) has a right to a refund or reversion of a transfer, or when a transferor transfers its debt (or the debt of a related person) to a QSF.

G. The determination as to whether a distribution to a claimant is includible in the claimant's gross income for federal income tax purposes is generally determined as if the distribution were made directly by the transferor to the claimant. For example, if a distribution is in satisfaction of personal injury damages or sickness, the distribution may be excludable from gross income under IRC Section 104(a)(2). Similarly, to the extent a distribution is in satisfaction of a claim for taxable debt interest, the distribution may be includible in the claimant's gross income under IRC Section 61(a)(4).

V. FEDERAL INCOME TAXATION OF DESIGNATED SETTLEMENT FUNDS (IRC SECTION 468B).

A. A DSF is any fund that satisfies all of the following criteria:

1. it is established pursuant to a court order and which extinguishes completely the taxpayer's tort liability with respect to claims arising out of personal injury, death or property damage;

2. no amounts can be transferred to the fund other than in the form of "qualified payments";

3. the fund is administered by persons a majority of whom are independent of the taxpayer;

4. the fund is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person or formerly related person) arising out of personal injury, death or property damage;

5. the taxpayer (or any related person) may not hold any beneficial interest in the income or corpus of the fund; and

6. a tax election is made by the taxpayer to treat the fund as a DSF.

B. A "qualified payment" means any money or property which is transferred to a DSF pursuant to a court order, but does not include (i) money or property that may be transferred from the fund back to the taxpayer (or to any related person), or (ii) any stock or indebtedness of the taxpayer (or any related person).

C. A DSF is taxed for federal tax purposes similar to a QSF. The federal income tax rules for transferors to a QSF apply to transferors to a DSF. Similarly, the rules for taxing claimants of a QSF with respect to distributions received apply to distributions to claimants of a DSF. A fund, account, or trust that does not qualify as a DSF is a QSF if it satisfies the requirements of a QSF.

VI. FEDERAL INCOME TAXATION OF DISPUTED OWNERSHIP FUNDS (IRC SECTION 468B).

A. A Disputed Ownership Fund is an escrow account, trust, or fund that satisfies all of the following criteria:

1. it is established to hold money or property subject to conflicting claims of ownership;

2. it is subject to the continuing jurisdiction of a court;

3. it requires the approval of the court to pay or distribute money or property to, or on behalf of, a claimant, transferor, or transferor-claimant; and

4. it is not a QSF, a bankruptcy estate (or part thereof) resulting from the commencement of a case under Title 11, or a liquidating trust under Treas. Reg. 301.7701-4(d).

B. For federal income tax purposes, a DOF is treated as a separate taxable entity. The administrator of the fund is required to get an employer identification number for the fund, make all required income tax and information returns, and deposit all tax payments.

C. A DOF is taxable as either:

1. a C corporation, unless all the assets transferred to the fund by or on behalf of transferors are passive investments assets. Passive investment assets are assets of the type that generate portfolio income for federal income tax purposes; or

2. a QSF, if all the assets transferred to the fund by or on behalf of transferors are passive investment assets.

D. The trustee of a liquidating trust established pursuant to a plan confirmed by the court in a case under Title 11 may file an election with the IRS for the liquidating trust's first taxable year, to treat an escrow account, trust, or fund that holds assets of the liquidating trust that are subject to disputed claims as a DOF. Pursuant to this tax election, creditors holding disputed claims are not treated as transferors of the money or property transferred to the DOF. A trustee is required to make the tax election by attaching a statement to the timely filed federal income tax return of the disputed ownership fund for the taxable year for which the election becomes effective.

E. In general, similar to a QSF and a DSF, a DOF is not required to report as income transfers of disputed property to the DOF. A DOF is required to include in income all income received or accrued from the disputed property, including items such as:

1. payments to a disputed ownership fund made as compensation for late or delayed transfers of money or property;

2. dividends on stock of a transferor (or a related person) held by the DOF; and

3. interest on debt on debt of a transferor (or a related person) held by the DOF.

F. In general, the initial basis of property transferred by, or on behalf of, a transferor to a DOF is the fair market value of the property on the date of transfer to the fund, and the fund's holding period begins on the date of the transfer. If the transferor is a transferor-claimant, the fund's initial basis in the property is the same as the basis of the transferor-claimant immediately before the transfer to the fund.

G. A DOF taxable as a C corporation is allowed to adopt any allowable accounting method. A DOF taxable as a C corporation may use any allowable taxable accounting year. A DOF taxable as a QSF is also allowed to adopt any allocable accounting method and use any allowable taxable year.

H. If on the termination of a disputed ownership fund, the fund has an unused net operating loss carryover, an unused capital loss carryover or an unused tax credit carryover, or if the fund has, for its last taxable year, deductions in excess of gross income, the claimant to which the DOF's net assets are distributable will succeed to and take into account the unused net operating loss carryover, unused capital loss carryover, unused tax credit carryover, or excess of deductions over gross income for the last taxable year of the DOF. If the DOF's net assets are distributable to more than one claimant, the unused net operating loss carryover, unused capital loss carryover, unused tax credit carryover, or excess of deductions over gross income for the last taxable year is allocated among the claimants in proportion to the value of the assets distributable to each claimant from the DOF.

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