



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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MEMORANDUM FOR M. K. MORTENSEN
ASSOCIATE AREA COUNSEL
CC:SB:5:SLC
ATTN: MARK HOWARD

FROM: James L. Atkinson
Acting Deputy Associate Chief Counsel
(Income Tax & Accounting)

SUBJECT:

Legend

X =

Y =

Z Office =

A =

year 1 =

date 1 =

date 2 =

This Field Service Advice responds to your request for assistance in determining the proper application of the Qualified Settlement Fund (QSF) rules in the above-captioned case. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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Facts

In the early 1990's, several X individuals subscribed to investments in Y securities promoted by X and Y promoters (including A). Apparently the promoters were not complying with securities regulations, and in year 1 the Z Office handed down a criminal indictment against the promoters and began forfeiture proceedings against them. On date 1, the court overseeing the proceedings (which by this time also included a civil suit brought by the X investors) ordered, in accordance with a stipulation of the promoters, that the seized property should be delivered to the investors as restitution under a plan to be set forth in a subsequent stipulation of the parties. Pending the distribution, the court ordered the Y to retain possession of the property.

The Z Office requested appointment of a receiver. We understand that the seized assets did not generate a substantial amount of income between date 1 and date 2. On date 2, the court appointed a receiver to manage the seized assets, with the ultimate goal of liquidation and restitution to the X investors. In the order the court instructed the Y to turn over all properties it held to the receiver, encumbered the property with a judicial lien, and directed the receiver to prepare an accounting of the receivership. The order also subjected the property in the receivership to the jurisdiction of the court. Since this time the receiver has been locating additional property hidden by the defendants.

In addition, some of the investors have sued, and received a recovery from, a law firm that was involved in the securities promotions. We understand that the court plans to take this recovery into account in ordering the final distribution from the receivership.

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Law and Analysis

Section 468B(g) of the Internal Revenue Code states 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 income current tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

The Qualified Settlement Fund (QSF) regulations were published to implement the congressional mandate to provide for the current income taxation of such accounts and funds as grantor trusts or **otherwise**.¹ Pursuant to § 1.468B-1(c), a fund, account, or trust is a QSF, as relevant here, if:

- It is established pursuant to an order of, or is approved by, the United States or any agency or instrumentality (including a court of law) thereof, and it is subject to the continuing jurisdiction of that governmental authority;
- It is established to resolve or satisfy one or more contested 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 arising out of a tort, breach of contract, or violation of law; and
- 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).

Section 1.468B-1(b) provides that if a fund, account, or trust that is a QSF could be classified as a trust under § 301.7701-4, it is classified as a QSF for all purposes of the Internal Revenue Code. This regulation also provides that if a fund, account, or trust, organized as a trust under applicable state law, is a QSF and could be classified as an association under § 301-7701-2 or a partnership under § 301.7701-3, it is a QSF for all purposes of the Code.

¹Section 468B(g) was enacted to provide for the current taxation of escrow accounts, settlement funds, and similar funds, reversing Rev. Rul. 71-119, 1971-1 C.B. 163 (a settlement fund is not a trust, and the court administering the fund is not a fiduciary). See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986), 1986-3 (Vol. 4) C.B. 844-845. This eliminates the “homeless income” problem that arose when a defendant deposited an amount into a settlement fund to pay a claim. Under prior law, the defendant asserted it was not taxable on the fund income since it paid the corpus into a court-established fund to settle a liability. In addition, the amount payable to any particular claimant was not known until a later date. Section 1.468B-1 fulfills the mandate to publish regulations providing for the **current** taxation of income on such funds, by treating the settlement fund itself as a taxable entity with respect to earnings on the deposited amount, regardless of the nature or character of the potential claimants.

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Section 1.468B-2(a) provides that a QSF is a United States person and is subject to tax on its modified income for any taxable year at a rate equal to the maximum rate in effect under § 1(e) of the code.

Court Order

A fund, account, or trust is “ordered by” or “approved by” a governmental authority when the authority issues its initial or preliminary order to establish, or grants its initial or preliminary approval of, the fund, account, or trust, even if the order or approval is subject to review or revision. Section 1.468B-1(e).

The date 1, order meets the “court order” requirement of § 1.468B-1(c). Although the order did not explicitly state that the court retained jurisdiction, it is clear from the context that the court remained involved in the disposition of the assets.

The receivership in this case was established by court order on date 2, and the order explicitly gives the court jurisdiction over the receivership. Therefore, the receivership meets this requirement.

Resolves or Satisfies Claims

The facts indicate that the seizure and holding of the property (both by the Z Office and by the receiver) were not designed to fully satisfy all the claims in this action. We understand that the investors may have other legal avenues for recovering their losses from the promoters. However, we also understand that the investors will not be allowed a double recovery – that is, if they receive 60 cents for every dollar’s worth of claims against the promoters, any separate recovery will be limited to the remaining 40 cents.

Although the regulations are not explicit on this issue, it is this office’s position that this type of *pro tanto* resolution or satisfaction meets the regulation standards. The QSF rules should be distinguished from the Designated Settlement Fund rules that appear in §468B(a)-(f), which require that the fund extinguishes completely the transferor’s liability. The QSF rules were designed to provide more flexibility. For example, if a defendant’s total liability is \$50 million, and the defendant pays \$20 million into an account in partial satisfaction, there is a resolution or satisfaction with respect to \$20 million of the liability, even though the rest of the liability will be satisfied outside of this arrangement. See example 1 of § 1.468B-1(k), which concludes that a fund to resolve a liability of \$150 million is a QSF where only \$125 million was transferred to the fund. See also example 4 of § 1.468B-1(k), which concludes that a defendant’s partial deposit of amounts into a fund is treated as a QSF. Accordingly, this requirement has been met.

Segregated Assets

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This requirement is satisfied if assets are physically segregated from other assets of the transferor. This is the case with respect to both the Z Office stewardship and the receivership.

Conclusion

The fund held by the Z Office and the receiver is a QSF because each of the three requirements for classification of a QSF in § 1.468B-1(c) were met on date 1. In addition, pursuant to § 1.468B-1(b), classification as a QSF precludes treatment of the fund as a trust or other type of entity. Further, the fact that the potential claimants are not subject to United States income tax because they are nonresident aliens is not a relevant consideration. Instead, § 1.468B-2(a) states that a fund that is a QSF is a United States person and that it is subject to tax on fund earnings.



I hope you find this information to be helpful. Please contact Edwin B. Cleverdon at (202) 622-4920 if you need further assistance.