
DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8459]

RIN 1545-A099

Settlement Funds

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of transfers to funds, accounts, and trusts used in the settlement of certain controversies, the taxation of income earned by these funds, and the tax treatment of distributions made by these funds. Changes to the applicable law were made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. The regulations affect these settlement funds, taxpayers who make transfers to these funds, and taxpayers who receive distributions from these funds. The regulations are necessary to provide these taxpayers with guidance needed to comply with these changes.

DATES: These regulations are effective January 1, 1993. Thus, the regulations apply to transfers to, income earned by, and distributions made by a qualified settlement fund after December 31, 1992. The regulations provide transition rules for funds, accounts, and trusts established after August 16, 1986.

FOR FURTHER INFORMATION CONTACT: Linda M. Kroening of the Office of Assistant Chief Counsel (Income Tax & Accounting), telephone (202) 622-4910 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information requirements contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1299.

The estimated total annual reporting burden is 3,751 hours. The estimated annual burden per respondent varies from 25 minutes to 12 hours and 45 minutes, depending on individual circumstances, with an estimated average of 1 hour.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or lesser time, depending on their particular circumstances.

Comments regarding the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224 and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On February 14, 1992, the Internal Revenue Service published a notice of proposed rulemaking in the Federal Register (57 FR 5399) regarding settlement funds. The preamble to that notice contains an explanation of the proposed rules. A public hearing was held on May 27, 1992. After consideration of the public comments regarding the proposed regulations, the regulations are adopted as revised by this Treasury decision.

Explanation of Statutory Provisions

Section 468B (a) through (d) provides rules for the taxation of designated settlement funds and for taxpayers that make qualified payments to such funds. Section 468B(e) provides that section 468B (other than subsection (g)) does not apply with respect to any liability of a taxpayer arising under a workers compensation act or any contested liability (within the meaning of section 401(f)) of a taxpayer. Section 468B(f) provides that, except as provided in regulations, any payment in respect of a liability arising out of personal injury, death, or property damage (and not

described in section 468B(e)) that is made to a trust fund or escrow fund that is not a designated settlement fund does not constitute economic performance.

Section 468B(g) provides that "[n]othing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax." In addition, section 468B(g) provides that "(t)he Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise." Section 468B(g) was enacted, in part, to reverse the finding in Rev. Rul. 71-119, 1971-1 C.B. 163. See § 601.601(d)(2)(ii)(b) of this Chapter. (Some taxpayers argued that Rev. Rul. 71-119 was authority for avoiding the current taxation of income earned on the assets of an escrow account, settlement fund, or other similar fund.) See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-845 n. 2 (1986). In accordance with section 468B(g), Rev. Rul. 92-51, 1992-27 I.R.B. 9, obsoletes Rev. Rul. 71-119 (and modifies or obsoletes related revenue rulings) for funds established after August 16, 1986. Accordingly, no authority exists for the position that the income of an escrow account, settlement fund, or other similar fund is not subject to current taxation.

The provisions applicable to designated settlement funds are generally effective after July 18, 1984, under rules applicable to section 461(h). Section 468B(g) is effective for funds established after August 16, 1986.

Public Comments

Section 1.468B-1 Qualified Settlement Funds

In General

The proposed regulations mandate qualified settlement fund treatment for a fund, account, or trust that satisfies the requirements of a qualified settlement fund. Commentators recommended that the final regulations make the application of the qualified settlement fund rules elective. The Service and the Treasury Department believe that inconsistent tax treatment for similar funds, claimants, or transferees, as well as the accompanying complexity, is undesirable. Therefore, the final regulations do not provide electivity.

The proposed regulations invited comments regarding the extent to which qualified settlement funds should be available for the claims of general creditors and security holders in bankruptcy. Generally, commentators stated that the qualified settlement fund

rules should not be imposed in the bankruptcy context. Some commentators recommended that the qualified settlement fund rules be applied to a bankruptcy fund on an elective basis.

The Service and the Treasury Department have concluded that the application of the regulations should not be elective. The final regulations exclude claims of general trade creditors and debtholders that relate to a title 11 or similar case, or to a workout. However, qualified settlement fund treatment remains available for other liabilities such as tort liabilities irrespective of whether the liability, for example, relates to a title 11 case. For instance, if a corporation is a defendant in a class action involving a tort liability and subsequently files a petition for bankruptcy, the defendant's bankruptcy will not affect the qualified settlement fund treatment of a fund, account, or trust established to resolve or satisfy the tort liability.

Coordination With Other Entity Classifications

The final regulations continue to provide that, for all purposes of the Internal Revenue Code (Code), the status of a fund, account, or trust as a qualified settlement fund overrides its possible classification as a trust, a § 1.461-2(c)(1) contested liability fund, or, if it is organized as a trust under applicable state law, an association or partnership. Unless it is organized as a trust under state law, however, an association or partnership does not qualify as a qualified settlement fund.

Requirements of a Qualified Settlement Fund

Under the proposed regulations, a fund, account, or trust is a qualified settlement fund only if it satisfies three requirements. The first requirement is that it must be established pursuant to an order of, or be approved by, a governmental authority and must be subject to the continuing supervision or jurisdiction of that governmental authority. A governmental authority is defined as the United States, any state, territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing. The second requirement under the proposed regulations is that the fund, account, or trust must be established to resolve or satisfy one or more claims that result from an event, or series of events, that has occurred and that gives rise to liabilities under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA); out of a

tort, breach of contract (which is not defined in the same manner as in § 1.461-4(g)(2)(i)), or violation of law, or designated by the Commissioner in a revenue ruling or revenue procedure.

The third requirement under the proposed regulations is that the fund, account, or trust must be a trust under state law or its assets must otherwise be segregated from other assets of the transferor (and related persons).

Governmental Order or Approval Requirement

Commentators have asked whether the first requirement is met if a court enters a dismissal of a lawsuit pursuant to a settlement between the parties but does not order the establishment of, or approve, a fund, account, or trust that is established by the parties to the lawsuit in connection with the settlement. In such cases, the fund, account, or trust would not meet the governmental order or approval requirement because it was neither established pursuant to an order of, nor approved by, the governmental authority.

One commentator requested that arbitration panels be included as a governmental authority. To further the goals of alternative dispute resolution procedures, the final regulations treat certain arbitration panels as governmental authorities. Another commentator requested the elimination of the requirement in the proposed regulations that a fund, account, or trust be subject to the continuing supervision of the governmental authority. Accordingly, the final regulations do not require continuing supervision but retain the requirement that the fund, account, or trust be subject to the continuing jurisdiction of the governmental authority that either ordered its establishment or approved it.

Resolve or Satisfy Requirement

One commentator requested that the final regulations clarify whether all potential claims must be asserted before a fund, account, or trust satisfies the requirement of § 1.468B-1(c)(2). In response to this comment, the final regulations clarify that even a single claim satisfies the requirement. In addition, as requested by another commentator, the final regulations clarify that a declared finding of liability is not required. The final regulations also clarify that a § 1.461-2(c)(1) contested liability fund satisfies the "resolve or satisfy requirement" by providing that qualified settlement fund treatment is available for both contested and uncontested liabilities.

Commentators requested that the final regulations allow additional types of

qualified settlement fund liabilities to be designated by private letter ruling. This comment was not adopted. The Service and the Treasury Department believe that designating additional types of liabilities only by revenue ruling or revenue procedure will ensure efficient and consistent administration of the qualified settlement fund rules.

Commentators requested that, in addition to CERCLA liabilities, the final regulations also apply to other similar environmental liabilities arising under state law or other federal laws. Certain state and federal environmental laws vary significantly from CERCLA. Therefore, the Service and the Treasury Department will consider adding other categories of environmental liabilities by revenue ruling or revenue procedure after the different laws are individually studied.

Consistent with the rules in section 461(h)(2)(B) (regarding economic performance for liabilities to provide property or services), the final regulations also provide that qualified settlement fund treatment is not available with respect to a liability to provide property or services to the extent a transfer to the fund does not extinguish that liability. However, the final regulations provide an exception to this rule for CERCLA liabilities, if, after a transferor makes a transfer to a fund, account, or trust, the transferor's only remaining liability to the Environmental Protection Agency is a remote, future obligation to provide property or services.

Trust or Segregation Requirement

As requested by some commentators, the final regulations clarify that a separate bank account satisfies the segregation requirement. Commentators also requested clarification as to whether a trust or segregated assets can qualify as a qualified settlement fund if, under state or federal law, the trust or segregated assets may be reached by creditors of the transferor. This contingency does not affect the status of a fund, account, or trust as a qualified settlement fund.

Classification of a Fund Established to Resolve or Satisfy Allowable and Non-allowable Liabilities

Commentators requested clarification as to the proper treatment of a fund, account, or trust that is established to resolve or satisfy claims for liabilities described in § 1.455B-1(c)(2) as well as other types of liabilities. In response to these comments, the final regulations provide that a qualified settlement fund may be used to resolve or satisfy both allowable and non-allowable claims.

However, a transfer to a qualified settlement fund with respect to non-allowable claims does not constitute economic performance.

Section 1.468B-2 Taxation of Qualified Settlement Funds and Related Administrative Requirements

Modified Gross Income

The proposed regulations provide that a qualified settlement fund is subject to tax on its modified gross income, which is defined as gross income computed with certain modifications. One modification excludes amounts transferred to the qualified settlement fund by, or on behalf of, the transferor. The other modifications are deductions for administrative costs and other incidental expenses incurred in connection with the operation of the fund; losses sustained by the fund in connection with the sale, exchange, or worthlessness of property; and specially defined net operating losses. One commentator was uncertain as to whether section 382 limitations apply to a qualified settlement fund net operating loss. Taxpayers should note that, since qualified settlement funds are only treated as corporations for purposes of subtitle F, the net operating loss deduction is applied without regard to section 362.

Commentators requested that a qualified settlement fund be allowed to deduct all expenses incurred in operating a trade or business, including its distributive share of partnership expenses. The Service and the Treasury Department believe that the operation of a trade or business is inconsistent with the general nature of a qualified settlement fund. Therefore, the final regulations do not adopt the suggested modification. However, because some previously established qualified settlement funds may hold illiquid partnership interests, the final regulations provide a 10-year transition rule for partnership interests acquired by a qualified settlement fund prior to February 15, 1992. Subject to certain limitations, a qualified settlement fund that holds one of these partnership interests may generally deduct its distributive share of the partnership's items of loss, deduction, or credit, but only to the extent of its distributive share of that partnership's items of income and gain for the same taxable year.

Commentators also requested that a qualified settlement fund be allowed to deduct payments made on behalf of claimants, such as payments for claimants' legal expenses. The Service and the Treasury Department believe

such payments are properly viewed as distributions to the claimants. Accordingly, the final regulations do not allow qualified settlement funds to deduct payments made on behalf of claimants.

The proposed regulations invited comments regarding whether a qualified settlement fund should be taxable on its modified gross income if the transferor is exempt from tax and the distributions are excludable from the claimants' income. Commentators generally recommended that the income of such funds not be taxable. Some commentators also recommended that the final regulations go further and not tax the income of a qualified settlement fund if either the transferor is exempt from tax or the distributions to claimants are excludable from their gross income.

The final regulations do not adopt these suggestions. The Service and the Treasury Department believe that basing the taxation of a qualified settlement fund's income on the tax status of the transferor and the claimants would lead to complex rules that would be difficult for taxpayers and the Service to apply and administer. In many settlement funds with multiple transferors, only some of the transferors are tax exempt. Similarly, many claims allege multiple liabilities only some of which will result in distributions to claimants that are excludable from gross income. Thus, the regulations would have to require burdensome tracing and allocation rules for tax-exempt transferors and excludable liabilities. However, the Service and the Treasury Department agree with the suggestion of some commentators that a longer transition rule will alleviate certain concerns of tax-exempt transferors. Accordingly, the final regulations permit funds to continue to use, until January 1, 1996, a reasonable, consistently applied method of taxation. A tax exempt transferor that has established a fund could, therefore, reasonably continue to take the position until January 1, 1996, that the fund is a grantor trust and the income is exempt from tax.

Taxable Year and Accounting Method

The proposed regulations provide that the taxable year of a qualified settlement fund is the calendar year and that the fund must use the accrual method of accounting. One commentator requested that qualified settlement funds, or at least small qualified settlement funds, be permitted to use the cash receipts and disbursement method of accounting. In the alternative, the commentator requested that the final regulations treat the use of the cash

receipts and disbursement method of accounting as a reasonable method of accounting through 1992. The final regulations provide that for a qualified settlement fund established prior to January 1, 1993, the Service will not challenge the fund's use of the cash receipts and disbursement method of accounting prior to 1996.

Treatment as a Corporation for Purposes of Subtitle F

The proposed regulations provide that a qualified settlement fund is treated as a corporation for purposes of subtitle F of the Code. Thus, a qualified settlement fund must file an income tax return for the period it is in existence. This period begins on the first date it satisfies the requirements of § 1.468B-1, and ends on the earlier of the date it no longer meets those requirements or the date it no longer has any assets and will not receive any more transfers. A commentator requested that, to facilitate the "winding up" of a qualified settlement fund, a fund's existence end if the only remaining assets are reserves for certain contingencies, such as taxes. To accommodate this concern, the final regulations permit a qualified settlement fund whose only remaining assets are reserves for potential tax liabilities and related professional fees to request the prompt assessment of tax under section 6501(d).

The proposed regulations designate certain persons, in order of priority, as the administrator of a qualified settlement fund. In response to commentators' requests, the final regulations provide that the administrator may be approved (and not just designated) by the governmental authority, the trustee of a trust that is the qualified settlement fund may be the administrator, and the "default" administrator is the transferor rather than the escrow agent.

The proposed regulations provide that a qualified settlement fund must make an information return for, or withhold on, a distribution to a claimant if the transferor would have been required to if it had made the distribution directly to the claimant. Several commentators stated that the administrator of a qualified settlement fund may lack sufficient information to make this determination. A suggested alternative was to require gross proceeds reporting on distributions to claimants. Another suggested alternative was to allow the administrator to reasonably rely on information provided by the transferor.

The Service and the Treasury Department believe that the proposed regulations generally do not impose a greater burden with respect to

information reporting or withholding than existed with respect to funds, accounts, or trusts before the enactment of section 468B. In addition, the Service and the Treasury Department believe that administrators generally have the ability to require transferors to provide the information needed to comply with the reporting and withholding requirements. Nevertheless, in response to commentators' concerns, the final regulations make some revisions to the information reporting and withholding rules. For example, the final regulations provide that if one or more transferors to a qualified settlement fund would have been required to make a return, the fund must make a return. This eliminates some of the difficulties an administrator would encounter in determining how to report payments if some, but not all, transferors would have been required to report a direct distribution.

The Service and the Treasury Department believe that gross proceeds reporting would impose an undue burden on claimants and the Service because the reported information will not identify a claimant's gross income from a distribution. Therefore, except as otherwise required under subtitle F, qualified settlement funds are not subject to gross proceeds reporting.

Section 1.468B-3 Rules Applicable to the Transferor

Transfer of Property—In General

The proposed regulations provide that a transferor must treat a transfer of property to a qualified settlement fund as a sale or exchange of that property for purposes of section 1001(s). One commentator was uncertain whether, under this rule, the transfer of a transferor's obligation to provide services or property at a reduced price in the future would result in gain or loss to the transferor. Under general principles of federal income tax law, 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. Thus, it generally does not result in a sale or exchange by the transferor. The final regulations clarify this.

Transfer of Transferor's Stock or Partnership Interests

The proposed regulations reserve on the treatment of transfers to a qualified settlement fund of a transferor's stock and of a partnership interest in a partnership that is controlled by the transferor. Commentators recommended

that such transfers be treated the same as transfers of other property but that to prevent valuation abuses the final regulations could require appraisals of the stock or partnership interests and disclosure of such transfers by the transferor.

Accordingly, the final regulations generally treat transfers of a transferor's stock, an interest in a transferor that is a partnership, or a partnership interest in which the transferor is a direct or indirect partner the same as transfers of other property. However, the final regulations require the transferor to obtain an appraisal for partnership interests and its stock if it is not publicly traded, to attach a copy of the appraisal to its income tax return, and to provide a copy of the appraisal to the administrator of the qualified settlement fund.

Statement to the Qualified Settlement Fund and the Internal Revenue Service

The proposed regulations provide that for each year in which a transferor transfers cash or property to a qualified settlement fund, the transferor must provide to the administrator a statement indicating the cash or property transferred and also attach a copy of the statement to its income tax return. A commentator requested that transferors be allowed to use a combined statement to maintain the confidentiality of the amounts they contributed to a settlement fund.

Accordingly, the final regulations allow any two or more transferors to provide a combined statement to the administrator. A transferor that uses a combined statement, however, must attach a schedule to its income tax return that describes each asset the transferor transferred to the qualified settlement fund.

Distributions to Transferors

The proposed regulations provide that a distribution from a qualified settlement fund to a transferor is excluded from the gross income of the transferor to the extent the transferor has been denied economic performance with respect to a transfer to the fund. Commentators requested that the final regulations expand the tax benefit rule to any distribution to a transferor that relates to a prior transfer for which the transferor did not receive a tax benefit. The final regulations provide that a distribution is excluded from the gross income of the transferor to the extent provided by section 111(a).

In response to another commentator's request, the final regulations clarify that information reporting or withholding rules apply with respect to distributions

to transferors. The final regulations provide that a qualified settlement fund is deemed to be in a trade or business and to have made the distribution to the transferor in the course of its trade or business for purposes of sections 6041 and 6041A.

Section 1.468B-4 Taxability of Distributions to Claimants

Under the proposed regulations, the inclusion of a distribution in the claimant's gross income is determined by reference to the claim for which the distribution is made and as if the distribution were made directly by the transferor. Several commentators stated that, to avoid double taxation, a claimant should not be taxed on a distribution to the extent it is attributable to income earned by and taxed to a qualified settlement fund. As shown by the following examples, the Service and the Treasury Department believe that the proposed regulations do not generally impose double taxation.

Facts. Corporation X, a defendant in a class action alleging tort liabilities, is subject to a 34% tax rate. The claimants and the qualified settlement fund are subject to a 31% tax rate. Corporation X and the qualified settlement fund it establishes earn a 10% rate of return on investments.

Example 1. On January 1, 1993, Corporation X establishes a qualified settlement fund and transfers \$93.55 to the fund. The qualified settlement fund earns \$9.35 of interest during 1993 and pays \$2.90 of tax. On January 1, 1994, the fund makes a taxable distribution of the remaining \$100 to the claimants.

Example 2. On January 1, 1993, Corporation X establishes a reserve and deposits \$93.55 in a separate bank account. The account is neither ordered nor approved by a governmental authority and, therefore, is not a qualified settlement fund. Corporation X earns \$9.35 of interest during 1993 and pays \$3.18 of tax. On January 1, 1994, Corporation X makes a taxable distribution of the remaining \$99.72 to the claimants.

Thus, under the rule in the proposed regulations, not only is there no double taxation but, if the transferor is subject to tax at the maximum corporate tax rate, the overall combined tax with respect to the earnings component of distributions to claimants could be slightly less if the fund is a qualified settlement fund rather than an account that is the transferor's property. In addition, as shown in *Example 3* below, the result in *Example 1* is the same (on an after-tax basis) as if the defendant pays the claimant directly on January 1, 1993, instead of either depositing money in a bank account or transferring money to a qualified settlement fund. The final regulations, therefore, retain the rule in the proposed regulations.

Example 3. On January 1, 1993, Corporation X makes a taxable settlement payment of \$93.55 directly to a claimant. The claimant deposits \$64.55 (\$93.55 less \$29 of tax) in a bank account. The claimant earns \$6.46 of interest during 1993 and pays \$2 of tax. On January 1, 1994, the claimant has \$69.01. Thus, on January 1, 1994, the claimant has the same amount on an after-tax basis (approximately \$69) as the claimant in *Example 1* does after it pays \$31 of tax on the \$100 distribution it receives from Corporation X.

Section 1.468B-5 Effective Dates and Transition Rules

In General

In general, the final regulations are effective on January 1, 1993. Thus, the final regulations apply to income of a qualified settlement fund earned after transfers to a fund after, and distributions from a fund after, December 31, 1992.

Request for Alternative Taxation of Post-1992 Fund Income

The proposed regulations provide that a qualified settlement fund in existence on February 14, 1992, and its transferor, may jointly request a ruling from the Service permitting the fund to be taxed in a manner other than that required by the regulations for taxable years ending after December 31, 1992. To obtain a favorable ruling, the proposed regulations require the transferor and the qualified settlement fund to demonstrate that the method of taxation requested is reasonable and is consistent with prior tax positions, and that the fund will exist after 1992 for only a reasonably short period of time.

A commentator requested that a ruling not be required and that instead transferors and qualified settlement funds be allowed to jointly elect to continue to use their current, reasonable method of taxation for the remainder of the fund's existence. As an alternative, the commentator requested that transferors and qualified settlement funds be allowed to continue to use their current, reasonable method of taxation for at least three additional years.

In response to these comments, the final regulations have eliminated the need for a ruling and provide that for funds established after August 16, 1986, but prior to February 15, 1992, the Service will not challenge a reasonable, consistently applied method of taxation for transfers to, income earned by, and distributions made by a fund, account, or trust after August 16, 1986, but prior to 1996.

Taxation of Pre-1993 Fund Income

The proposed regulations provide that the Service will not challenge a reasonable, consistently applied method of taxation for transfers to a fund or income earned by the fund prior to 1993. As discussed above, this safe-harbor rule has been extended to apply to reasonable, consistently applied methods of taxation used prior to 1996.

With respect to a fund, account, or trust that is eligible for this safe-harbor rule, commentators requested that penalties be waived during the period a reasonable, consistently applied method of taxation is used. The final regulations provide that for taxable years beginning prior to January 1, 1993, penalties will generally not be imposed with respect to the use of a reasonable, consistently applied method of taxation.

The proposed regulations provide that transferors to a fund, account, or trust and the person who would be the administrator if the fund were a qualified settlement fund may jointly elect to retroactively apply the qualified settlement fund rules to the fund, account, or trust. Commentators requested, and the final regulations permit, a unilateral election by the person who would be the administrator of the fund, account, or trust.

Section 130 Qualified Assignments

Several commentators requested that the final regulations provide that a designated or qualified settlement fund may enter into a structured settlement agreement with a claimant and may make a section 130 qualified assignment to extinguish the fund's liability to make a distribution to that claimant. The Service and the Treasury Department are considering these and related comments and anticipate providing guidance with respect to the interaction of section 130 qualified assignments and section 468B(g) in the future.

Other Escrow Accounts; Settlement Funds, or Similar Funds

Commentators requested that additional rules under section 468B(g) be provided for the tax treatment of funds, accounts, or trusts that are not qualified settlement funds, such as escrow accounts used in the sale of property and section 1031 qualified escrow accounts. The Service and the Treasury Department are aware of the need for guidance in this area. In order that the final qualified settlement fund regulations not be delayed, however, the Service and the Treasury Department have decided to address these other issues in future projects.

Special Analyses

It has been determined that these final regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, a copy of the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Linda M. Kroening of the Office of Assistant Chief Counsel (Income Tax & Accounting), Office of Chief Counsel, Internal Revenue Service. However, other personnel from the Internal Revenue Service and Treasury Department participated in developing the regulations, in matters of both substance and style.

List of Subjects

26 CFR 1.461-1 through 1.469-11T

Accounting, Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1993

Paragraph 1. The authority citation for part 1 is amended by adding the following citation to read as follows:

Authority: 26 U.S.C. 7805 * * *

§ 1.468B also issued under 26 U.S.C. 461(h) and 468B. §§ 1.468B-0 through 1.468B-5 also issued under 26 U.S.C. 461(h) and 468B. * * *

Par. 2. Sections § 1.468B and 1.468B-0 through 1.468B-5 are added to read as follows:

§ 1.468B Designated settlement funds.

A designated settlement fund, as defined in section 468B(d)(2), is taxed in the manner described in § 1.468B-2. The rules for transferors to a qualified settlement fund described in § 1.468B-

3 apply to transferors to a designated settlement fund. Similarly, the rules for claimants of a qualified settlement fund described in § 1.468B-4 apply to claimants of a designated settlement fund. A fund, account, or trust that does not qualify as a designated settlement fund is, however, a qualified settlement fund if it meets the requirements of a qualified settlement fund described in § 1.468B-1.

§ 1.468B-0 Table of contents.

This section contains a listing of the headings of §§ 1.468B-1 through 1.468B-5.

§ 1.468B-1 Qualified settlement funds.

- (a) In general.
- (b) Coordination with other entity classifications.
- (c) Requirements.
- (d) Definitions.
 - (1) Transferor.
 - (2) Related person.
- (e) Governmental order or approval requirement.
 - (1) In general.
 - (2) Arbitration panels.
- (f) Resolve or satisfy requirement.
 - (1) Liabilities to provide property or services.
 - (2) CERCLA liabilities.
- (g) Excluded liabilities.
- (h) Segregation requirement.
 - (1) In general.
 - (2) Classification of fund established to resolve or satisfy allowable and non-allowable claims.
 - (i) [Reserved]
 - (j) Classification of fund prior to satisfaction of requirements in paragraph (c) of this section.
 - (1) In general.
 - (2) Relation-back rule.
 - (i) In general.
 - (ii) Relation-back election.
 - (k) Examples.

§ 1.468B-2 Taxation of qualified settlement funds and related administrative requirements.

- (a) In general.
- (b) Modified gross income.
- (c) Partnership interests held by a qualified settlement fund on February 14, 1992.
 - (1) In general.
 - (2) Limitation on changes in partnership agreements and capital contributions.
- (d) Distributions to transferors and claimants.
- (e) Basis of property transferred to a qualified settlement fund.
- (f) Distribution of property.
- (g) Other taxes.
- (h) Denial of credits against tax.
- (i) [Reserved]

- (j) Taxable year and accounting method.
- (k) Treatment as corporation for purposes of subtitle F.
- (l) Information reporting withholding requirements.
- (1) Payments to a qualified settlement fund.
- (2) Payments and distributions by a qualified settlement fund.
 - (i) In general.
 - (ii) Special rules.
- (m) Request for prompt assessment.
- (n) Examples.

§ 1.468B-3 Rules applicable to the transferor.

- (a) Transfer of property.
 - (1) In general.
 - (2) Anti-abuse rule.
- (b) Qualified appraisal requirement for transfers of certain property.
 - (1) In general.
 - (2) Provision of copies.
 - (3) Qualified appraisal.
 - (4) Information included in a qualified appraisal.
 - (5) Effect of signature of the qualified appraiser.
- (c) Economic performance.
 - (1) In general.
 - (2) Right to a refund or reversion.
 - (i) In general.
 - (ii) Right extinguished.
 - (3) Obligations of a transferor.
 - (d) Payment of insurance amounts.
 - (e) Statement to the qualified settlement fund and the Internal Revenue Service.
 - (1) In general.
 - (2) Required statement.
 - (i) In general.
 - (ii) Combined statements.
 - (f) Distributions to transferors.
 - (1) In general.
 - (2) Deemed distributions.
 - (i) Other liabilities.
 - (ii) Constructive receipt.
 - (3) Tax-benefit rule.
 - (g) Example.

§ 1.468B-4 Taxability of distributions to claimants.

§ 1.468B-5 Effective dates and transition rules.

- (a) In general.
- (b) Taxation of certain pre-1996 fund income.
 - (1) Reasonable method.
 - (i) In general.
 - (ii) Qualified settlement funds established after February 14, 1992, but before January 1, 1993.
 - (iii) Use of cash method of accounting.
 - (iv) Unreasonable position.
 - (v) Waiver of penalties.
 - (2) Election to apply qualified settlement fund rules.

- (i) In general.
- (ii) Election statement.
- (iii) Due date of returns and amended returns.
- (iv) Computation of interest and waiver of penalties.

§ 1.468B-1 Qualified settlement funds.

(a) *In general.* A qualified settlement fund is a fund, account, or trust that satisfies the requirements of paragraph (c) of this section.

(b) *Coordination with other entity classifications.* If a fund, account, or trust that is a qualified settlement fund could be classified as a trust within the meaning of § 301.7701-4 of this chapter, it is classified as a qualified settlement fund for all purposes of the Internal Revenue Code (Code). If a fund, account, or trust, organized as a trust under applicable state law, is a qualified settlement fund, and could be classified as either an association (within the meaning of § 301.7701-2 of this chapter) or a partnership (within the meaning of § 301.7701-3 of this chapter), it is classified as a qualified settlement fund for all purposes of the Code. If a fund, account, or trust, established for contested liabilities pursuant to § 1.461-2(c)(1) is a qualified settlement fund, it is classified as a qualified settlement fund for all purposes of the Code.

(c) *Requirements.* A fund, account, or trust satisfies the requirements of this paragraph (c) if—

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

(2) It is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability—

(i) Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (hereinafter referred to as CERCLA), as amended, 42 U.S.C. 9601 et seq.; or

(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; 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).

(d) *Definitions.* For purposes of this section—

(1) *Transferor.* 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 claims described in paragraph (c)(2) of this section against that person.

(2) *Related person.* A "related person" is any person who is related to the transferor within the meaning of sections 267(b) or 707(b)(1).

(e) *Governmental order or approval requirement—(1) In general.* A fund, account, or trust is "ordered by" or "approved by" a governmental authority described in paragraph (c)(1) of this section 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 that order or approval may be subject to review or revision. Except as otherwise provided in paragraph (j)(2) of this section, the governmental authority's order or approval has no retroactive effect and does not permit a fund, account, or trust to be a qualified settlement fund prior to the date the order is issued or the approval is granted.

(2) *Arbitration panels.* An arbitration award that orders the establishment of, or approves, a fund, account, or trust is an order or approval of a governmental authority described in paragraph (c)(1) of this section if—

(i) The arbitration award is judicially enforceable;

(ii) The arbitration award is issued pursuant to a bona fide arbitration proceeding in accordance with rules that are approved by a governmental authority described in paragraph (c)(1) of this section (such as self-regulatory organization-administered arbitration proceedings in the securities industry); and

(iii) The fund, account, or trust is subject to the continuing jurisdiction of the arbitration panel, the court of law that has jurisdiction to enforce the arbitration award, or the governmental authority that approved the rules of the arbitration proceeding.

(f) *Resolve or satisfy requirement—(1) Liabilities to provide services or property.* Except as otherwise provided in paragraph (f)(2) of this section, a liability is not described in paragraph (c)(2) of this section if it is a liability for the provision of services or property, unless the transferor's obligation to provide services or property is extinguished by a transfer or transfers to the fund, account, or trust.

(2) *CERCLA liabilities.* A transferor's liability under CERCLA to provide services or property is described in paragraph (c)(2) of this section 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.

(g) *Excluded liabilities.* A liability is not described in paragraph (c)(2) of this section if it—

(1) Arises under a workers compensation act or a self-insured health plan;

(2) 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;

(3) Is an obligation of the transferor to make payments to its general trade creditors or debtholders that relates to a title 11 or similar case (as defined in section 368(s)(3)(A)), or a workout; or

(4) Is designated by the Commissioner in a revenue ruling or a revenue procedure (see § 601.601(d)(2)(ii)(b) of this chapter).

(h) *Segregation requirement—(1) In general.* If it is not a trust under applicable state law, a fund, account, or trust satisfies the requirements of paragraph (c)(3) of this section 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 of paragraph (c)(3) of this section.

(2) *Classification of fund established to resolve or satisfy allowable and non-allowable claims.* 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.

(i) [Reserved]

(j) *Classification of fund prior to satisfaction of requirements in paragraph (c) of this section—(1) In general.* If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section, the assets of the fund, account, or trust are treated as owned by the transferor of those assets until the fund, account, or trust also meets the requirements of paragraphs (c)(1) and (3) of this section. On the date the fund, account, or trust satisfies all the requirements of paragraph (c) of this section, the transferor is treated as

transferring the assets to a qualified settlement fund.

(2) *Relation-back rule—(i) In general.* If a fund, account, or trust meets the requirements of paragraphs (c)(2) and (c)(3) of this section prior to the time it meets the requirements of paragraph (c)(1) of this section, the transferor and administrator (as defined in § 1.468B-2(k)(3)) may jointly elect (a relation-back election) to treat the fund, account, or trust as coming into existence as a qualified settlement fund on the later of the date the fund, account, or trust meets the requirements of paragraphs (c)(2) and (c)(3) of this section or January 1 of the calendar year in which all the requirements of paragraph (c) of this section are met. If a relation-back election is made, the assets held by the fund, account, or trust on the date the qualified settlement fund is treated as coming into existence are treated as transferred to the qualified settlement fund on that date.

(ii) *Relation-back election.* A relation-back election is made by attaching a copy of the election statement, signed by each transferor and the administrator, to (and as part of) the timely filed income tax return (including extensions) of the qualified settlement fund for the taxable year in which the fund is treated as coming into existence. A copy of the election statement must also be attached to (and as part of) the timely filed income tax return (including extensions), or an amended return that is consistent with the requirements of §§ 1.468B-1 through § 1.468B-4, of each transferor for the taxable year of the transferor that includes the date on which the qualified settlement fund is treated as coming into existence. The election statement must contain—

(A) A legend, "§ 1.468B-1 Relation-Back Election", at the top of the first page;

(B) Each transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number;

(D) The date as of which the qualified settlement fund is treated as coming into existence; and

(E) A schedule describing each asset treated as transferred to the qualified settlement fund on the date the fund is treated as coming into existence. The schedule of assets does not have to identify the amount of cash or the property treated as transferred by a particular transferor. If the schedule does not identify the transferor of each asset, however, each transferor must include with the copy of the election statement that is attached to its income

tax return (or amended return) a schedule describing each asset the transferor is treated as transferring to the qualified settlement fund.

(k) *Examples.* The following examples illustrate the rules of this section:

Example 1. In a class action brought in a United States federal district court, the court holds that the defendant, Corporation X, violated certain securities laws and must pay damages in the amount of \$150 million. Pursuant to an order of the court, Corporation X transfers \$50 million in cash and transfers property with a fair market value of \$75 million to a state law trust. The trust will liquidate the property and distribute the cash proceeds to the plaintiffs in the class action. The trust is a qualified settlement fund because it was established pursuant to the order of a federal district court to resolve or satisfy claims against Corporation X for securities law violations that have occurred.

Example 2. (i) Assume the same facts as in *Example 1*, except that Corporation X and the class of plaintiffs reach an out-of-court settlement that requires Corporation X to establish and fund a state law trust before the settlement agreement is submitted to the court for approval.

(ii) The trust is not a qualified settlement fund because it neither is established pursuant to an order of, nor has it been approved by, a governmental authority described in paragraph (c)(1) of this section.

Example 3. On June 1, 1994, Corporation Y establishes a fund to resolve or satisfy claims against it arising from the violation of certain securities laws. On that date, Corporation Y transfers \$10 million to a segregated account. On December 1, 1994, a federal district court approves the fund. Assuming Corporation Y and the administrator of the qualified settlement fund do not make a relation-back election, Corporation Y is treated as the owner of the \$10 million dollars, and is taxable on any income earned on that money, from June 1 through November 30, 1994. The fund is a qualified settlement fund beginning on December 1, 1994.

Example 4. (i) On September 1, 1993, Corporation X, which has a taxable year ending on October 31, enters into a settlement agreement with a plaintiff class for asserted tort liabilities. Under the settlement agreement, Corporation X makes two \$50 million payments into a segregated fund, one on September 1, 1993, and one on October 1, 1993, to resolve or satisfy the tort liabilities. A federal district court approves the settlement agreement on November 1, 1993.

(ii) The administrator of the fund and Corporation X elect to treat the fund as a qualified settlement fund prior to governmental approval under the relation-back rule of paragraph (j)(2) of this section. The administrator must attach the relation-back election statement to the fund's income tax return for calendar year 1993, and Corporation X must attach the election to its original or amended income tax return for its taxable year ending October 31, 1993.

(iii) Pursuant to the relation-back election, the fund begins its existence as a qualified

settlement fund on September 1, 1993, and Corporation X is treated as transferring \$50 million to the qualified settlement fund on September 1, 1993, and \$50 million on October 1, 1993.

(iv) With respect to these transfers, Corporation X must provide the statement described in § 1.468B-3(e) to the administrator of the qualified settlement fund by February 15, 1994, and must attach a copy of this statement to its original or amended income tax return for its taxable year ending October 31, 1993.

Example 5. Assume the same facts as in Example 4, except that the court approves the settlement on May 1, 1994. The administrator must attach the relation-back election statement to the fund's income tax return for calendar year 1994, and Corporation X must attach the election statement to its original or amended income tax return for its taxable year ending October 31, 1994. Pursuant to this election, the fund begins its existence as a qualified settlement fund on January 1, 1994. In addition, Corporation X is treated as transferring to the qualified settlement fund all amounts held in the fund on January 1, 1994. With respect to the transfer, Corporation X must provide the statement described in § 1.468B-3(e) to the administrator of the qualified settlement fund by February 15, 1995, and must attach a copy of this statement to its income tax return for its taxable year ending October 31, 1994.

Example 6. Corporation Z establishes a fund that meets all the requirements of section 468B(d)(2) for a designated settlement fund, except that Corporation Z does not make the election under section 468B(d)(2)(F). Although the fund does not qualify as a designated settlement fund, it is a qualified settlement fund because the fund meets the requirements of paragraph (c) of this section.

Example 7. Corporation X owns and operates a landfill in State A. State A requires Corporation X to transfer money to a trust annually based on the total tonnage of material placed in the landfill during the year. Under the laws of State A, Corporation X will be required to perform (either itself or through contractors) specified closure activities when the landfill is full, and the trust assets will be used to reimburse Corporation X for those closure costs. The trust is not a qualified settlement fund because it is established to secure the liability of Corporation X to perform the closure activities.

§ 1.468B-2 Taxation of qualified settlement funds and related administrative requirements.

(a) *In general.* A qualified settlement fund 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 rate in effect for that taxable year under section 1(e).

(b) *Modified gross income.* The "modified gross income" of a qualified settlement fund is its gross income, as defined in section 61, computed with the following modifications—

(1) *In general,* amounts transferred to the qualified settlement fund by, or on

behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income. However, dividends on stock of a transferor (or a related person), interest on debt of a transferor (or a related person), and payments in compensation for late or delayed transfers, are not excluded from gross income.

(2) A deduction is allowed for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund that would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operation of the qualified settlement fund, and expenses arising from the notification of claimants and the processing of their claims. Administrative costs and other incidental expenses do not include legal fees incurred by, or on behalf of, claimants.

(3) A deduction is allowed for losses sustained by the qualified settlement fund 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 under section 165 (f) or (g), and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of a net operating loss of the qualified settlement fund to the extent the loss would be deductible in determining the taxable income of a corporation under section 172(a). For purposes of this paragraph (b)(4), the net operating loss of a qualified settlement fund for a taxable year is the amount by which the deductions allowed under paragraphs (b)(2) and (b)(3) of this section exceed the gross income of the fund computed with the modification described in paragraph (b)(1) of this section.

(c) *Partnership interests held by a qualified settlement fund on February 14, 1992—(1) In general.* For taxable years ending prior to January 1, 2003, a qualified settlement fund that holds a partnership interest it acquired prior to February 15, 1992, is allowed a deduction for its distributive share of that partnership's items of loss, deduction, or credit described in section 702(a) that would be deductible in determining the taxable income (or in the case of a credit, the income tax liability) of a corporation to the extent of the fund's distributive share of that partnership's items of income and gain

described in section 702(a) for the same taxable year. For purposes of this paragraph (c)(1), a distributive share of a partnership credit is treated as a deduction in an amount equal to the amount of the credit divided by the rate described in paragraph (a) of this section.

(2) *Limitation on changes in partnership agreements and capital contributions.* For purposes of paragraph (c)(1) of this section, changes in a qualified settlement fund's distributive share of items of income, gain, loss, deduction, or credit are disregarded if—

(i) They result from a change in the terms of the partnership agreement on or after December 18, 1992, or a capital contribution to the partnership on or after December 18, 1992, unless the partnership agreement as in effect prior to December 18, 1992, requires the contribution; and

(ii) A principal purpose of the change in the terms of the partnership agreement or the capital contribution is to circumvent the limitation described in paragraph (c)(1) of this section.

(d) *Distributions to transferors and claimants.* Amounts that are distributed by a qualified settlement fund to, or on behalf of, a transferor or a claimant are not deductible by the fund.

(e) *Basis of property transferred to a qualified settlement fund.* A qualified settlement fund's initial 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.

(f) *Distribution of property.* A qualified settlement fund must treat a distribution of property as a sale or exchange of that property for purposes of section 1001(a). In computing gain or loss, the amount realized by the qualified settlement fund is the fair market value of the property on the date of distribution.

(g) *Other taxes.* The tax imposed under paragraph (a) of this section is in lieu of any other taxation of the income of a qualified settlement fund under subtitle A of the Internal Revenue Code. Thus, a qualified settlement fund is not subject to the alternative minimum tax of section 55, the accumulated earnings tax of section 531, the personal holding company tax of section 541, or the maximum capital gains rate of section 1(h). A qualified settlement fund is, however, subject to taxes that are not imposed on the income of a taxpayer, such as the tax on transfers of property to foreign entities under section 1491.

(h) *Denial of credits against tax.* The tax imposed on the modified gross

income of a qualified settlement fund under paragraph (a) of this section may not be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code.

(i) [Reserved]

(j) *Taxable year and accounting method.* The taxable year of a qualified settlement fund is the calendar year. A qualified settlement fund must use an accrual method of accounting within the meaning of section 446(c).

(k) *Treatment as corporation for purposes of subtitle F.* Except as otherwise provided in §§ 1.468B-5(b), for purposes of subtitle F of the Internal Revenue Code, a qualified settlement fund is treated as a corporation and any tax imposed under paragraph (a) of this section is treated as a tax imposed by section 11. Subtitle F rules that apply to qualified settlement funds include, but are not limited to—

(1) A qualified settlement fund must file an income tax return with respect to the tax imposed under paragraph (a) of this section for each taxable year that the fund is in existence, whether or not the fund has gross income for that taxable year.

(2) A qualified settlement fund is in existence for the period that—

(i) Begins on the first date on which the fund is treated as a qualified settlement fund under § 1.468B-1; and
(ii) Ends on the earlier of the date the fund—

(A) No longer satisfies the requirements of § 1.468B-1; or

(B) No longer has any assets and will not receive any more transfers. (See paragraph (m) of this section for procedures for the prompt assessment of tax.)

(3) The income tax return of the qualified settlement fund must be filed on or before March 15 of the year following the close of the taxable year of the qualified settlement fund unless the fund is granted an extension of time for filing under section 6081. The return must be made by the administrator of the qualified settlement fund. The "administrator" (which may include a trustee if the qualified settlement fund is a trust) of a qualified settlement fund is, in order of priority—

(i) The person designated, or approved, by the governmental authority that ordered or approved the fund for purposes of § 1.468B-1(c)(1);

(ii) The person designated in the escrow agreement, settlement agreement, or other similar agreement governing the fund;

(iii) The escrow agent, custodian, or other person in possession or control of the fund's assets; or

(iv) The transferor or, if there are multiple transferors, all the transferors, unless an agreement signed by all the transferors designates a single transferor as the administrator.

(4) The administrator of a qualified settlement fund must obtain an employer identification number for the fund.

(5) A qualified settlement fund must deposit all payments of tax imposed under paragraph (a) of this section (including any payments of estimated tax) with an authorized government depository in accordance with § 1.6302-1.

(6) A qualified settlement fund is subject to the addition to tax imposed by section 6655 in the case of an underpayment of estimated tax computed with respect to the tax imposed under paragraph (a) of this section. For purposes of section 6655(g)(2), a qualified settlement fund's taxable income is its modified gross income and a transferor is not considered a predecessor of a qualified settlement fund.

(1) *Information reporting and withholding requirements—(1) Payments to a qualified settlement fund.* Payments to a qualified settlement fund are treated as payments to a corporation for purposes of the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code.

(2) *Payments and distributions by a qualified settlement fund—(1) In general.* Payments and distributions by a qualified settlement fund are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code (Code), and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C of the Code.

(ii) *Special rules.* The following rules apply with respect to payments and distributions by a qualified settlement fund—

(A) A qualified settlement fund must make 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;

(B) For purposes of sections 6041(a) and 6041A, if a qualified settlement fund makes a payment or distribution to a transferor, the fund is deemed to make the payment or distribution to the transferor in the course of a trade or business;

(C) For purposes of sections 6041(a) and 6041A, if a qualified settlement fund makes a payment or distribution

on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business;

(D) With respect to a distribution or payment described in paragraph (1)(2)(ii)(C) of this section and the information reporting requirements of part III of subchapter A of chapter 61 of the Internal Revenue Code, the qualified settlement fund is also deemed to have made the distribution or payment to the transferor or claimant.

(m) *Request for prompt assessment.* A qualified settlement fund is eligible to request the prompt assessment of tax under section 6501(d). For purposes of section 6501(d), a qualified settlement fund 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.

(n) *Examples.* The following examples illustrate the rules of this section:

Example 1. On June 30, 1993, a United States federal district court approves the settlement of a lawsuit under which Corporation X must transfer \$10,833,000 to a qualified settlement fund on August 1, 1993. The \$10,833,000 includes \$10 million of damages incurred by plaintiffs on October 1, 1992, and \$833,000 of interest calculated at 10 percent annually from October 1, 1992, to August 1, 1993. The \$833,000 of interest is not a payment to the qualified settlement fund in compensation for a late or delayed transfer to the fund within the meaning of paragraph (b)(1) of this section because the payment of \$10,833,000 to the fund is not due until August 1, 1993.

Example 2. Assume the same facts as in Example 1 except that the settlement agreement also provides for interest to accrue at a rate of 12 percent annually on any amount not transferred to the qualified settlement fund on August 1, 1993, and the only transfer Corporation X makes to the fund is \$11,374,650 on January 1, 1994. The additional payment of \$541,650 (\$11,374,650 paid on January 1, 1994, less \$10,833,000 due on August 1, 1993) is a payment to the qualified settlement fund in compensation for a late or delayed transfer to the fund within the meaning of paragraph (b)(1) of this section.

§ 1.468B-3 Rules applicable to the transferor.

(a) *Transfer of property—(1) In general.* A transferor must treat a transfer of property to a qualified settlement fund as a sale or exchange of that property for purposes of section 1001(e). 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 under § 1.468B-1(g)) to the qualified settlement fund. Because

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; it generally does not result in gain or loss to the transferor under this paragraph (a)(1). If a person other than the transferor transfers property to a qualified settlement fund, there may be other tax consequences as determined under general federal income tax principles.

(2) *Anti-abuse rule.* The Commissioner may disallow a loss resulting from the transfer of property to a qualified settlement fund if the Commissioner determines that a principal purpose for the transfer was to claim the loss and—

(i) The transferor places significant restrictions on the fund's ability to use or dispose of the property; or

(ii) The property (or substantially similar property) is distributed to the transferor (or a related person).

(b) *Qualified appraisal requirement for transfers of certain property—(1) In general.* A transferor must obtain a qualified appraisal to support a loss or deduction it claims with respect to a transfer to a qualified settlement fund of the following types of property—

(i) Nonpublicly traded securities (as defined in § 1.170A-13(c)(7)(ix)) issued by the transferor (or a related person); and

(ii) 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) *Provision of copies.* The transferor must provide a copy of the qualified appraisal to the administrator of the qualified settlement fund no later than February 15 of the year following the calendar year in which the property is transferred. The transferor also must attach a copy of the qualified appraisal to (and as part of) its timely filed income tax return (including extensions) for the taxable year of the transferor in which the transfer is made.

(3) *Qualified appraisal.* A "qualified appraisal" is a written appraisal that—

(i) Is made within 60 days before or after the date the property is transferred to the qualified settlement fund;

(ii) Is prepared, signed, and dated by an individual who is a qualified appraiser within the meaning of § 1.170A-13(c)(5);

(iii) Includes the information required by paragraph (b)(4) of this section; and

(iv) Does not involve an appraisal fee of the type prohibited by § 1.170A-13(c)(6).

(4) *Information included in a qualified appraisal.* A qualified appraisal must include the following information—

(i) A description of the appraised property;

(ii) The date (or expected date) of the property's transfer to the qualified settlement fund;

(iii) The appraised fair market value of the property on the date (or expected date) of transfer;

(iv) The method of valuing the property, such as the comparable sales approach;

(v) The specific basis for the valuation, such as specific comparable sales or statistical sampling, including a justification for using comparable sales or statistical sampling and an explanation of the procedure employed;

(vi) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the transferor (or a related person) or the qualified settlement fund that relates to the use, sale, or other disposition of the transferred property, including, for example, the terms of any agreement or understanding that temporarily or permanently—

(A) Restricts the qualified settlement fund's right to use or dispose of the property; or

(B) Reserves to, or confers upon, any person other than the qualified settlement fund any right (including designating another person as having the right) to income from the property, to possess the property (including the right to purchase or otherwise acquire the property), or to exercise any voting rights with respect to the property;

(vii) The name, address, and taxpayer identification number of the qualified appraiser; and if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person, or an independent contractor engaged by a person other than the transferor, the name, address, and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

(viii) The qualifications of the qualified appraiser, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations; and

(ix) A statement that the appraisal was prepared for income tax purposes.

(5) *Effect of signature of the qualified appraiser.* Any appraiser who falsely or fraudulently overstates the value of the transferred property referred to in a qualified appraisal may be subject to a civil penalty under section 6701 for aiding and abetting an understatement

of tax liability and may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

(c) *Economic performance—(1) In general.* Except as otherwise provided in this paragraph (c), for purposes of section 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.

(2) *Right to a refund or reversion—(i) In general.* Economic performance does not occur to the extent—

(A) 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

(B) 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.

(ii) *Right extinguished.* With respect to a transfer described in paragraph (c)(2)(i) of this section, economic performance is deemed to occur on the date, and to the extent, the transferor's right to a refund or reversion is extinguished.

(3) *Obligations of a transferor.* 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 with respect to such an obligation occurs as services, property or payments are provided or made to the qualified settlement fund or a claimant.

(d) *Payment of insurance amounts.* 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.

(e) *Statement to the qualified settlement fund and the Internal Revenue Service*—(1) *In general.* A transferor must provide the statement described in paragraph (e)(2) of this section to the administrator of a qualified settlement fund no later than February 15 of the year following each calendar year in which the transferor (or an insurer or other person on behalf of the transferor) makes a transfer to the fund. The transferor must attach a copy of the statement to (and as part of) its timely filed income tax return (including extensions) for the taxable year of the transferor in which the transfer is made.

(2) *Required statement*—(i) *In general.* The statement required by this paragraph (e) must provide the following information—

(A) A legend, “§ 1.468B-3 Statement”, at the top of the first page;

(B) The transferor's name, address, and taxpayer identification number;

(C) The qualified settlement fund's name, address, and employer identification number;

(D) The date of each transfer;

(E) The amount of cash transferred; and

(F) A description of property transferred and its fair market value on the date of transfer.

(ii) *Combined statements.* If a qualified settlement fund has more than one transferor, any two or more of the transferors may provide a combined statement to the administrator that does not identify the amount of cash or the property transferred by a particular transferor. If a combined statement is used, however, each transferor must include with its copy of the statement that is attached to its income tax return a schedule describing each asset that the transferor transferred to the qualified settlement fund.

(f) *Distributions to transferors*—(1) *In general.* A transferor must include in gross income any distribution (including a deemed distribution described in paragraph (f)(2) of this section) it receives from a qualified settlement fund. If property is distributed, the amount includible in gross income and the basis in that property, is the fair market value of the property on the date of the distribution.

(2) *Deemed distributions*—(i) *Other liabilities.* If a qualified settlement fund makes a distribution on behalf of a transferor to a person that is not a claimant, or to a claimant to resolve or satisfy a liability of the transferor (or a related person) other than a liability

described in § 1.468B-1(c)(2) for which the fund was established, the distribution is deemed made by the fund to the transferor. The transferor, in turn, is deemed to have made a payment to the actual recipient.

(ii) *Constructive receipt.* To the extent a transferor acquires a right to a refund or reversion described in paragraph (c)(2) of this section of all or a portion of the assets of a qualified settlement fund subsequent to the transfer of those assets to the fund, the fund is deemed to distribute those assets to the transferor on the date the right is acquired.

(3) *Tax benefit rule.* A distribution described in paragraph (f)(1) or (f)(2) of this section is excluded from the gross income of a transferor to the extent provided by section 111(a).

(g) *Example.* The following example illustrates the rules of this section:

Example. On March 1, 1993, Individual A transfers \$1 million to a qualified settlement fund to resolve or satisfy claims against him resulting from certain violations of securities laws. Individual A uses the cash receipts and disbursements method of accounting. Since Individual A does not use the accrual method of accounting, the economic performance rules of paragraph (c) of this section are not applicable. Therefore, whether, when, and to what extent Individual A can deduct the transfer is determined under applicable provisions of the Internal Revenue Code, such as sections 162 and 461.

§ 1.468B-4 Taxability of distributions to claimants.

Whether a distribution to a claimant is includible in the claimant's gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor. For example, to the extent a distribution is in satisfaction of damages on account of personal injury or sickness, the distribution may be excludable from gross income under section 104(a)(2). Similarly, to the extent a distribution is in satisfaction of a claim for foregone taxable interest, the distribution is includible in the claimant's gross income under section 61(a)(4).

§ 1.468B-5 Effective dates and transition rules.

(a) *In general.* Section 468B, including section 468B(g), is effective as provided in the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. Except as otherwise provided in this section, §§ 1.468B-1 through 1.468B-4 are effective on January 1, 1993. Thus, the regulations apply to income of a qualified settlement fund earned after December 31, 1992,

transfers to a fund after December 31, 1992, and distributions from a fund after December 31, 1992. For purposes of § 1.468B-3(c) (relating to economic performance), previously transferred assets held by a qualified settlement fund on the date these regulations first apply to the fund (i.e., January 1, 1993, or the earlier date provided under paragraph (b)(2) of this section) are treated as transferred to the fund on that date, to the extent no taxpayer has previously claimed a deduction for the transfer.

(b) *Taxation of certain pre-1996 fund income*—(1) *Reasonable method*—(i) *In general.* With respect to a fund, account, or trust established after August 16, 1986, but prior to February 15, 1992, that satisfies (or, if it no longer exists, would have satisfied) the requirements of § 1.468B-1(c), the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, but prior to January 1, 1996. A method is generally considered reasonable if, depending on the facts and circumstances, all transferors and the administrator of the fund have consistently treated transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, as if the fund were—

(A) A grantor trust and the transferors are the grantors;

(B) A complex trust and the transferors are the grantors; or

(C) A designated settlement fund.

(ii) *Qualified settlement funds established after February 14, 1992, but before January 1, 1993.* With respect to a fund, account, or trust established after February 14, 1992, but prior to January 1, 1993, that satisfies the requirements of § 1.468B-1(c), the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation as described in paragraph (b)(1)(i) of this section for transfers to, income earned by, and distributions made by the fund prior to January 1, 1993. However, pursuant to paragraph (a) of this section, sections 1.468B-1 through 1.468B-4 apply to transfers to, income earned by, and distributions made by the qualified settlement fund after 1992.

(iii) *Use of cash method of accounting.* For purposes of paragraphs (b)(i) and (b)(ii) of this section, for taxable years beginning prior to January 1, 1996, the Internal Revenue Service will not challenge the use of the cash receipts and disbursement method of accounting by a fund, account, or trust.

(iv) *Unreasonable position.* In no event is it a reasonable position to assert, pursuant to Rev. Rul. 71-119 (see § 601.601(d)(2)(ii)(b) of this chapter), that there is no current taxation of the income of a fund established after August 16, 1986.

(v) *Waiver of penalties.* For taxable years beginning prior to January 1, 1993, if a fund, account or trust is subject to section 468B(g) and the Internal Revenue Service does not challenge the method of taxation for transfers to, income earned by, and distributions made by, the fund pursuant to paragraph (b)(1)(i) or (b)(1)(ii) of this section, penalties will not be imposed in connection with the use of such method. For example, the penalties under section 6655 for failure to pay estimated tax, section 6651(a)(1) for failure to file a return, section 6651(a)(2) for failure to pay tax, section 6656 for failure to make deposit of taxes, and section 6662 for accuracy-related underpayments will generally not be imposed.

(2) *Election to apply qualified settlement fund rules—(i) In general.* The person that will be the administrator of a qualified settlement fund may elect to apply §§ 1.468B-1 through 1.468B-4 to transfers to, income earned by, and distributions made by, the fund in taxable years ending after August 16, 1986. The election is effective beginning on the first day of the earliest open taxable year of the qualified settlement fund. For purposes of this paragraph (b)(2), a taxable year is considered open if the period for assessment and collection of tax has not expired pursuant to the rules of section 6501. The election statement must provide the information described in paragraph (b)(2)(ii) of this section and must be signed by the person that will be the administrator. Such person must also provide each transferor of the qualified settlement fund with a copy of the election statement on or before March 15, 1993.

(ii) *Election statement.* The election statement must provide the following information—

- (A) A legend, "§ 1.468B-5(b)(2) Election", at the top of the first page;
- (B) Each transferor's name, address, and taxpayer identification number;
- (C) The qualified settlement fund's name, address, and employer identification number; and
- (D) The date the qualified settlement fund was established within the meaning of § 1.468B-1(j).

(iii) *Due date of returns and amended returns.* The election statement described in paragraph (b)(2)(ii) of this section must be filed with, and as part

of, the qualified settlement fund's timely filed tax return for the taxable year ended December 31, 1992. In addition, the qualified settlement fund must file an amended return that is consistent with the requirements of §§ 1.468B-1 through 1.468B-4 for any taxable year to which the election applies in which the fund took a position inconsistent with those requirements. Any such amended return must be filed no later than March 15, 1993, and must include a copy of the election statement described in paragraph (b)(2)(ii) of this section.

(iv) *Computation of interest and waiver of penalties.* For purposes of section 6601 and section 6611, the income tax return for each taxable year of the qualified settlement fund to which the election applies is due on March 15 of the year following the taxable year of the fund. For taxable years of a qualified settlement fund ending prior to January 1, 1993, the income earned by the fund is deemed to have been earned on December 31 of each taxable year for purposes of section 6655. Thus, the addition to tax for failure to pay estimated tax under section 6655 will not be imposed. The penalty for failure to file a return under section 6651(a)(1), the penalty for failure to pay tax under section 6651(a)(2), the penalty for failure to make deposit of taxes under section 6656, and the accuracy-related penalty under section 6662 will not be imposed on a qualified settlement fund if the fund files its tax returns for taxable years ending prior to January 1, 1993, and pays any tax due for those taxable years, on or before March 15, 1993.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by adding the entries to the table to read as follows:

§ 602.101 OMB Control Numbers.

* * * * *
(c) * * *

CFR part or section where identified and described	Current OMB control No.
§ 1.468B-1(j)	1545-1299
§ 1.468B-2(k)	1545-1299
§ 1.468B-2(l)	1545-1299
§ 1.468B-3(b)	1545-1299
§ 1.468B-3(e)	1545-1299
§ 1.468B-5(b)	1545-1299

CFR part or section where identified and described

Current OMB control No.

Shirley D. Peterson,
Commissioner of Internal Revenue.
Approved: October 30, 1992.
Fred T. Goldberg, Jr.,
Assistant Secretary of the Treasury.
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