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Department of the Treasury

Washington, DC 20224

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Date: July 26, 2002

LEGEND:

Taxpayer =

Corporation =

PI Trust =

Item =

Agency =

State =

Site 1 =

Site 2 =

Year 1 =

date 1 =

date 2 =

date 3 =

date 4 =

date 5 =

date 6 =

b =

c =

d =

e =

f =

g =

h =

j =

Dear :

This letter responds to your letter requesting a private letter ruling concerning the application of various sections of the Internal Revenue Code (Code) to Taxpayer's settlement of certain liabilities. You also requested rulings concerning the PI Trust, which Taxpayer will fund to pay some of those liabilities.

FACTS:

You represent the facts to be as follows:

TAXPAYER'S HISTORY

Taxpayer and its subsidiaries are engaged in the manufacture and distribution of certain products. Taxpayer, which was incorporated as a subsidiary of Corporation during date 1, has used the accrual method of accounting since its incorporation. Before date 1, Corporation had been named as a defendant in numerous lawsuits claiming damages for personal physical injury, physical sickness, or death from exposure to Item that was included in products that Corporation sold.

Until Year 1, Corporation manufactured products in Site 1 and Site 2. These manufacturing operations generated large amounts of hazardous materials that either remain on those sites, or were transported to landfills, or have contaminated other sites (including wetlands and groundwater). Consequently, the Agency and the State have undertaken operations to investigate and remediate the hazardous substance contaminations caused by Corporation's operations in Site 1 and Site 2.

During date 2, Taxpayer became the parent corporation of Corporation. Taxpayer then devised a restructuring plan under which it acquired valuable business assets from Corporation, divested itself of its Corporation shares, and attempted to divest itself of Corporation's Item-related liabilities. Thereafter, Taxpayer was named a co-defendant with Corporation in numerous Item-related lawsuits as successor in liability to Corporation. Subsequently, federal courts have held that Taxpayer was a successor to Corporation's Item-related liabilities and issued an order barring Taxpayer from continuing to litigate the issue of its successor liability for Corporation's liabilities.

PLAN OF REORGANIZATION

During date 3, Taxpayer filed for Chapter 11 bankruptcy protection in a United States Bankruptcy Court (the "Bankruptcy Court"). During date 4, Taxpayer entered into a Memorandum of Understanding with its unsecured creditors (the "Unsecured Creditors"), the terms of which have been incorporated into a consensual plan of reorganization ("the Plan"). The Plan and each of its provisions were confirmed in their entirety in the order (the "Order") of the Bankruptcy Court that was entered on date 5. The Order also stated that the Bankruptcy Court has and will retain exclusive jurisdiction of the litigation and of the PI Trust, which was established by the Plan.

<u>Composition of the Unsecured Creditors</u>. Almost all of the Unsecured Creditors consist of the following groups: (1) the PI Claimants, who are all individuals holding present or future Item-related personal injury tort claims against Corporation for which Taxpayer has successor liability; and (2) the Environmental Claimants. The Environmental Claimants consist of the Agency, the State, and one private party holding environmental claims under federal and state environmental laws against Taxpayer. In the Chapter 11 proceeding, the claims held by the PI Claimants and the claims of the Environmental Claimants have been estimated at approximately $b and $c, respectively.

<u>Description of the Unsecured Creditors' Share</u>. The Plan provides that the Unsecured Creditors will receive Taxpayer Stock, Available Cash, and Tax Benefits. These assets are referred to collectively as the Unsecured Creditors' Share.

Taxpayer Stock consists of stock of the reorganized Taxpayer. The Unsecured Creditors (through the PI Trust in the case of the PI Claimants) will receive d percent of Taxpayer Stock and Taxpayer's pre-existing shareholders will retain e percent of Taxpayer stock. Taxpayer Stock's overall value was appraised in a qualified appraisal described in § 1.468B-3(b) of the Income Tax Regulations. Taxpayer provided a copy of this appraisal to the administrator of the PI Trust on date 6 and attached a copy of the appraisal to its income tax return in the time and manner required by § 1.468B-3(b)(2).

The Available Cash, determined when the Plan was consummated, equaled $f. It consisted of the amount of cash that was not reasonably needed to meet certain estimated near-term cash operating needs and capital needs of the reorganized debtor on the effective date of the Plan.

The Tax Benefits are described in the Plan's Tax Assignment and Assumption Agreement (the "Tax Agreement"). Under the Tax Agreement, the PI Claimants and the other Unsecured Creditors collectively will receive present and future federal and state income tax savings relating to transfers to the PI Trust and to the implementation of the settlement plan.

Taxpayer is obligated by the Tax Agreement to take all reasonable actions necessary to obtain the Tax Benefits and to pay them over to the Unsecured Creditors as expeditiously as possible. Taxpayer anticipates that most of the net operating loss ("NOL") resulting from the contribution of Taxpayer Stock and Available Cash to the Unsecured Creditors will be carried back 10 years. This NOL is anticipated to result in a tax refund of approximately $g. The balance will be carried forward. Payment to the Unsecured Creditors of the Tax Benefit resulting from the carryback, as well as the use by Taxpayer of the carryforward, will then give rise to future Tax Benefits that must also be transferred to the Unsecured Creditors pursuant to the Tax Agreement. All Tax Benefits will be paid in cash.

<u>The Governments' Agreement: Division of the Unsecured Creditors' Share</u>. The PI Claimants and the Environmental Claimants agreed in a Governments' Settlement Agreement (the "Governments' Agreement") to divide the Unsecured Creditors' Share into sub-shares.

Under the Governments' Agreement, a *de minimis* sub-share of the Unsecured Creditors' Share was allocated to the Allowed Claims of unsecured creditors other than the PI Claimants and the Environmental Claimants. The PI Claimants and the Environmental Claimants also agreed on how to allocate the amount of the Unsecured

Creditors' Share remaining after the Allowed Claims were paid. Of that remaining amount, h percent was to be transferred into the PI Trust. The PI Trust would assume Taxpayer's tort liability to the PI Claimants by processing and paying their claims in accordance with specified procedures ("PI Trust Distribution Procedures"). The Environmental Claimants, which have no interests in the PI Trust, would receive the remaining j percent of the Unsecured Creditors' Share.

Discharge of Liabilities. Upon Taxpayer's transfer of the Taxpayer Stock and its payments of Available Cash and Tax Benefits, Taxpayer's obligations to the PI Claimants and Environmental Claimants were discharged.

Terms of the PI Trust Agreement and the PI Trust Distribution Procedures. You represent that under the present terms of the PI Trust Agreement and the PI Trust Distribution Procedures, the PI Trust may not make a payment to a PI Claimant except with respect to a personal physical injury that manifests itself before the date of the payment. You also represent that payments from the PI Trust to the PI Claimants are solely for compensatory damages on account of currently manifested, personal, physical injuries, within the meaning of § 104(a)(2) and that the present PI Trust documents do not allow payments from the PI Trust to the PI Claimants for interest, punitive damages, or any other item of taxable income.

Because numerous PI Claimants are expected to file claims against the PI Trust over its lifetime, the PI Trust would not find it practical to require PI Claimants to provide prior-year tax returns or otherwise to have access to those returns for purposes of determining whether such Claimants have taken any medical expense deductions under § 213 relating to any personal injuries with respect to which any amounts may be paid by the PI Trust.

Expenses of the PI Trust. The PI Trust expects to incur costs, including the costs related to recovery of amounts on certain Item-related claims and causes of action transferred to the PI Trust by Taxpayer. The PI Trust does not expect to recover any claims for insurance proceeds transferred to the PI Trust by Taxpayer.

LAW AND ANALYSIS

Taxpayer's requested rulings fall into two broad categories. The first of these involves the legal status, federal income tax consequences, and information reporting requirements of the PI Trust (Ruling Requests 1 through 6); the second, the federal tax consequences to Taxpayer resulting from its transfers to and fulfillment of its obligations to the Unsecured Creditors (Ruling Requests 7 through 12).

RULINGS RELATING TO THE PI TRUST

Ruling Request 1: Is the PI Trust a qualified settlement fund?

Section 468B(g) provides that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

Section 1.468B-1(c) provides that the following requirements must be met for a fund, account, or trust to be classified as a qualified settlement fund (QSF): (1) it must be established pursuant to an order of, or be approved by, the United States or any agency or instrumentality (including a court of law) thereof and be subject to the continuing jurisdiction of that governmental authority; (2) it must be 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 arising out of tort, breach of contract, or violation of law; and (3) the fund, account, or trust must be a trust under applicable state law, or its assets must otherwise be segregated from other assets of the transferor.

The PI Trust meets each of the requirements of § 1.468B-1(c). First, the PI Trust was approved by the Bankruptcy Court and is subject to that court's continuing jurisdiction. Second, the PI Trust was established to resolve Item-related tort claims. Third, the PI Trust is organized as a trust under applicable state law.

Accordingly, based on the information submitted and representations made, we conclude that the PI Trust is a QSF under § 1.468B-1(c).

<u>Ruling Request 2</u>: Is the PI Trust subject to income tax only on its modified gross income?

Section 1.468B-2(a) provides that a QSF 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 § 1(e). The modified gross income of a QSF is its gross income, as defined in § 61, computed with the modifications listed in § 1.468B-2(b)(1) - (4). As noted above, the PI Trust is a QSF.

Accordingly, based on the information submitted and representations made, we conclude that only the modified gross income of the PI Trust is subject to federal income tax.

<u>Ruling Request 3</u>: Are the amounts of Taxpayer's transfers of Taxpayer Stock, Tax Benefits, and Available Cash to the PI Trust excludable from the PI Trust's gross income?

Section 1.468B-2(b)(1) provides, in general, that amounts transferred to a QSF by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from a QSF's gross income. Taxpayer's transfers to the PI Trust of Taxpayer Stock, Tax Benefits, and Available Cash fall squarely within § 1.468-2(b)(1).

These transfers are in full satisfaction of the PI Claimants' present and future claims against Taxpayer. The PI Trust, in turn, was established for the express purposes of assuming Taxpayer's tort liabilities and paying the claims of the PI Claimants.

Accordingly, based on the information submitted and representations made, we conclude that the amounts transferred to the PI Trust – its sub-share of Taxpayer Stock, Tax Benefits, and Available Cash – are excludable from the PI Trust's gross income under § 1.468B-2(b)(1).

<u>Ruling Request 4</u>: Is the PI Trust allowed to deduct its administrative costs?

Section 1.468B-2(b)(2) allows a QSF to deduct administrative costs and other incidental expenses incurred in connection with the operation of the QSF that would be deductible under Chapter 1 of the 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 QSF, 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.

Accordingly, based on the information submitted and representations made, we conclude that the PI Trust is allowed a deduction in computing its modified gross income for those administrative costs and incidental expenses it incurs that would be deductible under Chapter 1 of the Code in computing the gross income of a corporation. No opinion is expressed, however, whether any particular expense incurred by the PI Trust is an expense that is deductible under § 1.468B-2(b)(2).

<u>Ruling Request 5</u>: Is the PI Trust's basis in Taxpayer Stock the fair market value of that stock on the date it is transferred by Taxpayer to the PI Trust?

Section 1.468B-2(e) provides that a QSF's initial basis in the 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.

Taxpayer is a transferor under § 1.468B-1(d)(1) with respect to the transfer of Taxpayer Stock to the PI Trust.

Accordingly, based on the information submitted and representations made, we conclude that the PI Trust's initial basis in Taxpayer Stock is the fair market value of that stock on the date Taxpayer transfers that stock to the PI Trust.[1]

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[1] The Governments' Agreement indicates that the Environmental Claimants may transfer Taxpayer Stock to the PI Trust under certain circumstances. You have not requested a ruling, and we do not rule, regarding the tax consequences of any transfer of Taxpayer Stock by the Environmental Claimants, either to the PI Trust or to any other person.

<u>Ruling Request 6</u>: Is the PI Trust subject to the information reporting requirements of § 6041 for payments it makes to PI Claimants?

Section 6041(a) requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of fixed or determinable gains, profits, and income of $600 or more in any taxable year to file an information return with respect to such payments.

Section 1.6041-1(c) provides that income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained.

Section 104(a)(2) provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

Section 1.468B-2(l)(2)(i) provides that payments and distributions made by a QSF are subject to the information reporting requirements of Part III of Chapter 61 of the Code.

Section 1.468B-2(l)(2)(ii)(A) requires a QSF to file information returns on a distribution to a claimant if one or more transferors to the fund would have been required to make a return had that transferor made the distribution directly to the claimant.

Section 1.468B-4 states that the determination whether a distribution to a claimant is includible in the claimant's gross income is generally made by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor.

You represent that all payments made by the PI Trust to PI Claimants will be made on account of personal physical injuries under § 104(a)(2). Accordingly, based on the information submitted and representations made, we conclude that the PI Trust is not required to file information returns under § 6041 for any payments it makes to the PI Claimants that are not subject to the tax benefit rule discussed below.[2]

Payments that would otherwise be excludable from gross income under § 104(a)(2) are includible in income to the extent there was a prior tax benefit – that is, to the extent such payments are attributable to (and not in excess of) an individual's prior years' deductions allowed under § 213. Even if such payments are taxable to the PI Claimants, however, the payments do not constitute fixed and determinable income

[2] We decline to rule on whether the payments are in fact excludable from the income of any particular PI Claimant under § 104(a)(2), because we have no PI Claimant before us. See section 2.01, Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 9.

within the meaning of § 6041. Because the PI Trust will neither find it practical to require PI Claimants to provide the PI Trust with prior-year tax returns nor otherwise have access to those returns, the PI Trust will not have the information from which to ascertain the extent (if any) of a prior-year medical expense deduction.

Accordingly, based on the information submitted and representations made, we also conclude that the PI Trust is not required to file information returns under § 6041 with respect to the portion of the payments it makes to PI Claimants attributable to (and not in excess of) the PI Claimants' § 213 deductions.

RULINGS REGARDING THE EFFECTS OF CERTAIN TRANSFERS ON TAXPAYER

Ruling Request 7: Does § 1032 apply to Taxpayer's transfer of Taxpayer Stock to the Unsecured Creditors, so that Taxpayer does not recognize any gain on that transfer?

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

Section 1001(a) provides generally that gain or loss from the sale or other disposition of property is the difference between the amount realized and the basis of the property, as determined under § 1011.

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

Section 1.468B-3(a)(1) provides that a transferor must treat a transfer of property to a QSF as a sale or exchange for purposes of § 1001(a), with the amount realized by the transferor being the fair market value of the property on the date the transfer is made.

Section 1032(a) provides that no gain or loss will be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation. Although § 1032 refers to an exchange for "money or other property" and does not expressly refer to exchanges of stock for debt, it is generally acknowledged that § 1032 applies to an exchange of a corporation's stock for its debt, subject to §§ 61(a)(12) and 108, which provide that a corporation may have income from cancellation of indebtedness on an exchange of its stock for its own debt (that is, cancellation of indebtedness income can be realized and recognized when debt is satisfied with stock of the debtor corporation, even though no gain is recognized on the issuance of the stock).

In this case, Taxpayer will transfer d percent of its stock to the Unsecured Creditors, as a result of which the Item-related tort and environmental claims held by those creditors will be discharged under the bankruptcy statute. In the case of the PI Claimants, the discharge will occur as a result of the PI Trust's assumption of Taxpayer's Item-related liabilities. In the case of the Environmental Claimants, the discharge will occur directly.

Accordingly, based on the information submitted and representations made, we conclude that Taxpayer will not recognize any gain or loss on its stock in exchange for the satisfaction of its debts to the PI Claimants, through the PI Trust, and the Environmental Claimants.

Ruling Request 8: Will Taxpayer recognize gain or loss by entering into the Tax Agreement, under which it is obligated to transfer Tax Benefits in future years to the Unsecured Creditors?

As just noted, a transfer of property (whether to a QSF or another person) in exchange for money or other property generally is a sale or exchange – and thus a realization event – under §§ 1001(a) and 1.468B-3(a)(1). However, § 1.468B-3(a)(1) also provides that because the issuance of a transferor's debt, an obligation to provide services or property in the future, or an obligation to make a payment described in § 1.461-4(g) are generally not transfers of property by the transferor, the issuance of that debt or obligation generally does not result in gain or loss to the transferor under that section.

Section 1.461-4(g)(2) pertains to liabilities requiring a payment or series of payments to another person that arises under any workers compensation act or out of any tort, breach of contract, or violation of law. Under this provision, a liability arising out of a tort, breach of contract, or violation of law includes a liability arising out of a settlement of a dispute in which a tort, breach of contract, or violation of law is alleged.

By entering into the Tax Agreement, Taxpayer has undertaken the obligation to pay future Tax Benefits to the Unsecured Creditors (through the QSF in the case of the PI Claimants). Taxpayer's liability to the PI Claimants arises under alleged violations of tort law; its liability to the Environmental Claimants are based on alleged violations of federal and state environmental law. Thus, both types of claim are described in § 1.461-4(g).

Accordingly, based on the information submitted and representations made, we conclude that Taxpayer will not realize any gain or loss under § 1001 as a result of entering into the Tax Agreement.

In addition, when Taxpayer receives future-year tax refunds, you represent that Taxpayer will pay those refunds over in cash to fulfill its obligations under the Tax Agreement. Accordingly, we conclude that these payments, if made in cash, will not constitute a realization event under § 1001.

Ruling Request 9: Is Taxpayer allowed a deduction under § 162 in the years it transfers Taxpayer Stock, Available Cash, and cash arising from the Tax Benefits, to the PI Trust and the Environmental Claimants?

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

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

Section 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to the item occurs.

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

Section 461(h)(2)(C) and (D) and § 1.461-4(g)(2) provide that with respect to liabilities arising out of tort or a violation of law, economic performance occurs as payment is made to the person to whom the liability is owed.

Section 1.468B-3(c)(1) provides that for purposes of § 461(h), economic performance occurs with respect to a liability described in § 1.468B-1(c)(2) to the extent the transferor makes a transfer to a QSF to resolve or satisfy the liability. Liabilities described in § 1.468B-1(c)(2) include tort liabilities.

Payments made in settlement of a lawsuit or potential lawsuits are generally deductible under § 162 if the acts that gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. Here, Taxpayer's payments of damages to satisfy its tort liabilities for personal physical injuries caused by Item to PI Claimants are business expenses under § 162. In addition, Taxpayer's payments to the Environmental Claimants to settle Taxpayer's violation of federal and state environmental law liabilities, which will compensate those claimants for a portion of their costs of performing environmental remediation at sites formerly owned by Taxpayer's predecessors in interest, are also business expenses under § 162.

The transfers of Taxpayer Stock, Tax Benefits, and Available Cash are deductible in the years of transfer, because the all events and economic performance tests will be satisfied in each of those years. Both prongs of the all events test – the fact of Taxpayer's liability to both classes of claimants and the amount of that liability – were met not later than date 5 (when the Bankruptcy Court approved the Plan). Under § 1.461-4(g)(2), economic performance occurs with respect to Taxpayer's liability to the Environmental Claimants when the transfers are made to those claimants. Under § 1.468B-3, economic performance occurs with respect to Taxpayer's liability to the PI Claimants as transfers are made to the PI Trust. In addition, with respect to the transfer of Taxpayer Stock, you represent that Taxpayer has obtained a qualified appraisal as required by § 1.468B-3(b) and has met the requirements of § 1.468B-3(b)(2).

Therefore, based on the information submitted and the representations made, we conclude that Taxpayer is allowed a deduction under § 162, in an amount equal to the fair market value of Taxpayer Stock, in the taxable year during which that Taxpayer Stock is transferred to the Environmental Claimants and the PI Trust. Additionally, Taxpayer will be allowed a deduction under § 162(a) for the taxable years in which cash payments of Tax Benefits and Available Cash are made.

Ruling Request 10: Will Taxpayer realize cancellation of indebtedness (COD) income when the claims of the Unsecured Creditors are discharged?

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

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

The documentation submitted by Taxpayer suggests that, prior to the Plan's consummation, a few of the Item-related tort and environmental claims against Taxpayer were liquidated. To the extent those claims were discharged under the Plan for amounts that were less than their face value, Taxpayer presumptively would have discharge of indebtedness income under § 61(a)(12). Preslar v. Commissioner, 167 F.3d 1323, 1327-1328 (10th Cir. 1999). However, because payment of the liquidated claims would have given rise to a § 162(a) deduction (as discussed in Ruling Request 9, above), the § 108(e)(2) exception applies. Accordingly, Taxpayer did not realize discharge of indebtedness income with respect to any liquidated claims that were discharged under the Plan.

The great majority of the Item-related tort and environmental claims, however, were unliquidated prior to consummation of the Plan. In the case of unliquidated claims – that is, in the case of claims in which the amount of debt owing is disputed – the settlement of those claims does not give rise to discharge of indebtedness income. Rather, if the dispute concerning the amount of the debt is in good faith, settlement of the dispute is "'treated as the amount of debt cognizable for tax purposes.'" Preslar, supra, at 1327, quoting from Zarin v. Commissioner, 916 F.2d 110, 115 (3rd Cir. 1990); Fidelity & Columbia Trust Co. v. Lucas, 11 F.Supp 537 (W.D. Ky. 1935).

Accordingly, based on the information submitted and representations made, we conclude that Taxpayer did not realize discharge of indebtedness income from its settlement of the Item-related tort and environmental claims.

Ruling Request 11: Will Taxpayer's payments to the Unsecured Creditors qualify as specified liability losses under § 172(f)?

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

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

Section 172(f)(1)(A) and § 172(f)(1)(B) define the term “specified liability loss.”

Section 172(f)(1)(A) defines a specified liability loss to mean any amount allowable as a deduction under §162 or 165 for amounts which are attributable to product liability or expenses incurred in investigating, settling, and opposing claims against the taxpayer on account of product liability.

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

Section 172(f)(1)(B)(i) defines a specified liability loss to include any amount allowable as a deduction under Chapter 1 of Subtitle A of the Code (other than § 468(a)(1) or 468A(a)) which is in satisfaction of a liability under a federal or state law requiring the remediation of environmental contamination. Section 172(f)(1)(B)(ii) provides that a liability shall be taken into account under § 172(f)(1)(B) only if (i) the act (or failure to act) giving rise to such liability occurs at least three years before the beginning of the taxable year, and (ii) the taxpayer used an accrual method of accounting throughout the period or periods during which such act (or failure to act) occurred.

The Item liability claims made by the PI Claimants are “product liability” claims because they arose out the settlement of claims for physical injury to individuals due to exposure to Item, which Taxpayer’s predecessor manufactured and sold, and which injuries arose after Taxpayer’s predecessor relinquished control of the items.

The claims made by the Environmental Claimants are for environmental remediation required by federal and state law, and Taxpayer’s (and/or Taxpayer’s predecessor, Corporation’s) act or failure to act arose from actions that occurred more than three years before the taxable year of the transfer. Moreover, Taxpayer has used an accrual method of accounting since its incorporation during date 1, and thus was on that method during any period or periods in which its act or failure to act occurred.

Accordingly, based on the information submitted and representations made, we conclude that –

1. The transfers to the PI Claimants (through the PI Trust) of Taxpayer Stock, Available Cash, and Tax Benefits are specified liability losses within the meaning of § 172(f)(1), which therefore may be carried back to each of the 10 taxable years preceding the year of such loss.

2. Taxpayer's transfers to the Environmental Claimants of Taxpayer Stock, Available Cash, and Tax Benefits to satisfy environmental remediation claims for Site 1 and Site 2 are specified liability losses within the meaning of § 172(f)(1), to the extent that Corporation used the accrual method of accounting throughout any period or periods during which (determined separately for Site 1 and Site 2) an obligation was imposed upon Corporation for environmental remediation of those sites under the earlier of –

   (a) federal law (for example, the Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601 et. seq.); or

   (b) applicable state law,

   To the extent the above conditions are met, Taxpayer may carry back these losses to each of the 10 taxable years preceding the year of such loss.

<u>RulingRequest12</u>: Will Taxpayer's Carryforwards of its net operating losses be subject to the loss limitation rules of § 382(b)?

Section 382 places limitations on the NOL carryforwards and certain built-in losses of a loss corporation that can be utilized following an ownership change in that loss corporation. Once § 382 is activated by a prescribed change-of-ownership event, the limitation of § 382(a) takes hold and restricts the amount of the new loss corporation's taxable income that can be offset by the taxpayer's net operating loss carryforwards in taxable years after the change of ownership. Section 382 limits the amount of income that can be offset by the carryforwards to the "section 382 limitation."

However, §§ 382(l)(5) and 1.382-9 prescribe special rules for corporations under the jurisdiction of a bankruptcy court. Section 382(l)(5)(A) provides that § 382(a) shall not apply to an ownership change if (i) the old loss corporation is (immediately before the ownership change) under the jurisdiction of the court in a title 11 or similar case, and (ii) the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders or creditors immediately before such change) 50 percent or more of the stock, in vote and value, of the reorganized corporation.

Under § 1.382-9(d)(1), a "qualified creditor" is a beneficial owner, immediately before the ownership change, of "qualified indebtedness" of the loss corporation. These regulations also provide that a qualified creditor owns stock of the new loss corporation only to the extent that the qualified creditor receives stock in full or partial satisfaction of qualified indebtedness in a transaction ordered by the court or pursuant to a plan approved by the court in a title 11 or similar case.

Under § 1.382-9(d)(2)(i), indebtedness of the loss corporation is qualified indebtedness if it –

(A) Has been owned by the same beneficial owner since the date that is 18 months before the date of the filing of the title 11 or similar case; or

(B) Arose in the ordinary course of the trade or business of the loss corporation and has been owned at all times by the same beneficial owner.

Section 1.382-9(d)(2)(ii) provides that beneficial ownership of indebtedness is determined without applying attribution rules.

Section 1.382-9(d)(2)(iv) provides that "ordinary course indebtedness" includes claims arising out of a tort or breach of a statutory duty and indebtedness incurred with respect to expenses that would be deductible under § 162.

Section 1.382-9(d)(5)(ii)(D) permits tacking of the holding period for a qualified transfer if the transferee's basis is determined under §§ 1014 or 1015 or with reference to the transferor's basis in the indebtedness. Section 1014 provides basis rules for property held by a person who acquired the property from a decedent or to whom the property passed from a decedent.

Taxpayer has represented that the Environmental Claimants held their claims for more than 18 months prior to the Chapter 11 filing, that they have been the only holders of their claims, and that the claims arose in the ordinary course of Taxpayer's business.

Accordingly, based on the information submitted and representations made, we conclude that –

1. The Environmental Claimants will be qualified creditors of the old loss corporation because they held qualified indebtedness of Taxpayer before the change in ownership.

2. The PI Claimants will be considered qualified creditors of the old loss corporation because they will be treated as directly owning Taxpayer stock placed in the PI Trust as of the original date of transfer by Taxpayer (and thus of owning a "deemed stock interest").

3. A PI Claimant will be considered to hold qualified indebtedness if that claimant (i) has held the claim for more than 18 months prior to the Chapter 11 filing, or (ii) has been the only holder of the claim and the claim arose in the ordinary course of Taxpayer's business.

4. Taxpayer's carryforwards of its NOLs will not become subject to the loss limitation rules of § 382 if an individual receives a "deemed stock interest" in the PI Trust from a deceased PI Claimant as long as all other requirements are fulfilled. See § 1.382-9(d)(5)(ii)(D), which provides that a transfer from a decedent will be considered a qualified transfer.

CAVEATS

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Pursuant to powers of attorney on file in this office, copies of this letter have been furnished to your authorized representatives.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 12.04 of Rev. Proc. 2002-1, 2002-1 I.R.B.1, 50 (or its successor).

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

Sincerely,
Michael J. Montemurro
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax Accounting)

Enclosures:
Copy of letter
Copy for § 6110 purposes

cc: