Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Date:
November 30, 2005

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Dear :

This is in response to your ruling request on behalf of Company dated April 26, 2002, and supplemental correspondence dated August 29, 2002, October 24, 2002, October 25, 2002, November 6, 2002, December 18, 2002, April 15, 2003, June 27, 2003, September 17, 2003, October 31, 2003, March 1, 2004, and June 16, 2005. You requested the following rulings concerning the tax treatment of certain escrow accounts required by and established pursuant to law:

(1) the escrow accounts that Company established with B pursuant to the D, are qualified settlement funds within the meaning of section 1.468B-1 of the Income Tax Regulations;

(2) all payments made by Company to these escrow accounts are fully deductible;

(3) subsequent payments by Company made to these accounts and to other accounts set up with B or a similar financial institution pursuant to agreements entered into with other Cs are deductible in the year deposited into escrow;

(4) each escrow account 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) of the Internal Revenue Code; and

(5) transfers to the escrow accounts by Company will not constitute gross income to the accounts.

A taxpayer conference of right was held on November 19, 2002. An additional taxpayer conference was held on May 2, 2005.

FACTS

Company is a public corporation engaged in the manufacture and wholesale distribution of J G, a brand of G products, including F. Company began operations in Year 1 as a contract manufacturer of G and F. Company uses an accrual method of accounting. Since Year 2, Company has engaged in extensive research and development activities relating to the development of its proprietary products utilizing its patented J technology.

The Cs brought a consolidated suit against the major manufacturers and sellers (manufacturers) of G products. The suit asserted various claims for monetary, equitable and injunctive relief under state laws, including consumer protection and/or antitrust laws. The Company was not a party defendant in the suit brought by the Cs against the major manufacturers of G products.

On Date 1, the Cs entered into a settlement agreement, A, to resolve litigation against the major manufacturers of G products. Under the A, the party defendant manufacturers of G products are required to establish escrow accounts and make annual payments (in perpetuity) into escrow for the benefit of the Cs. The A provides that all payments are in settlement of H. The party defendants' payments to the escrow accounts are determined by a formula based on their F sales. In exchange for these payments, the defendant manufacturers of G products are "absolutely and unconditionally released and forever discharged from all claims that the Cs directly, indirectly, derivatively or in any other capacity ever had, now have, or hereafter can, shall or may have" against the defendant manufacturers from liability relating to past, present and certain future claims stemming from the use, sale, distribution, manufacture, development, advertising, or marketing of F. Under the A, these escrow accounts are expressly intended to be treated as qualified settlement funds for federal income tax purposes.

The party defendant manufacturers believed that the manufacturers of G products not named as party defendants in litigation also contributed to the harms alleged by the Cs. Consequently, the party defendant manufacturers of G products demanded as a condition of the settlement that nonparty manufacturers of G products be required to share the financial burdens and make deposits into escrows as well. The Cs agreed. The Cs and the party defendant manufacturers structured their settlement to require nonparty manufacturers to contribute to the settlement in one of two ways. In relevant part, the A directs the Cs to require that certain nonparty manufacturers, of which Company is one, establish escrow accounts based on the same formula provided in the A. The D was incorporated into and made an integral part of the A approved by the court having jurisdiction. Each C has enacted a law in the same or substantially similar form as the D.

The objective of the D is to force nonparty manufacturers who refuse to opt into the A to assume a share of the financial burdens created by the use of F and other G products. The D applies to any nonparty manufacturer selling F within a C . The amount of a manufacturer's annual deposits into the escrow accounts required by the D are based on a manufacturer's sales of F during the year in question. Any escrow accounts set up for this purpose must be approved by the Cs.

Company has refused to opt into the A. Therefore, as a nonparty manufacturer of G products selling F within C, Company is required under the D to establish escrow accounts based on the same formula provided in the A.

The Cs have advised Company of its duty to deposit funds in accordance with the Ds and have made written demands for the deposits. In Year 3, Company established the escrow accounts at B. The escrow accounts at B were approved by the Cs. To date, Company has deposited a total of $ X into escrow accounts in accordance with the Ds. As long as Company remains a manufacturer of G products, it will continue to be required to make annual deposits into such escrow accounts, either at B or similar financial institutions.

On or about Date 2, the L (one of the Cs referred to above) notified Company via letter of its intent to file a suit against Company in state court. L alleges at least one claim against Company asserting liability arising out of a violation of laws resulting from the sale of G products and related actions.

Company represents that pursuant to the Ds, it contributes to the escrow accounts held for the sole purpose of satisfying C (of which L is a party) claims. The escrow accounts exist to satisfy C claims brought against Company within Number after the date such fund is placed into escrow. Company may not access the fund for any purpose other than satisfying C claims during the Number period. Any remainder will revert to Company. Company expects that claims will be made against all the contributed funds and, if successful, the funds will be used to satisfy C claims and that nothing will remain to revert to Company. Company further represents that the D placed Company in substantially the same economic position as the party manufacturers of G products agreeing to the A. That is, Company effectively contributes funds to satisfy its ultimate liability to the Cs for damage caused by its G products. Consequently, Company believes that it should receive the same tax treatment under sections 461 and 468B of the Internal Revenue Code as the manufacturers of G products agreeing to the A.

REQUESTED RULING 1

Escrow Account Classification

Section 468B(g) of the Code provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority of section 468B(g), the Secretary has published sections 1.468B-1 through 1.468B-5 of the regulations regarding qualified settlement funds.

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account, or trust that satisfies all three requirements of section 1.468B-1(c). First, section 1.468B-1(c)(1) requires that the fund, account, or trust is established pursuant to an order of, or it is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continued jurisdiction of that governmental authority. Second, section 1.468B-1(c)(2) requires that the fund, account, or trust is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability (i) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980; (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the Commissioner in a revenue ruling or revenue procedure. Third, section 1.468B-1(c)(3) provides that the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).

Section 1.468B-1(j)(1) provides that if a fund, account or trust is established to resolve or satisfy claims described in section 1.468B-1(c)(2), 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 sections 1.468B-1(c)(1) and (c)(3). On the date the fund, account, or trust satisfies all the requirements of section 1.468B-1(c), the transferor is treated as transferring the assets to a qualified settlement fund.

Section 1.468B-2(k)(2) provides that 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 section 1.468B-1; and (ii) ends on the earlier of the date the fund (A) no longer satisfies the requirements of section 1.468B-1; or (B) no longer has any assets and will not receive any more transfers.

Based on the facts represented, on Date 2 the escrow accounts established by Company satisfied all three requirements of section 1.468B-1(c), and therefore are treated as qualified settlement funds as of that date. First, in Year 3 the escrow accounts were approved by the Cs and are subject to the continuing jurisdiction of the Cs. Each escrow account established by Company must be approved by the C for which the account is established. The appropriate official of each C has the authority to monitor and pursue in court charges against Company to enforce annual compliance with the D.

Second, the escrow accounts are 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 a violation of law. There is no question that Company used, sold, distributed, manufactured, developed, advertised, and marketed G products. In its draft complaint sent to Company on Date 2, L alleges at least one claim against Company asserting liability arising out of a violation of laws resulting from the sale of G products and related actions. The escrow accounts, although mandated by D, are expressly and solely established by Company to resolve or satisfy those, and similar, claims.

Note that the facts in this case are distinguishable from Example 7 in section 1.468B-1(k) regarding a landfill operator. There, a corporation owned and operated a landfill in a state that required the corporation to transfer money to a trust annually based on the total tonnage of material placed in the landfill during the year. Under the law, the corporation is required to perform (either itself or through contractors) specified closure activities when the landfill is full, and the trust assets would be used to reimburse the corporation for these closure costs. The trust in that example is not a qualified settlement fund because it is established to secure the liability of the corporation to perform such closure activities. The instant case does not involve a performance liability. The funds transferred to the escrow accounts under the D are not used to secure the future performance of Company. To the contrary, the funds will be used to satisfy the Cs claims based on the past conduct of Company that has resulted in known injuries to the Cs (i.e., increased M and related financial burdens) that have given rise to known liabilities (i.e., violations of state laws) against Company.

Third, the assets in the escrow accounts are segregated from other assets of Company (and related persons). Beginning in Year 3, Company established separate escrow accounts with several leading financial institutions, including accounts at B. Under the regulations, a separate bank account is sufficient to satisfy this requirement. See section 1.468B-1(h)(1).

Thus, since the escrow accounts satisfied all three requirements on Date 2 (in Year 4), Company is treated as transferring the assets to qualified settlement funds on Date 2, which is the first date on which the escrow accounts are treated as qualified settlement funds under section 1.468B-1.

REQUESTED RULINGS 2 and 3

Deduction of Payments

Section 162(a) of the Code provides the general rule that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also section 1.162-1(a).

Section 461(a) provides, in part, that the amount of any 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 1.461-1(a)(2) provides, in part, that under an accrual method of accounting, a liability is incurred, and generally 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(f) provides that if (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of section 461(h), then the deduction shall be allowed for the taxable year of the transfer.

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

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

Section 1.468B-3(c)(1) provides that for purposes of section 461(h), economic performance occurs with respect to a liability described in section 1.468B-1(c)(2) to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability.

Section 1.468B-3(c)(2) provides that 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.

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

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

Based on the above, the amounts transferred into escrow accounts will be used to pay money damages to the Cs for liabilities that arose as a result of Company's principal business activity, that is, the manufacture and sale of G products and F. Thus, such amounts are deductible under section 162(a) as ordinary and necessary business expenses. To the extent that the all events tests under section 1.461-1(a)(2), including economic performance, are met, the amounts transferred into the escrow accounts would be deductible in the taxable year transferred. In this case, the first prong of the all events test, i.e., all the events have occurred that establish the fact of the liability, is met because this is a contested liability within the meaning of section 461(f). Likewise, the second prong, i.e., the amount of the liability can be determined with reasonable accuracy, is met because the amount of the liability can be readily ascertained based on the formula prescribed by the D. Finally, under section 1.468B-3(c), transfers to a qualified settlement fund to resolve or satisfy claims for which it is established constitute economic performance. Therefore, transfers to the escrow accounts are deductible in the taxable year Company makes the transfers to the qualified settlement funds. In this case, transfers made prior to Date 2 will be treated as made on Date 2, which is the first date on which the escrow accounts are treated as qualified settlement funds. See supra.

The fact that the D provides for a reversion of monies if any remain after Number from the date of the transfers does not prevent economic performance from occurring under the facts represented. The D provides that the monies transferred into the escrow accounts revert to Company after Number from the date of the transfers if the Cs have not filed and prevailed on claims either by obtaining a judgment against, or a settlement with, Company. The funds exist to satisfy C claims brought against Company within Number after the date monies are transferred into the funds. Company may not access the funds for any purpose other than satisfying C claims during the Number period. Company expects that claims will be made against all the assets of the funds and, if successful, the funds will be used to satisfy C claims and that nothing will remain to revert to Company. There is no guarantee and little likelihood that any amounts will revert to Company after Number. The reversion in this case requires not only the passage of time, but also the successful defense against claims brought by the Cs before anything reverts to Company. Although the passage of time (i.e., Number) is certain to occur, it is clearly uncertain whether the Cs will neither file nor prevail on claims against Company. Thus, the payments are not transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur. Finally, Company does not have a currently exercisable right to a refund or reversion. However, to the extent Company receives any distributions from the escrow accounts, e.g., overpayments, refunds, interest or other appreciation on the funds, Company must include such amounts in its gross income.

REQUESTED RULING 4

Taxation of Escrow Accounts

Section 1.468B-2(a) of the regulations provides that 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) of the Code.

Section 1.468B-2(k)(1) provides that a qualified settlement fund must file an income tax return with respect to the tax imposed under section 1.468B-2(a) for each taxable year that the fund is in existence, whether or not the fund has gross income for that taxable year.

Because the escrow accounts in this case are qualified settlement funds beginning in Year 4, they will be subject to tax on their modified gross income for any taxable year that the qualified settlement funds are in existence at a rate equal to the maximum rate in effect for that taxable year under section 1(e).

REQUESTED RULING 5

Payments Not Gross Income to Escrow Accounts

Section 1.468B-2(b)(1) of the regulations provides that, 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.

In this case the escrow accounts are qualified settlement funds that are established, pursuant to the approval of the Cs, to assume and pay Company's liabilities related to the sale of G products and F. Accordingly, transfers made by, or on behalf of, Company to resolve or satisfy such liabilities will not constitute gross income to the qualified settlement funds.

CONCLUSIONS

Based solely on the information provided and the representations made, we conclude as follows:

(1) The escrow accounts established with B pursuant to the D are treated as qualified settlement funds within the meaning of section 1.468B-1 of the regulations, as of Date 2, which is the date on which all of the requirements of section 1.468B-1 are satisfied.

(2) All transfers to the qualified settlement funds are deductible in the taxable year transferred to qualified settlement funds. With respect to transfers to escrow accounts made prior to Date 2, Company is treated as transferring those assets to qualified settlement funds on Date 2, which is the first date the escrow accounts are treated as qualified settlement funds. Further, to the extent the qualified settlement funds make any distributions to Company for any overpayments or refunds in the event monies remain after Number from the date of transfer, Company must include such amounts in its gross income to the extent provided by section 111. In addition, to the extent the qualified settlement fund makes a distribution to Company for interest earned on the escrow accounts, Company must include such amount in gross income under section 61(a)(4). See also § 61(a)(15).

(3) Subsequent transfers to the qualified settlement funds, as well as new qualified settlement funds established with B or a similar financial institution to resolve or satisfy like claims of the Cs, will be deductible in the taxable year transfers are made into the qualified settlement funds.

(4) Each qualified settlement fund 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) of the Code.

(5) Transfers to the qualified settlement funds by Company will not constitute gross income to the qualified settlement funds. However, the interest earned on the assets in the qualified settlement funds will constitute gross income to the qualified settlement funds.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to Company who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Powers of Attorney on file with this office, a copy of this letter is being sent to Company's authorized representatives. A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the Company and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Jeffery Mitchell, Branch Chief
Office of Associate Chief Counsel
(Income Tax and Accounting)

cc: