REPORT #730

TAX SECTION

New York State Bar Association

Report on Escrow Accounts,

Settlement Funds and Similar Arrangements

Governed by Section 468B(g)

of the Internal Revenue Code

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June 20, 1992

The Honorable Shirley Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Commissioner Peterson:

Please find enclosed a report on escrow accounts, settlement funds and similar arrangements governed by Section 468B(g) of the Internal Revenue Code.[1]

The report comments upon the proposed regulations under Section 468B(g) and makes recommendations regarding the many other types of escrow accounts, settlement funds and similar arrangements as to which there is still no regulatory guidance. The principal comments and recommendations are as follows:

---

[1] This report was prepared by an ad hoc committee comprised of members of the Committee on Pass-Through Entities and members of the Committee on Tax Accounting Matters. The principal author of the report was William B. Brannan. Substantial contributions were made by David H. Bamberger, Stephen B. Land, Carol A. Quinn, Allen V. Scheiner, Tiberio Schwartz and Eric R. Wapnick. Helpful comments were received from John A. Corry, Simon Freidman, Gordon D. Henderson, Simon Jacobson, Yaron Z. Reich, Irving Salem, Michael L. Schler, Alan J. Tarr and Ronald E. Whitney.

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Dear Commissioner Peterson:

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The report comments upon the proposed regulations under Section 468B(g) and makes recommendations regarding the many other types of escrow accounts, settlement funds and similar arrangements as to which there is still no regulatory guidance. The principal comments and recommendations are as follows:

[1] This report was prepared by an ad hoc committee comprised of members of the Committee on Pass-Through Entities and members of the Committee on Tax Accounting Matters. The principal author of the report was William B. Brannan. Substantial contributions were made by David H. Bamberger, Stephen B. Land, Carol A. Quinn, Allen V. Scheiner, Tiberio Schwartz and Eric R. Wapnick. Helpful comments were received from John A. Corry, Simon Freidman, Gordon D. Henderson, Simon Jacobson, Yaron Z. Reich, Irving Salem, Michael L. Schler, Alan J. Tarr and Ronald E. Whitney.

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1. The basic approach of the proposed regulations of treating qualified settlement funds as separately taxable entities should be maintained, but an election should be added permitting the parties to treat the settlement fund as a grantor trust (with the defendant as the grantor) to avoid the double tax burden that such approach could impose in certain circumstances.

2. The definition of the term "qualified settlement fund" should be broadened in certain respects so that the proposed regulations will apply to more types of settlement funds.

3. The taxable income of a qualified settlement fund should be determined without the proposed limitation on expense deductions.

4. Certain issues with respect to settlement funds created to satisfy contested liabilities pursuant to IRC Section 461(f) should be resolved.

5. Regulations should be issued under Section 468B(g) regarding escrow accounts created in the property sale context, which generally should treat such escrow accounts as grantor trusts (with the buyer as the grantor).

6. Regulations should be issued under Section 468B(g) regarding escrow accounts created in bankruptcy and work-out transactions.

We would be glad to discuss the report with you or members of your staff.

Very truly yours,

John A. Corry
Chair

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Tax Report #730

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Escrow Accounts, Settlement Funds and Similar Arrangements Governed by Section 468B(g) of the Internal Revenue Code

July 20, 1992

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Escrow Accounts, Settlement Funds and Similar Arrangements Governed By Section 468B(g) of the Internal Revenue Code [*]

I. Introduction

Escrow accounts, settlement funds and similar arrangements are used in a wide variety of situations, including litigation settlements, property sales, bankruptcy and work-out transactions, corporate reorganizations and divorce settlements. Section 468B(g) of the Internal Revenue Code provides that the income attributable to escrow accounts, settlement funds and similar arrangements shall be subject to current taxation under regulations to be issued by the Treasury Department. On February 14, 1992, the Treasury Department issued Proposed Treasury Regulation Sections 1.468B-0 through 1.468B-5 (the "Proposed Regulations") regarding the taxation of so-called "qualified settlement funds" pursuant to that regulatory authority.2/

This Report comments upon the Proposed Regulations and makes recommendations regarding the many other types of escrow

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2/ 57 Fed. Reg. 5399 (February 14, 1992).

accounts, settlement funds and similar arrangements as to which there is still no regulatory guidance. As more fully discussed below, the principal comments and recommendations of the Committee are as follows: (i) the basic approach of the Proposed Regulations of treating qualified settlement funds as separately taxable entities should be maintained, but an election should be added permitting the parties to treat the settlement fund as a grantor trust (with the defendant as the grantor) to avoid the additional tax burden that such separate taxable entity approach could impose in certain circumstances; (ii) the definition of the term "qualified settlement fund" should be broadened in certain respects so that the Proposed Regulations will apply to more types of settlement funds; (iii) the taxable income of a qualified settlement fund should be determined without the proposed limitation on expense deductions; (iv) certain issues with respect to settlement funds created to satisfy contested liabilities pursuant to Section 461(f) should be resolved; (v) regulations should be issued under Section 468B(g) regarding escrow accounts created in the property sale context, which generally should treat such escrow accounts as grantor trusts (with the buyer as the grantor); and (vi) regulations should be issued under Section 468B(g) regarding escrow accounts created in bankruptcy and work-out transactions that generally will permit them to qualify as grantor trusts or simple or complex trusts, but that will require that escrow accounts that hold the interests of disputed or contingent creditors be treated as qualified settlement funds (subject to an election to treat such escrow accounts as grantor trusts with the debtor as grantor where the debtor remains in existence).

A. Legislative Background. Before 1986, the Service issued a number of rulings indicating that certain types of escrow accounts, settlement funds and similar arrangements

constituted grantor trusts or mere custodial arrangements, with the consequence that there was no account-level tax, except in the unusual case where the account constituted a taxable trust.3/ Moreover, there were a number of cases and rulings indicating that the earnings of certain types of escrow accounts (principally litigation settlement funds) were not subject to current taxation in the hands of any of the other parties were a number of cases and rulings indicating that the earnings of certain types of escrow accounts (principally litigation settlement funds) were not subject to current taxation in the hands of any of the other parties to the transaction as long as the identity of the party entitled to the earnings could not be determined.4/ On the basis of those cases and rulings, it was generally believed that there was no current taxation of any of the parties to the transaction until the identity of the party entitled to the earnings of the escrow account was determined, at which time such party would be required to include all the earnings in income.5/

3/ See, e.g., Rev. Rul. 70-567, 1970-2 C.B. 16 (litigation settlement fund not separately taxable); and Rev. Rul. 71-119, 1971-1 C*B. 163 (litigation settlement fund not separately taxable); but see Rev. Rul. 69-300, 1969-1 C.B. 167 (custodial arrangement for land trust shares where the custodian had certain discretionary management powers treated as a taxable trust).

4/ See, e.g., North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932) (oil-producing property held by a receiver); Rev. Rul. 64-131, 1964-1 (Part 1) C.B. 485 (litigation settlement fund); Rev. Rul. 70-567, supra note 2; and Rev. Rul. 76-50, 1976-1 C.B. 378 (litigation settlement fund).

5/ See, e.g., Moore and Sorlien, Homeless Income, 8 Tax L. Rev. 425 (1953); Jacobs, Escrows and Their Tax Consequences, 39 N.Y.U. Inst. 5-1 (1981); and Strasen, Income in Search of a Taxpayer: Taxing Homeless Income, 68 Taxes 945 (1990). The Service has validated that position in eight recent private letter rulings applying pre-Section 468B(g) law to what apparently were pre-August 17, 1986 litigation settlement funds. See P.L.R. 8723056 (March 11, 1987); P.L.R. 8838027 (June 24, 1988); P.L.R. 8924090 (March 23, 1989); P.L.R. 9030019 (April 26, 1990); P.L.R. 9032036 (May 16, 1990); P.L.R. 9037004 (June 5, 1990); P.L.R. 9129018 (April 19, 1991), and P.L.R. 9228020 (April 10, 1992).

However, that position was not beyond question. First, the authority provided by the cases and rulings supporting the above-described general rules was not entirely solid, as those cases and rulings often dealt only with limited aspects of the transaction in question. Second, there were recognized exceptions to the general rules.6/ One exception applied where the earnings were distributed to one of the parties on a current basis (which apparently caused that party to be subject to tax on the earnings, even though that party might not be entitled to retain them).7/

Another exception was where one of the parties exercised sufficient dominion and control over the escrowed funds that it should be regarded as being in constructive receipt of such funds (in which event that person was treated as having immediately received such funds and therefore was taxable on their earnings).8/

The deferral benefit afforded by these rules presumably has resulted in a substantial revenue loss to the Treasury. To remedy that situation, the Conference Committee that produced the Tax Reform Act of 1986 (the "1986 Act") added Section 1807(a)(7)(D)(i) to the 1986 Act as an appendage to the 1986 Act provisions relating to Section 468B. Section 1807(a)(7)(D)(i),

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6/ For example, in Revenue Ruling 71-119, which dealt with a settlement fund created to settle a securities law action and which is widely regarded as the seminal ruling in the area, the Service merely concluded that the fund was not a trust and, therefore, that neither the court nor the special master that administered the fund was required to file a Form 1041 trust return on behalf of the fund. The ruling did not hold that none of the other parties to the settlement was subject to current tax with respect to the earnings of the fund (although it was not inconsistent with that position).

7/ See, e.g., Rev. Rul. 65-203, 1965-2 C.B. 437. Cf. North American Oil Consolidated v. Burnet, supra note 3.

8/ See, e.g., Rev. Rul. 69-92, 1969-1.C.B. 138; and G.C.M. 37073 (March 31, 1977) and the cases cited therein.

which for some unexplained reason was not codified in the Code, provided as follows:

> "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. If contributions to such an account or fund are not deductible, then the account or fund shall be taxed as a grantor trust."

The Conference Committee Report on the 1986 Act indicates that this provision was intended to overrule Revenue, Ruling 71-119, which the Conference Committee presumably viewed as the embodiment of the long line of cases and rulings on the subject.9/ Section 1807(a)(7)(D)(i) was to be effective for escrow accounts established after August 16, 1986. Although the statutory language seemed to contemplate a straightforward application of the grantor trust rules where the funding of the account did not give rise to an immediate deduction, the Conference Committee Report did not indicate how to determine whether there was an immediate deduction or how the earnings on escrow accounts that did give rise to an immediate deduction should be taxed.

The Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") codified Section 1807(a)(7)(D)(i) of the 1986 Act in the Code as Section 468B(g). However, Congress changed the second sentence of the provision to read as follows: "The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise."

9/ H.R. Rep. No. 841, 99th Cong., 2d Sess. II-845, n.2 (Sept. 18, 1986) (the "Conference Committee Report"). Curiously, Section 1807(a)(7)(D)(i) of the 1986 Act was captioned "Clarification of Law With Respect to Certain Funds" (emphasis added). The Service has recently issued a published ruling stating that Section 468B(g) has rendered Rev. Rul. 71-119 and certain other escrow account rulings obsolete. See Rev. Rul. 92-51, 1992-27 I.R.B. 1.

The new “or otherwise” language in the 1988 Act version of the provision seems to grant very broad discretion to the Treasury Department to promulgate regulations governing the taxation of escrow accounts, settlement funds and similar arrangements. Without commenting on the significance of the new language, the House and Senate Committee Reports on the 1988 Act both provided the following guidance to the Treasury Department:

> “It is anticipated that these regulations will provide that if an amount is transferred to an account or fund pursuant to an arrangement that constitutes a trust, then the income earned by the amounts transferred will be currently taxed under Subchapter J of the Code. Thus, for example, if the transferor retains a reversionary interest in any portion of the trust that exceeds 5 percent of the value of that portion, or the income of the trust may be paid to the transferor, or may be used to discharge a legal obligation of the transferor, then the income is currently taxable to the transferor under the grantor trust rules.”10/

Section 468B(g) has the same August 16, 1986, effective date as the original provision.

B. Status of Regulatory Guidance. Although the earnings on escrow accounts, settlement funds and similar arrangements have supposed to have been subject to current taxation since 1986, there was no published authority as to what substantive tax rules should apply for almost six years until the recent promulgation of the Proposed Regulations. The only guidance prior to the promulgation of the Proposed Regulations was Private Letter Ruling 8916030, which dealt with a settlement fund created to provide compensation to utility customers that were damaged as a result of a utility fuel supplier's breach of a

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10/ H.R. Rep. No. 795, 100th Cong., 2d Sess. 377 (July 26, 1988) (the “House Report”) and S. Rep. No. 445, 100th Cong., 2d Sess. 398 (Aug. 3, 1988) (the “Senate Report”).

contract to provide fuel to the utility at a fixed rate.11/ Without giving any real explanation (but perhaps foreshadowing the approach to be taken in the Proposed Regulations), the ruling concluded that the settlement fund itself was subject to tax as a taxable trust.12/ The Service apparently has received many other requests for private letter rulings with respect to escrow accounts governed by Section 468B(g) as to which it has not yet acted.

In view of the absence of definitive guidance, it has been, and remains, very difficult for taxpayers to determine how to comply with Section 468B(g). Some taxpayers involved with escrow accounts have attempted to cope with the uncertainty in the law by obtaining contractual agreements that one of the parties to the transaction would report the earnings on the account in its own return as if the account were a grantor trust or a mere custodial arrangement. Other taxpayers have attempted to arrange for the escrow account itself to reserve funds sufficient to pay taxes on the earnings in anticipation of the issuance of regulations imposing an account-level tax (although in such cases the tax usually has not been volunteered to the Service). Nevertheless, there does not seem to have been widespread compliance with Section 468B(g). Hence, the Proposed Regulations were eagerly awaited by the tax bar. Unfortunately, while the Proposed Regulations do provide important new guidance,

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11/ P.L.R. 8916030 (January 19, 1988). The Internal Revenue Service has issued nine other private letter rulings dealing with the taxation of escrow accounts and settlement funds subsequent to the 1986 Act. See the eight private letter rulings cited in note 4, supra, and P.L.R. 9138034 (June 20, 1991). The eight rulings cited in note 4 apparently involved escrow accounts that were "grandfathered" because they were created before the effective date of Section 468B(g), although some of the rulings do not expressly discuss Section 468B(g). P.L.R. 9138034 dealt only peripherally with Section 468B(g).

12/ The treatment of the settlement fund as a taxable trust was not burdensome, because the settlement fund's expenses were expected to exceed its investment income.

they are somewhat disappointing inasmuch as they seem to deal only with certain types of litigation settlement funds, as discussed below. Consequently, there is still a critical need for additional regulatory guidance in this area.

The following three sections of this report discuss Section 468B(g) and the Proposed Regulations in the context of the three principal types of escrow accounts, settlement funds and similar arrangements that are used by taxpayers--litigation settlement funds, property sale escrow accounts and bankruptcy and work-out funds.

II. Litigation Settlement Funds

A. Background. One of the most common contexts in which escrow accounts, settlement funds and similar arrangements are employed is in the settlement of litigation. In such situations, the defendant typically pays money or transfers property to a settlement fund administered by a court or a third-party trustee pursuant to a written settlement agreement, and the assets of the settlement fund are subsequently used to discharge the claims asserted against the defendant by the plaintiffs. 12/ In most cases, the identity of all the plaintiffs and/or the amount of their allowable claims will not have been finally determined at the time the settlement fund is established, and it may take several years to make such determinations. 13/ In

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12/ For convenience of reference, settlement funds and similar arrangements created in the context of the settlement of litigation are referred to in this section as “settlement funds”.

13/ For a description of an extreme example of a complex litigation settlement arrangement, see Internal Revenue Service News Release IR-90-79 (May 16, 1990), which describes the “Agent Orange” litigation settlement. Under the terms of the settlement, a settlement fund with $180 million of assets was established to make payments to up to 2.9 million veterans and their spouses, children and parents over a six-year period ending in 1994 based on criteria that would vary over time.

certain cases involving contested liabilities, however, the identities of the plaintiffs are known, but it is uncertain whether the assets of the settlement fund will be paid over to the plaintiffs. The law in effect before the promulgation of the Proposed Regulations contained special rules regarding three specific types of litigation-related settlement funds, as briefly described below. 14/

1. Designated Settlement Funds. As part of the 1986 Act, Congress enacted Section 468B, which created the concept of the "designated settlement fund" (the "DSF") to provide elective relief with respect to the economic performance requirement of Section 461(h) as it relates to payments by defendants to settlement funds. 15/ Before the enactment of Section 468B, payments by defendants to settlement funds generally did not satisfy the economic performance requirement if the monies in the settlement fund were not disbursed immediately to the plaintiffs, since actual payment to the plaintiffs generally is required under Section 461(h). 16/ Section 468B provides that a "qualified payment" by a defendant to a DSF will be deemed to satisfy the economic performance requirement.

In order to qualify as a DSF, the settlement fund must satisfy the six requirements set forth in Section 468B(d): (i) it

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14/ The following discussion does not address structured settlements for personal injury liabilities that are governed by Section 130. Such structured settlements involve the assumption by a third party of the defendant's liability, rather than a conventional type of litigation settlement fund. Accordingly, such structured settlements do not involve the usual "homeless income" problem.

15/ See S. Rep. No. 99-313, 99th Cong., 2d Sess. 926 (May 29, 1986). The 1986 Act provision that enacted Section 468B was classified as a "technical correction" to the original Tax Reform Act of 1984 economic performance provisions. See Section 1807(a)(7)(A) of the 1986 Act.

16/ See Treas. Reg. § 1.461-4(g).

must be established for the "principal purpose" of discharging claims against the defendant (or related persons) relating to personal injury, death or property damage, (ii) it must be established pursuant to a court order that completely "extinguishes" 17/ the liability of the defendant for such claims, (iii) it must receive only "qualified payments" from the defendant, (iv) it must be administered by persons a majority of whom are "independent" of the defendant, (v) no beneficial interest in the income or corpus of the fund may be held by the defendant (or any related person) and (vi) the defendant must affirmatively elect that the settlement fund be treated as a DSF. 18/

Under Section 468B(b), a DSF is taxed at the maximum rate applicable to trusts (currently 31 percent) on its gross income, less the amount of its "administrative costs" and "other incidental expenses". The gross income of a DSF includes any income generated by its assets, but it does not include the amount of the defendant's contributions to the DSF. The DSF is not entitled to a deduction for distributions to the plaintiffs.

Section 468B by its terms does not purport to affect the taxation of the plaintiffs with an interest in the DSF.

17/ Neither Section 468B nor the legislative history thereof sheds any light on what it means to "extinguish" a liability. It seems clear that an extinguishment should be deemed to have occurred whenever the terms of the DSF provide that the defendant has no further legal obligation to the plaintiffs in respect of the claims covered by the settlement arrangement. The possibility that other plaintiffs may assert similar or related claims presumably would not preclude the defendant's deduction for amounts contributed to the DSF with respect to the claims that are settled.

18/ Section 468B(d)(2) contemplates that the defendant creating the DSF may revoke the DSF election with the consent of the Service. No guidance exists as to the circumstances in which a revocation will be permitted or the tax consequences thereof. It may be appropriate to allow revocation when all claims against the defendant are satisfied, so that any residual amount remaining in the DSF can revert to the defendant without jeopardizing the prior deduction in respect of amounts paid to the plaintiffs.

Presumably, the plaintiffs do not recognize income as a consequence of the creation of the DSF (assuming that there is no constructive receipt issue), even though the defendant creating the DSF would usually become entitled to an immediate deduction. Rather, the plaintiffs would recognize income only if and to the extent that distributions are made to them by the DSF.

As explained below, the Proposed Regulations seem to supplant the statutory DSF concept with the concept of the qualified settlement fund, which includes not only settlement funds that would qualify as DSFs, but other types of settlement funds as well. 19/

2. Qualified Funds. Proposed Treasury Regulation § 1.461-6(c), which was promulgated in 1990, created the concept of the "qualified fund" (the "QF") to provide defendants with an alternative elective mechanism to satisfy the economic performance with respect to the settlement of certain types of claims. Under Proposed Treasury Regulation § 1.461-6(c), an "approved payment" by a defendant to a QF would have been deemed to satisfy the economic performance requirement. In order to qualify as such, the QF must have been established to "extinguish" a liability arising under a workers' compensation act or out of any tort, 20/ breach of contract 21/ or violation of law. In all other respects, the requirements for a QF were

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19/ See Part 11(B), infra.

20/ The inclusion of the tort category arguably meant that all settlement funds that are eligible for DSF treatment (i.e., settlement funds to satisfy claims relating to personal injury, death or property damage) also were eligible for QF treatment. See note 62, infra.

21/ The term "breach of contract" for this purpose did not include any liability to make payments required under a contract for services, property or "other consideration", unless such payments constituted incidental, consequential or liquidated damages. See Prop. Treas. Reg. § 1.461-4(g)(2)(i).

similar to those for a DSF: (i) the QF must have been established pursuant to a court, administrative or governmental order, (ii) the QF must have had independent management, (iii) neither the defendant (nor any related person) could have had any interest in the QF and (iv) the defendant must have affirmatively elected QF status for the settlement fund.

Like a DSF, a QF was taxed upon the amount of its gross income (less the amount of its ordinary and necessary administrative or incidental expenses that are ordinarily deductible by a corporation) at the maximum rate applicable to trusts. 22/ And, as in the case of a DSF, the gross income of a QF did not include the amount of the contribution from the defendant, and the amount of distributions to the plaintiffs could not have been deducted. The plaintiffs with an interest in the QF presumably were taxed in the same manner as plaintiffs with an interest in a DSF, i.e., the contribution of assets to the QF did not ordinarily require the recognition of income by the plaintiffs, unless there was constructive receipt.

On April 10, 1992, the Treasury Department promulgated new final regulations under Section 461. 23/ Those regulations completely eliminate the qualified fund concept, because the Treasury Department regarded it as being subsumed under the new qualified settlement fund concept contained in the Proposed Regulations. 24/

3. Contested Liability Funds. Under Section 461(f), it is possible for a defendant to satisfy the "all events" test with

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22/ Prop. Treas. Reg. $ 1.461-6(c)(4).

23/ T.D. 8404, 57 Fed. Reg. 12411 (April 10, 1992).

24/ See id. at 12418.

respect to a liability that is still being contested. To satisfy the "all events" test, the defendant must transfer cash or other property for the satisfaction of the liability (i) to the person asserting the liability, (ii) to an escrowee or trustee pursuant to a government order or a written agreement among the taxpayer, the person asserting the liability and the escrowee or trustee or (iii) to the court with jurisdiction over the contest. 25/ (Such contested liability settlement funds are referred herein to as "461(f) Funds".) In addition, the liability must be of a type that would give rise to a deduction but for the existence of the contest, and, if the defendant is an accrual method taxpayer, a deduction is allowed only if the defendant satisfies the economic performance requirement of Section 461(h). 26/ As discussed below, it was unclear before the promulgation of the Proposed Regulations whether the mere transfer of cash or property to a 461(f) Fund satisfied the economic performance requirement, and that issue remains unclear even after the promulgation of the Proposed Regulations. 1327/

461(f) Funds differ from DSFs and QFs in several respects. First, and most importantly, 461(f) Funds differ from DSFs and QFs in that the defendant continues to contest the asserted liability after the establishment of the 461(f) Fund. That greatly increases the likelihood that the defendant may

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25/ Treas. Reg. § 1.461-2(c)(1)

26/ See Section 461(f)(4). The "determined after application of subsection (h)" language in Section 461(f)(4), which incorporates by reference the economic performance requirement, was added by the Tax Reform Act of 1984. It should be noted that Treas. Reg. § 1.461-2, the key regulation governing deductions for payments to 461(f) Funds, was originally promulgated before the Tax Reform Act of 1984 was enacted and has not been amended to address the economic performance requirement.

27/ See Part 11(C)(11), infra.

recover some or all of the assets in the 461(f) Fund, since the outcome of the contest may be favorable to the defendant. Second, unlike DSFs and QFs, 461(f) Funds do not need to be established pursuant to a court or other governmental order. Third, except for an exclusion for certain foreign tax liabilities, there is no limitation as to the type of claim to be satisfied by a 461(f) Fund. 28/ Fourth, there is no specific requirement that the administrator of the 461(f) Fund be independent from the defendant, although the funds must be placed beyond the defendant's control.

The taxation of 461(f) Funds previously was addressed by Proposed Treasury Regulation § 1.461-2(f). Under that regulation, a 461(f) Fund was not treated as a taxable trust. Rather, a 461(f) Fund generally was treated as a grantor trust, with the defendant as its grantor. 29/ Hence, the defendant had to report on its own return the items of income, gain, loss, deduction and credit recognized by the 461(f) Fund. However, since the defendant was granted an immediate deduction equal to the fair market value of the assets transferred to the 461(f) Fund at the time of contribution, the 461(f) Fund rules had to depart somewhat from the normal grantor trust rules. Accordingly, the defendant had to recognize gain or loss on any transfer of property to the 461(f) Fund as if the property had been sold for its fair market value. Furthermore, the defendant had to include in income any amounts returned to it or distributed to persons other than those for whom the 461(f) Fund was established. 30/

28/ However, it should be noted that Treas. Reg. § 1.461-2(a)(5) contains a cryptic reservation that might possibly reflect a concern that 461(f) Funds established to satisfy certain types of claims should not give rise to an immediate deduction.

29/ Prop. Treas. Reg. § 1.461-2(f)(2)(ii). That treatment seemed inconsistent with granting the defendant an immediate deduction.

30/ Prop. Treas. Reg. §§ 1.461-2(f)(2)(i) and (iv).

The defendant was allowed a deduction for the taxes that it paid on the earnings of the 461(f) Fund. 31/

The recently-issued final Treasury Regulations under Section 461 contain a reservation regarding the taxation of contested liability settlement funds, indicating that the 461(f) Fund tax regime described in the preceding paragraph is no longer in effect and that the Treasury Department is reevaluating how contested liability funds should be treated for tax purposes. 32/

The preamble to the Proposed Regulations states that a fund, account or trust established to satisfy a contested liability shall be treated as a qualified settlement fund if it meets the definition thereof. 33/ Since, as discussed below, it is unclear whether the Treasury Department intended for 461(f) Funds generally to be treated as qualified settlement funds, it is still unclear how 461(f) Funds should be taxed. 34/

B. Summary of the Proposed Regulations. Pursuant to the authority granted by Section 468B(g), the Treasury Department has issued the Proposed Regulations, which provide that a settlement fund that meets certain requirements will automatically be classified as a "qualified settlement fund" (a "QSF") for all purposes of the Code. 35/ This treatment will apply even though the settlement fund could be classified as a

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31/ Prop. Treas. Reg. § 1.461-2(f)(2)(v).

32/ Treas. Reg. $ 1.461-2(f).

33/ See 57 Fed. Reg. 5399, 5401 (February 14, 1992). It is curious that the preamble to the recently-issued economic performance regulations did not mention this point.

34/ See Part 11(C)(11), infra.

35/ Prop. Treas. Reg. § 1.468B-1(b).

trust, partnership or association under general tax classification principles. The Proposed Regulations generally are effective beginning on January 1, 1993. 36/

In order to be classified as a QSF, a settlement fund must satisfy the following three requirements: (i) it must be established pursuant to the order of, or approved by, a court or other governmental authority in the United States (which order or approval apparently may be preliminary in nature); (ii) it must be established to "resolve or satisfy" one or more claims (collectively, "QSF Liabilities") that (A) arose out of a tort, breach of contract or violation of law, (B) arose under the Comprehensive Environmental Response, Compensation and Liability Act (the "Superfund" statute) or (C) that is designated by the Commissioner by Revenue Ruling or Revenue Procedure, other than claims relating to certain "recurring liabilities"; and (iii) it must constitute a trust under applicable state law or its assets must otherwise be "segregated" from the other assets of the defendant and related persons. 37/ Unlike the DSF rules (or the old QF rules), the Proposed Regulations do not require that the settlement fund extinguish the defendant's liability, that it be administered by independent persons or that an affirmative election be made to obtain QSF status.

If a defendant contributes noncash assets to a QSF, the defendant must recognize gain or loss as if such assets had been sold for their fair market value. 38/ As a corollary, the QSF obtains a fair market value tax basis in such assets. 39/

36/ Prop. Treas. Reg. $ 1.468B-5(a).

37/ Prop. Treas. Reg. $ 1.468B-1 (C).

38/ Prop. Treas. Reg. § 1.468B-3(a).

39/ Prop. Treas. Reg. § 1.468B-2(d).

The Proposed Regulations provide that a QSF will be treated as a separate taxable entity, which will be taxed on its "modified gross income" at a rate equal to the highest tax rate for a trust. 40/ The "modified gross income" of a QSF, which is to be computed on a calendar year basis using the accrual method of accounting, is equal to its gross income, less the amount of its ordinary and necessary "administrative costs" and "incidental expenses" which would ordinarily be deductible by a corporation and certain types of losses. 41/ However, the gross income of the QSF does not include amounts transferred to the QSF by the defendant.

The "administrator" of the QSF is responsible for filing returns and paying tax on behalf of the QSF. 42/ The Proposed Regulations provide that if the settlement fund otherwise qualifies as a QSF but it has not met the requirement of government approval, its income will be taxed to the defendant as if the defendant continued to own the assets in the settlement fund until government approval is obtained. 43/

Under the Proposed Regulations, the defendant generally is deemed to satisfy the economic performance requirement as assets are contributed by it to the QSF. 44/ However, economic

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40/ Prop. Treas. Reg. § 1.468B-2(a). However, a QSF is treated as a corporation for purposes of Subtitle F (Procedure and Administration). See Prop. Treas. Reg.

41/ Prop. Treas. Reg. $ 1.468B-2(b).

42/ Prop. Treas. Reg. § 1.468B-2(j)(1)

43/ Prop. Treas. Reg. § 1.468B-1(g).

44/ Prop. Treas. Reg. § 1.468B-3(b). The recently-issued Section 461 regulations, which were issued after the Proposed Regulations, contain a reservation as to whether the transfer of cash or property to any type of settlement fund (other than a DSF) constitutes economic performance. See Treas. Reg. § 1.4 61-6(c). That reservation presumably was included because

performance is not deemed to occur if either the defendant (or a related person) has the unilateral right to obtain the assets in the settlement fund or it is certain that a reversion will occur. The plaintiffs are taxable only to the extent that they receive distributions from the QSF, and such distributions are treated in their entirety as a payment by the defendant, with the tax character of the payment depending upon the nature of their claim. 45/

The preamble to the Proposed Regulations indicates that the QSF concept is intended to supplant the statutory (and elective) DSF concept, apparently because the DSF concept is subsumed under the broader QSF concept and essentially the same substantive tax rules apply to both. 46/ That presumably represents a valid exercise of the Treasury Department's authority under Section 468B(g), since the Proposed Regulations effectively are just filling in the "hole" in the settlement fund tax law that exists with respect to settlement funds that do not qualify as DSFs. However, the practical effect of the Proposed Regulations is to broaden dramatically the application of the DSF tax regime.

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the Section 468B(g) regulations are currently in proposed form, and it presumably will be eliminated once final Section 468B(g) regulations are issued.

45/ Prop. Treas. Reg. § 1.468B-4.

46/ The introductory part of the preamble states that "these proposed regulations provide a single set of operative rules for the taxation of designated settlement funds and certain funds, accounts, or trusts called qualified settlement funds". 57 Fed. Reg. 5399, 5404 (February 14, 1992). Prop. Treas. Reg. § 1.468B specifically provides that DSFs shall be taxed as QSFs and that all the other aspects of the Proposed Regulations generally apply to DSFs. The last sentence of that regulation suggests that there may be settlement funds that qualify as DSFs without qualifying as QSFs, but it is difficult to see how that situation could exist.

C. Comments and Recommendations. Set forth below are the comments and recommendations of the Committee with respect to the Proposed Regulations as they relate to settlement funds.

1. General Approach. A majority of the Committee members generally endorse the approach that the Proposed Regulations adopt of treating settlement funds as separate taxable entities. First, that approach does not involve the creation of an entirely new tax regime for settlement funds; rather, it simply represents an extension of the established DSF tax regime. Second, that approach is relatively simple as compared to most of the alternative approaches, such as treatment as a complex trust under Subchapter J, which would raise novel questions if applied to complex litigation settlement situations. It also does not require any inquiry into the likelihood of reversion to the defendant, which, despite some theoretical appeal, would be very difficult to determine as a practical matter.

The two principal objections that have been raised to the approach adopted by the Proposed Regulations are that as a legal matter such approach may be invalid because it differs from the approach contemplated by Congress and that as a policy matter it may impose an unacceptable double tax burden as compared to the alternative approaches that might have been adopted. Those two objections are discussed separately below.

(a) Legal Argument. It has been suggested that as a legal matter the Treasury Department may have exceeded its authority under Section 468B(g) in view of the specific recommendation in the legislative history that settlement funds be subject to tax under Subchapter J. That view is based in large

part upon the committee reports on the 1988 Act, which, as noted earlier, state:

> "It is anticipated that these regulations will provide that if the amount is transferred to an account or fund pursuant to an arrangement that constitutes a trust, then the income earned by the amounts transferred will be currently taxed under Subchapter J of the Code. Thus, for example, if the transferor retains a reversionary interest in any portion of the trust that exceeds 5 percent of the value of that portion, or the income of the trust may be paid to the transferor, then the income is currently taxable to the transferor under the grantor trust rules." 47/

Since a settlement fund usually is either an actual trust or is in the nature of a constructive trust, that legislative history suggests that Congress intended that settlement funds generally should be subject to current tax under Subchapter J, often as a grantor trust. In any event, nowhere is there any express indication in the legislative history that Congress intended that settlement funds be treated as separate taxable entities under DSF-type rules.

However, the Committee is not persuaded by the foregoing legal argument. First, the above-quoted legislative history seems to be precatory in nature. Second, the broad "or otherwise" language in the statute clearly does not limit the Treasury Department to Subchapter J approaches. Indeed, the "or otherwise" language presumably was added in the 1988 Act because the Treasury Department was already contemplating a non-Subchapter J approach, perhaps the DSF tax regime (which had been in existence for two years at the time the 1988 Act was enacted).

47/ House Report at 377; Senate Report at 398 (emphasis added).

(b) Double Tax Concern. It also has been suggested as a policy matter that the approach adopted by the Proposed Regulations would always impose an additional tax burden on the income earned by settlement funds as compared to the tax consequences of the principal alternative approaches. The approach adopted by the Proposed Regulations does appear to involve an element of double taxation, since the earnings on the assets of a QSF are subject to tax at the QSF level and then again at the plaintiff level when the earnings are distributed (subject to any basis that the plaintiffs may have in their claims and any applicable exclusion provision, such as Section 104). Consider the following simplified example:

> Example (1). Suppose that a defendant contributes $100 of cash to a settlement fund qualifying as a QSF at the beginning of year 1, that the cash is invested in a money market account that earns 10% per year and that the net proceeds in the settlement fund are distributed to the plaintiffs at the beginning of year 2. In that case, the settlement fund would earn $10 of interest income in year 1 on which it would pay tax of $3.10, leaving $106.90 of net proceeds for distribution to the plaintiffs. Assuming that the plaintiffs are fully taxable on the proceeds (say at a 31% rate), they would pay a tax of $2.14 on the $6.90 of after-tax income of the settlement fund. Thus, the income of the settlement fund has borne two levels of tax -- $3.10 at the settlement fund level and $2.14 at the plaintiff level. The total amount of after-tax proceeds to the plaintiffs would be $73.76 (the $106.90 distribution less the $33.14 of tax on the distribution).

It is argued that the income of a settlement fund would generally be subject to a single level of tax under the principal alternative approaches to the taxation of the earnings of settlement funds, which are treatment as a grantor trust (with the defendant as the grantor) and treatment as a simple or complex trust under Subchapter J. If a settlement fund were treated as a grantor trust, it would not be subject to a separate

level of tax; if it were treated as a simple or complex trust, it would be subject to a separate level of tax, but such tax would be minimized or completely avoided as a result of the deduction for amounts distributed to the beneficiaries or the credit to the beneficiaries for the taxes paid by the settlement fund.

Since the grantor trust approach under which the defendant would be treated as the grantor would involve the minimum amount of complexity, it would appear to be the most attractive alternative. Consider the following illustration of that approach:

> Example (2). Assume that the facts are the same as in Example (1), but that the settlement fund is treated as a grantor trust with the defendant as the grantor. In that case, the settlement fund would not be subject to a separate level of tax, the defendant would pay tax of $3.10 on the interest income of the settlement fund (assuming that the defendant is taxable at a 31% rate) and the net proceeds available for distribution to the plaintiffs would be $110. Such proceeds would be subject to a tax of $34.10 in the hands of the plaintiffs. Thus, at least from the plaintiffs' standpoint, the $10 of interest income would not be subject to a double tax, since they would receive it without reduction for any settlement fund-level tax. The total amount of after-tax proceeds to the plaintiffs would be $75.90 (the $110 distribution less the $34.10 of tax on the distribution), which is $2.14 more than in Example (1).

However, the Committee does not believe that there would be a double tax burden as a general rule under the approach adopted by the Proposed Regulations. First, the double tax concern generally arises only when the issue is viewed from the perspective of Examples (1) and (2) above, where the contribution by the defendant is fixed and, therefore, the tax liability of the QSF seems to represent a true loss to the plaintiffs. However, in the typical settlement fund situation, the defendant presumably would not agree to contribute the same amount

regardless of whether QSF or grantor trust treatment applied, since grantor trust treatment would inflict an additional cost on the defendant (the $3.10 of tax in Example (2) above) and confer an additional benefit on the plaintiffs (the correspondingly higher distribution). Thus, the comparison between Examples (1) and (2) is not realistic. Second, as an economic matter, the alleged double tax burden generally does not exist, because (i) the settlement fund level tax in the QSF case is effectively a surrogate for the defendant level tax in the grantor trust case and (ii) the accelerated deduction in the QSF case is essentially equivalent in present value terms to the deferred but larger deduction in the grantor trust case.

Both of the above points are illustrated by the following two simple examples:

> Example (3). Suppose that a defendant must establish a settlement fund taxable as a QSF at the beginning of year 1 to be used to fund a $100 payment to the plaintiffs at the beginning of year 2. Assume that the marginal tax rate of the defendant and the settlement fund is 31%, that the pre-tax rate of return on invested funds is 10% and that the proper after-tax discount rate is 6.9%. Since the settlement fund is taxable as a QSF, the defendant would have to contribute $93.55 to establish the settlement fund at the beginning of year 1, the settlement fund would earn $9.35 during the year on which it would pay tax of $2.90 and the plaintiffs would receive the $100 balance at the beginning of year 2. The value of the deduction to the defendant (assuming that it is realized when the QSF is established) would be $29.00 (31% of $93.55), and the net after-tax cost of the settlement to the defendant would be $64.55 (the $93.55 initial funding cost minus the $29.00 tax benefit).

> Example (4). Assume the same facts as in Example (3), except that settlement fund is treated as a grantor trust with the defendant as the grantor. In that case, the defendant would contribute $90.91 to establish the settlement fund, the settlement fund would earn $9.09 during the year on which it would pay no tax (but on which the defendant would pay tax of $2.82) and the plaintiffs would

receive the $100 balance in the settlement fund at the beginning of year 2. Assuming that the benefit of the deduction and the detriment of the income occur at the beginning of year 2, the defendant would realize a net tax benefit of $26.36 as of the beginning of year 1 (the $100 deduction less the $9.09 of income, multiplied by 31% and discounted for one year at 6.9%). Thus, the net after-tax cost of the settlement to the defendant would be $64.55 (the $90.91 initial funding cost less the $26.36 tax benefit), which is the same as in Example (3). From the Treasury's standpoint, the present value of the taxes collected is only $0.08 less as compared to Example (3), and that small difference disappears when the tax on the defendant's earnings on the $2.64 of savings in initial funding costs in this example is taken into account.

As the above examples suggest, it generally should be a i matter of indifference for the defendant and the plaintiffs as to whether the settlement fund is treated as a QSF or a grantor trust in cases where the defendant's contribution to the QSF would be deductible, since in either case their after-tax position generally should be the same.

There are, of course, situations where the defendant would not be entitled to an immediate deduction upon funding a QSF because of the nondeductible nature of the claim being satisfied. 48/ The Committee believes that the QSF tax regime should still apply even in those situations. Although it may seem surprising, there really is no double tax even if the claim would not give rise to a deduction to the defendant. 49/ Consider the following simple example:

48/ If the claim is deductible in nature but the "all events" test is not satisfied at the time of contribution, there could be a double tax problem, as discussed in Part 11(C)(2), infra.

49/ For a taxable defendant, it would be somewhat unusual for a claim not to involve some potential marginal tax benefit. Most claims would either (i) give rise to a current deduction, (ii) be treated as a capital expenditure that would give rise to increased depreciation or amortization deductions or to reduced gain (or increased loss) on the disposition of the asset to which it relates, (iii) result in less gain (or more loss) on a prior sale transaction or (iv) produce a tax benefit by preventing the

Example (5). Assume the same facts as in Examples (3) and (4) above, except that the claim is nondeductible in nature. If the settlement fund were treated as a QSF, the only consequence to the defendant is that it would have to contribute $93.55 to the settlement fund at the beginning of year 1. If the settlement fund were treated as a grantor trust, the defendant would have to contribute $90.91 to the settlement fund at the beginning of year 1 and then pay tax of $2.82 at the beginning of year 2 on the $9.09 of interest income. The total cost to the defendant in present value terms in the grantor trust case would be $93.55 (the $90.91 initial funding amount plus $2.64, the present value of the $2.82 tax cost discounted at 6.9%), which is the same total cost as in the QSF case. From the Treasury's standpoint, it would collect $2.90 of tax from the settlement fund in the QSF case. In the grantor trust case, it would collect $2.82 of tax from the defendant with respect to the interest income of the settlement fund, but it also would collect an additional $0.08 of tax on the $0.26 of earnings that the defendant would make on the $2.64 of savings on the initial funding cost.

The positions of both the defendant and the Treasury do not change because, as in Examples (3) and (4), the tax liability of the settlement fund in the QSF case effectively functions as a surrogate for the defendant level tax in the grantor trust case.

While it must be acknowledged that the Example (3), (4) and (5) model is somewhat simplistic in that it ignores potential differences in tax rates, to say nothing of the possibility that the defendant and the plaintiffs might not be fully cognizant of the applicable tax rules when they reach their settlement, the basic point of the model seems valid. The only situation where the QSF tax regime would inflict an additional out-of-pocket cost on the parties is where the defendant is tax-exempt or where the defendant has net operating losses or other tax attributes that

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recognition of cancellation of indebtedness income or some other adverse tax consequence. However, it is possible that the defendant would not be able to use any such tax benefit because of the availability of other tax attributes or, in a case where the tax benefit would be avoidance of cancelation of indebtedness income, because such income could be excluded under Section 108.

could eliminate the tax on the earnings of the settlement fund if the grantor trust approach were applicable. 50/

The most obvious situation where QSF treatment would impose an additional tax cost would be where the defendant is tax-exempt. The preamble to the Proposed Regulations requests comments on whether the QSF rules should apply if the defendant is exempt from tax and the plaintiffs may exclude the distributions from the settlement fund from their income. 51/ There is no policy reason to apply the QSF rules in situations where the defendants are tax-exempt and all the plaintiffs would be able to exclude the payments from their income (or, for that matter, where all the plaintiffs are tax-exempt), since by definition no tax is being deferred in such situations. The Committee believes, therefore, that settlement funds created in such situations should not be subject to the QSF rules. Rather, they should be treated as grantor trusts whose income is reportable by the defendant in the same manner that settlement funds that are established to satisfy QSF Liabilities are treated prior to satisfying all the QSF requirements.

The Committee believes that the exclusion discussed in the preceding paragraph should also apply even if the plaintiffs are taxable and, therefore, generally would be required to include the distributions from the settlement fund in income. In those situations, characterization of the settlement fund as a QSF would increase the tax burden on the parties as compared to the grantor trust approach discussed earlier, since no tax would have been payable with respect to the earnings of the settlement fund under the grantor trust approach. If the QSF rules applied

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50/ In the latter case, there is, of course, a cost to the defendant in the form of the consumption of its tax attributes, which it might otherwise be able to use at some point.

51/ 57 Fed. Reg, 5402 (February 14, 1992).

in those cases, the plaintiffs would attempt to force the tax-exempt defendant to make additional contributions to the settlement fund to preserve the economic position of the plaintiffs after giving effect to the tax cost associated with QSF treatment. Since the defendants in these situations are tax-exempt entities, there is a legitimate policy reason for allowing such settlement funds to avoid the QSF rules and the additional tax burden that such characterization would entail. In other words, the Committee sees no reason why the taxable or tax-exempt status of the plaintiffs should affect the availability of grantor trust treatment where the defendant is tax-exempt.

Similarly, an additional tax burden as compared to the grantor trust case could arise where the defendant has net operating losses or other tax attributes that could be used to reduce or eliminate its tax liability with respect to the income of the settlement fund. An additional tax burden also could arise in situations where the contribution to the settlement fund would not give rise to a current tax deduction, but would give rise to a tax deduction or other benefit at a later date. Two illustrations of the latter situation would be where the contribution to the settlement fund would not give rise to an immediate deduction because of a failure to satisfy the "all events" test 52/ and where payments from the settlement fund would give rise to basis in property, rather than a current deduction. 53/ In any such case, the amount of the defendant's tax deduction or other benefit would be limited to the amount of its initial contribution if the settlement fund were treated as a QSF, whereas the amount of the deduction would be the accreted

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52/ See Part 11(C)(2), infra.

53/ This double tax problem is essentially the same as the one discussed in Part III(B), infra, that would arise if property sale escrow accounts were treated as QSFs.

amount at the time the deduction or other tax benefit arises (such as the date of payment to the plaintiffs) if the settlement fund were treated as a grantor trust.

The Committee believes that the grantor trust approach rather than the QSF approach should apply in all the foregoing situations where the QSF approach would impose an additional tax burden. However, it would be very difficult to draft a regulation that would adequately define all those situations (plus any that the Committee has overlooked), and any such regulation undoubtedly would introduce considerable complexity into this area of the law. As a result, the Committee recommends that the final Section 468B(g) regulations should provide an election that would enable the parties associated with a litigation settlement fund that otherwise would be treated as a QSF to treat the settlement fund as a grantor trust with the defendant as the grantor. 54/ If such an election were available, then the parties could make their own determination as to when the additional tax burden would exist and could avoid such burden by making the election. The election would be completely consistent with the purpose of Section 468B(g), since it would result in a taxpayer (either the settlement fund itself or the defendant) including the earnings of the settlement fund in income on a current basis. It would also give recognition to the reference to grantor trust treatment in the legislative history of Section 468B(g).

2. "All Events" Test. The Proposed Regulations seem to assume that satisfaction of the economic performance requirement is the only barrier to a taxpayer obtaining an immediate deduction upon transferring funds or property to an escrow

54/ Any such election presumably should require the consent of the defendant, the plaintiffs (or their legal representatives or the court on their behalf) and the administrator.

account, settlement fund or similar arrangement. However, in order for an accrual method taxpayer to obtain a deduction, the "all events" test in Treasury Regulation S 1.461—1(a)(2) also must be satisfied. 55/ That may not occur when the escrow account is created. The most obvious illustration of a failure to satisfy the all events test would be where there is a meaningful possibility that the assets in the escrow account will revert to the defendant. In such situations, the defendant presumably would not be entitled to an immediate deduction (unless the transaction gives rise to a deduction under Section 461(f)), because all events to establish the fact of liability have not occurred.

The Committee recommends that the Treasury Department give careful consideration to the all events test issue in drafting final regulations under Section 468B(g). Since QSF treatment entails an entity level tax, such treatment generally would result in an additional tax burden as compared to grantor trust treatment if the taxpayer is not treated as satisfying the all events test at the time the QSF is funded. Consider the following example:

> Example (6). Suppose the facts are the same as in Example (3), except that the defendant is not entitled to a deduction in respect of its $93.55 contribution to the settlement fund until the beginning of year 2 because of the "all events" test. In that case, the present value of the deduction to the defendant as of the beginning of year 1 would be $27.13 ($29.00 discounted for one year at 6.9%) and the net cost of the settlement to the defendant would be $66.42 (the $93.55 initial funding cost minus the $27.13 present value of the deduction). Thus, the net cost of the settlement to the defendant would be $1.87 higher than in Example (4),

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55/ The preamble to the Proposed Regulations acknowledges that the all events test is an independent requirement for deductibility, but the text of the Proposed Regulations does not address the point. See 57 Fed. Reg. 5399, 5402 (February 14, 1992).

which difference is attributable to the diminution in the value of the deduction caused by its deferral until year 2. 56/

Consequently, the Committee recommends that the final Section 468B(g) regulations specifically provide that the all events test will be deemed to be satisfied upon the making of a contribution to a settlement fund that is treated as a QSF, subject to the requirement that the taxpayer satisfy the economic performance requirement. Since economic performance also generally occurs upon making the contribution, 57/ the double tax problem would be minimized. However, if the Committee's recommendation that there be a grantor trust election is followed, then the all events test should not be deemed to be satisfied when the settlement fund is funded in situations where the election is made. Rather, consistent with grantor trust treatment, the all events test should be deemed to be satisfied, and a deduction allowed, only if and when payments are made from the settlement fund to the plaintiffs.

3. QSF Liabilities. The Proposed Regulations provide that settlement funds set up to pay "recurring" liabilities will not be subject to the QSF rules. Recurring liabilities are defined as those arising under workmen's compensation plans or self-insured health plans, obligations to refund the purchase price of or to replace products regularly sold in the ordinary course of the transferor's business and such other liabilities as

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56/ That diminution does not occur in Example (4), even though the deduction is deferred in that case as well, because the amount of the deduction is increased in Example (4) by the amount of the earnings of the QSF.

57/ The exceptions would be (i) situations described in Prop. Treas. Reg. § 1.468B-3(b) that negate economic performance as described in Part 11(B), supra, and (ii) if the Committee's suggestion relating to liabilities to perform services in Part 11(C)(12) is accepted, where the claim involved relates to a liability to provide services.

the Commissioner may designate. 58/ It is unclear how the Treasury Department intends that the earnings on recurring liability settlement funds be taxed.

The Committee is aware of no compelling reason for treating settlement funds involving recurring liabilities any differently than any other type of settlement fund. 59/ The Treasury Department may be concerned that the recurring liability exception is necessary to prevent taxpayers from accelerating large amounts of deductions for frequently-incurred liabilities prior to actual payment to the claimants, but the analysis earlier of the double tax issue would suggest that the recurring liability exception is basically revenue neutral. Moreover, the potential to accelerate large amounts of deductions for recurring liabilities should be greatly reduced by the government approval requirement. 60/ The exclusion from QSF treatment for settlement funds relating to recurring liabilities, which represent a major type of settlement fund, relegates such settlement funds to the nebulous world where earnings should be subject to current taxation under currently nonexistent rules. 61/ The Treasury Department should strive to avoid that result in the absence of a compelling policy reason to the contrary.

The Committee is also concerned that the definition of QSF Liabilities does not expressly include many types of claims

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58/ Prop. Treas Reg. $ 1.468B-1(1).

59/ It should be noted that recurring liabilities generally are treated more favorably from the taxpayer's standpoint under the economic performance regulations. See Treas. Reg. § 1.461-5.

60/ In other words, the liabilities may be recurring, but the settlement fund, which would satisfy a specified amount of such liabilities, presumably would not be recurring.

61/ Such exclusion also may put pressure on the multiple claim settlement fund issue discussed in Part 11(C)(8), *infra*

that might be settled by means of a settlement fund, particularly claims arising under statutes other than the Superfund statute. One would normally conclude that such other statutory claims represent either tort claims 62/ or claims for violations of law, a conclusion which is supported by the examples in the Proposed Regulations of QSFs created to discharge securities law liabilities. 63/ Because securities law liabilities are not expressly included in the definition of QSF Liabilities, securities law liabilities must be regarded as either tort liabilities or liabilities for violations of law. However, the express inclusion of Superfund statute claims in the definition of QSF Liabilities may create a negative implication that such other statutory claims do not constitute QSF Liabilities. 64/

This definitional issue should be resolved. The Committee is not aware of any compelling policy reason why QSF Liabilities should not include all types of legal liabilities, and, as indicated above, it believes that there should be a presumption against excluding settlement funds from the QSF rules. Hence, the Committee recommends that the QSF Liability definition be expanded to cover all legal liabilities. At a minimum, the Section 468B(g) regulations should take the approach of stating that QSF Liabilities include any legal liability, subject to stated exclusions where justified, rather than the

62/ Black's Law Dictionary defines the term "tort" broadly as "a private or civil wrong or injury ... for which the court will provide a remedy in the form of an action for damages". Black's Law Dictionary 1489 (6th ed. 1990). That would seem to cover situations where the cause of action is created by statute, such as a Rule 10b-5 claim.

63/ See Prop. Treas. Reg. § 1.468B-l(h) (Examples 1-3).

64/ One possible explanation for the specific reference to the Superfund statute is that the Treasury Department may regard a liability under the Superfund statute as being in the nature of a special fee for engaging in waste-generating activities that may not have been unlawful at the time, rather than a liability for a violation of law in the ordinary sense.

opposite approach of defining QSF Liabilities by way of example and providing that additional types of claims may be added later by way of ruling.

4. Government Approval Requirement. The examples in the Proposed Regulations indicate that the governmental approval requirement will be satisfied only if and when a court or other governmental authority has passed on the merits of the settlement arrangements. 65/ Thus, if the parties to a litigation merely file with the court a document that discontinues the litigation, the governmental approval requirement apparently would not be satisfied. This is an important aspect of the QSF rules that should not be left to the examples but rather should be explicitly addressed in the Proposed Regulations.

The Committee recommends that the government approval requirement should be deemed to be satisfied upon the filing with a court of a document that discontinues the litigation, since much litigation is settled without the court actually passing on the merits of the settlement arrangements. Indeed, that is the rule rather than the exception outside of the bankruptcy and class action contexts. Again, this position reflects the Committee's view that the Treasury Department should eliminate the uncertainty as to the proper tax treatment of as many types of settlement funds as possible. This position also reflects the Committee's concern that the applicability of the QSF rules should not turn on the unimportant fact as to whether the litigants discontinue the litigation without court approval of the settlement arrangements or they obtain what would be a

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65/ See Prop. Treas. Reg. § 1.468-1(h) (Example 2).

perfunctory court approval of the settlement arrangements. 66/

The first sentence of Proposed Regulation S 1.468B-1(d) seems to imply that the mere fact that a contest is subject to the supervision or jurisdiction of a governmental authority could in some instances be sufficient to satisfy the government approval requirement. However, that possible reading of the sentence is contradicted by the rest of the Proposed Regulations, which make clear that approval by a governmental authority only occurs when the authority grants its actual approval of the settlement fund. Therefore, in order to avoid confusion, the first sentence of Proposed Regulation § 1.468B-1(d) should be revised or deleted.

The Proposed Regulations also should be modified to make it clear that the mere fact that a governmental authority is a plaintiff or a defendant in a lawsuit would not cause a settlement fund created in such situations to be automatically treated as having been approved by a governmental authority. Rather, the approval of a separate governmental authority with jurisdiction over the matter should be required.

5. Settlement Funds as Security Arrangements. In some litigation settlement situations, the settlement agreement provides that the defendant will make one or more fixed payments to the plaintiffs after the litigation is settled, and a pool of assets is set aside by the defendant to secure its obligation to make such payments. In such situations, the settlement fund represents a mere security device rather than the settlement payment itself. However, if the settlement involves a QSF

66/ The litigants might want to elect into QSF treatment in certain situations, including (i) where the defendant's marginal tax rate was higher than that of a QSF and (ii) where the defendant desired to accelerate its tax deduction because the deduction would be less valuable in the future.

Liability and the settlement is approved by a court or other government authority, the settlement fund would literally seem to be a taxable QSF. The only argument to the contrary would be that the settlement fund was not "established to resolve or satisfy one or more claims", since it may be more appropriate to view the claim as being satisfied by the defendant's contractual obligation to make payments, rather than by the settlement fund itself.

This issue should be clarified. The Committee believes that such settlement funds should not be subject to QSF treatment. First, the policy of current taxation underlying the QSF rules is not really implicated by such settlement funds, since but for the Proposed Regulations the earnings on such settlement funds would normally be currently taxable to the defendant on the theory that the settlement fund constitutes a grantor trust or a custodial arrangement. 67/ Thus, there should be no "homeless income" problem in this context. Second, the QSF rules could impose an undue tax burden on the defendant where the assets have a built-in gain (since the gain would be triggered upon the creation of the QSF) or where the defendant has tax attributes that would otherwise reduce or eliminate its tax liability on the earnings of the settlement fund (since those attributes could not be used to reduce the settlement fund's tax liability as a QSF). Third, there does not seem to be a legitimate reason to draw a distinction between the situation where the defendant grants a security interest in certain of its assets to secure its obligation to make settlement payments (in

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67/ Cf. Rev. Rul. 65-203, supra note 6 (owner of stock held in escrow to secure a payment obligation to another person is taxable on the dividends on such stock); Rev. Rul. 77-260, 1977-2 C.B. 466 (interest on tenant security deposits held by landlord is reportable by the tenants); and Rev. Rul. 85-42, 1985-1 C.B. 36 (corporation that transfers government bonds to a trust to defease its debt is taxable on the interest on such bonds).

which case QSF treatment, including the separate fund-level tax, often would apply) and the economically equivalent situation where the defendant owns the same assets but does not grant a security interest in them (in which case QSF treatment does not apply).

The Committee recognizes that there is a difficult line-drawing problem in distinguishing between settlement funds that function as mere security devices and settlement funds that represent payment itself. 68/ In particular, there is no real substantive difference between the situation where the defendant agrees to make specified payments to the plaintiffs, with that obligation being secured by the assets in a settlement fund with no further recourse against the defendant, and the situation where the defendant creates a settlement fund the terms of which provide that the settlement fund will make the same payments to the plaintiffs, with any funds that remain after payment of such amounts reverting to the defendant. The Committee's recommendation that the parties be permitted to elect grantor trust treatment would make this issue largely academic, as the parties could make a protective grantor trust election to avoid QSF treatment for settlement funds that function as mere security devices. If that recommendation is not accepted, it will be necessary for the final Section 468B(g) regulations to address this issue and draw the line. In that event, the Committee would recommend that QSF treatment not apply in cases where (i) the liability of the defendant to the plaintiffs is for a sum certain or a variable amount not linked to the earnings of the settlement fund and (ii) the recourse of the plaintiffs is not limited to

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68/ This issue is analogous to the difficult issue that arose in the installment sale context before the Installment Sales Revision Act of 1980 as to whether a cash escrow or similar arrangement used to secure an installment note represented payment itself or a mere security device. See generally Jacobs, supra note 4, at 9-13.

the assets of the settlement fund, but that QSF treatment apply in all other cases.

6. Use of Securities Issued by the Transferor. Proposed Treasury Regulation § 1.468B-3(c) contains a reservation as to whether a taxpayer may obtain a deduction where the assets that are transferred to the QSF consist of stock or partnership interests issued by the taxpayer or certain related persons. The preamble to the Proposed Regulations specifically requests comments on this issue. 69/ The Treasury Department may be concerned that taxpayers will tend to try to inflate the values of such interests to maximize their tax deductions.

In the case of related party stock or partnership interests, that would not normally be the case, since inflating the value would not improve the taxpayer's net tax position (except possibly due to character differences). Consider the following simplified example:

> Example (7). Suppose a taxpayer agreed to transfer to a QSF 1,000 shares of stock of a related party that had a fair market value of $10 per share and a basis of $5 per share. The taxpayer would be entitled to a $10,000 deduction upon transferring the stock to the QSF (assuming the underlying claim was deductible and the all events test was satisfied), but it also would recognize a $5,000 capital gain under Prop. Treas. Reg. § 1.468B-3(a)(1), thereby leaving it with a net deduction of only $5,000. On the other hand, if the taxpayer were successful in arguing that the stock was really worth $12 per share, it would be entitled to a $12,000 deduction and would recognize a $7,000 capital gain, which would leave it in the same net tax position (ignoring character differences).

69/ 57 Fed. Reg. 5399, 5402-3 (February 14, 1992). It should be noted that Section 468B(d)(1)(B) provides that a "qualified payment" for DSF purposes does not include the transfer of any stock or indebtedness of the taxpayer or related persons.

In the case of the taxpayer's own securities, the taxpayer's net tax position could improve, because Section 1032 or 721 should prevent gain recognition. However, the potential to use the taxpayer's own securities is tempered by the fact that the issuance of such securities involves a real economic cost to its owners through dilution of their ownership interests. 70/ Moreover, it is well established that the taxpayer's own securities may be used as currency to obtain deductions in other contexts. 71/ Indeed, from the taxpayer's standpoint, the transaction is economically equivalent to issuing its own securities to a third party for cash (which would be tax-free) and then using the cash to fund the QSF.

As a general rule, the Committee believes that such stock or partnership interests should be treated in all respects like any other type of asset that is transferred in kind to a QSF. While such stock or partnership interests may involve difficult valuation issues, those issues should not be inherently more difficult than with stock or partnership interests issued by unrelated parties. Furthermore, the beneficiaries of the QSF would have adverse tax interests where the assets were expected to be distributed in kind. In order to prevent valuation abuses, the final Section 468B(g) regulations could impose a requirement

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70/ In situations where the taxpayer had a significant chance of reversion, the potential to use the taxpayer's own securities also would be tempered by the fact that the QSF might recognize gain under Prop. Treas. Reg. § 1.468B-2(e) when the reversion occurs, which would result in a tax liability that presumably would be borne by the taxpayer.

71/ See, e.g., Rev. Rul. 62-617, 1962-2 C.B. 59 (stock issued to employees as compensation); Rev. Rul. 69-75, 1969-1 C.B. 52 (same); Treas. Reg. §§ 1.83-1-1.83-8 (same); Duncan Industries, Inc. v. Commissioner, 73 T.C. 266 (1979) (stock issued as a fee to obtain a loan); and Hollywood Baseball Association v. Commissioner, 42 T.C. 234 (1964), acq. 1964-2 C.B. 6, aff'd Commissioner v. Hollywood Baseball Association, 352 F.2d 350 (9th Cir. 1965) (stock issued to pay for organizational expenses). Cf. Rev. Rul. 56-100 (property in a taxable exchange with the acquiror's own stock obtains a fair market value tax basis).

that where non-publicly traded stock or partnership interests are involved, an independent appraisal be obtained, similar to the appraisal requirement for charitable contributions of such assets. 72/ Also, the Section 6662(e) understatement penalty and other penalty provisions could be imposed in cases of abuse.

7. Related Party Issues. Proposed Regulation § 1.468B 1(c)(3) seems to imply that if two related persons are defendants in a litigation and both transfer money into one settlement fund, an argument can be made in the case of either person that such assets will not be considered to be segregated from assets of related persons, particularly if one or both of the defendants has a right to a reversion of the assets remaining after the plaintiffs are paid. That does not seem to have been the intent of the Proposed Regulations, and, therefore, they should be modified to avoid that implication.

Furthermore, the Proposed Regulations should be modified to provide that if a defendant or a related party is also a claimant, then that fact will not cause the settlement fund to fail to satisfy the segregation requirement and any payments to the defendant (or the related party) from the settlement fund will be taxed to it under the rules applicable to plaintiffs. That situation could arise, for example, where a related person holds a claim against the defendant or where the defendant makes a counterclaim against one of the plaintiffs or brings an impleader action.

72/ See Treas. Reg. $ 1.170A-13(C).

8. Multiple Claim Settlement Funds. Many settlement funds are established to satisfy more than one type of legal claim. Thus, it is possible that a settlement fund could be established with respect to both a QSF Liability and a non-QSF Liability. The Proposed Regulations are not clear as to whether such a settlement fund could qualify in whole or in part as a QSF, since they do not expressly state that the settlement fund must be established exclusively or primarily to settle QSF Liabilities. 73/ The significance of this issue obviously will depend upon how broad the definition of QSF Liabilities is in the final regulations.

The Committee recommends that the definition of a QSF indicate that a settlement fund will qualify as a QSF if it is established for the principal purpose of settling QSF Liabilities. That would be in accord with the analogous rules for DSFs. 74/

9. Designation of Administrator. Under the Proposed Regulations, the administrator of a QSF is the first person associated with the QSF that is described in a list of four categories of eligible persons--(i) the person designated by the approving government authority, (ii) the person designated in the escrow or settlement agreement, (iii) the defendant (or, if there are multiple defendants, the defendant designated in the escrow or settlement agreement) and (iv) the escrow agent or other person that has custody of the QSF's assets. 75/

73/ See Prop. Treas. Reg. $ 1.468B-1(C)(2).

74/ See Section 468B(d)(2)(D) (a DSF must be established "for the principal purpose" of settling specified types of liabilities).

73/ Prop. Treas. Reg. § 1.468B-2(j)(3).

The Committee recommends that the third and fourth categories be reversed. The escrow agent or other person that has custody of the QSF's assets is more of a neutral party than the defendant. Moreover, such person is the party with the best access to the information needed to prepare the QSF's returns and with control over the funds out of which the tax normally would be paid. In fact, in some cases the defendant does not have any continuing involvement with the QSF. If that suggestion is adopted, the defendant category could be eliminated, as it would never have any application.

10. Deductible Expenses of a QSF. As noted earlier, Proposed Treasury Regulation § 1.468B-2(b) generally limits the expenses that a QSF may deduct in computing its "modified gross income" to its "administrative costs and other incidental expenses", such as accounting fees and expenses incurred to process claims, and certain types of losses. The Committee is concerned that this limitation may cause the modified gross income of many QSFs to greatly exceed what would be their taxable income and, therefore, to impose a severe tax burden on such QSFs. For example, a QSF might incur interest expense to carry its assets, which presumably would not be treated as an administrative cost or incidental expense. Another example would be where the QSF holds a partnership interest in an operating business or holds operating assets directly, which could give rise to depreciation and other operating expenses that would not be deductible under the Proposed Regulations. 76/ In some such cases, a tax based on the modified gross income of the QSF could easily exceed the taxable income of the QSF.

76/ This problem would be of much greater significance if the general creditor trusts discussed in Part IV, infra, are treated as QSFs, since such general creditor trusts often hold operating assets, prosecute preference claims or otherwise generate substantial amounts of expenses that would not be allowable under the "modified gross income" definition.

The Committee is not aware of any good reason why the tax liability of a QSF should be based upon its "modified gross income". This expense limitation, which was derived from the statutory provisions relating to the taxation of DSFs, 77/ may reflect a belief that QSFs should only hold passive investment assets. However, there is no apparent policy reason for that limitation, and in any event the Treasury Department should not attempt to impose it through the "back door" manner of a special deduction limitation. Accordingly, the Committee recommends that the tax liability of a QSF be determined based on its taxable income as computed under normal tax principles without any special limitations. The Committee also recommends that QSFs be entitled to claim tax credits like other taxpayers.

The foregoing recommendation would create a technical conflict between the Proposed Regulations and the statutory DSF expense limitation, since the Proposed Regulations, including the rules for determining the tax liability of a QSF, purport to apply to DSFs as well. 78/ That conflict could easily be resolved if the Treasury Department provided in the final Section 468B(g) regulations that the QSF expense deduction rules do not apply to settlement funds qualifying as DSFs (which may render the DSF provisions obsolete, since there would be no reason to elect DSF treatment where the QSF rules would otherwise apply).

11. Contested Liability Settlement Funds. There are two major unsettled issues with respect to 461(f) Funds that were not expressly addressed by the Proposed Regulations. The first is

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77/ See Section 468B(b)(2).

78/ See Part II(B), supra.

whether the transfer of cash or property by a defendant to a 461(f) Fund satisfies the economic performance requirement. Because economic performance as to a payment liability generally requires actual payment to the party to whom the liability is owed, economic performance would not occur upon the contribution of cash or property to a 461(f) Fund in the absence of a special rule to the contrary. 79/ The recently-issued Section 461 regulations reserve on the issue of whether contributions of cash or property to any type of settlement fund (other than a DSF) constitute economic performance. 80/ However, the preamble to the Proposed Regulations states that 461(f) Funds that satisfy the definition of a QSF will be treated as such, which presumably would mean that the economic performance rule for QSFs would apply. 81/

Unfortunately, it is not entirely clear whether the typical 461(f) Fund would qualify as a QSF. Obviously the 461(f) Fund would have to satisfy the requirements that it be established with respect to a QSF Liability and that it receive government approval, but those two requirements would normally be

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79/ See Treas. Reg. § 1.461-4(g), particularly § 1.461-4(g)(1)(i). It should be noted that the legislative history of Section 461(h) expressly indicates that Congress did not intend that contributions to 461(f) Funds established to satisfy tort or workers' compensation claims be treated as economic performance. See H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 876 (June 23, 1984). In addition, Section 468B(f) provides that, except as otherwise provided in regulations, a payment to a settlement fund to satisfy a claim relating to personal injury, death or property damage shall not constitute economic performance unless the settlement fund qualifies as a DSF. Those distinctions are academic, since the Treasury Department has pronounced in Treas. Reg. § 1.461-4(g) that actual payment generally is required to satisfy the economic performance requirement as to any type of payment liability. See also T.D. 8404, 57 Fed. Reg. 12411, 12414-5 (April 10, 1992).

80/ See Treas. Reg. § 1.461-6. By definition, a 461(f) Fund could not constitute a DSF, since Section 468B(d)(2)(A) requires that the DSF extinguish the defendant's liability. See also Section 468B(e).

81/ See Part II(A)(3), supra.

satisfied, except where the 461(f) Fund is established by private parties that settle a contest without resorting to litigation. 82/ Thus, the only real issue would seem to be whether the 461(f) Fund would be viewed as having been established to "resolve or satisfy" the underlying claim. On the one hand, the mere establishment of a 461(f) Fund does not itself finally resolve or satisfy the contest, and all the examples in the Proposed Regulations involve situations where the defendant's liability was finally determined and extinguished upon the establishment of the settlement fund. On the other hand, the establishment of a 461(f) Fund does represent a preliminary step in the resolution of the contest, and the funds contributed to the 461(f) Fund are dedicated to the satisfaction of any liability that is ultimately determined to exist. In addition, Section 461(f) and the regulations thereunder use the term "satisfaction" in describing a 461(f) Fund, which implies that a 461(f) Fund would meet the "satisfy" part of the "resolve or satisfy" requirement. 83/ On balance, it seems that a 461(f) Fund should be viewed as satisfying the "resolve or satisfy" requirement.

The second unsettled issue is how 461(f) Funds should be taxed. As noted earlier, the old proposed Section 461 regulations imposed a modified grantor trust tax regime, but the recently-issued final Section 461 regulations reserve on the issue of how

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82/ Even if the parties had resorted to litigation, the 461(f) Fund apparently would not be treated as a QSF under the Proposed Regulations unless the court actually passed on the merits of the settlement arrangements. See Part II(C)(4), supra.

83/ Section 461(f)(2) states that one of the requirements for a 461(f) Fund is that the defendant have contributed money or other property "to provide for the satisfaction of the asserted liability" (emphasis added). See also Treas. Reg. §§ 1.461—2(a)(1)(ii) and 1.461-2(c). The language used by the Proposed Regulations is that the settlement fund be established "to resolve or satisfy one or more claims" (emphasis added), which would seem to describe Section 461(f) Funds, unless "to satisfy" is regarded as meaning something more definite and final than "to provide for the satisfaction".

461(f) Funds should be taxed. 84/ That issue also would be resolved if 461(f) Funds constitute QSFs, but, as discussed in the preceding paragraph, it is unclear whether 461(f) Funds do constitute QSFs. Thus, under current law, litigants do not know what tax price they must pay to accelerate the defendant's tax deduction through the creation of a 461(f) Fund.

The Treasury Department should clarify the law with respect to both of these 461(f) Fund issues. In order to resolve both issues, the Committee recommends that the final Section 468B(g) regulations expressly indicate (perhaps by way of example) that contributing assets to a 461(f) Fund shall be deemed to "resolve or satisfy" the underlying claim and, therefore, that 461(f) Funds may qualify as QSFs. Hence, it would once again be clear that contributions to 461(f) Funds generally satisfy the economic performance requirement. The Committee believes that its recommendation is not inconsistent with the economic performance requirement for two reasons. First, as a theoretical matter, the defendant in a sense has performed by making a payment to the 461(f) Fund (even though the payment has not been received by the plaintiffs). While it is true that the defendant is still trying to get the payment back by contesting the plaintiffs' claim, it is difficult to distinguish in principle the contest in the 461(f) Fund case from other possible bases for a reversion of the assets in a settlement fund. Such bases might include, for example, the failure to obtain final government approval of the settlement arrangements after preliminary approval is granted or the failure of some of the plaintiffs to comply with whatever procedures are imposed to prove the validity of their claims.

84/ See Part II(A)(3), supra.

Second, 461(f) Funds, if treated as QSFs, generally could not be used to perpetuate the time value of money abuse that the economic performance requirement was intended to eliminate. The economic performance requirement was enacted because Congress was concerned that accrual method taxpayers were claiming deductions for the face amount of their expenses when incurred even if economic performance would not occur for a long period of time, which resulted in such deductions being overstated as an economic matter when the time value of money is taken into account. 85/ Since, as a QSF, a 461(f) Fund would be subject to tax as a separate entity and the defendant would be taxable on any reversion of the 461(f) Fund's assets (including its previously taxed earnings), the defendant generally would not obtain any time value of money benefit by establishing the 461(f) Fund. As a corollary, it would make no sense to treat 461(f) Funds as QSFs but not allow the defendant to take an immediate deduction. 86/

The Committee's recommendation that a grantor trust election be made available to QSFs applies equally to 461(f) Funds that otherwise would be treated as QSFs. If the election were made, the defendant should not be entitled to an immediate deduction.

85/ See, e.g., H.R. No. 98-432, 98th Cong., 2d Sess. 1254-5 (March 5, 1984).

86/ Compare the discussion of the "all events" test issue in Part 11(C)(2), supra.

It should be noted that the recommendation above that 461(f) Funds be treated as QSFs may be somewhat inconsistent with the recommendation in Part II(C)(5) that settlement funds that function as mere security devices not be treated as QSFs, since in both situations the defendant's liability usually would not be limited to the amount in the settlement fund and the plaintiffs usually would have full recourse against the defendant (although the amount of the defendant's liability would be fixed in the security device case). The only explanation for that inconsistency, which seems necessary to give effect to Section 461(f), is that in the security device case the defendant normally would satisfy the "all events" test (exclusive of the economic performance requirement) under general tax principles, whereas in the 461(f) Fund case the defendant would not. This is an additional reason why it is important for the parties to have an election to choose between QSF and grantor trust treatment.

12. Economic Performance as to Liabilities to Perform Services. The Proposed Regulations provide that economic performance will be deemed to occur with respect to a QSF Liability to the extent the defendant makes a payment to the QSF to satisfy that liability. 87/ However, as noted earlier, this rule does not apply to the extent that the defendant (or a related person) has the right exercisable currently and without the agreement of an unrelated party to receive a refund of the transferred assets or where the reversion is certain to occur. In such event, economic performance will occur only if and when the defendant's reversion rights are extinguished.

87/ Prop. Treas. Reg. § 1.468B-3(b).

The recently issued regulations under Section 461(h) provide that if the liability of a taxpayer requires that it perform services, economic performance generally will be deemed to occur as the taxpayer incurs costs to satisfy the liability. 88/ However, those regulations appear to indicate that economic performance will not be deemed to occur with respect to any liability to perform services if all the taxpayer does is transfer funds to a third party that will perform such work in the future. 89/ The question of the deductibility of such transfers to QSFs is reserved. In any event, the preamble to the Section 461(h) regulations makes clear that the Service is emphatic in its belief that economic performance in the case of service liabilities cannot be accelerated by making payments to third parties who will actually perform the actual work at a later time. 90/ If that is the intent, the Proposed Regulations should be modified to provide that a contribution to a QSF will be deemed to represent economic performance only with regard to liabilities to make payments, not if the QSF will use the funds to pay a third party to perform services. However, if that modification is made, the Treasury Department should provide that a QSF established with respect to a liability to perform services will be treated as a grantor trust (with the defendant as grantor) to avoid the potential double tax problem. 91/

13. Transition Rules. The general effective date for the Proposed Regulations is January 1, 1993. 92/ Thus, QSFs

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88/ See Treas. Reg. § 1.461-4(d).

89/ See Treas. Reg. § 1.461-4 (d)(7) (Examples 1 and 3).

90/ T.D. 8404, 57 Fed. Reg. 12411, 12412-3 (April 10, 1992).

91/ That problem is analogous to the problem discussed in Part 11(C)(2), supra, with respect to contributions to QSFs that do not satisfy the "all events" test.

92/ Prop. Treas. Reg. § 1.468B-5(a).

established after December 31, 1992, will be subject to the new rules, as will income earned after that date by QSFs established after August 16, 1986, but prior to January 1, 1993. A preexisting QSF that was in existence on February 14, 1992, may apply before March 16, 1993, for a ruling from the Service permitting the continued use after December 31, 1992, of a different method of current taxation, provided that such method is "reasonable in light of the facts and circumstances of the QSF and the law prior to the publication of these regulations". 93/ The ruling application must be made jointly by the administrator and all the defendants. A method of reporting is "reasonable" for this purpose only if it results in the earnings on the assets in the QSF being included in the income of an "appropriate person" on a current basis. Any such reasonable reporting method may be used only for "a reasonably short period of time". 94/

While the Committee generally approves the prospective application of the Proposed Regulations, the Committee has four comments on the transition rules in the Proposed Regulations. The first comment is that tax rules for the pre-1993 income of settlement funds created after August 16, 1986, are not clear. Proposed Treasury Regulation § 1.468B-5(c)(1) does state that the Service will not challenge a "reasonable", consistently applied method of taxation of pre-1993 settlement fund income, and it lists three alternative methods of taxation of pre-1993 settlement fund income that "generally ... depending upon the facts and circumstances" will be deemed to be reasonable. Those methods are (i) taxation as a grantor trust with the defendant as grantor, (ii) taxation as a complex trust with the defendant as grantor or (iii) taxation as a DSF. However, Proposed Treasury

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93/ Prop. Treas. Reg. § 1.468B-5(b).

94/ Prop. Treas. Reg. § 1.468B-5(b)(iii).

Regulation § 1.468B-5(c)(1) does not expressly indicate whether such methods of taxation are the exclusive reasonable methods of taxation 95/ or under what circumstances any such method would not be deemed to be reasonable. 96/ More importantly, the Regulation is completely silent on the very basic issue of what tax rules apply if the pre-1993 income of a settlement fund was not subject to current taxation under a reasonable method.

Second, the Proposed Regulations are not explicit as to what a reasonable method of taxation is for purposes of the transition relief available to settlement funds in existence on February 14, 1992, for periods beginning after December 31, 1992. The Treasury Department needs to provide specific guidance on that issue. The Committee suggests simply cross-referring to Proposed Treasury Regulation § 1.468B-5(c)(1), since the alternative "reasonable" methods of taxation of pre-1993 settlement fund income set forth therein all seem "reasonable" for post-1992 transition relief purposes as well.

95/ If the Committee's recommendation in Part IV(C), infra, that general creditor trusts not be treated as QSFs is not accepted, Prop. Treas. Reg. § 1.468B-5(c)(1) should be modified to add taxation as a grantor trust with the beneficiaries as grantors as a reasonable method of taxation, since that is how most such general creditor trusts are being treated in practice and that treatment achieves the objective of current taxation of the income of the general creditor trust.

96 The "generally ... depending on the facts and circumstances" language in Prop. Treas. Reg. § 1.468B-5(c)(1) suggests that there could be circumstances under which the Service would assert that a settlement fund that used, say, a grantor trust reporting method should not have done so and instead should have used either a complex trust or DSF reporting method. If that is the intent, the final regulations should expressly say so and should spell out the specific reasons why one approach should be used instead of the other approaches. The Committee also questions why DSF-type reporting is an option, given that there is no authority in the Code for the use of such a reporting system except where specific statutory criteria contained in Section 468B are satisfied.

The third comment relates to the procedure that must be followed by an existing settlement fund whose income has been subject to current taxation under a "reasonable" tax regime in order to obtain transition relief after 1992. As noted above, the Proposed Regulations would tax any such settlement fund as a QSF beginning in 1993, unless such settlement fund obtains a ruling from the Service permitting it to continue the tax regime that it has been following. The Committee believes that the requirement to obtain a ruling is unnecessary and unduly burdensome, since the final Section 468B(g) regulations could (and, as noted above, should) expressly indicate what constitutes a reasonable tax regime, at least by way of nonexclusive examples. Transition relief for eligible settlement funds should be available simply by means of an election that could be made by the administrator acting singly, provided that written notice of the election is given to all the defendants. 97/

Fourth, the Committee recommends that the post-1992 transition relief for existing settlement funds whose earnings have been subject to current taxation under a reasonable tax regime be made permanent. The Committee believes that it is unfair to change the tax ground rules for such settlement funds in such a fundamental manner after the "reasonably short period of time", especially since the Proposed Regulations often will have the practical effect of shifting the economic burden of the tax liability with respect to the earnings of the settlement fund from the defendants to the plaintiffs. 98/ Such economic

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97/ If all the defendants were required to join in the election, then, given the economic point discussed in note 98, *infra*, and the accompanying text, defendants could be expected to attempt to extract a price from the plaintiffs for joining in the election.

98/ That will occur because most existing settlement funds that satisfy the reasonable tax regime requirement do so by having the defendant treat the

consequences will ensue because the Treasury Department took almost six years to issue the Proposed Regulations, during which time persons associated with such settlement funds had to structure their settlement arrangements without meaningful guidance as to the tax consequences of such arrangements. The Committee recommends, therefore, that existing settlement funds whose earnings have been subject to current tax under a reasonable tax regime be permitted to elect to continue to use that method until their termination without any special approval from the Service.

The Committee has recommended elsewhere in this Report that special rules relating to other non-QSF funds (property sale escrows, general creditor trusts, etc.) be included in the final Section 468B(g) regulations. Assuming that the Committee's recommendations relating to such non-QSF funds are adopted, then the final Section 468B(g) regulations should follow a prospective application approach for those rules (possibly coupled with the right to apply for a ruling authorizing the use of other reasonable methods), similar to the approach recommended above for QSFs. In any case, the final regulations should make it clear that, in the case of non-QSF funds in existence when the final regulations are promulgated, any of the methods set forth in Proposed Treasury Regulation § 1.468B-5(c)(1) will continue to be permissible after December 31, 1992.

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settlement fund as a grantor trust as to it, which results in the defendant paying the tax cost. If the settlement fund is forced to pay tax as a separate entity, the plaintiffs would bear part or all of that tax cost, unless either (i) the plaintiffs' claims are fixed and the settlement fund has enough assets to cover all the plaintiffs claims plus all the tax cost, (ii) the defendant is obligated to reimburse the settlement fund for such tax cost or (iii) the settlement fund previously reimbursed the defendant for its tax cost and could cease doing so once the settlement fund becomes separately taxable.

III. Property Sale Escrow Accounts

A. Background. Another context in which "homeless income" frequently arises involves property sales or exchanges. In such transactions, it is common for an escrow account to be created either to hold a deposit posted by the buyer pending the closing of the transaction or to hold monies after the closing to secure either an indemnity obligation of the seller or a contingent payment obligation of the buyer. 99/ Such escrow accounts would not be treated as QSFs under the Proposed Regulations, because they normally would not receive any government approval and in any event they would not be established to satisfy QSF Liabilities. The following discussion addresses various Section 468B(g) issues that may arise with respect to escrow accounts established in connection with property sale transactions, which the Committee urges be addressed by future regulations under Section 468B(g). 100/

B. Recommended General Approach. There are three basic ways in which the income on an escrow account created in connection with a property sale transaction potentially could be taxed under Section 468B(g): (1) the escrow account could be treated as a separate entity taxable in the manner that QSFs are treated under the Proposed Regulations; (2) the escrow account could be treated as a grantor trust with the seller as grantor, which would result in the income of the escrow account being

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99/ For convenience of reference, escrow accounts and similar arrangements created in the context of property sale or exchange transactions are referred to in this section as "escrow accounts".

100/ The following discussion addresses only bona fide escrow accounts established pursuant to arm's-length negotiations between the purchaser and the seller. The income earned on an escrow account that is unilaterally and voluntarily established by either party and that remains subject to that party's control should be taxed to such party as a grantor trust or a mere custodial arrangement. See, e.g., Williams v. United States, 219 F.2d 523 (5th Cir. 1953).

taxed to the seller on a current basis; or (3) the escrow account could be treated as a grantor trust with the buyer as grantor, which would result in the income of the escrow account being taxed to the buyer on a current basis.

The first alternative, treatment of the escrow 4 account as a separate taxable entity, is not recommended. First, unlike the typical litigation settlement fund, property sale transactions typically involve only two parties, not numerous parties where the identities of some of the parties and/or the nature of their interests are not immediately known. Thus, there is no need to resort to escrow account-level taxation to solve the "homeless income" problem.

Second, QSF treatment in the property sale context would involve a potential double tax burden that does not exist in the litigation settlement fund context. In the property sale context, the buyer's contingent payment obligation may result in an increase in the buyer's basis in the acquired property, which would result in increased depreciation or amortization deductions and/or reduced gain (or increased loss) on any subsequent sale of the property, rather than an immediate deduction. It is well-settled that the buyer generally may increase its basis in the acquired property only if and when the funds in the escrow account are paid to the seller. 101/ Thus, the timing of any such

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101/ See, e.g., Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945), acq. 1959-2 C.B. 3 (amounts payable for a patent contingent on earnings increase cost basis each year only by amount of annual payment); Rev. Rul. 67-136, 1967-1 C.B. 58 (same); James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964) (assumption of contingent obligations capitalized as part of purchase price as they become fixed and determinable); and Rev. Rul. 76-520, 1976-2 C.B. 42 (same). The Treasury Regulations under Sections 168, 338, 1060 and 1275 similarly reflect the view that the payment of contingent amounts should be taken into account for purposes of determining basis only if and when such amounts become fixed and determinable. See Prop. Treas. Reg. § 1.168-2(d)(3)? Temp. Treas. Reg. §

basis increase would not vary depending upon whether the escrow account is treated as a grantor trust with the buyer as grantor or as a QSF. However, the buyer would potentially obtain a higher maximum basis increase in the grantor trust case, since in the grantor trust case the buyer would be viewed as paying the full amount distributed from the escrow account to the seller (including the pre-tax earnings of the escrow account), whereas in the QSF case the buyer at most would be treated as paying over to the seller the amount of its initial contribution to the escrow account. Consider the following example:

> Example (8). Assume that a seller agrees to sell an office building to a buyer for $1,000 cash at the closing and an additional $100 on the first anniversary date of the closing if the monthly rental income from the building is at least $20 at that time. The parties agree that the buyer will contribute sufficient funds to the escrow account at the closing (to be invested in a money market account yielding 10%) to grow to $100, which amount would be distributed to the seller if the condition is satisfied. Assume further that the sale closes on January 1 in year 1 and that the condition is satisfied on January 1 of the following year. If the escrow account were treated as a grantor trust, the buyer would contribute $90.91 to the escrow account at closing, the escrow account would earn $9.09 of interest income and the buyer would pay tax of $2.82 on that income. The buyer would obtain a $100 basis increase at the beginning of year 2 when the $100 in the escrow account is distributed to the seller, and the seller would have an additional $100 of amount realized at the same time. On the other hand, if the escrow account were treated as a QSF, the buyer would have to contribute $93.55 to the escrow account and the escrow account would earn $9.35 of interest income on which it would pay tax of $2.90. In that case, the buyer would obtain only a $93.55 basis increase at the beginning of year 2, but the seller would still have an additional $100 of amount realized at that time. From the buyer's standpoint, the present value of funding and tax costs

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1.338(b)-3T(c); Temp. Treas. Reg. § 1.1060-IT(f); and Prop. Treas. Reg. § 1.1275-4(c).

of the escrow are the same in either case (as in Examples (3) and (4) earlier), but the basis increase is $6.45 less in the QSF case. 102/

This problem does not arise with the typical litigation settlement fund, since the smaller deduction that is available where the settlement fund is treated as a QSF is accelerated vis-a-vis the grantor trust case, with the result that the present value of the deduction should be the same in either case. 103/

Third, escrow accounts tend to be different from litigation settlement funds as a business matter. Payments made into the typical litigation settlement fund usually will not revert to the defendant but instead will be disbursed to the plaintiffs with interests in the escrow account once they have been identified and the amount of their allowable claims has been determined. However, and escrow account created in connection with the sale of property usually is established to fund a payment that will be made either to the seller or to the buyer upon the occurrence (or nonoccurrence) of a stated event, the occurrence (or nonoccurrence) of which is genuinely uncertain. As a result, it often will be uncertain as to which of the two parties will actually receive the funds in the escrow account.

Whether the income of an escrow account should be taxed to the buyer or to the seller is a more difficult question. One possible approach would be to treat the party that actually transfers the funds to the escrow account as the grantor. An escrow account is established either to satisfy the buyer's obligation to pay additional contingent consideration if stated conditions with respect to the acquired property occur (e.g., the

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102/ This problem is analogous to the "all events" test problem discussed in Part 11(C)(2).

103/ See Part II(C)(1), supra.

attainment of stated revenue levels) or to satisfy the seller's indemnity, warranty or other continuing obligations under the purchase contract (e.g., a warranty that the property has no environmental problems). Under the grantor trust rules, a trust established to satisfy the obligations of a party normally is treated as a grantor trust as to such party, 104/ with the consequence that such party is treated as the owner of the trust property for all purposes of the Code. 105/ Thus, the party that funds the escrow account might be viewed as the grantor.

While the formalistic test of looking at which party actually transfers funds to the escrow account has a certain intuitive appeal, the Committee urges that it not be adopted. Regardless of how the parties to a property sale transaction view the escrow account as a business matter, the escrow account generally could be structured either as an escrow account to secure an obligation of the buyer to make additional payments to the seller or as an escrow account to secure an obligation of the seller to make additional payments to the buyer without changing the economic substance. Consider the following simple example:

> Example (9). A buyer agrees to purchase a piece of real estate from a seller. The business deal is that the seller will receive $1,000 for the property at closing and an additional $200 in three years if the property has attained a specified revenue target by that time. The more natural way to structure the transaction would be for the sale contract to provide that the buyer will pay $1,000 to the seller at closing and that the buyer will have a contingent obligation to pay an additional $200 in three years if the revenue target is met, which obligation would be secured by a $200 escrow account funded by the buyer at closing. However, the parties also could structure the transaction as a sale of the property for $1,200 payable by the buyer at closing,

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104/ Treas. Reg. § 1.677(a)-1(d).

105/ Section 671

> with the seller warranting that the property will reach the revenue target and agreeing to refund $200 of the purchase price if the revenue target is not achieved, which refund obligation would be secured by a $200 escrow account funded by the seller at closing. Ignoring time value of money considerations (for which appropriate adjustments could be made), these two alternatives are economically equivalent.

Hence, the potential for manipulation and abuse would exist if the rule was that the party that is the formal transferor and whose obligation is satisfied by the escrow account is the one who is taxed on the income earned by the escrow account. The parties to property sale transactions could (and would) structure the escrow account to have the income taxed to the party who would suffer the less onerous tax consequences. A related approach would be to follow the suggestions in the legislative history of Section 468B(g) and test whether the escrow account is a grantor trust under the existing grantor trust rules. 106/ Thus, the transferor of the funds placed in the escrow account generally would be treated as the grantor thereof only if the transferor retained a reversionary interest of more than 5%. 107/ The post- Committee believes that such an approach also should not be adopted. It would be difficult, if not impossible, to administer the 5% reversionary interest test in the real world, with the consequence that taxpayers would not have certainty as to the tax consequences of their escrow accounts and the Service would have to deal with many controversies relating to the issue on audit.

106/ *See* Part I(A), *supra.*

107/ See Section 673. As noted earlier, the legislative history of the 1988 Act also suggests that the transferor also might be treated as the grantor if the funds in the escrow account could be used to discharge a legal liability of the transferor. See Part I(A), supra. However, that rule would be tantamount to saying that the transferor is always the grantor, since by definition the funds in the escrow account always may be used to discharge a legal liability of the transferor.

To avoid the potential for manipulation and to achieve some degree of simplicity and certainty in this area, the Committee believes that a simple "bright line" rule that makes either the buyer or the seller the grantor in all cases should be adopted. Although arguments can be made to tax either the buyer or the seller, the Committee recommends that the buyer always be treated as the grantor (subject to the limited exception discussed below for certain residential real estate transactions). There are several reasons for that recommendation.

First, the buyer is always the party that transfers the funds into the escrow account where the escrow account is created prior to the closing to hold a deposit. In the case of escrow accounts created at closing to satisfy post-closing obligations, the buyer usually is the party that actually transfers the funds into the escrow account, and even in cases where the seller is the party that transfers the funds into the escrow account, the buyer presumably is the source of such funds.

Second, to the extent that it is possible to generalize, it may be more appropriate to view the obligations to be satisfied from an escrow account as those of the buyer. In the case of a pre-closing escrow account, the buyer is obligated to cause the principal amount in the escrow account (and usually the earnings as well) to be remitted to the seller, which is economically equivalent to an obligation to pay additional purchase price. In the case of a post-closing escrow account that is used to make additional payments to the seller upon the occurrence of stated contingencies, the escrow account obviously satisfies a buyer obligation. In the case of a post-closing escrow account used to secure an indemnity obligation of the seller for liabilities arising from the acquired property, the liabilities involved generally are those of the buyer as the

property owner as a matter of law, which the seller effectively has assumed by contract. On balance, then, the economic substance of escrow accounts established in connection with a property sale suggests that they are more properly viewed as a grantor trust of the buyer.

Third, treating the buyer as the grantor of an escrow account would keep the Section 468B(g) law reasonably consistent with the voluminous existing authorities discussed below relating to the treatment of the principal amount in escrow accounts for various other tax purposes, which authorities Congress presumably did not intend to have overruled by Section 468B(g) regulations. In theory, the buyer could be treated as the grantor of the income earned on the escrowed funds and the seller could be treated as being in immediate receipt of the principal amount thereof. However, the Committee believes that the taxation of the income earned by the escrowed account should follow the taxation of the principal amount in the escrow account for reasons of simplicity and consistency.

The most important line of such authorities deals with the effect of escrow accounts on the timing of gain recognition by the seller. If the buyer promises to make additional payments after closing contingent upon the occurrence of a real and substantial contingency, the seller generally must include in its amount realized for Section 1001 purposes the fair market value of the right to receive such payments, taking into account the existence of such contingency. 108/ That is the rule regardless

108/ See S. Rep. No. 96-1000, 96th Cong., 2d Sess. 24 (1980); Treas. Reg. § 1.1001-1(a); and Treas. Reg. § 15A.453-1(d)(2). See generally Goldberg, Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980, 34 Tax Law. 605 (1980). If the contingency is "remote and incidental", the Service may disregard the existence of the contingency. See Prop. Treas. Reg. § 1.1275-4(b)(1). On the other hand, if the contingency is so uncertain as to make the transaction one of those rare

of whether the seller is on the cash or accrual method of accounting. 109/ Assuming that the transaction is eligible for the installment method of reporting under Section 453 and that the seller does not elect out, the seller generally would report its gain over the period during which the contingent payment obligation exists as "payments" are made under Section 453. 110/ If the buyer places funds in an escrow account to secure its contingent payment obligation, the timing of gain recognition by the seller generally should not be affected (assuming that there is no constructive receipt issue). If the seller is not reporting its gain on the installment basis, the existence of the escrow account should not affect the fair market value of the buyer's contingent payment obligation, except in cases where the escrow account materially increases the likelihood of collection if the payment becomes due. If the seller is reporting its gain on the installment basis, the seller generally is required to report gain only if and when the contingency is satisfied and a payment is made. 111/ In other words, the creation of the escrow account

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and unusual situations where open transaction treatment would be permitted, the seller would not be required to include the value of the right to receive the contingent payments in income and could recover all its basis before reporting any gain.

109/ Section 1001(b) provides that a seller's amount realized is "the sum of any money received plus the fair market value of the property (other than money) received", without any qualification with respect to the seller's method of accounting. See also Treas. Reg. § 15A.453-1(d)(i). There is authority indicating that a seller on the accrual method of accounting must include in its amount realized the face amount of any fixed payment obligation on the theory that the right to receive money is equivalent to money itself for an accrual method taxpayer. See, e.g., Rev. Rul 79-292, 1979-2 C.B. 287, and Treas. Reg. § 15A.453-l(d)(2)(ii). See generally Schler, The Sale of Property for a Fixed Payment Note: Remaining Uncertainties, 41 Tax L. Rev. 209, 212-216 (1986). However, the face amount rule for accrual method sellers should not apply in the case of a contingent payment obligation, since the contingent payment obligation would not satisfy the "all events" test. See Treas. Reg. § 15A.453-l(d)(2)(iii).

110/ See Part III(C), infra.

111/ See, e.g., Anderson v. Commissioner, 20 T.C.M. 697 (1961), acq. action on decision (August 14, 1962) (payments contingent on the absence of any breach of representations and warranties); Bassett v. Commissioner, 33

is not treated as an immediate "payment" for installment sale purpose

The foregoing result for sellers reporting gain on the installment basis might appear to be inconsistent with Treasury Regulation § 15A.453-1(b)(3), which provides that the receipt of an installment obligation secured by cash or cash equivalents will be deemed to be an immediate "payment" for installment sale purposes. However, that Regulation does not seem to have been intended to cover escrow accounts where the seller's right to receive payment is subject to a real and substantial contingency. It was promulgated after the enactment of the Installment Sales Revision Act of 1980 to eliminate the uncertainty that previously existed concerning the effect of escrow accounts for installment sale purposes. 112/ However, the only conflicting authorities on that issue apparently involved situations where the escrow account secured an obligation of the buyer to make a fixed payment at a specified future time (and in some cases there was a constructive receipt-type issue as well). 113/ Where the buyer's

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B.T.A. 182 (1935) aff'd, Commissioner v. Bassett, 90 F.2d 1004 (2d Civ. 1937) (same); Carpenter v. Commissioner, 34 T.C. 408 (1960), acq., 1960-2 C.B. 4 (payments contingent on title to the acquired property being cleared); Goetze Gasket & Packing Co. v. Commissioner), 24 T.C. 249 (1955), acq., 1956-1 C.B. 4 (payments contingent on the absence of any breach of representations and warranties); Murray v. Commissioner, 28 B. T.A. 624 (1933), acq., XII-2 C.B. 10 (1933) (payments contingent on compliance with a noncompetition agreement); Stiles v. Commissioner, 69 T.C. 558 (1978), acq., 1978-2 C. B. 3 (payments contingent on the absence of any breach of representations and warranties). See also note 115, infra.

112/ See S. Rep. No. 1000, 96th Cong., 2d Sess. 18-19(1980), which recommended the issuance of such regulations.

113/ Compare Busby v. United States, 679 F.2d 48 (5th Cir. 1982) (no immediate gain recognition); and Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983) (same) with Kuehner v. Commissioner, 214 F.2d 437 (1st Cir. 1954) (immediate gain recognition required); Oden v. Commissioner, 56 T.C. 569 (1971) (same); Pozzi v. Commissioner, 49 T.C. 119 (1967) (same); Rev. Rul. 73-451, 1973-2 C.B. 158 (same); Rev. Rul. 77-294, 1977-2 C.B. 173 (same); Rev. Rul. 79-91, 1979-1 C.B. 179 (same). See also G.C.M. 37073 (March 31, 1977) and the authorities cited therein.

obligation to pay was subject to a real and substantial contingency (and there was no constructive receipt issue), the pre-1980 authorities apparently were unanimous that the existence of the escrow account should not be treated as an immediate payment for installment sale purposes. 114/ Unfortunately, there is a dearth of post-1980 authority on this issue, but the little authority that does exist indicates that Treasury Regulation § 15A.453-1(b)(3) does not apply in these situations. 115/

Even if Treasury Regulation § 15A.453-1(b)(3) did apply to cause a contingent payment obligation secured by an escrow account to be treated as immediate "payment" for installment sale purposes, it would still be necessary to treat the buyer as the grantor to be consistent with existing law. 116/ That follows because the payment that would be deemed to be received would be the value of the right to receive the contingent payment, which would necessarily be less than the amount placed in escrow because of the existence of the contingency. Moreover, the fact that Treasury Regulation § 15A.453-1(b)(3) deems the seller to be in receipt of immediate "payment" for purposes of determining the seller's eligibility to report its gain on the installment method and when that gain must be reported is not equivalent to deeming the seller to be the owner of the escrowed funds for any purpose.

114/ See the authorities cited in note 111, supra.

115/ There are two post-1980 private letter rulings that do not treat an escrow account subject to a real and substantial contingency as immediate payment for installment sale purposes, relying on Rev. Rul. 77-294, 1977-2 C.B. 173, and other pre-1980 authorities. See P.L.R. 8629038 (April 18, 1986) (payments contingent on the absence of any breach of representations and warranties); and P.L.R. 8645029 (August 8, 1986) (same). Rev. Rul. 77-294 specifically states that "if an escrow arrangement incident to a deferred payment transaction imposes a substantial restriction, in addition to the payment schedule, upon the seller's right to receipt of the sales proceeds, the Service will allow the seller to use the installment method of reporting income . . .".

116/ The same conclusion applies where the transaction is ineligible for installment sale reporting or the seller elects out.

Accordingly, none of the above-described authorities hold that the seller should be treated as the owner of the escrowed funds. 117/ As a result, even if Treasury Regulation § 15.453-1(b)(3) does apply to contingent payment escrow accounts, such escrow accounts should be treated as buyer grantor trusts.

The Treasury Regulations regarding deferred like- kind exchanges under Section 1031 take a similar position with respect to the treatment of funds in an escrow account created in connection with a deferred like-kind exchange. Under Treasury Regulation § 1.1031(k)-1(f), money or other property transferred by one of the parties to a "qualified escrow account" or a "qualified trust" will not be treated as actually or constructively received by the other party for purposes of Section 1031. A "qualified escrow account" or "qualified trust" essentially is one that is independently controlled and that limits the right of the other party to obtain the benefit of the escrowed funds. Although application of the regulation is limited to Section 1031, implicit in the regulation is the assumption that the funds placed in such an escrow or trust does not constitute part of the taxpayer's amount realized under Section 1001.

Fourth, given the collateral tax consequences of escrow accounts as discussed below, 118/ it would be somewhat fairer and more administratively convenient to treat the buyer as the grantor. In the case of a pre-closing escrow account, the

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117/ As a factual matter, seller often was entitled to receive the funds in the escrow account only if the buyer defaulted on its payment obligation, and the buyer was entitled to receive the funds in the escrow account once it made the required payments to the seller. In cases where the payments were made from the escrow account directly to the seller, the buyer usually was entitled to receive any excess funds in the escrow account.

118 / *See* Part III(C), *infra*.

rationale is obvious: the seller should not be treated as receiving part of its amount realized prior to the time when the sale is deemed to occur for tax purposes, which almost always is on the closing date, 119/ since the sale may not close at all or it may close in a later taxable year. In the case of a post-closing escrow account, the seller also should not be treated as the grantor. Otherwise, the seller would have to include in its amount realized the entire amount placed in escrow (thereby overstating its gain if it actually does not receive the maximum possible payment and presumably precluding the use of installment reporting) and then the seller would have to report a loss later under the Arrowsmith doctrine if and when the conditions to the buyer's additional payments fail to occur. 120/

C. Collateral Tax Issues. Under the grantor trust approach recommended above, the buyer in a property sale transaction generally would be treated as the owner of the funds in the escrow account for Federal income tax purposes. Accordingly, while the seller would be required to treat the value of the buyer's obligation to make contingent payments as part of the amount realized for Section 1001 purposes, the seller would not be treated as if it had received any portion of the escrowed funds until a payment is actually made to the seller. 121/ Moreover, any payment to the seller from the escrow account, including any portion of such payment derived from the earnings on the assets in the account, would be treated in its entirety as a payment of additional purchase price by the buyer at that time.

119/ See generally Chapman, Time of Sale Under the Internal Revenue Code, 22 N.Y.U. Inst. on Fed. Tax'n 139 (1964)

120/ See Arrowsmith v. Commissioner, 344 U.S. 6 (1952), reh'g denied 344 U.S. 900 (1952).

121/ See Part III(B), supra.

122/ That would cause every property sale transaction with an escrow account to become a contingent installment sale, which would have various collateral tax consequences that should be addressed by the regulations under Section 468B(g).

One such consequence is that payments from escrow accounts would become subject to the imputed interest rules of Section 1274 (unless part of such payments are expressly denominated as interest and the interest rate is adequate under Section 1274). Thus, part of each deferred payment to the seller would be deemed to be interest based upon the "applicable Federal rate" in effect at the time the transaction is entered into, and such interest would be deductible by the buyer (and reportable by the seller) when paid. 123/

The balance of each payment to the seller would be deemed to be principal. From the buyer's standpoint, such additional principal payment would add to its basis in the purchased property when paid. Since the basis increase is deferred until payment, the buyer might initially have an aggregate tax basis in the purchased assets (based on the fixed portion of its purchase price) that is less than the fair market value of such assets, exclusive of goodwill. Under the rules for allocating purchase price to assets under Sections 338(h)(10) and 1060, the result would be a "bargain purchase" that would cause most such assets (including accounts receivable and inventory) to have a tax basis that is less than their fair market value. That

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122/ That would be consistent with the treatment of plaintiffs that receive payments from a QSF. See Part 11(B), supra.

123/ The buyer would not be able to deduct such interest prior to payment, since the buyer's obligation to make the payment would be contingent. See Prop. Treas. Reg. § 1.1275-4(c)(3). See generally New York State Bar Association Tax Section, Report of the Ad Hoc Committee on Proposed Original Issue Discount Regulations, reproduced in 34 Tax Notes 363, 388-401 (January 26, 1987).

could cause the buyer to recognize an artificially high amount of income upon the collection of accounts receivable or the sale of inventory prior to the contingent payments being made. 124/

From the seller's standpoint, such additional principal payments would produce additional taxable gain when paid. The amount of gain to be reported by the seller would depend upon how much of its basis in the property sold that the seller could apply against each such payment. For a seller reporting its gain under the installment method, the basis allocation would be governed by the contingent installment sale regulations. 125/ Those regulations may produce inequitable basis allocations that would artificially overstate the amount of gain that must be reported by the seller at closing, particularly when the maximum amount that could be paid to the seller is not limited to a specified amount. Since it is possible to apply for permission from the Service to use an alternative method of basis recovery that does not unduly defer basis recovery, the Service may experience an increase in alternative basis recovery requests.

There may be certain special circumstances in which all the collateral tax consequences that would follow under a strict application of the grantor trust rules would not be appropriate. For example, an issue that arises in connection with tax-free reorganizations where some of the acquiring company's stock is placed in escrow is whether that stock may be counted for purposes of satisfying the continuity of interest requirement in Treasury Regulation § 1.368-1(b). The Service has issued a Revenue Procedure setting forth certain guidelines for private letter rulings to be issued on tax-free reorganizations that

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124/ See generally Schler, Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10) and More, 43 Tax L. Rev. 605, 665 (1988).

125/ See Treas. Reg. § 15A.453-1(c).

involve escrowed stock. 126/ Although not entirely clear, the Revenue Procedure seems to indicate that the escrowed shares will count for continuity of interest purposes if the target corporation shareholders are entitled to receive the dividends paid on the escrowed stock. Three earlier private letter rulings support that conclusion, 127/ which also has been confirmed in informal telephone conversations by a Committee member with the Service. The Committee recommends that the Section 468B(g) regulations regarding escrow accounts not change that result.

A related issue invokes the potential applicability of Section 483 to escrow accounts created to hold stock of the acquiring corporation issued in connection with corporate reorganizations. Treasury Regulation § 1.483-1(b)(6) (Example 8) and Revenue Ruling 70-120 128/ both state that Section 483 does not apply to stock placed in an escrow account created in connection with a tax-free reorganization where the target shareholders are entitled to vote the escrowed shares and receive all the dividends paid thereon. The theory, which is a bit strained, is that the such shares were initially "received" by the target shareholders prior to going into escrow, and, therefore, they do not represent deferred payments for purposes of Section 483. In Feifer v. United States, 129/ a case involving escrowed shares issued in a subsidiary merger, the district court reached the same conclusion based on Example 8, although the facts were not identical. The target shareholders' voting rights with respect to the escrowed stock were restricted, and any dividends were to be paid to the ultimate recipient of the

126/ Rev. Proc. 84-42, 1984-1 C.B. 521

127/ P.L.R. 7952205 (October 1, 1979); P.L.R. 7951039 (September 18, 1979)

128/ 1970-1 C.B. 124.

129/ 500 F. Supp. 102 (N.D. Ga. 1980)

escrowed shares, although the target shareholders agreed to report the dividends as income when paid into the escrow account. Again, the conclusion was reached on the theory that the target shareholders were considered to have initially received the escrowed stock. The Committee recommends that Section 483 (and Section 1274) continue not to apply to those types of escrow accounts.

D. Residential Real Estate Exception. The approach recommended above presumably can be understood and applied by well-advised taxpayers in a business context. However, escrow accounts frequently are used in residential real estate sale transactions, particularly for purposes of holding the buyer's down payment pending the closing. This probably is the only context in which most individual taxpayers encounter escrow accounts governed by Section 468B(g).

Individuals involved in such transactions might find it surprising and indeed unfair that the buyer should always be taxable on the earnings on the escrow account, even if, as is usually the case, the seller is the party who actually receives the earnings on the account. For that reason, the Committee recommends that the regulations to be issued under Section 468B(g) contain a special exception applicable to escrow accounts created prior to closing in connection with residential real estate sale transactions where the parties are individuals. Under that exception, the earnings on the escrow account would be taxable to the party to the transaction that actually receives the escrowed funds if the escrow account is closed within the calendar year during which it is created; otherwise the earnings would be reportable by the buyer under the general principle that the buyer is the grantor. That rule should insure that the parties have adequate time to prepare their tax returns correctly

and that the payor of the interest or dividends earned by the escrow account is able to timely satisfy its information reporting requirements under Section 6049.

IV. Bankruptcy and Work-Out Funds

The third major context in which escrow accounts, settlement funds and similar arrangements arise is bankruptcy and work-out transactions, where trusts and similar arrangements are used to satisfy the claims of general creditors and security holders (referred to herein as "general creditor claims"). In the preamble to the Proposed Regulations, the Treasury Department specifically requested comments concerning the extent to which QSF treatment should apply to such arrangements and whether the Proposed Regulations, which apply to claims for "breach of contract", should apply in the case of general creditor claims. 130/ This section discusses certain tax issues associated with general creditor trusts and similar arrangements. 131/

A. Background. In bankruptcy and work-out transactions where general creditor trusts are employed, the debtor typically transfers all or part of its assets to a trust, and its creditors whose claims have not been previously satisfied are issued interests in the trust in satisfaction of their claims against the debtor. The trust then liquidates such assets as promptly as practicable and distributes the net proceeds to the creditors in accordance with their relative interests in the trust. The debtor typically does not retain a reversionary interest in the trust, although in some cases it does.

130/ 57 Fed. Reg. 5399, 5401 (February 14, 1992).

131/ For convenience of reference, trusts and similar arrangements set up to satisfy general creditor claims in connection with bankruptcy and workout transactions are referred to herein as "general creditor trusts".

Practitioners usually believe that general creditor trusts should be classified as liquidating trusts within the meaning of Treasury Regulation § 301.7701-4(d). 132/ As such, they qualify as grantor trusts, with the creditors as the grantors ("creditor-grantor trusts") 133/ or, in certain limited cases where the debtor retains a reversionary interest, with the debtor as the grantor ("debtor-grantor trusts"). 134/ In certain other cases, a general creditor trust may be treated as a simple or complex trust under Subchapter J, 135/ as an association taxable as a corporation 136/ or even as a taxable successor to

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132/ Rev. Proc. 82-58, 1982-2 C.B. 847, and Rev. Proc. 91-15, 1991-1 C.B. 484, which provide stringent guidelines for private letter rulings on liquidating trust treatment, suggest that many general creditor trusts would not qualify as liquidating trusts because of the nature of their assets, their duration or other factors. Fortunately, the case law is clear that many general creditor trusts that do not satisfy the narrow ruling guidelines may still qualify as liquidating trusts. See, e.g., Wilson Syndicate Trust, 1 T.C.M 377 (1943) (liquidating trust with a 20-year term); Cebrian v. United States, 181 F. Supp. 412 (1960) (liquidating trust with a 24-year term).

133/ See, e.g., Rev. Rul. 63-228, 1963-1 C.B. 229 (liquidating trust treated as creditor-grantor trust); and Rev. Rul. 80-150, 1980-1 C.B. 316 (same). See generally Treas. Reg. § 301.7701-4(d). As a creditor-grantor trust, the trust is not treated as a separate taxable entity; rather, creditors are treated as the owner-grantors and generally: (1) recognize gain or loss at the time the trust is created, which is measured by the difference between the fair market value of their proportionate share of the trust's assets and their respective bases in their claims; (2) are taxed on the income of the liquidating trust directly at the time such income is earned; and (3) recognize gain (or loss) on the disposition of the trust's assets to the extent that their share of the amount realized by the trust exceeds (or is less than) their basis in such assets.

134/ See, e.g., In re Sonner, 53 B.R. 859 (E.D. Va. 1985); and Stockton v. United States, 335 F. Supp. 984 (C.D. Cal. 1971).

135/ See, e.g., P.L.R. 8524052 (March 19, 1985); P.L.R. 8848019 (August 31, 1988); and G.C.M. 39368 (June 3, 1985). Treatment as a simple or complex trust under Subchapter J may be appropriate if the trust engages in some business activities, but those activities are extremely limited (such as being confined to prosecuting preference claims against persons that dealt with the debtor).

136/ A general creditor trust that failed to qualify as a liquidating trust under Treas. Reg. § 301.7701-4(d) because the trust engaged in significant business activities generally would be classified either as an association or as a partnership. Cf. Treas. Reg. § 301.7701-4(b). As a

the bankrupt party under Section 6012(b). 137/ However, the proper tax treatment of most general creditor trusts that do not qualify as DSFs is not entirely clear. 138/

Liquidating trust treatment works reasonably well when the identities of all the creditors are known, and none of their claims are disputed or contingent. In such a case, the general creditor trust serves the primary purpose of marshalling and liquidating assets, and liquidating trust treatment does not appear to result in any "homeless income" problem. In many cases, however, some of the interests in the general creditor trust are held by an escrow agent for creditors that cannot immediately be located, and other interests may be held by an escrow agent for creditors whose claims have not been proven or are being disputed. These escrow accounts are similar to other types of escrow accounts created to hold income-producing assets until the true owners can be determined. The only unique aspect of these escrow accounts is that the assets involved are interests in a liquidating trust. Practitioners typically take the view that, to the extent that interests are reserved for disputed or contingent claim holders, the disputed or contingent claim asset reserve is itself a separate taxable entity subject to tax under Subchapter

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practical matter, the result usually would be association status, since a general creditor trust usually has more than two out of the four possible corporate characteristics under, Treas. Reg. § 301.7701-2.

137/ See, e.g., Holywell Corporation v. Smith, 112 S. Ct. 1021 (1992) (trustee of a liquidating trust created to satisfy both corporate and individual debts held liable for corporate income tax under Section 6012(b)(3) and individual income tax under Section 6012(b)(4)); and Louisville Property Company v. Commissioner, 140 F.2d 547 (6th Cir. 1944), cert, den. 322 U.S. 755 (1944)(trustee liable for corporate income tax under the predecessor of Section 6012(b)).

138/ See generally Henderson and Goldring, Failing and Failed Businesses, Vol. II, Ch. 9 (1991); and Howard, The Taxation of Liquidating Trusts, Escrows and Settlement Funds in Chapter 11 Bankruptcy Cases, 64 Am. Bankruptcy L.J. 403 (1990).

J. 139/ The proper tax treatment of such a disputed or contingent claim reserve, however, is by no means clear under current law.

B. Application of the Proposed Regulations. It is not clear whether the Proposed Regulations, as currently drafted, would apply to the typical general creditor trust. The requirement that the assets of the arrangement be held in trust or otherwise segregated from the assets of the debtor obviously would be satisfied. The requirement of government approval also generally would be satisfied, except in the case of a consensual work-out transaction that is not under the jurisdiction of a bankruptcy court or other government authority. Thus, the only real issue is whether general creditor claims constitute QSF Liabilities. While it would seem clear that such claims literally fall under the "breach of contract" rubric, 140/ the Committee has been informed that the drafters of the Proposed Regulations did not intend that general creditor trusts be treated as QSFs. If the term "breach of contract" is construed to include all general creditor claims, then most general creditor trusts would become subject to the QSF system of taxation, which would completely change the tax ground rules for bankruptcy and work-out transactions.

C. Comments and Recommendations. Some members of the Committee assert that the QSF rules should apply to general

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139/ The "unknown beneficiary" issue may occur with respect to liquidating trusts utilized in nonbankruptcy situations as well. See, e.g., P.L.R. 7730029 (April 28, 1977).

140/ Black's Law Dictionary defines the term "breach of contract" as the "failure, without legal excuse, to perform any promise which forms the whole or part of a contract". Black's Law Dictionary 188 (6th ed. 1990). An agreement to pay money to a general creditor obviously is a contract. It should be noted that Treas. Reg. § 1. 461-4(g)(2)(i) provides that, for purposes of the economic performance regulations, the term "breach of contract" generally does not include the failure to make cash payments due under a contract. The implication of that special exception is that the term "breach of contract" would otherwise include general creditor claims.

creditor trusts in order to bring some clarity and certainty to an area of law that is somewhat muddled. However, most members feel that the QSF rules should not generally apply to general creditor trusts for four reasons.

First, however uncertain the current state of the law regarding the tax treatment of general creditor trusts may be, it does not appear to be a context in which there is a major "homeless" income" problem. 141/ Regardless of whether liquidating trust treatment or one of the other possible tax characterizations noted above applies, the income of the general creditor trust generally would be taxable to someone on a current basis. The only exception is that there may not be current taxation to the extent that interests in the general creditor trust are held by unknown or disputed creditors, but, as discussed below, that is a limited problem that can be adequately addressed without imposing a fundamental change in the tax treatment of general creditor trusts for all the participants.

Second, application of the QSF rules to general creditor trusts often would cause the total tax liability of the participants to be significantly more than the tax liability that is incurred under current law, assuming that general creditor trusts otherwise would qualify as liquidating trusts or as simple or complex trusts under Subchapter J. The debtor typically contributes to the general creditor trust all the assets that it is capable of contributing, because it has exhausted its assets and/or because the tax consequences to it would not vary depending upon whether the general creditor trust was treated as a liquidating trust or as a QSF. As a result, from the creditors'

141/ In that regard, it should be noted that the legislative history of Section 468B(g) makes no specific reference to general creditor trusts as an area to be addressed by regulations thereunder.

standpoint, the earnings of the general creditor trust will either be taxed once or twice, depending upon how the general creditor trust is treated for tax purposes. Compare the following two simplified examples:

> Example (10). Suppose that a debtor corporation transfers assets worth $80.00 to a general creditor trust at the beginning of year 1 and that the assets appreciate in value to $90.00 at the beginning of year 2, at which time they are sold for cash and the cash is distributed to the creditors. Assume further that the creditors have an aggregate tax basis in their claims of $100.00. If liquidating trust treatment applies (with the consequence that the general creditor trust is treated as a grantor trust with the creditors as grantors), then the creditors would recognize a $20 tax loss at the beginning of year 1 on the exchange of their claims for general creditor trust interests (with respect to which they would realize $6.20 tax benefit, assuming a 31% tax rate) and they would recognize $10 of taxable income at the beginning of year 2 (with respect to which they would pay $3.10 of tax). On a present value basis as of the beginning of year 1, the net amount received by the creditors would be $87.49 (the $6.20 benefit of the initial tax loss plus the present value of the $90.00 of proceeds received, minus the $3.10 of tax paid, at the beginning of year 2).

> Example (11). Suppose the facts are the same as in Example (10), except that the general creditor trust is treated as a QSF. In that case, there presumably would be no tax consequence to the creditors under Proposed Treasury Regulation § 1.468B-4 in year 1. At the beginning of year 2, the general creditor trust would recognize $10.00 of income on which it would owe $3.10 of tax. The creditors would receive a distribution of $86.90 from the general creditor trust (the $90.00 of sale proceeds less the $3.10 of trust-level tax) and would recognize a tax loss of $13.10 (the $86.90 distribution less their tax basis of $100.00), which loss would result in a tax benefit to them of $4.06. On a present value rate basis as of the beginning of year 1, the net amount received by the creditors would be $85.09 (the present value of the $86.90 distribution plus the $4.06 tax benefit), which is $2.40 less than in Example (10).

Indeed, the tax burden associated with QSF treatment might be quite draconian for general creditor trusts if the limitation on the deductible expenses of a QSF is not modified as recommended earlier, given the tendency of general creditor trusts to have expenses that would not be allowable under the current "modified gross income" rules. 142/

Third, application of the QSF rules may prevent creditors that have a loss inherent in their claims from recognizing that loss prior to the termination of the general creditor trust or the sale of their interests therein, since Proposed Treasury Regulation § 1.468B-4 provides that persons with an interest in a QSF are not taxable until they actually receive payments from the QSF. Such deferral of creditors' losses may tend to impede bankruptcy and work-out transactions, as creditors often view the potential to recognize such losses an as important benefit of the transaction. That consideration may be counterbalanced to some extent by the fact that application of the QSF rules would offer a deferral benefit to creditors that took a bad debt deduction or otherwise did not have a full basis in their claims. 143/

Fourth, the parties to work-out transactions sometimes attempt to structure general creditor trusts as debtor-grantor trusts so that the net operating losses of the debtor will be available to offset the income generated by the assets of the general creditor trust. That potential benefit would no longer be available if general creditor trusts were to be classified as

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142/ See Part II(C)(10), supra.

143/ Some such creditors may take the position under current law that they do not have to recognize any income or loss on the receipt of an interest in a general creditor trust under current law on the theory that the receipt of the interest represents an open transaction, thereby permitting in full basis recovery prior to recognizing any gain.

QSFs. That result might tend to discourage work-out transactions where debtor-grantor trust treatment would otherwise be available, since creditors would attempt to force the debtor to transfer additional funds to the general creditor trust to reflect the fact that the amounts they would ultimately receive will be diminished by taxes paid on the trust's income.

Accordingly, the Committee recommends that the final Section 468B(g) regulations specifically provide that the QSF rules will not apply to general creditor trusts that are treated by the participants as a grantor trust or as a simple or complex trust. The Committee further recommends that the Service give further study to this important area, with the objective of issuing guidance regarding the proper tax treatment of general creditor trusts, including "safe harbor" rules that would permit debtors and creditors to be certain that they had achieved the desired tax treatment for their general creditor trusts. Nevertheless, to provide a measure of certainty in this area prior to the completion of that study and the issuance of such guidance and consistent with the Committee's recommendations as to litigation settlement funds, the Committee recommends that regulations be issued under Section 468B(g) authorizing general creditor 4 trusts affirmatively to elect to be treated as QSFs.

However, the Committee does recommend that the QSF rules generally be extended to contingent and disputed creditor escrow arrangements. Grantor trust treatment usually would not be feasible or appropriate for such arrangements. The contingent or disputed creditors could not be treated as the grantors, since the identities of all the contingent or disputed creditors and/or the amount of their allowable claims are not known for some time after the creation of the arrangement. It also usually would be possible to treat the debtor as the grantor, since in most cases

the debtor ceases to exist in connection with the creation of the arrangement. The liquidating trust itself conceivably could be treated as the grantor, but that approach would force the known creditors to pay tax on income that ultimately will go to the contingent and disputed creditors during the period when the contingent and disputed creditors are attempting to have their claims validated and that approach would cause complex tax effects as contingent or disputed claims are allowed. 144/

On the other hand, QSF treatment for contingent and disputed creditor escrow arrangements would not be fundamentally inconsistent with what most practitioners believe to be the proper tax treatment of such arrangements under current law. By extending the QSF treatment only to such contingent or disputed creditor escrow arrangements, the Treasury Department would be providing regulations governing the taxation of income-producing arrangements the tax treatment of which is currently very uncertain--which is the mandate of Section 468B(g). However, there may be some additional tax burden associated with QSF treatment, as illustrated by Examples (10) and (11) above. In recognition of that concern (and consistent with its recommendations for litigation settlement funds), the Committee recommends that such regulations include an election that would be available where the debtor remains in existence after the contingent or disputed creditor escrow account is created pursuant to which the escrow account could be treated as a grantor trust with the debtor as guarantor. In addition, special transition relief should be considered for contingent or disputed claims reserves in existence prior to the effective date of any such regulations.

July 20, 1992

144/ See Rev. Rul. 72-137, 1971-1 C.B. 101.