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Date:
November 7, 2000

Legend

State A =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
\$X =

Dear

This responds to your ruling request, dated July 10, 2000, and supplemental correspondence concerning the federal income tax consequences of amounts paid pursuant to the settlement of a class action, including state intangible property tax refunds and interest thereon, administration costs, and attorneys' fees. Specifically, you have requested the following rulings:

- (1) Does the Fund have a reporting obligation under section 6050E of the Internal Revenue Code (Code) for payments it makes to class members?
- (2) Does the Fund have a reporting obligation under section 6041 of the Code for payments it makes to class members?
- (3) Does the Fund have reporting obligations to the class members under sections 6041, 6049, or 6050E of the Code for amounts paid from the Administrative Fund for administration costs and for attorneys' fees paid directly to class counsel?

I. FACTS

Prior to Date 1, State A imposed an annual intangible property tax on its residents owning shares of stock in certain corporations. Specifically, State A imposed an intangibles tax based on the value of shares of stock in corporations that either: (1) had no income allocable to State A for corporate income tax purposes; or (2) had only a portion of income allocable to State A for corporate income tax purposes. Residents who owned stock in corporations that were based in State A paid no intangible property

tax on the shares of such stock. During Date 2 residents of State A filed a class action suit challenging the legality of the intangibles tax. On Date 3, the United States Supreme Court ruled that the State A intangibles tax was unconstitutional and remanded the case for further disposition.

On Date 4, the State A legislature entered into a settlement agreement with the plaintiff class (Agreement). On Date 5, the State A court entered a consent order approving the Agreement and retaining jurisdiction over the case. Under the Agreement, State A is required to deposit \$X into a settlement fund (Fund). Under the Agreement, 85 percent of the Fund is set aside and segregated for the payment of refunds of the intangible property taxes and interest (Claim Account), and 15 percent of the Fund is set aside and segregated for the payment of administrative costs, litigation costs, and attorneys' fees (Administrative Account). In the event the Administrative Account is greater than necessary to cover the expenses, the court may order the remainder to be distributed to the class members.

Class members are required to submit claim forms to the settlement administrator to receive payments from the Fund. Class members are also permitted to opt out of the settlement and pursue their claims individually. Class members have not personally agreed to compensate the class counsel.

II. LAW

A. Gross Income Defined

Section 61 of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived.

Section 1.61-1(a) of the Income Tax Regulations (regulations) provides that gross income includes income realized in any form.

Gross income is an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207.

Rev. Rul. 80-364, 1980-2 C.B. 294 (Situation 3), involved the settlement of a lawsuit brought by a union against an employer to enforce a collective bargaining agreement. The ruling held that the portion of the settlement paid by the union for attorneys' fees was a reimbursement for expenses incurred by the union and was not includible in the gross income of the union members.

Section 111 of the Code provides that gross income does not include income attributable to the recovery during the taxable year of an amount deducted in a prior taxable year to the extent such amount did not reduce the federal income tax imposed. Conversely, gross income includes income attributable to the recovery during the taxable year of an amount deducted in a prior taxable year to the extent such amount

reduced the tax imposed (tax benefit rule). See Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983), 1983-1 C.B. 50.

Rev. Rul. 70-86, 1970-1 C.B. 23, considered the federal income tax consequences of a program in the State of California to refund real property taxes. The ruling held, in part: (1) that if the recipient of a refund had not claimed a federal income tax deduction for the real property tax in the year paid, the refund would be excludible from the recipient's gross income in the year received; and (2) that if the recipient of a refund had claimed a deduction for the real property tax in the year paid, under the tax benefit rule the refund would be includible in the recipient's gross income in the year received, but only to the extent the deduction of the real property tax reduced the federal income tax imposed.

B. Qualified Settlement Fund Requirements

Section 468B(g) of the Code provides that nothing in any provision of law will be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax.

Section 1.468B-1(c) of the regulations generally provides that a fund, account, or trust is a qualified settlement fund (QSF) if the following requirements are satisfied:

- (1) It is established pursuant to an order of, or is approved by, a court of law or other governmental authority and is subject to the continuing jurisdiction of such authority;
- (2) It is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability arising out of a tort, breach of contract, or violation of law; and
- (3) It is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related parties).

Section 1.468B-2(l)(2)(i) of the regulations provides that, in general, payments and distributions by a QSF are subject to the information reporting requirements of part III of subchapter A of chapter 61 of the Code, and the withholding requirements of subchapter A of chapter 3 of subtitle A and subtitle C of the Code.

Section 1.468B-2(l)(2)(ii) of the regulations provides that a QSF must make a return for, or must withhold tax on, a distribution to a claimant if one or more transferors would have been required to make a return or withhold tax had that transferor made the distribution directly to the claimant. For purposes of sections 6041(a) and 6041A of the Code, if a QSF makes a payment or distribution on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business. In such a situation, the QSF is also deemed to have made the distribution or payment to the transferor or claimant.

C. Information Reporting Requirements

Section 6041 of the Code requires all persons engaged in a trade or business and making payment in the course of that trade or business to another person of fixed or determinable gains, profits, and income (other than payments to which section 6049(a) applies) of \$600 or more in a calendar year to file an information return.

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

As used in section 6041 of the Code, the term “gain, profits, and income” means gross income and not the gross amount paid. A payor is generally not required to make a return under section 6041 for payments that are not includible in the recipient’s income, and a payor is not required to make a return if the payor does not have a basis to determine the amount of a payment that is required to be included in the recipient’s gross income.

Rev. Rul. 80-22, 1980-1 C.B. 286, held that crop insurance proceeds paid to farmers that had informed the payor insurance company that they were required to capitalize certain farming expenses were not fixed and determinable income under section 6041 of the Code because the payor could not require the farmers to disclose their bases in the destroyed crops. This information was required to determine the portion of the insurance proceeds constituting “gains, profits, and income” reportable under section 6041. Therefore, the payment of the insurance proceeds was not subject to reporting under section 6041.

Section 6049(a) of the Code requires every person who makes payments of interest (as defined in section 6049(b)) aggregating \$10 or more to any person during a calendar year to file an information return. Section 6049(b)(1)(A) states, in part, that “interest” means interest on any obligation issued in registered form, or of a type offered to the public, other than any obligation with a maturity (at issue) of not more than one year held by a corporation. Section 6049(b)(1)(E) provides that “interest” also includes interest on deposits with brokers (as defined in section 6045(c)).

Section 1.6049-5(b)(iv) of the regulations provides, in general, that for purposes of section 6049 the term “interest” does not include interest that a governmental unit pays with respect to a tax refund.

Section 6050E of the Code requires that every person who makes payments with respect to any individual of refunds of State or local income taxes aggregating \$10 or more during any calendar year to file an information return.

III. ANALYSIS

A. Classification of Fund as a QSF

The Fund is a QSF because it satisfies the three requirements in section 1.468B-1(c) of the regulations. First, as required in section 1.468B-1(c)(1), the Fund was created by a consent order issued by a court and the court has continuing jurisdiction over the Fund. Second, as required in section 1.468B-1(c)(2), the Fund was created to satisfy claims arising out of a tort, breach of contract, or violation of law. Third, as required in section 1.468B-1(c)(3), the Fund is segregated from the other assets of the transferor. Because the Fund is a QSF, the reporting obligations to the class members are governed by section 1.468B-2.

B. Reporting Obligations for Distributions to Class Members from Claim Account

Under the terms of the court order and the Agreement, State A is required to refund the intangible property taxes paid. The portions of the distributions that are properly allocable as refunds of the intangible property tax are not gross income to class members who did not claim itemized deductions for the tax on their federal income tax returns in the years when the tax was paid. However, the distributions may be gross income to class members who itemized and deducted the intangibles tax on their federal returns. Under the tax benefit rule, class members must include in gross income the refunds of the intangibles tax if the tax was deducted in the years paid, but only to the extent that a deduction reduced the federal income tax imposed. To the extent that a deduction did not reduce the tax imposed for an individual class member, the intangibles tax refund is not includible in the class member's gross income.

The Fund does not know whether the class members derived a tax benefit from the deducting the intangible property tax on their federal income tax returns, and the Fund cannot require the class members to disclose that information. As in Rev. Rul. 80-22, the Fund cannot determine whether the class members have gross income upon receipt of a refund of the intangibles tax. Accordingly, no payments from the Fund that are allocable as refunds of the intangibles tax are subject to reporting under section 6041 of the Code. In addition, the refunds of the intangible property tax are not subject to reporting under section 6050E because the intangible property tax is property tax and not an income tax.

The portions of the distributions that are properly allocable as interest on the class members' claims for the previously paid state intangibles property tax are an accession to wealth and are not excludible from gross income under any provision of law. Interest paid to the class members is not "interest" within the meaning of 6049(b) of the Code. The interest is based on claims and distributions related to class actions challenging the imposition of the intangible property tax. Consequently, these interest payments relate neither to registered obligations (under section 6049(b)(1)(A)), nor to deposits made with brokers (under section 6049(b)(1)(E)). In addition, interest paid by a governmental unit on a tax refund is not interest under section 6049(b), and the distributions are not interest under any other provision of section 6049. Accordingly, the Fund has no reporting obligation under section 6049. However, interest paid to a class member is fixed and determinable income under section 6041 and, therefore, is subject to information reporting under section 6041 if the interest paid to the class member is

\$600 or more during a calendar year. These interest payments are reportable on Form 1099-INT, "Interest Income."

C. Reporting Obligations to Class Members for Distributions from Administrative Account

Whether the Fund has reporting obligations to the class members for amounts paid from the Administrative Account for administration costs and for attorneys' fees paid directly to class counsel depends on whether these amounts constitute gross income to the class members.

Amounts paid from the Administrative Account to compensate class counsel are not income to the class members in this opt out class action where the members have not personally agreed to compensate class counsel. This conclusion is consistent with Rev. Rul. 80-364 (Situation 3), which held that the portion of a settlement paid by a union for attorneys' fees was a reimbursement for expenses incurred by the union and was not includible in the gross income of the union members. The conclusion that amounts paid to compensate class counsel are not income to the class members is limited to the particular facts of this ruling. Cf. Sinyard v. Commissioner, T.C. Memo. 1998-364 (settlement of opt in class action pursuant to Age Discrimination in Employment Act where class members had contingency fee agreements with counsel); Frederickson v. Commissioner, T.C. Memo. 1997-125, aff'd in unpub. opinion, 97-71051 (9th Cir. 1998) (settlement of mandatory, Title VII class action where class members personally signed settlement agreements providing for compensation of counsel).

Similarly, amounts paid from the Administrative Account to cover administration costs and other incidental expenses incurred in connection with the operation of the Fund (a QSF) are not payments or distributions on behalf of the class members and, therefore, are not gross income to the class members. The costs and expenses are deductible by the Fund as a QSF. See section 1.468B-2(b)(2) of the regulations.

Accordingly, the Fund has no reporting obligation to the class members under sections 6041, 6049, or 6050E of the Code for payments from the Administrative Account for administration costs and attorneys' fees. These amounts are not income to the class members. However, if the Administrative Account proves to be greater than required to cover the expenses and the excess is paid to the class members, the payments will be characterized as either refunds of the intangible property tax or as interest thereon.

IV. CONCLUSIONS

Based on the facts and information submitted and the representations made, the following rulings are issued:

- (1) The Fund is not subject to the information reporting requirement of section 6050E of the Code for payments to class members of amounts that are properly

allocable as refunds of the intangible property tax because the tax is a property tax and not an income tax.

(2) The Fund is not subject to the information reporting requirement of section 6041 of the Code for payments to class members of amounts that are properly allocable as refunds of the intangible property tax. However, the Fund is subject to the information reporting requirements of section 6041 for payments to a class member of amounts that are allocable to interest on the intangible property tax, if the interest payments aggregate \$600 or more during a calendar year. These interest payments are reportable on Form 1099-INT.

(3) The Fund does not have a reporting obligation to the class members under sections 6041, 6049, or 6050E of the Code for amounts paid from the Administrative Account for administration costs and attorneys' fees paid to class counsel.

No opinions are expressed under any provision of the Internal Revenue Code regarding the tax consequences of the transaction described in this letter except as specifically set forth in this letter. No opinion is expressed concerning the proper allocation between amounts paid as refunds of state intangibles property taxes and amounts paid as interest. See section 4.02(1) of Rev. Proc. 2000-3, 2000-1 I.R.B. 103, 111.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter should be attached to any income tax return(s) to which it is relevant.

Sincerely,
Pamela W. Fuller
Senior Technician Reviewer, Branch 1
Administrative Provisions & Judicial Practice

Enclosures (2):
Copy of this letter
Copy for 6110 purposes

cc: