Tax Accounting

By James E. Salles

This month's column discusses *United States v. Brown*,[1] in which the Tenth Circuit upheld the regulations under section 468B(g) concerning "qualified settlement funds" ("QSFs"). The court applied the regulations to a court-supervised receivership, and also addressed several issues concerning their interpretation.

The procedural history of the *Brown* case at the appellate level is a little unusual. The Tenth Circuit issued its published opinion in July, 2003. The taxpayers requested reconsideration and petitioned for a rehearing *"en banc"* by the full Tenth Circuit. The petition for rehearing by the full court was denied. In November, however, the panel withdrew its opinion in favor of a revised opinion that reached the same result but modified one portion of the discussion. Interestingly, the court chose not to publish the revised opinion. The published opinion has thus been vacated, while the substitute opinion technically lacks precedential value. The earlier opinion, however, is likely to continue to be cited to the extent not affected by the modification, the more so as there is little other authority on the issues that it addresses.

Traditional Rules

Understanding what the parties were arguing about in *Brown* requires an understanding of the QSF regulations' provisions and purpose. This in turn requires some background in the "traditional" rules for trusts, escrows, and similar arrangements that preceded them, and which still apply to the extent that the regulations have not displaced them.

Common escrow arrangements, or setting aside money to pay debt, or disputed or contingent claims, may result in a trust.[2] An arrangement is generally treated as a trust if its purpose is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility."[3] Sometimes, however, a custodian or agent may not have sufficient investment and administrative autonomy to be considered a trustee.[4] For example, a court, or a bank that is merely a passive stakeholder, will not be a trustee.[5] Whether or not the arrangement is a trust, the basic dividing line is drawn between property that is segregated to secure or provide for payment of an obligation of the settlor ("transferor"), and cases where tax ownership has actually been transferred, but for reasons of security or administrative convenience the transferred property continues to be held by a trustee or agent awaiting distribution.

Transferor Taxation

The grantor trust rules normally apply if the grantor retains significant reversionary rights or the trust accumulates income for future distribution to the grantor.[6] Early Supreme Court cases established,[7] and the Regulations now provide,[8] that these provisions extend to trusts that accumulate income that may be applied to meet the transferor's future or contingent obligations.[9] Thus, for example, *In re Sonner*[10] taxed a bankruptcy debtor on income in a post-confirmation liquidating trust when the trust's assets were to be sold and applied against his liabilities.[11]

The Supreme Court in *Holywell Corporation v. Smith*[12] declined to apply the grantor trust provisions in a similar setting when the assets passed to the trust directly from the bankruptcy estate, distinguishing *Sonner* as a case where the assets had been constructively distributed to the debtor before being transferred to the trust. However, the question of whether the debtor or the bankruptcy estate was the grantor seems only to have been important because the bankruptcy estate of an individual is a separate taxable entity.[13] Corporate debtors' bankruptcy estates are not separate taxable entities, and the court and the parties assumed without discussion that a related corporate debtor was taxable on income from a similar trust, although the parties disagreed about who was responsible for filing the corporation's return and paying the associated tax.[14]

If the arrangement does not create a trust, the end result will be much the same, apart from the responsibility for filing a return and information reporting, because the transferor will be treated as beneficial owner of the property itself while it is

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held by the custodian. The authority frequently cited for this proposition is Reg. § 1.61-13, which addresses corporate "sinking funds."[15] The regulation, however, merely expresses the general principle that income from property is taxed to its owner. Indeed, the early Supreme Court cases involving trusts relied more on bedrock principles of ownership than on the statutory grantor trust provisions.[16]

Transferee Taxation

The other basic taxation model applies after there has been a transfer of beneficial ownership of property in the fund. It was early settled that escrowed sales proceeds could be treated as property of the seller.[17] Some early cases simply deemed the seller to have received the money and placed it into escrow.[18] The later trend was to consider the seller as having received a vested interest in segregated assets,[19] which is itself a form of "property."[20] That the interest might be forfeited for future nonperformance would not prevent the seller's rights from vesting for this purpose. By the same logic, if the sold property is escrowed to secure the buyer's obligations, the buyer is treated as its owner once the benefits and burdens of ownership have passed.[21] Similar principles apply in settings not involving dispositions of property. For example, the Tax Court recently treated a taxpayer as receiving litigation proceeds held in his attorney's trust account pending resolution of a fee dispute.[22]

Normal tax principles govern such a transfer of ownership. Not every transfer of fund property represents a "payment" or causes a "receipt," just as not every cash remittance does. A deposit or a loan, for example, transfers tax ownership without being a recognition event to either party.[23] However, if fund property is applied against the transferor's liability, the transfer of ownership ordinarily marks the "payment." Correspondingly, the transferee(s), if identifiable, will have a "receipt," and in most cases will be taxable on future income from the property either under the grantor trust rules or as direct owners.

In *Johnson v. Commissioner*,[24] an auto dealer put part of its proceeds from service contract sales into a trust. The Tax Court rejected the dealer's argument that it held the receipts in trust for its customers. The court concluded that the customers had given up rights to the amounts that they paid, and that the trust was to secure the *dealer's* conditional obligation to make refunds. Consequently, the dealer was taxable as owner of a grantor trust. Similarly, in Revenue Ruling 63-228,[25] the trustee for a bankrupt partnership distributed property in kind to a liquidating trust for benefit of creditors. The ruling treated the creditors as having received undivided interests in the property which they then transferred to the trust, so that the liquidating trust was a grantor trust with respect to them. Reporting aside, the results would have been much the same in both cases if the trustees were "mere" agents.

Analyzing Potential Transfers

Sometimes it is hard to tell if the transferor or transferee taxation model should apply. The critical question is whether the fund property secures a future obligation of the original transferor or whether it has already been applied to pay that obligation. Once property has been applied to satisfy an obligation, the transferor is no longer its beneficial owner. By contrast, the transfer of an obligation *secured* by a trust or other fund may also be a taxable event,[26] but does not affect tax ownership of the collateral.

The distinction between property that secures an obligation and property that has been applied against an obligation is illustrated in three early Supreme Court cases. In *Douglas v. Willcuts*[27] and *Helvering v. Leonard*[28] the Court taxed settlors on income of an alimony trust for benefit of their ex-wives, because the Court determined that they remained subject to continuing liabilities for which the trust only served as security. On the other hand, in *Helvering v. Fuller*,[29] the wife was held taxable when the divorce decree left the husband "no continuing obligation, contingent or otherwise" and no right to reversion of the property.

The same line seems to divide cases such as *Sonner*, where the trust assets were to be sold and the proceeds applied to the debtor's liabilities, from Revenue Ruling 63-228, where the property was actually transferred to the creditors. *Holywell* implicitly reinforces the analysis in the earlier Supreme Court cases discussed above. The individual's liquidating trust was held separately taxable because the grantor trust provisions did not apply, but the income of the corporation's trust was simply assumed to be attributable to the debtor. The possibility that either trust might be a grantor trust as to the *creditors* was not considered, evidently because the assets had not been applied to the debtors' liabilities.

The alimony trust cases considered both

whether the settlor husbands retained any rights to the trust property and whether their continuing liabilities had been extinguished. The key consideration seems to be the status of the property rather than the liability. Confirmation of the bankruptcy plans in *Holywell* and *Sonner* may have limited the debtors' liability,[30] but the debtors retained beneficial ownership and — in *Holywell*,[31] and probably in *Sonner* – at least theoretically had the right to anything left over. This was evidently enough to continue to tax the debtors on the income from the property. This conclusion is reinforced by authorities holding that nonrecourse liabilities are still liabilities of the grantor for purposes of determining whether amounts are being accumulated to meet the grantor's liabilities.[32]

The "Homeless Fund" Problem

The basic analysis described above may give way to specific Code provisions. Section 402(b), for example, provides that "employees' trusts" will not be grantor trusts as to the beneficiaries. If the transferor/employer has transferred ownership — that is, if the assets do not merely serve as security — the trust will pay tax on its own undistributed income. Beneficiaries are taxed upon distributions from the trust's income, although under the rules applicable to annuities rather than the conventional trust rules. Beneficiaries that are "highly-compensated employees" may also be taxable on increases in the value of their interest in the undistributed assets in the trust. Alimony trusts now fall under section 682, which taxes divorced or separated spouses on trust income distributable to them that would otherwise be taxed to their ex-spouse.[33]

In each of the cases discussed above, however, the income from the trust property is being taxed either to the transferor, the transferee, or to the trust itself. The real problem arises when the transferor has given up all rights to the property and has been discharged of its obligation, but the transferees' identity is uncertain. This situation can come about because the interests of individual beneficiaries have yet to be determined, or because of disputes among the beneficiaries, or both. Traditional tax principles do not justify taxing the transferor as the owner of property to which it has given up all rights.[34] On the other hand, unidentified beneficiaries cannot be taxed on receipt of the property itself or on income that it may earn.

If the arrangement creates a trust, and the grantor trust rules do not apply, the trust will be currently taxable on its own income. Beneficiaries are taxed on distributions from trust income, and also potentially taxable as they receive principal, depending on the nature of their claims. However, in the "olden days," if the arrangement did not create a trust, there was no one to tax on undistributed income. Courts and the IRS glumly settled on taxing the transferees of these so-called "homeless funds" on principal and accumulated income when ownership was determined.[35]

Contested Liabilities: Section 461(f)

Contested liabilities add an additional wrinkle. The Supreme Court held in *United States v. Consolidated Edison Co. of New York*[36] that an accrual taxpayer could not deduct amounts paid against a contested liability. Disputed liabilities do not meet the "all events" test,[37] and the Court held that the payments did not change the result because the remittances were necessarily "mere deposits" pending the outcome of the dispute. The Court's "deposit theory" seemed to deny both cash and accrual taxpayers deductions even for amounts that were paid over, with no strings attached, pending the outcome of the dispute. This seemed especially unfair because in such circumstances the claimant would likely have to treat the amount as a receipt under claim of right, not a deposit.

Congress responded to the problem posed by *Consolidated Edison* in section 461(f), which provides that (except for foreign taxes) if a contest of the liability is the only obstacle to a deduction, the deduction is allowed when "the taxpayer transfers money or other property to provide for satisfaction of the liability." A "transfer to provide for satisfaction" of a liability may stop short of a payment. The regulations allow transfers to an escrow agent or trustee if under either a written agreement among the parties, or a court or agency order.[38]

Section 461(f) eliminated the mismatch created by *Consolidated Edison* at the cost of creating a new one. *Consolidated Edison* treated remittances that would normally be payments as deposits, denying transferors deductions even though the transferees might have income. Section 461(f) reversed the potential mismatch by treating a transfer to a fund securing a contingent liability — which would not ordinarily represent income to the claimant -- as the equivalent of a payment. This posed the question of who owned the property in the fund, and had to

report its income. The regulations specifically reserved on the subject.[39] If the arrangement creates a trust, and the grantor trust rules do not apply, the trust is probably taxable in its own right under normal trust rules.[40] Absent a trust, however, section 461(f) simply adds to the ranks of potential "homeless funds."

Section 468b and the QSF Regulations

The Deficit Reduction Act of 1984 ("DEFRA") modified the traditional "all events" test governing accrual method taxpayers. Accrual taxpayers traditionally took liabilities into account when they were fixed and their amount could be determined with "reasonable accuracy." After DEFRA, there must also be "economic performance" as to the liability.[41] The statute specified that "economic performance" occurred as to workers' compensation and tort liabilities upon payment to the person asserting the liability.[42] Regulations later extended this payment requirement to most other liabilities apart from those incurred for property, services, or the use of property.[43] Section 461(f) funds are of little use to accrual taxpayers if the dispute involves a liability subject to economic performance. "Payment" means a remittance that would entitle a cash basis taxpayer to a deduction and require a cash basis recipient to include income. Purchasing an asset to fund a liability is not treated as "payment" unless ownership of that asset is transferred to the claimant.[44]

"Designated Settlement Funds"

Congress moved to address some of the resulting problems in the Tax Reform Act of 1986. The 1986 Act added section 468B, which was enacted as a technical amendment retroactive to enactment of the economic performance rules,[45] on the grounds that DEFRA had left it unclear when payment into a settlement fund qualified as economic performance.[46]

Section 468B prescribed rules for "designated settlement funds" (DSF's) to provide for settlement of tort-like liabilities "arising out of personal injury, death, or property damage." "Qualified payments" to DSFs are treated as economic performance of covered liabilities. Except as provided in regulations, payments into other trusts or funds are not.[47] DSF's were thus envisioned as the exclusive means by which accrual taxpayers could deduct payments into settlement funds with respect to covered liabilities.

The statute provides for treatment of DSFs as separate entities taxable on their own income. DSF status requires an explicit election, and the fund has to meet several restrictive requirements:

- The fund must be established to resolve or satisfy claims arising out of personal injury, death, or property damage.
- It must be established pursuant to a court order and completely extinguish the settlor's liability.
- It must only accept "qualified payments," and be administered by persons a majority of whom are independent of the settlor. Neither the settlor nor any related person may have any beneficial interest in the fund.[48]

DSF's could not be funded while the claims were contested.[49] Moreover, the restrictions on the types of claims for which DSFs were available posed significant obstacles to their use. Complex litigation often involves a smorgasbord of claims, some of which might be eligible for DSF treatment and some not.

Section 468B(g)

The same section of the 1986 Act addressed "homeless funds."[50]

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

The quoted language, later codified by another technical amendment[51] as section 468B(g), applied to accounts or funds established after August 16, 1986. The 1986 Act legislative history observed that if the transfer to a fund were nondeductible, the fund should be treated as a grantor trust.[52] The report accompanying the codification was somewhat more forthcoming:

> It is anticipated that these regulations will provide that if the amount is transferred 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