

## FTB NOTICE

California Franchise Tax Board - Legal Division



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## FTB NOTICE 93-8

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November 15, 1993

**Subject: Qualified Settlement Funds  
Elections, Penalties, Procedures, and Filing**

### In General

Internal Revenue Code (IRC) §468B provides for the taxation of designated settlement funds and directs the Department of the Treasury to prescribe regulations providing for the taxation of an escrow account, settlement fund, or similar fund, whether as a grantor trust or otherwise.

Revenue and Taxation Code (RTC) §24693 incorporates IRC §468B by reference, with modifications to provide that a tax shall be imposed upon the gross income of the fund at a rate equal to the rate in effect under RTC §23501. This tax is in lieu of any other tax imposed by part 10 (Personal Income Tax) and part 11 (Bank and Corporation Tax) of the RTC upon or measured by that income.

Pursuant to IRC §468B, the Treasury promulgated regulations providing for the taxation of qualified settlement funds, including designated settlement funds. See Treas. Reg. §1.468B-0 to §1.468B-5.

Subdivision (f) of RTC §23051.5 provides as follows:

In the absence of regulations of the Franchise Tax Board, where provisions of this part [the Bank and Corporation Tax Law] conform to the Internal Revenue Code, regulations adopted under the Internal Revenue Code shall govern the interpretation of comparable provisions in this part, with due account for differences in federal and state terminology, effective dates, .... and other obvious differences.

Legal Ruling 93-4 (November 15, 1993) describes the California tax consequences applicable to a qualified settlement fund established pursuant to the order of a California court.

### Elections

NOTE: ((---)) = Indicates obsolete information.

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Treasury regulations under IRC §468B permit various elections. In particular, Treas. Reg. §1.468B-1(j) permits a "relation back" election and Treas. Reg. §1.468B-5(b)(2) permits an election to apply rules to a qualified settlement fund for periods after August 16, 1986 and before January 1, 1993. These elections are also available for purposes of the RTC.

Pursuant to RTC §23051.5(g), a proper election for federal purposes is deemed to be a proper election for purposes of the RTC. A copy of the federal election must be provided to the Franchise Tax Board upon request.

To obtain treatment other than that elected for federal purposes, a separate election must be filed with the Franchise Tax Board at the time and accompanying the return for which the election is to be effective.

Penalties

Treas. Reg. §1.468B-5(b)(1) provides transition rules for the taxation of (i) transfers to, income earned by, and distributions made by, funds, accounts, or trusts established after August 16, 1986, but prior to February 15, 1992, occurring after August 16, 1986 and before January 1, 1996, and (ii) transfers to, income earned by, and distributions made by qualified settlement funds established after February 14, 1992, but before January 1, 1993, occurring before January 1, 1993. The Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation used by these funds. Methods of taxation considered reasonable are those that treat the fund as: (A) a grantor trust and the transferors are the grantors; (B) a complex trust and the transferors are the grantors; or (C) a designated settlement fund.

Treas. Reg. §1.468B-5(b)(1)(v) provides as follows:

(v) Waiver of penalties. For taxable years beginning prior to January 1, 1993, if a fund, account or trust is subject to section 468B(g) and the Internal Revenue Service does not challenge the method of taxation for transfer to, income earned by, and distributions made by, the fund pursuant to paragraph (b)(1)(i) or (b)(1)(ii) of this section, penalties will not be imposed in connection with the use of such method. For example, the penalties under section 6655 for failure to pay estimated tax, section 6651(a)(1) for failure to file a return, section 6651(a)(2) for failure to pay tax, section 6656 for failure to make deposit of taxes, and section 6662 for accuracy-related underpayments will generally not be imposed.

Treas. Reg. §1.468B-5(b)(2) permits the person that will be the administrator of a qualified settlement fund to elect to apply qualified settlement fund rules, as reflected in Treas. Reg. §1.468B-1 through 1.468B-4, to transfers to, income earned by, and distributions made by the fund in taxable years ending after August 16, 1986.

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Treas. Reg. §1.468B-5(b)(2)(iv) provides as follows:

(iv) Computation of interest and waiver of penalties. For purposes of section 6601 and section 6611, the income tax return for each taxable year of the qualified settlement fund to which the election applies is due on March 15 of the year following the taxable year of the fund. For taxable years of a qualified settlement fund ending prior to January 1, 1993, the income earned by the fund is deemed to have been earned on December 31 of each taxable year for purposes of section 6655. Thus, the addition to tax for failure to pay estimated tax under section 6655 will not be imposed. The penalty for failure to file a return under section 6651(a)(1), the penalty for failure to pay tax under section 6651(a)(2), the penalty for failure to make deposit of taxes under section 6656, and the accuracy-related penalty under section 6662 will not be imposed on a qualified settlement fund if the fund files its tax returns for the taxable years ending prior to January 1, 1993, and pays any tax due for those taxable years, on or before March 15, 1993.

No regulations of the Franchise Tax Board provide authority to impose the penalties described above on designated settlement funds, qualified settlement funds, or funds, accounts, or trusts in the circumstances described in Treas. Reg. §1.468B-5.

Penalties under the RTC specifically conform to, or are sufficiently similar to be considered comparable to, penalty provisions of the IRC. For example, RTC §25961 (underpayment of estimated taxes) is comparable to IRC §6655, RTC §25931 (failure to file a return) is comparable to IRC §6651(a)(1), RTC §25934.2 (underpayment of corporate tax) is comparable to IRC §6651(a)(2), and RTC §25935 (accuracy-related penalty) specifically conforms to IRC §6662. (No provision of the RTC imposes a penalty for failure to deposit taxes as provided in IRC §6656.)

Pursuant to RTC §23051.5(f), penalties under the RTC which conform to penalties under the IRC will not be imposed in those circumstances described in Treas. Reg. §§1.468B-5(b)(1)(v) and 1.468B-5(b)(2)(iv).

Corporate Procedure and Administration

For purposes of subtitle F of the IRC (relating to procedures and administration such as information and returns, time and place for paying tax, assessment, collection, abatements, credits, refunds, limitations, interest, additions to tax, jeopardy, etc.) a qualified settlement fund, including a designated settlement fund, is treated as a corporation.

Treas. Reg. §1.468B-2 requires a qualified settlement fund to use a calendar year and accrual accounting. The fund administrator must file a federal return for each period the

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fund is in existence by March 15 of the following year unless an extension is approved. A return is required regardless of whether or not the fund receives gross income subject to tax. In addition, the administrator must obtain a federal employer identification number for the fund. IRS Form 1120-DF is used to file the federal income tax return of a qualified settlement fund.

Pursuant to RTC §23051.5(f), a qualified settlement fund is treated as a corporation for purposes of procedure and administration under the RTC.

Requirement to File a California Return

In the absence of evidence establishing a commercial domicile elsewhere, every qualified settlement fund established pursuant to the order of, or approved by, and subject to the continuing jurisdiction of, an agency or instrumentality (including a court of law) of the United States or the State of California (or a political subdivision thereof) located in California is considered to have a commercial domicile in California. See Legal Ruling 93-4 (November 15, 1993). As a result, each such qualified settlement fund is required to file a California income tax return. The requirement to file a California return does not depend on the receipt of income subject to tax under RTC §24693.

A California return is also required if a qualified settlement fund receives or expects to receive income from a California source, i.e., real or tangible personal property located in California, and intangible personal property with a business or taxable situs in California.

Form and Instructions for California Return

Although a qualified settlement fund is treated as a corporation for filing and reporting purposes, it should file its California income tax returns using California Form 541, prominently annotating the return "QSF" in red in the top margin, and attaching a copy of its federal return (IRS Form 1120-DF) and any statements and/or elections required by Treasury regulations. Returns are due two months and fifteen days after the close of the taxable year. Since a qualified settlement fund is required to use a calendar year accounting period, the return for a qualified settlement fund will be due on March 15 unless the fund terminates during the year.

An income tax return filed prior to December 31, 1993, for a qualified settlement fund, using California Form 100 and accompanied by a federal return and appropriate statements and elections, will not be rejected as an improperly filed return.

**DRAFTING INFORMATION**

The principal author of this notice is Patrick J. Kusiak of the Franchise Tax Board Legal Division. For further information regarding this notice, contact Mr. Kusiak at the Franchise Tax Board Legal Division, P.O. Box 1468, Sacramento, CA 95812-1468.