Qualified Settlement Funds In Corporate Transactions

By Robert W. Wood

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In this article, Wood argues that qualified settlement funds, with their apparent immunity from normal constructive receipt and economic benefit tax concerns, could make an attractive solution for a corporate transaction.

Qualified settlement funds, also called QSFs or section 468B funds, are often used to resolve litigation. Under regulations that took effect in 1993,[1] QSFs may be used — not unlike an escrow — to bring virtually any kind of claim to resolution. That includes claims that are not the subject of litigation.[2] Of course, they are not escrows and are decidedly better tools.

The primary objective of a QSF is to gather and administer cash or assets, and to determine the amounts and exact nature of payments each claimant will receive. QSFs are flexible and easy to establish. Unlike an escrow, which requires that one party generally be treated as the owner of the fund and pay tax on the income, a QSF is a true intermediary.

A QSF may simply consist of a fund or account segregated from the defendant's other assets.[3] However, most funds are more formal and are governed by a trust agreement. Paying money into a QSF offers accrual basis taxpayers an immediate income tax deduction.

Notably, that is so even if the money remains undistributed for years. The QSF therefore operates as an exception to the economic performance rules that normally allow a deduction only upon payment. They also get the defendant(s) in litigation — and potentially other payers where there is no litigation — out of the litigation process once they pay.

Legislative History

In 1984 Congress enacted restrictions that greatly curtailed the ability of companies to deduct different types of settlement payments. Congress made clear that even accrual basis taxpayers could only deduct claims for worker's compensation and tort claims when paid to claimants.[4] Before then, corporations could more aggressively deduct those payments.[5]

Those new restrictions made the payer's deduction hinge on "economic performance," generally requiring receipt by the intended payee. Accrual method taxpayers found that hard to fathom. Nonetheless, two years later, in 1986 Congress added section 468B to the tax code.[6]

Section 468B allows corporations to deduct payments to designated settlement funds (DSFs). Precursors to QSFs, DSFs are funds established to facilitate settlement payments by one or more defendants to some tort claimants.[7] Section 468B allows accrual basis taxpayers to deduct amounts paid to resolve legal claims even before the claimants receive payment.

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[1]*See* section 468B(f); reg. section 1.468B-1.

[2]*See* Robert W. Wood, *Qualified Settlement Funds and Section 468B*, para. 1.1 (Tax Institute 2009).

[3]Reg. section 1.468B-1(c)(3).

[4]Section 461(h)(2)(C).

[5]*See, e.g.*, *Ford Motor Co. v. Commissioner*, 71 F.3d 209 (6th Cir. 1995).

[6]Tax Reform Act of 1986, section 1087(a)(7)(A), 100 Stat. 2085 (1986); section 468B.

[7]Section 468B(d).

Nine years later, the approach in the earlier legislation was broadened and liberalized.[8] Although DSFs are still available, the 1993 regulations under section 468B allowed the use of QSFs,[9] making the earlier iteration with its more restrictive scope largely obsolete. QSFs have fewer requirements to establish,[10] provide more flexibility, and can be used for a broader range of claims.[11]

To claim a deduction for a payment to a QSF, the defendant must generally give up any right or claim to the amount paid.[12] Economic performance is deemed to occur when the payer puts money or assets into the fund. As an economic matter, the payer has given up any substantial right to the amount transferred.[13] And yet the possibility of a reversion, and a reversion in fact, will not spoil QSF treatment. It is only necessary for the reversion to be based on events beyond the control of the payer/recipient.[14]

Tax Characteristics

There are three general requirements for forming a QSF. It must be: (1) established under a court order or an order of a federal, state, or local government authority; (2) established to resolve or satisfy one or more contested or uncontested claims asserting specific types of liability; and (3) a trust under state law or its assets must be segregated from other assets of the transferor. QSFs are usually established by court order.[15] However, they can be approved by any government authority (for example, the SEC, the Environmental Protection Agency, or a state agency). Moreover, QSFs can be established to resolve essentially any legal claim. Litigation leading to a QSF is customary but not required. Notably, a QSF is not elective, and QSF status trumps all other entity classifications.[16]

If the three general requirements are satisfied, the entity, trust, or account is classified as a QSF, regardless of the intent of the parties, and no election is permissible. The mandatory nature of QSFs is not always welcome. For example, in *United States v. Brown*,[17] the taxpayers were victims of an investment fraud.

In *Brown*, the court transferred assets from the perpetrators of the fraud to an estate. The taxpayers, German citizens who had been defrauded, argued that the estate should not be treated as a separate taxable entity. Nevertheless, the Tenth Circuit determined that it was a QSF.[18]

Once formed, a QSF effectively operates as an intermediary between the parties, taxable in its own right at corporate tax rates.[19] Still, a QSF is only taxable on the income it earns.[20] It is generally not taxable on amounts transferred to it from a transferor.[21] Even prejudgment interest is excludable from the QSF's gross income.[22] Thus, a transfer to a QSF generates a deduction for the defendant without any corresponding inclusion by the QSF. That is a key feature of every QSF.

Although section 468B may have been enacted primarily to facilitate deductions by defendants, QSFs have significant advantages for all parties. The chief advantage for intended recipients of the funds, of course, is deferral, along with the time to consider the form and manner of payment. The character of the payment will be unaffected by the QSF.

The tax treatment of a distribution from a QSF to a claimant is determined by reference to the claim that relates to the distribution.[23] For example, a distribution to a claimant for personal physical injuries is excludable from income under section 104(a)(2) if a payment directly from the transferor would be excludable.[24] The tax doctrines of constructive receipt and economic benefit appear to be completely trumped by the QSF.

In the litigation context, the QSF stands in the shoes of the defendant. Thus, even though the defendant may be out of the picture, the money in

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[8]*See* section 468B(g)(1); reg. section 1.468B-5(a).

[9]*See* section 468B(g)(1) (providing authority to Treasury to prescribe applicable regulations); reg. section 1.468B-5(a) (providing the effective date for the QSF regulations).

[10]*Compare* reg. section 1.468B-1(c) (listing three major requirements for QSFs) *with* section 468B(d)(2) (listing six elements to establish a DSF).

[11]Wood, *supra* note 2, at ch. 13.

[12]*See* reg. section 1.468B-3(c)(2) (economic performance does not occur if the taxpayer (i) has a currently exercisable right to a reversion or refund or (ii) has a reversionary interest that is only subject to a condition that is certain to occur or that is subject to illusory restrictions).

[13]Several letter rulings, apparently concerning tobacco litigation, ruled that funds qualified as QSFs even when defendants held reversionary interests when defendants expected claims to exhaust all amounts transferred to the QSF. *See, e.g.*, LTR 200951001; LTR 200821019. In some cases, the IRS has even held that funds qualified as QSFs when defendants retained a right to all interest income earned by the fund and could sell that right to third parties. *See Kelly Capital LLC v. S&M Brands Inc.*, 873 F. Supp.2d 659, 663 (E.D. Va. 2012) (describing the ability of a tobacco company to sell ''escrow release'' consisting of right to interest income of a QSF).

[14]*See* Wood, ''Qualified Settlement Funds Pending Appeal?'' *Tax Notes*, July 12, 2010, p. 207.

[15]Reg. section 1.468B-1(c).

[16]*See* T.D. 8459 (Dec. 18, 1992); reg. section 1.468B-1(b).

[17]348 F.3d 1200 (10th Cir. 2003).

[18]*Id*. at 1211.

[19]Reg. section 1.468B-2(a).

[20]Reg. section 1.468B-2(b)(1).

[21]*Id*.

[22]Reg. section 1.468B-2(n), Example 1; LTR 200717013.

[23]Reg. section 1.468B-4.

[24]*Id*.

the QSF is not treated as a set-aside for the benefit of the claimants. Until the QSF makes a payment or distribution, there is no economic benefit or constructive receipt.

In describing the tax treatment of a distribution to a claimant, the Treasury regulations suggest that a claimant does not receive the funds until the distribution by a QSF is actually made. Congress evidently intended that QSFs operate as a statutory exception to the economic benefit and constructive receipt doctrines.[25] The importance of that congressional override cannot be overstated.

Tax Neutrality

QSFs are tax neutral, and the tax treatment of the settlement or judgment is unaffected by its presence. For example, if damages qualify as tax free under section 104(a), a lump sum transferred to a QSF is excludable from a QSF's income as a qualified payment under section 468B(b)(3).

Upon a later distribution from the QSF, the payment will be excludable from the claimant's income to the same extent as if it had been received directly from the defendant. Of course, if any income is earned on the lump sum while housed in the QSF, it will be taxable to the QSF.[26]

Time Limits?

There is no express time limit on the duration or existence of a QSF. That may lead some advisers to suggest using a QSF as an incorporated pocketbook or indefinite holding account. Some of them even seem to think that is not abusive or risky. After all, they reason, the QSF will remain subject to taxation on its income. Also, without an express time limit, can't a good QSF remain so forever? That seems more than a stretch. One could argue that if there is no controversy about what each party will receive, the QSF would no longer exist to resolve claims and should cease to qualify. However, a different conclusion should be reached where legal or contractual considerations dictate if, when, and how amounts are to be paid. In any case, a QSF can clearly exist for substantial periods.

Corporate Deals and Escrows

Acquisition agreements often require that a portion of the purchase price be placed into an escrow account. Often, the documents say that monies are to be released after the expiration of a date or the occurrence of one or more specified events. Buyers often insist on an escrow to guarantee the performance of the seller or to protect themselves from unknown or contingent liabilities.

Moreover, although escrows are rarely the idea of the seller, the seller may reap advantages too. They can sometimes use an escrow to defer some of the gain on the sale until the escrowed funds are released. But one of the dilemmas of the escrow is the overriding question of who owns and is taxed on it. Indeed, cash basis taxpayers face a dilemma with an escrow. They may not even have to actually receive the escrowed portion of the purchase price for it to be treated as income to them.

Axiomatically, cash basis taxpayers must report income when they actually or constructively receive it. If cash or property is placed in escrow and the taxpayer has no right to control the assets, the amount is generally not taxed until the contingency is met and the funds are released. Nonetheless, if the taxpayer exercises significant dominion and control over the assets in escrow, they are typically viewed as constructively received by the seller despite the existence of the escrow.

In short, one can be treated as in receipt of money even when not actually in possession of the money. Most sellers put a major emphasis on getting access to and ownership of the escrow. Even so, the constructive receipt issue can make timing messy.

For example, if the seller is deemed to have constructively received escrowed amounts, the seller will recognize gain even though the seller does not have access to the escrow. What if the escrow is of assets or instruments that fluctuate in value, such as stock? The seller may have additional gain due to those fluctuating balances.

It can be frustrating as a seller who recognizes gain based on the fair market value of the stock on the closing. It is even worse if the stock (on which one has already paid tax) declines in value.

Modest Proposal?

Most escrows are relatively short-lived. Furthermore, the tax problem associated with which party pays the tax on the earned income of the escrow is usually not momentous. Nevertheless, using a QSF instead of a traditional escrow to affect the consummation of a corporate deal may be worth considering in at least some cases.

Unlike an escrow, a QSF is a statutory (or perhaps more accurately, a statutory-regulatory) vehicle. That means that income earned on the funds during the term will be taxable solely to the QSF. Even if it is clear that the buyer or the seller will ultimately receive the corpus and the interest, the corpus is taxed to no one until it is distributed. The income earned on the fund is taxed to the QSF itself.

The rules for QSFs, in short, are vastly clearer than those for escrows, where the facts and circumstances matter, and there are many concerns regarding escrow funds. Who pays the tax is only one of them. In some cases, however, the tax worries affect

[25]Reg. section 1.468B-2(b)(1).
[26]*Id.*

drafting and can even influence the ultimate disposition of the escrow. The tax tail can wag the dog.

The QSF, in contrast, is entirely tax neutral. That, together with its apparent immunity from normal constructive receipt and economic benefit tax concerns, could make it an attractive solution for a corporate transaction.