Do Pooled and Law Firm Qualified Settlement Funds Qualify as QSFs?

by Robert W. Wood and Alex Brown

Robert W. Wood

Alex Brown

Robert W. Wood (Wood@WoodLLP.com) and Alex Brown (Brown@WoodLLP.com) are tax lawyers with Wood LLP in San Francisco.

In this article, Wood and Brown examine pooled qualified settlement funds under section 468B and explore whether and how they should be used.

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Qualified settlement funds (QSFs) provide a safe and easy way to resolve claims, pay lawyers, negotiate liens, and arrange structured settlements and structured legal fees. Having the defendants out of the picture can present material advantages. Historically, QSFs were used primarily in cases having many plaintiffs and defendants. They are still ideal for that but are used far more widely today.

Section 468B and its regulations, which authorize the establishment of QSFs, were designed to give defendants immediate income tax deductions, even though it could be years before money is dispersed to plaintiffs. Normally, defendants cannot claim tax deductions for settlement payments until there is economic performance, requiring receipt by plaintiffs. QSFs are separate taxable entities, so they operate as tax-neutral intermediaries.

During the time a QSF holds funds, plaintiffs are not treated as receiving anything until they actually do. It may be clear how much each plaintiff will receive, but they have no income until distributions from the QSF occur. Among other benefits, QSFs give plaintiffs time to consider structured settlements, whether the proceeds are taxable or tax free.

The Big Three

Reg. section 1.468B-1 sets forth the three foundational requirements that must be satisfied for a fund, account, or trust to qualify as a QSF. The fund, account, or trust must be:

1. established under an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continuing jurisdiction of that governmental authority;[1]
2. 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 (i) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 . . .[2]

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

[2] 42 U.S.C. section 9601 et seq.

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or (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the commissioner in a revenue ruling or revenue procedure;[3] and
3. the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from the other assets of the transferor (and related persons).[4]

What Are Pooled QSFs?

Forming a QSF for a specific case is still safest and best. Yet one hears about law firm QSFs (for some or all cases of a single law firm), master QSFs, or pooled QSFs. These terms are not precisely defined and are industry-created terms rather than derived from tax law, but here is how we hear them used. A master QSF may involve sub-QSFs established within the master QSF. Each sub-QSF may itself qualify as a QSF.

A pooled QSF does not necessarily imply a parent-subsidiary arrangement and may simply involve cases being added to or joined to an existing QSF. A law firm QSF could be structured as either a master QSF with distinct sub-QSFs or as a pooled QSF. Yet all three terms describe similar structures, and the term "pooled QSF" arguably covers them all. A traditional non-pooled QSF typically contains claims by one or more plaintiffs against one or more defendants that were litigated in the same or related legal action, addressing claims arising from a single event or related series of events.

In contrast, a pooled QSF may hold claims against different defendants by different plaintiffs, potentially involving different legal actions. The perceived benefit of a pooled QSF is that a plaintiff or lawyer who does not wish to establish a new QSF can use the preexisting pooled QSF to help resolve the claims. Although QSFs can be established rather quickly, particularly by companies that specialize in forming QSFs, many plaintiffs and defendants want to settle litigation quickly once the substantive terms of the settlement have been negotiated.

Whether or not their perception is accurate, some litigators find pausing a settlement to form a QSF to be an inconvenience. Even more inconveniently, the pause tends to spring forth right at the moment parties are most eager to simply put ink to paper and be done. Unsurprisingly then, some lawyers are attracted to using a pooled QSF that in their estimation facilitates settlements by allowing a claim to be added to an existing QSF more quickly than it would take to form a new one.

Adding Claims

With pooled QSFs, claims can be added by a joinder agreement. Joinder agreements formally add claims to be resolved through a QSF. Joinder agreements can also contain additional provisions about how claims will be resolved. Ideally, joinder agreements are approved by a court, so the court is approving the claims as part of the QSF. The idea is that the joinder agreement can be treated as a separate sub-QSF.

Indeed, a well-drafted joinder agreement will itself contain language to satisfy all the requirements for a QSF under the regulations. In that sense, a pooled QSF that uses court-approved joinder agreements can be seen as a collection of separate QSFs that all happen to use the same name, employer identification number, trustee, operating agreement, supervising court, and tax return for efficiency. If a pooled QSF gets court-approved joinder agreements every time, that should eliminate most, perhaps even all, concerns.

If the joinder agreement is carefully drawn, it should mean that each case really has its own QSF, even if it is nominally part of the master (there's the master QSF concept again). But when you do not have those court-approved joinders, is there a problem? Of course, a pooled QSF is only attractive if it is in fact a QSF.

Therefore, a key question is whether a pooled QSF can qualify as a QSF under the regulations. If the pooled QSF is set up like most QSFs, we think we can assume that it does qualify on most of the fundamentals. That is, no one seriously contests that a pooled QSF can be a trust under state law, and no one seriously contests that a pooled QSF cannot be formed under the supervision of a court or other qualifying government entity.

[3] Reg. section 1.468B-1(c)(2).

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

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That allows us to focus on the key question that is sometimes debated for pooled QSFs: Do all cases in a law firm QSF or other pooled QSF arise from an event or related series of events? That is necessary for the QSF to qualify.

The big query with pooled QSFs is the "resolve or satisfy" requirement. The main questions are: (1) the meaning of "related" and (2) whether all the events that created claims must have occurred before the pooled QSF was formed, or whether claims arising from events that occurred after the pooled QSF was formed can be added to a preexisting pooled QSF.

Before we look at the authority, what are the common questions? Might claims of sexual abuse against members of the same organization (for example, the Boy Scouts of America or the clergy of a particular church) be considered related events even if the plaintiffs filed separate suits? One can argue they should be. Claims involving the same torts (for example, workplace sex discrimination and sexual harassment), particularly when pursued by the same plaintiffs' counsel, arguably may be, too.

Is there an abuse if a law firm has a single QSF for all its asbestos cases? Court-approved joinder orders should eliminate much of the concern in that case. But what if the law firm doesn't do that? Is there reason to be concerned, and what are the legal standards?

Related Series of Events

A QSF must be established to resolve or satisfy claims that have resulted or that may result "from an event (or related series of events)." Therefore, a threshold question is whether the events being resolved within a pooled QSF are sufficiently related. The meaning of "related" for purposes of reg. section 1.468B-1(c)(2) is unclear. Yet the phrase "or related series of events" appears later in the same regulation — reg. section 1.468B-1(h)(2).

Reg. section 1.468B-1 provides that some types of claims cannot be resolved through a QSF. Reg. section 1.468B-1(h)(2) provides that "excluded liabilities" (that is, claims that are prohibited from being resolved through a QSF) can be resolved through a QSF if and only if the excluded liability arises from "the same event or related series of events" as a claim that can be and is being resolved through the same QSF. In LTR 9549026, the IRS considered the "related series of events" language in the context of paragraph (h)(2) and found the language to have legal effect, limiting the scope of potential claims that could be resolved through a QSF.

One can read this as pretty damning to the pooled QSF concept. Yet notably, this private letter ruling considered the "related" phrase in paragraph (h)(2), not the similar phrase in paragraph (c)(2). The IRS ruled that the entire trust did not qualify as a QSF. The language in both paragraphs of reg. section 1.468B-1 is similar, but the context and function in the two sections seem different. The language in (h)(2) provides a limited exception to a limitation on QSFs. The "related series of events" language allows claims that otherwise cannot be resolved through a QSF, by way of the exception, to be resolved through a QSF.

In that context, the IRS construes the language narrowly in LTR 9549026. Otherwise, the exception might swallow the rule. However, the "related series of events" language in paragraph (c)(2)'s resolve or satisfy requirement uses paired phrases to expand the scope of claims that can be resolved through a QSF. The language casts the QSF net wider rather than limiting the permissible scope of QSFs.

The "related series of events" language is not surplusage, but this phrase seems different from its use in paragraph (h)(2), which was considered in LTR 9549026. For paragraph (c)(2), if the "related series of events" language were to be construed more liberally, it wouldn't necessarily result in claims that wouldn't qualify for resolution through a QSF.[5] Instead, arguably the result is primarily efficiency and convenience.

The main result would be that claims that could be resolved through separate QSFs could instead be resolved through the same QSF. It seems unlikely that Treasury's intent in including the language in paragraph (c)(2) was to require

[5]The most glaring exception to this might arguably be if a legal action involving a single plaintiff with a single claim were joined to a pooled QSF. That is, does using a pooled QSF convert what would be a controversial "single-claimant QSF" into a multi-claimant QSF, allowing QSF resolution for a claim that, some argue, could not be resolved through a QSF on its own? In any case, treading into the still-churning waters of the single-claimant QSF discussion is beyond the scope of this article.

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plaintiffs to establish separate QSFs when one would suffice, particularly when those additional burdens would not appear to generate revenue for the IRS.

Instead, it seems more logical to believe that Treasury was trying to prevent taxpayers from setting up QSFs and obtaining tax deductions for liabilities and events not yet existing. After all, the primary intended beneficiary of the QSF regulations was not the plaintiff, but the defendant. The QSF regulations were created to allow defendants to consider the payment to the QSF to be economic performance. Accordingly, the QSF regulations are generally designed to prevent defendants from abusing QSFs to unfairly accelerate tax deductions for settlement payments.

Allowing defendants to fund QSFs before an event that could give rise to liability has even occurred seems inappropriate. Without the "related series of events" language, defendants might conceivably try to treat QSFs as savings accounts or reserves against inchoate or theoretical future liabilities, paying in and claiming deductions whenever they want additional tax deductions. Requiring the QSF to resolve at least one claim that has 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*"[6] arguably prevents QSFs from being formed too early (emphasis added).

Treasury's concern about defendant abuse of QSFs also shows up in other parts of the regulations. Reg. section 1.468B-3 contains other provisions designed to avoid abuse, including when property transferred to a QSF must be appraised to qualify for a deduction. They also say when reversionary rights cause defendants to lose a deduction. If these provisions are read to be aimed at preventing defendant abuse of QSFs, then they do not seem to bear much on the legitimacy of pooled QSFs. If a case is joined to an existing pooled QSF at settlement, then the payment by the defendant to the pooled QSF would naturally occur well after the event giving rise to the plaintiff's claim occurred and after the plaintiff asserted liability.

'That Have Occurred'

A QSF must be "established" to resolve or satisfy a claim or claims "that have resulted or may result" from an event or related series of events "that has occurred." This suggests that some claims may arise after the QSF is formed, but the event creating the liability evidently must occur before the QSF is formed. Some commentators argue that pooled QSFs do not qualify because as new claims are added, the new claims may arise from events that occurred after the pooled QSF was formed.

One can certainly read it that way, but a contrary reading seems equally plausible. The resolve or satisfy requirement says a QSF must be *established* to resolve a claim arising from an event that has occurred and that has already given rise to at least one claim asserting liability. It seems unlikely that Treasury intended to prevent taxpayers from adding claims from an unambiguously related event to a QSF merely because the related event occurred after the QSF was formed.

If a QSF is established at the appropriate time (that is, after at least one event that has given rise to at least one claim), there would not appear to be a reason to prevent claims from related events from being added to the QSF once those events have also occurred. T.D. 8459 elaborates on the purpose, scope, and language of the resolve or satisfy requirement:

> One commentator requested that the final regulations clarify whether all potential claims must be asserted before a fund, account, or trust satisfies the requirement of section 1.468B-1(c)(2) [namely, the resolve or satisfy requirement]. In response to this comment, the final regulations clarify that even a single claim satisfies the requirement.[7]

This language discusses the timing of claims, not the timing of the events giving rise to the claims. Treasury appears to have intended QSFs to be able to include later arising related claims that were not alleged at the time the QSF was formed. That may be the case for related but later

[6] Reg. section 1.468B-1(c)(2).

[7] T.D. 8459; *see also* reg. section 1.468B-1(b).

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events, too. Reg. section 1.468B-1(c)(3) requires that the fund "is" a trust or that its assets "are" otherwise segregated from the assets of the defendant.

This implies that the QSF must always maintain this requirement, although the resolve or satisfy requirement suggests that the QSF must be "established" to resolve or satisfy a claim or claims arising from an event that has already occurred. The language requiring the event to have occurred appears to apply only to claims for which the QSF was originally established. By its text, the resolve or satisfy requirement does not appear to address whether any subsequent claims added to a QSF must arise from events that have already occurred at the time the QSF was established.

Still, there is a potential for abuse, and the IRS could challenge any it sees. If a defendant created a QSF to resolve a claim that has already been asserted arising from an event that has occurred, and the defendant accelerated deductions by contributing heavily to the QSF for hypothetical claims arising from events that have not yet occurred, the IRS could challenge it. But it is not clear that the resolve or satisfy requirement should prevent a later occurring related event and its related claims from being resolved through a QSF that was already properly formed.

Conclusions

It is difficult to reach conclusions on this topic, which, in some sectors, is controversial. Pooled QSFs are out there, and there seems to be no uniform practice or view concerning them. It is unclear whether the IRS is aware of pooled QSFs, or if it is, whether it perceives any abuse. We believe that the IRS generally likes QSFs and that it embraces QSFs much the way lawyers and litigants have — with open arms.

However, with only the regulations dating from 1993 and the veritable explosion in the use of QSFs in myriad ways since then, it is impossible to know. Besides, the IRS is not one person but rather a vast organization with many evolving viewpoints. There is also this immensely practical point: Given that QSFs are easy to set up, are pooled QSFs really needed?

It may depend on who you ask. Suppose that you are a structured settlement broker. Your favorite lawyer tells you that he just settled a big case, and the money is in his interest on lawyers trust account (IOLTA).[8] He might even ask you about structured legal fees and structured settlements for his clients, perhaps a whole group of them. That kind of call might make you love the idea of an evergreen QSF.

We do not know how many of those calls might occur or whether they may help explain the phenomenon. There may be a kind of shorthand, with the lawyer being told, "Next time, put the money in the QSF, not your IOLTA." Perhaps there is a risk that the lawyer will get sloppy, treating the QSF and the IOLTA as both run by him, whatever the QSF documents say. That seems like a big potential danger over time.

Plainly, preestablished QSFs can streamline case settlements and avoid a midnight scramble when an unanticipated settlement needs to be grabbed and quickly documented. That seems to be the major (and perhaps only) selling point of pooled QSFs. Perhaps they are the plaintiff lawyer's analog to "Don't leave home without it." But if you are risk averse, are there risks?

To answer that, the key questions would seem to be: How is the QSF used, for how long, with what connection between claims, counsel, defendants, etc.? Those factors are going to vary materially, and they may be hard to pin down when someone asks generally about pooled QSFs. You cannot evaluate the degree to which the IRS would likely care without answers to these and other factual questions. The details are going to matter, probably a great deal.

Where does the money go, and how is it used after it comes out of the pooled QSF? A structured legal fee and related loan done from a pooled QSF may give the IRS one more argument if it doesn't like the structured fee and loan. Alternatively, the IRS might not even comment on the pooled QSF.

If you are going to use pooled QSFs, it's best to have something finite, such as addressing only sex abuse cases, only medical device cases, etc. Aim to strive for commonality of events, topics, parties, or counsel. You need not have all of these, but the more boxes you can check, the less you

[8] Perhaps if it was a segregated trust account, one could consider a relation-back election to try to turn the account into a QSF, but we leave that bit of sophistry to the side.

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may worry. Of course, some lawyers and advisers may not worry at all.

Depending on your facts, your risk may not be high. Yet the possibility that a QSF might be disqualified and lose its status as such (retroactively?) is sort of like an anvil falling on Wile E. Coyote. Thus, if you are going to use a pooled QSF, we would suggest implementing joinder orders/agreements every time and having a subtrust for each one. Indeed, if you can, try to make each new case qualify as a QSF itself with a joinder order that is approved by the court or governmental entity.

That way, the high-rise QSF is really made up of a bunch of apartments that each qualify as a QSF. It doesn't seem that this defeats the pooler's purpose, particularly if the timing of the joinder orders could be relaxed. Of course, those precautions (a real belt and suspenders) may not be needed. But why not?

With all these precautions, problems seem unlikely. But with some of them missing, it is an open question. And with all of them missing, could you be low-hanging fruit? It's just unclear. And if the much more vitriolic and long-standing single claimant issue is still not one that the IRS has offered to expressly resolve, the comparatively more yawning pooled QSF question seems unlikely to be concluded anytime soon. There are many respects in which the QSF regulations need to be updated and modernized, and perhaps this topic should be added to the list. ■

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