

IRS Rules Give Lawyers Leeway On Qualified Settlement Fund Setup

By Robert W. Wood and Alex Z. Brown

A qualified settlement fund is commonly interposed between plaintiffs and defendants when a lawsuit is settled. Funds are sent to the QSF instead of to the lawyer's trust account. QSFs were put into the tax law in 1993, ostensibly so defendants could deduct settlement payments immediately upon payment to the QSF, even though it might take years for disputes among plaintiffs and lawyers to be resolved and amounts to be paid out. The normal tax rule is that a defendant can deduct a payment when the plaintiff receives it, so QSFs were meant to help defendants.

Of course, they help plaintiffs and lawyers too, and despite the origins of QSFs, they are most frequently invoked by the plaintiff side of a case. The reason is that QSFs are enormously flexible, enabling defendants to get a complete release, while plaintiffs do not have receipt of the funds for tax purposes. Even if there are no disputes between plaintiffs and their lawyers, a QSF allows plaintiffs time to evaluate structured settlement alternatives, and to make decisions without involving the defendant.

Some defendants try to block the use of QSFs so they can participate in selecting structured settlements they want plaintiffs to use or for other reasons. Some defendants raise objections about particular QSF providers or about how the QSF was set up. Some QSF administrators are trustees and trust companies, while others are bank or escrow companies. Some commentators argue that a QSF *must* be a trust or that its administrator must be licensed or registered as a trust company.

There is nothing wrong with QSFs established as trusts, and many or perhaps even most QSFs have historically been formed that way. Trust companies are subject to special fiduciary rules regarding their actions as trustees under established trust law. However, QSFs are not *required* to be set up as trusts.

The IRS regulations state that a QSF can be organized as a trust under state law, *or* that a QSF's assets can otherwise be segregated from the assets of the transferor. This "or" language is not accidental. The IRS regulations on QSFs state that if a QSF "is not a trust under applicable state law, a fund, account, or trust satisfies the requirements [...] of this section if its assets are physically segregated from other assets of the transferor." Under the QSF regulations, the transferor to the QSF is usually the defendant, even when the settlement is actually paid by its insurer. Accordingly, so long as the account established for the QSF does not also contain unrelated assets of the defendant, the segregated-account requirement should be satisfied.

Thus, the IRS allows QSFs to be organized as something *other* than trusts. The IRS regulations on QSFs say that a defendant opening a segregated bank account and setting funds aside for settlement satisfies the segregation requirement. The IRS Form 1099 reporting regulations are to the same effect. So, non-trust QSFs are valid.

Some are formed as escrow accounts, with the bank or an escrow company serving as an institutional administrator. The QSF regulations contain no requirements that a QSF administrator be a professional fiduciary such as a trust company or escrow company.

In short, QSF administrators can be individuals. For example, retired judges or attorneys may be selected as administrators. If a QSF is formed as a trust, these individual administrators can also be the trustee under state law. For QSFs not formed as trusts, individual administrators may simply be granted signature authority over a bank account opened in the name of the QSF. Under either approach, the assets of the QSF are segregated from the assets of the defendant-transferor.

Of course, there may be logistical and non-tax considerations bearing on the choices for forming a QSF and its administrator. The QSF regulations give claimants and their counsel the flexibility to form a QSF that is tailored to their situation.

Some commentators also argue that QSFs *must* be approved and supervised by a *court*. That too is *not* a legal requirement in the tax law to have a valid QSF. Many QSFs are approved and supervised by courts, and a court can be a ready resource in the event of disputes. Courts have well-established procedures for considering and deciding issues that may arise.

But the tax law does not *require* that a court of law be the governing authority that approves and supervises a QSF. A court of law is an *example* of a qualifying government instrumentality that is specifically identified in parenthetical in the IRS regulations, but it is not the only permissible government authority. The IRS regulations say that a QSF can be approved by and subject to the continuing supervision of any "agency or instrumentality" of the federal government, a state government (including the District of Columbia), or "a political subdivision thereof."

County and local governments are political subdivisions of their states, so they also fall within the definition of a qualifying governmental authority that can approve and supervise a QSF. The fact that the regulations include agencies of governments indicates that a supervising governmental authority can be in the executive branch of a government, not solely judicial. Examples include the SEC, the EPA, a city or county, or many other government agencies. Thus, a valid QSF can be formed as a segregated account that is approved and supervised by a non-court governmental authority, so long as that authority can generally be said to fall within the definition of an agency or instrumentality of a federal, state, county, or local government.

Over the last thirty years, qualified settlement funds have significantly changed the way many lawsuits are brought to conclusion, and this evolution is still occurring. Some practices with QSFs can be abused, in my view. An example would be unduly prolonging the existence of a QSF and using it as a long-term tax-deferred pocketbook. Notably, these potential abuses are largely fact-specific to how a particular

QSF is administered or supervised, or fails to be adequately administered or supervised. They are not categorical failings of any particular type of QSF.

Ultimately, QSFs are creatures of the tax law. And as a matter of the requirements in the tax law, QSFs are not required to be trusts, administrators are not required to be licensed trust companies, and QSFs do not need to be approved by and subject to the continuing supervision of a court of law. They can be those things, of course, and can be effective as such, but that is a matter of preference, not the consequence of a legal requirement. In short, QSFs are more flexible than you might think.

Robert W. Wood and Alex Z. Brown practice law with www.WoodLLP.com, and Robert W. Wood is the author of “Taxation of Damage Awards & Settlement Payments” (www.TaxInstitute.com). This discussion is not intended as legal advice.