Is Borrowing From Qualified Settlement Funds Taxable?

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In this article, Wood and Board examine some of the ways that taxpayers might try to monetize their rights to future distributions from a qualified settlement fund.

This discussion is not legal advice.

Many lawsuits are settled with defendants paying into a qualified settlement fund (QSF). The defendant gets a complete release, and the defendant's tax obligations — including payroll withholding duties — generally become the QSF's.[1] The QSF handles payments to claimants and lawyers, which can be a big and messy job with lots of recordkeeping. That is so even if all the claimants have been located and are responsive.

Tax deductions and inclusions are usually reciprocal, so the payer can normally deduct a payment only when the recipient recognizes it as income or receives the payment if it is nontaxable. However, in a departure from usual tax rules, defendants can take a tax deduction for payments into the QSF when made, even though the plaintiffs and plaintiffs' lawyers do not have income until the money is actually distributed by the QSF.[2] Congress thought defendants needed assurance about their tax deductions, even though there might be complexities or delays before plaintiffs and their counsel received the funds.

QSFs are governed by section 468B. Although that section was enacted in 1986, the use of QSFs dates from 1993, when the IRS published regulations governing their creation and operation.[3] A QSF is a trust designed to hold funds after defendants settle a case but before plaintiffs receive the money.

The regulations under section 468B are detailed, but a good deal less than comprehensive. Indeed, some basic questions about QSFs remain unresolved after nearly 30 years. As the uses of QSFs have expanded into everyman's territory over the last decade or more, the number of unanswered questions has kept growing.

Commentators and industry participants have long debated whether the regulations permit a single-claimant QSF.[4] The IRS seems to have tacitly acquiesced to the use of this common

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[1] *See* Robert W. Wood, "Qualified Settlement Funds Facing Employment Taxes," *Tax Notes Federal*, May 11, 2020, p. 1009.

[2] This includes defendants using the accrual method of accounting. *See* reg. section 1.468B-3(c) (transfer to a QSF constitutes economic performance for purposes of section 461(h)).

[3] *See* T.D. 8459 (adopting reg. section 1.468B-1 to -5, effective Jan. 1, 1993).

[4] *See* Wood and Alex Brown, "Actually, Single-Claimant Settlement Funds Are Valid," *Tax Notes Federal*, Feb. 10, 2020, p. 957.

structure, but its failure to provide official guidance keeps the controversy simmering.[5] Another open question is how long a QSF can be used to postpone tax once any distributional issues have been resolved (or reasonably should have been). There must be some limit on how long the funds can sit untaxed, but the regulations under section 468B do not expressly address this.[6]

Of course, some QSFs really do need to remain open for years after the defendant has paid in the settlement cash and exited stage left. In these cases, claimants who expect a big payday can find it frustrating that "their money" is locked away, just beyond their grasp. They may find it particularly galling that the funds are languishing in the QSF's bank account — protecting principal but earning a negligible return.

Taxing Loans?

That brings us to another question about QSFs — one that appears to have attracted comparatively little attention from commentators or the IRS. Suppose that one or more claimants need (or simply want) some or all of their cash *now*, not two or three years down the road. Can they monetize all or part of their expected future distributions without triggering a taxable event or undermining the settlement fund's qualification under the regulations?

In this article, we consider several ways that a cash-hungry plaintiff[7] might try to borrow against his expected distribution from a QSF. To give the plaintiff a tax stake in the outcome, we will assume that the anticipated recovery represents lost business profits or some other item that will be taxable when distributed by the QSF. After all, if the money coming to the plaintiff from the QSF will be tax-free physical injury damages under section 104, whether money is viewed as a distribution by the QSF or something else is not such an important issue.

There are timing issues to be sure, and maybe even something that could affect a structured settlement. However, these seem of lesser magnitude. If the money will be taxable when distributed, how the monetization is viewed seems more critical.

In our discussion, we will assume that any nontax impediments to the transactions have been overcome. For example, we assume that local trust law permits a qualified settlement fund to make loans to a claimant against the fund.

Unsecured Third-Party Loans

We begin our survey with what should be an uncontroversial case. A plaintiff approaches a bank about a loan. Assume that the bank is unrelated to the QSF within the meaning of section 267, and that it has no material business relationship with the QSF. In particular, the bank is not holding any funds that are attributable to the QSF.

As part of its underwriting process, the bank confirms that there is a high probability that the plaintiff will receive a large distribution from the QSF within the next three years. Duly impressed, the bank lends the plaintiff 50 percent of his projected recovery.

Assume that the loan must be repaid, with interest, in a single installment in six years. The plaintiff does *not* grant the bank a lien on either his interest in the QSF or his interest in any proceeds that may be generated by that interest (notably, amounts actually distributed by the QSF). Because we are focusing on QSFs, we will call this an "unsecured" loan, even if the plaintiff provides the bank with a security interest in other, non-QSF-related collateral — for example, a mortgage on his house.

This unsecured third-party loan should not trigger any immediate tax consequences to the plaintiff or the QSF. Even if the bank extends credit based entirely on its expectation that the plaintiff will receive a hefty distribution from the

[5] For several years beginning in 2004, the priority guidance plans released by Treasury and the IRS targeted "guidance under section 468B regarding the tax treatment of a single-claimant qualified settlement fund." *See, e.g.*, Treasury and the IRS, "2004-2005 Priority Guidance Plan" (Dec. 21, 2004). This item fell off the list, without explanation, in 2009.

[6] The IRS might try to combat delayed distributions by invoking more general language in in the QSF regulations. A QSF must be established "to resolve or satisfy one or more contested or uncontested claim" (reg. section 1.468B-1(c)(2)), and a fund ceases to qualify as a QSF when it no longer meets this requirement (reg. section 1.468B-2(k)(2)(ii)(A)). The IRS would presumably argue that a QSF that fails to make distributions to simply defer the imposition of tax no longer exists for the purpose of "resolving or satisfying" claims.

[7] Claimants against a QSF often include attorneys, but here we will focus on plaintiffs to simplify the discussion. Under *Commissioner v. Banks*, 543 U.S. 426 (2005), a plaintiff is generally taxed on 100 percent of the total recovery, even if, say, 40 percent is distributed directly to the plaintiff's attorney. From this perspective, it is the plaintiff, not the QSF, that is paying the attorney's fee.

QSF, its expectations have no legal effect on the plaintiff's rights to future distributions or on his rights to any funds that may be distributed. Hence, we see no basis on which the bank's unsecured advance would trigger a taxable event to the plaintiff.

Unsecured QSF Loans

The regulations under section 468B do not tell a QSF how it may invest the money it receives from a defendant. What happens if the QSF decides to invest the cash in an unsecured loan to the plaintiff? Here we distinguish between "coordinated" and "uncoordinated" loans. A coordinated loan is a loan whose terms have been engineered so that the timing and amount of the plaintiff's obligations to repay the QSF coincide (more or less) with the timing and amount of the QSF's obligations to make distributions to the plaintiff.

Coordinated QSF Advances

Suppose that the plaintiff and the QSF believe that the QSF will make a substantial distribution to the plaintiff within the next 18 months. The QSF makes a coordinated loan to the plaintiff of 75 percent of the expected distribution. Although the loan officially matures in three years, it also provides that the plaintiff's repayment obligation is accelerated to the extent that he receives any distributions in the interim. The plaintiff and the QSF see no point in sending each other offsetting checks, so they agree that the QSF will apply any distribution directly to the outstanding loan balance.

If things go as the parties expect, the plaintiff will never have to come out of pocket to repay the advance. Because cash flows out of the QSF but never comes back, could the IRS argue that the "advance" is actually a distribution? The IRS has successfully challenged coordinated loans in other contexts.

In *Heyn*,[8] the taxpayer agreed to settle a dispute with his former employer for $45,500, to be paid in five annual installments of $9,100. At the same time, the former employer lent the employee $41,835, the present value of the five annual payments. The taxpayer issued five promissory notes, which exactly matched the former employer's payment obligations in timing and amount.

The Tax Court held that the taxpayer had to treat the $41,835 "loan" as income in the year received. The court focused on the fact that the taxpayer's obligations to repay the advance were perfectly coordinated with his former employer's obligations to pay over the settlement proceeds. Because neither party would have to make any further payments, the Tax Court had no difficulty concluding that the employer's purported loan was a disguised lump-sum settlement payment.

The taxpayer in *Frierdich*[9] was a lawyer hired to settle an estate. A few months into the representation, the executor lent the lawyer $100,000, payable with interest when the estate was closed. The note specified that, in the event of default, the executor was entitled to deduct the unpaid loan balance from the lawyer's fee.

The Tax Court found that the purported loan was an upfront payment of compensation. Repayment was due upon closing of the estate, which was the same event that would trigger the lawyer's right to his fee. Because these two obligations would offset each other, the lawyer would have no net payment obligation for the loan. The Tax Court treated the $100,000 advance as a disguised payment of the lawyer's fee.

These cases are to some degree fact-specific, and they do not mean that all coordinated loans are really disguised distributions. How the documents are done will surely matter a great deal. However, if the QSF makes a coordinated loan to the plaintiff, the IRS could argue that the plaintiff has received a disguised distribution.

It is a risk worth considering, worth disclosing, and worth trying to minimize in effecting any such transactions. After all, in the event of a recast, the plaintiff would find himself owing tax, interest, and penalties on the "loan proceeds" that he failed to report as income in the year of the advance. And if the QSF later uses what it might assume are still good and

[8] *Heyn v. Commissioner*, 39 T.C. 719 (1963).

[9] *Frierdich v. Commissioner*, T.C. Memo. 1989-393, *aff'd*, 925 F.2d 180 (7th Cir. 1991).

undistributed proceeds to structure a settlement or legal fees, perhaps that could be attacked too.

Uncoordinated QSF Advances

What about an uncoordinated loan? The plaintiff, who expects a distribution in two years, borrows from the QSF with repayment due in six months. Assuming that the parties are serious about the repayment date, it seems hard for the IRS to argue that this short-term advance is really a distribution.[10] The same should go for a loan that is uncoordinated because it is scheduled to mature considerably *later* than the expected distribution from the QSF.

The plaintiff may not have to worry about an uncoordinated loan being recharacterized, but does that mean he is in the clear? Assume that the QSF's advance is respected as a bona fide loan. Could the IRS argue that the plaintiff is nonetheless subject to tax simply for *taking* the loan from the QSF?

The regulations under section 468B are silent on this point. However, there are other familiar contexts in which a taxpayer's right to continued deferral depends on his not gaining too much access to the deferred amounts. In some situations, borrowing the amount of the untaxed funds — or even just having a right to do so — can cross the line. For example:

- The regulations under section 409A provide that a payment to a service provider that is a "substitute" for the payment of deferred compensation is itself taxable as a payment of deferred compensation.[11] This includes a loan to the service provider if repayment "may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan." If the plan has the right to set off against the service provider, even an uncoordinated loan can trigger tax. One can certainly note that section 409A is arguably among the more stringent and rigorous provisions of the IRC, and that its reach is limited by the express scope of this code section.
- In a deferred exchange under section 1031, the purchaser of the relinquished property may secure its obligation to transfer replacement property by depositing cash in an escrow. To avoid an immediate taxable event to the seller, the parties may decide to use a qualified escrow account.[12] Their escrow agreement must "expressly limit" the seller's right to borrow the untaxed cash from the escrow.[13] Parallel restrictions apply to deferred exchanges in which the purchaser's cash is parked in a qualified trust[14] or with a qualified intermediary.[15]
- The regulations on split-dollar life insurance arrangements address the tax consequences of an employer paying the premiums on a policy it owns on the life an employee. The employer is treated as transferring the policy cash value to the employee to the extent that the employee has "current access" to it.[16] The employee has current access if he can borrow against the policy's excess value.[17]

Plainly, these regulatory analogies do not address QSF lending, nor, of course, do the regulations under section 468B. Nevertheless, caution may still be warranted. It seems awfully difficult for the IRS to argue that an uncoordinated advance is a distribution. However, the position that coordinated advances may be baked into the documents and used with abandon may not be as safe.

Despite the vaunted status of QSFs as virtually exempt from constructive receipt concerns, the IRS could contend that the plaintiff is subject to tax simply because the loan allows him access to the QSF's pool of untaxed cash. How that argument would come out is likely to depend on the documents, timing, and more.

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[10] If the advance were recast as a distribution, the plaintiff's repayment of the advance in six months would have to be recharacterized as a loan *from* the plaintiff *to* the QSF. The QSF's subsequent distribution to the plaintiff would have to be treated as repayment of this previously unsuspected loan. Such an analysis is possible, but it seems too extravagant to be convincing.

[11] Reg. section 1.409A-3(f).

[12] Reg. section 1.1031(k)-1(g)(3)(i).

[13] Reg. section 1.1031(k)-1(g)(3)(ii)(B).

[14] Reg. section 1.1031-1(k)-1(g)(3)(iii)(B).

[15] Reg. section 1.1031-1(g)(4)(ii).

[16] Reg. section 1.61-22(d)(2)(ii).

[17] *See* reg. section 1.61-22(d)(4)(ii) and (d)(6), Example 1.

Third-Party Secured Loans

Suppose that the plaintiff borrows from the bank again, but this time he grants the bank a lien on his interest in the QSF. As the holder of a security interest, the bank can step into the plaintiff's shoes in the event of default and notify the QSF that it must remit any distributions to the bank for application against the plaintiff's unpaid obligation.[18] If the plaintiff goes into bankruptcy, the bank's lien may translate into a secured claim for the unpaid loan balance or (if less) the amount that the QSF is obligated to distribute to the plaintiff.[19]

Here, the plaintiff is granting the bank a lien on his interest in the QSF. Even so, it is still the bank that is making the loan — no funds leave the QSF at the time of the advance. It should also be noted that the plaintiff is granting the bank a lien on *his* property, that is, his right to receive a distribution from the QSF. Plainly, the bank will be keenly interested in whether the QSF is holding cash to satisfy its obligations to the plaintiff. However, the bank's lien will not encumber the cash, or any other property of the QSF for that matter.

Thus, the bank's secured loan to the plaintiff does not touch the QSF. But is that the end of the story? In other areas of the tax law, provisions that prevent a taxpayer from borrowing deferred amounts from the QSF typically also bar him from pledging his right to be paid those amounts. Some familiar provisions again come to mind.

Reg. section 1.409A-3(f) states that a loan "secured by . . . an amount deferred under a nonqualified deferred compensation plan" is a taxable substitute for the payment of deferred compensation. Reg. section 1.1031(k)-1(g)(3)(ii) says that the escrow agreement must "expressly limit" the seller's right to pledge the cash in the escrow account. The IRS will not provide an advance ruling regarding the tax consequences of an employer's transfers to a rabbi trust unless the plan states that the employee may not pledge or encumber his rights under the plan.[20]

The regulations under section 468B do not discuss pledges, but the regulatory analogies seem like grounds for concern. The plaintiff is not accessing the QSF funds directly, as he would in a loan. But the IRS might argue that a third-party loan secured by a pledge of the plaintiff's rights against the QSF pushes the transaction over the edge.

QSF Secured Loans and Setoffs

What if the QSF makes a loan to the plaintiff that is secured by his right to a future distribution? As we noted above, even an unsecured QSF loan could be seen as a problem under regulatory analogies that the IRS might trot out. The risk is arguably compounded if the plaintiff also grants the QSF a lien on his right to receive a distribution.

A lender's set-off right is not technically a lien for commercial law purposes. However, if the QSF is able to apply amounts it owes the plaintiff against the plaintiff's obligations following a default, the QSF enjoys a privileged position vis-à-vis the plaintiff's general unsecured creditors. Could the IRS argue that this set-off right operates as a quasi-encumbrance on the plaintiff's interest in the QSF? If that argument were accepted, even a plaintiff who takes an *unsecured* loan from his QSF might be viewed as accessing a pool of untaxed cash.

Third-Party Loans Secured by 'Proceeds'

Let's suppose, perhaps unreasonably, that the plaintiff thinks about all these potential tax gremlins in advance and is well advised. Of course, the plaintiff still wants some cash. He might conclude that granting the bank a lien on his interest in the QSF presents an unacceptable tax risk. The bank, on the other hand, may be unwilling to lend unless it can lock in a priority interest in the plaintiff's share of the economic value that resides in the QSF. Is there a way to satisfy both parties, and steer clear of the IRS too?

[18] *See* Uniform Commercial Code section 9-607(a).

[19] Of course, if the plaintiff has also given the bank a lien on his *non*-QSF-related property, the value of that collateral will be considered when determining the amount of the bank's secured claim.

[20] *See* Rev. Proc. 92-64, 1992-2 C.B. 422 (model trust agreement, section 13(b)).

Suppose that the plaintiff refrains from granting the bank a lien on his rights against the QSF. Instead, he grants the bank a lien on his interest in any *proceeds* that may be generated by those rights. Without a security interest in the plaintiff's rights against the QSF, the bank cannot step into the plaintiff's shoes following default. The bank's lien attaches only to the plaintiff's interest in amounts that have actually been distributed by the QSF.

Obtaining a lien on a borrower's property (especially cash) is one thing; enforcing it against the borrower or competing creditors is another. As a practical matter, the bank will probably refuse to make a loan secured by proceeds unless the QSF agrees that it will pay any distributions into a "lockbox" account controlled by the bank. Getting control of the proceeds will perfect and help establish the priority of the bank's security interest.

Using a lockbox will also prevent the plaintiff from dissipating the cash or paying it to another creditor. The loan side of this transaction seems relatively unproblematic because the bank is lending its own funds. The consequences of the bank's security interest in "proceeds" are less clear.

On one hand, it is notable that the bank's lien attaches only to amounts that the QSF has actually distributed. These amounts will be taxable to the plaintiff. Hence, the plaintiff can argue that he has *not* granted the bank a lien on a pool of untaxed cash.

On the other hand, the security agreement providing for the bank's lien will have been put in place when the bank made its advance. From a technical commercial law perspective, the bank's loan remains "unsecured" until the QSF makes a distribution. Yet the parties have installed the legal machinery that will provide the bank with a lien on any distribution the instant it is made.

It seems at least conceivable that the IRS could contend that the plaintiff has monetized his interest in the QSF's pool of untaxed cash. The bank has made a loan in reliance on an arrangement that will give it a security interest in any amounts distributed by the QSF. Does the fact that the bank's security interest will not attach, for commercial law purposes, until the plaintiff obtains rights in the distributed cash change the substance of the transaction? If it does not, one or more of the regulatory analogies might suggest that the plaintiff should pay tax even though no funds have actually left the QSF.

Loans From QSF's Bank

So far, we have assumed that the bank has no material business relationship with the QSF. In particular, we have assumed that the bank does not hold any funds that are attributable, directly or indirectly, to the QSF. Now, let's assume the opposite.

The QSF transfers $14 million in settlement funds to the bank. The bank then makes an unsecured $5 million loan to the plaintiff. Is the plaintiff potentially taxable on the advance?

If the bank is a multibillion-dollar institution, its $5 million loan may be no more problematic than the third-party unsecured loan described in our first hypothetical. The amounts transferred by the QSF represent only a tiny fraction of the bank's deposits, so it would be hard to argue that the plaintiff is indirectly borrowing $5 million from the QSF. On these facts, the bank could plausibly be treated as a third-party lender, even though it holds funds traceable to the QSF.

Now consider a parallel transaction featuring a small institution that actively solicits deposits from QSFs. The bank's marketing materials tout its willingness to lend to persons who expect to receive distributions from its settlement fund customers. This has considerable appeal to claimants who expect that it will be four or five years until the QSF releases "their" funds.

Such delays are the norm in complex multidistrict litigation. A defendant may be settling with thousands of plaintiffs, who are represented by dozens of law firms that are entitled to a major cut. Attorneys who have invested significant time and money in their cases, but lack deep pockets, may be under intense pressure to monetize a portion of their expected fees. At least one financial institution

(Esquire Bank) appears to regularly make loans to lawyers with claims against QSFs that it administers.[21]

Returning to our hypothetical, suppose the QSF deposits $14 million in the small bank, which lends $5 million to the plaintiff. Legally, the bank is lending its *own* funds, but we might be getting into conduit territory here. Could the IRS argue that the plaintiff should be treated as borrowing directly from the QSF? As discussed above, an unsecured loan by a settlement fund could be problematic even if the repayment is not coordinated with the borrower's right to receive distributions. If the plaintiff's loan is secured by his rights against the QSF, or even his right to distributed proceeds, that could add an additional layer of risk.

Conclusions

This preliminary survey has attempted to identify some of the ways that claimants might try to monetize their interests in a QSF. The regulations under section 468B do not address the point. Of course, given the veritable explosion in the use of QSFs that now populate the land like leaves of grass, the fact that the QSF regulations don't address a topic hardly tells us much.

In fact, that is true of a large number of topics. Can a QSF have merely one claimant and merely one claim? Can a QSF exist for 50 years? Can a QSF formed for one event and claim be added to later to also resolve other unrelated claims? Can a QSF operate a trade or business — say, one in bankruptcy?

You get the idea. There are plenty of issues that the QSF regulations do not address, ones that doubtless have become issues since 1993. As QSFs have skyrocketed in popularity, the use of QSFs and QSF-related assets in lending transactions is hardly surprising. Given the way some of these transactions are papered, it seems appropriate to ask whether the IRS could challenge transactions that seem to allow taxpayers to access a pool of untaxed cash.

Clearly, paying tax on monies sitting in a QSF flies in the face of nearly 30 years of established learning. Still, as more interests in QSFs are tapped via loans, plaintiffs and their lawyers — who are likely to be the ones doing more of the tapping — might start facing these issues. QSF administrators could have decision-making roles to consider, too.

QSF administrators or trustees now routinely execute structured settlement and structured legal fee documents for the benefit of claimants and lawyers. Some QSF administrators and trustees are doubtless being asked to comment on, approve, or even sign loan, pledge, lockbox, and other documents, too. If one of these transactions goes bad somehow — and going bad might include via the IRS — is everyone likely to get sued?

We do not know the answer to all these questions. Many answers may be "it depends," hinging on the documents, timing, and even some points of finesse. But whatever your role in one of these may be, some of these issues seem worth considering before rather than after everything is signed and paid. ■

[21] Lending to hard-pressed lawyers seems like an act of mercy, but potential borrowers have not always seen it that way. The QSF for the attorneys in the Chinese Drywall multidistrict litigation was reportedly earning only 0.02 percent interest on a $200 million deposit. This did not sit well with lawyers who were given an opportunity to borrow "their money" at, say, 7 percent. *See* Jason Brad Berry, "Big Chiefs, Spy Boys, Flag Boys — How Poydras Street Meets Wall Street in a High Stakes New Orleans Courtroom Face-Off," American Zombie (July 16, 2018). The judge in the Chinese Drywall case ultimately ordered the QSF to pay the $200 million into the court registry. *See* Alison Frankel, "Setback for Plaintiffs' Lawyers' Bank: Judge Says He Will Order Return of $200 Million Deposit," Reuters (June 12, 2018).