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Qualified Settlement Fund Interest: Who Gets It and Why

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In this article, Wood and Brown examine the growing use of qualified settlement funds and explain why lawyers should become more aware of associated interest income issues.

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Qualified settlement funds (QSFs) were created under regulations[1] that went into effect on January 1, 1993.[2] Under section 468(g), these regulations clarify the taxation of settlement funds and "similar funds." A QSF is principally intended to function as an intermediary between plaintiffs and defendants to facilitate settlements. The defendant can pay a lump sum settlement into the QSF and exit the picture, and the QSF can hold the funds while the plaintiffs and their attorneys resolve any disputes among themselves about how the settlement funds should be allocated and divided.

For tax purposes, the defendant can treat the settlement as "paid" (and can deduct it) when the lump sum is paid into the QSF.[3] Nevertheless, the QSF's claimants (for example, the plaintiffs and their counsel) are not considered as having received their payments until funds are distributed out of the QSF.[4] An obvious question is: Who covers the taxes for the in-between time after the defendant is considered to have already paid the settlement but before the claimants are considered to have received the settlement while the settlement funds are still in the QSF?

The QSF regulations provide that the QSF itself is responsible for paying tax on any income produced on the settlement funds while they are in the QSF. The transfer of a settlement payment into a QSF is usually not taxable income to the QSF.[5] As a complement to this exclusion, distributions from the QSF to the claimants are generally not deductible.[6]

QSF Net Income

As a result, a QSF's taxable income is generally limited to any interest, dividends, or other income generated on the settlement funds while the QSF holds them. Some QSFs that exist for only a few weeks or months may not invest the settlement funds, which may result in no income tax liability being generated for the QSF. But some QSFs —

[1] *See* reg. sections 1.468B-1 through -5.

[2] *See* T.D. 8459.

[3] *See* reg. section 1.468B-3(c).

[4] *See* reg. section 1.468B-4.

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

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

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particularly in larger and more complicated class actions or mass torts — can exist for years. It is generally prudent in those cases for the QSF trustee to invest the settlement funds in safe, liquid investments during the QSF's existence, resulting in income that the QSF would need to report on its IRS Form 1120-SF, "U.S. Income Tax Return for Settlement Funds (Under Section 468B)," each year.

Against its income, the QSF can claim offsetting deductions for administrative expenses.[7] For most mechanical tax reporting purposes, a QSF is treated as a corporation,[8] but its net income is taxed at the highest marginal tax rate for trusts and estates (37 percent), not the lower corporate tax rate (21 percent).[9]

Once a QSF has served its purpose and the settlement funds have been distributed, it should wind down and dissolve. But when this happens, who should get the net income remaining in the QSF? There does not appear to be any required result under the QSF regulations. Ultimately, QSFs are governed by their governing document and are formed and supervised by a governmental authority, usually a court.[10]

The Problem of Interest

The QSF's trustee, governing document, and the governmental authority supervising the QSF should have the final say on how any net income or growth in the QSF gets divided and used. However, QSF agreements often do not provide for what happens to the net income remaining in the QSF. It may become a matter of discretion for the trustee and its supervising governmental authority. But why do QSFs have income in the first place?

QSFs are not intended to be profit-generating enterprises. They were designed and are intended to be used as a pragmatic and functional solution to help bring disputes to an end. Still, QSFs have costs related to their administration, including trustee fees, bank and wiring fees, and fees for settlement agents who help coordinate getting all the paperwork and information from the claimants to facilitate the division of the settlement funds. There may be disputes among the claimants and the lawyers in any setting, particularly in large mass tort contexts. The QSF may also face legal fees related to its efforts to facilitate the resolution of those disputes and any motions that must be filed with the supervising governmental authority to get guidance or confirmation on disputed topics.

If a QSF does not invest its funds to produce income, all these administrative expenses would have to come out of the principal amount held in the settlement fund, potentially depleting what will ultimately be available for distribution to the claimants. This hypothetical scenario, akin to Charles Dickens's *Bleak House*, does not seem a fair result for claimants, whose settlement funds, already agreed to by the defendant and paid into the QSF, end up being paid to the QSF's administrative personnel rather than the plaintiffs and their counsel. Mathematically, of course, a QSF would have to be very inefficiently managed, and likely for quite a prolonged period, for the claimants to end up with nothing whatsoever.

Many trustees try to avoid having a QSF's overhead expenses reduce its principal amount at all. Placing the funds in safe, liquid investments, like interest-producing savings accounts, Treasury bills, or certificates of deposit, is often seen as an acceptably safe compromise. These may not produce much income, but hopefully the QSF is not expensive to administer, so it doesn't necessarily need to produce that much income to cover its own costs.

General trust law, which is usually applicable here, would dictate prudence and some kind of investment, such as Treasury bills. However, there is no requirement in the regulations that a QSF must invest the settlement funds, and it is possible that a QSF can be quite expensive to administer, particularly if there are multiple ongoing disputes among the claimants or between the claimants and the QSF trustee. Trust law may be relevant, but it is no violation of the QSF regulations if the QSF overspends its income and ends up having to eat into the principal settlement fund to cover its administrative costs. Of course, QSF trustees try to avoid that result.

[7] *See* reg. section 1.468B-2(b)(2).

[8] Reg. section 1.468B-2(k).

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

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

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Hypothetically, if the income exactly matches the QSF's administrative expenses, the income tax results could be quite straightforward. The income reported by the QSF on its income tax return may be entirely offset by the administrative expense deductions, producing no net taxable income and no amount due by the QSF to the IRS. This results in essentially complete income tax efficiency with no difficult questions of who gets to keep the net income.

Another perceived benefit of investing the settlement funds in a safe, liquid investment is to mitigate the effect of inflation over time. If it takes a QSF two or three years to distribute all the settlement funds, the original value of the settlement payment agreed to by the defendant will be worth less than when the plaintiffs and their counsel receive all their money. Income-producing accounts and investments can allow the settlement amount to at least try to keep up with inflation.

Of course, this latter benefit requires that the QSF have net income remaining to distribute to the claimants, both net of the QSF's administrative expenses and the amount the QSF will need to pay its income tax liability (at 37 percent) on its net income when its income tax is due the following year. In that case, what might a QSF trustee look to for deciding who gets the net income?

Entitlement to Interest

One might assume the default should be for a QSF's net income to be distributed among all claimants in proportion to their principal distributions. That seems like a prudent default. If the lawyer and client are dividing a settlement 60-40, should that apply to the interest too? Perhaps, but what if the plaintiffs' fee agreements with their counsel provide that the attorney fees will not exceed a fixed amount, and the attorneys' principal distributions from the QSF already hit the fee cap? Does that mean the attorneys' share of the income should go to their client instead?

Many distributions to lawyers consist of a contingent fee, based on a percentage of the plaintiffs' recovery plus a reimbursement of the attorneys' actual litigation expenses, such as filing fees, expert costs, and so on. An attorney may be entitled to one-third of the recovery under the contingency fee, but after adding in the reimbursement for litigation expenses, may end up being paid 36 percent of the plaintiff's recovery from the QSF. In that case, should the QSF distribute one-third of the net income to the attorney (as an additional contingency fee on the now larger recovery), or 36 percent of it, effectively giving the attorney additional expense reimbursement (seemingly more than the actual litigation expenses)?

What if the contingency fee agreement provides that the attorney is entitled to 100 percent of any net income produced within a QSF as part of the attorney fees? Some QSFs are large operations, distributing settlement amounts totaling billions of dollars to potentially hundreds or thousands of plaintiffs affected by a mass tort. Can the QSF be expected to individually consider each contingency fee agreement to determine the appropriate division of the QSF's net income for each plaintiff?

Difficult Calculations

Computing the interest on funds sounds simple, but it may not be, particularly if you try to factor in individual computations for which timing will clearly matter. Some claimants' distributions are not in dispute and may be distributed from the QSF earlier than others. Some of the QSF's net income may have been generated on those funds, but most of the net income may have been generated on the funds ultimately to be distributed to the claimants whose shares have remained in the QSF for a longer period.

The claimants whose recoveries have been held in the QSF the longest may consider it only fair that they receive more of the QSF's net income. After all, they had to (or chose to) forgo their recoveries longer, and it was their recoveries that likely produced the lion's share of the income. This could foment a dispute among the claimants, the QSF trustee or administrator, and its supervising governmental authority.

Who would decide whether and how to try to trace the net income back to the underlying funds that produced the income — or if that is even possible? The regulations do not provide for how the income must be divided. Therefore, the trustee or administrator may need to rely on their own impartiality and good judgment, and, if need

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be, seek the input of the governmental authority to make the final call.

Reversions and Payments to Charity

It seems to rarely come up in practice in recent years, but what about a potential reversion to the defendant? If there is money left over, the defendant (if it is even aware of what has happened after paying the settlement funds to the QSF) may believe it is entitled to that money back, as a refund. Under its view, the settlement agreement provides for the plaintiffs and their counsel to get $X (the principal settlement amount paid into the QSF), and because the net income amount is the amount by which the funds in the QSF exceed $X, it should have the surplus returned to it.

Those refund provisions are more common in QSFs regarding the principal settlement and generally appear not to broach the topic of interest expressly. That is, in a settlement, there may be multiple plaintiffs whose exact damages are unknown, and the defendant may expect more plaintiffs to come forward over time. As part of a settlement agreement, the defendant may agree to pay a maximum amount, say $10 million, into a QSF for use in paying future settlements, even though less than $10 million of damages has been asserted.

In that case, the settlement agreement and QSF documents might provide that if the total settlement payments agreed to by the defendant and all plaintiffs by a certain date (perhaps, the close of the statute of limitations to bring claims) are less than the $10 million paid into the QSF, the surplus settlement amount paid will be returned to the defendant. By the time all the plaintiffs' claims are settled, if the QSF has paid out $9 million in damages, the defendant may be entitled to the return of the remaining $1 million. In that case, if the QSF also has net income remaining generated on the $10 million, the defendant will want its appropriate share of that income too.

The QSF regulations do not define who is considered a claimant of a QSF. The question of who is entitled to money from a QSF is based on the underlying dispute or litigation. Ostensibly, a court or other governmental authority that establishes the QSF could conceivably provide that any net income remaining in the QSF would be donated to a charity, obviating the issue of how to divide it. Although the claimants may not like that result, it could avoid complicated or bitter disputes about how to divide the income.

Payments of excess funds to charity were at one time more common in class action settlements and QSF documents than they appear to be today. In any case, the sheer number and variety of QSFs have also exploded, so it is difficult to track their use. In some cases, the exact dollar amount that a plaintiff will receive when funds go into a QSF is 100 percent clear. Those cases can bring the relative entitlement to interest into sharper focus.

Claimants, Lawyers, and Interest

If the claimants are only entitled to exactly $X under the settlement, and they end up getting that precise amount, their claim to the additional amounts of income earned by the QSF may appear weaker. Of course, if the money in the QSF were to already belong to the claimants, then it would follow that the income "belongs" to them too, and they are entitled to it.

However, the fundamental principle behind a QSF is that the claimants, both for tax purposes and in fact, are not considered to have received or to own any funds held in the QSF until the funds are actually distributed to them. Logically, then, the QSF's income has not been generated on any funds the claimants own. The income is the QSF's income earned on the QSF's funds, so as a tax matter, neither the plaintiffs nor the lawyers (who are often entitled to a percentage share of the claimants' recoveries) are entitled to the net income if the supervising court instructs that the income be handled otherwise.

In some cases, the QSF documentation could try to address this interest issue explicitly. For example, it could call for the QSF to pay tax on its interest income, after reducing the amount that is taxable by appropriate tax deductions for administrative fees and expenses. Then, the excess interest income could be divided 60-40 among clients and lawyers, perhaps following a 40 percent contingent fee. It may be appropriate for the lawyer and client to address the QSF income issue in their legal fee agreement, too.

Regardless of how the interest income issue is addressed, considering it as early as possible is rarely a mistake. Sometimes, a lawyer or QSF

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administrator may suggest that interest is being earned on the funds. A claimant may understand this as a promise that the claimant will actually be entitled to the interest. If that turns out not to be true, or even if there is a significant haircut on the interest earned to pay taxes, the claimant may be disappointed. In any QSF, and particularly when many plaintiffs and lawyers may be disagreeing over who is entitled to the QSF's net income — potentially for months or years — the idea of an orderly resolution may be welcome.

Interest Income and Tax Efficiency

One of the issues that may lead claimants, lawyers, and administrators into awkward territory is the notion that the money is already divvied up and owned by claimants and lawyers when it goes into a QSF. There is a natural tendency for parties and lawyers to think, "That is my money, so I'm going to get 100 percent of the interest while it is there." This can lead to difficult and bitter disputes.

The income tax considerations when net income is distributed from a QSF merit discussion because they highlight how QSFs were not designed to be tax-efficient vehicles for growing income. A QSF is not an investment account, and the purpose of a QSF is not for plaintiffs or their counsel to park their recoveries for prolonged periods, deferring their own recognition of that income. Whether intentional or not, the IRS's design of QSFs ensures that they can be particularly inefficient for accumulating and distributing QSF income.

The most obvious seemingly tax-inefficient feature of QSF income is the flat 37 percent income tax rate. This rate means that the funds could be invested more tax-efficiently in nearly any other vehicle long-term than a QSF. Corporations have lower income tax rates (at least at the corporate level), and for 2024, individuals do not reach the highest 37 percent tax bracket until they have over $600,000 of taxable income. This creates an incentive for taxpayers not to abuse QSFs by leaving funds in them for longer than necessary.

There is also the second level of tax. The term "double taxation" invokes a kind of circular logic. If you receive a salary payment and then use that payment to buy groceries at the grocery store, it would be uncontroversial that you would have to include your salary payment in your income, and the grocery store would also need to consider the money you paid it for the groceries as gross proceeds for its own tax reporting. Almost no one refers to that as double taxation because it is clear that you and the grocery store are different taxpayers, and that your salary and the grocery store's sales proceeds are two distinct transactions (even if it is the same money flowing from your employer, through you, and to the grocery store).

The IRS and courts could say the same thing about a corporation and its shareholders, a client and their attorney (regarding the contingency fee owed), or a QSF and its claimants. Formally, the QSF and its claimants are different taxpayers, so subjecting both to tax on funds that one earns and then pays to the other is not double taxation in the view of tax law. But, because the money generating income to the QSF is the claimant's recovery (at least, in the claimant's eyes), it's tempting to view this as double taxation when the QSF's net income (on which the QSF has already paid tax) is subject to tax again when distributed to a claimant.

A distribution from a QSF to a claimant is taxed as if the payment were paid directly by the defendant.[11] The QSF distribution is taxed based on the claims asserted in the dispute with the defendant.[12] Therefore, if a plaintiff who is receiving a settlement for taxable emotional distress damages receives a distribution of the QSF's net income, it would seem unavoidable that the distribution of net income would have to be included in the plaintiff's income as an additional taxable emotional distress recovery. If the plaintiff's attorney receives a portion of the QSF's net income, that is generally taxable as additional legal fees.

Although this look-alike for double taxation arises in many other contexts, it is notable that there appears to be no provision to provide any mitigation for its effects in the QSF context. Although corporations are a classic example of double taxation, the law only taxes corporations at 21 percent, and most dividends from U.S.

[11] Reg. section 1.468B-4.

[12] *Id.*

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corporations qualify as qualified dividends, which are taxed at 20 percent. Therefore, corporate income may only be effectively taxed at around 36.8 percent by the time it reaches the shareholder. That is, if a corporation has $100 of distributable income, the corporate-level tax would be 21 percent, leaving $79 to be distributed as a dividend, and the corporate shareholders would pay tax on 20 percent of the $79 dividend, leaving the shareholder with $63.20 of the original $100.

Non-grantor trusts avoid the double taxation issue by allowing the trust to claim a deduction against its own taxable income for income that has been distributed to the beneficiary during the year.[13] This mechanism essentially means that either the trust pays tax on an item of its income *or* the beneficiaries pay tax on the same item,[14] but the same income should generally not be subject to income tax by both the trust and the beneficiary.

Nondeductible Interest

For QSFs, distributions to claimants are identified as not being deductible by the QSF.[15] Consequently, distributing income out of the QSF does not reduce the QSF's income tax on the distributed income. The effect of this can be significant. If the QSF has $100 of net income after administrative expense deductions, it would owe 37 percent, or $37, in income tax, leaving $63 to distribute to a claimant. When the claimant receives the $63 distribution, if their settlement is subject to tax at ordinary income rates, the $63 distribution would be taxed at the claimant's marginal income tax rate, which could be as high as 37 percent federally, resulting in an additional $24.79 of tax due.

As a result of being subject to tax at the QSF level, and then again as part of the claimant's income, there is plainly more tax. Under these simplified assumptions, only $38.21 of the $100 of net income would remain, with an effective tax rate of up to 61.79 percent created by the QSF structure in this simplified example. If the claimant lives in a jurisdiction with a state income tax, there could also be state income tax imposed on the $63 distribution the claimant receives.

And, if the net income is distributed to a law firm and treated as additional legal fee income, the $63 distribution would also be subject to possible self-employment tax. The mechanics of calculating self-employment tax are too complicated for this simplified example. Indeed, the Social Security portion of the self-employment tax has a cap, and part of the self-employment tax is deductible against income tax. Suffice it to say that for claimants subject to other taxes like state income tax and self-employment tax, the ETR on QSF income that is ultimately distributed to them could be more than 61.79 percent.

This is not to say that QSFs are a bad deal — because they are decidedly not. They clearly provide astounding tax benefits and flexibility for claimants and their lawyers. Indeed, QSFs provide outsized benefits to defendants too. It is worth remembering that QSFs were put into the tax law for the benefit of defendants.

The rule is that a defendant can deduct a payment made to a QSF if it is otherwise deductible as a business expense, as it nearly always will be. Without a QSF, the economic performance rules of section 461(h) would require the defendant to wait for the funds to actually get to the claimants. A QSF is not an escrow; it is far better. The defendant's immediate tax deduction is the reason why defendants routinely pay into them at settlement time.

Still, for the long-term retention of funds and the accumulation of significant interest, there are taxes and a double tax effect. If the IRS's goal was to make it clear that a QSF is not to be used to hold funds and generate tax-deferred income (deferred to the claimant, at least) indefinitely or for a prolonged period, these mechanisms should create quite effective negative incentives. However, because claimants often do not know how much income is being produced within the QSF or the QSF's tax reporting, some claimants may not be aware of just how much QSF income they are losing to income tax.

Conclusion

As QSFs grow in use and familiarity, lawyers should become more sensitive to QSF interest income issues. QSF administrators may also want

[13] *See* sections 651, 661.

[14] *See* sections 652, 662.

[15] *See* reg. section 1.468B-2(d).

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to be more proactive. Lawyers may need to address these issues with clients, particularly when the lawyers are asserting that any net post-tax interest should go 100 percent to the lawyers, rather than 60 percent to the clients and 40 percent to the lawyers (or along the lines of the contingent fee agreement).

Being forearmed about how interest will be treated may alter claimant and lawyer behavior. If a claimant or lawyer knows that they will get no or limited interest, they may want their funds as soon as possible. Significant misunderstandings about how QSFs work, about how QSF interest is taxed, and about who is legally entitled to interest on the funds can usually be avoided. Whenever possible, try to map out interest issues in advance. Like many other disputes, if someone is convinced that they are being mistreated, or that they should have been told about this long before, these disputes can be difficult.

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