HEADNOTES

PRACTICE TIPS

Qualified Settlement Funds Cut Taxes and Disputes

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Call it a qualified settlement fund, a QSF, or a section 468B trust. By any name, it is a flexible vehicle that more lawyers—both plaintiff and defense—should be using. QSFs are governed by section 468B of the Internal Revenue Code. Although that section was enacted in 1986, the use of QSFs dates from 1993 when the Internal Revenue Service (IRS) published regulations governing their operation.

A QSF is a simple trust designed to hold funds after defendants settle a case but before the plaintiffs receive the money. In a departure from usual tax rules, defendants can take a tax deduction for payments into the QSF, even though the plaintiffs—and the plaintiffs' lawyers—do not have taxable income until the money is actually distributed. Tax deductions are usually reciprocal—the payer can deduct a payment only when the recipient of the payment recognizes it as income. Yet a QSF allows payers and recipients of settlement funds to break this rule. Congress thought defendants needed assurance of their tax deductions even though there might be complexities or delays regarding the timing and the amount of distributions to plaintiffs and their counsel.

Although originally designed for class actions, QSFs are now routinely used in other disputes as well. Even a case that involves three plaintiffs, their families, and lawyers can be complicated or contentious.

QSFs can help make cases less contentious and payments simpler. They allow time to allocate fees and costs or to determine whether plaintiffs want lump-sum payments, structured settlements, or both. Structured settlements, typically funded with annuities, allow plaintiffs to receive a stream of payments in a tax-favored way. However, they must be established before the plaintiff has receipt of settlement sums.

Similarly, structured-fee arrangements for contingent-fee lawyers allow them to stretch out their income rather than receiving fees in a lump sum and paying tax all in one year. Fee structures ameliorate the peaks and valleys of contingent-fee practice. In the same way that QSFs facilitate structured settlements for plaintiffs, QSFs aid attorney fee structures too. Once funds hit the lawyer's trust account, it is too late for the lawyer to structure payments. QSFs give plaintiffs and their counsel invaluable time to consider payment options thoughtfully and carefully after the defendant is out of the picture.

A QSF is also useful where there are multiple defendants or where it is not possible (or desirable) to resolve all disputes at once. All moneys can be held in the QSF until all defendants settle. Alternatively, distributions can be made as each settlement is reached.

If plaintiffs and defendants cannot agree on tax language for a settlement agreement, a QSF can help. The defendants can pay a certain sum into the QSF under a settlement agreement that releases all claims but contains no tax language. The QSF can report the settlement as a nontaxable contribution to the QSF. The plaintiffs then sign another settlement agreement containing the desired tax language (for example, reciting that payments are not taxable income or are recovery of basis for property damage). There are no tax consequences to the plaintiffs until money is actually distributed from the QSF.

Despite the substantial benefits of a QSF for plaintiffs, defendants, and their counsel, there are only three requirements to obtain these tax benefits.

First, a QSF must be subject to court or government agency supervision. Plaintiff or defense counsel can go to any court—not necessarily the court with jurisdiction over the underlying case—and ask the chosen forum to approve a trust document and take jurisdiction over the assets. The QSF provides the ultimate in permissible forum shopping.

Second, the QSF must be established to resolve or satisfy legal claims.

Third, the QSF must conform to any applicable state-law requirements for the establishment of a trust. Usually, one creates the QSF under the laws of the state in which the parties have the QSF administered, which in turn is usually the jurisdiction where the overseeing court is located.

There is no maximum or minimum duration for a QSF, but most QSFs do not continue in existence beyond the time necessary to allocate funds and effect payouts.

Any party, lawyer, judge, or mediator may suggest the formation of a QSF. Indeed, a QSF can even be established before a suit is filed. In such a case, the QSF would be funded with minimal assets, and the actual settlement funds would be contributed once the case settles. Forming a QSF early can help make settlements more streamlined and can contribute to the idea that all the plaintiffs who are beneficiaries of the QSF are already participating in a joint undertaking.

In many situations, a QSF can make the settlement process smoother, more efficient, and much more closely tailored to what the plaintiffs and their counsel need and want. Most obviously, by having moneys go from the defendants to a QSF, the plaintiffs and their lawyers can decide how and when they want payment. Our tax law rarely allows such planning, making the QSF truly unique. Give one a try. ■