Qualified Settlement Funds vs. Transaction Escrows

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Qualified settlement funds, or Code Sec. 468B funds (QSFs), are often used to resolve litigation. Under regulations that took effect in 1993, they may be used—not unlike an escrow—to bring virtually any kind of claim to resolution. That includes issues that are not the subject of litigation.

The primary objective of such funds is to gather and administer cash or assets and then to determine the amounts and exact nature of payments each claimant will receive. QSFs are flexible and easy to establish. And unlike an escrow, where one party or another must generally be treated as the owner of the fund and pay tax on the income, the QSF is a true intermediary.

A QSF may simply consist of a fund or account segregated from the defendant's other assets. However, most are more formal and are governed by a trust agreement. Paying money into a QSF offers accrual-basis taxpayers an immediate tax deduction.

Notably, this is so even if the money remains undistributed for years. The QSF thus operates as an exception to the economic performance rules that normally allow a deduction only upon payment.

Legislative History

In 1984, Congress enacted restrictions that greatly curtailed the ability of companies to deduct various types of settlement payments. Congress made clear that even accrual basis taxpayers could only deduct claims for worker's compensation and tort claims when paid to claimants. Before then, corporations could more aggressively deduct such payments.

The new restrictions made the payer's deduction hinge on "economic performance," generally requiring receipt by the intended payee. That was something accrual method taxpayers found hard to fathom. Nonetheless, two years later, in 1986, Congress added Code Sec. 468B to the tax code.

Code Sec. 468B allows corporations to deduct payments to designated settlement funds (DSFs). Precursors to QSFs, DSFs are funds established to facilitate settlement payments by one or more defendants to certain tort claimants. Code Sec. 468B allows accrual basis taxpayers to deduct amounts paid to resolve legal claims even *before* the claimants receive payment.

In 1993, nine years after the initial legislation, this approach would be broadened and liberalized. Although DSFs are still possible, the QSF regulatory vehicle has largely replaced it. Since 1993, the regulations under Code Sec. 468B have allowed the use of qualified settlement funds.

Notably, there are even fewer requirements to establish QSFs than there were for DSFs. Moreover, QSFs provide more flexibility and can be used for a broader range of claims than DSFs. To claim a deduction for a payment to a QSF, the defendant must generally give up any right or claim to the amount paid.

Economic performance is deemed to occur when the payer puts money or assets into a QSF. As an economic matter, the payer has given up any substantial right to the amount transferred.

Tax Characteristics

There are three general requirements for forming a QSF. It must be: (1) established pursuant to a court order or an order of a federal, state or local government authority; (2) established to resolve or satisfy one or more contested or uncontested claims asserting certain types of liability; and (3) a trust under state law or its assets must be segregated from other assets of the transferor. QSFs are generally established by court order.

However, they can be approved by any government authority. Moreover, QSFs can be established to resolve essentially any legal claim. Notably, a QSF is *not* elective, and QSF status trumps all other entity classifications.

If the three requirements are satisfied, the entity, trust or account is classified as a QSF, regardless of the intent of the parties, and no election is permissible. This mandatory nature of QSFs is not always welcomed. For example, in *Brown*, 348 F3d 1200 (10th Cir. 2003), the taxpayers were victims of an investment fraud.

The court transferred assets from the fraudsters to an estate. The taxpayers, German citizens who had been defrauded, argued that the estate should not be treated as a separate taxable entity. However, the Tenth Circuit determined that it was a QSF.

Once formed, a QSF effectively operates as an intermediary between the parties, taxable in its own right at corporate tax rates. Still, a QSF is only taxable on the income it earns. It is generally not taxable on amounts transferred to it from a transferor.

Even prejudgment interest is excludable from the QSF's gross income. Thus, a transfer to a QSF generates a deduction for the defendant without any corresponding inclusion by the QSF. This is a key feature of every QSF.

Although Code Sec. 468B may have been enacted primarily to facilitate deductions by defendants, QSFs have significant advantages for all parties. The chief advantage for intended recipients of the funds, of course, is deferral and the time to consider the form and manner of payment. The character of the payment will be unaffected by the QSF.

The tax treatment of a distribution from a QSF to a claimant is determined by reference to the claim that relates to the distribution. For example, a distribution to a claimant on account of personal physical injuries is excludable from income under Code Sec. 104(a)(2) if a payment directly from the transferor would be excludable. The tax doctrines of constructive receipt and economic benefit also appear to have been turned off.

The importance of this cannot be overrated. In describing the tax treatment of a distribution to a claimant, the Treasury Regulations suggest that a claimant has *nothing* until the distribution by a QSF is made. It appears that Congress intended QSFs to operate as a statutory exception to the economic benefit and constructive receipt doctrines.

Tax Neutrality

QSFs are tax-neutral, so the tax treatment of the settlement or judgment is unaffected by the presence of a QSF. For example, if damages qualify as tax-free under Code Sec. 104(a), a lump sum transferred to a QSF is excludable from a QSF's income as a qualified payment under Code Sec. 468B(b)(3).

Upon a later distribution from the QSF, the payment will be excludable from the claimant's income to the same extent as if received directly from the defendant. The QSF is tax-neutral. Of course, if any income is earned on the lump sum while housed in the QSF, it will be taxable to the QSF.

Time Limits?

There is no express time limit on the duration or existence of a QSF. That may lead some advisers to suggest using a QSF as an incorporated pocketbook or indefinite holding account. Of course, the QSF would remain subject to the taxation of the income.

Moreover, one could argue that if there is no controversy about who will get what, the QSF would no longer exist to resolve claims and should cease qualifying as such. Yet where there are legal or contractual considerations dictating if, when and how amounts are to paid, there is little doubt that a QSF cannot exist for substantial periods of time. And that brings us to escrows.

Corporate Deals and Escrows

Acquisition agreements often require that a portion of the purchase price must be placed into an escrow account, to be released after the expiration of a date or the occurrence of one or more specified events. Buyers often choose to place funds in escrow to guarantee the performance of the seller or to protect themselves from unknown or contingent liabilities. Moreover, although escrows are rarely the idea of the seller, the seller may reap advantages too.

Sellers can sometimes use an escrow to defer some of the gain on the sale until the escrowed funds are released. However, cash-basis taxpayers face a dilemma with an escrow. They do not have to actually *receive* the purchase price in order for it to be treated as income to them.

Indeed, cash-basis taxpayers must report income when they actually or *constructively* receive it. If cash or property is placed in escrow and the taxpayer receives no right to control the assets, the amount is generally not taxed until the contingency is met and the funds are released. However, if the taxpayer exercises significant dominion and control over the assets in escrow, they are generally viewed as constructively received by the seller despite the existence of the escrow.

Thus, one can be treated as in receipt of money even when one does not actually have it within one's possession. To be sure, most sellers put a major emphasis on getting access to and ownership of the escrow. Even so, the constructive receipt issue can make timing messy.

For example, if the seller is deemed to have constructively received escrowed amounts, the seller will recognize gain even though the seller does not have access to the escrow. Moreover, what if the escrow is of assets or instruments that fluctuate in value, such as stock? The seller may have additional gain due to those fluctuating balances.

It can be frustrating to be a seller who recognizes gain based on the fair market value of the stock on the closing. It is even worse to do so and thereafter to have the stock (on which one has already paid tax) decline in value.

Modest Proposal?

Most escrows are relatively short-lived. Moreover, the tax problem associated with which party pays the tax on the earned income of the escrow is usually not momentous. Nevertheless, using a qualified settlement fund instead of a traditional escrow to effect the consummation of a corporate deal may be worth considering in some cases.

Unlike an escrow, a qualified settlement fund means that income earned on the funds during the term will be taxable solely to the fund. Even if it is clear that the buyer or the seller will ultimately receive the corpus and the interest, the corpus is taxed to no one until it is distributed. The income earned on the fund is taxed to the qualified settlement fund itself.

The rules, in short, are vastly clearer than those for escrows, where the facts and circumstances matter. Various worries can attach to escrow funds. Who pays the tax is only one of them. In some cases, though, the tax worries impact drafting and can even influence the ultimate disposition of the escrow.

Clean Slate

The QSF, in contrast, is entirely tax-neutral. That, together with its apparent immunity from normal constructive receipt and economic benefit doctrine tax concerns, could make it an attractive solution for a corporate transaction.