Qualified Settlement Fund Tax Myths

by Robert W. Wood

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In this article, Wood explores common myths and misconceptions about section 468B qualified settlement funds.

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Qualified settlement funds (QSFs) have blossomed into important dispute resolution vehicles that possess remarkable flexibility and tax efficiency. QSFs can be invaluable when a plaintiff and defendant are negotiating a settlement but cannot agree on tax language or tax reporting specifics. Forming a QSF can bridge those difficulties, allowing the defendant to pay the money and the plaintiff to address the form of a release, tax reporting, and withholding once the defendant is out of the picture.

Could you use more time to determine an equitable allocation between plaintiffs? Could you use more time to fix final attorney fees and costs? Could you use more time to facilitate the thoughtful purchase of structured settlements? Are there disputes among plaintiffs, disputes among lawyers, liens, and other issues that must be worked out? If you answer yes to any of these questions, a QSF could be the answer. Here are some myths or misconceptions about QSFs.

Defendants Lose Tax Deductions

Should defendants worry that they won't get a tax deduction when they put money into a QSF instead of paying the plaintiffs directly? No. The whole idea of QSFs originally was to allow defendants to claim tax deductions for settlement payments immediately, even though funds could be tied up among warring plaintiffs for months or even years.

Our tax system is normally reciprocal, with no tax deduction for the payer until someone else has receipt of the funds. This usually means that a defendant cannot claim a tax deduction until the plaintiff receives the money. But these normal tax rules go out the window for QSFs, creating a big exception to the normal reciprocity between payer and payee.

Of course, the usual business expense rules apply, so the defendant has to conduct a trade or business, the lawsuit must relate to it, and so on. But the timing rules for tax deductions (and much of tax law is about timing) are radically changed with a QSF, which is one of its key features.

QSF Requirements Are Tough

If you think there are many hurdles to establishing a QSF, think again. There are only three requirements, and they are easy to satisfy. First, the QSF must be subject to court or other governmental supervision. That means you go to court and ask the judge to approve a trust document and take jurisdiction over the assets. If you are using a governmental agency (say the Environmental Protection Agency or the city of Honolulu), you need an appropriate official who has the power to agree. Second, the trust must exist to resolve or satisfy legal claims. Most people don't even have to think about this one. Third, the trust must qualify as a trust under state law. All you need is a trust agreement and trustee, and you're set.

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Of these three fundamental requirements for a QSF the first is that it must be subject to the jurisdiction and administration of a governmental authority (usually a court). It is ultimately the judge (or other governmental authority) who oversees when and how much to pay out, and to whom. Even so, in most cases, the judge rubber-stamps distribution requests — if the judge sees them at all. Most QSF documents do not require approval of every distribution but only call for overall supervision by the court.

Yet some QSF documents do call for plenty of per-item approvals. It really depends, which is yet another feature showing how flexible QSFs can be. Whether there is a lot or a little judicial oversight, it is the critical precept of court or government supervision that explains the tax-free status of a QSF. QSFs exist because Congress and the IRS have assured defendants that they can deduct payments made to resolve legal claims.

Finding a Trustee Is Difficult

You might think that the trustee requirements are rigorous or hard to satisfy. Surprisingly though, almost anyone who is not a minor and not legally incompetent can be a trustee. The trustee need not be a trust company or trust specialist. That gives you almost infinite flexibility. Even the plaintiff's lawyer can be a trustee, although I don't recommend that, given that the lawyer is already wearing one hat.

Lawyers and accountants often act as trustees to QSFs. Even your brother-in-law can do it. You can also bifurcate duties and have a trustee and a separate administrator. That structure can work particularly well when the trustee is a figurehead person who does not want to attend to administrative details. Of course, the trustee can also simply hire accountants, lawyers, and others to handle everything.

Only One Court Can Approve QSFs

Many people seem to assume that you must form your QSF with the same court and the same judge who has considered (and had jurisdiction over) your case. Actually, any court will do. If you are wrapping up a multiyear case before a federal judge you can't stand, you can go down the street and form a QSF in the probate court to administer the funds that will be paid when the federal case resolves. You can form your QSF in a state court even though the underlying litigation is a federal matter and vice versa.

You can cross state lines, too. Some advisers seem to prefer probate court because probate judges are usually familiar with trusts and trust documents. Some people do it ex parte, some not. And whatever court you select is unlikely to be intrusive unless you want it to be. Another common misconception is that the court will be way too involved in distributions to suit the lawyers.

In fact, most judges hope they'll see you only when the QSF is formed, when money is contributed, when a settlement agreement is signed, and when the QSF is dissolved. Unless your trust document requires it — and you have control over writing your own trust document — QSFs need not go to court to make distributions. There's simply no need for excessive court involvement. If for some reason you want to have the court approve every distribution, you can put that in the trust agreement.

QSF Tax Treatment Is Complicated

Most trial lawyers seem to know little about taxes, yet some people fear that if they form a QSF, somehow the tax position (of the lawyer, the clients, or both) is going to get more complicated. Nothing could be further from the truth. The tax rules are easy and straightforward. First, a QSF must apply for and receive its own employer identification number from the IRS.

If one looks at the latest Form SS-4, "Application for Employer Identification Number," it might appear tricky to request an EIN for a QSF because the form isn't drafted to make it intuitive. The language in Form SS-4 is designed for other more common types of entities. However, the IRS's website has questions and answers specifically tailored for QSFs that make it surprisingly painless to request an EIN online.

Second, the QSF must file a simple annual tax return with the IRS for every year that it is in existence. The QSF is taxed separately, but not on the money contributed by the defendants. Those are nontaxable contributions. In fact, the QSF is only taxed on the income (usually interest and dividends) it earns on those contributed funds.

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Against that income, the QSF gets to deduct trustee fees, lawyer fees (for the QSF's advisers, not the plaintiff's attorneys), and other expenses. Often, it all zeroes out so that no tax is due. Settlement payments to claimants and their lawyers, of course, are not deductible by the QSF. But because the initial contributions by the defendants are not income to the QSF, there is no need for a deduction.

Defendants Cannot Get Money Back

Maybe the defendant will express concern that once it puts settlement money into the QSF, it can never get its money back, no matter what, even if the settlement somehow unravels. Not true. This misconception arises because we often say that the defendant has to "irrevocably" pay the money and cannot have an interest in the QSF.

But this irrevocability is really a misnomer. If the settlement doesn't happen, no problem, the defendant can get its money back. A defendant can even fund a QSF while a case is on appeal. One just includes the express proviso that if the appellate court rules for the defendant the money comes out of the QSF and back to the defendant.

Remember, QSFs were created to help defendants by allowing an immediate income tax deduction when the QSF is funded. The application of this rule to a case that is on appeal might seem a little strained, but many defendants would argue that they still get their tax deduction immediately upon the contribution to the QSF. This is so even though the documents are explicit that the money can't be distributed to the plaintiffs while the case is on appeal, and that the money reverts to the defendant automatically if the court rules for the defendant.

Not all reversionary rights cause the defendant to lose the ability to deduct the payment to the QSF. The QSF regulations provide that economic performance has not occurred if the right to reversion can be triggered unilaterally (that is, "without the agreement of an unrelated person who is independent or has an adverse interest") by the defendant or if reversion would be triggered by an event that is "certain to occur."[1] Other than in these extreme situations, a defendant can deduct the payment even if it has a reversionary right; for example, if the defendant wins on appeal.

In that event, of course, the defendant would have to take the money back into income when it receives the reversionary payment to the extent the previous deduction created a tax benefit to the defendant. The QSF regulations specifically cross-reference the tax-benefit rule under section 111 for the mechanics.

Putting aside contributions in cases on appeal, there is also the more garden-variety reversion question. It used to be rare to see reversions, with typical provisions instead saying that if there is money left over it goes to a charity (perhaps one related to the nature of the case, such as cancer research). Today though, it is common for defendants to want any leftover funds returned.

QSFs Harm Plaintiff Tax Planning

Some plaintiffs or their lawyers worry that a QSF will destroy favorable tax language that they have negotiated in a settlement agreement with the defendants. They may also fear that a QSF will somehow add another layer of Forms 1099, making tax returns and compliance more difficult. Both fears are unfounded, and if anything, the reverse is true.

Adding a QSF usually improves the plaintiff's odds of getting the desired tax treatment. Indeed, when plaintiffs and defendants are negotiating a settlement but cannot agree on tax language or tax reporting, the formation of a QSF can bridge those difficulties. The QSF will allow the defendants to pay over the money and claim their deduction. Then the plaintiffs can make their case about the appropriate tax reporting to a more neutral party — the QSF trustee — often producing more favorable results.

QSFs Preclude Structures

Structured settlements call for payments over time. They have tax, financial planning, and asset protection advantages. Qualified physical injury structured settlements are tax-free to the plaintiff. In that case, each payment over time is fully tax-free, even though a portion of each payment might be viewed as an investment return on the original settlement amount.

[1] Reg. section 1.468B-3.

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Other structured settlements are taxable when the tax advantage is that each payment may be fully taxable. In that case, the advantage is that the installments are only taxed when and as each payment is received. With or without a QSF, virtually every plaintiff should be able to arrange a structured settlement. But some defendants will not cooperate with the stock structured settlement language that needs to be inserted into the settlement agreement to be effective for tax purposes. The same is true with structured legal fees.

Even if the defendants cooperate, one reason that many plaintiffs do not investigate secured structured settlements is simply a lack of time and expertise. A plaintiff overwhelmed with settlement details might not be ready to make financial decisions on the spot. Yet often the settlement process cannot wait.

QSFs facilitate that time crunch, allowing plaintiffs to consider settlement structures after the defendant is out of the picture and while the settlement money is safe — and in a tax-free holding pattern in the QSF. The plaintiffs can then consider the form of structure, the exact annuity payout, family needs, and so on.

In the same way, the plaintiffs' lawyers can choose to structure their legal fees, too. Of course, attorney fee structures can be done with or without a QSF. However, a QSF can give the lawyers time to work out the details before tax consequences attach to the legal fees.

QSFs Have Limited Duration

There is no express time limit on the duration of a QSF. It is true that in practice, QSFs usually exist for a brief time, sometimes a matter of a few months. In simple cases, that can be enough time to determine who will get what, resolve Medicare (or other) liens that might exist, investigate and select structured settlements, and so on. The QSF should not exist for an extended term once all those controversies are resolved. A QSF is not a bank account.

But in complex cases, QSFs can (and sometimes need to) exist for many years, and there appears to be no outside time limit. You should be guided by the need for the QSF, the continuing controversy about who should get what, and in what amounts. The lack of a firm term limit may seem remarkable given the normal tax rules of constructive receipt and economic benefit. With a QSF, monies are not treated as received by the plaintiffs or their lawyers until they are distributed by the QSF. Yet the defendant is entitled to a tax deduction as soon as the money is contributed to the QSF.

You Need Many Plaintiffs for a QSF

I am not sure it is fair to call this a canard or a myth (or a powder keg). Over the years, there have been many debates about this point, even though the IRS seems to yawn when the single-claimant debate is mentioned. QSFs are obviously invaluable in class actions, when the sheer number of plaintiffs means that something has to give when it comes to handling the inevitable fund administration.

Multiple defendants can also work in favor of a QSF. But you hardly need many defendants or many plaintiffs for a QSF to make sense. Even two plaintiffs can benefit big time. Whether one plaintiff is enough for a QSF may not have a concrete black-letter answer, but most people today would say that it is not exactly an open question, either. The statute and regulations suggest that a QSF should be fine if you have one or more claimants.[2]

However, the IRS has never made its opinion on this known, and the structured settlement industry still does not appear to have a unified view. Even if one tries to ensure that there are at least two claimants, it is not clear exactly what a claimant is for this purpose. For example, how about spouses or a lawyer and client? What about one plaintiff and a Medicare lien?

Optimally, there will be two or more named plaintiffs, but it is not clear that they are required. Indeed, large numbers of QSFs have been established with a single claimant and have not been attacked by the IRS. The meat and potatoes of QSFs — how and when to form them, how and why to draft them, how to administer them, and how and when to dissolve them — have never been controversial.

[2] Reg. section 1.468B-1.

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QSFs Don't Have Big Benefits

A QSF can address payment issues out of the presence of the defendant. The defendant can claim its tax deduction in exchange for a complete release and can go about its business. Traditionally, QSFs were used primarily in class actions and other multiplaintiff complex cases. Today however, you might merely need more time to determine exact numbers, fix final attorney fees and costs, or consider structured settlement alternatives.

The benefits of a QSF are enormous and provide a firewall to the fundamental tax concepts of constructive receipt and economic benefit. QSFs promote dispute resolution and are specifically authorized by section 468B and the regulations. The constructive receipt and economic benefit rules are non-IRC tax doctrines borne in the case law. Constructive receipt broadly stands for the proposition that a taxpayer with a legal right to receive money who simply chooses not to receive it is still taxed because he could have received it.

The economic benefit doctrine is similar. It stands for the concept that when money is irrevocably set aside for someone and will inure to his benefit, he should be taxed on it, even if he cannot receive it immediately. If waiting is the only impediment, the IRS can tax it. QSFs bypass both these rules, but they do so for valuable policy reasons: dispute resolution.

QSFs help resolve difficult and sensitive issues among multiple plaintiffs. They facilitate the resolution of disputes among competing lawyers, too. They contribute to societal well-being by helping to facilitate structured settlements that can provide conservative payouts to victims for healthcare, life planning, and so on. In short, there are benefits to virtually all parties that can be realized by using QSFs.

Conclusions

QSFs are tremendously flexible, and their use is increasing. They offer:

- time to make an orderly allocation of funds between multiple claimants;
- time (and a forum) to resolve liens and creditor claims;
- tax benefits to defendants and plaintiffs;
- time to consider structures and other arranged payouts for plaintiffs and their lawyers; and
- the ability to handle all tax, legal fee, and payout issues strictly between the plaintiffs and their lawyers outside the presence and influence of the defendants.

What's not to like? ■

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