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Los Angeles | Daily Journal

WEDNESDAY, AUGUST 11, 2021

Qualified Settlement Funds Have Become Important Dispute Resolution Vehicles

By Robert W. Wood

QSFs have blossomed into important dispute resolution vehicles as they possess remarkable tax efficiency.

Qualified settlement funds or QSFs have blossomed into important dispute resolution vehicles that possess remarkable tax efficiency. There are many different circumstances in which forming a QSF makes sense. Plaintiff and defendant might be negotiating a settlement, but they may not be able to agree on tax language or tax reporting specifics in the settlement agreement.

Forming a QSF can bridge such difficulties, allowing the defendant to pay over the money, and the plaintiff to address the form of a release with the QSF. Traditionally, QSFs were used mostly for class actions. Today, however, you might just need more time to determine exact numbers, to fix final attorneys' fees and costs, etc.

QSFs are flexible, and there is no express time limit on their duration. Some QSFs exist for a few weeks or a few months. In other cases, QSFs exist for many years to resolve claims. There is no outside time limit for how long a QSF can last, although one should not keep a QSF in existence for long after all the disputes are resolved and the time when it is clear who is going to get what, and how it is going to be paid out.

If a long-term structured settlement or trust arrangement is desired for a legal recovery, there are other vehicles that can better take over once the case is fully resolved. In the meantime, the QSF can truly work wonders. In fact, the benefits of a QSF (also known as a Section 468B settlement fund) are of staggering proportions. How could you not do handstands over a simple trust that sidesteps the fundamental tax concepts of constructive receipt and economic benefit?

Yet QSFs are not tax shelters, and they are not too good to be true. They are specifically authorized by Section 468B of the tax code and are blessed by Treasury Regulations that lay out necessary requirements and procedures. QSFs even do good works, promoting dispute resolution. Although QSFs clearly get special tax treatment, QSFs are not at odds with fundamental tax concepts.

The constructive receipt and economic benefit rules are non-Internal Revenue Code tax doctrines that come from case law. The first (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 nevertheless taxable 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 of these rules, but they do so for valuable policy reasons: dispute resolution. One of the fundamental three requirements for QSFs is the jurisdiction and administration of a governmental authority (usually a court). It is ultimately the judge who has the authority to decide when and how much to pay out. Even so, in most cases, the judge rubber-stamps distribution requests, and most QSF documents do not require approval of every distribution, but only call for overall supervision by the judge.

Yet it is the critical precept of court supervision that explains the tax-free status of a QSF. QSFs exist because Congress and the IRS have assured defendants they can deduct payments made to resolve legal claims. Monies can be transferred to a QSF and be deducted by the settling defendants, and yet not constitute income to them until the QSF distributes it.

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.

There is little controversy about how QSFs can be used and for what purpose. The only exception is a lingering debate about whether you can have a QSF with a single claimant, although plenty of QSFs have been set up that way 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, is not controversial.

There are three requirements. First, they must be subject to court or government agency supervision. Second, the trust must exist to resolve or satisfy legal claims. Third, it must qualify as a trust under state law. Although there are a few nuances, these three basic rules are usually easy to satisfy. Most QSFs are approved by a court, but government agencies work too.

The court or government agency need not have a connection to the legal dispute that is being resolved. Any court will do. Thus, you can go to the court that has jurisdiction over the underlying legal dispute, or you can go to a different court. You can use a state court in a federal matter, or vice versa. You can even go to a probate court. Some advisers prefer this, since probate judges are usually familiar with trusts.

There needs to be a trustee but there is great flexibility who can occupy this role.

The trustee need not be a trust company or trust specialist. Lawyers and accountants often act as trustees. A QSF must apply for and receive its own employer identification number from the IRS. The QSF is taxed as a separate entity, basically like a corporation.

The QSF is not taxed on contributions from defendants to resolve the claims, those are nontaxable contributions. The QSF is only taxed on the income it earns on the contributed funds. Usually, that means it is just taxed on interest and dividends. The defendant has no interest in the QSF. To claim a tax deduction for the settlement payment, the defendant must relinquish its interest in the money.

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