Qualified Settlement Funds Named Like Lawyer Trust Accounts

by Robert W. Wood


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In this article, Wood addresses whether a qualified settlement fund (QSF) must be labeled as a QSF in its title.

This discussion is not intended as legal advice.

A qualified settlement fund (QSF) must meet specific tests to comply with the tax law. Clearly labeling it as a QSF seems prudent. After all, sometimes labels help in cases of doubt. I generally name a qualified settlement fund "The ______ Section 468B Qualified Settlement Fund." Using either the section 468B or the QSF name costs nothing, and it just seems appropriate.

Using both labels can't hurt. Besides, why wouldn't you want to slap on such labels? You need to observe the tax rules, of course. But surely telling the world the nature of your fund is a good thing and helps to avoid doubt. It might even help to avoid trouble from the IRS, state tax authorities, third parties such as insurance companies, and so on.

But as a technical matter, can you name a qualified settlement fund something else? Perhaps the "Jones Law Firm Trust" or the "Jones Law Firm Trust re XYZ Case" or another generic name that *sounds* like the money is going into a lawyer's trust account, even if it isn't? Why might you even think about doing this?

The uneasy answer may be: When you have a defendant or defendant's insurance carrier that says it refuses to pay a settlement or judgment into a QSF. Suppose that you already asked the defendant as you were drafting the settlement agreement and have been told no. Could you change the settlement agreement draft from one calling for payment into "The ______ Section 468B Qualified Settlement Fund," to one calling for payment to the "Jones Law Firm Trust" or another generic name that sounds like a lawyer's trust account?

Could you change the name of your QSF or quickly form one with the generic name? Surely you are hoping that the defense or insurer assumes that the "Jones Law Firm Trust" actually means the Jones Law Firm Trust Account. I am solely a tax lawyer, so I will not try to answer the question whether there are any ethical or representation problems in doing this. Some of how you answer this question may depend on the specifics of the settlement: For example, exactly what has been said and by whom?

And which side you are on? If the parties have agreed to settle for a specific dollar amount, it seems relevant in what context the settlement discussions have occurred. There may be clever practice in this naming gambit. However, if the plaintiff thinks the defendant is wrong and unreasonable in refusing to accommodate a reasonable QSF payment request, is the plaintiff required to agree with the defense?

Understandably, some plaintiff lawyers say no. Lawyers often disagree, and some lawyers (plaintiff or defense) may answer this naming question differently from others. But as a technical tax matter, is a QSF named one way or the other different from a QSF named with bells and whistles proclaiming in the title that it is a QSF?

Put differently, can a generically named QSF still be a QSF that qualifies with the IRS? I say yes, and I will try to explain why I think so.

Lawyer Trust Accounts

To be clear, a lawyer trust account is not a QSF. With the QSF naming issue I am describing, I do not mean a lawyer trust account, segregated or not. I mean a real, documented QSF that is established (in accordance with the rules below) before the case is resolved and before the settlement money is paid. However, for the record, it is possible in some cases for a segregated lawyer trust account that is not comingled with other funds to *become* a QSF.

For completeness, before we leave lawyer trust accounts — or other accounts that are not already set up as QSFs — can one build, in a pinch, a QSF around a segregated account that already holds settlement proceeds? There is an extraordinary rule can allow the retroactive designation of a bank account as a QSF if two prerequisites are met:

1. The fund, account, or trust must be a trust under state law when the attorney established the account; or the account's assets must otherwise be segregated from other assets of the defendant/transferor.
2. The fund, account, or trust must be established to resolve or satisfy one or more claims that have resulted, or may result, from the litigation settlement. Usually, a segregated attorney-client trust account should satisfy the requirement of being a trust under state law.

Notably, an IRS election is required, there are deadlines to observe, and the cooperation of the defendant is required. Nevertheless, in limited circumstances, there is a potential for this Hail Mary procedure to save the day. That is a topic for another day.[1]

QSF Basics

QSFs provide an easy and safe architecture for resolving claims among litigants, paying lawyers, negotiating and satisfying liens, facilitating structured settlements, and winding up litigation. I have often written about their virtues.[2]

Historically, QSFs were most frequently used in large and unwieldy class actions involving multiple defendants and plaintiffs. They are still ideal for that, but they are used in a wider variety of cases today. They were originally created to protect defendants.

Defendants wanted the security of an immediate income tax deduction for their payment, even though it could be years before money would be dispersed. Section 468B makes it clear that defendants can deduct payments to a QSF. Plaintiffs and defendants are often neutral on the use of QSFs. But outside the context of class actions, today it is more likely that *plaintiffs* will advocate for a QSF.

QSFs are separate taxable entities, so they operate as a kind of court-supervised intermediary. During the time the QSF holds the money, the plaintiffs are not treated as having received anything. It may be apparent that the plaintiffs will receive a settlement, and it may even be clear precisely how much each plaintiff will receive. However, they have no income that can be taxed until the distribution from the QSF actually occurs.

This holding pattern feature of a QSF is attractive. For some plaintiffs, structured settlements can also be enticing. Section 104(a)(2) excludes from gross income amounts received as damages, other than punitive damages, because of personal physical injuries or physical sickness. This exclusion applies regardless of whether the amounts are received through a lawsuit or settlement, in a lump sum, or by periodic payments.

Plaintiff and defendant are unlikely to want continued interactions. Thus, the defendant will be paying cash in any event. Third parties such as

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[1] For details and requirements of this procedure, see Robert W. Wood, "'Retroactive' Qualified Settlement Funds: 10 Things You Should Know," *Tax Notes*, Feb. 8, 2010, p. 793.

[2] *See* Wood, *Qualified Settlement Funds and Section 468B* (2009); Wood, "Qualified Settlement Funds in Corporate Transactions," *Tax Notes*, Aug. 4, 2014, p. 623; Wood, "Ten Reasons *Not* to Form a Qualified Settlement Fund," *Tax Notes*, May 17, 2010, p. 823; Wood, "468B Qualified Settlement Funds Pending Appeal?" *Tax Notes*, July 12, 2010, p. 207.

insurance companies step into the void to accept payment from the defendant and to fund a stream of payments to the plaintiff.

If plaintiffs take cash in a settlement that is fully excludable from income, they will be taxed on future earnings on their funds. A structure of periodic payments enables the plaintiff to exclude from income not only the principal but also the earnings represented by the stream of payments. Moreover, there are nontax advantages.

Periodic payments can prevent a claimant from squandering a settlement or being preyed on by others. Structures can help ensure that funds are available in the future. But they also tie up money, preventing access once the payment stream has been fixed. Thus, some planning is clearly needed.

There are structures for taxable recoveries, too. The goal there is to stretch out the payments, and to pay taxes only as and when each payment is received. The entirety of each payment in such a structure will be taxable. However, the structure effectively allows a return based on the insurance carrier distributing the funds over time.

With either taxable or tax-free structures, some plaintiff lawyers complain that some defendants or insurers seek to inject themselves into the structure process, including their own brokers or even insurance companies. That can be one reason the plaintiffs and their lawyers want a QSF. It could be one reason some defendants or insurers say no.

If the defendant is out of the picture, as it will be if a QSF has been formed, qualified (tax free) or nonqualified (taxable) assignments can be made to a third-party assignee from a QSF. The QSF trustee or administrator will set up the periodic payment arrangement, including making an assignment to a third-party assignee to make the periodic payments. And the defendants, its insurer or insurance brokers, will not get a piece of it.

Attorney fees will usually come out of the gross funds transferred to a QSF. In the same way that QSFs can channel periodic payments to claimants, QSFs can facilitate structured fee arrangements for attorneys. Some defendants may also push back about structured legal fees, refusing to allow them. Notably, an attorney can facilitate structured fees via a QSF even if the claimants are not receiving structured payments.

Real Objections?

Some defendants and insurers object to QSFs when there is only one claimant, although they may well object to a QSF even if there are multiple claimants. On the single-claimant issue, I do not believe the IRS cares about this long-disputed point, and I have written that I do not find it too worrisome.[3] However, being risk averse, I also try to avoid single-claimant QSFs when I can.

Yet I will use them when the plaintiff and his lawyer understand there is at least conceivably a risk that the IRS could someday say that single-claimant QSFs are somehow bad. If defendants or insurers make an objection based on the single-claimant canard, I do not imagine they are actually worried about the plaintiff being somehow at risk on taxes.

I do not see how defendants or insurers themselves have any risk, or if they do, I do not know what it is. As far as I can tell, the objections from defendants and insurers are usually about something other than taxes. Some insurance companies paying settlements may hope to position their own companies or affiliates to write new policies for the structures.

Some defendants or insurers may be loyal to specific brokers and want to position them too. Thus, in some cases, the controversies might be about control over the money, whose structure brokers will be used and entitled to commissions, which life insurance companies write the structure business, or other topics.

QSF Requirements

The three requirements for a QSF are straightforward. A QSF:

1. must be established by an order of (or be approved by) the United States, any state (including the District of Columbia), any territory, any possession, any political subdivision, or any agency or instrumentality of the

[3] *See* Wood, "Reprising Single-Claimant Qualified Settlement Funds," *Tax Notes*, June 23, 2014, p. 1445; Wood, "Single-Claimant Qualified (468B) Settlement Funds?" *Tax Notes*, Jan. 5, 2009, p. 71.

foregoing (including courts); must be subject to the continuing jurisdiction of that governmental authority;
2. must be established to resolve or satisfy one or more claims from an event that has occurred and that has given rise to a claim of liability; and
3. must be a trust under state law, or its assets must be otherwise segregated from the transferor's (or related person's) other assets.

There is nothing in those three requirements about the name one must ascribe to the QSF. One can state in the QSF documents that it is a QSF and must comply with section 468B and list some particulars. But I suppose it could be called "The Xylophone Fund."

One objection to QSFs that is sometimes made by defendants or insurers is that there will somehow be "constructive receipt." I don't think this is a fair objection, unless one argues that the QSF really isn't a QSF at all, that it has failed as such. The argument would have to be that it does not qualify, despite what the documents and the court that approved the QSF have said.

Speaking generally, it is difficult for me to believe that a QSF that meets the three requirements would be struck down or deemed unworthy somehow. In contrast, I do think that it may be fair to ask if a QSF, despite proper formation, can someday lose that status. I wonder if it could essentially be defrocked in the way that a tax-exempt organization can lose its tax exemption.

For example, if the QSF sits for 10 years holding one person's money with no controversy, can it still fairly be regarded as a QSF that bars the usual constructive receipt and economic benefit tax doctrines? In any case, that duration issue is a topic for another day. What then about constructive receipt if a QSF is used, regardless of how it is named?

Some defendants object to QSFs even if there are multiple claimants. I do not know what the objection could be there. If there is only one claimant, though, the basis for objection presumably comes down to the single-claimant issue. I suppose the argument against a single-claimant QSF, if there is one, is that there could be constructive receipt of the money by the claimant.

Yet the way I read it, QSFs have a true get-out-of-jail-free card when it comes to constructive receipt.[4] If the money is in a QSF, the claimants and lawyers (really, anyone who receives money from the QSF) simply do not have receipt until there is an actual *distribution* from the QSF.[5] Thus, if there is a constructive receipt problem, it must be based on the notion that the QSF is actually not a real one — that it fails to qualify as a legitimate QSF.

To me, that argument seems strained. The regulations in reg. section 1.468B-1(c)(2) mention that there must be "one or more contested or uncontested claims."[6] There must be an event giving rise to "at least one claim asserting liability."[7] With the focus on the claim or claims, not the claimant or claimants, a plurality of claimants seems to be unimportant.

One claimant might have three claims. Multiple parties might constitute multiple claimants. Moreover, a person's personal injury claim and a spouse's loss of consortium claim could be viewed as multiple claimants. If the children also bring claims, there are surely multiple claimants.

More broadly, one might ask how the plaintiff's attorney fits into this. Is a single claimant's attorney (who has a contingent fee claim) a separate claimant? I would argue yes, but I suppose one could argue otherwise. In any case, there has been little indication that the IRS or Treasury cares about the single-claimant hubbub. Perhaps they too view it as a commercial dispute.

Constructive Receipt

If there is constructive receipt, of course, it is a bad thing. Suppose that a claimant has constructive receipt of a lump sum in a tax-free case but still somehow pursues a structure calling for payments over 30 years. The claimant could be taxed on earnings despite the structure.

If the settlement is a taxable one, the result could be even worse. If the structure fails because the claimant already had constructive receipt of

[4] *See* reg. section 1.468B-2(a) and -4.

[5] *Id.*

[6] Reg. section 1.468B-1(c)(2).

[7] *Id.*

the lump sum, the claimant could have more taxes to pay than the initial installments of cash received. So the constructive receipt issue — if real — is important.

Of course, the companies that write the annuities (whether of the tax free or taxable variety) have their own considerable interest in only writing structures that are taxed in that way. This is especially true with structures of the tax-free variety. These companies have their own due diligence procedures, and they do not write structures with which they are not comfortable.

If there is a constructive receipt issue, when does it attach? First, the constructive receipt doctrine is unnecessary in the case of an accrual-basis taxpayer. Under the accrual method, a claimant has income when the right to an item has matured, even though actual receipt of cash may come much later.[8] For an accrual-basis taxpayer, sending an invoice triggers the income, not the later payment.

Cash-basis taxpayers, conversely, generally do not have income until they receive cash. Constructive receipt operates as an exception to this rule. The constructive receipt doctrine reduces the opportunity for manipulation that can occur when one party is ready to pay but the intended recipient requests payment at a later date. The classic example is the employee who says, "Don't pay me in December, pay me in January."

How do settlements and judgments stack up to constructive receipt concepts? In the case of a settlement, there can be no right to income until the settlement agreement is signed. The settlement agreement is the document that embodies the release of the legal rights, which triggers the eventual payment.

Thus, there should be little concern that a settlement agreement calling for payment into a QSF rather than to a plaintiff would give rise to constructive receipt by the plaintiff. If the settlement agreement says the money goes to a QSF, there should be no issue of constructive receipt, unless one argues that the QSF fails to qualify as such. There is that issue again.

Judgments Too

Most QSFs are formed to facilitate settlements. However, the IRS has approved QSFs that were funded after all appeals were resolved or dismissed and after the judgment became final.[9] The judgment indicates the obligation of the defendant to pay the plaintiff. In that sense, it appears that there is no legal impediment to payment, which the plaintiff has the right to demand.

However, even a judgment does not automatically trigger constructive receipt. In fact, a judgment is often not as final as it might seem. There may be mechanical steps a plaintiff must complete even to secure payment under a judgment. The plaintiff may be required to complete (and to file with the court) a satisfaction of judgment form. There are some tax cases in which a plaintiff has collected money from the defendant but refused to sign the forms.[10]

Moreover, statutory interest provisions may lead to conflicting computations and economic disputes. There may be rehearings, appeals, or both. Even after a judgment, it is common for cases to be "settled" in order to resolve all remaining matters. More fundamentally, there is no reason to think that the constructive receipt doctrine should be applied to normal judgment creditor situations. A judgment is not much different from any other debt obligation. It is rarely, if ever, equivalent to cash.

The defendant may be a deadbeat or may do everything possible to avoid payment. Constructive receipt hardly seems appropriate for amounts the plaintiff may not ever actually receive.[11] Perhaps for this reason, I am not aware of cases in which courts have held that a plaintiff has constructive receipt merely on receipt of a judgment. The judgment may be a court order imparting the legal right to a payment, but it is not payment.[12]

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[8] *See, e.g.*, *Snyder Air Products Inc. v. Commissioner*, 71 T.C. 709 (1979).

[9] *See* LTR 200748010; *see also* Wood, "Can You Form a Qualified Settlement Fund With a Judgment?" *Tax Notes*, Nov. 29, 2010, p. 1017.

[10] *See Redfield v. Insurance Co. of North America*, 833 F.2d 1017 (9th Cir. 1987).

[11] *See Rhombar Co. v. Commissioner*, 47 T.C. 75 (1966), *aff'd*, *on other issue*, 386 F.2d 510 (2d Cir. 1967) (holding that no constructive receipt occurred when payer was financially unable to pay).

[12] *See United States v. Steck*, 295 F.2d 682 (10th Cir. 1961), and in contrast, see *Aldridge v. Commissioner*, 51 T.C. 475 (1968).

Conclusion

To return to where we started, I am not sure there is a conclusive answer to the question whether slipping in a cleverly named QSF title when a defendant has said "no QSF" is inappropriate or violates any rules or any understanding between the parties. It isn't a tax question, and I don't see a tax problem with a cryptically named QSF. If the defendant or insurer has objected to a QSF because they want their own structure broker or insurance carrier, perhaps that itself raises ethical issues.

In any case, on the question whether the QSF must be labeled as a QSF in its title in order for it to be one, I would answer no. It may not be elegant or even descriptive, but why couldn't a perfectly legitimate QSF be called "The Xylophone Trust"? ■