'Retroactive' Qualified Settlement Funds: 10 Things You Should Know

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Qualified settlement funds (QSFs) are tax neutral vehicles into which litigation settlements can be deposited after a defendant pays but before plaintiffs take receipt. The author examines the relations-back election that can effect QSF treatment belatedly, even after the taxpayer is already holding funds.

In LTR 200946022,[1] the IRS addressed a relation-back election for a qualified settlement fund (QSF). Without providing detailed facts, the ruling described a late-filing taxpayer who wanted to make a relation-back election, claiming retroactive treatment for a QSF. It suggests that the Service is willing to give reasonable extensions of time in appropriate cases and may even bend over backward to help taxpayers achieve QSF status. All of this should please litigants as well as those who help them wind up their cases.

A. Settlement Fund Basics

A QSF allows a defendant to pay money into a fund, account, or trust and be entirely released from liability in the underlying litigation. This can be good strategic planning, good litigation architecture, and even good public relations. Yet QSFs are first and foremost about taxes.

Significantly, on paying the money to discharge its liability, the defendant can claim a tax deduction.[2] There may be one defendant or many. If there are many defendants, the individual defendants may settle *seriatim* or all at once. Treasury regulations consider the defendant/transferor's payment to the QSF to be economic performance.[3]

This economic performance is an important threshold. It reflects the tax axiom that normally allows a payer to deduct a payment only when a payee includes it in income or otherwise receives it. In the QSF setting, however, the funds remain on hold in the QSF, often for months or even years pending the internecine resolution of claims among the plaintiffs. With a lack of reciprocity that is uncharacteristic in the tax law, the defendant's tax deduction is ensured. Nevertheless, neither the plaintiff nor the plaintiff's counsel will yet have income.

Unlike an attorney trust account, which can be treated as owned by the lawyer and the client, the QSF represents a holding pattern. Neither plaintiff nor defendant is taxed on the principal or corpus of the trust. The trust itself is taxed on any interest or other income earned on the QSF assets.

B. Timing

Given those benefits, setting up a QSF makes sense as a case is coming to a conclusion. Optimally, the QSF will be created before the settlement agreement is fully negotiated. Then, when the settlement is concluded, funds will be transferred directly into the QSF. This should preserve flexibility for plaintiffs and their counsel to consider structured settlements, special needs trusts, and the like.

Although a QSF should be set up before the settlement agreement is signed, sometimes the plaintiff attorneys will end up with a signed settlement agreement and with money in the bank. The attorneys may realize that the clients want to structure their recoveries or that an attorney fee structure for the lawyers would be advantageous. It may also become clear that disputes among the plaintiffs remain.

As tax professionals, we take our clients as we find them. Sometimes, fact patterns are messy. It may be tempting to say that it is simply too late. Our first reaction may be that what the clients or their counsel desire is simply no longer possible.

''You should have called earlier!'' we lament. Yet the QSF rules are surprisingly forgiving, as we shall see.

C. The Era of the QSF

The enactment of section 468B dates to 1986. However, the device it enables did not really take off until 1993. In that year, regulations expanded the statutory ''designated settlement fund'' into the broader, simpler, and

[1](Aug. 5, 2009), *Doc 2009-25031*, *2009 TNT 218-34*.

[2]Reg. section 1.468B-3(c).

[3]*Id.*

more flexible QSF.[4] Optimally, one plans ahead and establishes a QSF with no need for retroactivity.

But because we all live in an imperfect world, here are 10 things you should know about QSFs and relation-back elections.

1. You must meet three tests. To achieve the desirable holding pattern tax status of a QSF, a fund must:

- be established under an order of, or approved by, specified governmental entities (including courts) and be subject to the continuing jurisdiction of that entity;
- be established to resolve or satisfy one or more claims that have resulted or may result from an event that has occurred and that has given rise to at least one claim asserting specified liabilities; and
- constitute a trust under applicable state law, or its assets must otherwise be segregated from other assets of the transferor.[5]

All three of these tests must be satisfied. A QSF (normally) is not a QSF until it meets all three tests.[6]

2. Consider retroactive QSF treatment. As anyone who has been involved in settlement discussions knows, there is usually much to be done as a case winds down. In some instances, issues are not dealt with when they should be. Unfortunately, the form of a transaction and the order in which events occur are extraordinarily important to tax results.

Yet even if the defendant has already paid settlement monies to plaintiff's counsel, it may not be too late to establish a QSF. One may still be able to invoke QSF treatment even after some fund, account, or trust that is not yet a QSF receives settlement proceeds. This extraordinary rule may allow the retroactive designation of a bank account as a QSF if two prerequisites are met:

- The fund, account, or trust must be a trust under state law when the attorney established the account (usually it is); or the account's assets must otherwise be segregated from other assets of the defendant/transferor.
- 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, an attorney-client trust account will satisfy the requirement of being a trust under state law. However, it is important for the attorney to segregate the client's recovery from other monies. As we shall see, this topic can be debated and some doubts remain about precisely what is required.

3. Consider separate trust accounts. Consider what happens if the funds have not been segregated in the traditional sense of the word. Take, for instance, a commingled lawyer trust account, often referred to as an IOLTA account (interest on lawyers' trust accounts). Lawyers who handle client money are required by state law to maintain them.[7]

Under state bar rules, lawyers must segregate client monies from lawyer monies.[8] Client monies must be held in trust. That includes a retainer sent to a lawyer to fund work not yet performed. It also includes settlement monies paid by defendants.

Most lawyers maintain a single trust account into which all of this money is deposited. Normally, client funds are commingled, so that monies from clients A, B, and C, and monies paid by a defendant in case D, will all be held together. State bars generally allow lawyers to maintain multiple IOLTA accounts.[9] As a result, it is possible for a lawyer to set up a new trust account for each case.

As a practical matter, however, most lawyers only set up new trust accounts for large cases or only when there is some question about who should receive the interest. The normal rule is that the interest on IOLTA accounts goes to the state bar, legal relief for the poor, etc.[10] If a client requests it, however, most lawyers can and will set up a separate trust account for that client's funds, allowing the client to earn the interest.

Suppose a lawyer settles a case for $1 million, and 40 percent will be the lawyer's fee. The lawyer will deposit the (typically joint) check into the (usually commingled) lawyer-client trust account. He will then (usually immediately) cut a check to himself for $400,000, and another check to the client for $600,000.

The lawyer will probably consider a separate trust account only if the money is likely to remain in the account for months, or if the client insists on getting the interest. These two variables are interrelated. The longer the money is expected to remain undistributed, the more likely the client will care about receiving the interest.

For these practical reasons, the ability to morph a lawyer-client trust account into a QSF may be limited. The money must be segregated from other funds.

4. Which accounts are segregated enough? Exactly what does "segregated" mean? The regulations say the assets must be physically segregated from other assets of the transferor or a related person.[11] Surprisingly, there appears to be no ruling expressly addressing whether commingled client monies in a regular IOLTA account

[4]*See* T.D. 8459 (Dec. 22, 1992), *92 TNT 253-13* (enacting reg. section 1.468B-1 to 1.468B-5, effective Jan. 1, 1993).

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

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

[7]*See, e.g.,* Cal. Bus. & Prof. Code sections 6211-6213 (regarding IOLTA accounts); *see generally* http://www.iolta.org (for public information about IOLTA and IOLTA programs).

[8]*See, e.g.,* Cal. Rule of Professional Conduct 4-100 (requiring attorneys to deposit funds received or held for the benefit of clients in a trust account separate from the attorney's own funds); New York Disciplinary Rule 9-102 (22 NYCRR 1200.46) (b) (regarding separate accounts kept by the attorneys for funds belonging to clients).

[9]*See, e.g.,* Minnesota Office of Lawyers Professional Responsibility, Frequently Asked Questions About Trust Accounts (noting that lawyers may maintain multiple IOLTA accounts), *available at* http://www.mncourts.gov/lprb/trustfaq.html.

[10]*See generally* Cal. Bus. & Prof. Code sections 6210-6228.

[11]Reg. section 1.468B-1(h).

can qualify as sufficiently segregated to support a relation-back election. There is also no ruling saying it cannot.

However, the general view among tax practitioners appears to be that a regular commingled lawyer's IOLTA account is not segregated enough to support a relation-back election. A lawyer-client trust account, however, is arguably segregated from assets of the transferor, who will normally be the defendant. Even if the transferor is viewed as the lawyer, this may be enough.

The regulations specify, for example, that cash held by a transferor in a separate bank account satisfies the segregation requirement.[12] Presumably, this covers a separate lawyer-client trust account in which the monies belong to the plaintiffs *only in that case* and to their lawyers. However, could it also cover the more general IOLTA account?

It seems possible to argue that in the regulated world of lawyer trust accounts, even an IOLTA might be sufficiently segregated. It could be argued that the separate accounting generally required by state bars should be enough to support such separate treatment.

After all, lawyers maintaining an IOLTA account must be able to show exactly how much money is attributable to exactly which client. And the stakes are high. Lawyers can be disciplined and even disbarred for trust account violations.

If the lawyer has records to show exactly how much money is client A's and how much is client B's, isn't that segregated? Although money is fungible, that kind of segregation is sufficient under state bar rules, which are generally modeled after trust laws. Yet other tax authorities might be relevant.

For example, consider rabbi trusts. In that context, a segregation of funds would be a bad thing, spelling economic benefit and therefore early taxation of benefits. There, as long as monies are commingled and are not set aside in separate accounts, they are viewed as not segregated and therefore not yet as income.[13]

The rabbi trust example may rebut the argument that an IOLTA account could (by virtue of state trust law applicable to attorneys) be considered segregated. Of course, it could be argued that these are entirely different provisions with different purposes. Given the lack of guidance, the actual segregation of monies is certainly best. To avoid a big and expensive argument over these matters, funds should be segregated figuratively as well as literally in every case.

[12]*Id.*

[13]*See, e.g., Bank of Am. N.A. v. Moglia*, 330 F.3d 942, 944 (7th Cir. 2003) (discussing a rabbi trust example in which the trust was created by a congregation for its rabbi; the trust instrument provided that the rabbi would not receive the trust assets until he retired or otherwise ended his employment; until then, the trust corpus and any interest on it would be owned by the congregation and subject to claims of the congregation's creditors as if the assets were the general assets of the congregation); *see also* LTR 8113107 (Dec. 31, 1980) (funding of trust for N where assets of trust estate are subject to the claims of M's creditors and are not paid or made available within the meaning of section 451 will not constitute a taxable event for N).

Furthermore, what happens if the lawyer isn't considered the transferor to a lawyer-client trust account? Consider the situation in which a plaintiff's lawyer receives into his lawyer-client trust account a wire transfer from the defendant. In that case, the defendant would be the transferor, not the plaintiff's lawyer.

Clearly, the monies in a segregated lawyer-client trust account would satisfy the requirement of being segregated from the defendant/transferor's assets. (If the money is wired into the lawyer's general IOLTA account and thus not segregated from the money of other clients, it is not so clear.) In either case, however, the plaintiff's lawyer and his client arguably have constructive or actual receipt (or economic benefit) by having monies deposited into the lawyer-client trust account. Hence, if one or both of them wish to be claimants to a QSF, is it too late to unring the bell? Maybe not.

Again, there is no authoritative guidance on this issue. Treasury regulations focus on segregation from the transferor's assets, not from the claimants' assets (and obviously also not from other clients of the plaintiff law firm). One might argue that if a court is willing to issue an order establishing a lawyer-client trust account as a QSF (via a relation-back election or otherwise), that court order should effectively trump any actual or constructive receipt, or economic benefit, concerns. Whether the IRS would agree is an open question.

5. Selecting a court. Which court to approach must be considered with every QSF, whether prospective or retroactive. After all, QSFs are creatures of court supervision. If you are making a relation-back election, your petition will in most respects look similar to a regular petition to establish a QSF. In fact, it may be identical.

The relation-back election is derived from federal income tax law. If you can meet the two prerequisites, you can petition any court to create and approve a trust. Then, if you file the requisite relation-back election statement, the QSF springs into existence retroactively, whether or not the court order approving the QSF says anything about the effective date of the election.[14]

As with any QSF, regardless of the effective date, a relation-back election can provide the luxury of time to resolve exactly who will get what and in what form, including whether a structure is a better alternative than cash. In many (if not most) cases, a structure will be preferable as a means of achieving tax savings, retirement goals, investment return, and even asset protection.

A relation-back election is made after the court order, but the court order is much like any other court order signaling the birth of the QSF. The court order creating a QSF need not say that it is retroactive. If you are petitioning for a court order and you know you want retroactive treatment, you can so state in your petition. Yet it is ultimately the relation-back election filed with the IRS that will make that determination.

The QSF is treated as coming into existence on the later of the following: (a) when the fund, account, or trust meets the second and third basic QSF requirements

[14]Reg. section 1.468B-1(j)(2)(ii).

(other than the requirement of a court order); or (b) January 1 of the calendar year in which all three requirements are met. In other words, you can go back in time, but you can't go back before January 1. The assets held on the date the QSF is treated as coming into existence are treated as transferred to the QSF on that date.

6. When to make the election. The time for making the relation-back election is liberal: It is due at tax return filing time. You make a relation-back election by attaching a copy of the election statement to the federal income tax returns of the transferor, and of the QSF for the tax year in which the fund comes into existence.[15] The election statement must be signed by each defendant/transferor and by the administrator of the QSF. The returns must be timely filed, but fortunately, that includes extensions. Notably, it even includes amended returns of the transferors.[16]

By definition, you will have gone to court first before you can file the relation-back election. You ask the judge to order the QSF into existence. The resulting court order is what enables you to file your QSF relation-back election with the IRS.

In your petition requesting the court to approve the QSF, you might ask the court to approve the relation-back election, too, but this is not required. The relation-back election speaks for itself.[17]

The federal income tax return for a QSF is due on or before March 15.[18] A copy of the election statement must also be attached to the income tax return of the defendant/transferor and the return for the QSF.[19] In both cases, the relevant return is the one for the year the QSF is treated as coming into existence.[20]

The returns must be timely filed, but this includes extensions. Moreover, if you are a transferor, you can include a relation-back election statement on your amended return,[21] meaning that you can include the election statement as long as the statute is open on your ability to amend.

In general, you will have three years from the time your original return was filed, or two years from the time the tax was paid, whichever comes later, to include an election statement on your amended return.[22] The Treasury regulations treat the tax year of the transferor's payment to the QSF as the year in which the QSF was formed and accepted by the court.[23]

7. Obtaining the defendant's signature. Although the requirements for a relation-back election are not onerous, obtaining the defendant's signature can be difficult. You need the signature of the defendants who have transferred funds to the fund, account, or trust that you are seeking to have qualified as a QSF. The defendant may not be thrilled about losing the litigation, and consequently may not want to do anything that may be remotely helpful to the plaintiffs or their counsel.

However, some defendants can be persuaded to sign. Signing one or more documents after settlement can be innocuous, particularly if they are of the administrative or ministerial variety. You may be able to rely on language in a settlement agreement that the defendant will cooperate.

You may find the defendant wants a separate agreement or indemnity before signing. Of course, sometimes a defendant will sign out of self-interest, accelerating its tax deduction as shown in Example 1 below. Moreover, sometimes a judge may be helpful in convincing (or even ordering) the defendant to sign a relation-back election.

8. Consider some examples. For plaintiffs mired in the process of litigation and the crush of issues addressed at settlement time, the relation-back election provides a second chance to address tax issues. Consider these real-life examples:

Example 1: On September 1, 2008, a defendant corporation (with a tax year ending October 31) settles a class action for tort liabilities. Under the settlement agreement, the defendant transfers $50 million to a segregated fund on September 1, 2008, and an additional $50 million on October 31, 2008. On November 1, 2008, a federal district court approves the settlement agreement and the fund.

The defendant and the administrator may make a relation-back election by attaching an election statement to the fund's income tax return for the 2008 calendar year. The defendant must attach the election to its income tax return for the tax year ending October 31, 2008. The QSF will be treated as coming into existence on September 1, 2008 (the date of the first transfer). The defendant's September 1, 2008, and October 31, 2008, transfers to the fund are treated as transfers to a QSF.[24]

If the defendant did not consent to the election, the defendant might have trouble claiming its deduction on its tax return for its year ended October 31, 2008. After all, without the relation-back election, there is no QSF until November 1.

Example 2: On September 1, 2008, a defendant corporation (with a tax year ending October 31) settles a class action for tort liabilities. Under the settlement agreement, the defendant transfers $50 million to a segregated fund on September 1, 2008, and $50 million on October 31, 2008. On May 1, 2009, in the next calendar year, a federal district court approves the settlement agreement and the fund.

The defendant and the administrator may make a relation-back election by attaching an election statement to the fund's income tax return for the 2009 calendar year. The defendant must attach the election to its income tax return for the tax year ending October 31, 2009. The QSF will be treated as coming into existence on January 1,

[15] *Id.*
[16] *Id.*
[17] Reg. section 1.468B-1(j)(2).
[18] Reg. section 1.468B-2(k)(3).
[19] Reg. section 1.468B-1(j)(2)(ii).
[20] *Id.*
[21] *Id.*
[22] *See* section 6511(a).
[23] Reg. section 1.468B-1(c) and (j)(2).
[24] Reg. section 1.468B-1(1), Example 4.

2009 (not on September 1, 2008). The defendant's September 1, 2008, and October 31, 2008, transfers to the fund are treated as January 1, 2009, transfers to the QSF.[25]

9. IRS can issue waivers. Even the ordinary timing of the relation-back procedure is not rigid. The commissioner has discretion, with good cause shown, to grant a reasonable extension of time to make the relation-back election if any one of the following applies:

- the plaintiff requests relief before the failure to resolve the defect is discovered by the IRS;
- the plaintiff failed to make the election because of intervening events beyond his control;
- the plaintiff failed to make the election because, after exercising due diligence, the plaintiff was unaware of the necessity for the election;
- the plaintiff reasonably relied on the written advice of the IRS; or
- the plaintiff reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.[26]

The "or" at the end of this list is important. Again, the plaintiff must satisfy only one of the above tests for relief. Private letter rulings suggest that the IRS is pretty helpful on this issue when asked.[27] Although an IRS private letter ruling cannot be cited as precedent, it does provide an indication of the position of the IRS.

One big question is how an "I wanted to make the relation-back election, but I couldn't get the defendant to consent" entreaty would fare.

10. When in doubt, consider asking the IRS. All of this brings us back to LTR 200946022, the Service's most recent foray into the realm of the relation-back election. There, the taxpayer was a defendant in a case (on date 1) that eventually settled (on date 2). Under the settlement agreement, the taxpayer (on date 3) paid monies into an escrow account.

On date 5, the parties agreed that the fund would be treated as a QSF. The taxpayer and the escrow agent were required by a stipulation filed with the court to make any elections (including a relation-back election) so that the QSF would be legitimate. On date 6, the court entered an order approving the stipulation and ordering the fund to remain under its continuing jurisdiction. The fund included a proper relation-back election statement on its first timely filed income tax return.

However, the taxpayer failed to attach the relation-back election statement to its tax return for its tax year ending on date 4. Taxpayer later (on date 7) filed an amended income tax return for that year, attaching the missing relation-back election statement. At that point, the statute of limitations was still open on the tax year that ended on date 4.

The ruling concludes happily, blessing QSF treatment. In fact, rather than allowing this taxpayer extra time for making a late election, the ruling concludes that the taxpayer doesn't really require an extension. There was no need because the taxpayer made the relation-back election on an amended return. Reg. section 1.468-1(j)(2) expressly allows taxpayers to make such an election on an amended return. That meant the election was not late.

Arguably, there is no downside to asking the IRS for approval of a QSF. Of course, this should be tempered with the notion that if you are irrevocably committed to a particular course of action and cannot unring the bell, it may sometimes be better not to ask too many questions. Still, all indications are that the Service likes QSFs and sees no abuses, at least in normal cases such as that presented in LTR 200946022. But presumably if you fall squarely within the rules that allow a relation-back election and you do not need more time, you should not ask.

D. Conclusion

Plaintiffs, defendants, and their counsel are all finding that QSFs provide tax efficiency and allow time to evaluate structured settlement alternatives, resolve liens, and settle issues regarding fees and costs. These benefits are over and above the traditional purpose of a QSF — helping coplaintiffs to resolve their own disputes about who gets what following a defendant's settlement.

A QSF allows the defendant to pay its money and obtain a court-approved release, so the defendant is entirely out of the litigation. There may be one defendant or dozens, and the same liberal rule applies. This is so even if the trust holds the money for months or years before distributing it to the plaintiffs and their counsel. The defendant is entitled to an income tax deduction when the money goes into the trust, even if it will be years before the plaintiffs see a dime. It is almost too good to be true.

Plainly, a QSF should be formed before the settlement agreement is fully negotiated and signed. The QSF should be fully set up, and everyone should be aware that it will be the repository of settlement monies once the settlement agreement is finalized. Yet if the parties have not been so organized and find themselves in a pinch, a QSF is often still possible. In those cases, the relation-back election can extend the period in which to act after settlement monies hit a qualifying trust account.

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[25]Reg. section 1.468B-1(1), Example 5. For further discussion of the relation-back election, see Robert W. Wood, "Curing Constructive Receipt for Tax Purposes?" *Tax Notes*, Mar. 24, 2008, p. 1307, *Doc 2008-4073*, or *2008 TNT 58-24*.

[26]Reg. section 301.9100-1(a).

[27]*See* LTR 200140031 (July 3, 2001), *Doc 2001-25521*, *2001 TNT 195-68*; LTR 199904009 (Oct. 27, 1998), *Doc 1999-4349*, *1999 TNT 20-26*; and LTR 9550010 (Dec. 15, 1995), *95 TNT 245-28*.