Ten Reasons *Not* to Form a Qualified Settlement Fund

By Robert W. Wood

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Qualified settlement funds (QSFs) are flexible and tax advantaged vehicles and for that reason, it's hard to think of a reason not to form one as civil litigation winds down. Wood suggests 10 reasons not to form a QSF, hoping that reverse psychology will propel many naysayers to use QSFs to help resolve disputes, facilitate structured settlements, and regularize the conclusion of litigation.

Qualified settlement funds (QSFs, also called 468B funds because they are formed under section 468B), are so flexible and advantageous that it's hard to come up with a reason *not* to form one as a case is coming close to settlement. QSFs are de rigueur in class actions, in which all plaintiffs may not be identified or you need time to deal with individual claims and forms of payment. However, it's hard not to be amazed at how advantageous a QSF can be in just about every run-of-the-mill case.

Who couldn't use more time to determine an equitable allocation between plaintiffs? Who couldn't use more time to fix final attorney fees and costs? Who couldn't use more time to facilitate the thoughtful purchase of structured settlements? Across the board, everyone benefits by forming QSFs. They are good for mediators and judges, too.

QSFs are simple trusts set up to resolve claims. They do so in a kind of wondrous no man's land in between the defendant(s) and plaintiffs. They can cost as little as $5,000 to $10,000 from start to finish. Why doesn't everyone do it, I've wondered? In fact, the advantages are *so* great that I get frustrated extolling to lawyers and clients all of the benefits they'll get out of forming one. Too often, they don't listen, or don't want to invest a few dollars that will pay returns in triple digits.

Then it struck me: Maybe it would be more effective to tell them why *not* to form a QSF! Reverse psychology and myth-busting seem worth a try. Here, then, are 10 reasons *not* to form a QSF.

1. Defendants might not get a tax deduction. Should defendants worry they won't get their tax deduction when they put money into a QSF instead of paying the plaintiffs directly? Hardly. In fact, 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. That usually means a defendant cannot claim a deduction until the plaintiff receives the funds. But not with QSFs, the tax law's big exception to the normal reciprocity between payer and payee.

2. QSF requirements are hard to satisfy. If you think there are many hurdles to establish a QSF, think again. There are only three, and they are easy. First, the QSF must be subject to court supervision. That means you go to court and ask the judge to approve a trust document and take jurisdiction over the assets.

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.

3. Finding a trustee is tough. You might think trustee requirements are rigorous. Nope. Anyone over the age of 18 and legally competent can be a trustee. That gives you almost infinite flexibility. In fact, even the plaintiff's lawyer can be a trustee, although I don't recommend it given the fact that the lawyer is already wearing one hat. The trustee need not even be a trust company or trust specialist.

Lawyers and accountants often act as trustees to QSFs. Even your brother-in-law can do it. You can also bifurcate duties, having a trustee and a separate ''administrator.''

4. Only one court can approve a QSF, and it will be intrusive. If you think you must form your QSF with the same court and the same judge who has considered (and had jurisdiction over) your case, think again. Any court will do. If you're just wrapping up a several-year case before a federal judge whom you can't stand, you can go down the street and form a QSF in the local probate court to administer the funds that will be paid when the federal case resolves. You can form your QSF in a state court, although the underlying litigation is a federal matter and vice versa. Some advisers even prefer probate court, because probate judges are usually familiar with trusts and trust documents.

And whatever court you select is unlikely to be intrusive unless you want it to be. A common objection I hear is that the court will be way too involved in distributions to satisfy the lawyers. This fear is entirely unfounded.

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 excess court involvement.

5. QSF tax treatment is bad or complicated. Most trial lawyers know little about taxes, yet a common objection to forming a QSF is that the tax position (of the lawyer, the clients, or both) is somehow going to get more complicated. Nothing could be further from the truth. The rules are easy and straightforward.

A QSF must apply for and receive its own employer identification number from the IRS. That takes all of five minutes. Then the QSF files a simple tax return once a year, which is usually all the QSF lasts.

The QSF is taxed separately, but *not* on contributions from the defendants when they put their money in. Those are nontaxable contributions. In fact, the QSF is taxed only on the income (usually interest and dividends) it earns on those contributed funds. Against that income, the QSF gets to deduct trustee fees, lawyer fees, and other expenses. Often, it all zeroes out so no tax is due.

6. The defendant can never get the money back. The defendant may express concern that once it puts settlement money into the QSF, it can never get its money back, even if somehow the settlement unravels. Not true. That misconception arises because we often say that the defendant has to irrevocably pay the money and can't have an interest in the QSF.[1]

But this irrevocability is really a misnomer. If the settlement doesn't happen, no problem, the defendant can get its money back. You can even fund a QSF while a case is on appeal. One 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.

What's more, the defendant *still* gets its tax deduction *immediately* on 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.

7. A QSF will mess up plaintiff's tax planning. I sometimes hear plaintiffs or their lawyers worry that a QSF will destroy favorable tax language they have negotiated into a settlement agreement with the defendant(s). They may also fear that a QSF will somehow add another layer of Forms 1099, making tax returns and compliance more difficult. Both fears could not be more wrong.

In fact, the reverse is true. Adding a QSF almost invariably *improves* the plaintiffs' odds of getting their desired tax treatment. Plus, when plaintiff and defendant are negotiating a settlement but cannot agree on tax language or tax reporting, forming a QSF can bridge these difficulties. The QSF will allow the defendant to pay over the money and claim its deduction. Then, the plaintiffs can orchestrate *a second settlement agreement* with the QSF containing all the tax language they want.

8. You can't or won't do structured settlements. Structured settlements call for payments over time. They receive tax, financial planning, and asset protection advantages. Some structures are tax free and others are taxable. With or without a QSF, virtually every plaintiff can arrange one.

But one reason many don't is simply lack of time and expertise. A plaintiff overwhelmed with settlement details may not be ready to make financial decisions on the spot. Yet often the settlement process can't wait. QSFs facilitate that time, allowing plaintiffs to consider structures after the defendant is out of the picture and while the settlement monies are 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, etc. Plus, the plaintiff 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.

9. You have limited time with a QSF. There is no time limit on the duration of a QSF. True, in practice QSFs usually exist for a short time, sometimes a matter of a few months. In simple cases, that can be enough time to determine who will get what, to resolve Medicare (or other) liens that may exist, to investigate and select structured settlements, and so on. In complex cases, however, QSFs can exist for many years, and there appears to be no outside time limit.

That is remarkable, given the normal tax rules of constructive receipt and economic benefit. With a QSF, monies are not treated as received by the plaintiff(s) 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.

10. You need many plaintiffs to make a QSF work. QSFs are obviously invaluable in class actions, when the sheer number of plaintiffs means something has to give. Multiple defendants can also militate in favor of a QSF. But you hardly need that number for a QSF to make sense. Even two plaintiffs can benefit big time.

Whether one plaintiff is enough is an open question. The statute and the Treasury regulations suggest that a QSF should work fine if you have "one or more" claims.[2] However, the IRS has never made its opinion on this known, and the structured settlement industry is divided (actually, *polarized* would be a better description of this

[1]*See* reg. section 1.468B-3(c)(2); and LTR 9839027, *Doc 98-28997, 98 TNT 187-29*.

[2]*See* reg. section 1.468B-1(c)(2).

issue). Some structured settlement industry insiders have urged Treasury to come down one way or the other.

Personally, I always want at least two claimants. But what is "two"? How about husband and wife or lawyer and client? What about one plaintiff and a Medicare lien? Optimally, of course, there will be two or more *named* plaintiffs, but it is not crystal clear they are required.

Conclusion

So how do these 10 reasons not to form a QSF stack up? Not very well. In fact, it's hard to make a case *against* QSFs. They are tremendously malleable and their uses are increasing. Plaintiff and defense lawyers alike are surprised when they learn the demonstrable benefits of a QSF. Clients like them, too, as do mediators and judges.

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 defendant and to plaintiff;
- Time to consider structures and other arranged payouts for plaintiffs and their lawyers; and
- The ability to handle all the tax, legal fee, and payout issues strictly between the plaintiffs and their lawyers *outside* the presence and influence of the defendant(s).

What's not to like?