Curing Constructive Receipt for Tax Purposes?

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Lawyers and clients nearly always face tax considerations when settling a case. Ideally, they will consider taxes *before* executing settlement documents because, inevitably, they face tax considerations after receiving the money. Although there are many different tax considerations defendants and plaintiffs should bear in mind, I want to focus here on one of the most basic: constructive receipt.

We all know that tax considerations apply to many types of payments we receive. Receipt is understandable, and we are used to tax obligations hinging on receipt. Yet, often, tax considerations apply to payments we do not actually *receive*, but merely have the *right* to receive. Because much of tax law is about timing, these matters can be quite significant.

For example, suppose a lawyer receives $10,000 in settlement of a case. Suppose $6,000 belongs to the client (the lawyer's contingent fee is 40 percent). Even though the client may not physically receive his share right away, the lawyer is generally considered the client's agent. That means the client is *deemed* to receive the money when the lawyer gets it. This can have many practical ramifications. Cases settling late in the year can be problematic because the client may be taxed in year 1, even though he doesn't physically receive a check until year 2.

Because constructive receipt rules focus on when a taxpayer has the *right* to receive money, it is important to discuss legal and contract rights. Suppose a client agrees orally to settle a case in December, but specifies that the money is to be paid in January. In which year is the amount taxable? The mere fact that the client *could* have agreed to take the settlement in year 1 *does not* mean the client has constructive receipt. The client is free to condition his agreement (and the execution of a settlement agreement) on the payment in year 2.

In much the same way, you are free to sell your house, but to insist on receiving installment payments, even though the buyer is willing to pay cash. However, if your purchase agreement specifies you are to receive cash, it is then too late to change the deal and say you want payments over time. The legal rights in the documents are important. This concept of constructive receipt runs throughout the tax law.

Qualified Settlement Funds

These rather basic constructive receipt issues should be borne in mind as we discuss qualified settlement funds (QSFs). In many ways, the rules of constructive receipt seem to be thrown out the window when using this important and innovative settlement device. A QSF (sometimes called a section 468B trust because that is the enabling code section) is a mechanism typically set up as a case is being resolved.

The IRS regulations generally provide that a fund, account, or trust is a ''qualified settlement fund'' if it satisfies the following three requirements:

- it is established under an order of, or is approved by, specified governmental entities (including courts) and is subject to the continuing jurisdiction of that entity;
- it is 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
- the fund, account, or trust must be a trust under applicable state law or its assets must otherwise be segregated from other assets of the transferor.[1]

A fund, account, or trust is not treated as the owner of assets of the fund, account, or trust until all three of the above requirements are met.[2]

As a procedural matter, many plaintiffs' attorneys (or structured settlement brokers) contact a tax attorney before the settlement agreement is finalized to try to minimize the tax impact of the settlement to the plaintiff. Increasingly, savvy plaintiffs' counsel will ask a tax attorney to form a section 468B trust before any settlement payment is made. Then, when the settlement is concluded, funds are transferred directly into the section 468B trust, preserving flexibility for plaintiffs and their counsel to consider structured settlements, etc.

Section 468B trusts are counterintuitive from a tax perspective because they allow defendants to pay money into the trust and be entirely released from liability in a case, yet neither the plaintiff(s) nor plaintiffs' counsel will yet have income. Normally, tax law is reciprocal, but here, the defendant is treated as paying money even

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

though the funds are on hold in the QSF. Unlike an attorneys' trust account, which can be treated as owned by the lawyer and the client, the section 468B trust is a kind of holding pattern, in which no one is (yet) taxed on the principal or corpus of the trust (but the defendant is allowed to deduct the settlement payment). Any interest earned on the funds in the trust is taxed to the trust itself.

Given these benefits, setting up a section 468B trust can make enormous sense as a case is coming to a conclusion. However, as anyone who has been involved in settlement discussions knows, there is much to be done as a case winds down. In some cases, issues aren't dealt with when they should be. Unfortunately, tax lawyers will tell you that the form of a transaction and the order in which events occur are extraordinarily important to tax results.

If you wake up one morning and the defendant has already paid settlement money to plaintiffs' counsel, is it too late to establish a section 468B trust? Surprisingly, the answer is not necessarily.

Retroactive Fix

There are few times when the tax law seems merciful, but this is one. In some cases, even *after* receipt of settlement proceeds, one can still invoke QSF treatment. If you meet the rules, you can elect *after the fact* to have QSF treatment.

This extraordinary rule allows you to retroactively designate a bank account as a QSF if you meet two tests:

- the attorney's fund, account, or trust is a trust under the law of the state where the attorney established the account (usually it is); or the account's assets are otherwise segregated from other assets of the defendant (usually they are); and
- the attorney's trust or account is established to resolve or satisfy one or more claims that have resulted, or may result, from the litigation settlement (again, not difficult).

Usually, an attorney's client trust account will satisfy the requirement of being a trust account under state law. However, it is important for the attorney to segregate the client's recovery from other funds. Fortunately, this is the general practice of many plaintiffs' counsel.

When these tests are met — and they are easy to meet — you can petition any court to create and approve a trust. This relation-back election gives everyone more time to determine if 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 returns, and even asset protection.

Sweet Time

If you make a relation-back election, the QSF is treated as coming into existence on the later of the date the fund, account, or trust meets the second and third basic QSF requirements of the regulations (discussed above), or January 1 of the calendar year in which all of the three requirements listed above are met. The assets held on the date the QSF is treated as coming into existence are treated as transferred to the QSF on that date.

The time for making the election is liberal, too: It's due when the tax return to which it relates is filed. You make a relation-back election by attaching a copy of the election statement, signed by each defendant and the trust administrator, to the federal income tax return of the QSF for the tax year in which the fund comes into existence.[3] The return must be timely filed, but fortunately, that includes extensions. The federal income tax return for a QSF is due on or before March 15.[4] A copy of the election must also be attached to the timely filed income tax return (including extensions) of the defendant for the year of the payment. The tax year of the payment is the year in which the QSF was formed and accepted by the court.

Although the requirements for a relation-back election are not too tough, obtaining the defendant's signature can be difficult. After all, the defendant may not be thrilled about losing the litigation. However, many defendants can be won over to sign (signing one or more documents after settlement can be innocuous) by a good explanation. Moreover, sometimes a judge may be helpful in persuading the defendant.

Discretionary Relief

There is rarely a second chance when it comes to tax issues. For plaintiffs mired in the process of litigation and the crush of issues addressed at settlement time, the relation-back election can provide a second chance to address tax issues. Plus, even the relation-back procedure is not rigid. The IRS has discretion, with good cause shown, to grant a reasonable extension to make the election if the plaintiff:

- requests relief before the failure to resolve the defect is discovered by the IRS;
- failed to make the election because of intervening events beyond his control;
- failed to make the election because, after exercising due diligence, the plaintiff was unaware of the necessity for the election;
- reasonably relied on the written advice of the Service; *or*
- reasonably relied on a qualified tax professional, and the tax professional failed to make, or advise the taxpayer to make, the election.[5]

The "or" at the end of this list is important. The key point here is that 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.[6] Although an IRS private letter ruling cannot be cited as precedent, it does provide an indication of the position of the IRS in connection with such an issue.

Conclusion

Increasingly, plaintiffs, defendants, and their counsel are finding that QSFs can provide tax efficiency and allow the time needed to evaluate structured settlement alternatives. This is on top of their most classic purpose, helping coplaintiffs to resolve their own disputes about who gets what following a defendant's settlement. A section 468B trust allows the defendant to pay its money

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

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

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

[6]*See* LTRs 200140031, *Doc 2001-25521*, *2001 TNT 195-68*; 199904009, *Doc 1999-4349*, *1999 TNT 20-26*; and 9550010, *95 TNT 245-28*.

and obtain a court-approved release, so the defendant is entirely out of the litigation, even if the trust holds the money for months or years before distributing it to the plaintiffs and their counsel. Not coincidentally, the defendant also is entitled to a tax deduction when the money first goes into the trust.

Ideally, a QSF should be set up before the settlement agreement is signed and before the money is paid. A few weeks is usually enough time to do everything. Sometimes, however, for whatever reason, the plaintiff's attorney will end up with a signed settlement agreement and money in the bank, only then realizing that the clients want to structure their recoveries or that an attorney fee structure for the lawyers would be advantageous.

Amazingly, the relation-back election can facilitate such planning. Not only that, but the period in which to do so extends into the next year (possibly even two years) after the money hits a qualifying trust account. The rules are pretty clear for making a relation-back election, and they can be met relatively easily. But, because the tax benefits of using a QSF can be millions of dollars if you have a messy case and need an IRS ruling, even that process can be an economical way to provide the beneficiaries of the trust with a solution to an otherwise disastrous tax problem.