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468B Qualified Settlement Funds Pending Appeal?

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In this article, Wood points out that payments to qualified settlement funds can be deducted even though the defendant appeals the verdict. The appellate court puts it beyond the defendant's control, so the potential reversion does not cancel the deduction.

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I have often advocated the use of qualified settlement funds (QSFs) as a means of effecting orderly, thoughtful, and tax-efficient conclusions to litigation. QSFs hold advantages for plaintiffs, for plaintiff's counsel, and most classically for the defense. While QSFs today are most frequently touted by plaintiff's lawyers and structured-settlement brokers (the latter seeking to expand the structured-settlement annuities field), they were designed to aid defendants.

Defendants receive an income tax deduction on paying a settlement or judgment into a QSF. One might assume that the all-events test would not be satisfied until monies are actually paid out to plaintiffs. After all, section 461(h) requires economic performance before an accrual-basis taxpayer can claim a deduction. That usually requires someone to actually receive payment.

However, the rules governing payments to QSFs explicitly provide that economic performance occurs when the transferor pays a QSF to resolve or satisfy a liability.[1] The later receipt of the payment by the plaintiff-recipient is not required for economic performance. Therefore, in tax parlance, the QSF operates as an exception to the general economic performance rules for accrual-basis taxpayers.

[1]Reg. section 1.468B-3(c)(1).

QSF Basics

A QSF is a fund, account, or trust that meets three general requirements. First, it must be established in accordance with an order of, or approved by, the United States, any state (or political subdivision thereof), or any agency or instrumentality (including a court of law), and must be subject to the continued jurisdiction of that governmental authority.[2]

Second, it must be established to resolve or satisfy one or more contested or uncontested claims from an event that has already occurred. There must be at least one claim asserting liability:

- under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980;
- arising out of a tort, breach of contract, or violation of law; or
- designated by the commissioner in a revenue ruling or revenue procedure.[3]

Finally, the QSF must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).[4]

QSFs and Contested Liabilities

Can a payment to a QSF be deductible even though the defendants have a right to receive a refund if their appeal of the contested liability is ultimately successful? Stated differently, can a trust qualify as a section 468B trust even though it specifically provides for such a reversion? The answer is yes to both questions, and the reasoning behind that answer involves considerable history. Before perusing that history, however, it is worth noting the current law.

The regulations make clear that monies transferred to QSFs satisfy the economic performance requirements. They point out, however, that economic performance does not occur if the transferor has a right to a refund or reversion under some conditions.[5] The transferor's retained right will prevent economic performance if it is exercisable currently and without the agreement of an unrelated person with an adverse interest (such as the court that approved the fund or the claimants to the fund).[6]

The regulations also state that economic performance does not occur if the reversion to the transferor will occur on an event that is certain to occur (such as the passage of time).[7] Admittedly, the regulations do not *explicitly* state that a defendant's transfer of an amount subject to a

[2]Reg. section 1.468B-1(c)(1).
[3]Reg. section 1.468B-1(c)(2).
[4]Reg. section 1.468B-1(c)(3).
[5]Reg. section 1.468B-3(c)(2).
[6]Reg. section 1.468B-3(c)(2)(i)(A).
[7]Reg. section 1.468B-3(c)(2)(i)(B).

pending appeal satisfies the economic performance rule. Yet how does the case on appeal stack up against the two prohibited types of reversionary rights?

Clearly, if a defendant has suffered an adverse verdict and is appealing the judgment to an appellate court, the matter is out of the defendant's hands. The appellate court may affirm, reverse, or take another action, such as reducing the judgment. Whatever the appellate court does, it is beyond the defendant's control and is within the court's province. Neither one of the two prohibited types of reversions addressed in the regulations appears to apply.

There are several private letter rulings addressing such reversions. In LTR 200716013 (Jan. 11, 2007),[8] the IRS addressed a reversion of monies remaining in an escrow account, concluding that the obligor's right to the reversion did not preclude the application of economic performance. Under the facts in the ruling, amounts remaining after a specific number of days would revert to the transferor.

The ruling distinguished this case from the two prohibited types of reversions. The transferor could not access the funds for any purpose other than satisfying the plaintiffs' claims during the time the monies were in the escrow account. The transferor expected claims to be made against all the funds, that the funds would be used to satisfy claims, and that nothing would be available for reversion. Importantly, there was no guarantee (and little likelihood) that any amounts would revert to the transferor.

In that respect, reversion would require not only the passage of time (which would prevent economic performance under reg. section 1.468B-3(c)(2)(i)(B)), but also that the transferor would successfully defend against claims brought by the plaintiffs. Although the passage of time was certain to occur, it was uncertain whether the plaintiffs would either file or prevail on their claims against the transferor company. Thus, reversion was conditional.

Thus, the payments were not transferred under conditions allowing a refund or reversion on an event that was certain to occur. Similarly, the ruling points out that the transferor did not have a currently exercisable right to a refund or reversion which would have prevented economic performance under reg. section 1.468B-3(c)(2)(i)(A).

In LTR 200138006 (May 7, 2001),[9] a reversionary interest also did not prevent economic performance where the reversion required the agreement of an unrelated and independent trustee along with the occurrence of an event that was not certain to occur.

Under the regulations and several letter rulings, it seems difficult to argue that a defendant should not be permitted to deduct a verdict paid into a QSF under the all-events test. After all, the two exclusions preventing economic performance do not apply. That appears true no matter how vigorously the defendant is pursuing an appeal.

[8]*Doc 2007-10053, 2007 TNT 78-33*.

[9]*Doc 2001-24396, 2001 TNT 185-26*.

Historical Answer

The tax history on the point is perhaps even more persuasive. Axiomatically, contested liabilities are deductible when paid, regardless of appeals. In *Chestnut Securities Co. v. United States*,[10] the Court of Claims held that an accrual-basis taxpayer could deduct state income taxes it had paid but was contesting in the courts. The court explained:

> One is not entitled to accrue a debt or other liability which is asserted against him but which he disputes and litigates, until the litigation is concluded. But if a liability is asserted against him and he pays it, though under protest, and though he promptly begins litigation to get the money back, the status of the liability is that it has been discharged by payment. It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet 'accrued' within the meaning of the tax laws and the terminology of accounting.

Similarly, in GCM 25298,[11] the IRS concluded that taxes were deductible even though the taxpayer contested them in a refund claim and then via filing a suit in court. That remained the law until the U.S. Supreme Court decision in *United States v. Consolidated Edison Company of New York, Inc.*[12]

Consolidated Edison held that contested real estate taxes paid by the taxpayer were not deductible until the tax dispute was ultimately decided. The decision was a surprise to the tax community, was contrary to the IRS's policy, and disadvantaged accrual-basis taxpayers. It also provoked a reaction. Congress came to the rescue in 1964 by enacting section 461(f) to clarify that contested liabilities are deductible when paid or otherwise set aside to satisfy the contested liability.

Section 461(f) was simple in operation, allowing a deduction when a taxpayer transfers money or property to satisfy a contested liability beyond his control.[13] The Senate report explained:

> Although your committee does not question the legal doctrine laid down by the Supreme Court in the *Consolidated Edison* case, it believes that it is unfortunate to deny taxpayers a deduction with respect to an item where the payment has actually been made, even though the liability is still being contested either as to amount or as to the item itself.[14]

As enacted in 1964, section 461(f) allowed taxpayers to deduct the payment of contested liabilities if:

[10]62 F. Supp. 574 (Ct. Cl. 1945).

[11]1947-2 C.B. 39.

[12]366 U.S. 380 (1961).

[13]*Maxus Energy Corp. v. United States*, 31 F.3d 1135, 1142 (Fed. Cir. 1994), *Doc 94-7122, 94 TNT 149-13*.

[14]S. Rept. No. 830, 88th Cong., 2d Sess. 100 (1964); *see also* S. Rept. No. 830, 88th Cong., 2d Sess., 243 (1964): "The new subsection (f), in the case of contested taxes, provides that the contested amount is deductible for the year of payment."

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- the taxpayer contests the asserted liability;
- the taxpayer transfers money to provide for the satisfaction of the asserted liability;
- the contest with respect to the asserted liability exists after the time of the transfer; and
- but for the fact that the liability is contested, a deduction would be allowed for the tax year of transfer or for an earlier tax year.

And so it was for the next 20 years. Under the regulations, a taxpayer was entitled to deduct payments of contested liabilities in several ways:

> by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be delivered in accordance with the settlement of the contest.[15]

Orwellian 1984

In 1984 the enactment of subsection 461(h) changed the rules. Its enactment keyed a tax deduction for accrual-basis taxpayers to ''economic performance.''[16] That legislation similarly clarified section 461(f).[17] Two years later, as a technical correction to this 1984 legislation, section 468B was born.[18]

Under section 468B, economic performance occurs as qualified payments are made to a designated settlement fund (DSF), a type of litigation-settlement fund preceding the advent of the QSF.[19] However, section 468B(e) delimits the availability of the special economic performance rules *only* to payments made to DSFs. Payments to any other trust or escrow fund have to meet the normal all-events test to be deductible.

Still tinkering two years on, Congress amended section 468B in 1988, this time adding section 468B(g).[20] Section 468B(g) authorized the Treasury secretary to promulgate regulations. Congress also carved out section 468B(g) funds from the nonapplicability provisions of section 468B(e). Thus, funds created under the auspices of section 468B(g) were specifically made applicable to contested liabilities under section 461(f), a fact later confirmed in regulations.[21]

Becoming a Butterfly

What happened next was evolutionary — the DSF blooming into the QSF. Although section 468B speaks in terms of a DSF, Treasury saw fit to expand the concept materially by issuing regulations that are much more expansive than the DSF rules.[22]

While QSFs have only three establishment requirements, DSFs must meet six. A DSF may only receive qualified payments, consisting of money or property transferred to the DSF in accordance with a court order. Notably, the money or property so transferred cannot be transferred back to the taxpayer, and it cannot be the stock or indebtedness of the taxpayer or a related person.[23] The regulations contain no similar requirement that QSFs may receive only qualified payments.[24]

Also, the QSF rules are mandatory, not elective, so QSFs are considerably more flexible.[25]

The U.S. Court of Appeals for the Tenth Circuit has determined that the QSF birthing regulations were issued in accordance with Congress's mandate in section 468B(g) and are valid.[26] The regulations clarify that QSF treatment is available for *both* contested and uncontested liabilities. A fund, account, or trust is established as a QSF if, among other requirements:

> it is established to resolve or satisfy one or more *contested* or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability.[27]

The inclusion of the term ''contested . . . claims'' was specifically intended to refer to the types of contested liability trusts described in the old 26 C.F.R. section 1.461-2(c) (1983) rules, discussed above.

Indeed, the preamble to the regulations explains:

> The final regulations also clarify that a section 1.461-2(c)(1) contested liability fund satisfies the ''resolve or satisfy requirement'' by providing that qualified settlement fund treatment is available for both contested and uncontested liabilities.[28]

History therefore proves that:

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[15] 26 C.F.R. section 1.461-2(c) (1983).

[16] H. Conf. Rept. No. 98-861, 98th Cong, 2d Sess. 1559 (1984).

[17] *Id.* at 1560 and 1564.

[18] Tax Reform Act of 1986, section 1881, P.L. 99-514, 100 Stat. 2085, 2914 (1986).

[19] S. Rept. No. 99-313, 99th Cong., 2d Sess. 926 (1986), *reprinted in* 1986-3 C.B. (vol. 3) at 926.

[20] Technical and Miscellaneous Revenue Act of 1988, section 1018(f)(5)(A), P.L. 100-647, 102 Stat. 3342.

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

[22] Preamble, ''Section 1.468B-1 Qualified Settlement Funds,'' T.D. 8459, 57 *Fed. Reg*. 60,983, 60,984, *93 TNT 2-71*.

[23] Section 468B(d)(1) and (d)(2)(B).

[24] Reg. section 1.468B-3(c)(1) and -3(c)(2)

[25] Section 468(d) requires that the transferor make an election to treat the fund as a DSF.

[26] *United States v. Brown*, 348 F.3d 1200, 1215-1217 (2003).

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

[28] Preamble, ''Section 1.468B-1 Qualified Settlement Funds,'' T.D. 8459, *supra* note 22; *see also* Ellen K. Harrison and Gary B. Wilcox, ''Settlement Fund Final Regs. Answer Many Questions, But Problems Still Exist,'' 78 *J. Tax'n* 342 (1993). (''The final Regulations clarify that funds described in Section 461(f) meet the 'resolve or satisfy' requirement by providing that QSF treatment is available for both contested and uncontested liabilities.'')

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- Congress intended to treat QSFs for contested liabilities as fully qualified;
- Treasury issued regulations specifically recognizing that trusts similar to contested liability trusts under 26 C.F.R. section 1.461-2(c) qualify as QSFs; and
- transfers to these trusts are deductible.[29]

Conclusion

QSFs are good for plaintiffs and their counsel, often providing needed breathing room so that allocations among claimants can be determined, costs can be tallied, and structured payment arrangements can be considered. They are good for defendants too, often making the mechanics of a messy case easier. There are also tax advantages for everyone.

Most defendants are well aware they can deduct a payment to a QSF. Yet many defendants are not aware they can transfer funds to a QSF conditioned on losing an appeal. Stated differently, a defendant can vigorously appeal a verdict and yet also claim a tax deduction for its payment into a QSF. The deduction is available notwithstanding an express reversion clause that says the defendant will get its money back if its appeal is successful.

Express reversion clauses in QSF trust documents do not appear to be common. Yet they should often be considered, particularly when a defendant:

- knows the odds in an appeal are stacked against it;
- knows there are appeal bonding requirements to consider which might be obviated by the QSF; or
- does not want to throw in the proverbial towel on the litigation, but may be better off with a tax deduction this year rather than a year or two in the future.

[29]While there are no published cases involving the use of a QSF to secure a contested claim during an appeal, one would not expect to find any such case, unless the IRS challenged the use of a QSF for such purpose. Indeed, the absence of any such published case suggests that the IRS would not challenge the use of QSFs for such purpose. That conclusion would be consistent with the clear history supporting the use of QSFs for contested claims. The IRS has repeatedly issued rulings supporting QSF treatment for contested liabilities. *See* LTRs 199949008 (*Doc 1999-33878, 1999 TNT 238-26*), 9839027 (*Doc 98-28997, 98 TNT 187-29*), and 9503022 (*95 TNT 14-18*).

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