Can You Form a Qualified Settlement Fund With a Judgment?

By Robert W. Wood

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Qualified settlement funds (QSFs) are tremendously flexible vehicles for resolving litigation. Yet as their name suggests, they seem to be used nearly universally in settlements, not after a case has gone to final judgment. QSFs may also be used after judgment, and there is no abuse in employing them in that way.

Qualified settlement funds (QSFs) provide an easy and safe architecture for resolving claims among litigants, paying lawyers, negotiating and satisfying liens, facilitating structured settlements, and winding up complicated litigation. I have often written about their virtues.[1] Historically, QSFs were most frequently used in large and unwieldy class actions involving multiple defendants and plaintiffs.

Some observers find it surprising that QSFs 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 any money would be dispersed. Today it is more likely that plaintiffs will advocate the use of a QSF.

In effect, the QSF operates as an exception to normal accrual accounting that ties a defendant's tax deduction to economic performance, which typically occurs when plaintiffs receive their settlement money.[2] With the intervention of the QSF, a defendant is treated as economically performing a settlement (and therefore entitled to a tax deduction) when money is paid into the QSF, regardless of how long it takes for the funds to reach the plaintiffs.[3]

QSFs are also advantageous for plaintiffs. Because QSFs are separate taxable entities, they operate as a kind of court-supervised intermediary.[4] During the time the QSF holds the money, the plaintiffs are not treated as having received anything.

The plaintiffs may be beneficiaries of the QSF. Although it may be apparent that the plaintiffs will receive a settlement — and it may even be clear precisely how much each plaintiff will receive — they have no income that can be taxed until the distribution actually occurs.[5]

While the federal tax aspects of a QSF are attractive, structured settlements are even more enticing.

Structured Settlements

Section 104(a)(2) excludes from gross income amounts received as damages, other than punitive damages, on account of personal physical injuries or physical sickness.[6] This exclusion applies regardless of whether the amounts are received through a lawsuit or settlement, in a lump sum, or by periodic payments.[7]

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[1] *See* Robert W. Wood, ''Qualified Settlement Funds Pending Appeal?'' *Tax Notes*, July 12, 2010, p. 207, *Doc 2010-13152*, or *2010 TNT 135-12*; Wood, ''Ten Reasons Not to Form a Qualified Settlement Fund,'' *Tax Notes*, May 17, 2010, p. 823, *Doc 2010-9285*, or *2010 TNT 97-8*; Wood, '''Retroactive' Qualified Settlement Funds: 10 Things You Should Know,'' *Tax Notes*, Feb. 8, 2010, p. 793, *Doc 2010-1386*, or *2010 TNT 28-1*; Wood, ''The QSF,'' *The Employee Advocate* at 25 (Spring/Summer 2009); Wood, ''Qualified Settlement Funds: A Mechanism Whose Time Has Come,'' *Los Angeles Daily J.* at 6 (July 23, 2009) simultaneously published in the *San Francisco Daily J.* at 6 (July 23, 2009); Wood, ''Single-Claimant Qualified (468B) Settlement Funds?'' *Tax Notes*, Jan. 5, 2009, p. 71, *Doc 2008-25804*, or *2009 TNT 2-60*.

[2] Reg. section 1.461-4(g)(2).

[3] *See* reg. section 1.468B-3(c)(1).

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

[5] *Id.*; reg. section 1.468B-4.

[6] Section 104(a)(2). For further discussion of section 104(a)(2); *see also* Wood, ''What's Excludable? Despite Amendment, IRC Sec. 104 Leaves Some Questions Unanswered,'' *California CPA* at 31 (July 2006).

[7] Section 104(a)(2).

Of course, claimants will be taxed on future earnings on amounts after they are received.[8] However, 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 many other nontax advantages. Periodic payments can prevent a claimant from squandering a settlement or being preyed on by others, and can help ensure that funds are available for medical and family needs.

Typically a structured settlement is created because the defendant does not want a long-term payment commitment and the plaintiff does not want to rely on the defendant's creditworthiness. Accordingly, the defendant will pay a third-party assignee to assume its liability and make periodic payments to an injured plaintiff. The amount the assignee receives in this "qualified assignment" will not be taxable as gross income to the assignee, except to the extent the amount exceeds the aggregate cost of the "qualified funding asset."[9]

Thus, the assignee may be taxed on the fee it charges to make periodic payments to the claimant, but not on the amounts it receives that are applied toward making the periodic payments.[10] If the defendant is out of the picture, as it will be if a QSF has been formed, qualified assignments may be made to a third-party assignee from a QSF.[11] The trustee or administrator will be responsible for setting up the periodic payment arrangement, including making a qualified assignment to a third-party assignee to make the periodic payments.[12]

Attorney Fees and Structured Fee Arrangements

Attorney fees will usually come out of the gross funds transferred to a QSF. Attorneys representing plaintiffs who will be paid through a QSF can therefore also be thought of as QSF beneficiaries. In the same way that QSFs channel periodic payments to claimants, they facilitate structured fee arrangements for attorneys. In fact, an attorney may receive structured payments from a QSF even if the claimants are not receiving structured payments.[13]

However, some life insurance companies will only structure legal fees if the client is also structuring payments.[14] Thus, if a QSF will arrange the structured payment of fees for attorneys whose clients are not also receiving structured payments, the trustee, administrator, and attorney should seek a life insurance company willing to provide an annuity solely for the attorneys.

Settlement vs. Judgment

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

- 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 foregoing (including courts),[15] and must be subject to the continuing jurisdiction of that governmental authority[16];
- 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[17]; and
- must be a trust under state law, or its assets must be otherwise segregated from the transferor's (or related person's) other assets.[18]

The majority of QSFs are formed to facilitate settlement payments. In fact, many in the structured settlement industry seem to regard QSFs as only applicable to resolve claims in a settlement, and not cases that have reached a final judgment. But this is simply untrue. The IRS has approved QSFs that were funded after all appeals were resolved or dismissed and the judgment became final.[19] What then accounts for the concerns of the structured settlement industry? Some of the concern may simply be with semantics. A qualified settlement fund surely concerns settlements, not judgments. Even the predecessor entity to QSFs, the designated settlement fund, was all about settlements.

[8]Comment letter by Fred Goldberg, Kenneth Gideon, and Jody Brewster, *Doc 2003-15800, 2003 TNT 128-24*.

[9]Section 130(a).

[10]However, if an assignee received a nonqualified assignment to make periodic payments, the assignee would be subject to tax on the amount from which it later makes the periodic payments. It is conceivable that a QSF could be used to facilitate a nonqualified assignment. *See also* Daniel W. Hindert, Joseph J. Dehner, and Patrick J. Hindert, *Structured Settlements and Periodic Payment Judgments*, section 3.06A (2006); Wood, "Nonqualified Settlement Ruling Spurs Damage Structures," *Tax Notes*, July 14, 2008, p. 141, *Doc 2008-14609*, or *2008 TNT 136-30*.

[11]Rev. Proc. 93-34, 1993-2 C.B. 470, section 3, *Doc 93-8638, 93 TNT 167-9*.

[12]Section 130. For further discussion of those qualified assignments, and also of non-qualified assignments, see Wood, *Qualified Settlement Funds and Section 468B*, para. 7.6 (2009).

[13]Wood, "Ten Things CPAs Need to Know About Structured Legal Fees," *Tax Adviser* at 435 (July 2008).

[14]*Id.*

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

[16]*Id.*

[17]Reg. section 1.468B-1(c)(2). Notably, the claims may be contested or uncontested, and they may have already been made or may be possible in the future. This requirement has given rise to some controversy regarding whether a single claimant is sufficient for establishing a QSF.

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

[19]*See* LTR 200748010, *Doc 2007-26376*, *2007 TNT 232-12*.

There is also familiarity. Perhaps plagued by the myopic focus over the single-claimant issue,[20] some in the structured settlement industry seem to fear the QSF like a subterranean mine. Avoiding danger, they surely assume, simply makes sense.

We often think of a settlement and a judgment as fundamentally different. In the case of a settlement, there has been no event triggering a right to income until the settlement agreement releasing legal claims has been fully executed. That is the time at which we traditionally think of income as arising.

In contrast, it is still possible to make changes at any time before the execution of the settlement agreement. In the case of a judgment, it is assumed that all events necessary to fix the plaintiff's right to the income have already occurred. That is, the court has ordered the defendant to pay the plaintiff as specified in the judgment. We may also be tempted to assume that the tax treatment of a judgment that irrevocably calls for payment is somehow fixed in stone, at least after the opportunity for appeal has expired. There are several reasons I believe this reasoning is fundamentally flawed.

The structured settlement industry is often concerned with the notion of constructive receipt, which in general is rarely a good thing, and in the context of structured settlements is a very bad thing. If a claimant has constructive receipt of a lump sum and pursues a structure calling for payments over 30 years, the claimant could have far more taxes to pay than cash.

It can be confusing to ascertain exactly when a claimant has constructive receipt. 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.[21] It is the sending of the invoice, in effect, that triggers the income.

Cash basis taxpayers, conversely, do not have income until they receive cash. Constructive receipt operates as a necessary 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. 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, no one is concerned that a settlement agreement calling for payment into a QSF rather than to a plaintiff would give rise to constructive receipt by the plaintiff.

What about a judgment? Here it seems less clear, at least at first glance. 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, obtaining a judgment should not automatically trigger constructive receipt. In fact, a judgment is often not as final as it may seem. There may be mechanical steps a plaintiff must complete even to secure payment under a judgment.

For example, 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.[22] Moreover, statutory interest provisions may lead to conflicting computations and economic disputes. There is also the possibility of 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 always (or even sometimes) be applied in normal judgment creditor situations. Keep in mind that a judgment is not much different from any other debt obligation, and is rarely, if ever, equivalent to cash. In fact, the defendant may be a deadbeat, or may do everything possible to avoid making the payment. Constructive receipt hardly seems appropriate for amounts the plaintiff may not ever actually receive.[23]

Perhaps for this reason, I am not aware of any case in which the 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. A plaintiff has constructive receipt only when the defendant actually delivers payment or deposits the judgment amount into an account, and the plaintiff can receive or access that amount without compromising its rights.

In *United States v. Steck*,[24] individual plaintiffs obtained a judgment in 1956 for a condemnation award of $30,988.33, plus 6 percent interest. The

[20]"Single-Claimant Qualified (468B) Settlement Funds?" *Tax Notes*, Jan. 5, 2009, p. 71, *Doc 2009-25804, 2009 TNT 2-60*.

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

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

[23]*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).

[24]295 F.2d 682 (10th Cir. 1961).

Kansas Supreme Court affirmed the judgment in the same year. The defendant promptly deposited the principal, but not the interest, with the clerk of the court. The plaintiffs did not withdraw the principal amount, but sued the defendant for the unpaid interest. The Kansas Supreme Court sided with the plaintiffs. In 1958, two years after the original judgment and deposit, the defendant paid the interest to the clerk of the court. The clerk promptly disbursed the entire amount to the plaintiffs.

The tax question was whether the doctrine of constructive receipt required the inclusion of the principal amount of the award on the plaintiffs' 1956 returns, the year in which the defendant paid that amount to the clerk. The court affirmed the trial court's holding that the constructive receipt doctrine did not apply. The court found that under Kansas law, the taxpayer would have forfeited its claim to interest had the principal been subject to withdrawal.

The clerk was prohibited from releasing the judgment until the full amount was paid into the court. Significantly, the court did not hold, and the government did not appear to argue, that the plaintiffs had constructive receipt merely by receiving the judgment award. This was the case even though the judgment was affirmed by the Kansas Supreme Court and the defendant had actually paid most of the judgment to an account for the plaintiffs' exclusive benefit. Instead, the court's analysis focused on the plaintiffs' access to the funds after they were paid.

The Tax Court applied a similar analysis in *Aldridge v. Commissioner*,[25] holding that plaintiffs in another condemnation proceeding constructively received the proceeds in the year the money was deposited with the court. In contrast to *Steck*, the plaintiffs had the right to withdraw the funds at any time. Moreover, they would not have waived any rights under state law had they chosen to do so. Constructive receipt was appropriate because the money on deposit was there for the taking.

The rationale of *Steck* and *Aldridge* appears to be that a plaintiff has no constructive receipt immediately following a judgment award. A claimant has income for tax purposes only after the defendant actually pays the amount outright or to an account to which the plaintiff has unrestricted access. From these principles, it follows that no constructive receipt should occur if the defendant satisfies a judgment by paying into a QSF.

There is also the question whether a court order would bolster the case for the finality of a judgment. For example, suppose plaintiffs sue a defendant based on the effects of toxic mold. The defendant loses the trial and decides not to appeal. The judgment becomes final. Plaintiffs participate in creating a QSF that is approved by the trial court judge. The judge orders the defendant to pay the judgment into the QSF. Do the plaintiffs have constructive receipt?

It may seem that the court order trumps everything else. That is, even if there was a moment when the plaintiffs could have received the cash themselves, the facts played out otherwise. At the very least, it seems reasonable to assume that this fact pattern by itself raises no constructive receipt concerns, and that we would have to know if the defendant was actually trying to pay the plaintiffs and the plaintiffs were refusing to accept the funds, preferring instead that they be deposited into a QSF.

Finally, there is nothing in section 468B to prevent a valid QSF even when the plaintiffs have a current right to receive the funds. All the code requires is a claim or controversy — something that can be resolved or satisfied through the QSF. The language of the statute makes it plain that the purpose of the QSF may be entirely payment oriented.

The dispute may have long since been resolved, either by a judgment or a settlement, even though the payment has not yet occurred. Seen in this light, there is little difference between a QSF formed to effect payment under a judgment and a QSF formed to effect payment under a settlement.

In either case, there is little question about the timing of the payment or the amount, although there may be disputes among multiple claimants regarding who will get what. The income-triggering event, however, is no further along in either case.

Importance of Court Order

As a practical matter, most QSFs will be created as court-approved trusts, that is, the QSF will be ordered into existence by a court. This certainly is true before the court approves a settlement. It is equally true afterward.

Similarly, a judgment ordering a defendant to pay 1,000 plaintiffs does not mean there are no claims to resolve or satisfy. Nor does it mean the money will certainly be paid, or indicate when it will be paid (or even how). The defendant still must pay the money or otherwise satisfy the claims. The plaintiffs must still sort out any issues among themselves, such as determining if they will insist on all cash, structured settlements, and so forth.

Conclusion

Based on the principles discussed above and past ruling practices, it seems unlikely that the IRS would disapprove of a QSF formed following the

[25]51 T.C. 475 (1968).

entry of a judgment. There is no abuse, at least not one that I can detect. There would be a court order that directs the defendant to pay the money covered by the judgment into a QSF. Thus, it is hard to see how the canard of constructive receipt could stand in the way of using a QSF in this context. If using a QSF is generally good policy in the case of a settlement, as I believe it is, it should be just as good in the case of a judgment.