Forum

Qualified Settlement Funds: A Mechanism Whose Time Has Come

By Robert W. Wood

Whatever you choose to call it, a qualified settlement fund, called a QSF or a Section 468B trust, is a flexible dispute-resolution mechanism whose time has come. QSFs are enabled by Section 468B of the Internal Revenue Code, which was enacted in 1986, but they really didn't exist until 1993, when the IRS published regulations detailing their operation. They've really taken off only in the last few years.

In essence, a QSF allows for a tax-free way station. It is a simple trust that serves as a stopping point after one or more defendants pay money to settle a case but before the plaintiffs receive it. Miraculously, the defendant can take a tax deduction for the payment into the QSF, yet the plaintiffs do not have to include *anything* in income until the money is distributed.

Why is this rather amazing vehicle allowed? If you are not a tax lawyer — I confess to being one for 30 years — you may not know that the tax system is almost invariably reciprocal, with a tax deduction only when someone else has receipt. Here, however, Congress thought, and the IRS agreed, that defendants needed an incentive to pay. Defendants needed to be assured of their tax deduction, even though there might be complexities to work out, particularly in class actions.

The QSF is ideal when there are many plaintiffs, who may or may not even be identified. The QSF is also useful when there is some kind of claims procedure that must occur or other nuances of settlement. The QSF allows the various plaintiffs to determine precisely how they want their payment, whether in a lump sum, a structured settlement or some combination. The same is true for contingent-fee lawyers, who can decide through a QSF when and how they are paid.

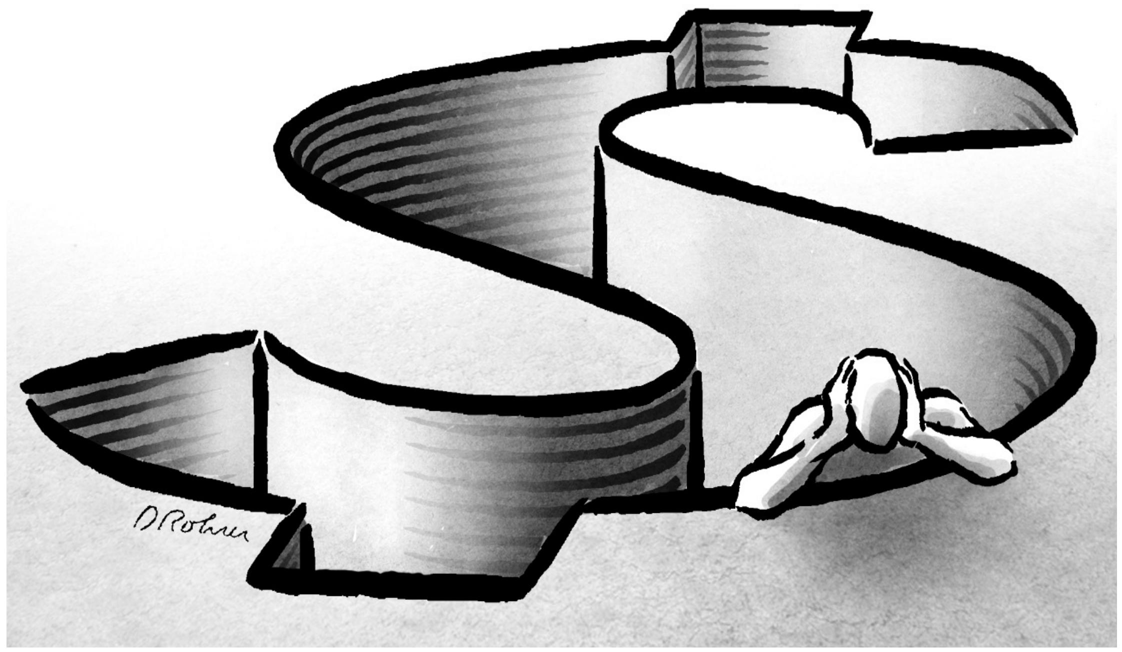
Most tax lawyers and tax accountants (not to mention regular old consumers) should find these tax benefits rather astounding. In general, our tax system does not allow one to hold income at arm's length and decide when and how to receive it. QSFs do allow that.

Although QSFs were designed classically for class actions, they are now routinely used even in two-party disputes. As long as there are multiple plaintiffs who are working out who gets what and how, a QSF can provide unique benefits.

For that matter, there is a raging debate in the tax world over whether a single-claimant QSF can also work. The IRS has not ruled on that question. Although the statute itself seems to suggest that even a single-claimant QSF should work, it is best to steer clear of this controversy until it is resolved.

Outside the class action context, you may simply need more time to sort out exactly which plaintiffs get what, to determine which plaintiffs want cash versus structures and to collect and allocate legal fees, costs and so forth. Even a case with only three plaintiffs (plus their families and lawyers) can get pretty complicated and pretty contentious. Having the defendant out of the picture — which a QSF accomplishes — can help to advance these discussions enormously.

A QSF is also useful when there are multiple defendants but it is not possible (or desirable) to resolve all disputes at once. If one defendant settles in 2008, another settles in 2009 and several defendants remain, a QSF can serve the plaintiffs and the defendants well. All monies can be held in the QSF until all defendants settle, or partial distributions can be made as each partial settlement is effected.



Another circumstance in which a QSF can be very useful is one in which the plaintiffs and defendant are negotiating a settlement, but they cannot agree on the tax language or tax reporting to be included in the settlement agreement. Forming a QSF can be a nice bridge past such difficulties. In fact, it can allow the defendant simply to pay the money to a QSF under a generic settlement agreement.

That can help the plaintiffs' tax posture. If the defendants simply pay the QSF, they normally should issue any IRS Forms 1099 to the QSF, not to the plaintiffs. The QSF will have its own taxpayer identification number, but it will report the payment from the defendant as a nontaxable contribution to the QSF, not as income. Then, the plaintiffs can enter into another settlement agreement with the QSF. More desirable tax language can be contained in that document, which can help the plaintiffs' tax posture.

An old adage says that time stands still for no one. Maybe so, but in most circumstances, a QSF can give plaintiffs and their counsel time that is simply invaluable. As a tax lawyer for the last 30 years, I cannot recite how many times I've seen plaintiffs or their counsel make mistakes in the rush to get documents signed and get paid. A QSF allows these parties to consider payment options thoughtfully and carefully.

Plus, the time for reflection can occur when the defendant has already paid the money and is effectively out of the picture. That dynamic does not exist anywhere else. It makes QSFs truly extraordinary.

As with anything that has great benefits, there are some rules. Yet the rules are surprisingly easy to navigate. In fact, despite the outsize benefits of a QSF, there are only three requirements to form a QSF.

First and foremost, a 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. Third, the trust must qualify as such under state law.

These rules are easy to satisfy. Anyone can be trustee. Any court can take jurisdiction. Notably, it need not be the court with jurisdiction in the underlying case. Even a probate judge will do.

Increasingly today, someone involved in litigation is likely to mention the advisability of establishing a QSF. The subject may be broached by a lawyer, client, mediator, judge or structured settlement broker. Usually, the topic comes up during settlement negotiations, but it can happen long before. It can even happen before a suit is filed.

I'm not suggesting QSFs are appropriate to settle every single case. In many situations, however, a QSF can make the settlement process smoother, more efficient and much more closely tailored to what the plaintiffs and their counsel really need and want.

Robert W. Wood practices law with Wood & Porter, in San Francisco, and is the author of "Taxation of Damage Awards and Settlement Payments" and "Qualified Settlement Funds and Section 468B."