Reprising Single-Claimant Qualified Settlement Funds

By Robert W. Wood

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Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009 with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Qualified settlement funds under section 468B serve as a bridge between plaintiffs and defendants in resolving litigation. Wood reviews the continuing question whether a single-claimant qualified settlement fund is viable.

Can you have a single-claimant qualified settlement fund (QSF)? QSFs, or section 468B funds, are designed to resolve litigation. Under regulations that took effect in 1993,[1] they may settle virtually any kind of claim, including those that are not the subject of litigation.[2] Their primary objective is to gather and administer cash or assets and determine the amounts and exact nature of payments that the plaintiffs, attorneys, and other claimants will receive.

After a QSF distributes all its assets to the appropriate recipients, it winds up its affairs. QSFs benefit both plaintiffs and defendants alike. They are separate entities for federal income tax purposes and are flexible and easy to establish. A QSF may simply consist of a fund or account segregated from the defendant's other assets,[3] although most are more formal and governed by a trust agreement.

Paying money into a QSF offers accrual basis defendants an immediate tax deduction even if the plaintiffs will not receive money until subsequent tax years. The QSF thus operates as an exception to the economic performance rules, which normally allow a deduction only when the plaintiff is paid. Therefore, QSFs get the defendants out of the way so the plaintiffs and their counsel can determine who gets what and how.

There has long been a controversy in the structured settlement industry over the legitimacy of QSFs with a single plaintiff or single claimant. These are slightly different concepts, but they are commonly combined. Five years ago, I surveyed the debate and tried to frame the issues. I said then that I thought the proponents of single-claimant and single-plaintiff QSFs had the better argument.[4] Has anything changed?

Who's on First?

Lawyers are literalists, and language matters, making this a puzzling discussion. The language of the tax code and regulations suggests there should be no controversy. Section 468B(d)(2)(A) allows designated settlement funds (DSFs) and QSFs to be established to completely extinguish a taxpayer's tort liability regarding claims described under section 468B(d)(2)(D). Those subparagraph (D) claims include "present and future claims against the taxpayer (or any related person or formally related person) arising out of personal injury, death, or property damage."[5]

Reg. section 1.468B-1(c)(2) suggests the possibility of a single claim, mentioning "*one or more contested or uncontested claims*"[6] and an event giving rise to "at least one claim asserting liability."[7] With the focus on the claim or claims, not the claimant or claimants, a plurality of claimants seems to be unimportant.

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[1] *See* section 468B(f); reg. section 1.468B-1.

[2] *See* Robert W. Wood, *Qualified Settlement Funds and Section 468B*, para. 1.1 (Tax Institute 2009).

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

[4] *See* Wood, "Single-Claimant Qualified (468B) Settlement Funds?" *Tax Notes*, Jan. 5, 2009, p. 71.

[5] *See* section 468B(d)(2)(D).

[6] Reg. section 1.468B-1(c)(2) (emphasis added).

[7] *Id*.

One claimant might have three claims. Multiple parties might constitute multiple claimants. Moreover, a person's personal injury claim and a spouse's loss of consortium claim could be viewed either as multiple claimants or a single claimant. One might argue that the couple has a unified interest that makes them a single claimant for purposes of section 468B. Married joint filers are regarded as a single taxpayer.

If the children also bring claims, there are surely multiple claimants. Similar questions can arise regarding a law partnership that brings a claim for breach of contract. More broadly, one might question the status of every attorney. Is a single claimant's attorney (who has a contingent fee claim) a separate claimant?

In any event, a lawyer's claim for fees is a "claim" in the regulations. The QSF must be "established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event . . . that has occurred and that has given rise to at least one claim asserting liability."[8] The attorney fees are a separate claim of liability, regardless of to whom that liability flows. One plaintiff and one lawyer arguably constitute two claimants.

The Stakes

Opponents of single-claimant QSFs argue that if there is a single claimant, there are no contingencies for the receipt of the funds. According to this argument, a sole claimant should be treated as receiving a lump sum transferred to a QSF.[9] In contrast, proponents of single-claimant QSFs say there is no principled way to distinguish "bad" single-claimant QSFs from "good" multiple-claimant QSFs.[10] If a single-claimant should be treated as receiving a lump sum transferred to a QSF, so too should multiple claimants.

Some argue that opposition to single-claimant QSFs is motivated by the insurance industry's desire to reduce competition in the structured settlement industry.[11] Defendants and their insurers may fear a loss of control following the formation of a QSF. However, a common reason for single-claimant QSFs is to navigate around defendants who are uncooperative in structuring a settlement.

Legislative History

Congress added section 468B in 1986.[12] Section 468B allows corporations to deduct payments to DSFs, which are funds established to facilitate settlement payments by one or more defendants to specified tort claimants.[13] This provision was enacted in response to rules passed in 1984 that greatly restricted the ability of corporations to deduct payments.

Before that time, corporations could more aggressively deduct settlement payments. For example, in *Ford Motor Co. v. Commissioner*,[14] Ford purchased annuities to fund structured settlements with several different plaintiffs. Ford deducted the entire amount of the future periodic payments without discounting the future payments, some of which were scheduled to take place decades in the future. Nevertheless, the Sixth Circuit affirmed the Tax Court's decision and held that Ford could deduct only the cost of the annuities.

In 1984, Congress made clear that even accrual basis defendants could only deduct claims for workers' compensation and tort claims when paid to plaintiffs.[15] After passing this restriction, Congress created an exception. Under section 468B, accrual basis taxpayers are entitled to deduct amounts paid to resolve some legal claims even before the plaintiffs receive payment.

Section 468B clarifies that under specified circumstances, an irrevocable payment to a court-ordered settlement fund that extinguishes tort liability of the payer constitutes economic performance.[16] In 1993, this rule would be broadened and liberalized, and the regulations under section 468B have since allowed the use of QSFs.[17]

There are fewer requirements to establish QSFs than DSFs.[18] Moreover, QSFs provide more flexibility and can be used for a wider range of legal claims than DSFs.[19] The rise of the QSF has made DSFs almost obsolete.

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[8] *Id*.

[9] *See* Letter from Malcolm Deener of the National Structured Settlements Trade Association to Treasury and the IRS (May 10, 2004); Stuart Odell and Joseph Dowley, "Structured Settlements/Single Claimant Situations," Letter to Treasury (Oct. 8, 2003).

[10] Fred Goldberg, Kenneth Gideon, and Jody Brewster, "Attorneys Urge Treasury to Publish Guidance on Personal Injury Liability Assignments" (June 19, 2003).

[11] Richard B. Risk Jr., "A Case for the Urgent Need to Clarify Tax Treatment of a Qualified Settlement Fund Created for a Single Claimant," *Virginia Tax Review*, Vol. 23, Issue 4, at 642 (Spring 2004).

[12] Tax Reform Act of 1986, P.L. 99-514; section 1087(a)(7)(A), 100 Stat. 2085 (1986); section 468B.

[13] Section 468B(d).

[14] *Ford Motor Co. v. Commissioner*, 71 F.3d 209 (6th Cir. 1995).

[15] Section 461(h)(2)(C).

[16] P.L. 99-514, TRA 1986, S. Rep. No. 99-313.

[17] *See* section 468B(g)(1) (providing authority to Treasury to prescribe applicable regulations); reg. section 1.486B-5(a) (providing the effective date for the QSF regulations).

[18] *Compare* reg. section 1.486B-1(c) (listing three major requirements for QSFs) *with* section 468B(d)(2) (listing six elements to establish a DSF).

[19] *See* Wood, *supra* note 2, at ch. 13.

To claim a deduction for a payment to a QSF, the defendant must generally give up any right or claim to the amount paid.[20] Economic performance is deemed to occur because, as an economic matter, the defendant has given up any substantial right to the amount transferred.[21] Yet strangely enough, rights of revision seem accepted and acceptable as long as the court or outside contingencies will control.

Tax Characteristics

The three general requirements for forming a QSF are that the fund must be: (1) established under a court order or an order of a federal, state, or local government authority; (2) established to resolve or satisfy one or more contested or uncontested claims asserting specified types of liability; and (3) a trust under state law or its assets must be segregated from other assets of the transferor.[22] Although QSFs are typically established by court order, they can be approved by any government authority. Moreover, QSFs can be established to resolve essentially any legal claim.

Notably, a QSF is not elective. The IRS considered and rejected proposals to make QSF status elective.[23] Also, QSF status trumps all other entity classifications.[24] If the three requirements are satisfied, the entity, trust, or account is a QSF, regardless of the intent of the parties.

The mandatory nature of QSFs is not always embraced by taxpayers. For example, in *United States v. Brown*,[25] the taxpayers were victims of an investment fraud. The court transferred assets from the perpetrators of the fraud to an estate. German citizens who were defrauded argued that the estate should not be treated as a separate taxable entity, but the Tenth Circuit determined that it was a QSF.[26]

Once formed, a QSF operates as a court-supervised intermediary between the defendant and plaintiff, taxable in its own right.[27] Although a QSF is taxed on any income it earns, it is generally not taxed on amounts it receives from a transferor.[28] Even prejudgment interest is excludable from the QSF's gross income.[29]

Thus, a transfer to a QSF generates a deduction for the defendant without any corresponding inclusion by the QSF. Importantly, section 468B was enacted primarily to facilitate deductions by defendants. Yet QSFs also have significant advantages for plaintiffs. The chief advantage is, of course, deferral and the time to consider the form and manner of payment.

The character of the payment should be unaffected by the QSF. The tax treatment of a distribution from a QSF to a claimant is determined by reference to the claim that relates to the distribution.[30] Therefore, a distribution to a claimant on account of personal physical injuries is excludable from income under section 104(a)(2) if a payment directly from the transferor would be excludable.[31]

The QSF is neutral in other ways, too. In describing the tax treatment of a distribution to a claimant, the Treasury regulations suggest that a claimant has nothing until the distribution by a QSF is made.[32] The regulations do not explicitly state that the common law economic benefit and constructive receipt doctrines do not apply.

For example, in Rev. Rul. 83-25,[33] a plaintiff was treated as the owner of a trust established by a court order for the plaintiff's benefit. The plaintiff was awarded damages in a personal injury suit. The damages were transferred to a court-established trust for the benefit of the plaintiff. Although the trust was administered by a trustee and was overseen by the court, the plaintiff was treated as the owner of the trust and as receiving the economic benefit of the trust corpus.

Does that mean a QSF would face the same treatment? Some commentators have argued that the economic benefit doctrine should apply to treat a claimant as receiving the economic benefit of a lump sum paid to a single-claimant QSF.[34] According to this argument, if a QSF has a single claimant, there are no adverse interests, and the single claimant should be treated as receiving the economic benefit of the total amount transferred to the QSF.

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[20]*See* reg. section 1.468B-3(c)(2) (economic performance does not occur if the taxpayer: (i) has a currently exercisable right to a reversion or refund or (ii) a reversionary interest that is only subject to a condition that is certain to occur or that is subject to illusory restrictions).

[21]Several letter rulings, apparently concerning tobacco litigation, ruled that funds qualified as QSFs even when defendants held reversionary interests when defendants expected claims to exhaust all amounts transferred to the QSF. *See, e.g.*, LTR 200951001; LTR 200821019. In some cases, the IRS has even held that funds qualified as QSFs when defendants retained a right to all interest income earned by the fund and could sell this interest in interest income to third parties. *See Kelly Capital LLC v. S&M Brands Inc.*, 873 F. Supp.2d 659, 663 (E.D. Va. 2012) (describing ability of tobacco company to sell "escrow release" consisting of right to interest income of QSF).

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

[23]T.D. 8459, 1993-1 C.B. 68.

[24]Reg. section 1.468B-1(b).

[25]348 F.3d 1200 (10th Cir. 2003).

[26]*Id.* at 1211.

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

[28]Reg. section 1.468B-2(b)(1).

[29]Reg. section 1.468B-2(n), Example 1; LTR 200717013.

[30]Reg. section 1.468B-4.

[31]*Id.*

[32]*See* reg. section 1.468B-2(a) and -4.

[33]1983-1 C.B. 116.

[34]Deener, *supra* note 9.

Tax Neutrality

But there are good reasons to believe that Congress intended to override the economic benefit doctrine. In fact, Congress appears to have intended QSFs to operate as a statutory exception to both the economic benefit and constructive receipt doctrines.[35] QSFs are tax neutral, so the tax treatment of the settlement or judgment is unaffected by the presence of a QSF.

If damages qualify as tax free under section 104(a), a lump sum transferred to a QSF is excludable from a QSF's income as a qualified payment under section 468B(b)(3). On distribution by the QSF, the payment is excludable from the claimant's income to the same extent as if it had been received directly from the defendant. If any income is earned on the lump sum, it will be taxable in the hands of the plaintiff or the QSF.[36]

Legal fees incurred by or on behalf of claimants are not deductible.[37] The payment of the plaintiff's legal fees is treated as a distribution to the claimant.[38] This is consistent with *Commissioner v. Banks*, in which the Supreme Court held that an individual must generally include an entire settlement in income — even the portion assigned and paid to his attorney.[39] Therefore, a QSF cannot shelter investment income by deducting legal fees and other expenses that would otherwise not be deductible.[40]

QSFs as Pocketbooks

QSFs allow plaintiffs and attorneys to defer the receipt of payments or the recognition of income until distribution. To some, that may seem to be an enticing proposition. Indeed, there is no antiabuse rule in the statute or regulations, nor do there appear to be any rulings or cases that test the bounds of the concept.

Thus, one might debate the potential risk that an aggressive plaintiff or aggressive counsel might use a QSF as an incorporated pocketbook. With no express time limit on the existence of a QSF, a plaintiff or his attorney might use a QSF to defer paying tax on a recovery indefinitely, letting the money sit in the QSF to earn interest and dividends, then doling it out when needed.

However, the risk that such behavior may occur may be no greater with a single claimant than with several claimants. In either case, there may be little controversy about who will get what, but the claimants could attempt to use a QSF to artificially defer income beyond reason.

If this occurs, it could be argued that the QSF would no longer exist to resolve claims and should cease qualifying as a QSF. This would be similar to how a section 501(c)(3) organization can lose its exempt status because of private inurement. Yet just as with exempt organizations, the potential for abuse (which seems possible with any number of claimants) should not drive the debate. There is no reason to ban the use of QSFs for all cases in which there is a single claimant.

Reasons for Single-Claimant QSF

QSFs have benefits beyond deferral and beyond tax considerations. A QSF may offer administrative efficacy that is not possible when money is paid directly to a claimant. For example, insurers sometimes have subrogation clauses in policies. Insurance companies often have the right to be reimbursed for medical care, property damage, or other costs they have paid and for which a portion of the claimant's award is allocated.

This is especially true with Medicare and Medicaid, which have broad powers to collect medical expenses and routinely impose liens on settlements and judgments. The failure of an attorney to properly manage reimbursement of these creditors may be considered malpractice. In some cases, an attorney may end up being liable to an insurance company or medical provider for failure to make sure those with a lien on the proceeds of litigation are paid.[41]

A QSF can be used to pay off all those creditors and provide time to negotiate and settle liabilities with creditors such as expert witnesses. Of course, one of the main reasons plaintiffs resort to single-claimant QSFs is to structure the settlement payment without the involvement of the defendant.[42]

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[35]This is similar to the statutory override for security interests in the case of qualified assignments under section 130(c).

[36]Reg. section 1.468B-2(b)(1).

[37]Reg. section 1.468B-2(b)(2).

[38]*See Wanamaker Trustees v. Commissioner*, 11 T.C. 365 (1948) (payment of state inheritance tax by trust constituted a payment of a liability of the trust beneficiary and therefore was income to the beneficiary).

[39]*Commissioner v. Banks*, 543 U.S. 426 (2005).

[40]There may be some advantage in using a QSF because expenses for a QSF are deductible in the same way they would be in determining the taxable income of a corporation. Expenses paid directly by a claimant would likely either be treated as nondeductible or be treated as a miscellaneous itemized deduction that would be subject to various limitations. However, the benefit is not likely to be very significant because QSFs are generally limited to deducting administrative and miscellaneous expenses.

[41]*See, e.g.*, *Saint Francis Hosp. v. Vaughn*, 1998 OK CIV APP 167 (1998).

[42]*See Continental Casualty Co. v. United States*, 2006 U.S. Dist. LEXIS 90012 (N.D. Cal. 2006) (court rejected plaintiff's request to establish a QSF because the plaintiff would be circumventing the Department of Justice's guidelines on structuring settlements and judgments, although court did not object on the grounds that the QSF would be a single-claimant QSF).

When a defendant refuses to cooperate, a single-claimant QSF provides the plaintiff with time to put a structure in place and to direct payment to the appropriate parties.

Whether there is one claimant or many, it is hard to see these goals as not abusive. The same negotiations and considerations take place in structuring a settlement when the defendant is involved. The main difference is that when the plaintiff does not have access to a QSF, the defendant and its insurer exercise greater leverage and negotiating power. That leaves the plaintiff with a much narrower range of alternatives.

Conclusion

In Rev. Rul. 83-25, the IRS ruled that a fund set up by a court for the benefit of a plaintiff should be treated as a grantor trust wholly owned by the plaintiff. The IRS reasoned that the plaintiff received the economic benefit of the fund even though the plaintiff did not control the distributions. This principle was well established when section 468B was passed in 1986 and when the QSF regulations were finalized in 1993.

In that sense, from a temporal perspective, the statute and the regulations came later. It appears that a QSF overrides this economic benefit principle by statute. Besides, it seems difficult to argue that the economic benefit doctrine should apply to a QSF solely because it has a single claimant. I can draw no principled distinction between single-claimant and multiple-claimant QSFs.

The single-claimant issue has been raised to the IRS officially and unofficially over the years. For example, it was raised during the hearing on proposed regulations under section 104.[43] For years, the IRS listed the status of single-claimant QSFs on its priority guidance plan.[44]

The repeated presence of the single-claimant issue on the priority guidance plan suggests that the IRS might take a position on single-claimant QSFs. However, without explanation, in 2009 the QSF issue was removed from the IRS priority guidance plan.[45] The issue had once been so hotly discussed that even its removal from this list was controversial.

Some said single-claimant QSFs were fine. Others said the reverse. It is unclear why the issue was removed from the priority guidance plan. Perhaps the IRS did not want to outlaw them because their use can clearly be legitimate, or maybe the Service wanted to avoid issuing a blanket blessing for single-claimant QSFs out of concern that they could be abused.

Moreover, QSFs may sometimes be used inappropriately to defer the receipt of monies for protracted periods. Nevertheless, focusing solely on the number of claimants is surely a red herring. Perhaps the IRS concluded that single claimant or not, there could be abuse.

In any event, the squabbles over whether single-claimant QSFs should be permitted are likely to continue in the structured settlement industry. Despite the ''one or more'' language of section 468B, some people continue to express concern that the IRS may eventually invalidate single-claimant QSFs. If the IRS takes this action, it will probably not do so retroactively.

In any event, it seems more likely that the IRS would establish some sort of antiabuse rule addressing the inappropriate use of QSFs to defer income rather than establishing a minimum number of plaintiffs or claimants. Also, remember that there is a distinction between plaintiffs and claimants. In the meantime, to be cautious, taxpayers should try to establish QSFs with multiple claimants. To a far larger extent than five years ago, however, this may be a debate the IRS largely ignores.

[43]*See* comments by Risk, ''Public Hearing on Proposed Regulations, 26 CFR Part 301 'Damages Received on Account of Personal Physical Injuries or Physical Sickness''' (REG-127270-06) (Feb. 23, 2010).

[44]The priority guidance plan is a plan published annually by Treasury and the IRS announcing the IRS's priorities for publishing taxpayer guidance. The IRS listed ''Guidance under section 468B regarding the tax treatment of a single-claimant qualified settlement fund'' in the 2004-2005 priority guidance plan. *See* Treasury, Office of Tax Policy and IRS 2004-2005 priority guidance plan, *available at* http://www.irs.gov/pub/irs-utl/2004-2005pgp.pdf. This item also appeared in the 2005-2006, 2006-2007, 2007-2008, and 2008-2009 priority guidance plans.

[45]*See* Office of Tax Policy and IRS 2009-2010 priority guidance plan.