Rulings Make Qualified Settlement Funds More Attractive

By Robert W. Wood

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Qualified settlement funds (QSFs), often referred to as 468B trusts, are an outgrowth of the designated settlement fund authorized by IRC section 468B. There's a great deal of interest in these funds these days. They have morphed from being used only in large catastrophic injury class actions to being employed in garden variety cases with relatively few litigants. The genesis of QSFs is curious. Many people today think of the 468B trust as primarily benefiting plaintiffs and plaintiffs' advisers who look to the trust structure to regularize the recovery, providing administrative structure, tax advantages, and alternative payouts.

Yet, the 468B trust traces its origin to concern over deductibility of damage payments by defendants. Defendants generally cannot deduct a settlement or judgment until the payment is received by the plaintiff. In the usual case, that might be the same day. But in cases of complex litigation with many parties, it often takes substantial time to sort out which of the plaintiffs will receive which amounts. Often there is a claims procedure that must be followed, and different plaintiffs receive different payments.

The tax code prohibits a defendant from deducting a settlement or damage payment until there is ''economic performance'' of the amount. Generally, that concept of economic performance requires that the plaintiff actually receive the money. But here's the big exception: Section 468B says that if a trust is established under its provisions, economic performance occurs when money is *deposited* into the trust, not when it is paid out.

That means a defendant receives a full income tax deduction on a payment into the 468B trust, even though the trust may not distribute any money to plaintiffs for years. The 468B trust is court administered and must meet specific tests. The defendant will not place the money into the trust unless the defendant receives a complete release, but the court supervision accomplishes that. The defendant will receive a complete release from the court (and sometimes from the individual or class plaintiffs), so it can be assured that the defendant will have no further liability. The payment into the trust is irrevocable, so as far as the defendant is concerned, the case is over, even though the 468B trust may go on for years.

There are only three basic requirements a QSF must meet. It is a fund, account, or trust that:

- is established under an order of, or is approved by, a governmental authority;
- is established to resolve or satisfy some specified claims arising from an event or series of events that has occurred; and
- is a trust under applicable state law, or the assets of which are segregated from other assets of the transferor or a related person.[1]

In determining whether the first requirement is met, a fund, account, or trust is considered ordered by or approved by a governmental authority when the authority provides its initial or preliminary order or approval, even if it is subject to review or revision.

In some cases, a QSF can be considered established under an order of, or approved by, a governmental authority (even before the actual order or approval) under a relation-back election. Basically, that election allows an entity that meets the order or approval requirement after it has already met the other two requirements of reg. section 1.468B-1 to be retroactively treated as a QSF as of the date that the other two requirements are met.[2] However, the retroactivity of the relation-back doctrine is limited in effect. If the order or approval is granted in a calendar year after the one in which the other two requirements are met, the entity will be treated as a QSF only retroactive to the first day of that subsequent calendar year.[3]

The types of claims that a QSF may address are described in the regulations to include liabilities under the Comprehensive Environmental Response, Compensation, and Liability Act and claims that arise out of a tort, breach of contract, or violation of law. Various types of regularly recurring liabilities cannot be the subject of a QSF, including: liabilities arising under a worker compensation act or a self-insured health plan; liabilities to refund the purchase price of, or to repair or replace, products regularly sold in the ordinary course of the transferor's business; and other liabilities designated by the IRS. Nevertheless, the regulations also allow the IRS the flexibility to designate additional types of claims to be resolved with a QSF.

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[1]IRC section 468B. *See* reg. section 1.468B-1.

[2]For a detailed discussion of the relation-back election, see Muntean, ''The Relation-Back Election for Settlement Fund Trusts,'' *Tax Notes*, May 30, 2005, p. 1146.

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

New Rulings

The IRS recently issued two private rulings regarding QSFs.[4] Both rulings deal with class-action lawsuits. The fact that there are two class-action rulings issued at the same time is itself notable, because there is a dearth of authority surrounding the taxation of awards received in class-action lawsuits.

Perhaps even more remarkable is the fact that each taxpayer asked the IRS to rule on three issues, two of which are precisely the same: confirmation that the fund in question is a valid QSF and, assuming it is, what its reporting obligations are for distributions made to class members. Each ruling asks a further question surrounding attorney fees: One asks if the payment of attorney fees would be income to the class members, the other asks whether the QSF would have a reporting obligation for attorney fees paid to class counsel. Those are important topics.

LTR 200609014 concerns the bankruptcy of a publicly held corporation. In what has become an all-too-familiar situation, some of the corporation's officers allegedly perpetrated a massive fraud on the corporation's shareholders. Those officers caused the corporations to issue false and misleading public statements that overstated earnings and that caused the value of the corporation's stock to increase. Simultaneously, those officers allegedly sold hundreds of millions of dollars of the corporation's stock.

Suit and Trust

On learning of the alleged fraud, many shareholders filed suit. Ultimately, all lawsuits were consolidated into a single opt-out class action. In other words, all relevant shareholders were included in the class (and would automatically benefit from a settlement or judgment), unless a shareholder affirmatively opted out of being a member of the class.[5] A shareholder might choose to opt out of the class for many reasons. Perhaps most fundamentally, he might opt out if he believed he could obtain a better settlement or judgment on his own without the assistance of class counsel.

Evidently believing the lawsuit created a massive and fatal liability, the company filed for bankruptcy protection. Under the bankruptcy reorganization plan, a trust was created, evidenced by a liquidating trust agreement. That agreement provided that the trust had as its primary purpose to litigate the trust claims (which claimants assigned to the trust) and then to distribute the proceeds to class members (in satisfaction of their claims). The trust had no objective to engage in the conduct of a trade or business, except to the extent reasonably necessary to, and consistent with, the liquidating purpose of the trust. We'll see later that this espoused lack of a trade or business is not relevant under the QSF rules.

Under the reorganization plan, class members assigned their causes of action to the trust. That assignment also covered any other claims against the corporation relating to the purchase of stock during the period of alleged fraudulent activity. That consolidation and assignment of claims seems not to have bothered the bankruptcy court, which approved the reorganization plan. Based on the ruling, the assignment of claims didn't bother the IRS either. As part of the plan, a portion of the shares of one of the corporation's subsidiaries was transferred to the trust. The remaining shares of the subsidiary were distributed (outside the trust) to the corporation's shareholders in complete liquidation of the corporation. Notably, the plan also called for class counsel fees to be paid from the trust.

Later, the court approved a final settlement of the class action, awarding attorney fees to class counsel and retaining jurisdiction pending the complete administration of the trust. Yet, the trust did not immediately distribute its assets to the claimants. Even after the approval of the final settlement, the trust continued to pursue other avenues to recover more money. Three years later, the trust received additional property from one of the corporation's former officers. After receiving the officer's recompense, the trust distributed funds to class members and class counsel.

A Valid QSF

In LTR 200609014, the IRS made three rulings on the recovery in the class action against the corporation. The first ruling is on a fairly prosaic question — whether the trust qualifies as a QSF. Although the QSF rules are fairly mechanical, the taxpayer would have been remiss not to ask that question because he was also asking two other much more thorny questions. Yet strangely, the taxpayer asked for the ruling three years after the trust was created. Apparently, the reorganization was moving forward regardless of QSF qualification.

The time lag aside, the IRS still ruled that the trust qualified as a QSF because it met the three requirements of reg. section 1.468B-1(c). The trust was established under a court order, and the court retained jurisdiction over it.[6] The trust was established to resolve and satisfy claims brought by class members against the corporation for damages allegedly sustained as a result of securities fraud.[7] Finally, the trust was a trust under state law.[8] Because the trust met all three requirements, the IRS had no trouble finding that the trust qualified as a QSF.

The three-year delay raises an interesting issue about the timing of deductions. One reason why taxpayers may create a QSF is to enable a defendant to obtain a current deduction on the transfer of money and property to the QSF, even if the QSF does not remit that money and property to the claimants for years. That was the genesis of section 468B — to ensure that defendants received full tax deductions despite the fact that under the general

[4]LTR 200609014, *Doc 2006-4154*, *2006 TNT 43-35*; LTR 200610003, *Doc 2006-4663*, *2006 TNT 48-32*.

[5]In an opt-out class action, class members obtain the benefits of an opt-out class action merely by coming within the definition of the class, unless the member affirmatively excludes himself from the suit.

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

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

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

"economic performance" rules, no performance occurs until the plaintiffs actually receive the money.

In effect, the 468B trust becomes a kind of way station. The defendant gets a tax deduction on *contribution* to the trust, but the plaintiffs don't have to include it in their income until the trust distributes it. In the meantime, although the earnings (interest and dividends) are taxed to the trust annually, *no one* is taxed on the monies in the trust. That's a boon to both plaintiff and defendant.

In any case, on the facts of LTR 200609014, that impetus was probably lacking because the corporation's transfer to the trust was part of a liquidating distribution.

Attorney Fees Not Income

The second issue that the IRS analyzed was whether the attorney fees paid by the trust constituted income to either the class members or the trust. Gross income means income from any and all sources.[9] As a general rule, a taxpayer must include in gross income the portion of taxable damages paid to his attorney, even if the payment is made directly to the attorney.[10] However, that rule may not apply to the payment of attorney fees to class counsel.

Indeed, payments made to class counsel in an opt-out class action generally are not considered income to the class members. The IRS has consistently ruled that this result conforms to situation 3 of Rev. Rul. 80-364.[11] In that ruling, a union filed claims on behalf of its members against a company because of a breach of a collective bargaining agreement. The union and the company later entered into a court approved settlement agreement under which the company paid the union \$40x in full settlement of all claims. The union paid \$6x in legal fees, and remitted \$34x to the employees for back pay owed to them. The ruling concluded that the portion of the settlement paid by the union for attorney fees was a reimbursement for expenses incurred by the union and not includible in the gross income of the union members.

LTR 200609014 analogizes the class action against the corporation to situation 3 of Rev. Rul. 80-364. The class members, like the union members, did not personally agree to compensate class counsel. The IRS therefore ruled that amounts paid by the trust to class counsel also do not represent gross income to the class members.[12] Moreover, those amounts are not gross income to the trust because regulations exclude from a QSF's gross income amounts transferred to it to resolve or satisfy a liability for which the QSF has been established.[13]

Reporting to Class Members

The third issue the taxpayer asked the IRS to rule on in LTR 200609014 was whether the trust had any reporting obligations for the payments it planned to make to class members. Generally speaking, payments and distributions from a QSF are subject to the regular information reporting rules required by the code.[14] Under those rules, the trust must file an information return for a distribution to a claimant if the person who originally transferred money or property to the QSF would have been subject to information reporting had that person made the transfer himself directly to the claimant.[15] That sounds convoluted, but it really isn't.

The original transferor would be subject to information reporting if he is engaged in a trade or business and makes payments of "rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, or other fixed or determinable gains, profits and income of \$600 or more."[16] Accordingly, two requirements must be met before information reporting is required. First, the original transferor must be in a trade or business. Here, even though the trust agreement provides that the trust had no objective to engage in a trade or business, the first requirement will be met. Under the regulations, payments made by a QSF are deemed to have been made in the course of a trade or business.[17]

Second, the payment must be of a type in the enumerated list. Although that list appears simple, it has traditionally been difficult to determine if a payment out of a QSF would qualify as any of the items on the list. Taxpayers usually have little trouble determining that payments from a QSF do not fit into most of the categories. The difficulty surrounds the final category of "other fixed or determinable gains, profits and income of \$600 or more." Payments from this trust were fairly typical in that sense. They clearly don't fall within most of the categories, but there is difficulty determining the application of the final category.

According to the regulations, income is "fixed" when it is to be paid in amounts definitely predetermined.[18] Income is "determinable" whenever there is a basis of calculation by which the amount to be paid may be ascertained.[19] Yet, if the determination of the recipient's gross income inclusion is based on the knowledge of the recipient's basis, and the payer lacks that information, the amount to be paid is not a payment of fixed or determinable income.[20] Moreover, the uncertainty in determining

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[9]Section 61; reg. section 1.61-1(a); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

[10]*Commissioner v. Banks*, 543 U.S. 426, *Doc 2005-1418*, *2005 TNT 15-10* (2005).

[11]1980-2 C.B. 294.

[12]*But see Sinyard v. Commissioner*, T.C. Memo. 1998-364, *Doc 98-29997*, *98 TNT 195-10*, *aff'd*, 268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001) (settlement of opt-in class action under the Age Discrimination in Employment Act when class members had contingency fee agreement with counsel); *Fredrickson v. Commissioner*, T.C. Memo. 1997-125, *Doc 97-6985*, *97 TNT 48-10*, *aff'd in unpub. opinion*, 97-71051 (9th Cir. 1998) (settlement of mandatory, Title VII class action when class members personally signed a settlement agreement providing for compensation of counsel).

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

[14]Reg. section 1.468B-2(l)(2)(I).

[15]Reg. section 1.468B-2(l)(2)(ii)(A).

[16]Section 6041.

[17]Reg. section 1.468B-2(l)(2)(ii)(C).

[18]Reg. section 1.6041-1(c).

[19]*Id.*

[20]*See* Rev. Rul. 80-22, 1980-1 C.B. 286 (payment of insurance proceeds not a payment of a fixed or determinable amount of gains, profits, or income when the determination of the recipient's gross income inclusion of the insurance proceeds was

(Footnote continued on next page.)

a recipient's gross income inclusion is increased by the possible application of the tax benefit rule. That rule could require an amount to be included in gross income if it has been deducted in any prior tax year.[21]

Indeed, the tax benefit rule could require a distribution from the trust to be includable in the gross income of a class member. That could occur if the recipient derived any federal income tax benefit from a previous deduction. The trust (and trustee) would surely have no knowledge of whether a recipient took a deduction in a previous year or of the amount by which the deduction reduced his federal tax.

Because of the tax benefit rule, and because the trust would not know a recipient's basis in his stock, the trust cannot determine if a distribution to a class member is includable in gross income, and if so, the amount of the inclusion. Consequently, payments from the trust are not fixed or determinable gains, profits, or income of $600 or more. Based on that, the IRS ruled that the trust does not have a reporting obligation for payments it makes to class members. That may surprise some advisers. Because preparing Forms 1099 requires some cost and effort, administrators and trustees of QSFs should be jumping for joy over this one.

Insurance Fraud

The second ruling (LTR 200610003) concerns a nonprofit company that provided insurance coverage for employee-sponsored health and welfare benefit plans. The company violated the rules governing those plans, including the Employment Retirement Income Security Act of 1974 and other federal and state laws. Those violations allegedly caused participants to overpay for services. The plan failed to fully reimburse policyholders for medical costs and services.

Not surprisingly, once word of the violations leaked out, many interested parties — including individual policyholders, participants, and beneficiaries — filed suit. Shortly thereafter, the suit was certified as a class action. The ruling does not expressly mention whether the suit was an opt-out or opt-in class action. It is my understanding as a tax lawyer (and I am not a litigator) that that determination would have been made at the outset of the class action, as part of the process to certify the class. In any event, the ruling later makes several references suggesting that the suit is an opt-out class action.

Nine years later, the parties settled. As part of the settlement, the defendant agreed to pay a particular sum into a fund to be used to settle all claims of class members. Although the ruling provides little detail about the fund, it appears to be nothing more than a segregated bank account of the defendant. The costs of administering the fund, including the payment of attorney fees, were paid from the fund.

Because of the nine-year delay, the fund planned to send an initial distribution to the last-known address of each class member. Nine years had elapsed since the suit was filed, and the administrators of the fund were probably uncertain whether they could even locate the multitude of claimants. Because no similar litigation had been initiated during the nine years, no actual "opt out" or request for exclusion was necessary as part of the settlement or as an element in the notice to class members.

A second distribution was planned for the following year. To receive that, a claimant had to provide a current address and a signature. That suggests that the first distribution may have been nominal and that the second distribution contained the more substantial portion of the recovery.

The amount that a claimant could receive is based on actual claims data submitted by the defendant to the fund. However, the actual amounts to be distributed are based on estimates. Evidently, too much data (drug copays, office visits, and so forth) made it "impractical and hopelessly expensive" to calculate actual amounts. Moreover, no reliable data were available to the parties to determine whether amounts paid by policyholders were ever deducted on a tax return or reimbursed from a tax-sheltered plan, such as a cafeteria plan.

A Valid QSF

The first issue on which the IRS ruled in LTR 200610003 was whether the fund qualifies as a QSF. The language and analysis in that section of the ruling are similar to that in LTR 200609014. Both rulings were authored by IRS Branch Chief Jeffrey G. Mitchell and released at virtually the same time.

Yet, there is one factual difference between the rulings. In the first ruling, the QSF was a state law trust. In the second, the defendant merely set the money aside in the fund. Fortunately, that difference is not fatal. The fund was maintained in a separate account under the dominion and control of fund administrators, and its assets were segregated from the defendant's other assets. The IRS therefore ruled that the fund qualified as a QSF.

Reporting Requirements

The final two issues discussed in LTR 200610003 relate to reporting requirements. As in the first ruling, this ruling discusses the reporting requirements for distributions made to class members. The analysis and conclusions are virtually identical to the first ruling. Essentially, the fund has no reporting requirement to class members because payments are neither fixed nor determinable.

The fund was unaware of any federal income tax benefit (if any) a class member may have received on taking a deduction (assuming a deduction was even claimed) for the amounts in a prior year. Interestingly, basis issues do not arise because the underlying facts involved violations of medical reimbursements, not stock in a publicly traded corporation. Yet, the application of the tax benefit rule (and its focus on what deductions were claimed by individual taxpayers) was sufficient to allow the IRS to rule that no reporting was required.

The final issue on which the IRS ruled was the reporting requirement of the fund's payments of legal fees. Generally speaking, payments made by a QSF are

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based on the knowledge of the recipient's basis and the insurance company lacked that information).

[21]Section 111.

subject to information reporting.[22] If a QSF makes a payment on behalf of a claimant (such as the payment of legal fees on behalf of class members), the fund is deemed to make the payment in the course of a trade or business.[23] The information reporting rules generally require that legal fees be reported if they are paid in the course of a trade or business.[24]

Yet, the ruling concludes that the fund does not have an information reporting requirement. That conclusion is based on the notion that the fund is not making a payment on behalf of the class members. In other words, reporting the payments of legal fees hinges on whether the fees are considered income to the class members. The IRS noted, as it did in LTR 200609014, that a QSF's payment of legal fees does not constitute income to the class members. That important threshold was based on the IRS's long-standing position that payments made to class counsel in an opt-out class action are not considered income to the class members.[25]

[22]Reg. section 1.468B-2(l)(2)(i).
[23]Reg. sections 1.468B-2(l)(2)(ii)(C) and -2(l)(2)(ii)(D).
[24]Section 6041; reg. section 1.6041-1(d)(2); section 6045(f).
[25]*See* Rev. Rul. 80-364.

Because the payments were not considered income to class members, the IRS ruled that the fund did not have any reporting requirement. Notably, the IRS was not asked whether the fund had a reporting obligation to the *attorneys* themselves on the payment of legal fees. I assume that there would be such an obligation. The code and regulations appear to require it.[26]

Conclusion

QSFs are growing in popularity, I think with good reason. That is what makes the two letter rulings quite important. They take a ''don't report'' position regarding the trusts when the tax benefit rule applies to claimants. Given that so many questions can arise about basis, and about other topics that are arguably as taxpayer-specific as the tax benefit rule, that makes me wonder whether the reasoning of the two letter rulings could be expanded. Perhaps it is merely wishful thinking, but not being saddled with a reporting yoke for at least some payments makes the already attractive QSF device even more so.

[26]Sections 6041(a) and 6045(f).