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Ten Things I Love About Qualified Settlement Funds

BY ROBERT W. WOOD

Hey, what about using a qualified settlement fund? Increasingly today, someone involved in litigation is likely to raise the topic of qualified settlement funds.

The subject may be broached by a lawyer, client, mediator, judge, or structured settlement broker. Usually, this occurs during settlement negotiations, but it can happen long before.

It is important for plaintiffs, defendants, their counsel, mediators, judges, and structured settlement professionals to know the basics about qualified settlement funds.

If this has not happened to you yet, it probably will. It is important for plaintiffs, defendants, their counsel, mediators, judges, and structured settlement professionals to know the basics about qualified settlement funds. So you are not caught flat-footed, you should have a sense how these funds work, when they are appropriate, and what limitations apply.

Here are 10 things I love about qualified settlement funds.

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This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

1. Names Are Not Important

Qualified settlement funds are actually called by a variety of different names. Qualified settlement funds, qualified settlement trusts, QSFs, 468B funds, and even DSFs or designated settlement funds (although these DSFs are slightly different from QSFs) are all enabled by Section 468B of the Internal Revenue Code. Basically, they are trusts or accounts set up to resolve claims.

2. Defendants Get a Tax Deduction

QSFs date to 1986, when Section 468B was enacted. This code section was a response to industry practice with class actions, and Section 468B was enacted at the behest of defendants. The idea was to enable defendants to claim their tax deductions for settlement payments currently, even though amounts might be tied up among warring plaintiffs for months, or even years.

The normal tax rule is that a defendant cannot claim a deduction until the plaintiff receives the funds. The QSF rules are a big exception to the normal reciprocity between payor and payee in the tax law. Do not underestimate how important this is.

3. QSF Requirements Are Easy to Satisfy

There are three requirements to form a QSF. First and foremost, they have to be subject to court supervision. That means you go to court and ask the judge to approve a QSF trust document and take jurisdiction over the assets. Second, the trust has to exist to resolve or satisfy legal claims. Third, the trust must qualify as a trust under state law. Although there are a few nuances, these three basic rules are usually easy to satisfy.

4. Anyone Can Be Trustee

There needs to be a trustee but there is great flexibility as to who can occupy this role. In fact, even the plaintiff's lawyer can be a trustee, although I would never recommend that. Technically, anyone who has legal capacity can be a trustee (so it could not be a minor or a legally incompetent person). However, the trustee need not be a trust company or a trust specialist. Lawyers and accountants often act as trustees to QSFs.

5. Any Court Can Approve a QSF

A court must take jurisdiction over the QSF but it need not be any particular court. Notably, it need not be a court having a connection to the legal dispute that is being resolved. Any court will do. Thus, you can go to the court that has jurisdiction over the underlying legal dispute, or you can go to a different court. You can use a state court in a federal matter, or vice versa. You can even go to a probate court. Some advisers prefer this, since probate judges are usually familiar with trusts and trust documents.

6. The Tax Treatment of QSFs Is Simple

A QSF must apply for and receive its own employer identification number from the Internal Revenue Service. The QSF is taxed as a separate entity, basically like a corporation is taxed. Notably, however, the QSF is not taxed on contributions from one or more defendants to resolve the claims. Those are nontaxable contributions. The QSF is only taxed on the income it earns on those contributed funds. Usually, that means it is just taxed on interest and dividends.

The defendant can have no interest in the trust. The defendant wants to claim its tax deduction right away and get out of the case. One of the requirements of the QSF is that, in order for the defendant to claim a tax deduction for the settlement payment, the defendant must relinquish all interest in the money.

7. A QSF Can Address Many Problems

There are many different circumstances in which forming a QSF makes sense. One circumstance is where the plaintiff 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 to such difficulties, allowing the defendant to simply pay over the money, and the plaintiff to worry about the form of the release the plaintiff will later sign with the QSF. You can look at a QSF as a kind of a tax-free way station.

Traditionally, QSFs were used mostly for class actions. Today, however, that is no longer true.

Another circumstance where you may want to form a QSF is in a class action, where all of the plaintiffs have not been identified. Alternatively, even if they have been identified, you may need to establish a claims procedure to determine exactly who gets what. Traditionally, QSFs were used mostly for class actions.

Today, however, that is no longer true. QSFs are still widely used in class actions but you do not have to have a class action to have a QSF. You might just need more time to determine exact numbers, to fix final attorneys' fees and costs, etc.

8. QSFs Facilitate Structured Settlements

At its most basic, a structured settlement is simply an arrangement calling for payments over time. There are tax, financial planning, and asset protection advantages to arranging a structure. A QSF can facilitate structured settlements, generally involving the purchase of annuities that provide regular payments to plaintiffs for a term of years or for life.

In fact, a desire for implementing structured settlements is a common reason for setting up a QSF. The plaintiffs may need time to determine the form of a structure, the exact annuity payout, family needs, etc. Not only that, but structures can be purchased for lawyers from a QSF too. Attorneys' fee structures are also becoming increasingly common. A QSF can give needed time to work out all the details before tax consequences attach to the money.

9. There Is No Minimum or Maximum Time

QSFs are flexible, and there is no express time limit on their duration. In my experience QSFs usually exist for a relatively short time, sometimes a matter of a few weeks or a few months. In simple cases, that can be enough time to determine who will get what, to investigate and select structured settlements, etc. In complex and large class actions, however, QSFs may exist for several years to resolve claims. There appears to be no outside time limit for how long a QSF can last.

As you evaluate the benefits of a QSF, bear in mind that there are broad statutory and nonstatutory doctrines in our tax code—-the most complex tax code in the world. People with a little tax knowledge find QSFs odd. They seem to fly in the face of the normal constructive receipt and economic benefit doctrines that might suggest that plaintiffs and their lawyers are taxable when money is irrevocably set aside for them in a trust. The QSF truly operates as a tax-free holding pattern. Monies are not treated as received by the plaintiff(s) and lawyers until they are paid out of the QSF. Yet the defendant is entitled to a tax deduction as soon as the money is put into the QSF.

10. Even Single Claimants Can Benefit (Maybe)!

One of the most controversial issues today is whether you can legitimately have a QSF with just one claimant. This is a real hot-button question. The statute itself and the Treasury Regulations suggest that a QSF should work fine if you have ''one or more'' claims. Thus, from a technical viewpoint, I would argue that a single claimant QSF is probably OK.

However, IRS has repeatedly said it is studying this issue. Not only that, but some structured settlement industry insiders have urged Treasury to come down one way or the other on the point. Because of this, I urge caution.

Although the statute seems to support single claimant funds, there is no guidance, and IRS is thinking about this issue. The structured settlement industry is quite polarized on this point. Personally, I always want to have at least two claimants, but there is even debate about what we mean by two or more claimants.

In considering what multiple claimants should mean, are husband and wife enough? What about lawyer and

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client, since the lawyer's share of the case generally also winds up in the QSF? Optimally, of course, there will be two or more named claimants, but it is not crystal clear that is required.

This single claimant issue has become a kind of flash point in the structured settlement industry. Plaintiff brokers often feel they are frozen out of the process by defense brokers and insurance companies. As such, plaintiff brokers may try to take control of the case (and therefore the commission on the structures) by forming a QSF.

Conversely, defense brokers also do not want to be frozen out of the process. If the money goes into a QSF, the defense broker may receive no commission.

The insurance companies are also concerned. For one thing, they do not want to issue annuities from single claimant funds, if it turns out single claimant funds are ineffective. Some insurance companies also seem to think that if monies go into a QSF, annuities may never be purchased.

The majority of these awkward issues can be worked out between cooperative parties, and commissions can certainly be shared. Yet I still urge caution on the single claimant issue. Ultimately, I predict single claimant funds will eventually be OK'd. Even if I am wrong and they are disallowed, I think the disallowance is likely to be prospective only. Nevertheless, try to avoid this issue entirely until it is resolved.

Conclusion

QSFs are tremendously flexible and their uses are increasing. Class action lawyers are used to these vehicles, but many lawyers (both plaintiff and defense lawyers) are surprised when they hear about the demonstrable benefits of a QSF, which stand as a huge exception to fundamental constructive receipt and economic benefit tax rules. Both plaintiffs and defense counsel can use a QSF for making the settlement process much smoother, much more efficient, and much more closely tailored to what the plaintiffs (and the plaintiffs' counsel) really need and want.

Remarkably, in a QSF, money can sit after the defendant(s) pay but before the plaintiffs and plaintiffs' counsel have to report the money for tax purposes. A QSF can be very good for defendants too.

I am not suggesting QSFs are appropriate to settle every case. But I can tell you that they work great and they can really save the day in some circumstances.