Qualified Settlement Funds: A Quick Guide for Trial Lawyers

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Introduction

Assume you just settled a personal injury case for John Doe who is married to Jane. John has a significant brain injury and there are questions of competency. John was injured on the job but had a products liability claim which is the part of the case you resolved. He receives both Medicaid and Medicare benefits. Medicare and Medicaid both have substantial liens along with the Workers' Compensation carrier. Jane has a consortium claim and there are issues of allocation of the settlement to deal with. A Medicare Set Aside may be necessary and a Special Needs Trust is a must to preserve his Medicaid eligibility. A structured settlement is being considered for part of the settlement proceeds.

What do you do when you settle a case likes this where your client is on public assistance, there are allocation issues, settlement planning issues must be addressed and there are liens to negotiate? Where can you "park" the money while you set up any necessary public benefit preservation trusts, determine allocation of the proceeds, figure out a financial plan and negotiate the liens? How can you get the money from the defendant immediately without ruining the client's available settlement planning options? The answer to all of these questions is to use a Qualified Settlement Fund ("QSF" or "468B QSF").

What is a QSF and Why Use One?

A QSF is a temporary trust established to receive settlement proceeds from a defendant or group of defendants. Its primary purpose is to allocate the monies deposited into it amongst various claimants and disburse the funds based upon agreement of the parties or court order, if required. Upon disbursing all of the monies the QSF ceases to exist.

There are many reasons to use a QSF in a complicated settlement. First and foremost, they are quite easy to establish. There are only three requirements for establishing a QSF. It must be created by a court order with continuing jurisdiction over the QSF.[1] The trust is set up to resolve tort or other legal claims prescribed by the Treasury regulations.[2] Finally, it must be a trust under applicable state law.[3] Any court, with or without jurisdiction over the matter, may sign the order creating the QSF and exert continuing jurisdiction over the trust.

The QSF is a temporary holding tank for the litigation settlement proceeds. It does not exist in perpetuity and is not meant to be a support trust for claimants. Instead, it exists for as long as there are allocation issues between the parties or planning that needs to be done prior to disbursement. It can exist for weeks, months or years sometimes. There is no limit on the duration of a QSF.

A QSF may hold benefits for all parties as it relates to taxes, timing of income and settlement planning needs. A tax-free structured settlement and a tax-deferred attorney fee structure can be properly created through the use of a QSF. The parties can influence timing of income through the use of a QSF. QSF claimants are typically not taxed on funds in the QSF until those funds are distributed (assuming the damages are taxable). A QSF also gives some extra time and flexibility for claimants to make decisions related to settlement planning issues.

The defendant receives an immediate tax deduction upon contributing the agreed upon amount to the QSF and is typically permanently released.[4] This is a large benefit to the defendant as normally they can't claim a deduction until the funds are received by the claimant which can be delayed in a complicated settlement. An important point is that the tax deduction for the defendant is not impacted by when distributions actually flow out of the QSF.

The tax treatment of QSFs is uncomplicated. A QSF is assigned its own Employer Identification Number from the IRS. A QSF is taxed on its modified gross income[5] (which does not include the initial deposit of money), at a maximum rate of 35%. Thus, it is taxed on accumulations to the principal from interest or dividends less deductions[6] available which include administrative expenses.

Brief Legislative History

Qualified Settlement Funds grew out of Internal Revenue Code ("IRC") Section 468B. IRC Section 468B was added to the Code by Congress as part of the Tax Reform Act of 1986[7] and created Designated Settlement Funds ("DSF"). A DSF can be funded by or more defendants to make settlement payments to tort claimants. The DSF was fairly limited in the way it could be utilized and in 1993 passed regulations creating a new type of fund, Qualified Settlement Funds. There are fewer requirements to create a QSF than DSF and a QSF can address a broader range of legal claims with increased flexibility.

The DSF and QSF were originally created for use in mass tort litigation enabling a defendant to settle a claim by depositing money into a central fund that could then settle the claims with each individual plaintiff. The defendant could walk away from the settlement fund after its creation and funding, taking a deduction for the entire settlement amount in the year it was deposited.

However, the QSF is not limited to situations involving mass torts. A Qualified Settlement Fund can be used to settle cases of any value involving multiple plaintiffs including cases involving the personal injury victim with a derivatively injured spouse, child or parent. It can arguably be used in single plaintiff cases based upon the plain language of the Treasury Regulations implementing QSFs.

How it Works

Using a 468B Qualified Settlement Fund settlement proceeds can be placed into a QSF trust preserving the right to do a structured settlement and protecting public benefit eligibility temporarily. While the money is in the QSF, a financial settlement plan can be designed and liens can be negotiated. Additionally, if the settlement recipient is on public benefits the QSF avoids issues with receipt of the settlement, which could trigger a loss of public benefits. While the funds are in the QSF, there is time to create public benefit preservation trusts for the settlement recipient. A structured settlement or other financial products can then be set up to work in concert with a special needs trust or Medicare Set Aside so that the injured victim does not lose their public benefits.

IRS Code § 468B and Income Tax Regulations found at § 1.468B control the use of a QSF. These provisions provide that a defendant can make a qualifying payment to the QSF and economic performance would be accomplished, crucial for tax reasons to the defendant. Thus the QSF trustee can receive settlement proceeds allowing the defendant a current year deduction releasing them from the case. The QSF trustee can, after receiving the settlement proceeds, agree to pay a plaintiff future periodic payments, assign that obligation to a third party, and allow the plaintiff to receive tax-free payments under IRC § 104(a) (the provision excluding from gross income periodic payments from a structure).[8] The transaction works exactly the same as it normally would when you have the defendant involved in the structured settlement transaction.

There are only three requirements under 468B to establish a QSF trust. First, the fund must be established pursuant to an order of a court and is subject to the continuing jurisdiction of the court. Second, it must be established to resolve **one or more** contested claims arising out of a tort. Third, the fund, account, or trust must be a trust under applicable state law.

As for the first requirement, any court may create a QSF by court order and exercise continuing jurisdiction. It can be the court that the underlying litigation is being heard by, but it does not have to be that court. The court does not have to have jurisdiction over the tort action to establish the QSF. A QSF is "established" once a court signs the order creating it and not before. Thus a QSF can't be funded until it is properly established.

The Treasury Regulations implementing 468B require a QSF to be established to satisfy *one or* more claims arising out of a tort[9]. However, Workers' Compensation claims are specifically excluded from being the basis for establishing a QSF. As long as the QSF is established to resolve a claim involving a physical injury, other than a Workers' Compensation claim, this requirement is easily established. The last requirement of the fund being a trust under applicable state law is simply satisfied by proper drafting of a trust and approval by the court.

In terms of the mechanics, it is easy to establish a QSF. First, a court must be petitioned to establish the QSF. The court is provided with the QSF trust document and an order to establish the trust. Once the order is signed, the defendant is instructed to make a check payable to the QSF and the defendant is given a cash release in return for the payment. The consideration for the release with the defendant is payment into the QSF thus the consideration recital should reflect payment to the QSF and not the injury victim.

In terms of timing of distributions from a QSF, that is dependent on the agreement amongst claimants or as ordered by a court. For example, if the case involves minor or incompetents the necessary court approvals would need to be obtained prior to disbursement of fund from the QSF just like they would if no QSF was involved. The QSF can provide a lump sum payment to the claimant(s); fund a SNT or MSA, pay liens and fund a structured settlement. If a structured settlement or an attorney fee structure is funded, the QSF replaces the defendant and the transaction is consummated just as any other structured settlement would be if a defendant were involved. Upon distribution of funds from the QSF, the trustee will obtain a release from the claimants for the distributions from the QSF evidencing the fact that the distribution resolved or satisfied the claimant's claims against the QSF.

Once all funds have been distributed, the QSF ceases to exist. A court order is obtained closing the QSF and terminating the court's jurisdiction over the QSF.

The Single Claimant QSF Question

QSF for single claimant cases has become commonplace today. However, there is some question of doubt whether a QSF can be used in a single claimant case.[10] The basis for the controversy is the assertion by some that money placed into a QSF for a single claimant triggers constructive receipt or economic benefit.[11] If either of these is triggered, the monies would be attributed to the claimant from a tax perspective defeating one of the main purposes of establishing the QSF (timing of income and funding future periodic payments). The IRS, despite requests, has refused to comment or clarify this issue.

We are therefore left with the plain meaning of "one or more contested or uncontested claims" in the Treasure regulations relating to IRC 468B. The regulations say one or more. The only logical interpretation based upon the meaning of these words would be that it is permissible to establish a QSF for a single claimant.

Nevertheless, defendants may raise this issue in an attempt to prevent the creation of a QSF. This typically happens when future periodic payments will be funded from a QSF and relates frequently to issues over control of structured settlement funding. The bottom line is that if the defendant refuses to cooperate with funding a single claimant QSF for these reasons, it will be impossible to create the QSF unless a court orders a defendant to fund the QSF.

Advantages of a QSF from the Plaintiff's Perspective

There are several advantages to utilizing a QSF from the plaintiff's perspective. First, funding the QSF removes the defendant and defense counsel from the settlement process. It is very much like an all cash settlement in the eyes of the defendant. Once the Trustee receives the settlement money, economic performance has occurred and the defendant is out of the case. Second, the attorney's fees and other expenses can be paid immediately from the 468B fund. Third, the 468B trust removes the defendant from process of allocating the settlement amounts between the various plaintiffs. Finally and probably most importantly, the time crunch is alleviated with regards to the lien negotiations, allocations, and probate proceedings. The plaintiffs can take their time, carefully considering the various financial decisions they must make and addressing public benefit preservation issues.

Conclusion

The end of a personal injury case is typically a rush to settlement which I call the "settlement time crunch". There is enormous pressure to wrap up the case quickly to get the client compensated for their injuries. However, in the rush to finalize the settlement, things may be overlooked or important settlement planning issues may be missed. A Qualified Settlement Fund can be created to receive the settlement proceeds thereby giving everyone the time necessary to carefully plan for the future. Plaintiff counsel can get his or her fees and costs quickly. The funds are obtained from the defendant, they are released and the client's settlement dollars can be procured quickly. The liens can be negotiated, allocation decisions can be made, public benefit preservation trusts can be implemented and settlement planning issues, including structured settlements, can be considered. The attorney's option to structure his or her attorney fees is also preserved. The QSF is an important tool for trial lawyers to consider using in the appropriate case.

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[1] Treas. Reg. §1.468B-1(c)(1).
[2] Treas. Reg. §1.468B-1(c)(2).
[3] Treas. Reg. §1.468B-1(c)(3).
[4] See Treas. Reg. §1.468B-3(c).
[5] Treas. Reg. §1.468B-2(b)(1).
[6] Treas. Reg. §1.468B-2(b)(2).
[7] Tax Reform Act of 1986, Pub. L. No. 99-514; I.R.C. §1087(a)(7)(A), 100 Stat. 2085 (1986); I.R.C. §468B.
[8] I.R.C. §104(a). Section 104(a) excludes from gross income personal physical injury recoveries paid in a lump sum or via future periodic payments. It excludes personal injury recoveries under 104(a)(2); Workers' Compensation recoveries at 104(a)(1) and disability recoveries under 104(a)(3).
[9] Treas. Reg. §1.468B-1(c)(2). There are other claims besides torts that a QSF may be used to resolve. According to the Treasury regulations, it can be used for CERCLA claims, breach of contract, violation of law or any other claims the Commissioner of the Internal Revenue service designates in a Revenue ruling or Revenue procedure. *Id.*
[10] *See* Dick Risk, *A Case for the Urgent Need to Clarify Tax Treatment of a Qualified Settlement Fund Created for a Single Claimant*, 23 VA. TAX REV. 639 (2004); Robert Wood, *Single-Claimant Qualified (468B) Settlement Funds?* TAX NOTES (January 5th, 2009).
[11] Constructive receipt is a tax doctrine which says a taxpayer has income for tax purposes when he has the unfettered vested right to receive funds immediately. Childs v. Commissioner, 103 T.C. 634, 654 (1994), Doc 94-10228, 94 TNT 223015, aff'd, 89 F.3d 856 (11th Cir. 1996), Doc 96-19540, 96 TNT 133-7. According to the IRS, under the "economic benefit doctrine, a taxpayer using the cash receipts and disbursements method of accounting must include in gross income currently any financial or economic benefit derived from the absolute right to receive property in the future that has been irrevocably set aside for the taxpayer in a trust or fund." IRS.gov, http://www.irs.gov/govt/tribes/article/0,,id=180235,00.html