QUALIFIED SETTLEMENT TRUSTS
A Useful Tool in Multi-Party Litigation

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I. Introduction.

A Designated Settlement Fund or Qualified Settlement Fund (both hereafter referred to as QSFs) is a trust or fund established under §468B of the Internal Revenue Code (IRC or Code). This Code section permits a defendant to deposit money or property into a trust or fund and receive a full and complete release of liability. Once the funds are deposited, the defendant is entitled to a current deduction from income tax for the amount paid into the fund. This represents an exception to the general rule that a defendant is not entitled to the deduction until the point in time in which the settlement funds are actually disbursed to the plaintiff, the time in which the plaintiff has received the so-called "economic benefit" of the settlement.

This arrangement has been in use for over ten years in class actions suits, suits brought under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA) and other types of multi-party litigation. However, QSFs can also be used very effectively in traditional tort cases such as a medical malpractice case where you often have multiple plaintiffs (e.g. mother and child in a birth injury case) and multiple defendants (hospital, doctors, nurses) or accident cases where you have more than one injured party and/or more than one responsible party.

As will be seen below, the usefulness of a QSF has been enhanced by a determination by the IRS that a QSF can be a party to a qualified assignment under Section 130 of the IRC. The use of a QSF as an interim device to hold partial or full settlements now gives the plaintiff greater flexibility and superior bargaining power in negotiating a structured settlement.

A QSF can also be established after a jury award as long as there is an appeal pending. If the plaintiff chooses to settle on appeal, and a structured settlement is purchased through a QSF, the imposition of income taxation on the pre and post judgment interest portion of a judgment can be avoided.

A QSF can be used in connection with the establishment of a Special Needs Trust to ensure that an otherwise eligible injured plaintiff is not disqualified from receiving government benefits.

Finally, a QSF can be used to mitigate the income tax impact for a plaintiff receiving a taxable award or settlement, especially in matters where the plaintiff will be subject to income taxation on the portion of the award that has been paid to the attorney.

II. What is a Designated or Qualified Settlement Fund?

A. Requirements.

Although Designated Settlement Funds and Qualified Settlement Funds have differing requirements, the tax treatment of the two types of entities are identical for defendants as are the resulting benefits for plaintiffs. For our purposes we will focus on the Qualified Settlement Fund which has a broader definition and encompasses nearly all traditional torts.

A Qualified Settlement Fund is defined by the regulations under Section 468B(d)(2) as a fund or account that meets three requirements:

1. It is established under an order of, or is approved by, a governmental authority (including a court) and is subject to the continuing jurisdiction of that governmental authority;

2. It is established to resolve or satisfy one or more contested or uncontested claims arising from an event or series of events that has occurred and that has given rise to at least one claim asserting liability.

3. It is a trust under applicable state law or its assets are segregated from other assets of the transferor or a related person.

Treas. Reg. 1.468B-1.

The types of claims which a QSF may address include liabilities under CERCLA, claims that arise out of a tort, breach of contract, or violation of law. (Id.)

Some types of regularly recurring liabilities cannot be the subject of a QSF. These include liabilities arising under a workers compensation act or a self-insured health plan, and liabilities to refund the purchase price of or repair or replace products regularly sold in the ordinary course of the transferor's business. The Regulations also exclude claims of general trade creditors and debtholders relating to a bankruptcy case or workout. (Id.)

B. Tax treatment of a QSF

The rules regarding the taxation of Qualified Settlement Funds and Designated Settlement Funds are the same. Briefly, the modified gross income of either is taxed at the maximum rate applicable to trusts. This tax is in lieu of any other taxes on the income of the QSF. Thus, a QSF is not subject to the alternative minimum tax, the accumulated earnings tax, the personal holding company tax or the maximum capital gains rate. Treas. Reg. 1.468B-2.

The initial transfer of funds by the defendant to the QSF is not treated as income to the QSF. A deduction is allowed for administrative costs and incidental expenses incurred in connection with the operation of the fund , capital losses and net operating losses are allowed to the extent they would be deductible by a corporation in determining taxable income. (Id.)

III. Structured settlements and QSFs – a combination worth considering.

As more fully described in the "Taxation of Judgments and Settlements" outline in these materials, damages received by a plaintiff for physical personal injuries or sickness are excluded from the plaintiff's taxable income. IRC §104(a)(2). Consequential damages such as emotional distress damages and loss of consortium damages are also excluded from income as long as the core injury is a physical personal injury. Other types of related damages, including punitive damages and pre and post judgment interest do not receive this favorable treatment. (Id.; Rozpad v. Commissioner, 154 F.3d 1 (1st Cir. 1998).

Damage awards are afforded tax free treatment regardless of whether the plaintiff receives the funds in one lump sum or receives a series of periodic payments.
IRC §104(a)(2). The exclusion from income is not affected by the manner in which the payments are structured. This is true even when the periodic payment are guaranteed for a period which may extend beyond the life of the plaintiff or the contract calls for commutation to a lump sum on the death of the plaintiff. PLR 9812027. This tax free treatment is available even though each periodic payment in reality consists in part of a return of principal and in part income earned from the investment of that principal.

The benefit of the tax-free treatment is lost, however, at the moment the plaintiff receives or constructively receives the funds. IRC §451. From that point forward any income earned from investing the funds is subject to current taxation. Thus, to successfully structure a settlement it is critical to avoid constructive receipt of the future payments prior to their actual receipt.

Constructive receipt occurs when income has been credited to the taxpayer's account, the income has been set apart for the taxpayer, or it has otherwise been made available so that the taxpayer may obtain the income at any time. Conversely, if the taxpayer's receipt of income is subject to substantial limitations, constructive receipt is avoided. Treas. Reg. 1.451-2.

The need to avoid constructive receipt often presents a stumbling block for a plaintiff in the settlement process. To illustrate, where a mother and child have a medical malpractice claim against a doctor and a hospital for injuries occurring during the birth of the child, it is not uncommon for, say, the doctor to agree to settle for the policy limits on his or her malpractice insurance policy while the hospital continues to contest liability. At that point, the plaintiffs may wish to consider structuring all or part of the offered settlement but are unsure as to whether or how much to 'invest' in the structure because of the uncertainty as to what the total settlement will be.

Interposing a QSF in this process gives the plaintiffs much more flexibility. As noted above, a QSF can be a party to a qualified assignment under §130 of the IRC (see Part V. of this outline below), and thus creates an option for the plaintiff to delay the decision as whether and how much to structure until all the claims have been settled. The doctor/liability insurer can deposit the settlement amount into the QSF and receive a full and complete release. The funds can remain in the QSF, earning interest for the plaintiffs, until all claims are settled. It is clear that the plaintiffs will not have constructive receipt so long as there are sufficient issues still in dispute (e.g. the allocation of the proceeds between mother and child) to constitute a substantial limitation. Once a settlement is reached with all of the defendants, the plaintiffs can more easily and precisely determine whether and how to structure all or a portion of the settlement. Equally important, it gives the plaintiffs the opportunity to hire their own settlement broker who can approach a variety of annuity companies to obtain the most competitive payout from the highest rated carriers. This is an improvement over having to rely solely on the defense broker who is limited as to which company's product he offers. There are numerous pricing breaks on the cost of structured settlements, daily rates, jumbo case discounts, and age-ratings that leverage benefits. These can be used by a defense broker to save his client money but these cost savings should be passed on to the claimant instead.

The question arises as to whether a QSF can be used to avoid constructive receipt if there is only one plaintiff but multiple defendants. It is certainly arguable that no constructive receipt has occurred because typically the trust itself and the court order establishing the trust provide that no distributions can be made from the QSF without a court order. To the author's knowledge, there have been no pronouncements from the IRS on whether the requirement of a Court Order to distribute funds constitutes a substantial limitation.

IV. A QSF can be used in connection with a Special Needs Trust.

As discussed in more detail in "Settling Personal Injury Cases for Plaintiffs Receiving Public Benefits" section of these materials, a disabled plaintiff who is receiving government benefits under the Supplemental Security Income program or MassHealth (Medicaid) is permitted to transfer assets, such as a settlement or jury award, to a Special Needs Trust complying with the provisions of 1396P(d)(4)(a) or 1396P(d)(4)(c) and remain eligible to receive those public benefits. Among the requirements for the more commonly used safe harbor trust, a (d)(4)(a) trust, is that although the trust must be funded with the assets of the plaintiff/recipient, the trust must be established by a parent, grandparent, guardian, or a court. Because the plaintiff cannot establish the trust himself, this creates an obstacle for adult competent clients whose parents and grandparents are deceased. The only way to take advantage of the safe harbor rule for such a client is to have a court proceeding in which the court orders the establishment of the trust.

A side benefit of using a QSF in connection with the settlement of a case for a plaintiff receiving public benefits is that a court-ordered trust can easily be made part of the order of distribution which terminates the QSF, thus avoiding an additional and often costly and unnecessary court proceeding.

V. Background on structured settlements and qualified assignments.

It is often the case with personal injury settlements that the defendant or the defendant's insurer does not want to accept direct responsibility for making a stream of periodic payments to the plaintiff and the plaintiff does not want to be treated merely as general creditor of the defendant. Thus it can be beneficial to both parties and is quite common for the defendant to transfer the liability for making the periodic payments to a settlement company which in turn purchases an annuity from an insurance company.

To illustrate, say a defendant agrees to pay a plaintiff $500,000 over a ten year period in equal annual installments of $50,000. The defendant will then assign the liability to a settlement company, paying the company the present value of approximately $425,000. The settlement company then purchases an annuity from an insurance company for $400,000. Under §130 of the Code, if the assignment of liability from the defendant to the settlement company is a so-called qualified assignment, the $425,000 payment is not treated as income to the settlement company. Only the difference between what the settlement company received and the cost of the annuity contract (in this illustration: $25,000) is treated as income. If this weren't the case, the settlement company would have to treat the whole $425,000 as income but would only receive a deduction of $50,00 per year over the ten year period as payments were made to the plaintiff. This is not a good tax result for the settlement company (but would have no direct or indirect consequence to the plaintiff/annuitant).

A qualified assignment is defined as any assignment of a liability to make periodic payments as damages on account of physical injury or sickness if several technical requirements are met. One of these requirements is that the assignee (settlement company) must assume the liability from a person who was a party to the suit or agreement.

In Revenue Procedure 93-34, the IRS announced that a QSF can be treated as a party to the litigation and therefore can make a qualified assignment to a settlement company. As noted above, this opened up myriad possibilities for plaintiffs in physical personal injury cases.

VI. "Non-qualified" assignments in taxable tort cases.

As noted, if the core injury which is the subject of the liability claim is not a physical personal injury, no qualified assignment can be made by the defendant to a settlement company. Thus, in the past, plaintiffs in employment law or discrimination cases, for example, were unable to purchase structured settlements.

Recently however, one annuity company, Allstate, has begun selling a product designed for this market. It has avoided the negative potential tax consequences under §130 of the Code by using an off-shore company as the settlement company. The off-shore company then purchases the annuity contract from Allstate. The off-shore company is not subject to U.S. taxes and thus is not adversely affected by the non-qualified treatment of the assignment.

Although not necessarily required, the purchase of a taxable annuity through a QSF is appropriate because through its use the plaintiff is at least one step further removed from the constructive receipt of the settlement.

In spite of the fact that this type of annuity product cannot offer the total tax-free internal buildup of a traditional structured settlement, it still may be attractive to certain plaintiffs. Some of the benefits of this arrangement are tax deferral - taxes are paid over the life of the contract rather than reducing the award all at once, avoidance of ongoing management fees for investment of the asset, and providing creditor protection for the funds remaining in the contract.

This arrangement is even more attractive in those instances where the attorneys' fees are also treated as taxable income to the plaintiff. Since the deduction for attorney's fees is not allowed in calculating the Alternative Minimum Tax, it may be beneficial to the plaintiff to spread her own portion of the award out over a number of years rather than receiving all of the income at once.

The best result of all can be obtained in those instances where the attorney is also structuring her fee. See "Taxable Interest in a Settlement or Judgment" section of these materials. In the above example, say the attorneys fees in that case were an additional $300,000 and are all treated as taxable income to the plaintiff. If the attorney also agrees to take her fee over a ten year period, then the plaintiff is realizing $30,000 per year of additional income rather than realizing all $300,000 as income in the year of the settlement. This will significantly mitigate the negative effect of the alternative minimum tax.

VIII. Conclusion.

A QSF should be considered in all tort cases involving multiple litigants. The down-side risk and complexity of establishing a QSF is minimal and they provide plaintiffs with the luxury of time to make a reasoned decision as to how maximize their enjoyment of their awards.