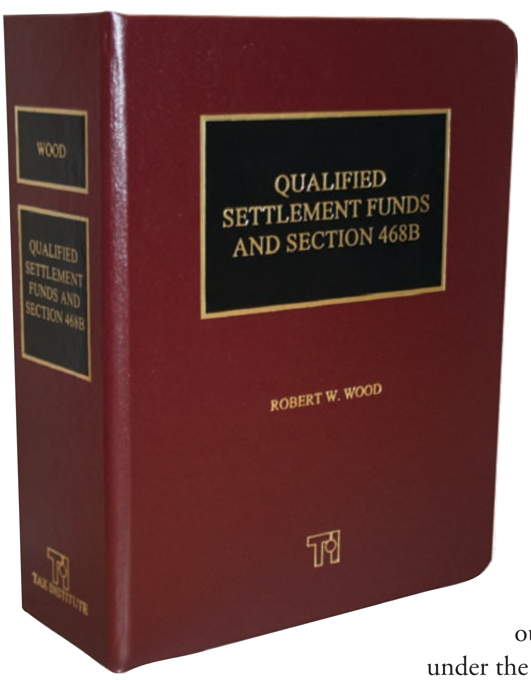
Qualified Settlement Funds and Section 468B

As noted by the author and Wyoming State Bar member, Robert W. Wood, "[i]f you are reading this book, you are probably someone who has previously established a QSF [Qualified Settle–ment Fund], someone who has decided to establish a QSF, or at the very least, someone who is considering establishing a QSF." If you fit any of these categories, this treatise (the "Treatise") should be required reading for you.



As the Treatise explains, qualified settlement funds ("QSFs"), also known as Section 468B trusts, were established by the 1993 regulations promulgated under Section 468B which was enacted as part of the Tax Reform Act of 1986. QSFs were designed as a mechanism to help resolve a broad range of claims, including tort liability claims, arising out of personal injuries; claims under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"); and other claims arising out of a tort, breach of contract, or violation of law.

Originally created for use in mass tort litigation, the author points out that the use of QSFs has evolved to include not only large class actions involving drug and other product manufacturers; claims involving shareholder, investment or security violations; and environmental clean-up claims, but also virtually any other controversy involving multiple claimants. The Treatise contains an excellent discussion of the controversy over whether a QSF can be established for a single claimant, including the impact of the "doctrine of constructive receipt" and the "economic benefit doctrine" on this issue. The Treatise concludes that due to the unsettled nature of this controversy it is preferable to establish a QSF with multiple claimants having multiple claims. The Treatise provides an interesting discussion of whether QSFs can be used to settle cases involving multiple plaintiffs in personal injury actions, including the injured victim and derivatively injured persons such as a spouse, children or parents. Since a QSF must be established by a governmental authority, usually a court, the Treatise provides a sample petition and order for use in obtaining the approval required under the Treasury regulations.

Although not strictly required by the regulations, usually a QSF will take the form of a trust which satisfies state law trust requirements. As a result a written trust agreement will often serve as the governing instrument of the QSF. The Treatise offers an extensive discussion of the essential elements that should be contained in every QSF trust agreement, and provides a detailed sample trust agreement with optional provisions for the reader's review and consideration.

Once the QSF has been established, there are a number of responsibilities a trustee and/or administrator may have with respect to the administration of the QSF. Several chapters of the Treatise are devoted to the various administrative issues, duties and powers of the trustee and administrator. The author guides the reader through everything from the requirements to apply for a federal employment identification number for the QSF, to receiving and investing settlements funds, including the release of the transferor of these funds (sample forms are included), and how to terminate the QSF. Although the QSF is often held up as an important device through which a defendant can obtain immediate tax benefits from a cash settlement payment, of particular interest is the trustee's authority to resolve competing claims for the settlement funds, and the flexibility that the QSF provides in funding structured settlements, paying liens and even funding special needs trusts.

Finally, the Treatise also covers the major tax aspects of a QSF. Of primary concern to a defendant is the ability to deduct, for income tax purposes, a payment to a QSF. As a general rule, payments to a trust fund for the benefit of a plaintiff are not deductible because such payments do not discharge the taxpayer's liability to the plaintiff. However, Section 468B provides for an exception that allows such irrevocable payments made to court-ordered settlement funds to be deductible. The Treatise provides examples of the typical business requirement of such expenditure versus those of a capital nature. It also discusses the "sale or exchange" treatment of transfers of property made to a QSF. The bottom line is that the defendant can obtain a deduction up front for the amount of property transferred to the QSF. Once the QSF is established, the plaintiff then has the ability to stretch its income treatment over time as distributions are made out of the QSF. Once a QSF is established, it is a separate taxpayer for federal income tax purposes. The Treatise discusses that under the regulations promulgated under Section 468B, a QSF is treated as a United States person subject to his own modified gross income. Generally, the transfer from a defendant itself is not subject to tax, but if the transfer is made of stock or debt, the dividends or interest, as the case may be, is included. The discussions with respect to filing, tax payments, and penalties would be very helpful to any tax return preparer of a QSF.

The Treatise includes an entire chapter on the tax treatment of attorney fees. Included is a nice discussion of the "origin of claim" test to determine deductibility of attorney fees. In general, attorney fees can be capitalized if incurred in connection with obtaining a capital asset, deducted if spent defending a claim of an operating business, or partially deducted if incurred arising out of an investment activity. The Treatise covers issues with respect to shareholder-corporate actions, including derivative suits. Finally, the Treatise includes a nice history and summary of the current state of the law regarding contingent fees as set forth in Commissioner v. Banks 543, U.S. 426 (2005) which generally stands for the proposition that a litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. Included is a discussion of the exceptions to this rule (set out in statute and established by the Courts), as well as instructions on how to report attorney fees to the IRS.

Whether you are defense counsel looking at options that can extract your client from litigation involving multiple claimants, while providing important, immediate tax benefits, or plaintiff's counsel seeking to address important settlement planning issues, you will benefit from Robert Wood's clearly written and detailed discussion of QSF.

For more information, visit www.taxinstitute.com. *

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