

Is a qualified settlement fund right for your client?

Current tax law allows plaintiffs to select a structured-settlement program that meets their needs and financial goals while maintaining the settlement's tax-free status.

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A qualified settlement fund (QSF) allows claimants to set up structured settlements without defendants' participation, so plaintiffs can receive the tax advantages of these settlements on terms that best meet their needs. Although QSFs are commonly used to settle class action liti-

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gation, they also offer advantages to plaintiffs with individual claims.

Many high-profile class action lawsuits in recent years—including *Vizcaino v. Microsoft Corp.*, *People v. Philip Morris, Inc.*, the Nasdaq Market-Makers antitrust case, and the Austrian and German bank Holocaust litigation—have incorporated QSFs into their master trust agreements.¹ Some federal courts have even adopted rules of civil procedure for establishing these funds for class action lawsuits and individual claims.²

The QSF—created in the early 1990s from provisions in §468B of the Internal

Revenue Code—is the latest in a series of tax-code changes that were made to address defendants' concerns about participating in structured settlements. In the mid-1980s, insurance companies and self-insured defendants worried that payments to settlement trusts would not be tax deductible, as were lump-sum payments made directly to claimants. Defendants wanted to deduct a payment into a settlement trust or other deferred arrangement in the year they made the payment, rather than in the year the trustee chose to distribute the payment to the beneficiary. To address this concern, Congress enacted

§468B in 1986.³

Section 468B created designated settlement funds (DSFs), which the Treasury Department expanded via regulatory ruling in 1993 to include QSFs. Qualified settlement funds include the designated settlement fund plus liabilities under tort, environmental, breach-of-contract, violation-of-law, and other claims as designated by the IRS. The primary difference between a QSF and a DSF is that a QSF allows a broader range of claims to be considered, including environmental and breach-of-contract claims. Also, a QSF needs continuing oversight of the court or government entity that created it. A DSF does not.

Revenue Procedure 93-94 treats a DSF or QSF as a "party to the suit or agreement" and allows a defendant or its insurer to settle one or more claims by agreeing to pay a cash settlement into the fund.⁴ The defendant can release its liability and receive a tax deduction for the full amount paid, just as it would with any cash settlement.

Once the money has been deposited into the fund, it then can be paid in cash to the plaintiffs, paid into a trust or supplemental-needs trust, or used to buy a structured-settlement annuity that would provide the same tax advantages to the injured parties as a structured settlement purchased by a defendant insurance carrier.

After the fund has been established, the fund administrator and the plaintiff work together to settle important details. They discuss whether a trust ought to be set up to preserve government benefits such as Medicaid. They also consider whether or not to use a tax-advantaged structured settlement, how cash will be allocated, how beneficiaries will be designated, and whether the plaintiff attorney should structure legal fees.

QSFs offer defendants several advantages. By paying money into a fund, the defendant fulfills its obligations to the plaintiff and gets an immediate tax deduction for payments made. This is true whether or not the litigation is a class action. The full release and immediate tax deduction simplify the settlement and tax situation, which may encourage defendants to settle cases.

Professional administrators specialize in establishing and running qualified settlement funds so plaintiff attorneys can focus entirely on settling the case.

A qualified settlement fund must meet three criteria:

- It must be established by order of a government entity and remain subject to the continuing jurisdiction of that entity.
- It must be established to resolve one or more claims.
- It must be kept in a segregated account.

Personal injury claims

These funds may be particularly effective in certain personal injury cases:

When it is necessary or desirable to protect government benefits. The plaintiff in a case we handled was in a coma and lived in a nursing home. Her settlement and those of other parties to the case were paid into a QSF. The fund earned interest while various government agencies involved in the plaintiff's ongoing care—such as the Centers for Medicare & Medicaid Services (formerly the Health Care Financing Administration) and the Social Security Administration—considered approval of a supplemental-needs trust that had been drawn up for her benefit. Only after the supplemental-needs trust was approved were allocations made from the QSF and the trust funded.

When there is a dispute over the allocation of benefits. Since a QSF is subject to the continuing jurisdiction of the government entity or judicial body that formed it, that entity is the final decision-maker in benefits allocation. This is particularly ben-

eficial to plaintiff attorneys who sometimes get caught between clients who are competing among themselves for larger settlement allocations. The attorney doesn't have to choose sides and can stay out of a situation that could damage his or her relationship with a client.

When the claimant wants a structured settlement and the defense will not cooperate. In the 1980s, structured settlements were almost exclusively proposed by defendants' insurers. Few plaintiff attorneys used their own structured-settlement consultants, and if they did, it was strictly to evaluate an offer from the defense.

Many insurance carriers used consultants who had integrity and offered honorable service. But some abused their advantage and offered structured settlements only through affiliated life-insurance companies on terms that were unfavorable to plaintiffs. Some made it difficult for claimants to consult with their own structured-settlement advisers: They imposed a policy that denied the plaintiff's consultant compensation from the commission built into a settlement's pricing.

A qualified settlement fund gives plaintiff attorneys a tool to combat abusive or self-serving insurance carriers. In fact, the legislation that created QSFs bars defendants from funding a structured settlement using an affiliated insurance carrier, and it prohibits any party related to the carrier from administering the fund.⁵

Since the structured-settlement community has come to accept that consultants may work with plaintiffs and their attorneys, it is common for consultants on both sides to work together to fund a structured settlement, with or without a QSF. The availability of QSFs may keep defendants' consultants working to get the best annuity rates possible, which will help the claimants and defendants get the highest rate of return on the structured settlement.

Establishing a fund

Professional administrators specialize in establishing and running QSFs. This allows plaintiff attorneys to focus entirely on settling the case, leaving the mechanics of the fund to the administrator. The attorney should take precautions to make sure that

the administrator does not mishandle the money. One way to do this is to use one who is bonded and insured.

The administrator will draw up a proposal for setting up a fund and submit it to a court or government entity to be established. Then, the administrator will arrange for a taxpayer identification number and set up a fund account.

Once the defendant deposits money into the fund, the administrator will handle the financing of any trusts or structured settlements, as well as immediate cash payments to the injured parties, case expenses, and attorney fees. Structured settlements are assigned to companies owned by the insurance carriers that issue settlement annuities. The payment stream is set before settlement, and the fund does not need additional oversight. That is one of the primary advantages of structured settlements.

The administrator will also file tax returns for the fund, including a final

return once all the monies are distributed. Interest earned by the fund will be taxed in the highest federal corporate tax bracket. Most states will tax the interest as well.⁴ However, since most of the interest earned would have been held by the defendant or in a non-interest-bearing escrow account if the fund had not been established, in the long run the interest benefits the claimant.

Overall, a QSF can simplify settlement. The plaintiff attorney will negotiate strictly for an amount that, if accepted, will be paid directly into the fund. (The plaintiff attorney has the fund drafted, approved, and set up before settlement talks, even though the defendant may not cooperate.) In class actions, the fund administrator will then settle the claims of each plaintiff.

Although QSFs have many advantages, they do involve some complex legal and tax issues. Consult a tax attorney or other tax professional before you proceed.

If you determine that a QSF might be a good option for your client, set up a fund.

QSFs can give plaintiffs and their attorneys control of the allocation of settlement money and ensure that plaintiffs' financial needs are met. □

Notes

1. *Viacino v. Microsoft Corp.*, 142 F. Supp. 2d 1299 (W.D. Wash. 2001); *People v. Philip Morris, Inc.*, No. 97-AS-30301 (Cal., Sacramento County Super. Ct. June 12, 1997); *In re NASDAQ Market-Makers Antitrust Litig.*, No. 94 Civ. 3996 RWS, 2000 WL 37992 (S.D.N.Y. Jan. 18, 2000); *In re Austrian and German Bank Holocaust Litigation*, 80 F. Supp. 2d 164, 180 (S.D.N.Y. 2000).

2. See, e.g., LOCAL RULES OF THE U.S. DIST. CT. FOR THE DIST. OF NEW HAMPSHIRE VII. PROVISIONAL AND FINAL REMEDIES N.H. U.S. DIST. CT. R. 8-67.5 (2001).

3. Glenn Karish, *Court Created Trusts in Texas*, in STATE BAR OF TEXAS ADVANCED DRAFTING: ESTATE PLANNING & PROBATE LAW COURSE 35 (1996).

4. 26 C.F.R. §1.468B (1996).

5. 26 U.S.C.A. §468B(a) (1998).

6. Note that Delaware recently exempted QSFs from state income taxes. See DEL. CODE ANN., tit. 30, pt. II, ch.16, §1633 (2001).

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