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Settling Easier With Qualified Settlement Funds

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Plaintiffs and defendants regularly negotiate a settlement "number," leaving most "everything else" to be figured out later. Once negotiated, defendants want to finalize quickly, while plaintiffs need time to address taxes, investment strategies, liens, and other issues that impact defendants far less.

Qualified Settlement Funds (QSFs) allow both sides to meet their goals. Tax rules ordinarily match a payor's deduction with a payee's income recognition. However, IRS regulations and guidance make QSFs a temporary intermediary. The value is so significant that the preeminent treatise found it necessary to explicitly state this: "QSFs are definitively *not* tax shelters." Qualified Settlement Funds and Section 468B, Preface. Rather, Congress and the IRS established a mechanism to encourage settlement.

I. Defendants' Immediate Benefits

The benefits of QSFs are most obvious for defendants and others paying on their behalf. Once a defendant negotiates a settlement amount, it's typical to prioritize

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securing (1) a fast and full liability release, (2) an immediate deduction, and (3) separation from plaintiffs' tax, benefits, and other concerns.

However, achieving these goals is often delayed by plaintiffs' need to resolve several open questions. Skipping past them can substantially reduce settlement value for plaintiffs and even expose plaintiff lawyers to liability. QSFs allow defendants to immediately meet their three goals.

First, when defendants make full payment to a QSF, they get a full release. Since plaintiffs know that the amount will be held for their benefit, they can grant the full release that defendants need, including for their use of the QSF itself.

Second, defendants get an immediate deduction upon payment to a QSF. Treas. Reg. § 1.468B-3(c). Defendants can even deduct their payment if they'll get some of their payment back, as long as an independent party decides whether and how much of the funds are returned.

Third, QSFs allow defendants to avoid their most difficult tax reporting responsibility: preparing and issuing IRS Form 1099. In most circumstances, defendants must determine and report the taxable amount of a settlement payment. This can prompt new disputes with plaintiffs, who often push for defendants to report smaller amounts as taxable. But defendants don't need to issue 1099s for payments to QSFs, avoiding the conflict entirely. Treas. Reg. § 1.468B-2(l)(1); Treas. Reg. § 1.6041-3(p)(1). Instead, defendants provide a general statement identifying themselves, the QSF, and the amounts transferred.

In this way, QSFs provide a "quick exit" for Defendants. They get a full release, immediate deduction, and avoid the many nuanced and time-consuming issues that defendants typically don't care about. We discuss those below.

II. Plaintiffs' Benefits Preserved

The benefits of QSFs for plaintiffs are just as immediate and often far more significant. Once plaintiffs know the amount defendants will pay, there's a lot of decisions to make. And yet, there's pressure to "close the deal" quickly. QSFs allow plaintiffs to accept defendants' payment while preserving their ability to make the many decisions necessary to close the case and maximize settlement value. We discuss four benefits to plaintiffs here.

First, QSFs offer a straightforward mechanism to allocate recoveries amongst many plaintiffs. Defendants often negotiate a single amount in cases of multiple plaintiffs. QSFs allow defendants to "walk away" while a QSF Administrator coordinates and allocates. They've been used in large class actions and small cases alike.

Second, QSFs allow defendants to exit before plaintiffs have addressed outstanding liens. Plaintiffs and plaintiff lawyers must address Medicare and other liens as part of settlement. This can take significant time, especially if plaintiffs attempt to negotiate lien reductions. QSFs allow time for these negotiations, preserving plaintiffs' ability to keep more of their recovery. While waiting, plaintiffs who fundraise for medicals should consider using platforms like the Plaintiff Fund Charity, a vital tool for plaintiffs to avoid jeopardizing their Medicaid benefits.

Third, QSFs preserve plaintiffs' ability to obtain advantageous tax treatment. Defendants and plaintiffs often disagree about the taxable amount of the settlement that should be reported to the IRS. QSFs bypass this problem because defendants need not issue 1099s to QSFs. And plaintiffs' advantageous tax treatment is preserved. Payments by a QSF are tax-free to a plaintiff to the same extent as if paid by a defendant. Treas. Reg. § 1.468B-4. QSFs are also typically able to work with other tax-saving arrangements, like the Plaintiff Recovery Trust, a critical arrangement in taxable cases.

Fourth, QSFs preserve plaintiffs' ability to use structured settlements, an incredibly valuable settlement strategy. Structures provide tax deferral, and in many cases, tax-free treatment for earnings on the original settlement amount. But fast-moving settlements sometimes don't allow time for plaintiffs to choose between structure providers or to identify the right amount to defer. In 1993 the IRS explained how to ensure that structured settlements work with QSFs. IRS Rev. Proc. 93-34. This allows plaintiffs to avoid rushing life-changing financial decisions.

Thus, QSFs offer significant flexibility to plaintiffs and the ability to accept settlement offers from defendants without losing settlement value.

III. Easy to Use

Fortunately, Congress and the IRS have made the creation and use of QSFs quite straightforward. They must be established (1) under the right authority, (2) for the right purpose, and (3) in the right form. Using relationships and automated systems, some QSF Administrators have made it possible to create QSFs almost instantaneously.

A QSF can be "established" by a federal or state court, or federal or state agency, that exercises continuing jurisdiction. Notably, a court establishing the QSF need not be the court considering the underlying dispute. In order to quickly establish QSFs, some QSF Administrators regularly use government agencies rather than courts.

The QSF must be created to "resolve or satisfy" claims of certain liabilities from an event (or a related series of events), including tort or breach of contract liabilities. QSFs have been used for all manner of lawsuits, including claims for personal injury, products liability, securities violations, environmental damage, and many others.

The QSF must be formed as a state law trust or a segregated account. Segregated accounts are typically used when a defendant intends to hold the funds. This is less attractive to plaintiffs who prefer funds to be held and handled by an independent party. Typically, QSFs are established by trust companies and professional fiduciaries, who serve as QSF Trustee or QSF Administrator.

IV. Conclusion

Use of Qualified Settlement Funds has steadily increased over the years. They don't provide much benefit when plaintiffs and defendants have no open loops, or if the parties don't mind waiting and discussing plaintiffs' personal financial decisions.

But when that's not the case, they can be instrumental in allowing the defendant to "walk away" while plaintiffs are left with discretion to strategize, structure, and negotiate outstanding liens.