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COMMENTS:

Jody, Here are the articles we've referred to in the past. The last page is just the first page of a 46 page law review article by Rickard Risk. I trust these are helpful, and we look forward to your comments regarding the 130/single-claimant QSF soon. Thanks,

Terrance

TM

Resolving Mass Torts with Designated Settlement Funds

William L. Winslow

A new approach to settling mass tort claims has evolved. In 1986 Congress created a new entity in the tax law with Internal Revenue Code (IRC) §468B.[1] That statute gave birth to the designated settlement fund (DSF).

Treasury regulations that became effective January 1, 1993, expanded the new concept, inaugurating the qualified settlement fund (QSF).[2] There are differences between the two, both in scope and requisites, but this article deals mainly with the DSF except where differences are important.

The great usefulness of the DSF is that it serves as an intermediary. It allows lump-sum settlement payments to flow from defendants and liability insurers into a fund. The fund administrator can then arrange a settlement tailored to the claimant's needs.

In this way each claimant can have the option of receiving an all-cash settlement, a structured settlement, or a settlement with a special needs trust. The necessity of negotiating with the defense for a customized remedial arrangement is removed; no "favor" from the defense is needed.

Before development of the DSF entity in the tax law, a plaintiff risked running afoul of the constructive receipt doctrine if the defendant or its liability insurer simply paid a lump sum, even to a third party, without suitable provision for a periodic payment settlement.[3]

The use of a designated settlement fund simplifies negotiations in large cases.

The development of special purpose funds primarily grew out of asbestos cases and other toxic tort litigation. The breast implant settlement will involve creation of one or more DSFs.

The new rules are yet another evolution in the tax law required by changes in scope and complexity of tort litigation and remedial requirements of injured parties. Nowadays most large cases involve structured payments,[4] and the settlements are often crafted to protect eligibility for government benefits[5] or to address open-ended medical care requirements.[6]

The operation of §468B and its supporting regulations and procedure can best be analyzed using a simple example. Suppose Dogged, Inc., allegedly allowed a leak of toxics causing Patricia, Philip, Priscilla, and others to become ill. Dogged wishes to pay $5 million in 1994 to a fund to settle all the claims and deduct the $5 million on its 1994 tax return.

It seems simple, but suppose that (1) it is not yet decided whether Patricia will be paid more or less than the other claimants, and (2) it is not intended that all claimants receive all payments in 1994.

Under the "economic performance" doctrine of IRC §461(h), the general rule was that Dogged could not deduct all $5 million in 1994. It could deduct only the payments actually received by claimants. But with the new rules, if Dogged pays its $5 million to a court-ordered DSF, it may deduct the full amount at once, leaving such problems as allocation, structuring of settlements, and the like to the DSF.

There is considerable risk of confusing DSF and QSF rules. Their properties, or limits, are similar. The requirements for a DSF are set forth in the IRC,

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whereas the requirements for a QSF are defined by Treasury regulations. It appears that the secretary of the Treasury chose to adapt the settlement fund concept—first given expression in the statute—for a wider variety of dispute-resolving transactions than only those arising from torts.

IRC §468B(d)(2)(D) requires that a DSF be established "for the principal purpose of resolving and satisfying present and future claims . . . arising out of *personal injury, death or property damage*."[7] By contrast, the regulations authorize a QSF where the fund is established to resolve or satisfy claims under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980,[8] or arising out of a "tort, *breach of contract*, or *violation of law*. . . ."[9]

A QSF may also be used for other types of disputes the IRS commissioner designates in a revenue ruling or revenue procedure.[10] So, a QSF may be used in many more situations than just tort claims. Moreover, the idea that a DSF is just one type of taxpayer in a larger category called QSF may be inferred from the fact that Treasury Regulation §1.468B prescribes that a DSF shall be taxed in the manner provided in the regulations for a QSF.[11]

Stricter Requirements

However, in several places the regulations impose stricter requirements for a qualified settlement fund than for a designated settlement fund. For example, the statute demands only that the latter be "established pursuant to a court order,"[12] but the regulations provide that the former be established under the order of a court or government agency and that the fund be "subject to the continuing jurisdiction of that governmental authority. . . ."[13]

Many mass tort settlements might not require continuing court supervision (such as a case involving only competent adult claimants); and it is doubtful whether the Treasury secretary has authority to impose that additional requirement, at least as to a DSF.

On the other hand, the regulations may have softened the statutory requirement that a designated settlement fund be "administered by persons a majority of whom are independent of the taxpayer [the defendant or its insurer]."[14] This provision was probably intended to prevent defendants from income-tax sleight of hand in funding a DSF.

The deduction would only be available if the defendant did not keep a string attached to its contribution to the fund—for instance, by controlling the administrator (or administrative committee) of the fund. Yet, in a private letter ruling, the Internal Revenue Service allowed QSF treatment (as the defendant-taxpayer desired) where the administrator was a nonprofit corporation and its members (the equivalent of stockholders in a for-profit corporation) were all defendants or liability insurers as to certain products liability claims.[15]

Generally, the best course for plaintiffs' counsel in mass tort settlements is to comply with the statutory requirements for a DSF and, to the extent it is not onerous, to meet the requirements of the QSF.

Designated settlement funds remove the necessity of negotiating with the defense for a customized remedial arrangement.

The order establishing the DSF should provide that the taxpayer's tort claim liability be extinguished completely.[16] Also, either the fund must be a trust under state law, or its assets must be segregated from assets of the transferor or related persons.[17]

The DSF administrator must file a tax return whether or not there is taxable income.[18] Income above $7,500 will be taxed at 39.6 percent,[19] and unlike what is the case with most trusts, distributions from the fund are not deductible.[20] Thus, it is usually best not to have large sums held within a fund for a long time. Also, the transferor (the defendant or its liability insurer) must issue to the DSF and the IRS a Section 1.468B-3 Statement showing the dates and amounts of cash and other property transferred to the fund.[21]

The critical function of a designated settlement fund is to take over the funding and administration of a variety of remedial payments. Most important, a DSF can act like a defendant or liability insurer in creating and assigning a periodic payments obligation under IRC §130, Rev. Proc. 93-34.[22] In practice, the control that formerly rested with the defense is transferred to the fund.

The options for distributing fund resources to claimants are virtually unlimited. For example, many DSFs create trusts or other ongoing arrangements for future medical care or examinations and screening. Some mass tort settlements have included funds to educate the public about the hazard. A reserve to address the needs of as yet unidentified claimants also may be required.

Practical Issues

Some people have hailed §468B as a sword in the hands of plaintiffs, on the assumption that using a DSF eliminates the usual need for defense-side cooperation in working out suitable remedies, especially structured settlements and special needs trusts. Nevertheless, plaintiffs' counsel should evaluate several factors in deciding whether a DSF is appropriate in a given litigation.

The most common question is, How many plaintiffs must participate in the compromise in order to use a designated settlement fund? This question has no easy answer. Unfortunately, no specific number of claimants appears anywhere in the statute, regulations, or revenue procedure. The statute describes a DSF as a fund that extinguishes the taxpayer's liability with respect to "claims" (*plural*);[23] but the regulations allude to a fund established to resolve "*one or more* contested or uncontested claims. . . ."[24]

Another level of analysis focuses on the interrelated income tax doctrines of constructive receipt and economic benefit. In essence, the constructive receipt doctrine provides that a taxpayer may have to recognize income if, though the money or property is not actually in his or her hands, the taxpayer has effective control over it. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.[25] The economic benefit doctrine treats a taxpayer as having received money if it is invested for the taxpayer's benefit and no other person has any claim to, interest in, or right to the money.

Caveats

Where only one competent adult plaintiff is involved, creating a DSF to accomplish a structured settlement under Rev. Proc. 93-34 subjects the plaintiff to a significant risk from the constructive receipt doctrine. The revenue procedure did not write the constructive receipt doctrine out of this area of the law. Also the necessity of any court involvement—which is required to obtain a DSF—is open to question where there is only one competent adult plaintiff. In most circums[...]s this plaintiff may settle his or her individual lawsuit without court permission or approval.

By contrast, in most jurisdictions any substantial claim by a minor or incompetent must have court approval. Therefore, until the court acts there is no enforceable settlement, which means there cannot be constructive receipt. If when the court acts it creates a DSF for one minor plaintiff, this might not constitute constructive receipt. However, some would argue that there remains a risk that the economic benefit doctrine would be applied because no person has an interest adverse to the minor in the money placed in the fund. This arrangement might be regarded as an investment for the minor.[26]

In cases involving just a handful of claimants, if the DSF is funded one day and emptied the next (for example, to fund one or more structured settlements), there may be raised eyebrows at the IRS when the DSF's tax return is filed. Under the tax law the characterization of a transaction should conform to its true elements. Substance should control over form.

Other factors might be important. For example, where a litigation involves a fairly unusual number of plaintiffs (that is, 10 to 12 or more), this factor alone is likely to deflect IRS concern. In my opinion, a settlement with 25 or more plaintiffs is presumptively a proper situation for a designated settlement fund. At the other extreme, where just a few competent plaintiffs are involved—say, 2 or 3 adults—an agreement among them as to allocation of shares concluded *before* the fund is created would be dangerous.

It is important to remember that §468B addresses the tax treatment to be received by *transferors* to the fund. The asbestos cases represent a good example of the kind of claims that Congress had in mind when it enacted this statute. These cases usually have had a number of defendants, sometimes a dozen or more. The fact that multiple defendants or liability insurers or both will pay into the fund will help the transaction appear to the IRS like a proper application of the statute.

A defendant's need to have a current deduction for its contribution to the settlement of a large-scale tort suit caused Congress to create a flexible new tax entity. There is now a body of supporting rules that allow plaintiff's counsel to negotiate for all-case contributions to a designated settlement fund that is administered outside of def[...] control. The use of a fund simplifies negotiations, which are already complicated enough in large cases. It also makes it possible to develop the best settlement package for each plaintiff. □

Notes

1 Tax Reform Act of 1986, Pub. L. No. 99-514, §1807(a)(7)(A), 100 Stat. 2814 (1986).
2 Treas. Reg. §§1.468B to 1.468B-5.
3 Since the promulgation of Rev. Rul. 79-220, 1979-2 C.B. 74, a sine qua non of a structured settlement transaction that will provide tax-free benefits is the creation, at least initially, of an obligation on the part of a defendant or its insurer to make set periodic payments to the injured party. Rev. Proc. 93-34, 1993-28 I.R.B. 49 authorizes a QSF also to be the obligor of the future payments. Once the obligation comes into being, it can be assigned under I.R.C. §130.
4 ISO DATA, INC., CLOSED CLAIM SURVEY FOR COMMERCIAL GENERAL LIABILITY: SURVEY RESULTS 13 (1991).
5 The best methods are special needs trusts and/or "spend downs."
6 Usually trusts are used, with or without a reversion to the defense. *See* Rev. Rul. 77-230, 1977-2 C.B. 214 regarding the reversionary medical trust.
7 The statute also requires that the designated settlement fund be established under a court order "which extinguishes completely the taxpayer's *tort* liability . . . ." [Emphasis added.] I.R.C. §468B(d)(2)(A).
8 42 U.S.C. §9601.
9 Treas. Reg. §1.468B-1(c)(2)(ii).
10 Treas. Reg. §1.468B-1(c)(2)(iii).
11 Treas. Reg. §1.468B-5(b)(1)(C).
12 I.R.C. §468B(d)(2)(A).
13 Treas. Reg. §1.468B-1(c)(1).
14 I.R.C. §468B(d)(2)(C).
15 Priv. Ltr. Rul. 94-16-032 (1994).
16 I.R.C. §468(B)(d)(2)(A).
17 Treas. Reg. §1.468B-1(c)(3).
18 Treas. Reg. §1.468B-2(k)(1). The return is due on or before March 15 of the year following the close of the taxable year of the fund. Treas. Reg. §1.468B-2(k)(3).
19 Treas. Reg. §1.468B-2(a).
20 Treas. Reg. §1.468B-2(b)(2).
21 Treas. Reg. §1.468B-3(e). This statement must be sent by February 15 of the year following each calendar year in which the transferor or its insurer makes a transfer to the fund.
22 Rev. Proc. 93-34, 1993-28 I.R.B. 49. Note that the legislative history to the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647, 100 Stat. 3342 (1986) contains a statement that "a designated settlement fund must extinguish completely the taxpayer's liability with respect to a *class* of claimants. . . ." [Emphasis added.] H.R. REP. NO. 795, 100th Cong., 2d Sess. (1988).
23 I.R.C. §468B(d)(2)(A).
24 Treas. Reg. §1.468B-1(c)(2). [Emphasis added.]
25 Treas. Reg. §1.451-2.
26 *Cf.* Rev. Rul. 76-133, 1976-1 C.B. 34, involving a blocked account into which the proceeds of a minor's personal injury settlement were placed. Moreover, a trial court's favorable characterization of a transaction will not necessarily be dispositive when it comes to the transaction's income tax treatment.

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§468B Designated Settlement Fund Assumes Liability from Defendant

Plaintiffs and defendants alike are finding merit to the use of a designated settlement fund (DSF) or qualified settlement fund (QSF) created under the authority of Section 468B of the Internal Revenue Code ("the Code").

Congress created the DSF when §468B was added to the Code in the Tax Reform Act of 1986. Treasury regulations that became effective January 1, 1993, expanded the concept of mass tort claim settlements and gave birth to the QSF. Both funds operate identically.

The concept is simple, although setting up the fund definitely should involve tax counsel. A taxpayer can establish a DSF or QSF, if certain conditions are met. The defense pays money into the fund and is released from liability for the act or acts that gave rise to the claim. The fund, which has assumed the liability, settles with the individual claimants. The settlement can include a cash component or periodic payments, the obligation for which will be assigned to a third party under IRC §130. The fund then settles any obligations, including any tax liability, and dissolves — ceases to exist.

If there is money left over after the fund has settled with all plaintiffs, it must not revert to the defendant or its insurer unless the reversion is subject to approval by the plaintiffs, the court or other authority. David Higgins, of The Settlement Law Group in Los Angeles and a foremost authority on structured settlement tax law, suggests that the fund be set up with a provision to give any surplus to a charity related to the plaintiffs' injuries.

The fund is not required to be set up as a trust. A bank or escrow account can also qualify as a Section 468B fund, as long as the assets of the fund are segregated from other assets of the defendant or its insurer.

Advantages to Defendant

- Any individual taxpayer, insurance company, corporation or other entity that identifies a future liability may be able to accelerate the full deduction of funds set aside to settle that liability to a current year status.
- The insurer receives reserve relief and creates surplus.
- The defendant can settle a class action cause even before all potential plaintiffs have been identified.
- The defendant can extinguish future liability by settling for one element of damages while leaving open the ability for plaintiffs to receive compensation for damages that occur later, such as from a latent disease process that doesn't manifest itself for years after exposure to a toxic substance.
- The defendant receives immediate relief from any future liability, sparing it the expense, trauma, notification to shareholders and regulators, and the prolonged adverse publicity of a series of trials.
- The defendant is taken out of the individual negotiation process, leaving it to the fund administrator to develop the best settlement for each plaintiff, including future periodic payments from a structured settlement.
- Legal fees terminate as all further involvement by the defendant or the insurer ends.

Advantages to Plaintiffs

- The money is irrevocably guaranteed to be distributed to the plaintiffs, subject to its allocation among all plaintiffs, providing solace that there is the ability and willingness of the fund to settle the claim. Thus, the plaintiffs avoid risk of the defendant's insolvency.
- The plaintiff does not negotiate with the original defendant or its casualty insurer, both of which are considered adversaries of the plaintiff, and instead deals with the fund administrator, who cannot be influenced whatsoever by the defense.
- The plaintiff's attorney can redirect efforts from proving tort liability to allocating the settlement funds among the plaintiffs.
- The plaintiff can preserve future tax-free growth of damage payments for physical injury, since the fund has the ability to act in place of an original defendant or casualty insurer to set up a structured settlement.
- The plaintiff will have more control over certain aspects of the settlement process traditionally controlled by the defense.

Funds Handle Variety of Claims

Section 468B of the Code requires that a DSF be established "for the principal purpose of resolving and satisfying present and future claims...arising out of *personal injury, death or property damage*." A QSF, on the other hand, may be used in more situations than just tort claims. Treasury Regulations [§1.468B] authorize a QSF to resolve or satisfy claims under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), or arising out of a *"tort, breach of contract, or violation of law...."* The Internal Revenue Service commissioner may expand the use of the QSF further in other types of disputes by the issuance of a revenue ruling or revenue procedure.

The legislation was passed with lawsuits in mind involving mass tort claims over such things as asbestos, aviation crashes and toxic chemicals. *"Any litigation involving multiple claimants for damages from the same exposure or from the same accident is a candidate for settlement with a DSF,"* says Encino, California attorney William L. Winslow, who holds an LL.M. in taxation and concentrates his practice on complex personal injury settlements. The DSF is very useful because it serves as an intermediary, according to Winslow.

A DSF or QSF cannot be used to satisfy liabilities arising under a workers' compensation statute or a self-insured health plan. Nor can it be used for claims to repair, replace or refund the price of products or to pay trade creditors or debtholders in a bankruptcy or workout.

While the choice of whether to use a DSF or QSF depends on the type of inci-

Nation's Largest Settlement Payment Purchaser in Class Action Suit - Page 4

dent that gave rise to the claim, the two are subject to essentially the same tax treatment. The fund's earnings over $7,500 are taxed at the highest rate, currently 39.6 percent, with deductions allowed only for such items as administrative expenses. Thus, except for what is needed to pay an accountant, the arbitrator who hears any disputes over allocations, actuarial services, attorney fees, to pay taxes, and for other possible reasons that demand immediate access, it is not a good idea that funds be held inside the trust longer than necessary.

The original sum received by the DSF or QSF is not taxable as income, and the distributions it makes to claimants are not deductible. These two transactions are tax neutral.

Attorneys Benefit from Concept

Attorney fees can be paid out of the fund almost immediately after the defense pays the monies into the fund. This is a distinct advantage for the plaintiffs' attorney(s) over traditional personal litigation, where the attorneys normally are paid only after their clients are paid. The attorneys may also elect to structure their fees instead of taking the full amount as a lump sum, if they have a deferred compensation agreement in effect with their client.

The plaintiff's attorney can avoid the disputes and liability from allocation issues because they are handled by the fund administrator subject to the continuing jurisdiction of the court that approved the fund.

Special Rules for Assignments

Revenue Procedure 93-34, created by the IRS, provides that a settlement fund created under Section 468B of the Code may enter into a Section 130 qualified assignment. This rule introduces requirements not in either section of the Code, including:

- The claimant must agree in writing to the assignment;
- The assignment must relate to a claim on account of personal injury or sickness (in the case involving personal injury or physical sickness) that is one of the types of claims addressed by the Section 468B rules (tort, breach of contract, violation of law or CERCLA);
- Each qualified funding asset purchased by the assignee must relate to a liability to make periodic payments to a claimant;
- The assignee must be unrelated to the transferors (alleged wrongdoers or their liability and casualty insurers) who had transferred monies to the fund in extinguishment of their liability, as well as being unrelated to the fund itself;
- The assignee must neither control nor be controlled by the fund; and
- The revenue procedure is effective for Section 130 assignments made after August 10, 1993.

Before the development of the DSF entity in the tax law, a plaintiff could be considered to have constructive receipt of the lump sum settlement payment if the defendant or its liability insurer paid it even to a third party, without provision for future tax-free payments as allowed under IRC §104(a)(2). The main economic disadvantage of a lump sum payment to a plaintiff is that, while the lump sum itself is free of income taxation, the growth of the funds is fully taxable.

With the DSF, each claimant can have the option of receiving a settlement all in cash, as a structured settlement of future periodic and deferred lump sum payments, or through a supplemental needs trust that could serve to prevent the claimant from losing government entitlements such Medicaid and Supplemental Security Income (SSI) payments for disability. (See IRC §1396p.)

Funds Established by Court

The court order establishing the fund does at least three things:

(1) Creates the fund pursuant to IRC §468B;

(2) Appoints an administrator who may be an individual, committee or institution (while the administrator could be the plaintiffs' counsel, the fund cannot be controlled by defense representatives);

(3) Extinguishes completely the defendant's liability.

The administrator's tasks are to receive and safeguard the funds, make fair and reasonable allocations from the fund to each plaintiff, and file income tax returns.

The defendant has only one duty, to file a one-page information return to the IRS (Form 1120-SF), showing the date and amount of the money transferred to the fund by the defendant, and showing also the fund's taxpayer identification number and address. The defendant gets to take a current year tax deduction for the full amount paid into the fund. Prior to the passage of IRC §468B and the inauguration of the DSF and QSF concept, the defendant as a general rule could deduct only the payments actually made to claimants, under the "economic performance" doctrine of IRC §461(h).

Two or More Claimants Needed

Neither the statutes nor the regulations of Sections 130 and 468B address the interaction between these two sections of the Code. Absent a regulation, published ruling, revenue procedure or private letter ruling, one can only guess how certain sets of facts would be treated by the IRS.

One such unresolved question is whether a DSF or QSF can enter into a qualified assignment in a case involving a single party or even multiple related parties. If there is only one claimant to a Section 468B fund, and that claimant is intended to receive everything paid into the fund, some tax commentators believe that claimant will be treated as having received the entire amount, under the concept of economic benefit.

Others argue that the concept of economic benefit does not apply to a 468B fund, and that Revenue Procedure 93-64 authorizes qualified assignments from 468B funds because of the procedure's use of the phrase "one or more claims." If all of the provisions of Section 130 must also be satisfied, then the economic benefit concept does apply.

There is also some concern over the economic benefit concept applying when funds are established for multiple related and even unrelated parties, if the interests of those parties are not adverse. Some feel that the IRS might take the position that the absence of adverse interests triggers economic benefit. The argument against economic benefit would be weakened if all parties were represented by separate counsel. Any agreement among the parties prior to settlement on distribution of the fund assets would result in constructive receipt.

David Higgins agrees. "Each case must be examined on its own facts," he says. "Two or three family members, each of whom is represented by the same lawyer, might have difficulty proving there was no pre-QSF understanding as to how the settlement fund was to be allocated among them."

In physical injury cases where individuals other than the injury victim may have derivative claims, it is important that these claims not be resolved at the time amounts are transferred into the fund, to avoid constructive receipt.

William Neff, a tax counsel to the National Structured Settlements Trade Association, speculates that one fact bearing considerable weight in an IRS or court decision as to whether an enforceable agreement was in place "would be the amount of time that passed between the funding of the 468B fund and the resolution of the claims. If the period is short, it could logically be concluded that an agreement already existed," says Neff.

"Unfortunately, no specific number of claimants appears anywhere in the statute, regulations or revenue procedures," says William Winslow, "the statute describes a DSF as a fund that extinguishes the taxpayer's liability with respect to claims (plural)." But, Winslow points out, the regulations allude to a fund established to resolve "one or more contested or uncontested claims."

The bottom line is there seems to be some tax risk if a 468B fund is created for just one claimant, but significantly less, perhaps no risk, if there are two or more.

Qualified Assignments from Single-Claimant QSFs are Supported by Tax Code and Regs

Ever since the Secretary of the Treasury issued regulations in 1993 for the qualified settlement fund (QSF), 26 C.F.R. 1.468B, there has been debate within the structured settlement industry as to whether the phrases **"one or more"** and **"at least one"** really mean what they say. Assuming the Treasury Secretary meant to use those phrases in their plain meaning, some have expressed opinions that the Secretary exceeded the intent of Congress in authorizing the creation of a QSF for a single claimant.

To understand why this debate has been taking place, one must examine the effects of the QSF on structured settlements. Section 130 of the Internal Revenue Code specifies that the future payment liability created in the settlement agreement must be assumed by the assignee "from a person who is a party to the suit or agreement."[1] This means the released party or its liability insurer. When a QSF is established, it assumes the tort or workers compensation liability from the original party before the settlement is made, at which time the original party is released or dismissed with prejudice.

The QSF then stands in the shoes of the original liable party with full authority to settle the claim, including the authority to promise future payments. Revenue Procedure 93-34 provides that the QSF may also make the qualified assignment of the future payment liability as the "party to the suit or agreement." This preserves for the claimant the income tax-free status of all payments, including the portion of the future payments representing the annuity's growth.

Those who would like to see the QSF unacceptable for use with a single claimant include some liability insurers and the structured settlement brokers who work with them, often under some rebate arrangement, to settle claims on behalf of the tortfeasor. Use of a QSF eliminates them from the structured settlement transaction because the insured is left with no more liability. Plaintiff attorneys, who feel uneasy about turning over their client's financial future to an adversary, are discovering the QSF as a means of being able to select someone of their choice as the broker. Most structures involve single claimants.

That is the background and the basis for the debate over the single-claimant QSF.

Opponents Argue "Economic Benefit"

Aside from the general contention that Congress never intended the QSF to be applied to a single claimant because the QSF was meant for mass tort claims, the main argument advanced by those who do not want the single-claimant QSF to be allowed is that it triggers constructive receipt under the "economic benefit" doctrine. If this doctine becomes operative, there is loss of future tax benefits by the claimant. Under this common-law principle, the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A "fund" is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in such a fund is "vested" if it is nonforfeitable.

It is well established in law that, when a statute or regulation is more current and more specific, the statute or regulation overrides the common law. Such is the case of the qualified assignment transaction under section 130, when the payee is given a security interest in the annuity contract. Clearly, that ordinarily would trigger the economic benefit doctrine. Yet, the periodic payments are not taxed. The Internal Revenue Service has acknowledged in at least one Private Ruling (9703038) that the 1988 amendment to section 130(c) of the Code "was intended to allow assignments of periodic payment obligations without regard to whether the recipient has the current economic benefit of the sum required to produce payments." Yet, section 130 does not mention this intention, proving that a statute does not need specifically to spell out an override of the "economic benefit" doctrine.

The same thing applies to the single-claimant QSF. Congress was specific in its delegation of authority to the Treasury Secretary, who in turn specifically authorized a single-claimant QSF. The economic benefit common-law rule is overridden, even though section 468B is once again silent on this question.

Single-Claimant QSF Accepted

The congressional intent and current economic benefit arguments by those opposed to them were persuasive for several years, and the annuity companies would not accept assignments from single-claimant QSFs. Recently, others becan to dispute these arguments.

Major life insurance markets have begun to accept, through their assignment entities, periodic payment liabilities from QSFs in which a single claimant is the beneficiary. John Hancock Life, CGU Life and Farmers New World Life recently announced that they will assume the future payment obligation from single-claimant QSFs. Otto J. Preikszas, Jr., an attorney in John Hancock's tax law department, provided the following opinion to his company's management:

"I do not believe that a single claimant is in constructive receipt of a fund's assets merely because he or she is the only claimant and, therefore, at some time must receive such assets.... Such single claimant must have some right to recover or to use the assets without restriction or limitation in order to be in constructive receipt of the fund's assets.

"Income Tax [Treasury] Regulations § 1.451-2(a) provides that *income* is constructively received in the taxable year during which it is credited to the individual's account, set apart for the individual, or otherwise made available so that the individual may draw upon it at any time. Income is not constructively received if the individual's control of its receipt is subject to substantial limitations and restrictions. Typically an individual is found to be in constructive receipt of income if the individual has the right to either elect a cash payment in lieu of deferring receipt of income, has the right to terminate a deferral arrangement at will (without giving up any "valuable rights") and receive a cash payment and, in some cases, if the arrangement is funded.

"Unless a single claimant of a fund has a right to elect a cash payment in lieu of fund establishment or to terminate the fund at will and receive a cash payment (or has a similar such right), it is my position that such a claimant is not in constructive receipt of the fund's assets merely because that person is a single claimant....

"In addition, please note that, in Revenue Procedure 93-34, the IRS provides rules under which a 468B fund will be considered a "party in interest" for purposes of Code section 130. I am not aware of any provision under section 130 that would cause a single claimant to be in constructive receipt of any amount of a qualified assignment established on his or her behalf merely because there is only one claimant. In fact, the Conference Committee Reports with respect to TAMRA provide that a liability assignment is treated as a qualified assignment notwithstanding that the recipient is provided creditor's rights against the assignee greater than those of a general creditor. [Emphasis his.] **No amount is currently includible in the recipient's income solely because the recipient is provided creditor's rights that are greater than the rights of a general creditor.** (This is the funding aspect of constructive receipt.)

"Finally, I note that Income Tax Regulations § 1.468B-3(f)(2)(ii) provides that, to the extent that the transferor of amounts to fund acquires a right to a refund or reversion of the fund's assets, it is in constructive receipt of such assets. There is no other regulation under section 468B (or section 130) dealing with instances in which a claimant may be in constructive receipt.

"Based on the above, it is my opinion that a single claimant of a section 468B fund is not in constructive receipt of the fund's assets merely because such person is the only claimant."

A further examination of Congress' intent creating designated settlement funds and in delegating authority to the Secretary of the Treasury to promulgate regulations governing these funds demonstrates conclusively that such funds may be used when there is only a single claimant.[2]

Multiple Claimants Not Required

The Code, 26 U.S.C. § 468B(d)(2), defines a "designated settlement fund" as any fund "which is established pursuant to a court order and which extinguishes completely the taxpayer's tort liability with respect to claims described in subparagraph (D)...[and] which is established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person or formerly related person) arising out of personal injury, death, or property damage...." The Code also authorizes a tax deduction for payment into the fund by saying "[f]or purposes of section 461(h), economic performance shall be deemed to occur as qualified payments are made by the taxpayer to a designated settlement fund." [26 U.S.C. § 468B(a).] There is no suggestion whatsoever in the language of the Code that more than one claimant is required, unless one unreasonably construes the term found in subparagraph (d)(2)(D), "satisfying present and future claims," to mean a requirement of multiple claimants. The Treasury Secretary obviously did not make this interprettion.

Congress Anticipated Single Claimant

Section 468B was created to give a defendant in a mass tort claim the ability to settle it even before all the plaintiffs have been identified. But, there is no way to be sure that there would be multiple claimants if they have not been identified at the time the QSF is established.

Suppose there was an explosion and fire in a building with the potential to have killed several people, but with the number of occupants at the time of the explosion and fire unknown. One body is recovered and the spouse brings suit on a negligence theory against the building owner. The liability insurer obtains a court order to establish a QSF on the probability that there were more victims, obtaining release of tort liability from all victims, known and unknown. The QSF is substituted for the building owner under a novation[3] and assumes all liability for the damages caused by the explosion and fire. If no more victims are identified, the entire fund assets may be paid to only one claimant.

Certainly, the drafters of this statute anticipated this scenario or one similar and never intended that the surviving spouse of the single victim would lose the tax benefits that otherwise would have resulted had there been more than one victim.

Secretary Specifically Said "One"

The Secretary of the Treasury, in issuing 26 C.F.R. § 1.468B, defined a "qualified settlement fund" as a "fund, account, or trust [that] satisfies the requirements...if

"(1) It is established pursuant to...and is subject to the continuing jurisdiction of [a] governmental authority;

"(2) It is established to resolve or satisfy **one or more** contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability [Emphasis added.] (i) Under [CERCLA]; or (ii) Arising out of a tort, breach of contract, or violation of law; or (iii) Designated by the Commissioner in a revenue ruling or revenue procedure; and

"(3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons)."

In the unlikely event that the Secretary inadvertently used the word "one" more than once in defining a QSF, intending to mean "two" (as some claim), there was plenty of opportunity to say that a fund involving a single-claimant did not qualify. Subparagraph (g) lists "excluded liabilities" and fails to name any liability involving a single claimant.[4]

Additionally, the proposed Treasury Regulations § 1.468B, in its entirety, was subject to the rule making procedure prescribed in section 553 of the Administrative Procedure Act.[5] This process calls for publication in the Federal Register and the opportunity for the public to voice opinions before the rule can take effect. If the use of the word "one" was inadvertent, any perceived unintended impact could have been raised during this process. Evidently, the use of the word "one" was not questioned. The reasonable conclusion is that it was intended.

Treasury Regulations § 1.468B-1(k) gives seven scenarios, stating whether or not the acts taken would result in a QSF or what actions must be taken to qualify the fund. In no example is it suggested that having only a single claimant would disqualify the fund. And, as Preikszas notes, section 1.468B-3(f)(2)(ii) is the only instance in both the Code and Treasury Regulations, based on Code sections 130 and 468B, where an instance of constructive receipt is described. There was plenty of opportunity for Congress or the IRS, through the Code and Treasury Regulations, to preclude the use of a QSF for a single claimant on the economic benefit theory. Its use in single-claimant cases was not precluded.

It would seem reasonable that, because it promulgated the regulations authorizing a single-claimant QSF, the IRS has no inclination to challenge the validity of a fund so created. The IRS must live by its own rules, just as a taxpayer has a right to rely on them.

Income Tax Regulations are Authority

It has been suggested by some that the Secretary exceeded the authority granted by Congress under the statute in authorizing the use of the QSF for "at least one claim asserting liability." As such, these people contend, there is no authority for the single-claimant QSF. Section 7805(a) of the Code provides this authority:

"Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

U.S. Supreme Court Upholds Authority

With this broad charter granted to the Secretary, there have been challenges over the years to the Secretary's authority. It may be helpful to review some of these judicial interpretations and decisions by the United States Supreme Court cited in 26 U.S.C.A. § 7805:

- "Treasury Department is authorized to make regulations governing collection of internal revenue by Congress, which in turn is authorized by Constitution to make all laws necessary for executing the powers vested in government or any department." *Boske v. Comingore*, 177 U.S. 459 (1900).

- "Incidental to Commissioner's authority to administer income tax law is power to make regulations for information of taxpayers, guidance of the collectors, and realization of purposes of the taxing acts." *Spreckels v. Commissioner*, 119 F.2d 667 (1941), *aff'd* 315 U.S. 626.

- "Where plain meaning of provision of Internal Revenue Code does not require contrary interpretation, statute must be construed to accord with clearly expressed congressional purposes and relevant Treasury Regulation." *United States v. Stapf*, 375 U.S. 118 (1963).

- "Treasury regulations made pursuant to provision of revenue act are valid unless unreasonable or inconsistent with statute." *Fawcus Machine Co. v. United States*, 282 U.S. 375 (1931).

- "As contemporaneous constructions by those charged with administration of Internal Revenue Code..., Treasury Regulations must be sustained unless unreasonable and plainly inconsistent with revenue statutes, and should not be overruled except for weighty reasons." *Fulman v. United States*, 434 U.S. 528 (1978).

If there is a challenge to the regulation in question, it would need to come from the Treasury Department, in contravention to its own rules. And, that is unlikely because an agency must abide by the rules it sets. And Treasury Regulations can be cited as evidence in a court proceeding as to how the agency responsible for administering the Internal Revenue Code interprets it.

Case law is very clear that the courts have no intention of ruling against a taxpayer, considering that the regulations are plainly consistent with the statute.

NOTES

1. *See* 26 U.S.C. § 130(c)(1).

2. The statute, 26 U.S.C. § 468B, authorizes the creation of a "designated settlement fund." However, the implementing regulation, 26 C.F.R. § 1.468B, refers to a "qualified settlement fund."

3. A novation substitutes a new party and discharges one of the original parties to a contract by agreement of all parties. [*See* Restatement (Second) of Contracts § 280.]

4. Excluded under 26 C.F.R. § 1.468B-1(g) are any liability that:

(1) "Arises under a workers' compensation act or a self-insured health plan;

(2) "Is an obligation to refund the purchase price of, or to repair or replace, products regularly sold in the ordinary course of the transferor's trade or business;

(3) "Is an obligation of the transferor to make payments to its general trade creditors or debtholders that relates to a title 11 or similar case..., or a workout; or

(4) "Is designated by the Commissioner in a revenue ruling or a revenue procedure...."

5. The Administrative Procedure Act of 1946 is codified at 5 U.S.C. § 551 et seq.

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36 Tulsa L.J. 865, *

Summer, 2001

36 Tulsa L.J. 865

LENGTH: 19751 words

COMMENT: STRUCTURED SETTLEMENTS: THE ONGOING EVOLUTION FROM A LIABILITY INSURER's PLOY TO AN INJURY VICTIM's BOON

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SUMMARY:
... Now into its third decade, the structured settlement has earned its place as an integral part of the negotiation process in settling tort type claims for personal physical injury or physical sickness and, to a lesser extent, for workers' compensation claims. ... With a structured settlement, the injury victim received an excellent rate of return guaranteed for the life of the annuity. ... As explained in Section VI, the QSF renders moot any legitimate objection that can be raised by the liability insurer. ... Now, plaintiffs can take control of the structured settlement process through a QSF and leave the defense out of the picture once the money has been paid into the fund. ... Use of QSF would also deprive the defense structured settlement brokers of the ability to show up at a settlement conference, telling the plaintiff, "I have been assigned to this case," when the plaintiff has every right to select the person to handle the structured settlement transaction on his or her behalf. ... In contrast, a QSF allows for a structured settlement transaction in its traditional sense, without the cooperation or involvement of the defendant or its liability insurer. ... The risk to the plaintiff's attorney, therefore, of a legal malpractice claim brought by his or her client for allowing an adversary to handle the structured settlement for the client seems to be far greater than any tax risk claimed by the opponents of the single-claimant QSF. ...

TEXT:
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