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Articles
Trust and Estate Law
Using Qualified Settlement Funds in Personal Injury Settlements for Protected Persons
by Sarah L. Golombek

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About the Author

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Qualified settlement funds have become a common mechanism used in personal injury settlements for protected persons. This article provides an overview of the process of using qualified settlement funds and the advantages of doing so.

Rule 16 of the Colorado Rules of Probate Procedure (Rule 16) provides the structure for seeking court approval of a settlement of a claim for a protected person.[1] Most often, a Rule 16 petition is brought on behalf of a minor or an incapacitated or disabled adult to settle a claim in a personal injury, wrongful death, or medical malpractice case; or in receiving life insurance proceeds or a distribution from a decedent's estate.[2] One tool that has become extremely useful to practitioners in these cases is a qualified settlement fund (QSF).[3]

As many practitioners handling Rule 16 cases may have experienced, obtaining court approval of a settlement often can be delayed by factors such as unresolved liens or subrogation claims, or when additional time is needed to contemplate a financial plan or to apply for government benefits. Using QSFs provides the opportunity to resolve or set aside many of these issues, ultimately allowing practitioners to obtain court approval of the settlement in a speedier and more efficient manner.

Additionally, a QSF enables the protected person (referred to as the claimant or plaintiff in this article) to receive his or her settlement proceeds immediately. These proceeds can be used to fund a special needs trust or a structured settlement. A QSF also benefits the insurance company paying out the proceeds, because on payment, the insurer is released from any further liability in the matter. A QSF further provides practitioners with the immediate financial resources to fund future litigation against additional defendants on behalf of their clients.

QSFs at a Glance

A QSF:

- allows the claimant to receive funds early without constructive receipt for tax purposes
- removes the defendant from litigation without further liability
- allows the defendant to take a tax deduction that otherwise would not be available until the funds are distributed to the claimant
- allows the claimant to make his or her own determination about distribution of funds
- provides practitioners with the immediate financial resources to fund future litigation against additional defendants
- provides time to make final determinations on the allocation of funds
- provides time to decide how best to preserve government entitlement benefits for the claimant
- provides time to establish a special needs trust
- provides time to obtain financial counseling
- provides time to determine the appropriate role and underwriting of a structured settlement annuity
- provides time to verify and negotiate liens and/or subrogation claims
- can fund a special needs trust for immediate medical needs of the claimant while other issues are resolved.[1]

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1. Pursuant to CRS § 25.5-4-301(4), 10 C.C.R. 2505-10, § 8.100.7.E.6.b.i.f, the Colorado Department of Health Care Policy and Financing will not approve the funding of a special needs trust until any Medicaid liens against the settlement proceeds have been resolved.

What is a QSF?

A QSF is a type of trust account that can be used by a plaintiff or multiple plaintiffs

settling a claim to protect the settlement proceeds. A QSF shelters the proceeds without constructive receipt by the plaintiff, which could trigger tax consequences or public benefit ineligibility.[4] Among other benefits, a QSF provides the plaintiff additional time to resolve any claims or subrogated interests against the proceeds; arrange long-term planning for the proceeds, including structuring the funds; or fund a disability trust for the plaintiff's immediate needs.

According to some practitioners, a QSF provides breathing space after settlement that is valuable for determining several key factors without the pressure associated with the litigation itself.[5] Others describe a QSF as a means of transferring control of the settlement process from the defendant to the claimant.[6]

The general requirements for a settlement fund to qualify as a QSF are as follows:

1. The fund is established pursuant to an order of, or is approved by, the United States (or agency thereunder, including a court of law), and is subject to the continuing jurisdiction of that governmental authority.

2. The fund 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 has given rise to at least one claim asserting liability.

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).[7]

A Brief History of QSFs

The QSF concept was enacted in 1986 as § 468B of the Internal Revenue Code (Code). Among the reasons for QSF creation are: (1) to enable large product liability defendants to get a tax deduction for amounts paid to settle lawsuits before the claimants agreed on how the amounts would be allocated among them;[8] (2) to address defendants' concerns about participating in structured settlements;[9] and (3) to deal with the various tax questions that arise when an independent settlement fund is created to pay a debtor's liabilities.[10]

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.[11] They 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 distributed the payment to the beneficiary.[12]

The purpose of § 468B was to create a shelter for qualified payments made by a defendant in a tort claim, without it being deemed economic performance by the Internal Revenue Service (IRS).[13] Originally, this vehicle was termed a designated settlement fund (DSF). The QSF followed in 1993 in regulations by the U.S. Treasury Department relating to § 468B (thus, also termed 468B Fund), which allowed for similar shelters for a broader range of settlement funds that no longer were limited to tort claims.[14]

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.[15] Accordingly, QSFs have been used in a variety of settlements, from mass torts to an individually injured claimant.[16] Some federal courts have even adopted rules of civil procedure for establishing these funds.[17]

Benefits of a QSF

From the defendant's perspective, the use of a QSF is beneficial because it allows the defendant to satisfy its obligation to the plaintiff, disengage from the litigation, and qualify for economic performance, thereby reducing legal costs and freeing resources tied up in litigation. Payment is made by the defendant in exchange for a release from present and future claimants. A further advantage is that the QSF allows the defendant to take an immediate tax deduction that otherwise would not be available until the funds are distributed to claimants.[18] The full release and immediate tax deduction simplify the settlement and tax situation, which may encourage defendants to settle cases.

The QSF is advantageous to the claimant because he or she obtains the defendant's money early and thereby avoids an insolvency risk. Additionally, the QSF temporarily shelters the settlement proceeds, avoiding constructive receipt resulting in taxable income by the claimant.[19] This provides the claimant and his or her advisors additional time to consult with financial professionals, resolve any outstanding issues, or make a determination regarding how to structure or allocate the funds, while the funds are earning interest. A QSF provides the claimant time to apply for needs-based government benefits, such as Medicare, Medicaid, and Social Security, and obtain approval of a special trust that will protect the settlement proceeds from those agencies.

Another advantage to the claimant is that the defendant no longer is involved in the litigation or in the determination regarding the allocation or structure of the funds, and the funds are no longer subject to the defendant's creditors. Significantly, the claimant can structure the settlement with qualified assignments without losing the tax advantages associated with structures.[20]

The QSF is beneficial to plaintiffs' attorneys, as well. It provides them with a tool to combat abusive or self-serving insurance carriers.[21] The availability of a QSF may keep defendants' consultants working to get the best annuity rate possible, which will help the claimants get the highest rate of return on the structured settlement. Additionally, claimants can consult with their own structured settlement advisors.[22] In fact, the legislation that created QSFs bars defendants from funding a structured settlement using an affiliated insurance carrier, and prohibits any party related to the carrier from administering the fund.[23]

Another benefit to plaintiffs' attorneys is that the QSF is subject to the continuing jurisdiction of the government entity or judicial body that formed it.[24] Thus, the court is the final decision maker in benefits allocation, thereby relieving plaintiffs' attorneys from being caught between clients competing for larger settlement allocations. Similarly, the use of a QSF allows the lawyer to let the QSF hold settlement funds while competing lien interests[25] are sorted out and eventually decided by the court. This alleviates such problems as potential attorney liability to

Medicare,[26] as well as other claims that could be made against lawyers by governmental authorities or entities that have contractual relationships with the client. Finally, the existence of a QSF administrator allows plaintiffs' attorneys to focus entirely on settling the case, leaving the mechanics of the fund to the trustee.

Creation and Termination of a QSF

To create a QSF, either litigating party may petition the court, seeking an order approving the creation of a QSF.[27] The petition is submitted with a draft of the QSF and a proposed order setting forth the purpose of the QSF and the nominated trustee who will administer the QSF proceeds.[28]

The trustee can be a bank or other trust institution. However, when appropriate, an individual may act as trustee; the claimant's attorney or anyone else who could be characterized as an agent of the claimant may not act as trustee, because this could be construed as constructive receipt on the claimant's behalf.[29]

Once the court approves the QSF and appoints a trustee, the trustee will arrange for a taxpayer identification number and set up a fund account. The defendant then pays the agreed compensation, which is deposited into the QSF, and is released from any further liability. The QSF assumes the liability for the action through a novation, and settles the claims with the individual claimants.[30] The plaintiff cannot revoke or modify the QSF and must petition the court to compel any distributions from the QSF.

A major benefit to this process is that the parties can proceed with obtaining court approval of the settlement, including approval of attorney fees and costs, approval of any liens against the settlement proceeds, and approval of distributions for immediate medical needs, and/or a partial disbursement to a special needs trust. The remaining funds then are deposited into the QSF for further resolution of any remaining issues. This is especially advantageous when there are contested liens, in that it encourages lien holders to settle on a negotiated amount before the court orders the funds to be deposited into the QSF.

Thus, a QSF offers an opportunity to separate consideration of the settlement from the ultimate distribution of the settlement proceeds. It provides the plaintiff the flexibility to bifurcate a lien issue or other unresolved matter from the settlement approval. It also allows the plaintiff to keep confidential from the defendant certain information, such as attorney fee applications and other claims being requested from the proceeds. This is possible by scheduling a hearing on those matters for a later date after the settlement has been approved by the court and the defendant has been released.

Essentially, the QSF stands in the shoes of the original defendant.[31] Thus, a true adversarial situation no longer exists. Even though the QSF technically is the opposing party, it has no stake in saving any money at the claimant's expense, because the QSF's objective is to disburse all assets of the fund, extinguish its tort liability, and then go out of existence.[32] The defendant or its insurer can settle one or more claims by agreeing to pay a cash settlement into the fund, and then be granted a full release by all parties. The defendant would receive a tax deduction

for the full amount paid, just as it would with any cash settlement.[33] The QSF trustee could enter into a full and final court-approved settlement agreement with the plaintiff.

After the money has been deposited into the fund, the trustee can directly pay it out to the claimant, or the funds can be structured with qualified assignments, pursuant to Code § 130, or paid into a trust or special needs trust. The trustee can work with the plaintiff to resolve important issues, such as whether a special needs trust is appropriate to preserve government benefits, whether to use a tax-advantaged structured settlement, how cash will be allocated, how beneficiaries will be designated, how to resolve any outstanding liens, and whether the plaintiff's attorney should structure legal fees. The trustee can pay for costs such as case expenses and attorney fees that are approved by the court, and file tax returns for the fund.

The regulations require that the court retain jurisdiction over the QSF.[34] Some courts order that the funds be held in a restricted account. The extent to which such retained jurisdiction is exercised varies with each court. However, common practice dictates that any disbursements to be made from the QSF must be approved by the court. The QSF terminates once all of the funds have been exhausted or by order of the court. Many courts require the trustee to file a final accounting with copies to all interested parties so that they can be discharged.

Structured Settlements and QSFs

The IRS ruled in Revenue Procedure 93-94 that structured settlement annuities under §§ 104(a)(2) and 130 of the Code may be purchased from a QSF. A structured settlement exists when a tort claim for physical injury is resolved through judgment or settlement, and the defendant's tort liability is extinguished in exchange for monetary consideration that includes a series of future periodic payments, future lump sums, or some combination of the two.[35] It has been said that the structured settlement concept arguably is the most responsible means of indemnification for victims of physical injury or sickness.[36] However, structured settlements have become an integral part of the negotiation process in settling personal injury cases, and it now is common practice to structure all or part of a personal injury settlement with a qualified annuity and a qualified assignment.

Although the structured settlement likely was invented in the mid-1960s, it first gained legitimacy in the late 1970s, when the IRS issued three Revenue Rulings on the tax treatment of periodic payments made to personal injury claimants.[37] By 2004, structured settlements accounted for more than $6 billion in annual premiums for annuity sales.[38]

One of the primary advantages of a QSF is that it allows claimants to set up structured settlements without the defendant's participation, so plaintiffs can receive the tax advantages of these settlements on terms that best meet their needs. In fact, the IRS permits QSFs to enter into structured settlements the same way the defendant would, preserving all of the same tax benefits for the claimant.[39]

The primary benefits of a structured settlement are that it protects against

spendthrift behavior by the plaintiff, and it adds the benefit of tax-free growth of the periodic payment funding asset, as long as the payee does not have constructive receipt or economic benefit of the asset.[40] An added advantage is that the payment stream is set before settlement, and the fund does not need additional oversight.[41] Other benefits include guaranteed income for life to meet needs for support and medical care, no investment decisions are necessary, bankruptcy protection for future income, and relief from guardianship burdens for minors and incompetents.[42] Ultimately, structured settlements within QSFs provide a tax-free alternative to the traditional, defendant-directed structured settlement arrangement.[43]

Taxation of the QSF

The proceeds of a personal injury settlement used to fund a QSF continue to receive favorable tax treatment under Code § 104(a)(2). However, QSFs are taxed as a corporation and the interest earned by the fund is taxed at the highest federal corporate tax bracket for as long as the QSF continues to hold the funds.[44] Most states tax the interest, as well. Nevertheless, because 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, the interest benefits the claimant in the long run.[45]

The trustee of the QSF is responsible for filing annual state and federal income tax returns, and must serve copies on all interested parties as required by the court. Investment of the QSF funds is within the discretion of the trustee, and the trustee can use the funds to pay expenses to operate and manage the QSF. The trustee has many of the same powers as a trustee of an ordinary trust, as well as the same fiduciary responsibilities. However, QSF funds should be invested in a manner that permits full liquidity at all times, and not in a way that exposes the funds to unreasonable risk of loss, which usually results in a low yield in fund income.[46] Thus, there is an incentive for claimants to complete their financial planning as early as possible to put the funds to work financially.

Conclusion

QSFs can be of great benefit to plaintiffs and their attorneys in personal injury settlements for protected persons. A QSF allows the plaintiff to obtain the settlement funds immediately and avoid constructive receipt resulting in taxable income. While the funds earn interest, a QSF also provides the plaintiff and his or her counsel time to consult with financial professionals, set up a special needs trust, apply for government benefits, make a determination regarding how to structure or allocate the funds to ensure that the plaintiff's financial and medical needs are met, and resolve any additional outstanding issues.

Notes

1. Colorado Rule of Probate Procedure (C.R.P.P.) 16. *See also* Stewart, "Court Approval of the Settlement of Claims of Persons Under Disability," 35 *The Colorado Lawyer* 97 (Aug. 2006) (more detailed guide to the procedural aspects of filing a Rule 16 petition); "Personal Injury Settlement Packet for Lawyers," available at

www.denverprobatecourt.org.

2. *See* Stewart, *supra* note 1.

3. *See* Garretson, "A Fine Line We Walk: Counseling Clients About the 'Form' of Settlement," 13 *ABA Prof. Law* 1 (Summer 2002).

4. *See id. See also* Campbell, "The Use of Qualified Settlement Funds, Qualified Assignments and Special Needs Trusts in Physical Injury Settlements," 4 *NAELA J.* 99 (Spring 2008).

5. Garretson, *supra* note 3.

6. Risk, "Comment: Structured Settlements: The Ongoing Evolution From a Liability Insurer's Ploy to an Injury Victim's Boon," 36 *Tulsa L.J.* 865, 870, 892 (Summer 2001). *See also* Campbell, *supra* note 4 at 102; McNay and Garmer, "Is a Qualified Settlement Fund Right for Your Client?" *Trial Magazine* (Jan. 2002); Garretson, *supra* note 3.

7. 26 C.F.R. § 1.468B-1. *See also U.S. v. Brown,* 348 F.3d 1200, 1207 (10th Cir. 2003) (holding that a receiver's estate may be a qualified settlement fund (QSF) under § 468B(g) and Reg. § 1.468B-1 if it is established to resolve claims, even if the establishment of the fund and the transfer of assets to it does not extinguish claims against the alleged tortfeasor).

8. Robinson, "Settlement Tools and Tips," 22 *GPSolo* 42, 47 (April/May 2005). *See also* Campbell, *supra* note 4; Garretson, *supra* note 3.

9. McNay and Garmer, *supra* note 6.

10. *Brown*, *supra* note 7 at 1206.

11. McNay and Garmer, *supra* note 6.

12. *Id*.

13. Garretson, *supra* note 3. This is significant because the payment cannot be deducted until there has been economic performance.

14. 26 C.F.R. §§ 1.468B-1 *et seq*. A QSF includes the designated settlement fund, plus liabilities under tort, environmental, breach of contract, violation of law, and other claims as designated by the Internal Revenue Service. McNay and Garmer, *supra* note 6. Critics argue that a QSF cannot be used for single tort claimant, a topic that is not within the scope of this article. For a more thorough examination of that topic, *see Sproull v. Comm'r*, 16 T.C. 244 (1950) *aff'd*, 194 F.2d 541 (6th Cir. 1952). *See also* Campbell, *supra* note 4; Risk, "Article: A Case for the Urgent Need to Clarify Tax Treatment of a Qualified Settlement Fund Created for a Single Claimant," 23 *VA. Tax Rev.* 639, 645 (Spring 2004).

15. McNay and Garmer, *supra* note 6. Also, a QSF needs continuing oversight of

the court or government entity that created it, whereas a designated settlement fund (DSF) does not.

16. Garretson, *supra* note 3; McNay and Garmer, *supra* note 6. Neither a DSF nor a QSF can be used in workers' compensation or warranty claims.

17. McNay and Garmer, *supra* note 6.

18. *Brown, supra* note 7 at 1207; McNay and Garmer, *supra* note 6. *See also* Kuneyl, "Qualified Settlement Funds, A Tool to Shelter Gains and Taxable Income with Payments on Account of Disputed Claims," 24 *Cal. Bankr. J.* 137 (1998).

19. I.R.C. § 104(a)(2); Treas. Reg. § 1.451.2.

20. Rev. Proc. 93-94; I.R.C. § 130.

21. McNay and Garmer, *supra* note 6. *See also* Campbell, *supra* note 4. In the past, many insurance carriers 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 advisors. McNay and Garmer, *supra* note 6.

22. McNay and Garmer, *supra* note 6. *See also* Campbell, *supra* note 4.

23. McNay and Garmer, *supra* note 6.

24. *Id*.

25. The settlement of liens and claims against settlement proceeds is becoming more difficult over time. These can include such things as hospital liens, ERISA claims, Medicare conditional payments, and Medicaid liens. *See* U.S.C. § 1395y(b); CRS §§ 25.5-4-301(5)(a) *et seq.*; *Ahlborn v. Arkansas*, 126 S.Ct. 1752 (2006).

26. *U.S. v. Harris*, No. 5:08 CV 102 (N.D.W.V. 2008) (Medicare successfully recovered more than $11,000 from an attorney who did not protect Medicare's interest in settlement funds).

27. According to Treasury Regulations, a QSF can be approved by an arbitrator or a governmental entity, but not a mediator. *See* Robinson, *supra* note 8 at 47.

28. The QSF does not need to be a formal trust. The Treasury Regulations permit something as minimal as segregation of the settlement money into a separate checking account. However, in practice, trusts normally are used because the actions of a trustee are well-regulated by the fiduciary rules of each state. Robinson, *supra* note 8 at 47.

29. *Id*. at 48.

30. Garretson, *supra* note 3. *See also* Campbell, *supra* note 4; Risk, *supra* note 6 at 894.

31. Rev. Proc. 93-94 treats a DSF or QSF as a "party to the suit or agreement."

32. Risk, *supra* note 6.

33. McNay and Garmer, *supra* note 6.

34. Some courts want to approve every disbursement. Others require that complete agreement is reached by all claimants of the QSF before any disbursement is made. *See* Robinson, *supra* note 8 at 47.

35. *See* Risk, *supra* note 14 at 641.

36. *See id*.

37. *Id*. at 641-42.

38. *Id*. at 644.

39. Robinson, *supra* note 8 at 48, *citing* Rev. Proc. 93-34, 1993-2 Cum. Bull. 470. *See also* Garretson, *supra* note 3; Risk, *supra* note 6 at 893.

40. Risk, *supra* note 14 at n.5. Risk argues that the judicial doctrine of economic benefit does not apply to QSFs or structured settlements because the claimant does not have control over the funds. *See id.* at 656. Likewise, Campbell argues that the economic benefit doctrine is no longer applicable to bar a qualified assignment under I.R.C. § 130 after the 1988 revisions to that section. *See* Campbell, *supra* note 4.

41. McNay and Garmer, *supra* note 6.

42. *See* Risk, *supra* note 6. *See also* Campbell, *supra* note 4.

43. Campbell, *supra* note 4.

44. *Id*. QSFs involve some complex legal and tax issues. For an in-depth explanation of how QSFs are taxed, *see* Kuneyl, *supra* note 18. It is recommended that practitioners consult with a tax attorney or other tax professional on this issue.

45. McNay and Garmer, *supra* note 6.

46. Robinson, *supra* note 8 at 48.

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