Qualified Settlement Fund: Nirvana for Plaintiffs and Their Attorneys!

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A Qualified Settlement Fund ("QSF") is a powerful tax vehicle used to control the taxability of legal settlements. Properly done, an attorney can use a QSF to defer receipt and subsequent taxation of legal settlements or awards.

A QSF can be established to collect the award from a legal claim, determine the amounts to be paid to the various plaintiffs and attorneys, and disburse these amounts (in cash, property [including insurance annuities], or other forms) to the various parties. It can exist for a few days, months, or years, even if, shortly after approval and formation, all parties (except the attorneys) have been paid. It will exist until the final payment to the final "beneficiary" has been paid.

Basically, a QSF "is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing…" Treas. Reg §1.468B-1(c)(1). Alternative Dispute Resolution forums may also qualify.

"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." Treas. Reg §1.468B-1(c)(2). "…Arising out of a tort, breach of contract, or violation of law…" Treas. Reg §1.468B-1(c)(2)(iii).

A QSF is a trust under state law, which requires an "independent trustee." This trustee cannot be "related" to any of the parties (i.e., beneficiaries), but can take directions from the beneficiaries (including the attorneys).

The QSF is a taxable entity. However, when computing its taxable income, "amounts transferred to the qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from gross income." Treas. Reg §1.468B-2(b)(1).

With the plaintiff's attorney the sole remaining beneficiary, the QSF almost becomes an "incorporated checkbook" that can serve as a nonqualified retirement plan, an investment vehicle, or other fund which invests money that has not been subject to tax, until paid to the remaining beneficiary.

This article is a very brief description of a Qualified Settlement Fund. To properly initiate, fund, utilize, maintain, and finally terminate this type of vehicle, professional advice must be obtained.