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Actually, Single-Claimant Settlement Funds Are Valid

by Robert W. Wood and Alex Brown

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In this article, Wood and Brown make the case that single-claimant qualified settlement funds are perfectly legitimate.

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Can a qualified settlement fund (QSF) have only one claimant? The language of the tax code and regulations suggests there should be no controversy. That makes this a puzzling discussion, given how surprisingly controversial the issue has been over the years. To naysayers, single-claimant QSFs are anathema.

QSFs could deny defendant tax deductions, trigger constructive receipt to a plaintiff, or both. Despite there being no formal prohibition against single-claimant QSFs in the tax code or IRS guidance, skeptics argue that the true purpose of a QSF is to hold a legal recovery while multiple plaintiffs and other claimants decide how to divide it. They say establishing a QSF for a single claimant (when there is no dispute about how to divide a recovery) violates that purpose and raises fundamental constructive receipt issues.

We want to revisit previous articles on this subject from 2009[1] and 2014.[2] As was indicated in those articles, the issue seems driven by the marketplace of lawyers, insurers, and structured settlement industry stakeholders, not by the technical tax issues. In fact, we have found no suggestion that the IRS or any court has publicly expressed any concern, warning, or sentiment that a settlement fund established for a single claimant does not or should not qualify under section 468B.

Instead, the arguments against single-claimant QSFs originate from insurance industry or structured settlement personnel, tax professionals, and commentators. Some insurance companies have been the loudest and most powerful of the naysayers, refusing to put money into such a taboo fund. It is unclear if those positions are motivated by genuine tax concerns, or by a desire to control the funds, the issuance of new structured settlement policies, and similar motives.

In any case, the drumbeat of these concerned insurance companies appears to have been heard by defendants and their counsel. Some of them are starting to voice the same objections to single-claimant QSFs (or to QSFs in general) in consumer cases. A prime example is cases brought against auto manufacturers under state lemon laws. Judges facing virtual fisticuffs over whether a QSF

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[1] Robert W. Wood, "Single-Claimant Qualified (468B) Settlement Funds?" *Tax Notes*, Jan. 5, 2009, p. 71.

[2] Wood, "Reprising Single-Claimant Qualified Settlement Funds," *Tax Notes*, June 23, 2014, p. 1445.

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is kosher can be forgiven for not knowing which way to turn.

Simple Requirements

IRS views and guidance should be of paramount importance. Agency guidance interprets and expands rules and requirements established by Congress in the tax code. An IRS interpretation of any tax statute is given significant weight, although the tax code itself clearly has priority. IRS rules and regulations can be challenged if they are incompatible with the tax code and the intentions of Congress.

It is worth remembering that QSFs are only tangentially derived from the tax code. Actually, section 468B does not directly address QSFs — instead, it addresses a similar but distinct type of settlement fund, the designated settlement fund. Section 468B(g)(1) provides Treasury with the broad authority to "prescribe regulations providing for the taxation of any" escrow account, settlement fund, or similar fund.

Based on this broad delegation of power, the IRS created QSFs by regulation. It extended the tax treatment of designated settlement funds to other settlement funds that do not meet all of the statutory requirements for a designated settlement fund. Because QSFs are an invention of the IRS, the IRS's views on QSFs are intrinsic to the question of what qualifies as a QSF.

Reg. section 1.468B-1 provides the following requirements for a fund, account, or trust to qualify as a QSF:

1. The fund, account, or trust must be established in accordance with an order of, or be 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 and be subject to the continuing jurisdiction of that governmental authority.[3]
2. The fund must be 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 (i) under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), as amended;[4] (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the IRS commissioner in a revenue ruling or revenue procedure.[5]
3. The fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from the other assets of the transferor and related persons.[6]

How do these three requirements stack up to our subject? The fact that a QSF is a single-claimant QSF has no bearing on whether it is formed and operated under the continuing jurisdiction of a qualifying governmental authority. A single-claimant QSF's status also does not bear on whether it is a trust under state law. Thus, in the insurance industry's debates over single-claimant QSFs, much of the attention is on the second requirement.

This requirement is often referred to as the "resolve or satisfy requirement." Reg. section 1.468B-1(c)(2) suggests the possibility of a single claim, mentioning "*one* or more contested or uncontested claims" and an event giving rise to "*at least one* claim asserting liability" (emphasis added).[7] To be sure, two people could have the same claim, but it seems a strained reading to suggest that this is required for a QSF to be possible.

Resolve or Satisfy

Of the three requirements for a QSF identified in reg. section 1.468B-1, the resolve or satisfy requirement speaks directly to the intended purpose of a QSF. Accordingly, both skeptics and proponents of single-claimant QSFs often scrutinize the resolve or satisfy requirement most closely in a search for support. The resolve or satisfy requirement does not require any intended

[3] Reg. section 1.468B-1(c)(1).

[4] 42 U.S.C. section 9601 et seq.

[5] Reg. section 1.468B-1(c)(2).

[6] Reg. section 1.468B-1(c)(3).

[7] Reg. section 1.468B-1(c)(2).

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purpose among the plaintiffs, their counsel, or other potential QSF claimants for needing a QSF.

The resolve or satisfy requirement also does not require that there be any confusion, dispute, or ambiguity among potential claimants to a QSF about how to divide a legal recovery. Neither does any other requirement for QSF treatment under reg. section 1.468B-1. Instead, the resolve or satisfy requirement addresses only the purpose of the QSF regarding a claim or claims made against the defendants in litigation.

The IRS defines a QSF's purpose more broadly as a means of resolving a legal claim. Some skeptics have defined the purpose of a QSF more narrowly to include only situations in which there are potential disputes among plaintiffs and other claimants. However, this imagined (although admittedly common-sense) purpose is not reflected in the promulgated regulations.

Indeed, the language of the resolve or satisfy requirement appears to expressly allow single-claim QSFs. The resolve or satisfy requirement says a QSF must be 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 given rise to "at least one" claim asserting liability. This straightforward and clear language within the Treasury regulation itself seems hard to ignore.

Twice in the text of the regulation the IRS unequivocally states that a single claim is sufficient to qualify as a QSF. In any event, the resolve or satisfy requirement does not mention or require any particular number of claimants. Instead, it refers only to one or more "claims." Therefore, if a QSF were established with a single claimant who asserted "one or more" contested or uncontested claims, that QSF should satisfy the resolve or satisfy requirement.

A single claimant might have one claim or several. And what is a claimant anyhow? Is a claim by a parent and child one claim or two? And are they single claimants? How about a husband and wife, joint tax filers, or even proprietors? How you come out on such points seems to be determined by your thumbs-up or thumbs-down view of the single-claimant endgame.

That the IRS twice provides that a single claim is sufficient to qualify as a QSF weighs strongly in favor of single-claimant QSFs qualifying as QSFs — in fact, it suggests that there should be no debate. If the number of claims in a case were critical to qualifying as a QSF, the QSF regulations, the IRS, or another authority would need to define what a "claim" is for these purposes.

Suppose that a plaintiff suing her employer for wrongful termination seeks damages for lost earnings. The plaintiff may assert violations of multiple labor laws that all provide that her termination was wrongful. Nevertheless, all these violations were ultimately asserted to support the plaintiff's claim for lost earnings. In such a scenario, there may be reasonable disagreement over whether there is a single claim (for lost earnings) or multiple claims (for each violation of labor law cited).

In any event, the absence of any definition of "claim" in the QSF regulations or related authorities seems noteworthy. It arguably suggests that the IRS is unconcerned with quantifying the claims in a given case. As long as at least one claim has actually been asserted, the resolve or satisfy requirement would be met.

In fact, we should remember that a QSF may be formed to resolve claims that are not actually asserted in litigation, but that "may result" from the underlying event or related series of events. That the IRS appears to assume that there are additional potential claims further emphasizes how unconcerned it appears to be about quantifying the claims asserted, or with the bona fides of QSFs that involve only a single claim or a single claimant.

Plain Language

It is hard to argue with plain language. In connection with the promulgation of the QSF regulations, the IRS released a Treasury decision, T.D. 8459. T.D. 8459 contains a subsection elaborating on the purpose, scope, and language of the resolve or satisfy requirement. In this subsection, the IRS published the following discussion:

> One commentator requested that the final regulations clarify whether all potential claims must be asserted before a fund, account, or trust satisfies the requirement

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> of reg. section 1.468B-1(c)(2) [that is, the resolve or satisfy requirement]. In response to this comment, the final regulations clarify that *even a single claim* satisfies the requirement.[8] [Emphasis added.]

This language in T.D. 8459 makes clear that the IRS intentionally used language in the resolve or satisfy requirement to expressly allow QSFs with only a single claim (or claimant) to qualify as QSFs. That the IRS has not amended the resolve or satisfy requirement to require more than one claim also undercuts any argument that the language in the regulation is a mistake. If the IRS (or Congress, or a court) had come to consider this language as misleading or erroneous, it easily could have corrected it at any point over the last 25 years.

Notably, the IRS has never done so. Without question, the IRS is aware of the single-claimant controversy. In fact, it looked as though the agency would say something one way or the other. Between 2004 and 2009 the IRS listed the status of single-claimant QSFs on its annual summary of topics for which providing guidance was considered a "high priority."[9]

Providing guidance on single-claimant QSFs was not listed as a high priority for 1993-2004, nor has it appeared on this list for any year since 2009. Commentators have interpreted the inclusion and removal of the single-claimant issue in a variety of ways, usually in the way that best supports their larger argument. The author himself witnessed an IRS official speaking at a structured settlement industry conference practically being pilloried over not providing guidance on whether single-claimant QSFs qualified.

If the event was any indication, some within the IRS may understandably view the issue as toxic. Regardless of speculation, the obvious and predictable effect of not providing guidance on a known one-time point of controversy is that single-claimant QSFs continue to be created. They also continue to report their income as QSFs, filing Form 1120SF.

If the IRS is examining QSFs on a case-by-case basis, it seems none of those examinations have resulted in published guidance. That the IRS has chosen not to provide guidance that would limit the use of single-claimant QSFs is noteworthy. Indeed, that the IRS has instead chosen to maintain the status quo may also indicate that it is willing to embrace (or at least tolerate) the use of single-claimant QSFs.

Single-Claimant QSFs, IRS Consistency Goals

In T.D. 8459, the IRS provided a specific reason for including the single-claim language in the resolve or satisfy requirement. The IRS's stated reason was to allow claims to be added without affecting the tax treatment of the parties involved. That is, if single-claim QSFs were not allowed, a trust or fund that did not qualify as a QSF might spontaneously become a QSF once a plaintiff made a second claim, once a second plaintiff joined the litigation, or once a second claim was otherwise introduced.

Would such a possibility make sense? Plainly, such a rule would result in confusing and inconsistent tax treatments among similarly situated taxpayers. If the IRS were to draw a line requiring multiple claims, defendant deductions clearly allowable by statute could be at risk — that is, any settlement payments made to the fund while there was only a single claim would presumably not qualify for an immediate deduction.

In contrast, any settlement payments made to the fund after it became a QSF upon the addition of the second claim would qualify for immediate deduction. The potential tax result to a plaintiff could be equally skewed. A plaintiff might be taxed on income produced within the fund before it qualifies as a QSF.

However, a plaintiff would not be taxed on income produced within the fund on an amount added after qualifying as a QSF. It appears that the IRS actually considered this strange possibility. In T.D. 8459, the IRS noted that this outcome would be undesirable.

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[8] T.D. 8459, 57 F.R. 60983, 60985; *see also* reg. section 1.468B-1(b).

[9] The priority guidance plan is a plan published annually by Treasury and the IRS announcing the IRS's priorities for publishing taxpayer guidance. The IRS listed "guidance under section 468B regarding the tax treatment of a single-claimant qualified settlement fund" in the 2004-2005 priority guidance plan. *See* Treasury, Office of Tax Policy and IRS, "2004-2005 Priority Guidance Plan" (Dec. 24, 2004). This item also appeared in the 2005-2006, 2006-2007, 2007-2008, and 2008-2009 priority guidance plans.

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As stated in T.D. 8459, the IRS chose to allow even a single claim to be sufficient to satisfy the resolve or satisfy requirement. The potential addition of more claims would not affect the tax treatment to and obligations of the plaintiffs, the defendants, or the QSF itself. In so doing, the IRS arguably chose to adopt a bright-line rule to allow single-claim (and single-claimant) QSFs to avoid the worrisome situations that may result from a rule requiring more than one claim or claimant.

The IRS's desire for consistency among all similarly situated settlement funds is consistent throughout T.D. 8459. For example, T.D. 8459 states that QSF treatment is mandatory for all funds that qualify as QSFs, so that all qualifying funds will be taxed similarly. The IRS elaborated:

> The proposed regulations mandate qualified settlement fund treatment for a fund, account, or trust that satisfies the requirements of a qualified settlement fund. Commentators recommended that the final regulations make the application of the qualified settlement fund rules elective. The Service and the Treasury Department believe that inconsistent tax treatment for similar funds, claimants, or transferors, as well as the accompanying complexity, is undesirable. Therefore, the final regulations do not provide electivity.[10]

To further promote the consistent treatment of similar funds, reg. section 1.468B-1 provides that QSF status generally overrides any potentially competing statuses as a trust, as a contested liability fund under reg. section 1.461-2(c)(1), or as an association or partnership, if the fund is not organized as an association or partnership under state law.[11]

Based on these discussions, a single-claimant QSF for which there is the potential for additional claims or claimants should clearly qualify as a QSF.

Indeed, in T.D. 8459, the IRS expressly stated that it allowed for single claims to qualify specifically because of the potential for additional claims to be added at a later date.[12] Moreover, as discussed earlier, the IRS has an evident lack of interest in specifically quantifying claims. It also indicated a stated desire to treat similarly situated funds similarly.

Plainly, it would frustrate IRS goals if only some single-claimant QSFs were to qualify as QSFs based primarily on a potentially subjective assessment of the likelihood that additional claims would be asserted at a later date. Instead, the bright-line approach advanced by the IRS throughout the QSF regulations suggests that it does not intend to treat single-claimant QSFs differently.

CERCLA Claims

There is still further evidence that the IRS appears to be unconcerned about single-claimant QSFs. Arguably, the IRS tacitly endorsed single-claimant QSFs in the resolve or satisfy requirement by specifically allowing QSFs to be formed to satisfy CERCLA claims. CERCLA is used to allow defendants to pay moneys into a "superfund."

Such a superfund can be used by the federal government (typically, the Environmental Protection Agency), the states, or Native American tribes to recover national resource damages caused by hazardous substances.[13] In most cases a CERCLA superfund is used by the EPA. Most states have set up their own state-level versions of CERCLA.

These state vehicles help to hold polluters accountable for any damage they may cause. Some states may prefer using their own laws rather than CERCLA to clean up sites that the EPA is not addressing.[14] In effect, a federal CERCLA superfund often serves as a large single-claimant QSF, with the EPA as the sole claimant.

Despite the single claimant, a CERCLA claim is expressly identified as a qualifying claim for a QSF. This further suggests the IRS's broad and expansive view toward the inclusion of funds that qualify as QSFs. It also echoes the IRS's desire to

[10] T.D. 8459, 57 F.R. at 60984.

[11] *See* reg. section 1.468B-1(b); T.D. 8459, 57 F.R. at 60984.

[12] T.D. 8459, 57 F.R. at 60985.

[13] *See* 42 U.S.C. section 9611.

[14] *See, e.g.*, "An Analysis of State Superfund Programs," Environmental Law Institute (2002).

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expand QSF treatment to similarly situated funds for consistency and ease of administration.

IRS Has Not Disallowed Single-Claimant QSFs

It has been over 25 years since the QSF regulations went into effect. Over that expanse of years, the IRS and courts have not directly addressed the single-claimant issue. Nevertheless, there has been at least one case in which the IRS clearly could have chosen to disallow QSF treatment on account of the single-claimant issue. What did the IRS do?

On that occasion, the IRS did not even discuss the single-claimant concern. In LTR 9736032,[15] the IRS ruled on a case involving the creation of four QSFs. Each QSF was created for the benefit of a single preexisting trust, which had been established for estate-planning purposes. In turn, each preexisting trust was created for the benefit of a child of the taxpayer, with the child's heirs as remainder beneficiaries.

The underlying claim at issue concerned return preparers who failed to make generation-skipping transfer tax elections. That failure would eventually result in additional GSTT being due. Consequently, each of the separate QSFs in the ruling held funds provided by the defendants that would be used to satisfy a single tax liability (the GSTT), and which would be paid out to a single trust.

Moreover, at the time of the ruling, all the plaintiffs' children were still alive and were the sole present beneficiaries of their respective separate trusts. Despite this, LTR 9736032 ruled that each of the four distinct trusts qualified as a valid QSF. Of course, a ruling cannot be cited as precedent.

Still, we all read rulings, and it seems difficult to explain away this one. Nevertheless, debate involving single-claimant QSFs still seems common among structured settlement industry commentators. It seems quieter today than it was even a few years ago, although it has emerged with new participants like auto manufacturers objecting to QSFs in lemon law cases.

Curiously, however, any reference to single-claimant QSFs even being an issue at all seems to be entirely absent from the IRS's discussion of QSFs. Once the point dropped off the IRS priority guidance plan for 2010, the issue seems dormant, if not entirely resolved. Indeed, in LTR 9736032, as well as in the plain language of the Treasury regulations and the IRS's published Treasury decisions, the IRS appears to be quite consistent in its position.

To the IRS, the only indications we have are that the administrative simplicity and consistency that results from allowing single-claimant QSFs outweighs any risk that the single-claim rule might somehow expand QSF treatment to single-claimant QSFs that may have less of a need for the specific benefits QSFs provide. The argument against single-claimant QSFs often involves an implied accusation that a QSF established for a single claimant will be controlled by the single claimant. Of course, the IRS has a whole regime of antiabuse doctrines at its disposal.

Conclusions

We have tried to stay away from the topic of a QSF's duration. That is, is it possible that a valid QSF might become otherwise after it sits for too long holding undistributed funds? Perhaps, and that topic is interesting and well worthy of discussion. Perhaps it is even influenced by the number of claimants the QSF has. But it does not address becoming a valid QSF in the first place.

Similarly, we have tried to avoid addressing the constructive receipt and economic benefit doctrines. Those topics are fascinating too, but they do not bear on the single-claimant QSF question. After all, a QSF provides a kind of trump card, so funds placed in a QSF are not considered received until the claimant physically receives distributions. The issue thus comes back to whether it is a valid QSF in the first place.

Finally, we have tried to steer clear of trust law, although it is a fertile field unto itself. Most QSFs are trusts, and trust law has hundreds of years of tradition and authority. Trusts with a single beneficiary are common, too; they are effective for numerous purposes, including tax, asset protection, and others.

[15] Throughout LTR 9736032, IRS letter rulings and other pieces of IRS written guidance are mentioned. Technically, such written guidance does not constitute precedent, although even the U.S. Supreme Court has cited letter rulings. *See Rowan Cos. Inc. v. United States*, 452 U.S. 247 (1981). Those rulings reveal the interpretation put on the statute by the agency charged with the responsibility of administering the revenue laws. *See Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962).

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Notably, the U.S. Supreme Court recently gave trusts a nice shot in the arm with a unanimous decision upholding the status of a trust as distinct from its beneficiary for state income tax purposes.[16] The case did not involve a QSF, of course, but it still seems noteworthy in its resounding support for the proposition that for tax purposes, a trust and its beneficiary are distinct.

This article is unlikely to end the debate over single-claimant QSFs. Perhaps it will even make it worse, although we hope not. The other topics we have skipped over here seem more worthy of vigorous debate than this one. ■

[16] *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457 (June 21, 2019).

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