Qualified Settlement Funds and Section 468B

Reviewed by Lawrence B. Gibbs

Lawrence B. Gibbs reviews Robert W. Wood's book, *Qualified Settlement Funds and Section 468B*. Wood's book is available at http://www.taxinstitute.com. 936 pages, $399.

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Rob Wood has become a preeminent authority on the federal tax treatment of payments made and received in order to resolve litigation and of the legal fees of the parties to litigation. He has written and spoken extensively about those subjects. His well-known and widely used treatise, *The Taxation of Damage Awards and Settlement Payments*, is in its third edition. His new treatise, *Qualified Settlement Funds and Section 468B*, deals with qualified settlement funds (QSFs or section 468B funds, as they have become known) and is the definitive work on the federal tax consequences of those arrangements that have established themselves among many attorneys for plaintiffs and defendants as the preferred vehicles for handling litigation awards and settlement payments.

Wood explains the federal tax intricacies of establishing, operating, and terminating QSFs in a comprehensive and straightforward manner. For that reason, his new treatise is a must for all nontax litigators, as well as for those who advise them or their clients about the federal tax consequences of amounts paid by defendants to QSFs and amounts paid by QSFs to plaintiffs and their attorneys. Because QSFs are taxable entities, tax return preparers practicing in this area also will benefit from Wood's new book. Even judges, arbitrators, mediators, and others involved with the resolution of claims will find it helpful. The rules applicable to QSFs are sometimes unsettled and can be complex and occasionally counterintuitive. Also, they cannot be found in one place. Therefore, individuals who may become involved with QSFs will want to have Wood's new treatise within easy reach.

The QSF arose from the tax law. The predecessors to QSFs, called designated settlement funds (DSFs), were created 22 years ago when section 468B was added to the Internal Revenue Code of 1986, but QSFs for the most part have superseded DSFs as a result of Treasury regulations under section 468B that were issued in late 1992 permitting the more flexible QSF arrangements. QSFs are increasingly used today in connection with the resolution of large case litigation involving multiple plaintiffs, such as class actions in products liability and asbestos suits, breach of contract actions, consumer fraud cases, private litigation regarding securities violations, shareholder and bondholder investments, corporate shareholder actions, environmental liability cases, employment cases, and many other actions that Wood covers. Because of the tax benefits of QSFs to defendants and plaintiffs, QSFs are increasingly used in litigation involving fewer parties. One of the most important developments in this regard has been the ongoing dialogue among tax professionals about the advisability of using QSFs in controversies involving a single claimant, a subject to which Wood devotes significant discussion and on which he offers sound advice.

Although a QSF may be established as a fund, account, or trust, Wood recommends that a written trust instrument be used. The use of a trust established under state law with a trustee, and sometimes a separate administrator (that is required by the applicable Treasury regulations), introduces levels of sophistication, complexity, and opportunity that involve legal subjects in addition to the federal tax laws. Wood explains those subjects in a detailed but understandable manner. He also provides helpful examples of trust agreements and trust clauses and copies of the numerous IRS forms that may be required. Step by step, Wood explains why for nontax and tax reasons, QSFs are useful in resolving claims that arise in controversies; how QSFs can be established; how they operate; and when and how they can be terminated. Some of those steps require a weighing of alternatives and considerations that Wood explains.

Wood helpfully provides examples of legal documents practitioners may need to deal with, including petitions and orders to satisfy the Treasury regs' requirement that QSFs be approved by an appropriate governmental authority (usually judges); releases and indemnity agreements for those involved with QSFs; assignments and releases for distributions from QSFs; and petitions and orders to terminate QSFs. There is even a chapter discussing the duties and powers of the trustee and administrator of a QSF that addresses many tax and predominantly nontax issues that should be helpful for professionals who are less familiar with fiduciary concepts. A thoughtful glossary of plain English explanations of tax jargon will also aid nontax professionals. The breadth and depth of Wood's experience with the formation and operation of QSFs (and with those who could benefit from or otherwise come into contact with QSFs) are most evident in the manner with which, and extent to which, he deals with the nontax issues that can arise.

For tax practitioners, Wood discusses the tax considerations involved in defendants' payments to QSFs usually related to the timing and capital-or-ordinary nature of the defendants' deductions of the payments for tax purposes; the tax considerations in determining the QSF's income and deductions and in reporting its tax liabilities; and the tax considerations to the plaintiffs regarding distributions to them from the QSF. Each of those subjects can be nuanced and involves risks. Wood addresses the nuances and risks and suggests ways to avoid or minimize them. I found particularly helpful the chapters discussing the reporting and filing, payment, and penalty considerations that the administrator or trustee may face, because I have found little other practical guidance available about the tax aspects of administering a QSF. For the same reason, I also found helpful Wood's discussion of structured settlement distribution considerations in the context of a QSF.

For tax professionals, one of the best things about Wood's new treatise is its chapter on the tax treatment of QSF-related attorney fees. This subject will be important to tax advisers for both defendants and plaintiffs who are involved with QSFs. However, as Wood points out, most of the representation by plaintiffs' attorneys in QSF cases is done on a contingent fee basis. The federal tax consequences to plaintiffs resulting from distributions by QSFs to pay their attorney fees can be particularly important because of the tax law that has developed on this subject. Wood's discussion of the impact and aftermath of the 2005 decisions by the U.S. Supreme Court in the *Banks* and *Banaitis* cases, holding that the amount of contingent fees paid to plaintiffs' attorneys is taxable to the plaintiffs even though paid to their attorneys (who also are taxed on them), is excellent. Wood provides a comprehensive discussion of the potential tax costs and pitfalls for plaintiffs in this area of the tax law, along with some helpful suggestions about how to deal with potential alternative minimum tax problems and how to take advantage of benefits provided by federal tax legislative changes that enable some plaintiffs to offset with a deduction the amount of the attorney fees included in income.

Wood has provided litigators for plaintiffs and defendants, their tax advisers, and others who purchase his new treatise an excellent primer on the federal tax and nontax aspects of QSFs. He also provides insight and helpful suggestions in periodic, usually annual, supplements that are available by subscription. Prior experience shows us that change and complexity will continue to be the norm in this increasingly important, highly specialized area. In light of the litigation that last fall's market collapse and the fiscal crisis seem certain to generate, this book is especially timely. Practitioners should be grateful for Wood's comprehensive, lucid, and helpful explanation of this area of the law.