# State Tax Conformity and Qualified Settlement Funds

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Qualified settlement funds, also called section 468B trusts, are litigation settlement vehicles that permit tax deductions by defendants but precede the receipt of monies by plaintiffs. Although qualified settlement funds are creatures of federal income tax law, the authors urge practitioners not to forget about their state tax treatment. The state tax conformity and return compliance can be important, particularly for funds that exist for multiple tax years.



Qualified settlement funds (QSFs or 468B funds) are commonly set up to resolve litigation and to allocate settlement proceeds among claimants and their attorneys. The impetus for Congress enacting section 468B in 1986 was to confirm tax deductions to defendants. In contrast to the normal tax rule of reciprocity and economic performance, the idea was that defendants who contribute to a QSF should not have to wait to claim tax deductions for funds to be disbursed to plaintiffs.

Although the statute was enacted in 1986, QSFs really sprang to life after 1993 when Treasury regulations made them available and easy to access. For federal income tax purposes, a QSF is a separate taxable entity subject to special rules reflecting its intended function as a settlement vehicle.

The QSF is not taxed on money or property contributed by defendants and is generally taxed only on its investment income while the funds repose in the QSF. Predictably, this income tax rule is based on net income, not gross income. Thus, the QSF generally includes as gross income its investment returns and claims as deductions its administrative expenses.

That federal income tax treatment is simple and straightforward. However, the state income tax treatment of QSFs should not be assumed to follow federal law. That is especially true for anyone practicing in California, a state notorious for its lack of conformity with the code.

## Background of QSFs

The statute enacted in 1986 did not call for "qualified settlement funds" but actually enabled "designated settlement funds" (DSFs). DSFs are far more restricted and restrictive vehicles. Their more modern progeny was the QSF, which was actually enabled by the 1993 regulations. A QSF allows defendants to claim tax deductions for settlement payments even though amounts might not be distributed to plaintiffs for months or even years.

Forming a QSF is common practice in resolving class actions when all plaintiffs have not been identified. Even if all plaintiffs have been identified, QSFs are ideal when a claims procedure must be implemented to determine how much each plaintiff should receive. Beyond those obvious class action contexts, however, QSFs are today used in a broad range of circumstances.

For example, a QSF can be a useful mechanism to inject the time necessary to permit structured settlements. When defendants will not cooperate with plaintiffs in arranging structured settlements or when the defendant will not agree to insert desired tax language in a release, a QSF can be helpful. By stepping into the defendant's shoes, a QSF can effectively serve as a bridge between the parties.

The defendant obtains its all-important release by paying the settlement money into the QSF. Yet, in a virtually tax-neutral way, the plaintiffs are allowed additional time to implement tax planning and other payment details.

### Definition of a QSF

A QSF is a fund, account, or trust that meets three general requirements:

1. It must be established in accordance with an order of, or be approved by, the United States, any state (or political subdivision thereof), or any agency or instrumentality (including a court of law). Thereafter, it must be subject to the continued jurisdiction of that governmental authority.

2. It must be established to resolve or satisfy one or more contested or uncontested claims from an event that has already occurred. There must be at least one claim asserting liability:

   (a) under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980;

   (b) arising out of a tort, breach of contract, or violation of law; or

   (c) designated by the IRS in a revenue ruling or revenue procedure.

3. Finally, the QSF must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).[1]

### Federal Income Tax Reporting by QSFs

As a separate taxable entity, a QSF is subject to federal income tax on its modified gross income at the top marginal tax rate applicable to estates and trusts.[2] Notably, however, the QSF is not taxed on contributions from defendants to resolve claims. Those are nontaxable to the QSF. Instead, the QSF is taxed only on the income it earns on contributed funds, net of some limited deductions.[3] As a practical matter, a QSF is usually taxed only on interest and dividends.

In determining a QSF's federal tax reporting obligations, the regulations borrow from a number of different sources. Thus, although a QSF's federal income tax rate is based on the tax rate for estates and trusts, for purposes of procedure and administration, a QSF is generally treated as a corporation.[4] In that sense, QSFs are a type of hybrid.

[1]Reg. section 1.468B-1(c).
[2]Reg. section 1.468B-2(a).
[3]Reg. section 1.468B-2(b).
[4]Reg. section 1.468B-2(k).

### California Treatment

QSFs are creatures of federal tax law, but because most states have an income tax, some thought must be given to state tax treatment, too. In many cases, neither the federal tax rules nor the state rules will be thoroughly considered. In part, that may be because of the typically brief life of many QSFs.

As temporary vehicles designed to marshal assets, determine eligibility, and pay out claims, there are many QSFs that exist for less than one tax year. Even a long-lived QSF may have a short existence compared with many other entities. Perhaps for that reason, the federal taxation of QSFs is often not given much thought. The state taxation of QSFs may receive even less attention.

That can lead to some startling revelations. As might be expected, QSFs are subject to an entity-level tax under the laws of most states that have an income tax.[5] In other states, however, a QSF might not be subject to tax at all.[6]

Of course, California has its own rules governing the treatment of QSFs. As is true with many California tax rules, that treatment is not always logical or intuitive.

For instance, California generally follows federal law by treating QSFs as corporations for purposes of procedure and administration.[7] However, a California QSF files an annual Form 541, which is the form used for trusts and estates.[8]

### An Ambiguous Conformity

The foundation for California's treatment of QSFs is the state's general incorporation of section 468B, which provides special rules for DSFs:

> Section 468B of the Internal Revenue Code, relating to special rules for designated settlement funds, shall apply, except as otherwise provided.[9]

The California Revenue & Taxation Code contains some significant modifications to federal law. Because Cal. Rev. & Tax. Code section 24693(b) is not a model of clarity, it is worth quoting it in full:

> Section 468B(b) of the Internal Revenue Code, which imposes a tax upon the designated settlement fund, shall be modified for purposes of this part to provide that a tax shall be

[5]*See, e.g.*, Cal. Rev. & Tax. Code section 24693; Ill. Dept. Rev. IT 08-0002-PLR (July 10, 2008); Ind. Dept. St. Rev. 45 IAC 1.1-1-22(a)(10); Mass. Letter Ruling 08-7 (Mar. 28, 2008); Va. Dept. Tax'n Letter Ruling (Jan. 24, 1995).
[6]*See, e.g.*, N.Y. Adv. Op. TSB-A-06-(4)C (July 25, 2006); Conn. Dept. Fin. Ruling 2007-2 (July 3, 2007).
[7]Franchise Tax Board Notice 93-8 (Nov. 15, 1993), *available at* http://www.ftb.ca.gov/law/notices/1993/ftbn93_8.pdf.
[8]*Id. See* California Instructions to Form 541 (2010) at 3.
[9]Cal. Rev. & Tax. Code section 24693(a).

> imposed upon the gross income of the fund at a rate equal to the rate in effect for the taxable year under Section 23501. The income tax imposed upon the gross income of the fund by this section is in lieu of any other tax imposed by this part or Part 10 (commencing with Section 17001) upon or measured by that income.

Some of the intended effects of the modification seem clear. As is the case with QSFs, section 468B(b)(1) imposes tax on a DSF's gross income (with modifications) at the top federal rate applicable to estates and trusts. Yet for purposes of California tax rates, California has chosen to apply its corporate rate to QSFs.

However, there is much in the statutory language that is unclear. First, it is worth questioning whether California's general incorporation of section 468B necessarily applies to QSFs as well as DSFs. Although section 468B is often thought to govern QSFs, it does so only indirectly through regulations promulgated under the authority granted in paragraph (g)(1) of that section. Nevertheless, it seems almost self-evident that California's incorporation of the law applies to QSFs as well as DSFs.

Yet, if we assume that California Revenue and Taxation Code section 24693(b) applies to QSFs, we must inquire what it means to say that tax is imposed on the ''gross income of the fund.'' At first glance, the literal wording seems to dictate that the fund's entire *gross* income is subject to tax, without any allowance for deductions. Indeed, given that language, more than a few practitioners will read the statutory language at its (admittedly harsh) face value.[10] Fortunately, the Franchise Tax Board has taken a more federal-tax-law-reliant interpretation of the statute.

**Clarity From the FTB**

In FTB Legal Ruling 93-4,[11] the FTB considered whether a QSF was permitted to offset its current-year income by a net operating loss carried over from a prior year. The loss appears to have been attributable to expenses that would be deductible under federal rules. Examples of those expenses would include administration costs and losses related to the sale, exchange, or worthlessness of assets.

The FTB began its analysis by pointing to the general incorporation of section 468B in the California Revenue & Taxation Code. The FTB noted that the Treasury regulations promulgated under section 468B govern the interpretation of comparable provisions in the Revenue & Taxation Code.[12] Thus, although the Revenue & Taxation Code provides that a 468B fund is subject to tax on its gross income, that was not the end of the story.

The Treasury regulations clarify that a QSF is subject to tax, not on its gross income, but on its *modified* gross income. Modified gross income starts with gross income (broadly defined under section 61). It is then reduced by several permissible deductions, including administrative expenses and NOLs.[13]

Accordingly, the FTB followed the federal regulations, concluding that a QSF is permitted to deduct an NOL for California income tax purposes, subject to the limitations of California law. The ruling's conclusion is sensible. After all, a literal interpretation of ''gross income'' would presumptively cause the QSF to be taxed on all receipts from whatever source derived.

Perhaps that could even include amounts transferred to the QSF to satisfy the defendant's liability. Of course, that clearly would be inconsistent with the QSF's purpose to facilitate settlements. But the notion that the QSF could be taxed on its net investment income rather than its gross investment income is a far more nuanced and conceivable reading.

Even so, based on the generous incorporation of federal principles in Legal Ruling 93-4, it seems logical to conclude that California should permit a QSF to claim most other deductions allowed under federal law. Thus, administrative costs and legal, accounting, and actuarial fees relating to the operation of the QSF should qualify. Moreover, expenses arising from the notification of claimants and the processing of their claims should also all be deductible.

So too should be losses from the sale, exchange, or worthlessness of property.[14] All those items would clearly be deductible by the QSF for federal income tax purposes. Notably, however, California plainly does not allow a deduction for state income taxes. Parity goes only so far.

In addition to clarifying the determination of taxable income, the FTB has issued a notice that the regulations under section 468B apply to several other reporting provisions. For example, a QSF is

[10]*See* Robert W. Wood, ''More Notes From California's Tax Trenches,'' *Tax Notes*, Aug. 22, 2011, p. 839, *Doc 2011-15551*, or *2011 TNT 162-10*. We are indebted to Kate Kraus of Irell & Manella LLP for pointing out the nuances of this California rule, and particularly for sending along FTB Legal Ruling 93-4.

[11]November 15, 1993, *available at* http://www.ftb.ca.gov/law/rulings/active/lr93_4.shtml.

[12]Cal. Rev. & Tax. Code section 23051.5(f).

[13]Reg. section 1.468B-2(b).

[14]Reg. section 1.468B-2(b)(2)-(4).

required to use a calendar year and accrual accounting for both federal and California income tax purposes.[15] Similarly, California appears to follow federal elections for QSFs.

Thus, a relation-back election is deemed to be made under the California tax law when it is made for federal income tax purposes.[16] That election allows a QSF to come into existence for tax purposes on a limited retroactive basis, as of the later of:

1. when the fund, account, or trust meets the second and third basic QSF requirements (other than the requirement of a court order); or

2. January 1 of the calendar year in which all three requirements are met.

Presumably, other elections, such as the rare election to treat a QSF as a grantor trust, may also be respected for California tax purposes.[17]

[15]FTB Notice 93-8 (Nov. 15, 1993).
[16]*Id.*
[17]*See* reg. section 1.468B-1(k); Cal. Rev. & Tax. Code section 17731.

**Conclusion**

QSFs and their DSF parents are unquestionably creatures of federal tax law. And even at the federal level, nuances of income tax rules to be applied to the QSF's own tax return are often given short shrift. QSF tax returns are usually simple and usually report interest income, which is offset in whole or in part by administrative expenses and counsel fees. During the generally short, happy life of a QSF, there seems relatively little that could go wrong.

Yet the state tax treatment of a QSF is also worth more than a passing review. Particularly in states not known for wholesale federal conformity, advisers should beware. In the Golden State, California's incorporation of the federal tax principles relating to QSFs was not accomplished in the most artful way.

Nevertheless, thanks to clarification published by the FTB, although a QSF must file a California trust income tax return, it generally figures its modified gross income in the same manner as under federal law.