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How Law Firms Can Strategize Their Fees Around Tax Season

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To the Editor:

Even the most established trial law firms could be held back by the unpredictability of incoming revenue. Since it's difficult to pinpoint the month, or sometimes even the year a case will resolve, managing partners and law firm CFOs need to keep a tight financial belt to continually cover operating costs. Firm growth and other initiatives may go on the backburner as a result. Combined with the fact that attorneys' contingency fees are taxable, financial and tax planning for law firms is complex. Any tool that can be of use to streamline and gain better control over these processes should be considered.

There is a unique tool that will help contingency fee lawyers with their tax planning, both personally and professionally. It is called a qualified settlement fund (QSF), and firms that have used a QSF — whether in a mass tort or class action, or as an individually-ordered trust for a single case — know about the efficiencies and flexibility this tool provides at settlement time and beyond. These firms have the ability to time receipt of their fee revenue, plan for taxes, and improve their service offerings to their clients.

To give a brief background: A QSF holds settlement proceeds past the end of a lawsuit, affording trial lawyers flexibility in executing attorney fee deferral. The ability to structure and defer attorney fees has been around for decades, emanating in 1994 from *Childs v. Commissioner*.[1] Structured legal fees are exempt from section 409A as the IRS has issued in Notice 2005-1, 2005-1 C.B. 274. A QSF works in tandem with fee deferral for stronger law firm financial and tax planning.

But trial lawyers may be under the impression that they must establish a new QSF every time another settlement comes, which can be inconvenient and cumbersome. Enter: the firmwide qualified settlement fund. With one court order, a QSF is established on behalf of one law firm to use as their cases settle. Also referred to as a pooled QSF, firmwide QSFs can accept settlements from multiple lawsuits. Without constructive receipt, trial lawyers can choose to accept the portion of the fees they need upfront, then defer and invest the rest to support long-term firm growth.

However, the firmwide QSF is a new concept in tax attorney years — about a decade — and some have questioned its legality. Is this a legitimate financial tool for trial law firms?

Specifically, red flags have been raised around settling multiple cases into the same QSF. This centers on the issue of how the cases settled into a QSF must share commonalities, meaning how they are related. There must be several points of commonality among the claims for which the QSF was established to resolve. Under 26 CFR section 1.468B-1(c)(2) of the IRC, a qualified settlement 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 that has given rise to at least one claim asserting liability." So how do we determine what that looks like?

In the recent article[2] published in *Tax Notes*, tax attorney Robert Wood of Wood LLP examines the meaning of "related" in both reg. section 1.468B-1(c)(2) and reg. section 1.468B-1(h)(2).

From reg. section 1.468B-1(c)(2):

Requirements. A fund, account, or trust satisfies the requirements of this paragraph (c) if —

(2) 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 —

(i) Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (hereinafter referred to as CERCLA), as amended, 42 U.S.C. 9601 et seq.; or

(ii) Arising out of a tort, breach of contract, or violation of law; or

(iii) Designated by the Commissioner in a revenue ruling or revenue procedure

From Reg. section 1.468B-1(h)(2):

Segregation requirement —

(2) Classification of fund established to resolve or satisfy allowable and non-allowable claims. If a fund, account, or trust is established to resolve or satisfy claims described in paragraph (c)(2) of this section as well as other types of claims (i.e., non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund. However, under §1.468B-3(c), economic performance does not occur with respect to transfers to the qualified settlement fund for non-allowable claims.

From Wood's analysis, the main takeaway is that "claims that could be resolved through separate QSFs could instead be resolved through the same QSF. It seems unlikely that Treasury's intent in including the language in paragraph (c)(2) was to require plaintiffs to establish separate QSFs when one would suffice." The question remains: When would Treasury expect parties to create separate QSFs?

Strict interpretations of rules around the use (or abuse) of QSFs would have been to monitor the way defendants might take advantage, not trial lawyers and their clients. That's because the QSF was originally created for the tax benefits it gives defendants, not plaintiffs and trial lawyers. Congress enacted reg. section 1.468B-1 of the IRC in 1986 to set up "designated settlement funds" so that defendants and their insurers could deduct legal settlement payments in the year in which they were paid, regardless of when the money was distributed to claimants. Designated settlement funds were functionally limited, so in 1993 new regulations from Treasury established QSFs to allow the settlement of a broader range of legal claims.

Treasury's motive in making these changes is instructive for law firms exploring firmwide QSFs. As Wood explains, "It seems more logical to believe that Treasury was trying to prevent taxpayers from setting up QSFs and obtaining tax deductions for *liabilities and events not yet existing*." (Emphasis added.) Rather than allowing potential wrongdoers to create legal "slush funds" and claim tax deductions for harms that haven't yet been litigated, Wood argues that the regulations need to be read with that in mind. "Requiring the QSF to resolve at least one claim that has 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 arguably* prevents QSFs from being formed too early."

Law firm partners, shareholders, and CFOs should know there are best practices on how a firm handles their QSF. It is important that each case be handled in the same manner, as if each case being settled is its own “sub-QSF” that makes up the whole. Practitioners should strive to maintain commonality by settling cases with the same counsel, region, parties, and/or case type.

For example, a firm that practices both personal injury and mass torts cases is better served by maintaining different QSFs. A firm’s docket of Roundup cases share commonality based on injury and trial lawyer, but they do not share the same features with that same firm’s client who was hurt in a car crash. To comply with the spirit of the law and regulations, as it is currently understood, law firms should establish a separate QSF for those specific practice areas. A firm should consult with an expert in establishing QSFs if they think there would be an issue of commonality.

In conclusion, while there is not clear authority from the IRS around firmwide QSFs specifically, it seems reasonable to interpret the language under reg. section 1.468B-1 as done by Wood: “If the pooled QSF is set up like most QSFs, we think we can assume that it does qualify.” There is no other significant or contested legal question regarding firmwide QSFs. No one questions whether they are capable of being a trust, or whether they can be formed via an action in a state court. These vehicles are routinely used for this very purpose throughout the legal industry.

At the end of the day, the firmwide qualified settlement fund makes it easier for trial lawyers and law firms to settle litigation quickly once the terms of settlement have been negotiated. They can also help with planning over the long term when used in conjunction with attorney fee deferral. “Plainly, pre-established QSFs can streamline case settlements and avoid a midnight scramble when an unanticipated settlement needs to be grabbed and quickly documented,” Wood says. “Perhaps they are the plaintiff lawyer’s analog to ‘Don’t leave home without it.’”

Managing partners should speak with their CPA and accounting department when considering a firmwide QSF and its implications for future tax seasons. When the time is right, law firms can tap an experienced QSF administrator for help with establishing the fund and guidance on getting the best use out of it.

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FOOTNOTES

[1] *Childs v. Commissioner*, 103 T.C. 634 (1994).

[2] Robert W. Wood and Alex Z. Brown, "Do Pooled and Law Firm Qualified Settlement Funds Qualify as QSFs?" *Tax Notes State*, Mar. 14, 2022, p. 1187.

END FOOTNOTES

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