Attorney Fee Deferral: Unique Planning Tool to Defer Taxation of Contingent Legal Fees

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An often-overlooked issue for plaintiff attorneys is the management of taxation of their own contingent legal fees. As part of the normal rhythm of their practices, many attorneys experience peaks and valleys with their own personal income. This leads to concerns for trial attorneys about the unpredictability of their own income. However, attorneys have a unique opportunity, not available to others who earn professional fees, to take their contingent legal fees and invest them on a pre-tax and tax-deferred basis to smooth out income. Attorney fee structures and deferred compensation arrangements allow lawyers to avoid taking income all in one taxable year when they earn a large fee. However, these solutions have to be explored and decided upon prior to signing a release. While these financial products may seem complex, they are actually quite simple. Having an expert advisor who can provide you with different options is critical. The remainder of this chapter answers some frequently asked questions about deferral of contingent legal fees.

The legal foundation for this comes from a 1994 tax court decision *Childs v. Commissioner*.[1] This decision was the last time the Internal Revenue Service challenged an attorney's ability to enter into an agreement to defer their contingent legal fees. In Childs, U.S. Court of Appeals for the 11th Circuit affirmed the tax court's ruling that attorneys may structure their fees, holding that taxes are payable on structured attorney fees at the time the amounts are received.[2] The IRS has now cited the Childs decision favorably and recognized it as binding precedent in a Private Letter Ruling.[3] In that PLR, the IRS described that the "Tax Court held that the fair market value of taxpayer's right to receive payments under the settlement agreement was not includable income in the year in which the settlement agreement was effected because the promise to pay was neither fixed nor secured." It went on to state that the "court further held that the doctrine of constructive receipt was not applicable because the taxpayer did not have a right to receive payment before the time fixed in the settlement agreement."

Since these are "tax-advantaged" plans there are rules and formalities which can be a bit inflexible. It is a well-accepted tax construction that works. A lawyer, who earns a contingent fee, must decide before settlement to have his/her fee paid over time instead of taking it in a lump sum. The fee that is being deferred is paid to a life insurance company which will agree to make future periodic payments. The decision to defer can be made at any point before the settlement agreement is signed, even right up to the moment before the agreement is signed. Even though a fee has been technically earned over the course of representation of the client, the lawyer (according to tax authorities) hasn't earned the fee for tax purposes until the settlement documents are executed. An attorney has the autonomy to decide whether to defer all or part of their fee in this way.

Attorney Fee Structures

Attorney fee "structures" are annuities and work very much like a non-qualified deferred compensation plan. The taxes that would be otherwise paid on the fee earned at the time the case is settled are deferred, and that money grows without tax on the growth. When distributions are made, the entire amount distributed during a year is taxable for that year. Based upon a taxpayer's tax bracket, there

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[1] Childs v. Commissioner, 103 T.C. 634 (1994) affirmed without opinion 89 F. 3d 56 (11th Cir. 1996).
[2] Id.
[3] PLR-150850-07

may be some distinct tax advantages to entering into this type of arrangement as opposed to being taxed on the entire fee in the year it was earned and investing it after tax. Depending on how much the fees are, current tax bracket rates and any other sources of income, stretching out payment of fees can result in potentially a smaller tax burden. This is a challenge in most professions; timing of income but controlling the realization of income is possible for attorneys. Using attorney fee structures, plaintiff attorneys can defer their fees and income taxes on those fees for personal injury cases as well as many other types of cases. An attorney fee structure allows an attorney to set up a personally tailored retirement plan without the monetary and age restrictions or other drawbacks of a qualified plan. The attorney can defer taxes on his or her fees as well as the interest that those fees earn until the year in which a distribution is actually received from the fee structure.

The fee structure can help a lawyer avoid the highest tax brackets by leveling off income spikes due to large fees and spreading the income out over several years. An attorney who otherwise would have an unusually high income in one taxable year, but elects to spread the income over several years, avoids paying taxes in the highest bracket. Couple the tax savings with guaranteed earnings on the deferred funds, and the benefits of an attorney fee structure become very obvious. Fee structures can be done by one attorney in a firm, without the requirement that other attorneys and employees participate, as would be the case in a qualified retirement plan. Also, there is no limit as to the amount of income deferred. By comparison, there are statutory limits to the amount one can defer in a qualified retirement plan. Even if the attorney participates in a qualified retirement plan or individual retirement account (IRA), he or she may still defer additional income through an attorney fee structure. Unlike traditional retirement plans, there is no requirement of annual deferments. A bonus is that the attorney fee structure is exempt from creditor's claims in most jurisdictions.

When an attorney fee is earned in a personal physical injury case, including mass torts, with all payments to the claimant being eligible for exclusion from taxable income under I.R.C. § 104(a)(2), or workers' compensation case under section 104(a)(1), the same structured settlement annuities that the personal injury victim obtains can be used and the payment options are greatly expanded. A qualified assignment is done just as in the case of the personal injury victim. Attorney fee structures can also be done on fees from cases that are not personal physical injuries under section 104 (a)(2). These include fees from cases based on claims of discrimination, sexual harassment, employment litigation, defamation, wrongful imprisonment, wrongful termination, other non-physical personal injuries including emotional distress, punitive damages, bad faith, breach of contract and construction defects, to name several.

Since fee structures are pre-tax and tax-deferred investment vehicles, a major benefit is the compounding effect of deferring payments out over longer periods of time. The longer an attorney waits for payments or the longer the duration of the distribution term, the better the financial result and possibly the tax result as well. Payments can start right away, but don't have to. They can be deferred for any length of time and then can be paid out over a duration of years or for life. There are almost infinite possibilities in terms of the different types of arrangements that can be set up.

While structuring one hundred percent of every contingent fee earned probably doesn't make sense or even a percentage of every fee, there are some unique benefits to doing so that shouldn't be ignored. A systematic approach to structuring a portion of every fee can lead to a very attractive end result when an attorney wishes to retire. For example, if an attorney took fifteen to twenty five percent of every

contingent fee earned and deferred it out to retirement, then they would have taken advantage of the benefits of a stable retirement income, estate planning advantages and tax benefits that most people in the workforce can't achieve. With the unpredictability of the contingent fee law practice and life in general, you don't want to rely on any one solution for retirement and so exploring fee structures is one way to hedge against the uncertainties.

There are some key reasons to do an attorney fee structure:

1. It is a pretax investment in a guaranteed high yielding tax deferred annuity.
2. Deferring compensation over time results in less being lost to taxes.
3. Application of AMT can potentially be avoided.
4. Gives you custom cash flow management and allows you to tailor your own income stream.
5. Structured fees have enhanced protection from creditors, judgments and divorce decrees.

There are some frequently asked questions related to structured attorney fees.

- Does the personal injury victim have to structure a portion of their settlement before the attorney fee can be structured? No. The claimant can take one hundred percent cash and the attorney fee can still be structured.
- How does fee structuring work? Structuring an attorney fee works very similarly to structuring the victim's settlement. The most important thing to remember is you can't take receipt of the fees.
- Why structure an attorney fee in a fixed interest rate annuity? Every portfolio should have some portion of the investments in fixed income. An attorney fee structure is a fixed income investment but unlike all others an attorney can make, the fee structure is a pre-tax investment. Whether a fee structure is appropriate for you will depend on a variety of factors, including your age, health, risk tolerance, retirement goals, tax bracket as well as your current and long-term needs. However, structuring your attorney fees could provide beneficial tax relief as well as secure and stable tax deferred income up to, and including, your lifetime.
- Can I receive the same types of income streams the victim can with their settlement proceeds? Yes, you can have lifetime benefits. You can have a "period certain" for a defined amount of time or a future lump sum payment as well as a series of lump sum payments. You can select immediate or deferred payments. You can have multiple income streams such as lifetime payments coupled with lump sum payments.
- Can I only structure contingent fees from a personal physical injury or wrongful death settlement? No. You can structure contingent fees from nearly any type of settlement. Companies have developed innovative products to expand the availability of attorney fee structures.
- What do I need to do to prepare for structuring my attorney fees? You should negotiate the inclusion of the fee structure when settling the case since the creation of a tax-deferred fee

structure <u>does</u> require the cooperation of the defendant similar to when the victim's settlement is structured.

While the foregoing discussion focused on "fixed" attorney fee structure annuities, there are two other potential options that are available. First, there is an equity indexed attorney fee structure product. The equity indexed attorney fee structure ties return to the S&P 500 index. If the index is up, your payments increase. If the index is flat or negative, there is no decrease. So, no downside risk, only upside. The upside though is limited to a maximum ceiling of 5%. As the payments increase, they lock and you can only go up, never down. This type of product provides more upside potential than the traditional "fixed" fee structure while still remaining conservative. Second, there is a "non-qualified" attorney fee structure. These products in this type of structure involve an "off-shore" assignment to achieve tax-deferral based on international tax treaties. Instead of using an annuity as the funding vehicle, these are open architecture allowing the attorney to use his own financial advisor to select appropriate investments which typically include stocks, mutual funds, ETFs, bonds and other investments. These types of products are similar to the deferred compensation plans described immediately below since there are more available investment options but inherently have some additional risk due to the "off-shore" assignment. As with all of the decisions associated with fee deferral, you should consult with your own tax advisors to determine what is most suitable.

Deferred Compensation Plans for Attorneys

A non-annuity deferred compensation arrangement is another mechanism that trial lawyers can use to invest the contingent legal fees they earn on a pre-tax and tax-deferred basis. Like Fortune 500 executives who defer their compensation, you can defer all or a portion of your fees until you are ready to start receiving them. Using this kind of solution, you have flexibility with investments as well as more control over timing of income. For example, if you wanted to defer a five hundred-thousand-dollar fee in the current taxable year by splitting the fee plus the investment gains into twenty quarterly payment buckets you could do so. Thirteen months prior to any scheduled quarterly payment, you can elect to withdraw it. However, if you don't need the payment, the payment bucket will automatically roll forward to the end of the line. By laddering payments in this way, you can effectively manage your cash flow and better control the timing of taxation.

From a legal-tax perspective, fee deferrals are subject to the same body of tax rules that govern Nonqualified Tax-Deferred Compensation (NQDC). So, this means that the deferrals must avoid the application of the constructive receipt and economic benefit doctrines. NQDC has been used for decades by Fortune 500 companies as a way to attract, retain and further compensate their top-level executives. These deferred compensation plans rely upon the same decision as attorney fee structures; *Childs*. Since the legal underpinnings are the same and are well established, the risk is relatively similar to attorney fee structure annuities.

Conclusion

In summary, attorney fee deferral solutions allow a plaintiff lawyer to not only defer receipt of (and tax on) fees until received, he or she can have the deferred fees invested, and have the income produced from it also taxable over time rather than immediately. A lawyer may want to consider deferring fees as part of his or her own income tax planning, financial planning, and estate planning. Tax deferral mechanisms for lawyers are a great way to smooth out those income spikes caused by larger fees or just

take better control over timing of income. Due to the variety of options, there is likely something that will best suit an attorney's needs and investment preferences. Attorneys should explore these options to take back control of timing of income.