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Wood on the Private Annuity Regs And Structured Attorney Fees

To the Editor:

I am writing about the recent article by Burgess J.W. Raby and William L. Raby, ''Attorney Fees and Private Annuity Rules,'' *Tax Notes*, Jan. 22, 2007, p. 309, *Doc 2007-1103, 2007 TNT 15-65.* This intriguing (but to me, scary) article argues for a connection between the recently proposed private annuity regulations, *Doc 2006-21329, 2006 TNT 201-5*, and attorney fee structures. The Rabys conclude that if the proposed regulations are adopted unchanged, the entire amount of an attorney fee structure (using present value concepts) is income on entering the structure. In other words, the Rabys posit that the proposed anti-private annuity regulations may *target* private annuities, but they obliterate attorney fee structures too.

I don't want to overreact, since I'm unsure if the Rabys mean this as a thought-provoking exposé on how tax rules can apply beyond their intended sphere (like Vice President Cheney, sometimes shooting something unintentionally), or if they truly *believe* the proposed private annuity regulations could or would be interpreted in this fashion. The former is a well-worn axiom. Assuming the Rabys don't intend their piece as the former — as a rhetorical ''imagine if the IRS extended this to attorney fee structures'' question — I feel compelled to comment.

As the Rabys correctly point out, the proposed regulations apply when an annuity contract is received in exchange for property. To determine if the proposed regulations could conceivably apply to attorney fee structures, we must determine both whether the attorney receives an annuity, and whether there has been an exchange of property. For now, I will assume there's an annuity here. It is the latter requirement — whether there has been an exchange of property — I find more troubling.

The Rabys argue that there has been an exchange of property when an attorney agrees to look solely to a defendant for payment of legal fees. The Rabys state that before settlement a contingent fee lawyer has an ''inchoate'' property right to payment. On settlement, they argue, the lawyer exchanges that inchoate property right

for an obligation from the defendant to make structured payments, which they say is also a property right.

Of course, the proposed private annuity regulations speak to exchanges of property, not of property rights. Even if the terms are interchangeable (and I am not sure they are), I do not believe an attorney fee structure involves an exchange of property. According to the IRS's own regulations, property does not include an ''unfunded and unsecured promise to pay money or property in the future.'' Reg. section 1.83-3(e). That is what the attorney gets in a fee structure.

In the typical attorney fee structure, whether or not the attorney releases the client from any ongoing liability (a fact the Rabys seem to think is significant), all the attorney gets is an unsecured promise to pay. Section 83 simply does not tax that as property. Both the Tax Court and the 11th Circuit in *Childs* thought that was eminently clear, and I think it remains so. Indeed, although the IRS has never acquiesced in the *Childs* case, it has cited it.

In FSA 200151003, 2001 FSA Lexis 173, *Doc 2001-31373, 2001 TNT 247-70*, the IRS cited *Childs* for the proposition that when attorneys enter a structured settlement arrangement calling for deferred payments of their fees, there is no constructive receipt as long as the settlement is entered into before the attorneys obtain an unconditional right to compensation for their services. Perhaps one could make a case that the machinations of the typical attorney fee structure amount to a kind of *de facto* security.

Yet, there are established legal niceties that prevent that treatment. Although the statute and the regulations under section 83 do not define when a promise to pay is ''funded,'' it is clear that it is *not* funded in an attorney fee structure. In an attorney fee structure, when the insurance company guarantees payment of the attorney fees should the assignment company ever fail to pay them, that mere guarantee does not fund or secure the attorneys' right to receive payments. The IRS argued that point and lost in *Childs*, where the court stated: ''a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay.'' See 103 T.C. 634, *Doc 94-10228*, *94 TNT 223-15*, at 652 (1994), *aff'd*, 89 F.3d 856, *Doc 96-19540, 96 TNT 133-7* (11th Cir. 1996).

In every structured attorney fee arrangement I have seen, as in *Childs*, the owner of the annuity is the assignment (or structured settlement) company, not the attorneys. In *Childs* the court was impressed that the structured settlement company retained all rights incident to ownership, including the right to change the beneficiary (the attorney) during his lifetime. Further, the attorneys could not accelerate, defer, increase, or decrease their fees (once structured) during the term of the payment period. As long as the assignment company remains the sole owner of the annuity, and the attorneys have no rights under the policy greater than those of a general creditor, the attorneys should not realize the present value of the structured fees.

One of the Rabys' precepts is that the attorney fee structure involves the defendant's paying the plaintiffs' attorney, and that attorney looking solely to the defendant and not to his client. Thus, I believe some of the Rabys' views may emanate from a misperception of the facts, at least as I understand them. The Rabys suggest that a typical attorney fee structure involves the client's constructively receiving the unsecured promise of the defendant to pay the plaintiffs' legal fees, and the attorney's agreeing to accept the obligation of the defendant in full and complete satisfaction of the client's obligation to the attorney.

Perhaps some are done this way, but I do not believe that represents the majority practice. In fact, I'm including here variations of the kinds of permissive language I've seen in the underlying settlement agreements.

> Example 1
>
> The Plaintiff authorizes and instructs payment to be made to his or her attorney as provided herein. Such amount shall be paid from the periodic payments that otherwise would be payable to the Plaintiff pursuant to this Agreement. The Plaintiff acknowledges and agrees that these payment instructions are solely for the Plaintiff's convenience.
>
> Example 2
>
> The Plaintiffs and their attorney have an agreement to direct periodic payments to (attorney) from the settlement proceeds to fulfill the Plaintiffs' attorney fee obligation as follows, solely as a matter of convenience for the Plaintiff.

Whichever of those approaches is used, this is the kind of obligation that is later assigned to a third-party assignee. The defendant is not promising anything directly to the attorney, and in fact, the plaintiff's attorney is normally not even a signatory to the settlement agreement. It is the plaintiff who has the obligation to the attorney, and the payment is being directed to the attorney on behalf of the plaintiff and for the plaintiff's convenience.

As in so many other parts of the tax law, form is clearly important. There are numerous examples of substantial differences in tax treatment based on subtle differences in fact patterns, fact patterns that, on the surface, may appear to be homogenous. Clearly, structuring attorney fees requires adherence to form, but that is hardly an indictment.

If one goes back to the genesis of the IRS's proposed private annuity regulations, one finds that they were primarily aimed at abusive transactions, many of which involved related parties. Rather than attempting to discern which private annuity transactions were good and which were bad, given the enormous factual undertakings that could involve, the IRS chose — wisely in my view — to obliterate them entirely. Yet, I do not think the proposed private annuity regulations affect structured attorney fees, past or future. I do not think the IRS even in its wildest imaginations would think so either.

It is hard to know how to respond to the Rabys' argument that *Childs* was incorrectly decided, if that is indeed what they mean. I think that is what they mean, since they say ''we suggest that if *Childs* is viewed in light of *Towne v. Eisner*, however, it may be that Judge Scott [in the *Childs* case] erred in her application of Section 83.'' See *Tax Notes*, Jan. 22, 2007, p. 309 at 310. *Towne v. Eisner*, 245 U.S. 418 (1918), was a Supreme Court case decided more than five decades before *Childs* and long before the

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existence of section 83. I will be the first to admit that many of us today may be more inclined to cite hoary old cases and fundamental tax concepts, given the issued and then vacated *Murphy* decision (which the Rabys also cite). However, I fail to see how *Towne* has any relevance, beyond merely historical interest.

There is another reason the mechanics of payment from plaintiff or defendant should not matter, and that is the taxation of contingent attorney fees. The Rabys correctly note that the Supreme Court in *Commissioner v. Banks*, 543 U.S. 426, *Doc 2005-1418, 2005 TNT 15-10* (2005), established the general rule that ''when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee.'' I'm not sure if it is helpful or confusing to follow the path that the *Banks* case denotes, but here goes.

As the Rabys recognize, under the general rule announced in *Banks*, regardless of the arrangement between client and lawyer, it is the client's income first. If the case is a 100 percent physical injury/physical sickness case, the client's recovery is excludable under section 104, and that extends to the attorney fees as well. That means the client has no deduction to claim, although obviously the attorney is taxable on his portion. When the recovery is taxable to the client, the general rule of *Banks* says the client has income measured by the full recovery and must claim a deduction for the legal fees, even if they are paid directly to the contingent fee lawyer. The fact that *Banks* creates a general rule that it is the client's money first not the lawyer's hurts rather than helps the Rabys' theory.

The Rabys mention section 72 for support. Perhaps because of our different factual assumptions about fee structures, we differ on this point too. Although I agree with the Rabys that section 72 is broad (as also noted by Kevin McGrath in his letter to the editor, *Tax Notes*, Jan. 29, 2007, p. 479, *Doc 2007-1934, 2007 TNT 20-61*), the assignee owns the annuity, not the attorney. The attorney is an unsecured creditor. Although the Rabys may be right that a private annuity is *also* a type of unsecured promise to pay, that does not mean (in my view) that a structured attorney fee arrangement morphs into a private annuity.

If the Rabys intended to spark renewed thinking about attorney fees, I think they've done that. Moreover, if their article causes attorneys and tax practitioners to be very careful when structuring legal fees, that's entirely a good thing. On the other hand, since I am a literalist, it does concern me that their conclusion reads: ''We think it highly likely that if the issue is raised, the structured payments to attorneys would fit within the private annuity rules.'' *Tax Notes*, Jan. 22, 2007, p. 312. I disagree.

More frightening still is the second part of their conclusion, that ''for cases not within the scope of section 104(a), whatever that scope may turn out to be, so too would the payments to the successful plaintiffs.'' *Id.* By this I understand the Rabys to say that they believe it is highly likely that structured payment arrangements to *plaintiffs* do not work either (or more accurately, that they are *also* caught within the private annuity proposed regulations). That last half of the last sentence of their article is a doozy. It is an even more extreme a position than is their take on structured attorney fees.

Incidentally, although I am not sure how this fits in to the debate, I should note the controversy generated by the enactment of section 409A in October 2004, which drastically changed the landscape for deferred compensation arrangements. In the structured settlement industry, section 409A triggered concern whether attorney fee structures would run afoul of the new law. Indeed, many life insurance companies stopped issuing annuities in attorney fee structures after section 409A was enacted.

Not long after the enactment of section 409A, the IRS issued Notice 2005-1, 2005-2 IRB 1, *Doc 2004-24026, 2004 TNT 245-10*, which quelled the fears of those insurance companies, which again began issuing attorney fee structures. Although Notice 2005-1 does not identify attorney fees structures by name, in Question and Answer 8 it provides that section 409A does not apply to arrangements between a service provider and a service recipient, if the service provider is actively engaged in the trade or business of providing substantial services (other than as an employee or corporate director), and if the service provider provides those services to two or more unrelated service recipients. By virtue of that description, it has generally been assumed (by me and many others) that Notice 2005-1 means that section 409A does not apply to structured attorney fees.

Although the Rabys (as always) write about an interesting topic and make interesting arguments, I do not believe even the IRS, in its wildest dreams, would think the proposed private annuity regulations could torpedo attorney fee structures.

Very Truly Yours,

Robert W. Wood
Jan. 30, 2007

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