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IRS Attacks Structured Attorney Fees 28 Years After Losing Key Tax Case

For decades, contingent fee plaintiff lawyers have been able to receive their fee as a lump sum or paid over time and taxed in installments. Formalities are required, but the tax treatment is well-established. As a result, the IRS release

of Generic Legal Advice Memorandum AM-2022-007 (known as a GLAM) in December 2022 was a surprise to insurance companies, structured settlement providers and plaintiff lawyers. In 1994, the Tax Court and 11th Circuit approved structured fees in *Childs v. Commissioner* 103 T.C. 634 (1994), *aff'd without opinion*, 89 F3rd 856 (11th Cir. 1996).

The IRS left structured legal fees alone for nearly 30 years, allowing lawyers to even out their income, and in that sense, the IRS GLAM is a big surprise. Even so, it does not address the precise facts in *Childs* or directly call for it to be overturned. In any event, a GLAM is not binding on any taxpayer, but the IRS criticism of fee structures is broad. Most fee structures follow one of two models, an assignment structure modeled after *Childs*, or one based on deferred compensation authorities. Both erect formal barriers so the lawyer who is the ultimate payee does not own it or even have a security interest and cannot control it.

In essence, the price tag for the lawyer being able to delay payment (and delay attendant taxes until each installment comes in) is a formal structure ensuring that the lawyer is only a general creditor of the entity holding the deferred fee. The IRS can't outvote the Tax Court or Eleventh Circuit, but it can audit, and the IRS's arguments might surface there. The IRS makes four arguments why structure legal fees (at least in its hypothetical) should not work:

1. It violates the assignment of income doctrine. This tax doctrine applies when one person earns income but tries to assign it elsewhere, so someone else pays the tax. Yet the lawyer who earned the income is the same one paying the tax, just later, so it is hard to see how this applies.

2. It violates the economic benefit doctrine. This doctrine applies when money is set aside or secured, even though they cannot currently get it. In a

structured fee as approved in *Childs*, the assets are not segregated for the lawyer and are unsecured, so the lawyer is merely a general creditor.

3. It is taxable under section 83 of the tax code. This offshoot of the economic benefit doctrine is the code section that taxes restricted stock and other property transferred in connection with services when the property is vested and the recipient is certain to get it. The GLAM makes a complex argument why section 83 should tax the fee structure up front, but the *Childs* court specifically rejected the applicability of section 83 to the structured fees it approved.

4. It is a deferred compensation plan that violates section 409A of the tax code, which was enacted after *Childs* was decided. Section 409A says some compensation deferred should be currently taxed and face big penalties. Fortunately, the Treasury Regulations under Section 409A say that the *entire provision* does not apply to independent contractors who have two or more customers or clients (among other requirements that are usually easily satisfied for structured fees).

Since this Regulation was published in 2007, it has been widely understood to *exempt* structured legal fees. Most lawyers have two or more clients, so are exempt from Section 409A. Even so, the GLAM argues that legal fee structures are subject to Section 409A because adding a third party means it is no longer an amount deferred between client and lawyer.

The IRS could attack any fee structure, but ones like its hypothetical may be the primary target. It is worth asking how the IRS will identify fee structures, since they are often not reported on a tax return until the installment payments are reported and taxed. Even so, most lawyers who structure fees and the companies and brokers who help them are likely to pay attention to

the GLAM. At a minimum, it suggests that *if* they are audited, the IRS may make these arguments. That does not mean the IRS will win, and the specific facts and documents in question are going to matter a great deal.

IRS audits can be resolved at the audit stage, where the best result is the IRS saying there is no change. That used to be possible with structured fees, but the GLAM may make it more difficult now, depending on the facts and documents. Many IRS audits are resolved a step beyond audit at IRS Appeals, where vast numbers of tax cases are hammered out. IRS Appeals is still part of the IRS, but it is independent and tries, usually successfully, to resolve disputes between auditors and taxpayers, often by settlement.

Some industry pushback is also possible, particularly given the number of stakeholders impacted by the IRS arguments, including life insurance companies that issue life insurance annuities exactly like those in *Childs*. Some commentators even suggest that Congress could become involved to confirm the tax rules that plaintiff lawyers thought were clear in 1994. Then again, it is possible that we will end up with *another* tax case to resolve the issues many thought were resolved in *Childs*.

If that occurs, it will take time, perhaps years. And like any tax case, it will be based on the facts and documents in that *particular* case. It does not seem likely that plaintiff lawyers will stop structuring their fees, or that the insurance companies, brokers and others who facilitate structured fees will stop helping lawyers to do it. However, if nothing else, the IRS GLAM should cause the entire industry to dot their i's and cross their t's.

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