PERSPECTIVE

Los Angeles | Daily Journal

WEDNESDAY, JANUARY 11, 2023

IRS Targets Structured Fee Tax Deferrals for Plaintiff Lawyers

By Robert W. Wood

It would be difficult to overstate the surprise from insurance companies, structured settlement providers, settlement brokers, and plaintiff lawyers from the release in December 2022 of IRS General Legal Advice Memorandum, AM 2022-007, known in tax parlance as a GLAM. The only known attack on structured legal fees came in 1994, when the IRS was rebuffed by the Tax Court and 11th Circuit in the seminal case of *Childs v. Commissioner* 103 T.C. 634 (1994), aff'd without opinion, 89 F3rd 856 (11th Cir. 1996). The holding in *Childs* caused the IRS to leave structured legal fees alone for nearly 30 years. The IRS never formally acquiesced in *Childs,* but the IRS eventually accepted it and has even cited it with approval.

An entire industry of life insurance companies, structured legal fee brokers and facilitators have thrived ever since so plaintiff attorneys can flatten the peaks and valleys of their income and plan for retirement. The GLAM attacks points people thought were settled, but it does not address the precise fact pattern in *Childs* or directly call for it to be overturned. In fact, the GLAM's hypothetical seems to target primarily legal fee structures that differ from *Childs* in some potentially meaningful regards.

But it seems a mistake to read it as targeting only certain fee structures, as it seems to be more of a roadmap for what the IRS may argue in audits. The GLAM would not have been issued if there were not an IRS audit of a fee structure underway.

It is worth noting that a GLAM is not binding on any taxpayer and does not necessarily represent the collective view of the IRS or the Treasury Department. It is a research memo prepared by IRS attorneys.

It is also not published authority on which taxpayers can rely, unlike an IRS Revenue Ruling, a Treasury Regulation or a tax case like *Childs*. It deals with a hypothetical structured fee somewhat different from the one in *Childs*. Most fee structures follow one of two models, an assignment structure modeled after the assignment in *Childs*, or a structure based on other deferred compensation authorities that do not specifically address structured legal fees. Because of the differences between the GLAM's hypothetical and the *Childs* fact pattern, the GLAM more directly addresses certain non-*Childs* structured fees.

Both types of fee structures are formal, erecting barriers so the lawyer who is the ultimate payee of the arrangement does not own the structure, does not have a security interest in it, and cannot control it. In essence, the price tag for the lawyer being able to delay fee payments (and delay paying the attendant taxes until he or she receives each installment) is a formal structure that ensures that the lawyer is only a general creditor of the entity holding the deferred fee. Reading the IRS hypothetical, some practitioners may believe it is only attacking non-*Childs* fee structures similar to its hypothetical.

Perhaps, but it intimates that even the fee in *Childs* could be attacked, as it was in 1994, unsuccessfully. The IRS does not have the power to outvote the Tax Court or Eleventh Circuit, but it has the power to audit. The GLAM is lengthy, 25 pages single-spaced, and makes four arguments why a structure legal fee (at least the hypothetical one) 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. Section 409A was enacted in 2004 and took effect in 2005, a decade after *Childs*. It is highly complex and changed deferred compensation rules dramatically. The IRS's claim that this section applies to structured legal fees may have surprised the industry the most.

At its root, Section 409A says some compensation deferred under regular tax rules should nevertheless be currently taxed if it fails to comply with the multiple rules set forth in the section, or if the plan is not operated properly. 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 the time this Regulation was released 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. Nevertheless, the GLAM constructs the argument that legal fee structures—or at least the one in the hypothetical—are subject to Section 409A because adding a third party to the arrangement means it is no longer an amount deferred between the client and the lawyer. The GLAM invokes the Supreme Court's *Banks* opinion (also in 2005), which stands for the proposition that a payment of legal fees is *deemed* made by the client to his lawyer for tax purposes, even if the fee is paid separately.

In its substantive tax analysis, much of the IRS's discussion seems to rely on distinguishing its hypothetical from the facts in *Childs*' structured fee. The IRS may face bigger challenges if it seeks to apply its arguments to structures that more squarely line up with *Childs*. The IRS may advance its arguments against any fee structure, but ones like the hypothetical seem to be the primary target.

The GLAM suggests that on audit, the IRS may take a wholesale approach to attacking structured fees. Of course, like most tax returns, the vast majority of structured fees are never audited, and most, in my experience, are not even disclosed on tax returns. If the fee has been deferred, it is not income, so not reported on a return until it starts paying, when the 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 it does not seem likely that plaintiff lawyers (or tax lawyers) will be bowled over by the IRS's arguments. Still, some plaintiff lawyers may get cold feet, particularly if they think there is a possibility that they could be unable to get "their" fees and if the IRS could try to tax them *as if* they had collected a lump sum.

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. 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. A settlement in those cases often represents a compromise, and that could happen here.

Some industry pushback on the GLAM is also possible, particularly given the number of stakeholders potentially impacted by the IRS arguments, including large public 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 reprising the issues discussed in *Childs* to resolve the issues, at least for another period of relative calm.

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 arguments in the GLAM should cause the entire industry to dot their i's and cross their t's.

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