IRS Targets Structured Legal Fees 28 Years After *Childs*

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In this article, Wood and Brown examine a recent IRS generic legal advice memorandum, which they argue affects settled law regarding structured legal fees.

This discussion is not intended as legal advice.

It would be difficult to overstate the surprise of insurance companies, structured settlement providers, insurance brokers, and plaintiff lawyers over the IRS's December 9, 2022, generic legal advice memorandum (GLAM), AM 2022-007. The only prior known attack on structured legal fees came in 1994 when the IRS was rebuffed by the Tax Court in the seminal case of *Childs*.[1] The Tax Court's holding in *Childs*, affirmed by the Eleventh Circuit without opinion, resulted in the IRS leaving structured legal fees alone for almost 30 years.

The IRS never formally acquiesced in *Childs* but in the intervening years accepted it and occasionally cited it with approval.[2] An entire industry of insurance companies, structured legal fee brokers, and facilitators thrived in its wake so that contingent fee lawyers could get paid over time rather than in a lump sum. This settlement industry provides structured payouts for injured plaintiffs.

The IRS GLAM attacks issues that many thought were settled, affecting plaintiff attorneys who rely on structured fees to level the peaks and valleys of their income and plan for retirement. The GLAM does not directly call for *Childs* to be overturned nor does it address its facts. Rather, its hypothetical seems directed mostly at structured fees that differ from those considered in *Childs*. Even so, it seems a mistake to read it as targeting only fee structures that stray from *Childs*.

I. Reach of the GLAM

A GLAM is not binding on any taxpayer and does not necessarily represent the collective view of the IRS. It is essentially a research memo prepared by one or more IRS attorneys outlining their views on a topic. A GLAM is not authority on which a taxpayer can rely, unlike a revenue ruling or a tax case.

Most fee structures follow one of two basic models, an assignment structure modeled after *Childs*, or one based primarily on deferred compensation authorities. Although these other authorities do not directly address structured attorney fees like those in *Childs*, they provide

[1] *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996).

[2] *See, e.g.*, FSA 200151003; ILM 200110319; LTR 200836019.

guidance for when deferred compensation arrangements will be considered effective for tax purposes. Both types of structured fees are necessarily formal, erecting barriers so that the lawyer who is the ultimate payee of the arrangement does not own the structure, does not have a security interest, and cannot control it. In essence, the price tag for the lawyer being able to delay fee payments and attendant taxes is a formal structure that ensures that the lawyer is only a general creditor of the party making the payments.

AM 2022-007 deals with a hypothetical that differs in some respects from the *Childs* fact pattern. Some practitioners may believe the GLAM only targets the exact hypothetical, which does not directly emulate *Childs*. But the concerns generated by the GLAM do not appear to be limited to structures of any particular stripe. The life insurance companies that fund structured fees are generally a rather conservative group, and their structures are typically designed to follow *Childs* as closely as possible. Even though the structures they offer more closely mirror *Childs* than the structure in the hypothetical, insurers may be alarmed by the GLAM and what the general saber rattling may indicate.

Therefore, it is worth considering whether the GLAM's arguments should cause concern for any structured fee — even a copycat of *Childs*. The broader deferred compensation authorities are more nuanced than the rules that govern structured fees that rely directly on *Childs*. With the prevalence of *Childs*-based structures in the industry, we focus primarily on that analytical framework here.

II. Typical *Childs*-Based Facts

In a structured fee intended to closely emulate *Childs*, a plaintiff's attorney is entitled to receive a portion of the clients' recovery upon the resolution of their case. However, the attorney would prefer to receive the fee over several years to even out years of feast and famine (especially in anticipation of retirement) and to avoid having a massive tax bill in the year the case settles.

Therefore, before the case settles, the attorney, the attorney's client, and the defendant all agree to pay the fee in periodic payments (monthly, quarterly, etc.) over several years rather than as a lump sum at settlement. Neither the defendant nor the attorney's client is interested in holding onto the money for that long and having to make monthly payments themselves.

And after bitter litigation, no one is likely to trust the defendant to do that anyway. The same principle applies to structured settlements for plaintiffs, which have been well defined and approved in the tax law since the early 1980s. Indeed, that is how structured legal fees originated, with lawyers stretching out their receipt of fees and taxes, replicating the tried-and-true path used by their clients.

Hence, for structured legal fees directly following *Childs*, the defendant, with the consent of all parties, assigns the obligation to make the monthly payments to an assignment company and transfers an amount equal to the fee that the attorney would have been paid if the parties had not agreed to restructure the lump sum fee as periodic payments instead. When a settlement is paid through a qualified settlement fund (QSF), the assignment is typically made by the trustee or administrator of the QSF, who is generally treated as stepping into the shoes of the defendant for tax purposes.[3] The assignment company invests the transferred money and makes the periodic payments to the attorney as agreed in the settlement agreement on behalf of the defendant.

In *Childs*, the Tax Court and Eleventh Circuit held that this arrangement can successfully allow attorneys to defer their contingent fees until they actually receive the periodic payments from the assignment company, at least under the specific facts of that case. When the attorneys receive the periodic payments, they are still fully taxable as compensation. The structure does not allow attorneys to escape taxes but rather to stretch out their fees and to pay taxes when and as they receive installments.

[3] *See, e.g.*, reg. section 1.468B-4 (providing that distributions from QSFs are taxable to claimants in the same manner as if payment were received directly from the transferor (that is, the defendant or its insurer)); reg. section 1.468B-2(l)(2) (requiring section 6041 Form 1099 reporting for QSF distributions that are typically required of defendants for settlement payments); reg. section 1.6045-5(f), Ex. 9 (requiring section 6045 Form 1099 reporting for QSF distributions to attorneys that are typically required of defendants for settlement payments). *See also* Rev. Proc. 93-34, 1993-2 C.B. 470 (providing that a QSF generally steps into the shoes of the defendant and is considered "a party to the suit or [settlement] agreement" for purposes of establishing qualified assignments of structured recoveries under section 130).

This is precisely the same model on which structured settlements for injured plaintiffs are based. Structured settlements allow physically injured plaintiffs who are settling lawsuits to receive tax-free income over a period of years or for the duration of their lives. The Periodic Payment Settlement Act of 1982 codified these tax benefits for injured plaintiffs.

As the years elapsed, insurance companies began offering parallel products for non-physical-injury plaintiffs. That way, they too could decide whether they wanted a lump sum or periodic payments before signing a settlement agreement. For those fully taxable structured settlements, the plaintiff pays tax on each periodic payment when received, including the amount of the investment return facilitated by the annuity arrangement. The IRS approved those taxable structured settlements for plaintiffs in LTR 200836019 for documents that emulated the *Childs* structured fee. The IRS even cited *Childs.*

For the lawyer and the non-physically-injured plaintiff, there are two tax savings. First, the payments may be taxable at lower marginal tax rates on account of being spread out over multiple years. Second, the settlement proceeds can be invested with the assignment company on a pretax rather than a post-tax basis. For 28 years, these issues for structured legal fees have been uncontroversial.

III. The IRS's Hypothetical

The IRS's hypothetical in AM 2022-007 is reminiscent of the structured legal fee in *Childs*, but there are potentially meaningful distinctions. In *Childs*, the obligation to pay the attorneys' periodic payments is in the settlement agreement executed by the defendant and plaintiff. The obligation to pay the attorneys in installments is first borne by the defendant (or its insurer) and agreed to by both the defendant (or its insurer) and the plaintiff through the settlement agreement. The arrangement with the third-party assignment company is consequently an arrangement in which the assignment company assumes a periodic payment obligation that is owed by the defendant.

The GLAM's facts do not follow this structure. Instead of agreeing to make periodic payments to the attorney, the defendant simply agrees to make a lump sum payment to a recipient or recipients of the attorney's designation. Before executing the settlement agreement, the attorney decides to structure his fee and enters into an agreement with a third-party assignment company of his choosing. Often, this arrangement involves the attorney formally assigning his right to receive the lump sum fee to the third-party assignment company. In the hypothetical, the attorney's right to receive periodic payments is not reflected in the settlement agreement or seemingly in other documents signed by the plaintiff or the defendant. Under the settlement agreement in the hypothetical, the plaintiff's attorney is owed only a lump sum payment, not periodic payments, except by virtue of the deferral agreement with the third-party assignment company.

In the IRS's hypothetical, the attorney instructs the defendant to pay a portion of the lump sum payment to the assignment company. Neither the plaintiff nor the defendant agrees to the attorney's periodic payments, and the defendant was never obligated to make the periodic payments. Unlike *Childs*, there is no assignment between the defendant and the third-party assignment company. The defendant cannot assign any obligation to make periodic payments to the assignment company because the defendant does not have an obligation to make periodic payments.

The defendant does not assign its obligation to make the lump sum payments to the assignment company because that would be pointless; those obligations are already fully satisfied by the act of paying the assignment company as directed by the attorney or as a result of the attorney's assignment. These changes to the *Childs* facts seem important to the IRS, although the hypothetical is not entirely clear on all points of timing and other details. Ideally, structured legal fees are agreed to by the client and defendant in a settlement agreement and/or in assignment documents.

IV. The GLAM's Four Arguments

The IRS makes four arguments for why the hypothetical structured fees should fail, based on the anticipatory assignment of income doctrine, the economic benefit doctrine, section 83, and section 409A. The arguments are complex, and it is easy to get lost in the weeds, so a review might help before we address each one:

- The assignment of income doctrine says that the party who earns income should be taxed on it, and transactions that shift income to someone else will be recharacterized.
- The economic benefit doctrine recognizes that not all payments are made in cash. Payment might be made in property or as an interest in a trust, account, or fund set aside for the taxpayer. The economic benefit doctrine defines what types of interests are secured or "set aside" and taxable for that reason.
- Section 83 codifies the economic benefit doctrine for payments of property for services. Most commonly, section 83 is used to determine when an employee or independent contractor is treated as receiving equity-based compensation that is subject to restrictions and/or vesting.
- Section 409A regulates deferred compensation. It was enacted in 2004 in response to perceived abuses by highly compensated executives who deferred their compensation. Deferred compensation arrangements that do not satisfy section 409A's requirements are subject to taxes and penalties. Companies make great efforts to ensure that their deferred compensation arrangements (including equity-based compensation) are either exempt from section 409A or in compliance with it. If they fail to do so, there are accelerated taxes and big penalties.

V. Assignment of Income

The GLAM's assignment of income doctrine discussion hinges on the distinction between arrangements that delay when income is recognized with attempts to change who must recognize it. Arrangements that merely delay timing are usually unaffected by the assignment of income doctrine. Other doctrines (for example, constructive receipt, cash equivalency) might apply, but deferral is not the sin the assignment of income doctrine seeks to correct.

The assignment of income doctrine prevents shifting tax you owe to someone else. If your employer owes you compensation, but your employer pays your landlord or lender directly at your request, it is still taxed to you. Even though you never received the money, you earned it, and you are the one who owes your creditors. Under the assignment of income doctrine, you are treated as if you received the payment and then used it to pay your landlord or lender.

Assignments of income occur in other contexts too. Relatives try to assign income to friends and relatives as gifts. Taxpayers try to assign income to charities. Companies try to assign income to their owners or vice versa. The assignment of income doctrine determines when those assignments should be respected — and when the assignor must still pay tax on the income.

But a structured fee is not an arrangement to make someone else pay tax on the fees. It defers when the attorney receives and must recognize the fee as income. No one else is paying tax on the fees. The GLAM attempts to cast structured fees as shifting income, focusing on the payment from the defendant (or its insurer) to the assignment company. By cropping out all the other fundamental parts of the structured fee arrangement, the IRS suggests there is a taxable assignment of income.

Intrinsically, the GLAM relies on the fact that in the hypothetical, the attorney is owed an immediate lump sum payment under the settlement agreement. Consequently, the GLAM analogizes the attorney assigning or directing that the lump sum payment be made to the third-party assignment company to a taxpayer directing that their salary be paid to someone else in a typical assignment of income fact pattern. But the payment to the assignment company does not shift income to the assignment company. The GLAM says the structured fee arrangement affects who should be taxed, but it is still the attorney who is being taxed on the fee income, just later.

VI. Application to a *Childs* Structured Fee

Outside the GLAM hypothetical, trying to apply the assignment of income doctrine to *Childs* structured legal fees falls flat. The assignment of income doctrine requires the taxpayer to have made an assignment of their income. A *Childs* structured legal fee fails to satisfy even this most basic factual prerequisite.

In a *Childs* structured legal fee, the attorney is only receiving periodic payments owed on the schedule provided in the operative settlement agreement. The attorney has not assigned income to anyone, the attorney is the party who earned it, and she is the party who receives the periodic payments.

In a *Childs* structured legal fee, it is the defendant (*or their insurer*) who has assigned their obligation to make the periodic payments. The attorney may consent to the defendant's assignment of their payment obligation (and concomitant payment to the assignment company), but the attorney has not assigned any right to payment or directed that any amount be paid to the assignment company. Without any assignment or direction of payment by the attorney, there is no assignment of income.

Consequently, the IRS's arguments regarding the assignment of income doctrine present a significantly weaker threat to *Childs* structured legal fees than to fee structures in which the attorney is formally instructing, assigning, or designating that a lump sum fee obligation be paid to the third-party assignment company. That does not necessarily mean that non-*Childs* structures run afoul of the assignment of income doctrine, no matter what the GLAM suggests. The fundamental purpose of non-*Childs* structures is also to defer when an attorney receives income, not to shift tax on the income to someone else.

Still, structures that more closely follow *Childs* may have an easier time defeating the IRS's arguments. In *Childs*, there is simply no assignment by the attorneys in the first place to serve as a trigger for the assignment of income authorities.

VII. Economic Benefit

The economic benefit doctrine treats a taxpayer as receiving income when money or property is "set aside" for the taxpayer's benefit, beyond the reach of creditors. In its haste to reach its desired conclusion, the GLAM glosses over what it means to set aside funds for the benefit of a taxpayer. Removing the funds from the reach of the original obligor's creditors is a requirement of the economic benefit doctrine, but it is not the only requirement for setting aside funds, as that term has been understood.

Setting aside property or cash for an obligee requires more than transferring funds to a third party, particularly when the third party is the assignee of the original obligor's obligation to make payments to the obligee. The funds must be set aside by the third-party assignee for the exclusive benefit of the taxpayer. When the funds or property transferred to a third party are not set aside for the exclusive benefit of a taxpayer and instead become comingled with the third party's other assets, the promise to make future payments to the taxpayer remains unfunded and does not confer an economic benefit on the taxpayer.

The exclusivity requirement is apparent throughout the economic benefit authorities. *Sproull*,[4] heavily cited in the GLAM, involved money transferred to a trust set up solely for the taxpayer. In *Drescher*,[5] also heavily cited in the GLAM, an employer bought annuity contracts listing the taxpayer as the sole annuitant. These cases involved situations in which funds or property were specifically set aside for the sole benefit of the taxpayer. Correctly, the courts held that the taxpayer had received an economic benefit.

The IRS has acknowledged this. In LTR 200836019, the IRS described *Sproull* and the economic benefit doctrine: "A taxpayer is treated as receiving the current economic benefit of future payments when a payor unconditionally and irrevocably *establishes a separate fund or trust of assets exclusively for the taxpayer's benefit*. *Sproull*, 16 T.C. at 248." (Emphasis added.) In LTR 200836019, as in most structured legal fees — including both the *Childs* case and the GLAM hypothetical — no such exclusive trust or fund was created.

In both the *Childs* fact pattern and the GLAM hypothetical, the payment to the assignment company or other third party becomes part of the third party's general assets, and the recipient of the periodic payments only has the rights of a general creditor to the third party's assets. In LTR

[4] *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

[5] *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950), *cert. denied*, 340 U.S. 821 (1950).

200836019, the IRS ruled that there was no economic benefit conferred on the recipient of the periodic payments by the transfer of funds to an assignment company by a defendant that was obligated to make the periodic payments.

LTR 200836016 was and is important, but it is not an exception to the IRS's established interpretation of *Sproull* and other economic benefit cases. In fact, in 1998 the IRS issued LTR 9808002, in which, citing *Sproull*, the IRS described the economic benefit doctrine: "Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the taxpayer's sole benefit."

Consistent with these long-standing interpretations, the IRS has repeatedly found no economic benefit when cash or property was not set aside exclusively for the benefit of the taxpayer. For example, in Rev. Rul. 79-220, 1979-2 C.B. 74, the IRS considered a fact pattern similar to *Drescher*. But, unlike in *Drescher*, the parties did not directly name the taxpayer as the annuitant.

Instead, a third-party assignment company was named the annuitant, and the annuity payments were payable to the assignment company, not specifically set aside for payment to the taxpayer. The taxpayer only had the rights of a general creditor against the third-party assignment company, that is, the taxpayer had no secured or beneficial interest in any assets set aside by the third-party assignment company. Because the annuities were not set aside exclusively for the benefit of the taxpayer by the third party, the IRS ruled that there was no economic benefit conferred by the annuities.

Similarly, in Rev. Rul. 72-25, 1972-1 C.B. 127, an employer purchased annuities to provide income to make periodic payments to an employee. The employer was the named annuitant, not the employee. Consequently, there was no economic benefit conferred on the employee.

The GLAM inventively suggests that the economic benefit doctrine only asks whether the assets are separated from the assets of the *original* obligor (notably, the defendant required to make the settlement payment), with no concern for the relationship between the attorney and the assets of the third party. Under the IRS's novel interpretation, the fact that a payment is made to the third party is per se sufficient to confer an economic benefit on the attorney.

VIII. *Childs* Structured Fee Arrangement

In a structured legal fee arrangement emulating *Childs*, the defendant does have the obligation to make the periodic or future payments, and the defendant does assign those obligations to the third-party assignment company. Therefore, the authorities discussed earlier would be applicable, and the IRS would be unable to reject them as it tries to do under the GLAM hypothetical.

A structured legal fee following *Childs* does not have the assignment company set aside any assets exclusively for the benefit of any single attorney. A structured legal fee arrangement following *Childs* does not involve the assignment company granting a security interest to the attorney. Therefore, under the authorities discussed earlier concerning payments made through assignees, there is no economic benefit conferred, as the IRS's own rulings repeatedly confirm.

The GLAM suggests that a transfer to a third party is per se an economic benefit. Yet this is flatly inconsistent with many economic benefit authorities in which there is an express or de facto assignment to an assignee of obligations to make future or periodic payments. *Sproull* involved the transfer of property to a third-party trustee under a trust established solely for the benefit of the taxpayer.

Rev. Rul. 79-220 involved a third-party assignment company. The IRS clearly cared about who had rights in the annuities held by the third-party assignment company in the ruling. LTR 200836019 also involved a third-party assignment company, and the IRS held there was no economic benefit precisely because of how the assignment company held its assets and the rights of the taxpayer vis-a-vis the assignment company.

And then, perhaps most important of all, there is *Childs*. The GLAM claims that *Childs* has no bearing on the assignment of income and economic benefit analysis, saying that *Childs* only addressed section 83. Yet section 83 is widely understood to be a codification of the economic benefit doctrine.[6] As such, any authority interpreting section 83 bears directly on the economic benefit doctrine. The GLAM tries to deflect this point, noting that some cases decided after the enactment of section 83 still discuss the economic benefit doctrine without mentioning that section. The economic benefit doctrine is still treated as distinct in matters not directly governed by section 83 (that is, matters not relating to paying compensation for services with property).

Yet *Childs* unambiguously addresses the now-codified economic benefit concepts of whether a promise to pay is funded or unfunded, and what types of rights constitute property. *Childs* may be a section 83 case, but it is also an economic benefits case. It addresses facts similar to those in LTR 200836019, which involved deferred, taxable periodic payments from a settlement paid through a third-party assignment company. LTR 200836019 explicitly identifies and applies the economic benefit doctrine and the *Childs* case.[7]

Under the IRS's own authorities, the economic benefit doctrine and *Childs* go hand in hand. Therefore, any analysis of the economic benefit doctrine and structured legal fees that fails to wrestle with *Childs* is substantively deficient. Particularly for structures that follow *Childs*, the IRS will have a difficult time distinguishing the long line of authorities that directly addresses situations in which a payer assigns a payment obligation to a third-party assignee.

These cases strongly support the view that the assignment does not bestow an economic benefit on the eventual recipient of the payment as long as the assignee of the payment obligation does not set aside funds solely for the future payment. For structured fee arrangements that hew to *Childs*, the IRS could conceivably try to modify 77 years of economic benefit doctrine authorities. The IRS could seek to treat all transfers to third-party trustees and assignment companies as per se economic benefits.

But the IRS would have a very heavy lift ahead of it. The agency could even try to revoke 40 years of its own interpretations and rulings involving the economic benefit doctrine and payments made through third-party assignment companies. However, it would be inaccurate to describe the GLAM's analysis as describing the current state of the law.

IX. *Childs*, the Elephant in the Room

The GLAM next turns to the application of section 83. Even by the GLAM's own admission, *Childs* is a section 83 case. Thus, it is unsurprising that the protective Teflon-like power of *Childs* for structures that emulate it is most pronounced when considering the IRS's section 83 arguments.

A. *Banks*

Suggesting that the tax laws have changed since *Childs*, the IRS first suggests that the Supreme Court's 2005 *Banks*[8] decision fundamentally weakens its hypothetical facts' ability to avoid triggering income recognition under section 83. This argument seems hard to follow. *Banks* held that for tax purposes, amounts paid to an attorney as a contingent fee are treated as paid by the attorney's client who owes the fee, even if payment is made directly by the defendant.

Banks is an assignment of income case, ensuring that plaintiffs cannot avoid recognizing income on amounts retained by their counsel for contingent fees. Under *Banks*, plaintiffs must recognize 100 percent of their gross recoveries[9] and then to the extent allowable, deduct or capitalize the portion paid to their attorneys so that the plaintiffs hopefully only owe tax on their

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[6] *See, e.g.*, IRS, "Nonqualified Deferred Compensation Audit Technique Guide," Publication 5528, at 6 (rev. June 1, 2021) ("IRC section 83 codified elements of the economic benefit doctrine by providing that, generally, if property is transferred to a person as compensation for services, such person will be taxed at the time of receipt of the property when it is either transferable *or* not subject to a substantial risk of forfeiture.") (emphasis in original); Thomas A. Brisendine, Elizabeth Drigotas, and Thomas R. Pevarnik, "Deferred Compensation Arrangements," BNA Portfolio 385, Section VII.D ("Section 83, which lays out rules for the taxation of transfers of property in connection with the performance of services, is widely regarded as a codification of the economic benefit doctrine that had emerged in the cases discussed above. The perceived problem leading to its enactment was the absence of rules (under pre-1969 law) governing the tax treatment of restricted stock plans.").

[7] *See* Robert W. Wood, "Nonqualified Settlement Ruling Spurs Damage Structures," *Tax Notes*, July 14, 2008, p. 141.

[8] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[9] Except, of course, to the extent they can properly exclude the recoveries from their gross incomes under section 104 or on another basis.

net recoveries. It is a terribly important case, but *Banks* has no obvious bearing on taxes for the attorneys, who were not the taxpayers in *Banks*.

If anything, *Banks* supports the ability of lawyers to structure their fees. Many of the IRS's arguments in the GLAM, particularly about section 409A, discussed later, turn on the formal (even hyper-formal) identity of the parties to the deferral. In *Childs*, the deferral is created in the settlement agreement signed by the defendants and the plaintiff. In the GLAM hypothetical, the deferral is created by the attorney and the third party separately, without the formal participation of the defendant or the plaintiff. On multiple points, the GLAM suggests this change is meaningful.

However, under *Banks*, attorney fees paid to the attorney are deemed paid first to the plaintiff, and the plaintiff is then considered to pay the attorney the fee. Arguably, the plaintiff is deemed to be involved in all fee deferrals under *Banks* because the plaintiff is the constructive payer of the fee, even if the plaintiff is not formally a signatory of the deferral documents. That argument suggests a wide-ranging reading of *Banks*, but for now, it suffices to say that *Banks* does not prejudice attorneys with structured fees as the GLAM suggests. If anything, *Banks* helps them.

Even under the GLAM's analysis, the effect that the IRS suggests *Banks* is supposed to have on the IRS's analysis is vague. Legal fees are taxable to the attorneys regardless of whether the payment is considered received directly from the defendant, from the defendant's insurer, or directly from the plaintiff (or directly from the assignment company for a structured fee, for that matter). *Banks* does not directly address any timing issues for income recognition. It only asks the question of who is taxable on the attorney fees, a point that is uncontroversial for attorneys who are being paid fees.

Still, the GLAM sprinkles in a bevy of citations and footnote commentary meant to suggest that the underpinnings of structured attorney fees somehow collapsed after the *Banks* case, dawning a new tax world for structured legal fees. However, these vague overtures to the potential effect of *Banks* have little bearing on structured fees, especially ones emulating *Childs*.

In a *Childs* structure, the defendant is readily viewed as agreeing to make the periodic payments on behalf of the plaintiff. It is the plaintiff, after all, who has the underlying obligation to pay the attorney's fee. The defendant sends the attorney the checks, but these are indirect payments to the plaintiff. All of this seems perfectly consistent with *Banks*. Is it the defendant who is considered to agree to the periodic payments in the settlement agreement or the plaintiff? It may be both because they are both signatories of the settlement agreement. In any event, it does not appear to matter whether *Banks* considers the fees paid by the defendant or the plaintiff.

Banks does not affect much of the analysis in the GLAM hypothetical either. Even under the IRS's scenario, neither the defendant nor the plaintiff were formal parties to the deferral agreement between the attorney and the assignment company. In both a *Childs* fact pattern and under the IRS's hypothetical, the defendant and the plaintiff sign (or do not sign) the same documents. It just is unclear why *Banks* could alter the outcome in either situation. The fact that the IRS limited its discussion of *Banks* to asides and footnotes may suggest that it is not quite certain either.

B. Section 83

After going around Robin Hood's barn, the GLAM must address the *Childs* holding. The players in *Childs* can be confusing, and as a refresher, there were four insurance companies involved. Two were defendants (Stonewall Insurance Co. and Georgia Casualty & Surety Co.), one was the third-party assignment company (Executive Life), and one was a wholly owned subsidiary of Executive Life that issued the annuities (First Executive). In the GLAM hypothetical, the defined insurance company refers solely to the defendant insurance company, not the third party involved with the fee deferral.

Childs (which involved three lawyers who structured their fees) addressed two different structured fees. In one, a defendant insurance company (Stonewall) purchased annuities to pay for its periodic payments to the plaintiffs' attorney. In the other, the defendant insurance companies (Stonewall and Georgia Casualty) assigned their payment obligations to the third-party assignment company (Executive Life, also an insurance company). Then, the assignment company purchased the annuities (from First Executive, its subsidiary) to fund the periodic payments to the attorney.

Childs approved of both structured fees, concluding that both constituted unfunded promises to pay vis-a-vis the attorney for the purposes of section 83. Most attorney fee structures emulating *Childs* rely on the favorable holding regarding the latter of the two structures. That one involved an assignment to Executive Life as a third-party assignment company, a payment to Executive Life from the defendants, and investment assets acquired by Executive Life.

For structured fees that emulate *Childs*, the analysis here is at the most straightforward. *Childs* expressly approved structured fees under section 83, and any structured fee that is not materially distinguishable from the structures approved in *Childs* can continue to take comfort from it. Even if the GLAM can be read as attacking *Childs* directly, an internal IRS memo simply does not overturn a Tax Court opinion, much less one affirmed by the Eleventh Circuit.

Rather than attack *Childs* directly, the IRS's hypothetical deviates from its facts. The GLAM's facts do not involve an assignment of a periodic payment obligation by a defendant to an assignee; it involves an attorney unilaterally instructing a defendant to make a lump sum payment to a third-party structure company (which in practice is typically done in conjunction with the attorney formally assigning her right to receive the lump sum payment to the assignment company). This does not mean the IRS is correct even on its hypothetical.

However, it may provide sufficient factual differentiation to support the argument that *Childs* may not directly control the outcome of the hypothetical. Distinguishing *Childs* could allow the IRS an opportunity to argue whether non-*Childs* structured fees trigger income under section 83. That does not mean the IRS has carte blanche.

Indeed, as discussed, deferred compensation-based structures find support in many deferred compensation authorities that do not directly address structured attorney fees. Companies that follow deferred compensation-based structured fees are not relying solely on *Childs*. Therefore, for deferred compensation-based structures, the factual distinctions that may be made from *Childs* may provide the IRS with an opportunity to address these other deferred compensation authorities in the structured fee context. Yet even if the IRS is able to distinguish a case from *Childs*, that is clearly not itself a checkmate for the IRS.

C. Reg. Section 1.83-3(e)

The GLAM then attempts to argue a different passage in the regulations under section 83. The second sentence of reg. section 1.83-3(e) provides that "property" includes "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example in a trust or escrow account." This sentence immediately follows the sentence that *Childs* directly addressed: "The term 'property' includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."

Yet *Childs* held that:

> The fair market values of [the attorneys'] rights to receive payment under the settlement agreements *were not includible in income under sec. 83, IRC*, in the year in which the settlement agreements were effective, since the promises to pay under the structured settlements were neither funded nor secured and *thus did not meet the definition of property for the purposes of sec. 83*.[10] [Emphasis added.]

Thus, *Childs* did not limit its holding to the first sentence of reg. section 1.83-3(e). *Childs* answers the question presented under the entirety of section 83, not just any one sentence. The sentence the IRS singles out was in the regulations when *Childs* was decided by both the Tax Court and the Eleventh Circuit when it unambiguously provided guidance on what constitutes property under section 83.

Indeed, this specific question was already answered by *Childs* when it held that the

[10] *Childs*, 103 T.C. at 635.

structured fee agreements "did not meet the definition of 'property' for the purposes of Section 83."[11] Note here, too, that the court says "for the purposes of Section 83," not just "for the purposes of the first sentence of Section 1.83-3(e)." The GLAM's attempted hairsplitting on this point fails as a matter of common English and under the plain language of the *Childs* court's opinion.

In short, the Tax Court and Eleventh Circuit already answered the questions affected by the GLAM's newly identified sentences, at least for structures emulating *Childs*. The IRS picks a different sentence in the section 83 regulations, trying to suggest a new line of attack not covered by *Childs*, but the *Childs* holding covers the newly cited language too. Even if one ignores the fact that *Childs* expressly addressed this question, the GLAM's substantive analysis falls short.

In structures that hew to *Childs*, the defendant pays the assignee to assume its contractual obligation to make future payments to the attorney. In the GLAM hypothetical, the attorney directs the defendant to make a lump-sum payment to a third party that has agreed to make the future payments.

In the first case, all the attorney receives is a right to enforce the assignee's promise to satisfy the obligation it has assumed. In the second, the attorney receives nothing more than the right to enforce the third party's free-standing promise to make the periodic payments. In both cases, these are simply contractual rights that represent personal obligations of the respective obligors.

In neither case does the plaintiff acquire any "beneficial interest" in any money or assets of the new obligor, including the money or assets paid by the defendant. Beneficial interest denotes a property interest, not a mere contractual promise. The regulation's examples describe transfers of money or assets to a trust or escrow — that is, an arrangement in which legal title to property is vested in a fiduciary who is to hold the property for the benefit of the person or persons with the actual beneficial interests therein.

It is true that the defendant's payment puts assets beyond the reach of its creditors. But so does any commercial payment. What matters under reg. section 1.83-3(e) is whether the attorney obtains a beneficial interest in the transferred assets. And this question is already asked and answered in the attorney's favor in *Childs*.

The attorney in the transactions considered here plainly does not. This is another aspect of the fact that the attorney is simply an unsecured creditor of the assignment company or the third-party promisor. The attorney holds merely a personal claim against the defendant's transferee. The attorney does not have a beneficial interest — or even a security interest — in any of the transferee's money or assets. Thus, the GLAM's assertion that "Taxpayer received a beneficial interest in money that had been set aside from the claims of creditors of the Insurer and the Client" falls wildly wide of the mark.

The GLAM posits that for the purposes of the second sentence in reg. section 1.83-3(e), a transferor means only the defendant. That way, the IRS says, a payment to the assignment company per se qualifies as a transfer to a third party, triggering income recognition under section 83. If this interpretation sounds familiar, it's because it's the same argument the IRS made about the economic benefit doctrine considered earlier.

But it is just as hard to swallow when considering section 83 as it was under the economic benefit authorities. Indeed, *Childs* addresses this point — and not in the IRS's favor. The *Childs* court effectively treated Executive Life (the third-party assignment company) and its subsidiary, First Executive, as stepping into the shoes of the defendants, Georgia Casualty and Stonewall, when Executive Life assumed the obligation to make the periodic payments to the attorneys.

Consequently, in its section 83 analysis, the Tax Court effectively treated Executive Life and First Executive as being the agent or successor to the defendants regarding the periodic payment:

> Under this Assignment and Assumption Agreement, petitioners agreed that they were to have no rights against First Executive other than the rights of a general creditor. Since petitioners did not own the policies and since First Executive had the right to change the annuitant or

[11] *Id.*

> beneficiary of each policy without the consent of the annuitant, the promise to pay petitioners under the Garrett litigation structured agreement were not funded promises by the obligors, Georgia Casualty and Stonewall.[12]

In the last sentence of this excerpt, the Tax Court expressly acknowledged that the defendant insurers, Georgia Casualty and Stonewall, were the original obligors of the settlement payment. Still, the quoted passage does not look to the transfers and the relationship between the defendants and Executive Life or First Executive. Instead, the Tax Court looks to the relationship and rights existing between the attorney and First Executive, which was the subsidiary of the assignment company, Executive Life.

Essentially, once Executive Life assumed the obligation to make the periodic payments to the attorney, the Tax Court analyzed the relationship between the attorney and Executive Life and its subsidiary, First Executive. In so doing, *Childs* effectively adopts the same type of analysis used by the economic benefit doctrine cases involving payments made through assignees discussed earlier. This is not unexpected because section 83 is a codification of the economic benefit doctrine, and it further highlights the artificiality of the distinction the IRS attempts to draw between the economic benefit doctrine and section 83.

Notably, the court tracked the same analysis it pursued concerning the relationship between the attorney and the defendant Stonewall for the structure funded directly by Stonewall. This should also not be surprising. A defendant or other payer can choose to outsource its obligations to make a payment to an assignee, agent, payroll company, etc. That outsourcing should not generally affect the tax treatment of that payment to the recipient of the payment. The Tax Court implicitly acknowledges this in its analysis.

The IRS has similarly dismissed changes in payers as a result of a formal assignment of payment obligations as being largely inconsequential in its own rulings and analysis. As noted previously, one key ruling, not expressly involving a structured legal fee, was LTR 200836019. This ruling involved a nonqualified assignment of a taxable recovery by a plaintiff designed to emulate the *Childs* structured fee.

The IRS approved of this arrangement, and LTR 200836019 (at the time and since then) was viewed as approving carefully documented structured settlements and, indirectly, also structured legal fees that follow a similar path.[13] The letter ruling (applying the economic benefit doctrine) contains the following conclusion: "After the execution of the Non-Qualified Assignment, the taxpayer will possess only a mere promise to be paid (*although the identity of the promisor will have changed*)." (Emphasis added.) When an obligation to make a periodic payment is assigned to a new payer, the change in the payer is typically a mere parenthetical in the IRS's analysis.

This is a far cry from the IRS's new assertion that transfers to third parties per se trigger both section 83 and the economic benefit doctrine. Perhaps the GLAM means to apply its per se analysis only to arrangements in which there is not a formal assignment between the original payer and a third-party assignee. However, if that is the case, the GLAM is not as clear on the intended limitations of its analysis as it could be, thereby creating potentially undue alarm for taxpayers who follow *Childs* closely with their structured fees.

In any event, even if a court were to give the IRS a fresh bite at the section 83 apple under the sentence in the regulations the GLAM now identifies, it would not change the outcome. Other terms used in the regulation also present difficulties for the IRS. Notably, the regulation says, "transferred or set aside." This phrase harks back to the long line of (supposedly distinct) economic benefit cases addressed earlier.

As those economic benefit cases confirm, property is not considered set aside for purposes of an economic benefit analysis (nor, by implication, under section 83) if it is transferred to an assignee that does not itself set it aside in a trust or fund exclusively for the benefit of the

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[12] *Id.* at 651.

[13] For contemporaneous discussion of the importance of this ruling, see Wood, *supra* note 7.

eventual recipient or grant the eventual recipient any sort of security or beneficial interest in the property. It seems hard to argue otherwise.

This line of analysis also touches on the question whether structured fees are considered funded or unfunded. Once again, this point is directly addressed in the taxpayers' favor in *Childs*. The regulation even references trusts or escrow accounts, alluding to the same line of authorities under the economic benefit doctrine (particularly *Sproull*, an influential economic benefits case that involved a payment to a trust).

The assignment company in a *Childs* structure is not creating a trust or escrow account solely for the benefit of any single attorney. The GLAM invents an artificial distinction between section 83 and the economic benefit doctrine, but it fails to recognize that the language in selectively quoted passages in the section 83 regulations invoke and summarize a long line of authorities under the economic benefit doctrine that stretches back decades. These authorities make clear that transfers to assignees of payment obligations do not per se trigger an economic benefit to the taxpayer. They are unfunded promises to pay under section 83 as long as the assignment company does not itself set the transferred assets aside or otherwise earmark them solely for the benefit of the taxpayer.

X. Section 409A Exemption

With all the surprises in the GLAM, arguably the biggest relates to section 409A. Congress enacted section 409A in 2004 to take effect in 2005, imposing limits on deferred compensation arrangements. The GLAM notes that there is an exception to section 409A for most deferred compensation plans involving payments to independent contractors. The requirements for this broad exclusion from section 409A can be found in reg. section 1.409A-1(f)(2).

Even for the tax code, section 409A is doubly complex, and the regulations are labyrinthine. Fortunately, their application to structured legal fees is mercifully simple. Since section 409A was enacted and the regulations were released in 2007, it has been widely understood that attorneys structuring their contingent legal fees generally qualify for the independent contractor exception. Under this exception, nearly all lawyers who have two or more significant clients are entirely exempt from section 409A on their fee agreements.

The relationship between an attorney and an unrelated client is a quintessential example of an independent contractor-client relationship. Still, the GLAM argues that section 409A does apply to structured legal fees, or at least to its specific hypothetical legal fee, with a raft of accelerated income and penalties. The GLAM's angle of attack for the independent contractor exception is its requirement that the deferral plan be "between a service provider and service recipient." Essentially, in the context of a structured legal fee, the IRS's view appears to be that the structured legal fee must be an arrangement agreed to directly by the attorney and the client to avoid section 409A.

In the GLAM, the attorney's client does not appear to formally agree to the deferred fee. The client apparently signs only a settlement agreement that provides for a single, immediate lump sum payment of the legal fee to the attorney. Instead, the structured fee is created unilaterally by the attorney and the third-party structure company, potentially even without the client's knowledge. Again, the hypothetical is somewhat ambiguous about some details concerning knowledge, consent, and timing.

Does this mean the GLAM hypothetical does not qualify for the independent contractor exception for section 409A? The GLAM asserts that the fact that the plaintiff does not formally sign any document establishing the periodic payments means that the structured fee is not "a plan between a service provider and service recipient" to defer the payments owed to the independent contractor. This analysis seems artificially narrow.

First, the IRS limits its analysis of the "plan" to only the deferral agreement executed by the attorney and the third-party assignment company. Section 409A's definition of a plan is not so narrow, according to section 409A's regulations. Reg. section 1.409A-1(c) instead broadly provides that a plan for the purposes of section 409A includes "any agreement, method, program, or other arrangement, including an agreement, method, program or other arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers or service provider representatives."

For deferred compensation-based structured fees, the overall method or program for implementing a structured fee requires much more than just the deferral agreement executed by the attorney and the structure company. It also typically involves an assignment of the attorney's right to the lump sum payment to the assignment company (which is provided to the defendant and/or the plaintiff). It involves the negotiated terms in the settlement agreement that provide for payment to the assignment company, or at least under an assignment agreement or the attorney's instructions (which settlement agreement is signed by the plaintiff and the defendant). Some attorneys even sign fee agreements with their clients at the outset that contemplate payment via a structured fee, though not containing the particular payment details (amount and dates) that would typically be found in a settlement agreement. These other components do involve the knowledge or even cooperation of the defendant and plaintiff.

Moreover, in the GLAM hypothetical, given the language in the settlement agreement, the payment instructions provided by the attorney, and the overall timing of events, it strains credulity to assume that the defendant and the plaintiff were not aware that the attorney was structuring her fee when they signed the settlement agreement. Once the term "plan" is given the more natural, broader interpretation required under section 409A's regulations, it is not at all clear that the defendants or the attorney's client in the GLAM hypothetical were not parties to the deferral plan for purposes of section 409A. It seems hyper-literal to say that the fact that an attorney's client did not sign any particular item of paperwork means that a structured attorney fee is no longer fundamentally a deferral of a payment of a fee owed to an independent contractor by a client and deemed paid by the client under *Banks*.

Indeed, if the fee isn't a deferral of a payment to an independent contractor for services, then what is it? The GLAM suggests that we should have blinders on and are limited to looking at the relationship between the attorney and the assignment company because the assignment company is the other party to the deferral agreement in the IRS's hypothetical. Of course, the attorney is not an employee or independent contractor of the assignment company. If, wearing the blinders the GLAM suggests are required, the periodic payments paid to the attorney are not payments to an employee or an independent contractor, then perhaps the payment should not be considered compensatory and not be subject to section 409A in the first place.

After all, the attorney did not perform services for the assignment company and is not being compensated by the assignment company for its services. Clearly, the IRS would not agree with that, nor likely would many tax practitioners. Still, the GLAM suggests that the obviousness of the fee being compensation owed and paid by a plaintiff to an attorney should be recognized for the purposes of treating the fee as compensation generally subject to section 409A but then ignored for the purpose of determining whether it is a payment to an independent contractor. This seems an inconsistent and outcome-driven framework for applying section 409A.

XI. Section 130

In any event, the IRS and Treasury have regularly disregarded those points when evaluating deferred payments. A good example can be found in a closely related area concerning structured settlements. When Treasury regulations created QSFs in 1992[14] to help facilitate the allocation and distribution of settlement payments among plaintiffs, it soon became apparent that QSFs might have difficulty facilitating plaintiffs' desires to structure their recoveries under section 130.

Section 130(c)(1) requires that the assignee of the obligation to make periodic payments to a plaintiff in a structured recovery "assumes such liability from a person who is a party to the suit or [settlement] agreement." However, QSFs are typically not parties to the underlying lawsuit and sometimes not to the settlement agreement. It was clear that the purpose of section 130 and the QSF

[14] *See* T.D. 8459 (promulgating reg. sections 1.468B-1 through -5).

regulations was served by a QSF being able to enter into qualified assignments under section 130 for plaintiffs. But there was concern that the IRS could invalidate an assignment executed by a QSF if the IRS applied a strict reading of section 130.

In 1992 and 1993 the IRS realized that this strict reading would distort and misapply the intended scope and purpose of section 130 and the QSF regulations. Therefore, within about a year of the QSF regulations, the IRS issued Rev. Proc. 93-34, 1993-2 C.B. 470. That revenue procedure provides that QSFs in nearly all cases can be treated as parties to the underlying suit or settlement agreement for the purposes of section 130.

XII. Strained Arguments

The GLAM's hyper-literal reading of the section 409A regulations risks creating the same absurd result the IRS wisely avoided regarding QSFs and section 130. The IRS's strained reading seeks to treat a deferral of an attorney's fee as not qualifying as an arrangement to defer a payment to an independent contractor, solely because of a parsed reading of which parties are required to be involved in the paperwork establishing the deferral and a narrow view of what documents are and are not considered part of the deferral plan. In this regard, the GLAM's section 409A discussion sounds like its discussion about whether its hypothetical fact pattern addresses "who" or "when" in its assignment of income argument.

Both arguments focus on a small component or individual transfer in a way that misconstrues the unambiguous intent and effect of the fee structure as a whole. And notably, this textual argument regarding the parties to the deferral is the IRS's only argument for why the independent contractor exception should not apply. If a court were to reject the GLAM's reading of the regulation's text (which is not hard to imagine), the GLAM's entire section 409A argument falls away.

The GLAM's analysis of section 409A is even more strained in a *Childs*-based fee arrangement. *Childs*-based structures typically do involve the attorney's client signing the settlement agreement, consenting to the assignment of the periodic payment obligation, or both.

In any event, the court in *Childs* explicitly noted that periodic payments were agreed to by the attorney, the client, and the defendant. That should dispose of the IRS's section 409A argument. Regarding the IRS's hypothetical, the section 409A argument there is strained too. Despite the inventiveness of its invocation of section 409A, it is difficult to see a eureka moment for the IRS.

XIII. Conclusion

The possibility that the IRS or a court might invalidate the tax treatment of structured legal fees is a scary one, particularly considering how many attorneys rely on them for retirement and to even out their frequently irregular cash flows. Any indication that the IRS is even considering that attack puts the industry on alert. Many attorneys are locked into structured fee arrangements that they necessarily lack the power to unwind or amend. The prospect of a challenge is frightening if attorneys could become subject to income tax on funds they may be unable to access for years.

However, a close reading of the GLAM suggests that the IRS may have a difficult time mounting serious challenges to structured fees following *Childs*. On each of the doctrines and code sections discussed in the GLAM, the IRS's arguments can be rebutted. Yet the GLAM underscores the importance of ensuring that structured fees are implemented carefully. It also appears that the IRS is struggling with grounds on which to distinguish some structured fees from others.

Regarding *Childs*, revisiting its key elements seems wise. The IRS has raised the prospect that it may want to dispute, set limits, or even litigate its scope and meaning by throwing a series of arguments against the wall to see what might stick. But the IRS may face significant challenges, particularly on facts that stick close to the *Childs* model. Indeed, it is not even clear that the IRS would have much success in its arguments even when applied to its own hypothetical. ■