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Tax Deferral Options For Plaintiffs' Attorneys

By Robert W. Wood

Most plaintiffs' lawyers understand structured settlements for their clients. Originally used only in personal injury cases, structured settlements are also used today in employment and other disputes. With any structured settlement, the defendant pays a third-party annuity provider and the plaintiff receives the right to receive a stream of payments over a set number of years or for life. Structures offer tax, investment and asset protection advantages.

Attorney fee structures are a simple extension of this concept, offering tax-deferred investing, income averaging and asset protection to lawyers. They are available only to contingent fee plaintiffs' lawyers, not to lawyers who charge by the hour or based on flat fees. In fact, plaintiffs' lawyers are in a unique position to plan their income and save taxes. Virtually no other service provider can arrange a funded payment over time that the Internal Revenue Service will respect.

Surprisingly, all of this can be done on the eve of settlement. The attorney must elect to defer the fees before they are "earned." Once the settlement agreement is signed, it is too late to structure fees. Fortunately, the lawyer is generally not treated as "earning" a contingent legal fee until the settlement agreement is signed.

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Some plaintiffs' lawyers have boom and bust years and some lament the unpredictability of their income. Income averaging is no longer possible, but structured fees can regularize a lawyer's income and save significant taxes in the process. A structure impacts when the fees are taken into income and defers taxes on the investment earnings on those fees.

A lawyer who structures fees can invest pre-tax, securing legal fees before taking them into income and locking in pre-tax investment return. A legal fee structure is a tax-advantaged installment plan that does not rely on the credit-worthiness of a defendant or client. The lawyer elects to take all or a part of the contingent fee over time.

The fee will be paid by the defendant to a third-party for the purchase of annuities benefiting the attorney. In a sense, the lawyer has "earned" the fee over the course of the case. Nevertheless, the tax law says the lawyer has not *technically* earned the fee until the settlement documents are signed. The seminal tax case is *Childs v. Commissioner*, 103 T.C. 634 (1994); affirmed without opinion, 89 F.3d 856 (11th Cir. 1996), where the IRS unsuccessfully challenged several legal fee structures.

In *Childs*, as in most fee structures, the settlement documents required the defendant to pay a third-party annuity provider that had agreed to pay the lawyers over time. The IRS argued that the attorneys were entitled to the fee in cash, so it had "constructively" received the payments. However, the Tax Court and the 11th U.S. Circuit Court of Appeals ruled that the settlement documents controlled the timing of the income and that the doctrine of constructive receipt was inapplicable.

Because of tax-free compounding, the longer the attorney stretches out payments, the better the financial result. The fee structure can function as an unlimited retirement account. Payments might commence immediately and continue for five, 10 or 15 years. Alternatively, payments might be deferred entirely for 10 or 15 years to build up tax-free. Thereafter, they will begin paying annually for the attorney's life or jointly with the attorney's spouse. There is almost infinite flexibility.

The form and timing of fee structures are important. The lawyer must agree to a fee structure *before* the client signs settlement documents. Ideally, the contingent fee agreement should specify that the lawyer can elect to structure fees at the conclusion of the case. If the lawyer does not have such a provision in the fee agreement, it can be amended, even immediately before the settlement.

Although the lawyer cannot "own" the annuity contract, the lawyer will be designated to receive all of the payments. If the lawyer is not a solo practitioner and practices in a firm, the firm is probably entitled to the fee. Consider whether the firm will buy the structure and receive the periodic payments, paying them out to the individual lawyer as they are received. Even though the firm is entitled to the legal fee, it is usually possible for structure monies go directly to the individual lawyer. An additional clarifying agreement can help avoid confusion between the firm and its partners or shareholders.

Finally, it is worth noting that fee structures are also commonly arranged out of qualified settlement funds, also known as QSFs or Section 468B trusts. An increasing number of cases today involve groups of lawyers and groups of clients - the kind of situation that seems ideal for such funds. They are often set up to be the repository of moneys in settlement of a case.

Qualified settlement funds were originally designed to benefit defendants, allowing an immediate tax deduction upon payment into the fund while the plaintiffs continued to resolve their differences. Today, they are often used to give plaintiffs and their lawyers more time to choose their desired form of payment. It is easy to establish, involving a trust document and nominal court supervision. Because this type of settlement fund delays the receipt of the money by the lawyers and their clients, it can enable everyone to consider structures. Plaintiffs' lawyers are fortunate to be able to consider them.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.