Structuring Attorneys' Fees:

What's All the Fuss?

BY ROBERT W. WOOD

Plaintiffs' lawyers aren't very popular in Washington these days (witness the enactment of the recent class action legislation).[1] While that phenomenon may be new, one thing that *isn't* new are boom and bust years. Plaintiffs' lawyers have long enjoyed the peaks — and suffered through the valleys — of fluctuating income. In the current climate, plaintiffs' lawyers may be surprised to learn that they can ameliorate these peaks and valleys. Although our tax system is rigidly annual, and income averaging was eliminated many years ago, there are other ways of spreading out payments.

For plaintiffs' lawyers litigating increasingly big and complex cases, resolving a multi-year case can generate a huge tax bill for the lawyer. Plus, the lawyer's after-tax proceeds will go into taxable investments that will throw off additional taxable income. In contrast, a lawyer who structures his fees is effectively able to invest pre-tax, locking his share of the settlement proceeds into a high-yield obligation (typically an annuity).

According to Dan McCarthy, a lawyer and principal with Bradford Settlement Company in Chicago: "We place many of our attorney clients into deferred fee structures in order to create future income streams to offset the peaks and valleys of the litigation world, as well as retirement and personal planning. I liken this to a 401(k) plan, but without the investment caps normally associated with such plans." The periodic payments are taxed as received.

Fee Bonanza?

A plaintiffs' lawyer can not only defer receipt of (and tax on) his fees until he receives them, but he can have all of that money invested, and have the income produced from it also taxable over time. Although such structures have been around for years, they are becoming increasingly prominent, and with good reason. Lawyers may want to structure their fees as part of their own tax, financial, estate, and succession planning.

Plus, lawyers structuring their fees can actually help their clients avoid tax problems. The U.S. Supreme Court recently decided *Banks v. Commissioner*,[2] holding that plaintiffs have gross income even on the contingent legal fees paid directly to their lawyers.[3] This was a blow to plaintiffs, who often have no way to deduct lawyers' fees.[4] Yet, stretching out fee payments can ameliorate this tax result. Even if your clients choose to take all of their money in cash, the plaintiffs' attorney can still accept all or a portion of the attorneys' fees in the form of periodic payments.

There are some technical requirements that must be met for an attorney's fee structure to be successful. "Success" here simply means having the income taxed only as it is disbursed to the lawyer. The good news is that this takes only a few simple steps. One leader in the field is Allstate Life Insurance Company, which writes attorneys' fee structures with NABCO, an assignment company backed by an Allstate guaranty.

***Childs* — The Mother of All Cases**

It's impossible to discuss the structuring of attorneys' fees without mentioning the *Childs* case. In *Childs v. Commissioner*,[5] the IRS unsuccessfully challenged a transaction that paid three attorneys fees on a periodic basis. The IRS argued that the attorneys were entitled to all the fees at settlement, so had "constructively" received the whole stream of fees. The tax court rejected the IRS's argument, as did the 11th Circuit Court of Appeals, holding that the value of the attorneys' rights to receive deferred fees were not includable in gross income in the year of the settlement.

The structured-settlement broker in *Childs* was Charles Bradford of Bradford Settlement Company, a good choice for advice on structuring attorneys' fees. Bradford Settlement Company was a pioneer in structuring attorneys' fees, and continues to be a "go to" broker for implement-

ing attorney-fee-structured settlements. Mr. Bradford calls this option for plaintiff attorneys "a gift from Washington." The three *Childs* lawyers were quite careful. They would not accept a promise from the defendant (or from their own client) to pay their fees in installments. They wanted an annuity that provided a guaranteed stream of payments issued by a top-rated life insurance company. Though the settlement agreement provided for the purchase of annuities to satisfy the future installment payments of the attorneys' fees, the settlement agreement stipulated that the attorneys' rights under the annuity policies were no greater than those of a general creditor. Before settlement documents were signed, the parties agreed that all the legal fees would be paid in the form of structured payments.

The defendant insurers purchased an annuity to fund the future payments due each plaintiffs' attorney. The attorneys were each named payees under the annuity contracts, and their estates were designated as the primary beneficiaries. However, the defendant insurers guaranteed to pay the annuity payments if the life insurance company ever failed to make the payments.

The *Childs* attorneys had no right to accelerate the payments or reduce them to their present value. In fact, once the attorneys agreed to structure their fees, the attorneys were bound to the installment schedule. The tax court and the 11th Circuit held that the attorneys did not constructively receive the fees in the year the settlement documents were signed.

Of course, some precautions are necessary. The attorneys are subject to the same rules as the plaintiff. Like the plaintiff, the attorneys must be specifically precluded from withdrawing their attorneys' fees earlier than the scheduled payment dates. Wording which prevents the attorneys (or their beneficiaries) from accelerating, deferring, increasing, or decreasing their scheduled payments must be inserted into the relevant settlement documents. The attorneys should have no right or power to receive any payment before the scheduled payments are made.

But, that doesn't mean one can't structure the arrangement to provide security. In fact, the security can be ironclad without running afoul of the tax doctrine of constructive receipt. The annuity contract cannot be owned or controlled by the attorney. Instead, the annuity must be owned by a third-party assignment company. This prevents the IRS from arguing that the annuity contract is somehow "set aside for" or "otherwise made available to" the attorney,[6] which would be detrimental from a tax perspective.

Childs's Continuing Relevance

The IRS lost *Childs v. Commissioner*,[7] both in tax court and on appeal. No one has yet to fight a *Childs*-like battle elsewhere in the country, but there seems little danger. The tax court itself typically follows published authority from other circuits. Moreover, the IRS has even begun citing *Childs* as authority.[8] This suggests that the IRS has seen the writing on the wall and that properly implemented attorneys' fees structures are unassailable.

Proper Structures Avoid Worries

To properly implement an attorney's fees structure, it's useful to see what does not work, and where lawyers might misstep. You can't have the annuity contract name the attorney as the irrevocable payee.[9] Also, as previously stated, the attorney cannot be the owner of the annuity contract. The owner must be the third-party assignment company.

The assignment company purchases the annuity to fund its obligation, and the attorney is solely the payee, not the applicant, and not the owner of the annuity contract.[10] The life insurance company issuing the annuity can guarantee payment of the attorneys' fees should the assignment company ever fail to do so. That guarantee does not trigger any taxes.

Indeed, the *Childs* court stated: "It is well settled that a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay."[11] The *Childs* court was satisfied that the owner of the annuity was the third-party assignment company, not the attorneys. The assignment company retained all rights incident to ownership. Also, as previously stated, the attorneys could not accelerate, defer, increase, or decrease their attorneys' fees (once structured) during the term of the payment period.

Plaintiffs' attorneys should include appropriate language in their contingency-fee agreement referencing their ability to receive all, or a portion of, their fees in the form of periodic payments. An election should be made in writing before their fees are earned (i.e., before the settlement documents are signed). Ideally, the attorneys' election should be made before the attorneys' precise share of the settlement is determined, and the election should be irrevocable. The documents should forbid the attorneys from transferring, assigning, selling, or encumbering their rights to receive future payments. Any attempt by an attorney to sell, transfer, or assign his or her rights to fees will be void.

The Importance of Form

Tax law is archaic and regimented. A busy trial lawyer need not understand all of this, but there are several golden rules here:

- You cannot own the annuity contract. The assignment company must be the owner, even though you are the recipient of all the payments.
- All the documents (the annuity contract, the settlement agreement, your fee agreement, etc.) should clearly indicate that you have no right to accelerate any of the payments. You may not need to include this magic language in every single document, but repetition in tax law is usually a good thing.
- You must agree to a fee structure before the case is resolved. This means that before your client signs any settlement documents, your structure must be in place.
- Ideally, your contingent fee agreement with your client should specify that you may accept all or a portion of your fees in the form of periodic payments. I recommend including this provision in every fee contract. If you do not have it in your existing contract, it is a good idea to amend your fee agreement, even if that amendment occurs right before the settlement.

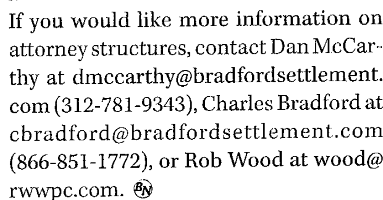
Conclusion

Attorneys' fee structured settlements are clearly here to stay. Not only do they serve many tax and financial goals, they offer the beauty of tax-deferred investing, the tax and nontax benefits of income averaging, and even serve asset-protection goals.

Most plaintiffs' lawyers understand the dynamics of a structured personal physical injury settlement for a client. It's not a big leap from this kind of structure to an attorneys' fee structure.

Try it, you'll like it.

More Information



If you would like more information on attorney structures, contact Dan McCarthy at dmccarthy@bradfordsettlement.com (312-781-9343), Charles Bradford at cbradford@bradfordsettlement.com (866-851-1772), or Rob Wood at wood@rwwpc.com.

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NOTES

1. *See* Class Action Fairness Act of 2005, PL 109-2. *See also* Morgensen & Justice, "Taking Care of Business, His Way," *New York Times* (Feb. 20, 2005), sec. 3, p. 1.
2. 2005 U.S. Lexis 1370, 125 S.Ct 826 (U.S. Jan. 24, 2005).
3. For further discussion on *Banks*, *see* Wood, "Supreme Court Attorney Fee Decision Leaves Much Unresolved," Vol. 106, No. 7, *Tax Notes* (Feb. 14, 2005), p. 792.
4. *See Spina v. Forest Preserve District of Cook County*, 207 F.Supp.2d 764 (N.D. Ill. 2002) as reported in 2002 National Taxpayer Advocate Report to Congress at 166. *See* Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Case," *New York Times* (August 11, 2002), sec. 1, p. 18.
5. 103 T.C. 634 (1994); *aff'd without op.*, 89 F.3d 856 (11th Cir. 1996).
6. *See* Treas. Reg. §§ 1.451-1(a) and 2(a).
7. 103 T.C. 634 (1994); *aff'd without op.*, 89 F.3d 856 (11th Cir. 1996).
8. IRS Field Service Advice 200151003, 2001 FSA Lexis 173 (Dec. 21, 2001).
9. *See Brodie v. Commissioner*, 1 T.C. 275 (1942); *Oberwinder v. Commissioner*, 35 T.C. 429 (1960), *aff'd*, 304 F.2d 16 (8th Cir. 1962).
10. *See* Revenue Ruling 72-25, 1972-1 C.B. 127.
11. *Childs v. Commissioner, supra* at 652, citing *Berry v. United States*, 760 F. 2d 85 (4th Cir. 1985), *aff'g per curium* 593 F. Supp. 80, 85 (M.D.N.C. 1984).