Structuring attorney fees when you're not a solo

Robert W. Wood

Leveling out income by structuring contingent fees has its advantages and is no longer limited to solo practitioners—if you observe the tax rules.

Structured settlements remain popular in personal injury cases: A steady stream of periodic payments provides plaintiffs with tax benefits and financial security not available with a lump-sum payment.

But what about the plaintiffs' attorneys? They're concerned about tax obligations and long-term asset protection, too. And given the ebb and flow of the caseload in a typical personal injury practice, most plaintiff lawyers have to cope with what can be an erratic and unpredictable income.

Attorneys can achieve some income leveling by controlling when cases settle, but most find that hard to do. A more certain and increasingly popular choice: structuring contingent fees. Structured fee arrangements can help lawyers keep their income on a more even keel, achieve tax savings, establish asset-protection strategies, and even meet estate-planning goals.

Fee structures allow a pretax accumulation of income, which means an attorney can defer paying taxes on a fee until it is received. If a fee is not structured, the attorney must pay taxes on the entire amount in the year in which the fee is received. But if, for example, the fee is structured evenly over 10 years, the attorney would pay taxes in the first year only on the portion of the fee received in that year.

A contingent fee can be converted into a payment stream of any shape, size, and flavor imaginable. For example, payments can be spread over the attorney's lifetime or issued as a joint and survivor annuity with his or her spouse. Or the lawyer may choose to receive a single balloon payment on a specific date.

The attorney can even choose to increase or decrease payment amounts over time, schedule interim lapses in payments, and set up multiple payment streams to allow for anticipated expenses, like college costs for children or the purchase of a house.

What happens if a client wants to structure a recovery, but the attorney does not want to structure the fee? What if the attorney wants to structure, but the client does not? The marketplace has tackled these issues by making structures available in either circumstance, but some restrictions may apply.

The California Bar, for example, announced that where a fee agreement is silent on the question of fee structuring, an attorney in that state cannot collect his or her entire fee at the time of settlement if the plaintiff elects to structure payments.[1] In other words, without a contrary agreement in the fee contract between the attorney and client, the attorney must participate in the structured settlement.

Ideally, every contingent fee agreement should say that the lawyer can elect to take his or her fee in periodic payments, whether or not the client also wants to structure the recovery. However, even if a fee agreement does not have this provision and a plaintiff wants the full recovery at once, it's unlikely that he or she will object to the lawyer receiving fees over time. An attorney who is structuring his or her fee can significantly lessen a plaintiff's own tax burden, because structuring will reduce the amount of attorney fees that the client must deduct in one year.[2]

Clients typically worry about whether they can deduct attorney fees. In a personal physical injury or employment case—where tax law allows a special deduction for all attorney fees—they should not have a problem listing legal fees as deductions.

But outside the employment or personal injury context, clients can usually deduct attorney fees on their taxes only as "miscellaneous itemized deductions." That means that clients lose 2 percent of their deduction right off the top and have to deal with other technical limits—most draconian of all is the alternative minimum tax (AMT), which can wipe out the client's legal fee deduction entirely. The higher the plaintiff's income is and the larger the attorney fees are, the greater the AMT problem. That's why a lawyer who structures his or her fees can actually *improve* the client's tax position.

Childs play

Attorneys have had the option to structure their fees since 1994, when the Tax Court issued its opinion in *Childs v. Commissioner.*[3] In that case, three lawyers who practiced law through their professional corporation—Swearingen, Childs, and Philips (SCP)—structured their legal fees from settlements in two 1984 gas explosion cases.

In each case, although the original fee agreement with the clients specified that fees would be paid to SCP, the firm did not receive the stream of payments. Instead, the plaintiffs directed payment to each attorney individually, bypassing SCP completely. Each attorney structured his portion of the contingent fee separately in each settlement.

SCP did not report income from fees earned in either case; after all, it had not actually received any of the payments. All three attorneys reported the fees as income over time, as they received them. The IRS challenged their tax returns, arguing that each payment stream in its entirety should be included in the respective attorney's income in the tax year he received the first payment.

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The Tax Court sided with the lawyers, and the Eleventh Circuit affirmed, laying the groundwork for attorneys nationwide to structure their fees.[4] Yet, more than a decade after this seminal decision, certain issues surrounding fee structures remain unresolved. Perhaps the most interesting issue not expressly decided by *Childs*—and not addressed by any other legal authority since—is the significance of who or what entity receives the taxable income.

Childs does not draw a distinction between who actually received the fees (the three attorneys) and who was legally entitled to receive them (SCP). The sole focus of the case is timing—whether each attorney could be taxed on the money he could have received had there been no structure or only on the payments he received each year.

The Tax Court's opinion details how the three attorneys practiced law. SCP was a professional corporation in which Childs and his "partners" were shareholders. The three attorneys were not acting individually when they settled the underlying tort cases. However, each attorney structured his fees *individually*, not as part of the professional corporation. The professional corporation was apparently entitled to receive contingent fees in both settlements, but neither the IRS nor the Tax Court mentioned it.

So if neither the IRS nor the Tax Court seemed to care who received the fee in *Childs*, why should plaintiff lawyers?

They should care because the legal relationship between a lawyer and his or her firm is hardly a trivial thing. Someday, the IRS and the Tax Court may revisit the issues in *Childs* and render a different opinion regarding who or what is taxed for contingent fees earned in a personal injury case.

Choice of entity

Given that the *Childs* case doesn't raise this issue, it's probably unlikely that the IRS or the courts will do so in the future. Still, you don't want a mismatch between the party receiving the fees (the structuring lawyer) and the party contractually entitled to them (the firm), since that could lead to higher taxes for the firm.

Good documentation is particularly necessary for a professional corporation because of the benefits it offers

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ROBERT W. WOOD, *who practices law with Wood & Porter in San Francisco, is the author of* Taxation of Damage Awards and Settlement Payments *(3d ed. Tax Institute 2005 & Supp. 2006). © 2006, Robert W. Wood.*

shareholders. A professional corporation provides, for example, a certain element of protection from liability. Suppose I practice law in a professional corporation. If a delivery person slips and falls on my office floor, my personal assets are not at risk. If the same delivery person wins a judgment against my firm for negligence, forcing my firm into bankruptcy, my personal assets are still protected.

This situation would be different if I were practicing through a general partnership, where my liability would extend not only to my interest in the firm and to all firm assets, but to my personal assets as well.

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If I am sued for my own malpractice—or for the conduct of personnel whom I supervise—a professional corporation or a limited liability partnership (LLP) doesn't protect my assets. But if I'm sued for the malpractice of a fellow shareholder—someone whom I call my "partner"—a professional corporation or LLP will shield my own personal assets from the lawsuit. A shield exists for what is usually known as "cross-liability."

Aside from liability protection, a professional corporation offers the benefit of deferred compensation. Several years ago, attorneys could not obtain certain pension benefits as individuals. These benefits were limited to professionals employed by corporations.

So, attorneys often self-incorporated to obtain these benefits. Some attorneys did this even though they were partners or associates in law partnerships. That's the reason you sometimes see law firm letterhead that proclaims the firm is a "partnership including professional corporations." Self-incorporating is not as popular anymore because you can now get the same pension plan benefits in any type of entity.

What if a firm's lawyer structures a fee on an individual basis even though the client has engaged the law firm as a whole? In *Childs*, the fact that payments were made directly to the attorneys as individuals did not bother the IRS. Perhaps the agency considered the payments as first made to the law firm, and then deemed them paid from the law firm to the individual attorneys.

Still, attorneys may be able to prevent the IRS from determining the flow of payments by executing an official "deemed-payment" agreement. Basically, this would say that even though the firm is allowing individual lawyers to receive fees, each payment is first deemed to be made to the firm, and then to the individual lawyers.

The law firm accounts for the receipt of the payments—as if it had actually received them—and then accounts for the transfer to the attorney. In effect, it's a wash.

Even though the *Childs* lawyers didn't take this deemed payment precaution, they escaped tax problems—aside from having to go to the expense of fighting the IRS in court. If attorneys take this extra precaution, their facts will be *better* than those in *Childs*.

Beneficiaries

Mark Twain aside, most people do not like to discuss the subject of their untimely demise. Attorneys who structure fees are no exception. Often, attorneys structure payments to plan for retirement, and the thought of not being around to enjoy their long-awaited retirement is anathema.

Still, attorneys should give some thought to survivors' benefits. Assignment documents frequently have standard beneficiary language such as "any payments made after the death of the claimant pursuant to the terms of this agreement will be made to the estate of the claimant." Attorneys don't typically ask to change such language, but it can be done relatively easily.

Insurance companies usually do not mind changing the beneficiary. They are willing to accommodate the attorney, since their payment obligation is discharged upon making payment to whomever the attorney may direct. Changes to the standard language sometimes reflect a desire to incorporate after-death payments into an existing estate plan or to have payments directed to a spouse or child. Alternatively, payments may be directed into a family trust.

Yet, even small changes can complicate tax matters. Given that the IRS may one day revisit the issues in *Childs* and decide that a fee structure cannot be paid directly to an attorney who practices in a firm without some tax consequences to the firm, one approach is to ensure that the law firm receives any remaining structured payments after the attorney dies. The agreement can also provide that the firm will pass on the payments to the attorney's estate, spouse, or family trust.

Generally, you'll want the surviving spouse, trust, or estate to receive the payments, not only so the firm has no tax liability, but also because most lawyers view the stream of structured payments as part of their property. Of course, the surviving spouse or other family members will have to pay tax on the stream of income as they receive it. Whether the after-death payments go to the firm, the estate, the surviving spouse or beneficiaries, or a family trust, the payments will be taxed. There are subtle differences, however, that make this a decision to consider carefully.

Commutation

The death of an attorney who is receiving structured fees can cause liquidity problems for his or her estate. Estate tax is due shortly after a taxpayer dies, and 2006 rates reach as high as 46 percent.

Some insurance companies will help estates with this liquidity problem, allowing an acceleration of structured payments when the lawyer dies by inserting a commutation clause into the assignment agreement. A typical clause might provide that all or part of the present value of outstanding structured payments is payable to the attorney's beneficiary when he or she dies, ensuring sufficient resources to pay the estate tax.

The good news is that the mere presence of a commutation clause under these circumstances doesn't spell constructive receipt.[5]

An alternative to using a commutation clause to access the cash is to enter into a factoring transaction.[6] Here, the recipient of the structured payments can assign the right to receive all or some of the future payments to a factoring company in return for a lump-sum payment. Factoring should help avert a liquidity crisis caused by the estate tax, but it adds a layer of administrative complexity and cost.

Notably, the tax code provides for a 40 percent excise tax on certain factoring transactions of qualified assignments—including those made in personal injury cases.[7] Parties can avoid the excise tax if they obtain a qualified court order. The order must find that the transaction is in the best interest of the payee, taking into account the welfare and support of the payee's dependents. Among other requirements, the order must not contravene any state or federal law.[8]

Income allocation

It's hard to find a plaintiff attorney who hasn't at least heard of the concept of structuring fees, yet the IRS has provided only basic guidance on the potential tax consequences of these arrangements. The *Childs* ruling makes clear that at least for now, the IRS will turn a blind eye to the tax liability of a law firm when its lawyers arrange to receive structured fee payments directly.

The IRS could, however, revisit the issues in *Childs*, possibly with negative tax consequences for a lawyer's firm and beneficiaries. To avoid this, lawyers who plan to structure their fees should consider preparing income-allocation agreements and assignment documents. A few simple documents can help ensure that structured payments go where the lawyer intends and that they carry the tax burden that he or she expects. ■

Notes

[1] Cal. B. Assn. Ethics Op. 1994-135.

[2] *See* Robert W. Wood, *Supreme Court Attorney Fee Decision Leaves Much Unresolved*, 106 Tax Notes 792 (Feb. 14, 2005).

[3] 103 T.C. 634 (1994), *aff'd without opinion*, 89 F.3d 856 (11th Cir. 1996).

[4] For more details of the *Childs* decision, see Robert W. Wood, *Structuring Attorney Fees: Kingdom of Heaven?*, 108 Tax Notes 539 (Aug. 1, 2005).

[5] *See* Priv. Ltr. Rul. 98-12-027 (Dec. 18, 1997).

[6] *See* Robert W. Wood, *Structuring Settlements & Factoring: Never the Twain Shall Meet*, 106 Tax Notes 1278 (Mar. 14, 2005).

[7] I.R.C. §5891(a) (2006).

[8] *Id.* §5891(b)(2).