The Astoundingly Lucrative Tax Loophole That Only Lawyers Can Use

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"The first thing we do, let's kill all the lawyers."
-- Dick the Butcher, Henry VI


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In 1591, Shakespeare wrote these words as part of the dialogue for one of his great historical plays, "Henry VI" -- and in the four centuries since, the public's view of the legal profession has, if anything, gotten worse.

In fact, lawyers consistently rank near the top of Gallup's annual poll of the most hated professions. The only other profession that regularly ranks higher (meaning lower) is being a member of Congress, of which -- insert irony alert here -- 43 percent list their occupation as "law."

Much of the public's dislike of lawyers stems from the perception that they don't uphold the law so much as manipulate the it to their own interests and those of their clients -- truth be damned. But that is a debate for another venue, and though I hate to pour fuel on the lawyer-bashing fire -- well, not really -- there is a special tax loophole which only lawyers can use, and when you learn about it, chances are you will think even less of them.

Billable Hours or Contingency

Lawyers generally charge their clients in one of two different ways: either at a set rate for each billable hour of work done, or on contingency. The way contingency works is that the lawyers agree not to charge the client anything unless they win a settlement for him, in which case they get a percentage of that settlement -- on average about 40 percent.

This means that a lawyer on contingency who sues a company on behalf of a client and wins a settlement of $1 million will receive $400,000 as compensation. And that amount can be set aside, in a tax-deferred account, for as long as the lawyer wishes, and then only taxed on the income and profits in the years that the payments are received from that account.

Yes, you heard me right.

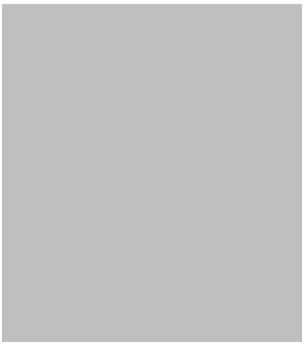
The Internal Revenue Service challenged this arrangement in a 1996 landmark case, Childs v. Commissioner, but lost in a 11th Circuit Court decision. There initially was concern that the IRS would eventually challenge the ruling, but since then, according to Robert Wood, an expert on taxation judgments, "the IRS has begun uniformly citing Childs favorably and is apparently quite comfortable with it."

Tax-Deferred for as Long as They Want

So thanks to the Childs ruling, lawyers enjoy a unique tax advantage unavailable to average citizens, which includes

- The ability to invest their contingency fees pre-tax, which allows 100 percent of their money to earn tax-deferred interest.
- The flexibility to spread out their income over a longer period of time, ideally into years when they fall into a lower tax bracket.
- Timing the future payments from their contingency fees to coincide with major expenditures, such as college tuition, retirement and so on.

And unlike tax-deferred instruments such as a 401(k), which limit the annual pre-tax contribution to $17,500, there is no limit to the amount of contingency fees that a lawyer can defer.



So, as an example, if a lawyer were to receive $1 million in contingency fees in a given year, putting him in the top tax bracket, he could defer paying taxes on 100 percent of that by placing it in a structured annuity.

He could then schedule payments in any amount, and at any time in the future.

So, if a decade later he were to take a year off from his practice, theoretically earning no income, he could schedule $200,000 of that $1 million (plus accumulated interest) to be realized, putting him in a lower tax rate and thus dramatically lowering his original tax liability.

Certainly this tax loophole is just another reason that most people will continue to look at the legal profession with disdain. But don't take it lying down. If you find this preferential tax treatment outrageous, like I do, pick of the phone, call your local member of congress and voice your opinion. And just hope that your congressperson is part of the other 57 percent.