Please Shelve Anti-*Childs* Proposals

By Robert W. Wood

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In *Childs v. Commissioner*,[1] the Tax Court and the Eleventh Circuit ruled that attorneys who were involved in a contingent fee case that had not reached a final resolution could structure the fees over time. I have previously written about those fee structures and their legal underpinnings.[2] The way in which fees must be structured is arcane and formulaic.[3]

Arcane structures are no strangers to the tax law, and the *Childs* fact pattern has been honed until it is, well, child's play. The IRS, as discussed below, seems comfortable with it. Recently, however, two law professors adopted the role of Kindergarten Cop.

I'm referring to the proposal by Profs. Gregg D. Polsky and Brant J. Hellwig to legislate a reversal of *Childs* (''Close the Yield Exemption Loophole Created by *Childs*,'' *Tax Notes*, June 1, 2009, p. 1141, *Doc 2009-11272*, *2009 TNT 103-15*). I recognize that the unvarnished purpose of the Shelf Project is to raise revenue. Even so, I do not see the wisdom of altering the result in *Childs*, which I believe is correct from both a policy and technical viewpoint.

I will not address the policy question, admitting that reasonable minds may differ regarding tax policy. Regarding the technical issues, however, I want to offer a few comments. The *Childs* structure is now well practiced. In *Childs*, the defendant paid an assignment company, which in turn purchased an annuity that would ''fund'' — purely in a colloquial sense of the word — the periodic payments. At all times, the attorney had only an unfunded promise to pay.

Is It Soup Yet?

An unstated target of the Polsky-Hellwig proposal appears to be basic accrual of income questions. One of the linchpins of *Childs* was the Tax Court's opinion (in which the Eleventh Circuit concurred) that when the transaction was undertaken, the attorney had no right to the income. It is axiomatic that an attorney fee structure cannot be implemented without this fundamental barrier — the lack of a right to the cash payment.

Polsky and Hellwig seem to suggest that a rifleshot amendment of the tax law will cure the perceived ill of attorneys who structure their fees. Yet I believe Polsky and Hellwig are raising much broader questions, ones that go considerably beyond the holding in *Childs*. The way I read the proposal, it would necessarily change established rules regarding deferred compensation structures in a variety of contexts.

Polsky and Hellwig would also alter structure arrangements for plaintiffs that the IRS has indicated are perfectly fine. On the latter point, I am referring to LTR 200836019 (June 2, 2008), *Doc 2008-18961*, *2008 TNT 174-22*. There, the IRS agreed that a plaintiff in an employment lawsuit can settle a case in exchange for a stream of periodic payments.

The IRS ruled that under this arrangement (which followed the *Childs* fact pattern virtually to the letter), the plaintiff would have neither constructive receipt nor economic benefit when her case settled. She would merely pay tax on the amount of each payment she received over time, when she received the payment. The same thing occurred in *Childs*. At several points in this letter ruling, the IRS cites *Childs* with approval.[4]

It is hard for me to argue with the numerical tables and income assumptions that Polsky and Hellwig have included in their proposal. They do demonstrate that the fisc is losing something by permitting deferral. Yet the same kinds of figures can be used concerning any tax deferral and any investment growth. Those tables, with their pejorative ''we shouldn't allow this'' message, could apply across the spectrum of deferred compensation.

Enron Taint

I also find it odd that Polsky and Hellwig seem to cherry-pick references to *Childs*. For example, there is an ''Aha!'' moment when (in footnote 25) they note that a draft Arthur Andersen opinion uncovered in the Enron investigation report relied on *Childs* to support a transaction that was later identified as a listed tax shelter. Zounds!

If Arthur Andersen had cited *Eisner v. Macomber*, 252 U.S. 189 (1920), or *Gregory v. Helvering*, 293 U.S. 465 (1935), surely that would hardly undermine those authorities. With all due respect, this reference struck me a little like saying that if a convicted tax cheat quotes the famous Judge Learned Hand aphorism about tax planning, it would impugn the cornucopia of other cases that have cited it. To me, resorting to those arguments weakens, rather than strengthens, the Polsky-Hellwig mission.

Admittedly, the entire structured settlement industry is somewhat artificial. This is true whether the recipient

[1] *Childs v. Commissioner*, 103 T.C. 634 (1994), *Doc 94-10228*, *94 TNT 223-15*, *aff'd*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-19540*, *96 TNT 133-7*.

[2] *See* Wood, ''Structuring Attorney Fees: Kingdom of Heaven?'' *Tax Notes*, Aug. 1, 2005, p. 539, *Doc 2005-15920*, or *2005 TNT 142-28*.

[3] *See* Wood, ''Legal Fee Structures, Law Firms, and Lawyers: Children of *Child*'s?'' *Tax Notes*, Apr. 10, 2006, p. 173, *Doc 2006-6493*, or *2006 TNT 69-20*.

[4] For a discussion of LTR 200836019, see Wood, ''Nonqualified Settlement Ruling Spurs Damage Structures,'' *Tax Notes*, July 14, 2008, p. 141, *Doc 2008-14609*, or *2008 TNT 136-30*.

of the periodic payments is an injured person receiving tax-free damages (as sections 104 and 130 allow), a person receiving taxable damages (as occurred in LTR 200836019), or an attorney receiving structured legal fees (as occurred in *Childs*). The IRS and the courts seem comfortable with the *Childs* fact pattern. Although it certainly provides an opportunity for tax and investment planning, I see nothing abusive about it.

Even if I am wrong about this, I do not think it calls for the kind of quick fix Polsky and Hellwig imagine. They assert that *Childs* was wrongly decided and that the Tax Court and the Eleventh Circuit failed to distinguish between third-party and second-party payment obligations. According to Polsky and Hellwig, third-party promises constitute ''property'' for purposes of section 83, while second-party obligations do not.

Whose Promise?

They cite to ''the dawn of federal tax law'' for the notion that the receipt of third-party promises gives rise to immediate taxation, regardless of the securitization or transferability of those promises. They argue for a fundamental distinction between third-party and second-party promises within section 83 jurisprudence.

To find an example of immediate taxation of third-party promises reaching back to the dawn of federal tax law, Polsky and Hellwig invoke an old chestnut, *United States v. Christine Oil & Gas Co.,* 269 F. 458 (W.D. La. 1920), which provides:

> What is there said of unpaid services applies with equal force to unpaid purchase money. If a seller accepts the notes of third persons *in absolute payment*, the rule would be different. But where the effect of the transaction is a mere promise to pay, and not an actual payment, it cannot be said to be income, until it has been actually received, and is not subject to be taxed as such until its actual receipt. 269 F. at 459-460. [Emphasis added.]

My reading of this passage is that *absolute* payment from a third-party gives rise to immediate taxation. Of course, absolute payment from a second party does, too. (I suppose ''absolute payment'' involves an obligation that imparts one or more ''bad'' rights.)

Polsky and Hellwig argue that Rev. Rul. 69-50, 1969-1 C.B. 140, and Rev. Rul. 77-420, 1977-2 C.B. 172, provide that third-party payment obligations constitute property for purposes of section 83, irrespective of their securitization or transferability. As a consequence, they contend that *Childs* was wrongly decided.

However, to read those revenue rulings in that way, Polsky and Hellwig must perform Houdini-like contortions. First, they apparently are distrustful of the regulations promulgated under section 83. The final sentence of reg. section 1.83-1 appears to sweep within the ambit of section 83 both third-party and second-party promises. The regulations state unambiguously that the general rules of section 83 apply ''to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed.''

Second, they must ignore (or explain away) the fact that rev. ruls. 69-50 and 77-420 explicitly address the economic benefit doctrine rather than section 83. In Rev. Rul. 77-420, the Service states that:

> In effect, the patients have funded their obligation to the physician with the [third-party] corporation, thereby conferring an economic or financial benefit on the physician.

Under Polsky and Hellwig's analysis, this economic benefit constitutes property for purposes of section 83. They state that ''given that section 83 was enacted to clarify the tax treatment of restricted stock and not to substantially alter basic cash method principles, it has been assumed that Congress intended that the historical definition of property apply.'' (*Tax Notes*, June 1, 2009, p. 1142.)

The Polsky-Hellwig argument can be distilled to this: (1) an economic benefit occurs when a third party makes a promise; (2) the economic benefit embodied in such a promise constitutes property for purposes of section 83; (3) this is a special type of property that obviates the security and transferability rules of section 83; and (4) as a result, section 83 should apply to attorney fee structures, notwithstanding *Childs* or established economic benefit and constructive receipt authorities.

No Receipt

Polsky and Hellwig do not appear to be ready to tangle with the constructive receipt doctrine. Presumably this is because it is clear (to the Tax Court and the Eleventh Circuit) that the *Childs* attorneys had no constructive receipt (or, for that matter, economic benefit). The lawyers in *Childs* had no perfected right to cash when their fee structure was put in place.

They wound up with unfunded promises to pay, with no right to assign, accelerate, defer, or otherwise alter the payment stream. That meant economic benefit, constructive receipt, and section 83 did not apply. Those conclusions seemed unassailable.

Indeed, even the IRS appears to have conceded that the facts of *Childs* — resulting in an unsecured, unfunded promise to pay — do not give rise to a third-party promise that might subject the attorneys to immediate taxation:

> [*Childs*] involves a structured settlement in which the service provider's compensation was contingent upon and to stem directly from the payment by the third party. In essence, the service recipient (the plaintiff) established a portion of its own funds (the potential settlement) as the only source from which the service provider would be paid. Although *technically* the service provider received a promise from the third party (the defendant), the service provider *in substance* continued to possess an unsecured interest in a portion of the service recipient's funds (the potential settlement which otherwise would have been paid to the service recipient), which would not be available until the settlement was paid.

IRS Coordinated Issue Paper, ''Transfer or Sale of Compensatory Options or Restricted Stock to Related Persons 19'' (Oct. 14, 2004), p. 19, *Doc 2004-20541, 2004 TNT 204-14*. [Emphasis added.]

Finally, it should be noted that in contrast to Polsky and Hellwig's position, the Ninth Circuit has said that Rev. Rul. 69-50 and Rev. Rul. 77-420 involved an instance where:

> the physician had effectively obtained the income. . . . The essence of those rulings was that the physician had constructively received the income before assigning it to the deferred compensation program. *United States v. Minor*, 772 F.2d. 1472, 1475 (9th Cir. 1985).

In *Childs*, the Tax Court held that the attorneys did not have constructive receipt of the deferred income, precisely because they were not entitled to their fees until recovery by their clients. Their right to receive payment arose only after settlement or disposition of the case — at which time the structured settlement had already been agreed on. This brings me back to where I began; a key axiom of *Childs* is this threshold.

No *Childs* Left Behind

I acknowledge the laudable goal of the Shelf Project. I also praise Polsky and Hellwig's attempt to contribute to the fisc. Still, for me, their argument requires that one ignore too many well-established concepts of fundamental accounting and deferred compensation, concepts that arguably go to the root of our federal income tax system.

Childs is just one in a long line of deferred compensation cases that have evolved out of section 83 and constructive receipt principles. The technical correctness of the *Childs* decision is based on the relationship between the constructive receipt doctrine and section 83. I would let *Childs* grow into old age untouched.