Structuring Legal Fees Without Annuities: Offspring of *Childs*

By Robert W. Wood

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In this article, Wood argues that life insurance annuities are not the only source of payment that attorneys can use for structured legal fees, as long as the fee structure documents closely follow the restrictions in *Childs*.

A contingent fee lawyer contracts for a percentage fee payable at the conclusion of a case. The lawyer is paid when the settlement or judgment is paid. Yet surprisingly, tax law allows contingent fee lawyers to "structure" their legal fees over time.

The mechanics are formal but not difficult. The lawyer must simply enter into a fee structure *before* the client signs a settlement agreement. Formally, the settlement agreement is what triggers the lawyer's right to a fee. As long as the lawyer structures before the case is conclusively resolved — even the night before — the fee structure is allowed.

Taxpayers are generally permitted to arrange their affairs to minimize their taxes. As Judge Learned Hand famously observed, "there is not even a patriotic duty to increase one's taxes."[1]

Structured Settlements Analog

Lawyers can think of fee structures in much the same way as their clients think of structured settlements. Indeed, plaintiffs in both personal and nonpersonal injury cases may want to structure all or a part of their recoveries. The process is similar to structured legal fees.

A plaintiff does not want to rely on a defendant to pay a stream of payments. Therefore, structure products are sold by life insurance companies that pay out a stream of reliable payments. In a tax-free personal physical injury structure, each periodic payment the plaintiff receives is tax free.

In a taxable structure, each payment the plaintiff receives is taxable, but not until it is actually received by the plaintiff. A lawyer's fee structure is similar, with each payment taxable when received but not until that time. In the meantime, the funds earn income on a tax-deferred basis.

Constructive receipt does not arise because the settlement agreement requires the defendant to pay the third-party life insurance company, which will make the periodic payments. If the terms are set *before* the plaintiff signs the settlement agreement, there is no constructive receipt.

A plaintiff who wants a structured settlement must include structure language in the settlement agreement before the settlement agreement is signed. A lawyer who wants to structure fees must do the same. Sometimes clients and lawyers both structure.

Sometimes clients structure their settlements, but lawyers prefer their fees in cash. Sometimes only the lawyer structures. Partial structures by clients and lawyers are permitted. The assignment and annuity documents are formal, but the IRS approves of structured legal fees.

Structured settlements for clients have been popular since a 1982 change in the tax law. Structured legal fees started shortly thereafter, but they really took off after the U.S. Tax Court and the Eleventh Circuit Court of Appeals approved them in *Childs v. Commissioner*.[2]

New Day?

Today, many lawyers include structured legal fees as part of their practice management and their financial, tax, and estate planning. Plaintiffs' lawyers may have dry periods with little income and then spikes of unusually large amounts of income

[1]*Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[2]103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996).

when a case is resolved. Structured fees can improve the predictability of their income, cash flow, and overall tax picture.

However, increasingly, lawyers who want to structure want something more flexible than the rather staid life insurance products popularized by the *Childs* case. The question, then, is whether lawyers can structure with something else. If so, what would that something be?

Put differently, is there anything magical about life insurance annuities that make them the only source of payments that lawyers can use to structure? Several companies are offering structured legal fees that involve a menu of investments instead of annuities à la *Childs*. Although the precise details vary, the common theme is similar.

Understandably, companies stick close to the model enunciated by the court in *Childs* and replicated by all of the U.S. life insurance companies that write structured legal fees. The attorney cannot accelerate, defer, increase, or decrease the periodic payments. Nor can the attorney sell, anticipate, assign, pledge, hypothecate, or encumber the periodic payments.

The attorney does not own the assets or have anything set aside in the attorney's name. These are all key points, whatever the assets may be that will serve as the source of the eventual periodic payments. The attorney is simply a general creditor with a contract right for a stream of payments.

With an annuity, the payment stream is sourced from the annuity, an investment made by the assignment company (an affiliate of the annuity issuer) that will hold the annuity.

Alternative Investments

What if the third party that owes a contractual duty to pay the attorney is not an assignment company that is an affiliate of a life insurance annuity issuer? What if that third party instead simply holds and invests the money for its account to pay the attorney later? Is there any reason to believe that the IRS would treat this differently than the *Childs* fact pattern that it already accepted?

It is hard to see why the IRS would treat these alternatives differently. The nature of the contract and the lawyers' rights are what seem most important. The documents likely give the deferred amount a rate of return based on the type of investment the attorney selects. Clearly, any such investment selections must be made in advance before the case is settled and the documents are signed.

Under some programs, the attorney may be able to make nonbinding requests about investments after the documents are signed. This may on the surface appear to create danger for the desired tax treatment. Nonetheless, there is nothing to suggest that this could prejudice the attorney's tax deferral as long as the requests are not binding on the third-party payer.

That is, once the attorney has signed documents agreeing to the investments and the payout of the fees over a predetermined period, none of these details can be changed. Even the nature of the investment cannot be changed at the behest of the attorney. But the attorney can *ask*, and the documents can allow this, as long as the third party is not required to comply.

As a matter of optics, it is important to state this clearly. Moreover, it is probably best for these precatory requests to be limited in frequency, perhaps to twice a year. Plainly, the attorney must not be able to *compel* anything. In effect, the attorney has distribution rights in much the same way that an attorney in a traditional *Childs* life insurance structure has a right to payments.

The source of the periodic payments today might be a portfolio of stocks and bonds rather than annuities. But otherwise, the situations are virtually identical. The structuring attorney has contract rights and a promise to pay, and the attorney must rely on them.

One of the factors motivating attorneys to consider these alternative arrangements is the presence of low interest rates that can make annuities unattractive. Further, successful plaintiffs' attorneys may want a hand in the direction of their investment portfolios. Clearly, the attorney must not be permitted to update and fine-tune the investment strategy once the structure is locked in place.

However, the attorney can at least help set the strategy from the outset. That can empower the attorney in more tangible ways than are possible with a life insurance annuity. A key feature of the new wave of structured attorney fee products is, in general, some degree of choice in investment policies.

The investment policy is a binding contract that will provide the basis for the stream of payments. The attorney may be permitted to make a limited number of nonbinding requests to alter the policy thereafter. Yet despite any such requests, the company should have an unfettered right not to act on any of them.

Section 83 and *Childs*

As you might expect, the *Childs* case still looms large. It is the only structured attorney fee tax case, and it therefore remains the benchmark authority. The IRS routinely cites it and has become comfortable with structured attorney fees.

But does that apply outside life insurance? Tax professionals should examine the same checklist as they do for annuities. The relevant tax doctrines include constructive receipt, economic benefit, assignment of income, etc.

These tax doctrines require the kind of formalism that existed in *Childs*, now being replicated outside the context of life insurance annuities. Under section 83, if property is transferred to a person in connection with the performance of services, the person is required to include the fair market value of the property in income.

In *Childs*, the court applied section 83 principles to determine if the attorneys received an economic benefit in the year they entered into the structuring arrangement. The attorneys assigned their right to attorney fees to an assignment company before they actually *earned* the fees. In exchange for the assignment, the attorneys received a promise of future payments.

The attorneys in *Childs* did not have the right to assign, transfer, sell, accelerate, or defer the future payments. The assignment company purchased annuity policies to fund its obligations to the attorneys, but it remained the owner of the policies. The policies were subject to the claims of the assignment company's general creditors.

The issuers of the annuity policies provided a guarantee to the attorneys. In *Childs*, the IRS argued that the assignment company's promise to pay the attorneys was funded and secured, making the value taxable at that time. But the court said the attorneys were not the owners of the annuity policies and had no rights against the assignment company other than those of general creditors.

The court explained that a mere guarantee did not make a promise secured. These were not funded and secured obligations but were mere promises to pay. There was no economic benefit to the attorneys.

The Tax Court's decision was affirmed by the Eleventh Circuit. The IRS has cited the decision in approval in several rulings.[3] In LTR 200836019, a plaintiff entered into a settlement agreement with her employer to conclude an employment discrimination case. The settlement agreement called for the defendant to pay a structure company that would make periodic payments.

The plaintiff had no right to accelerate, defer, or assign the payments, and she was a mere general creditor. The assignee did not set aside a separate fund for her benefit or otherwise segregate assets. The IRS concluded that there was no constructive receipt or economic benefit. The plaintiff would simply be taxed as each actual payment was made to her. No separate fund was created, and the plaintiff had only the rights of a general creditor.

Economic Benefit

If a promise to pay is funded and secured and the payee need only wait for unconditional payments, the IRS says that the payee has received a current economic benefit.[4] Nevertheless, not all rights to receive periodic payments will trigger the economic benefit doctrine. For example, in Rev. Rul. 79-220,[5] a right to receive certain periodic payments did not confer an economic benefit on the recipient.

In that ruling, a taxpayer entered into a settlement with an insurance company for periodic payments over an agreed period. The taxpayer was not given any immediate right to a lump-sum amount and did not have the right to control the investment. The insurance company purchased an annuity to fund its obligation.

The insurance company advised the issuer of the annuity to make payments directly to the taxpayer. However, the insurance company retained all rights of ownership over the annuity policy. The taxpayer could rely only on the general credit of the insurance company to collect the periodic payments.

In the same way, a structured attorney fee must not allow the attorney any rights of ownership or control over any securities acquired by the third-party company that contracts to make payments to the attorney. The attorney enters into the structured fee agreement when the right to payment is subject to substantial limitations. The settlement agreement will be conditional on the implementation of the structured fee agreement, and there can be no separate fund created for the attorney's benefit.

Constructive Receipt

The constructive receipt doctrine prohibits taxpayers from deliberately turning their backs on income so they can choose the year or years in which they want to receive it. The legal right to receive the fee triggers the income. Generations of lawyers and their tax advisers have wondered how this fundamental rule could leave open the possibility for attorney fee structures.

An attorney may invest years in a contingent fee case. The attorney's fee may be *almost* earned when agreements in principle are reached or a deal seems very close. But the fee is not actually earned and payable until the settlement documents are signed.

[3]*See* FSA 200151003; 2001 IRS CCA LEXIS 368 (Nov. 1, 2001); LTR 200836019.

[4]*Commissioner v. Smith*, 324 U.S. 177 (1945); *Drysdale v. Commissioner*, 277 F.2d 413 (6th Cir. 1960), *rev'g* 32 T.C. 378 (1959).

[5]1979-2 C.B. 74.

Just as a plaintiff can structure a settlement before signing documents, so the lawyer can structure the fee. Thus, in *Veit v. Commissioner*,[6] the taxpayer negotiated an agreement to receive a bonus payment in installments before he had a right to demand payment. The IRS has long acknowledged that taxpayers can enter into agreements to defer future compensation payments in some circumstances.[7]

Some special tax code sections may restrict this, but they do not alter the attorney fee structure. For example, under section 409A, some types of nonqualified deferred compensation arrangements are subject to current tax. But section 409A does not apply to attorneys that provide services — other than as an employee or director of a corporation — to two or more service recipients in a year.[8]

The attorney contracts for a stream of payments before the fee is earned. And the attorney has rights to the payments only as a general creditor. This must be true regardless of how the funds are invested. Whether the payment is funded by a life insurance annuity or a portfolio of stocks and bonds, the tax principles are the same.

Investment Request

The fact that an attorney is allowed to make periodic, nonbinding investment requests should not change this result. Yet this must be carefully circumscribed. In *United States v. Fort*,[9] the Eleventh Circuit held that a taxpayer had sufficient control over stock placed in escrow to determine that the taxpayer was in constructive receipt of the stock.

The court in *Fort* noted that the shares were held in an escrow account in the taxpayer's name for his benefit. He even had dividend and voting rights over the stock, which effectively functioned as security. Attorney fee structures, whether via annuities or something else, must not provide security or any rights to the underlying assets.

The agreement must not create an escrow account, trust fund, or other form of asset segregation. The benefits cannot be subject to anticipation, alienation, sale, transfer, assignment pledge, or encumbrance.[10]

Portfolio Calculations

The fact that non-annuity attorney fee structures may have a formulaic investment return element should not create problems. In LTR 199943002, a plaintiff was negotiating a settlement agreement with a defendant to recover damages for a physical injury. The settlement agreement provided for variable periodic payments based on the performance of the Standard and Poor 500 stock index.

The defendant assigned the obligation to make the variable periodic payments to an assignee. Following the assignment, the assignee purchased an annuity that was to provide variable payments reasonably related to the variable periodic payments under the settlement agreement.

The IRS said periodic payments were not precluded from being fixed and determinable as to amount and time of payment merely because the sum and number of payments and the precise date of the final payment are unknown at the time of the assignment. The IRS ruled that periodic payments determinable by reference to the S&P 500 stock index or to a mutual fund portfolio designed to achieve long-term growth of capital and moderate current income provide an objective basis for determining periodic payments under section 130(c).[11]

Cash Equivalency

The cash equivalency doctrine states that if a promise to pay a benefit to an individual (even though it is unfunded) is unconditional and exchangeable for cash, then the promise is currently taxable. In *Cowden v. Commissioner*,[12] the court held that a contract right to deferred bonus payments under an oil and gas lease was the equivalent of cash. The court found that the right was frequently transferred to lenders or investors and was readily convertible to cash.

Attorney fee structures — whether with annuities or something else — must clearly state that the rights under the contract cannot be assigned, transferred, pledged, or encumbered. With that documentation in place, it is unlikely that the cash equivalency doctrine could be applied.[13]

Conclusion

Structured legal fees should be an essential tool for contingent fee attorneys, who have a unique ability to regularize their income and achieve surprising tax benefits. Most other fee earners — and most other lawyers — cannot do this.

Structured fees can improve the predictability of income, cash flow, and overall tax picture. Fee

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[6]8 T.C. 809 (1947) (holding that agreement to receive bonus payment in installments did not result in constructive receipt).

[7]*See* Rev. Rul. 60-31, 1960-1 C.B. 174.

[8]*See* reg. section 1.409A-1(f)(2).

[9]638 F.3d 1334 (11th Cir. 2011).

[10]Rev. Rul. 72-25, 1972-1 C.B. 127.

[11]*See* Rev. Rul. 2008-31, 2008-1 C.B. 1180 (investors were not owners of U.S. real estate when they invested in a broad-based index that sought to measure appreciation and depreciation of residential or commercial real estate in large geographic areas).

[12]289 F.2d 20 (5th Cir. 1961), *rev'g and remanding*, 32 T.C. 853 (1959), *opinion on remand*, T.C. Memo. 1961-229.

[13]*See Reed v. Commissioner*, 723 F.2d 138 (1st Cir. 1983); *Johnston v. Commissioner*, 14 T.C. 560 (1950).

structures may involve the traditional life insurance products popularized by *Childs*. Alternatively, they may use a portfolio investment model closely patterned after the restrictions in the *Childs* case. With attention to the details of the contracts, lawyers' fees today can be even better structured than those in the past.