Attorney Fee Structures, *Banks*, Forms 1099, and Catch-22

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Structured legal fees may not be written about frequently, but they are a relatively common technique for plaintiffs' lawyers to level out their income and lawfully delay the receipt of their fees.[1] Although it is certainly possible that additional tax controversies about legal fee structures could arise in the future, most of the writing on the wall regarding structured attorney fees occurred with the now-famous *Childs* case.

Leading Case

In *Childs v. Commissioner*,[2] the IRS unsuccessfully challenged a transaction that paid three attorneys their fees on a structured basis. The IRS asserted that the attorneys were entitled to all the fees at settlement, so they had ''constructively'' received the whole stream of fees for tax purposes. The Tax Court rejected the IRS's argument, as did the Eleventh Circuit Court of Appeals. The courts held that the value of the attorneys' rights to receive deferred installment payments of fees was not includable in their gross incomes in the year of the settlement.

Although the settlement agreement in *Childs* provided for the purchase of annuities to satisfy the installment payments of the attorney 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 structured payments. The insurance companies that were originally liable to pay a portion of the settlement purchased an annuity to fund the settlement payments, issuing the annuities to a third-party assignment company that was to hold the annuities.

The attorneys were each named annuitants under the annuity contracts, and their estates were designated as the primary beneficiaries. The annuities were subject to the rights of general creditors of the assignment company, but the insurance companies guaranteed to pay the annuity payments if the assignment company ever failed to pay. The *Childs* attorneys had no right to accelerate the payments or reduce them to their current value.

In fact, once the attorneys agreed to structure their fees, the attorneys were bound to the installment schedule, and they had no rights greater than those of a general creditor. The IRS lost *Childs*,[3] both in the Tax Court and on appeal. Even so, the Tax Court technically is bound by *Childs* only in the Eleventh Circuit,[4] and the IRS could take a position contrary to *Childs* outside the Eleventh Circuit. However, no one has fought a *Childs*-like battle elsewhere in the country.

In any event, the Tax Court typically will follow published authority from another circuit when there is no other published guidance. Moreover, the IRS has reached similar results. For example, the IRS indicated that there should be no constructive receipt when a taxpayer makes an irrevocable election to receive periodic payments, as long as the taxpayer's control of the payments was subject to substantial limitations or restrictions.[5]

The IRS has even cited *Childs* as authority. For example, in FSA 200151003,[6] the IRS cites *Childs* for the proposition that when attorneys enter a structured settlement arrangement calling for deferred payments of their attorney fees, there is no constructive receipt as long as the settlement is entered into before the attorneys obtain an unconditional right to compensation for their services.

Formula 409A

Because there has been no significant case law other than *Childs*, there was at least a momentary scare with the enactment of section 409A in the American Jobs Creation Act of 2004. Section 409A provides that all amounts

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

[2]103 T.C. 634, *Doc 94-10228*, *94 TNT 223-15* (1994), *aff'd without opinion,* 89 F.3d 856, *Doc 96-19540, 96 TNT 133-7* (11th Cir. 1996).

[3]*Id*.

[4]*See Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd on another issue*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

[5]Rev. Rul. 2003-115, 2003-2 C.B. 1052, *Doc 2003-23359, 2003 TNT 209-15*.

[6]*Doc 2001-31373, 2001 TNT 247-70* (Dec. 21, 2001).

deferred under a nonqualified deferred compensation plan for all tax years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless some requirements are met.

Not long after the enactment of section 409A, the IRS issued Notice 2005-1,[7] which quelled the fears of insurance companies, which again began issuing attorney fee structures. Although Notice 2005-1 does not identify attorney fee structures by name, in Q&A-8 it provides that section 409A does not apply to arrangements between a service provider and a service recipient, if the service provider is actively engaged in the trade or business of providing substantial services (other than as an employee or corporate director), and if the service provider provides those services to two or more unrelated service recipients.

By virtue of that description, it has generally been assumed that Notice 2005-1 means that section 409A does not apply to structured attorney fees. Reg. section 1.409A-1(f)(2)(i) also states that it applies to a service provider who is not an employee.

Relatively Settled

Although there have been indications that the IRS is not wild about plaintiffs' attorneys leveling out their income, it seems safe to say that attorney fee structures are reasonably well settled, and virtually pedestrian in operation. To me, one significant exception to this proposed maxim occurs when there are multiple parties, and when there is an arguable mismatch between the law firm that has a fee arrangement with a client and individual structuring lawyers.

Should the individual lawyer be able to structure? Should only the firm be able to structure? Should the firm, in turn, be able to provide deferral to individual attorneys? Some of these questions may not have answers, but it is fair to say that attorney fees structures are materially more complicated and require more thought (and there is perhaps inevitably more risk) in those multiparty situations. I've tried to address some of these issues elsewhere.[8]

Banks

Most tax professionals remember the split in the circuits over the tax treatment of contingent legal fees. For many years, it was not clear whether a plaintiff would have gross income measured by the full amount of his recovery or could merely report the net recovery after attorney fees. The issue was of considerable moment because many such plaintiffs could deduct their attorney fees only as miscellaneous itemized deductions.

That led to tax haircuts caused by the 2 percent threshold for miscellaneous itemized deductions and by the phaseout of those deductions. Moreover, it often led to application of the alternative minimum tax. This problem was partially eliminated by the Jobs Act, which added an above-the-line deduction for some kinds of litigation, primarily employment cases. Because the Jobs Act really solved the problem only for federal False Claims Act cases and employment cases,[9] many plaintiffs today still face enormous tax problems with attorney fee deductibility.

Ultimately, the Supreme Court resolved the split in the circuits in *Banks* in early 2005.[10] The Supreme Court did so only as a ''general rule,'' providing that a plaintiff generally will have gross income measured by the full amount of the recovery, including attorney fees. It will then be up to the plaintiff to find a way to deduct the attorney fees if he can. That the Supreme Court enunciated this as a general rule leaves unanswered the question whether there may be exceptions to this treatment.

Several exceptions are outlined. The Supreme Court expressly declined to rule on whether an attorney and client could form a partnership and effectively avoid the general rule that *Banks* enunciated. The Supreme Court also did not resolve whether there would be gross income to the plaintiff measured by attorney fees in cases involving statutory fee awards and in cases involving injunctive relief. The answers to these questions remain unclear.

Yet generally, *Banks* means that clients will have gross income measured by their contingent attorney fees and will have to find a way to effectively deduct them.

What Happens in a Fee Structure?

In a structure of attorney fees, if we cut through the actual mechanics,[11] the attorney will end up as a beneficiary (but not the owner) of an annuity that will provide periodic payments. In a simple case in which the attorney receives $200,000 per year for 10 years, the attorney will expect to pay tax on each $200,000 payment he receives annually. The attorney might logically expect to receive a Form 1099 for each of those 10 payments.

But what about the client? Many defendants after *Banks* feel justified in issuing duplicate forms 1099 to both lawyer and client. This is particularly true given the Form 1099 regulations governing payments to attorneys under section 6045F. What should occur from a reporting perspective in a structured fee case?

Ironically, before *Banks*, some attorney fee structures were accomplished at least in part to help ameliorate the client's AMT implications. It was sometimes thought that a client facing problems with deductibility would be better off if the contingent attorney fees were paid over time, which (logically) reduces the client's AMT tax problem. Instead of the client being tagged with all of the income from contingent fees on settlement of the case in one year, the client presumably gets tagged only with income for whatever fees the lawyer actually receives (from the fee structure) in the first year.

The second part of this seeming success story, however, is not very clear. It is worth questioning whether the

[7]2005-1 C.B. 274, *Doc 2004-24026*, *2004 TNT 245-10*.

[8]*See* Wood, ''Legal Fee Structures, Law Firms, and Lawyers: Children of *Childs*?'' *Tax Notes*, Apr. 10, 2006, p. 173, *Doc 2006-6993, 2006 TNT 69-20*.

[9]*See* Wood, ''Taxation of Contingent Attorneys' Fees Altered by the Jobs Act and the Supreme Court,'' 57th Annual Tax Institute, USC Law School 2005 Tax Institute, ch. 4, vol. 1.

[10]*Commissioner v. Banks*, 543 U.S. 426, *Doc 2005-1418, 2005 TNT 15-10* (2005).

[11]For mechanics, see Wood, *supra* note 1.

client should be treated as receiving the structured fees the lawyer will receive over time. Consider the following:

- Recent correspondence from an annuity provider indicates that after *Banks*, the annuity provider would issue Forms 1099 for an attorney fee structure as follows:

  1. A Form 1099-MISC will be sent annually to the attorney for payments made to the attorney (this would be the $200,000 per year in the above example).

  2. Also, the annuity issuer will issue a Form 1099-MISC annually to the plaintiff for payments made to the attorney. In other words, again echoing figures from the above example, the client will also receive an annual Form 1099 for $200,000.

Duplicate Reporting

Is this logical or appropriate? It's hard to say. Because the Form 1099 regulations do propagate duplicate reporting to lawyer and client, maybe it is. If one accepts the notions that *Banks* (generally) requires the client to have income measured by the legal fees, and that the fee structure is successful in stretching out the tax impact of fees (to the lawyer and thus presumably to the client too), it may be.

Recall that one of the hallmarks of the structured legal fee is that the lawyer cannot have access to the money. The lawyer is committed to receiving periodic payments. That must be true for the plaintiff as well: The plaintiff surely has no greater rights to the money than the lawyer has. Presumably, the client could not receive the legal fees any faster than the lawyer can.

Yet, the practical return-filing affect is disturbing. If the underlying case from which the attorney fees are structured arises in the employment arena (or in a federal False Claims Act case), then (if there is no fee structure) presumably the client is entitled to an above-the-line deduction for the entire attorney fee in the year of settlement. If there is a fee structure paid to the attorney over 10 years, then presumably the client also has the same above-the-line deduction in each of the 10 years. Bear in mind, however, that we have not talked yet about whether the *client* is structuring.

Some insurance companies will write attorney fee structures for attorneys only when the client *also* structures. Some will write fee structures even when the client is not structuring. The latter might suggest that the client will end up with a large gross income in the year of the settlement.

A client who is not structuring a settlement over time would presumably want to make his tax return simple by including the attorney fees in gross income, and then claim the above-the-line deduction (assuming it is an employment case) to offset those fees. If this client is stuck with only a small portion of the deduction in the year of the settlement (because his attorney chose to structure his fees), the client may need to worry over the *next 10 years* of tax returns about an above-the-line deduction. This may raise audit risk, be an annoyance, and so on.

Of course, some clients may structure, and perhaps that helps ameliorate this. But the client may structure over a shorter or longer period than the lawyer. The client may structure over 5 years or 15 years, yet the attorney fees (and the Forms 1099 respecting them that are sent to the client) will presumably be governed by the attorney's distribution scheme (10 years, in my example). This may lead to many mismatches.

Conclusion

Further, if one takes the exemplar litigation out of the employment (or Federal False Claims Act) arenas, then almost inevitably the problems will be worse. No longer a wash to the plaintiff via the above-the-line deduction, the one-time attorney fee deduction may turn into a numerically smaller but annoyingly repetitive problem over the next 10 or 15 years — or even longer, depending on the duration of the plaintiff attorneys' structure.

That does not necessarily mean the plaintiffs' tax problem is worse, but it does mean number crunching will be that much more difficult. Above all, it needs to be considered. That situation also does not necessarily mean attorney fee structures are unattractive, or even that stand-alone attorney fee structures will hurt plaintiffs. However, it does complicate the analysis, adding still more to consider.

It is appropriate for insurance companies, plaintiffs' attorneys, and clients to start thinking about those issues. While I suspect the *Banks* issue in attorney fee structures is often being ignored, a client who receives a Form 1099 for every year of a lawyer's 20-year fee structure will not, at least if he isn't expecting it, be pleased.