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Top 10 Practice Points to Observe With Legal Fee Structures

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The importance of form, exactly how you do something, is extraordinarily important in federal income tax law.

Some deferred payment mechanisms work for tax purposes, and some do not. Although that is true across virtually the entire federal income tax system, it seems particularly true with issues relating to timing of income.

Despite more than a 10-year track record of structuring legal fees, many plaintiffs' lawyers remain confused about what they can do, what they cannot do, and what is most important to securing the financial and tax benefits of structures.

One such area involves structures of attorneys' fees, designed to level out the peaks and valleys that generally characterize the fluctuating income of plaintiffs' attorneys.

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This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

Ever since *Childs v. Commissioner*, 103 T.C. 634 (1994), *affirmed without opinion* 89 F. 3d 56 (11th Cir. 1996), attorneys have been able to structure their legal fees. Yet, despite more than a 10-year track record of structuring legal fees, many plaintiffs' lawyers remain confused about what they can do, what they cannot do, and what is most important to securing the financial and tax benefits of structures.

From my perspective as a federal income tax lawyer, here are the top 10 points every plaintiffs' lawyer should know about structuring legal fees.

1. Timing Is Everything

If you want to structure your legal fees, you need to get the ball rolling before you have a right to your fee. Once the settlement agreement is signed, it is too late to structure your fees.

Fortunately, though, the authorities have been pretty liberal on this issue. It is not necessary to have your fee agreement contemplate periodic payments from the time it is originally executed.

In other words, you are generally not treated as "earning" your contingent legal fee until the case is really resolved (meaning either a judgment or a signed settlement agreement). That gives you flexibility to consider whether you want a structure for some or all of your legal fees, as long as you do it before the case is resolved.

To be safe, however, as settlement negotiations heat up, start thinking about this, and get the appropriate professionals involved (more about professionals in Point 8 below).

2. Consider Your Legal Fee Agreement

You will probably be asked to amend your contingent fee agreement with your client. To avoid any awkwardness, consider revising your generic contingent fee agreement to expressly contemplate periodic payments for all your cases.

Exactly what wording you should use in your generic fee agreement is a matter of opinion. However, I usually like the fee agreement to state that the attorney may receive his applicable percentage in cash or in periodic payments. The fee agreement can provide that the at-

torney will specify which and for how much in writing before the case goes to judgment or is settled.

I cannot think of any disadvantage in doing this in every form legal fee agreement from the get-go. It does not bind you to do it, but only gives you the right to do it if you want to.

3. Client Structuring Versus You Structuring

Some lawyers believe they can only structure if their client does. This is not true. However, it is true that some life insurance companies will only structure legal fees if the client is also structuring. In contrast, some life insurance companies will structure a “stand-alone” legal fee.

That means you can structure your legal fees even though your client may choose to receive his or her recovery entirely in cash. Because of this, you should not need to convince your client to structure just so you can do so. Of course, structures can make sense for clients, too.

Indeed, while you clearly do not want to push a client to structure if he or she does not want to do so, it is almost always a good idea to mention structures to your clients any time you are resolving a case. The client may or may not want to structure, but mentioning structures to your client is almost always a good idea.

4. Annuities Versus Other Alternatives

A legal fee structure should follow a tried and true format. There is great flexibility in the types of payment structures you can obtain, but they all use life insurance annuity products. You should not structure legal fees with private annuities or other products. This point bears underscoring.

Unfortunately, many plaintiffs’ lawyers seem to want private annuity products, where there is a trustee appointed to manage the money (and take the lawyer’s directions regarding same). In the past, this kind of structure might have worked, but it no longer does today. Stick with annuity products if you want to structure.

5. Qualified Settlement Funds?

A tax code Section 468B trust, also known as a qualified settlement fund or QSF, is often set up to be the repository of moneys in settlement of a case. QSFs were originally designed so that defendants could pay money into a settlement trust and take an immediate tax deduction, while the various plaintiffs continued to scabble over who would get what.

Today, 468B trusts are often used to give plaintiffs and their lawyers more time to determine how they want to receive their money. One can use a 468B trust in this way, but you generally do not have to create a 468B trust to structure legal fees. A 468B trust or QSF is generally used when there are multiple plaintiffs and where there is some question about how moneys will be divided. Lawyers’ fees do not have to be placed into the QSF along with the client money, but it is generally advantageous to do so.

A QSF is relatively easy to set up, and involves a trust document with a trustee. The plaintiffs’ lawyer should not be the trustee (although there is actually no prohibition on this). The main point is that a court must su-

pervise the trust. The court might be the court having jurisdiction over the case.

However, any court will do. Many plaintiffs’ lawyers prefer probate courts, because probate judges are usually familiar with trusts. Properly set up, a QSF delays the receipt of the money by the lawyers and their clients. That can enable everyone to consider structures after the defendant (which puts the money into the QSF) is out of the picture.

6. Payment Alternatives

Consider carefully how you want to receive the payments over time. Do you want level payments for 10 years, payments over your lifetime, or perhaps payments for the joint lives of you and your spouse? Do you want payments to start immediately or not to start for 10 years? Do you want to have lump sums periodically disbursed when you might have particularly large expenses (for example, years in which you might have kids in college)?

There is almost infinite variety in what you can accomplish. However, once you lock in your payment structure, it cannot be changed. This may make a QSF attractive (see Point 5 above) to give you more time to consider the alternatives before you have to make a permanent decision. It also means you’ll need professional help (see Point 8 below).

7. Contingent Fees Only

With all the talk of tort reform in Washington, D.C., plaintiffs’ lawyers may feel discriminated against by Congress in various ways. Even so, they are entitled to a benefit no one else receives. Indeed, contingent fee lawyers are the only ones who can structure legal fees.

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Structuring legal fees is a great way to spread out your income, reduce your income tax burden, provide for retirement, do estate planning, etc. If you do it correctly, you can take part of your fee in cash and part in structured payments. Moreover, it may even be possible to interpose a fee structure in cases going to judgment, or in cases where a court award of attorneys’ fees is made.

For this kind of esoterica, though, you need a qualified tax lawyer to help.

8. Work With a Broker

A qualified settlement broker has access to the life insurance markets and to the various annuity tables you will need to review. A broker earns a commission on the sale of the annuity product, but the broker usually earns nothing unless the transaction closes. Brokers therefore have an incentive to provide you with all the data you need.

The only dumb question is one you do not ask, so ask your broker to run as many financial scenarios as you think make sense. Interestingly, if you choose not to use a broker, you will not save the broker's commission, as all of the major life insurance companies that issue annuities for structured legal fees will not deduct a commission even if you try to deal with them directly. In fact, they will likely steer you to one of the brokers that sells their insurance products.

So use a broker. A standard brokerage commission is 4 percent. Thus, if an annuity is purchased for a premium of \$1 million the broker (or several brokers working together) generally earn \$40,000. If the defendant has a broker and the plaintiff has a broker, they may share commissions.

Brokers usually have a good idea of desirable payment structures, perhaps a better idea than you have. Do not hold back on providing your broker with financial information about you and your family, you and your practice, and your medical, education, and retirement needs.

9. Do Not Get Creative

This is counterintuitive to most plaintiffs' lawyers, particularly successful ones. Although there is almost infinite flexibility in payment streams for structured legal fees, this is not a time to get creative on the legal structure. The timing of your income stream, any blips in the stream, unusual disbursements, etc., are all possible.

But, do not try to get creative and invent a new form of legal fee structure (see Point 4 above). If you are a

real high roller and like to take big tax risks as well as risks with your cases, satisfy that craving elsewhere, not here.

10. Consider Firm Arrangements

If you are a solo practitioner, structuring legal fees is usually simple. If you practice in a firm, there are usually additional legal niceties to be observed. For this, you probably need not only a broker (who should be used in every legal fee structure in any event), but also a tax lawyer.

In my experience, many plaintiffs' lawyers and their law firms do not adequately consider who is buying the structure (the firm or the individual lawyer?), and how the structure will be paid and taxed in the context of a professional corporation, partnership, or limited liability partnership.

Will the firm buy the structure, and then receive the periodic payments, paying them out as they are received to the individual lawyer? If the firm has the client relationship with the client (so the firm is technically entitled to the fee), is it OK to have an individual lawyer take his share of the attorneys' fees the firm receives and buy an annuity?

There is no right answer here for everyone, but it is important to consider these issues, to consider the legal structure and the lawyer-client relationship, and to take account of matters such as control, firm management, moneys that might pass to an estate, and so on. It is usually possible to cross the Ts and dot the I's so a structure works even in big law firms, but you will need extra time and care to do this.