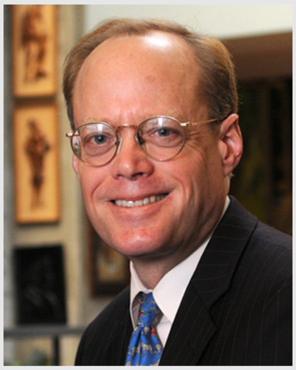
Lawyers Are Structuring Fees Despite IRS Attack

by Robert W. Wood and Alex Z. Brown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In this article, Wood and Brown examine a generic legal advice memorandum concerning attorney fees that was issued by the IRS in December 2022, and they consider why attorneys appear to be structuring their legal fees the same way they did before the guidance was issued.

This discussion is not intended as legal advice.

Introduction

If they observe the formalities, contingent-fee lawyers can defer their legal fees, have them invested pretax, and have them paid and taxed later. They must implement those arrangements before earning the fee. Yet even in cases that have been litigated for years, so long as the structure is implemented before the case settles — even the night before — the tax deferral is effective. The use of a qualified settlement fund (QSF) can expand the potential window of time to structure an arrangement because a QSF stands in the shoes of the defendant.

The execution of a formal settlement is the event that causes the receipt of income to the lawyer. From a tax and accounting viewpoint, the fee is contingent, so it is not income until the client signs the settlement agreement, triggering the fee. With the help of life insurance companies, lawyers have been implementing structured fee arrangements during settlement negotiations for 40 years. However, the real shot in the arm to plaintiff lawyers and the structured legal fee industry came in the 1990s, with *Childs.*[1]

In that Tax Court case, the IRS lost its sole litigated attack on structured legal fees. It appealed the case to the Eleventh Circuit and lost there too, albeit without a published opinion. In *Childs*, the IRS argued that the annuity contracts used to defer the lawyer's receipt of fees were not viable, so the lawyer should have been taxed presently, not later when the periodic payments started to trickle in. Rejecting the IRS's arguments, the Tax Court and Eleventh Circuit upheld the arrangement.

For more than a decade, the IRS grumbled about *Childs* — at least informally. But then it began citing the case with approval in several private letter rulings. This suggested — to us at least — that the IRS had accepted *Childs* as the law. For example, in FSA 200151003, the IRS cited *Childs* to support the proposition that when attorneys enter into a structured settlement arrangement calling for deferred payment of their fees, there is no constructive receipt as long as the settlement is entered into before the attorneys

[1] *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd without opinion*, 89 F.3d 856 (11th Cir. 1996).

obtain an unconditional right to compensation for their services.

Childs 30 Years Later

Childs involved structuring legal fees with annuities, which was the only game in town in the 1980s and 1990s. Indeed, many life insurance companies continue to offer these arrangements and they remain popular, especially in times of high interest rates. High interest rates generally make annuities attractive for plaintiffs who structure their recoveries, too.

As interest rates have risen over the last several years, there has been a resurgence in lawyers interested in structuring their fees with annuities. There is nothing wrong with annuities, and nothing wrong (and a lot right) with following *Childs* to the letter. Yet in the last three decades, during which structured legal fees have gained acceptance and popularity, many lawyers have moved away from annuities, despite the high interest rate environment. So has the insurance industry, offering market-based arrangements that essentially emulate *Childs* but with payments to the attorney calculated by reference to a portfolio of stocks and bonds.

There are various approaches, but there appears to be nothing magical about funding a structure with life insurance annuities.[2] Many lawyers and tax advisers are comfortable with alternative investments, so long as the teachings of *Childs* are followed. For example, the lawyer must remain a mere payee, a general creditor without ownership or control over the deferred fees. Although the amount of a payment may be calculated by reference to other assets (just as the payments in *Childs* were calculated by reference to amounts to be paid via an annuity), the attorney cannot own the referenced assets, either constructively or in fact.

Section 409A Enacted

A fly in the ointment of structured legal fees came in 2004 when Congress enacted section 409A following the Enron scandal. Section 409A was designed to regulate and tax many types of deferred compensation. Plaintiff lawyers are hardly corporate executives, but lawyers and insurance companies wondered if this complex provision would affect fee structuring by plaintiff lawyers. Not long thereafter, the IRS issued Notice 2005-1, 2005-1 C.B. 274.

This notice included a section labeled, "Arrangements With Independent Contractors," which described how new IRS regulations would protect independent contractors from the ambit of section 409A. It foreshadowed how the new regulations would provide that section 409A does not apply to arrangements between a service provider and a service recipient if (1) the service provider is actively engaged in the trade or business of providing substantial services (other than as an employee or corporate director), and (2) the service provider provides those services to at least two unrelated service recipients. This rule is designed to distinguish between employees (whose compensation arrangements are subject to section 409A) and bona fide independent contractors, whose compensation arrangements were not intended to be affected by section 409A.

The IRS position announced in the 2005 notice was followed by regulations in 2007 that said the same thing.[3] And that seemed to be that, with structured legal fee arrangements proceeding apace with no worry over section 409A. From 2005 until December 2022, tax opinions on structured legal fee arrangements usually had one paragraph or a footnote that said that under the regulations, section 409A does not apply to structured legal fees for independent outside counsel. Then, in December 2022, the IRS revealed that it had a new idea about how section 409A could apply to structured legal fees after all.

Mother of all GLAMs

A GLAM is an IRS generic legal advice memorandum, and plenty of them have been issued over the years to inform taxpayers and IRS field personnel about the National Office's position on a particular item or issue. Some GLAMs are controversial, but it is hard to remember one as contentious or widely read as AM 2022-007 — the GLAM released in December

[2] Robert W. Wood, "Structuring Legal Fees Without Annuities: Offspring of *Childs*," *Tax Notes*, July 20, 2015, p. 341.

[3] Reg. section 1.409A-1(f)(2).

2022. It came as a surprise to insurance companies, structured settlement providers, plaintiff lawyers, and tax advisers.

A GLAM is not binding on taxpayers, and this GLAM's criticism of fee structures is broad and scattershot in approach. Still, its analysis merited close consideration. Most fee structures follow one of two models: (1) an assignment structure modeled strictly after *Childs*, or (2) one with changes that also rely on *Childs* and other deferred compensation authorities and principles to bridge any gap between *Childs*' facts and the structure's facts. Both models rely on *Childs* to a material degree, and both erect formal barriers so the lawyer who is the ultimate payee does not have even a security interest in the right to periodic payments of the underlying reference or funding assets, and cannot control the structure once it is put in place. *Childs* was itself determined by the application of deferred compensation legal authorities.

The GLAM addresses a hypothetical fee structure that differs from *Childs*. Under *Childs*, a defendant has an obligation to make periodic payments to the plaintiffs' attorney as part of the settlement agreement, and the defendant assigns its obligation to make those periodic fee payments to a third-party assignment company. In the GLAM's fact pattern, the settlement agreement only provides for a lump-sum fee payment — the deferral of periodic payments is made by agreement between the attorney and the third-party assignment company outside of the settlement agreement.

The GLAM analyzes arguments that suggest this change causes the structured fee to fail, triggering immediate taxation to the attorney when the fee structure is funded. Indeed, some of the GLAM's analysis seems to challenge the facts and result in *Childs* — but it mostly tries to avoid a direct attack. Still, the overall tenor of the GLAM caused some companies to temporarily pause and reevaluate structured attorney fees.

Some say that the marketplace has grown busier than ever, suggesting that many lawyers still want to structure fee arrangements. This may be because the talk about the GLAM reawakened interest in structured fees. Alternatively, perhaps there is anxiety that lawyers should structure fees while they can, in case the IRS starts to push back hard and prevails. In any case, some of the discussion in the GLAM caused a reexamination of *Childs*:

- In the very first footnote, the GLAM notes that *Childs* has not been formally acquiesced to by the IRS, that Tax Court opinions are only binding on the Tax Court and no other courts, and that unpublished circuit court opinions, including the Eleventh Circuit's unpublished affirmation of the Tax Court's *Childs* opinion, are only persuasive authority. This is hardly an indication of deference to the leading legal authority on a topic for nearly three decades.
- *Childs* is repeatedly noted as not having addressed, and therefore not having issued a decision on, many of the GLAM's more novel arguments. Functionally, the GLAM merely indicates that the IRS may have freer rein to develop these arguments because they have not already been answered by *Childs*. And for many of the GLAM's novel arguments, the IRS, Tax Court, and Eleventh Circuit may not have thought they merited addressing in *Childs*.
- The GLAM's analysis of the economic benefit doctrine is curious. Although the GLAM says *Childs* did not specifically address the economic benefit doctrine, it's unclear whether or how the *Childs* fact pattern would fare better under the GLAM's peculiar application of the doctrine than the fact pattern addressed in the GLAM. Thus, the GLAM tacitly implies that a fundamental tax doctrine was in existence when *Childs* was decided, which may have changed the result in *Childs* but was simply ignored by the IRS, the Tax Court, and the Eleventh Circuit. This is even odder considering that *Childs* was decided by considering and applying section 83, which is a partial codification of the economic benefit doctrine.
- In its most direct attack, the GLAM notes in a footnote that it declines to address whether the Supreme Court's 2005 *Banks*[4] decision changes the outcome under *Childs*.

[4] *Commissioner v. Banks*, 543 U.S. 426 (2005).

Banks concluded that a contingent fee paid directly to a plaintiff's attorney by a defendant to satisfy the plaintiff's obligation to pay the contingent fee is treated for tax purposes as being paid to the plaintiff by the defendant and then paid by the plaintiff to its attorney. Despite having just said that it will not address this point, the footnote then gives its reasons for why *Banks* would change the outcome under *Childs*. In reaching this startling assertion on a topic that the footnote has just plainly asserted it is not addressing, the GLAM appears to apply the same economic benefit analysis that has been subject to criticism by commentators.

The GLAM makes four arguments for why its hypothetical structured legal fee should not work:

1. *It violates the assignment of income doctrine*. This tax doctrine applies when one person earns income but tries to assign it elsewhere so that someone else pays the tax. Yet the lawyer who earned the income is the same one paying the tax, just later, so it is hard to see how this applies.
2. *It violates the economic benefit doctrine*. This doctrine applies when money is set aside or secured, even though the taxpayer cannot presently get it. The classic example is when an employer puts money away in a trust beyond the reach of the employer's creditors that will unconditionally pay an employee certain amounts over time. Although the employee has not yet received the future payments and does not directly own the assets held in the trust or control the trust, the future payments are essentially fixed and funded once the trust is established and funded. Thus, the beneficiary's interest in the trust is itself an asset of value that creates income for the employee when the interest in the trust is first granted to the employee. However, in a structured fee as approved in *Childs*, the assets are not segregated for the lawyer and are unsecured, so the lawyer is merely a general creditor of the third-party assignment company. The same is true in the fee structure described in the GLAM. Still, the GLAM somehow concludes that the modified structure confers an economic benefit to the attorney.
3. *It is taxable under section 83*. This offshoot of the economic benefit doctrine is the code section that taxes restricted stock and other property transferred in connection with services when the property is vested, and the recipient is certain to get it. The GLAM makes a complex argument for why section 83 should tax the fee structure up front, but the *Childs* court specifically rejected the applicability of section 83 to the structured fees it approved and the IRS's arguments in the GLAM do not identify how the hypothetical fee structure should come out differently than the facts in *Childs*.
4. *It is a deferred compensation plan that violates section 409A*. Enacted after *Childs* was decided, section 409A says that some deferred compensation should be presently taxed and penalties will be faced if section 409A's requirements are not met. As noted, the regulations under section 409A say that the entire provision does not apply to independent contractors who have two or more customers or clients (among other requirements that are usually easily satisfied for structured fees).

Since reg. section 1.409A-1(f)(2) was published in 2007, it has been widely understood to exempt structured legal fees. Most lawyers have two or more clients, so they are exempt from section 409A. Even so, the GLAM argues that modified legal fee structures are subject to section 409A because the change of the formal assignor from the defendant to the attorney means the deferred fee is no longer an arrangement that is made between the client and the lawyer.

An interesting textual issue lies at the core of the IRS's argument on this point. But the GLAM's reasoning seems too formalistic and textually pedantic to support the IRS's fundamentally implausible conclusion that a structured fee is not a payment to an independent contractor. The purpose of the language the GLAM applied was to make sure that individuals who are employees in substance could not escape section 409A simply by labeling themselves independent contractors.

There is nothing in the language of the regulations to suggest that a person who is, in substance, an independent contractor should be subject to section 409A.

Market Reactions

After initial reactions to the GLAM subsided, the marketplace of lawyers, brokers, and life insurance and structure companies settled back into business. Fee structure documents should carefully adhere to the teachings of *Childs*. The principles of constructive receipt, economic benefit, and cash equivalency serve as the boundaries that one must stay within. The industry appears to have returned to normal, and many report that lawyers are more enthusiastic than ever about fee structures.

There are many possible reasons for this. For some attorneys and their tax advisers, the GLAM provided a rare opportunity to glimpse the IRS's possible lines of attack on at least some structured fees. No attack is welcome, but seeing the IRS's positions may have made some people more comfortable with the authorities that support structured fees. Others may be taking a less substantive view of the underlying tax doctrines and may be motivated by pragmatism. That is, it may take many years for the arguments presented in the GLAM to be addressed in a conclusive court decision.

Moreover, even if that future court decision is solidly in the IRS's favor, its effect will likely be confined to the facts before the court. Unless the most unlikely result occurs — the complete overturning of *Childs* — this hypothetical decision may only have consequences for some fee structures. Finally, some may find the prospect of structured fees being challenged all the more reason to structure fees while they can, based on the existing state of tax authorities. After all, *Childs* is precedential authority, while the GLAM is not.

Qualified Settlement Funds

In the days before *Childs* and for many years afterward, most structured legal fee arrangements appeared directly in settlement agreements between plaintiffs and defendants. Today, most structured legal fees are implemented by a QSF, which stands in the shoes of the defendant. In the context of qualified structures for physical injury recoveries, the IRS has issued guidance that says structures made from QSFs are fine because the QSF takes the place of the defendant for section 130 purposes.

Implementing a structure through a QSF should not change the tax result. QSFs give lawyers extra time to fence-sit about whether they want structured fees and about what type and amount of structured fee arrangement to ask the QSF to adopt. Plaintiffs also routinely need time to consider whether they want a structured settlement, what type of structure, and in what amount. We have never seen the IRS suggest that this need for time creates constructive receipt or economic benefit issues for plaintiffs. It will be interesting to see if the IRS tries to make that argument for lawyers who structure fees from a QSF.

Borrowing

The GLAM's focus on the modification of the formal assignor suggests that other common modifications to the *Childs* facts by fee-structuring agreements may also come under more scrutiny. One modification may be the inclusion of provisions that allow attorneys to borrow funds from the assignment company, or a related or unrelated company. Although the loan arrangements may not debit directly from the amount owed to the attorney under the structured fee, there is understandably a question of whether the loan is, in substance, an advance on the structured fee that compromises the structured fee.

When *Childs* was decided 30 years ago, no one considered borrowing. But today, market-based attorney fee structures are increasingly likely to permit borrowing or to recognize that a borrowing facility may be allowed — subject to conditions. The fee structure company and the lender may be related or not. And they may have their own protocols to ensure their transactions are independent and valid. Entities must be kept straight, borrowing ratios must be observed, and rates and protocols must be in place. These details may seem unimportant to the plaintiffs' lawyer, who may think in shorthand: "I'll structure fees to provide regular annual cash flow and to defer taxes. And I can always borrow my own money when needed."

However, if done properly, the proceeds of a loan are not income if the taxpayer is obligated to repay it.[5] A sale or disposition of a lender's collateral can trigger income,[6] but there does not appear to be any authority directly addressing a loan concerning an attorney's structured fee. In other contexts, the IRS has shown an interest in transparency and matching.

Thus, in *Heyn*, a plaintiff settled an employment dispute in exchange for five annual payments of $9,100.[7] At the same time, the employer "loaned" the employee $41,835 (the present value of the five annual payments). The employee issued five promissory notes to exactly offset the annual payments. The Tax Court held that the $41,835 was income, not a loan.

The taxpayer's obligation to repay exactly matched the future payments, so neither party had any obligation to actually pay. Economically, the loan was, in effect, an advance of the periodic payments and was debited against the future payments. The details, terms, and circumstances matter in determining whether an advance will be respected. One of the requirements for an advance ruling that a nonqualified deferred compensation plan does not result in constructive receipt is that the service provider must not be permitted to pledge, encumber, assign, transfer, or alienate the stream of future payments.[8]

In TAM 200040004, the IRS held that a combined note, pledge agreement, and bonus agreement constituted compensation for future services, not a bona fide loan. The employee received an upfront loan, signing a promissory note. He pledged his future bonus payments to secure the note. The employer agreed to pay annual bonuses in amounts exactly equal to the note amounts. The IRS acknowledged that the transaction took the form of a loan, but the employee had no unconditional and personal liability. The note would be repaid with guaranteed bonuses exactly matching the note payments, so it was held to be current compensation.

However, in *Dennis*, an insurance agent received advances secured by future commissions.[9] Although the balance of his advances was reduced by commissions, he had an unconditional obligation to repay. The Tax Court therefore respected the advances as loans.[10] In contrast, when an employee's obligation to repay is only conditional, it is generally current compensation.[11]

The IRS has said that an advance to an insurance agent qualifies as a loan if: (1) the advance takes the form of a loan and interest is charged; (2) the agent is personally and unconditionally liable; and (3) the employer actually or in practice demands repayment if the future commission income is not sufficient for repayment.[12] For a client's loan to his attorney to be respected, the attorney must have an unconditional, personal obligation to repay the principal and interest.[13] The loan and stream of periodic payments should be independent obligations, as they were in *Mastroeni*.[14] There, the bank was a lender to the taxpayer and the custodian of the taxpayer's IRA account.

With appropriate documentation and distance, it should be possible to have a bona fide legal fee deferral and a bona fide loan, and not have them collapsed together. Perhaps the best fact pattern would be to have truly independent and independently owned structure companies

[5] *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 207-208 (1990) ("It is settled that receipt of a loan is not income to the borrower."); *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) ("When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer.").

[6] *See Calloway v. Commissioner*, 691 F.3d 1315 (11th Cir. 2012) (treating a nonrecourse loan at 90 percent of the value of securities pledged as a sale of the securities rather than a mere pledge).

[7] *Heyn v. Commissioner*, 39 T.C. 719 (1963).

[8] Section 5.02 (model trust provisions); Rev. Proc. 92-64, 1992-2 C.B. 422.

[9] *Dennis v. Commissioner*, T.C. Memo. 1997-275.

[10] *See also Gales v. Commissioner*, T.C. Memo. 1999-27, AOD CC-1999-011.

[11] *Winter v. Commissioner*, T.C. Memo. 2010-287 (advance treated as compensation when employee did not have unconditional obligation to repay).

[12] *Dennis*, T.C. Memo. 1997-275; *Gales*, T.C. Memo 1999-27, AOD CC-1999-011.

[13] *See Mathers v. Commissioner*, 57 T.C. 666, 675 (1972) (noting that the transfer of the installment obligations did not take the form of a loan agreement); *Heyn*, 39 T.C. 719 (holding that promissory notes were to be disregarded in part because the taxpayer did not expect to ever pay any amount on the notes).

[14] *In re Mastroeni*, 57 B.R. 191 (Bankr. S.D.N.Y. 1986).

and loan-funding entities. The parties should all behave in a commercially reasonable manner. The lending entity should require a loan application, credit report, and so on. Ideally, the payments should not be matched to each other in timing and amount so as to offset each other, so payments must be made by the assignment company and the attorney for both the structured fee and the loan repayment. The more independent and arm's length the relationship, the better.

Fundamental Rules

Formality and form in structured legal fees are very important. The lawyer must sign the structure documents before the settlement documents are signed. Ideally, the fee agreement will give the lawyer the choice to accept cash or periodic payments, though it is unlikely that will determine the outcome of a tax examination. The lawyer must not be able to accelerate, pledge, defer, or otherwise change what he is promised to receive over time. The lawyer contracts for a series of payments before the fee is "earned" (that is, before the case settles, or before the fee is distributed by a QSF). The attorney may be empowered to choose investments or managers before signing, but not thereafter.

The lawyer must be a general creditor with no right to accelerate, defer, or assign the right to receive the periodic payments. The fact that there is a formulaic investment return should not create problems. In LTR 199943002, the IRS ruled that periodic payments determinable by reference to the S&P 500 stock index or a portfolio to achieve long-term growth and moderate current income qualified under section 130(c).[15] Investment selections must be made before the case settles. The attorney can have no security nor 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.[16]

All the documents should make clear that the attorney has no right to accelerate any of the payments. The attorney must agree to a fee structure before the case is resolved. That means that, before the client signs any settlement documents, the structure must be in place, or the structure must be implemented from a properly formed QSF. Ideally, the contingent-fee agreement with the client should specify that the attorney has the right to elect to take his fees in that way before the conclusion of the case.

Conclusion

Contingent-fee lawyers can defer the receipt and tax impact of their unearned legal fees until later. Attorneys should be careful to follow the rules for deferral, particularly when the design of the structure does not exactly match the structure approved by *Childs*, the only case to directly bless structured fees.

An attorney who uses life insurance annuities in a replica of the *Childs* fact pattern could probably simply point to *Childs* as dispositive and controlling (despite the GLAM's suggestion that *Childs* failed to address certain doctrines and that it may be affected by the *Banks* decision). An attorney who structures with a market-based assignment company model will need to say more. The fact that a structure is not exactly the same as the one approved in *Childs* means only that an attorney would need to address and defend the modifications in a tax examination. This may place a larger burden on attorneys and their tax counsel for vetting and defending fee structures.

Yet the IRS also has a burden if it wants to challenge any fee structure. The IRS should have to show how any modifications result in a structure differing from *Childs* in a meaningful way. The specific facts described in the GLAM seem to show how challenging that task may be for the IRS. Especially when considering structures that significantly modify the *Childs* fact pattern, attorneys should make sure they do not compromise the fundamental requirements, limitations, and timing that resulted in the taxpayer's success in *Childs*. ■

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

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