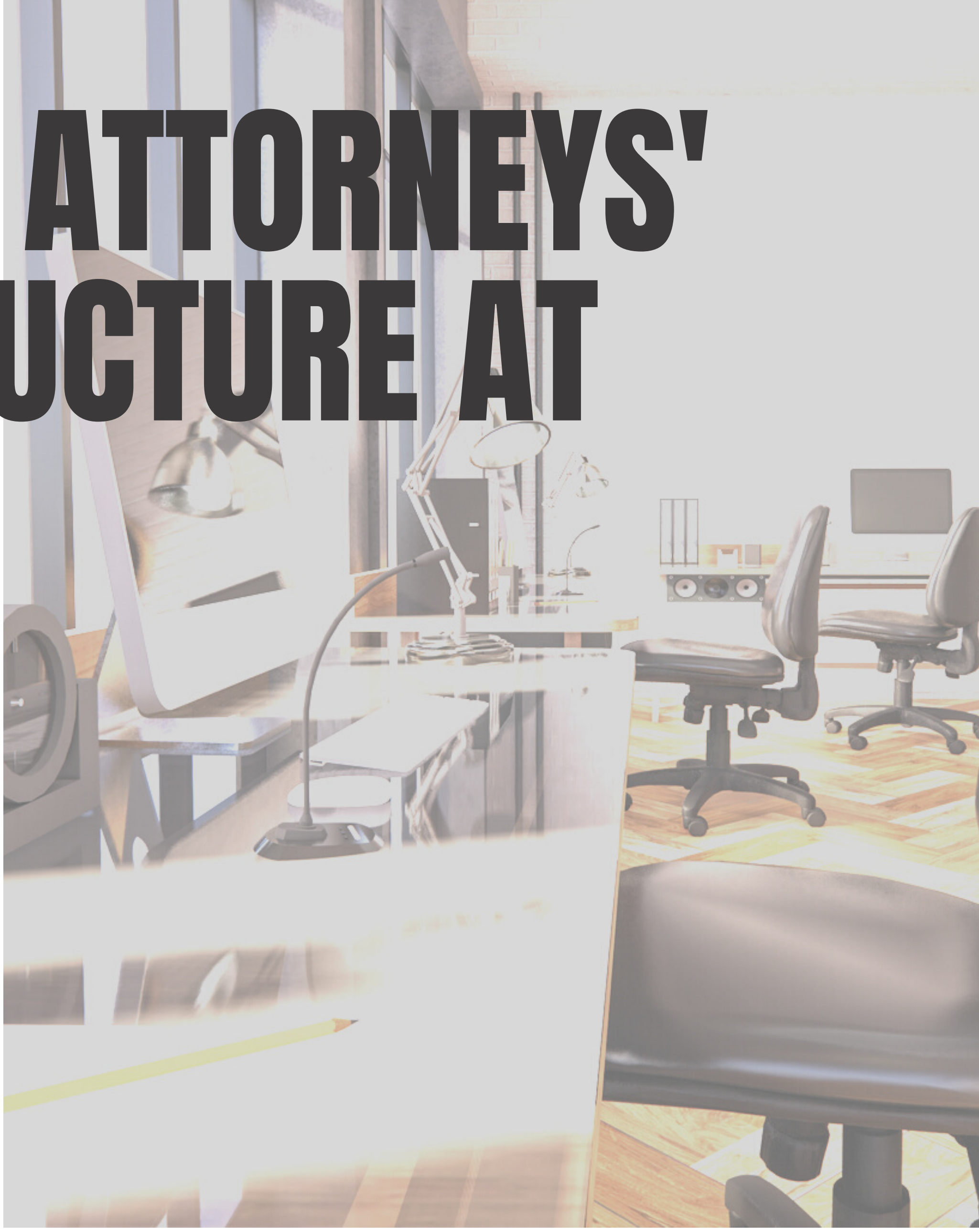
IS YOUR ATTORNEYS' FEE STRUCTURE AT RISK?



It should come as no surprise that lawyers, like many individuals and businesses, seek the assistance of tax attorneys to minimize their tax liabilities. One such strategy frequently employed by lawyers is the utilization of contingent fee arrangements. The IRS has recently issued GLAM 2022-007, addressing the issue of tax deferral in contingent fee arrangements and questioning their legitimacy. This remains a popular tax savings strategy for lawyers, so it is worth reviewing the IRS's position.

Structuring Attorneys Fees

The IRS's advice provides a background for how this tax strategy is commonly used by law firms for structuring contingent fees. Here is the summary: The law firm and its client agree to a fee arrangement where the client agrees to pay the law firm a 30% contingency fee from any money recovered from the defendant or the defendant's insurance company through a judgment or settlement. Subsequently, the law firm negotiates a settlement agreement with the defendant, resulting in a cash settlement of $1,500,000. Before the execution of the settlement agreement, the law firm enters into a deferral agreement with a third party. In this agreement, the law firm agrees to transfer 100% of its legal fees earned from the settlement to the third party in exchange for a lump sum payment to be received in the future. The third party places the funds in a trust and the law firm obtains a loan secured by the deferred payment. The loan is to be repaid once the lump sum is received by the law firm in the future.

By executing this strategy, the law firm is able to receive the funds as a loan and defer the payment of taxes until a later time. The structure envisons that the attorney receives the income for tax purposes at at time when they are in a lower tax bracket.

Tax deferral is often not the only benefit. The law firm may use this structure to augment retirement income, provide guaranteed cash flow, and meet future overhead expenses. Additionally, structured fees can accommodate diverse tax needs among partners and aid in buying-out retiring partners. The fees can

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also be used to create college funds for children or grandchildren.

Childs v. Commissioner

The authority for structuring attorneys fees can be found in Childs v. Commissioner, 103 T.C. 634 (1994), aff'd without published opinion, 89 F.3d 856 (11th Cir. 1996). In Childs, the courts expressly sanctioned such arrangements. The case addressed whether the contingency fees were property for purposes of I.R.C. § 83 and whether the doctrine of constructive receipt was applicable to the arrangement.

Section 83

Section 83 applies when someone performs services and the payment for the services is delivered to a third party. Section 83 says that property transferred to a person for performing services has to be included in the income of the person who performed the services. The income is equal to the fair market value of the property (minus any amounts paid for it). This amount is income in the first tax year in which the property becomes transferable or is not subject to a substantial risk of forfeiture, whichever comes first.

Section 83 applies to "property," such as real and personal property. It also applies to a promise to pay money in the future that is either funded or secured. The statute and regulations do not define when a promise to pay is considered "funded." There have been court cases that touch on this topic in other tax contexts. They look to whether an economic or financial benefit was conferred on the taxpayer.

Given these other rulings, the court in Childs held that the fair market values of the taxpayers' rights to receive payments under the settlement agreements were not includable in income under I.R.C. § 83 in the year in which the settlement agreements were entered into. The court reasoned that the promises to pay under the structured settlements were neither funded nor secured and did not meet the definition of "property" for purposes of I.R.C. § 83.

Constructive Receipt

The U.S. Tax Court also addressed the doctrine of constructive receipt. This issue starts with the concept of a method of accounting. For cash-basis taxpayers, their method of accounting is deceptively simple. The general rule is that cash basis taxpayers recognize income when they receive it. But there is also the concept of constructive receipt. This concept says that income is constructively received in the taxable year in which such income is credited to the taxpayer's account, is set apart for the taxpayer, or is otherwise made available so that the taxpayer could have drawn upon it during the taxable year if notice of intention to withdraw had been given.

The constructive receipt rules are not absolute. There are nuances. For example, they say that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. The taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment. This means that there must be an amount that is immediately due and owing that the obligor is ready, willing, and able to pay. The amount owed must either be credited to the taxpayer or set aside for the taxpayer so that the taxpayer has an unrestricted right to receive it immediately, and the taxpayer being aware of these facts, declines to accept the payment.

Applying these rules to the attorney fee agreements in Childs, the court concluded that the taxpayers did not constructively receive their attorney's fees for each case in the year that case was settled. The court noted that there was no money or property available at the law firms' unfettered demand from the structured fee agreement. Thus, the court determined that the doctrine of constructive receipt was not applicable to the arrangement.

The IRS' Recent Guidance

This brings us back to the IRS's recent guidance. The IRS asserts that the anticipatory assignment of income doctrine is applicable to structured attorney fees. The IRS guidance argues that the law firm retained control over the utilization of the fee, redirected the payment to another entity, and derived a benefit when the entity received the cash payment. The IRS disputes the notion that the Childs case is dispositive as it only addresses structured attorneys fees under I.R.C. § 83 and constructive receipt, it does not address the economic benefit doctrine or new I.R.C. § 409A rules.

The Economic Benefit Doctrine

The IRS guidance asserts that the economic benefit doctrine must be taken into account in evaluating structured attorneys fees. According to the economic benefit doctrine, compensation received by a taxpayer is gross income in the year it is received, even if it has been transferred to a third party and is beyond the reach of the taxpayer's creditors. This doctrine has been applied in various court cases involving funded compensation arrangements, where the compensation was paid to a third party. For instance, in United States v. Drescher, the Second Circuit Court of Appeals determined that the value of an annuity purchased by an employer for an employee was includible in the employee's gross income in the year of purchase, instead of the year when payments were made, as the taxpayer had received an "economic benefit" in the form of the obligation of the insurance company to pay money in the future. Similarly, in Sproull v. Commissioner, an employer transferring money to a trust for the benefit of an employee was deemed to be taxable income in the year the money was placed in the trust, as the payment to the trust represented an "economic or financial benefit conferred on the employee as compensation." The principle of the economic benefit doctrine is that any amounts paid to third parties for the sole benefit of the taxpayer, not intended to be gifted, must be included in the taxpayer's gross income.

The IRS guidance asserts that this doctrine results in the law firm recognizing its fee and incurring a tax obligation in the first year, rather than at a later time when the payments are received.

Section 409A

The IRS guidance also asserts that the arrangement in question constitutes a non-compliant non-qualified deferred compensation plan under I.R.C. § 409A. This section of the tax code applies to any plan that provides for the deferral of compensation, except for qualified employer plans or certain bona fide leave, disability pay, or death benefit plans.

According to the IRS guidance, structured attorneys' fees fail to meet the initial deferral election requirements under I.R.C. § 409A(a)(4) and the law firm violated I.R.C. § 409A(a)(3) by obtaining a loan from the third party, which could be repaid through an offset or reduction of the deferred payment. As a result of this violation, the IRS concludes that the entire value of the deferred payment would be subject to immediate income inclusion in the first year, along with an additional 20% tax.

The IRS guidance raises the question of whether attorneys' fees can be structured as unfunded deferred compensation plans, which would result in the fee not being taxable until the cash payment is received in future years. This would continue to allow structured attorneys fees to work as the law firm would still have the ability to defer the recognition of the income received from their client until a later date.

Conclusion

The structuring of attorney's fees has become a booming industry in the wake of the Childs ruling. As large sums of money are involved, sophisticated techniques and products have emerged in response. The recent IRS guidance, many years after the Childs decision, suggests that the IRS may soon be auditing and scrutinizing these arrangements, potentially leading to a reevaluation of the Childs ruling and unfavorable consequences.