Ten Things CPAs Need to Know About Structured Legal Fees

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The importance of form, knowing exactly *how* to do something, is extraordinarily important in federal income tax law. Accountants know that 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.

One such area involves structuring attorneys' fees. If an attorney has a contingent fee arrangement with a client, the lawyer may enter into a structured legal fee arrangement under which the defendant, instead of paying the attorney's fees for the case in a lump sum at the time of settlement, can fund an arrangement that pays the fees over time. As discussed below, payments under a structured legal fee arrangement have been held to not be taxable until actually paid to the attorney. Structured legal fee arrangements are designed to level out the peaks and valleys that generally characterize the fluctuating income of plaintiffs' attorneys. These arrangements let lawyers defer paying taxes on their fee income. Structuring legal fees is a good way to spread out income, reduce income tax burdens, provide for retirement, or contribute to estate planning.

A structured fee arrangement will generally be funded by an annuity purchased by an assignment company. That company purchases the annuity with funds provided by the defendant in the case—funds that would have paid the lawyer's fee. Properly set up, a legal fee structure takes the lump sum that would otherwise go to the client and puts it to work in a tax-deferred annuity. The lawyer pays tax only as he or she receives the periodic payments. For example, instead of receiving a $500,000 lump sum, the lawyer might receive $70,000 a year for ten years. The extra $200,000 in this example is attributable to the tax-deferred return on the money.

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

The use of structured legal fee arrangements to defer tax on contingent legal fees was first approved in *Childs*, 103 TC 634 (1994), aff'd without opinion, 89 F3d 56 (11th Cir. 1996). In *Childs*, the Tax Court held that the taxpayer, an attorney, did not constructively receive income in the year an annuity contract (a structured fee arrangement) was purchased. Under the retainer agreement, the attorney was to receive a percentage of the gross amount recovered by his client in personal injury litigation (i.e., a contingent fee). The structured fee arrangement was entered into before the case was settled. Because the client did not receive any money until after the settlement, the attorney had no right to any of the funds at the time the structured fee arrangement was entered into, and the court held that the doctrine of constructive receipt was inapplicable. Therefore, the fair market value of the right to receive payments was not includible in his income under Sec. 83 at the time of the annuity purchase, and he would not be liable for taxes until he received payments from the annuity.

Top Ten Points

Plaintiffs' attorneys are generally not tax experts and usually need their accountants' help to set up fee structures. Despite a more than ten-year track record of structuring legal fees, many accountants remain confused about what they can do, what they cannot do, and what is most important in securing structures' financial and tax benefits. Here are the top ten things accountants should know about structuring legal fees for their lawyer-clients.

1. Timing is everything: If a lawyer-client wants to structure legal fees, begin the process before the lawyer has a right to the fee. The attorney must elect to defer his or her fees before they are earned in order to avoid running into constructive receipt issues (see, e.g., FSA 200151003). Once the settlement agreement is signed, it is too late to structure fees. Fortunately, however, the authorities have been reasonably liberal on this issue: It is not necessary to have the legal fee agreement contemplate periodic payments from the time it is originally executed.

In other words, the lawyer is generally not treated as "earning" a contingent legal fee until the case is actually resolved (by either a judgment or a signed settlement agreement). That gives lawyers flexibility to consider whether they want a structure, as long as they do it before the case is resolved. To be safe, however, as settlement negotiations heat up, this issue should be raised with lawyer-clients as soon as possible.

2. Consider the legal fee agreement: The lawyer should generally consider revising his or her generic contingent fee agreement to expressly contemplate periodic payments for *all* cases. Exactly what wording to use in a generic fee agreement is a matter of opinion; however, it is good practice for the agreement to state that the attorney may receive his or her applicable percentage in cash or in periodic payments. The fee agreement can provide that the attorney will specify which payment type—and the amount—in writing before the case goes to judgment or is settled. There is no disadvantage in doing this from the beginning in every legal fee agreement. It does not bind lawyers but gives them the right to structure their fees if they want to.

3. Client recovery structuring vs. legal fee structuring: Some lawyers believe they can structure their fees only if their client structures his or her own recovery. This is not true. Some life insurance companies will structure legal fees only if the client is also structuring, but others will structure "stand-alone" legal fees.

This means that CPAs can help a lawyer structure legal fees even though the lawyer's client may choose to receive his or her recovery entirely in cash. Of course, structures may also make sense for the lawyer's clients. Clients may not want to structure, but it is almost always a good idea to mention structures to lawyers and their clients.

4. Annuities vs. other alternatives: A legal fee structure should follow a tried-and-true format. There is great flexibility in the types of payment structures that can be obtained, but they all use life insurance annuity products.

Unfortunately, many plaintiffs' lawyers want private annuity products that appoint a trustee to manage the money (and take the lawyer's directions). In the past, this kind of structure might have worked, but it no longer does. Use annuity products from major life insurance companies when helping lawyers structure fees.

5. Qualified settlement funds: A Sec. 468B trust, also known as a qualified settlement fund (QSF), is often set up to be the repository of moneys in settlement of a case. QSFs were originally designed so defendants could pay money into a settlement trust and take an immediate tax deduction, while the various plaintiffs continued to argue over the allocation of the settlement payment.

Today QSFs are often used to give plaintiffs and their lawyers more time to determine how they want to receive their money. A QSF can be used this way but it is not necessary to structure legal fees. A QSF is generally used when there are multiple plaintiffs and there is some question about how moneys will be divided. Lawyers' fees do not have to be placed in 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. CPAs often serve as trustees. (The plaintiffs' lawyer should not be the trustee.) The important point is that a court must supervise the trust. The supervising court might be the one with jurisdiction over the case; however, any court will do.

Properly set up, a QSF delays receipt of settlement money by the lawyers and their clients. That can allow everyone to consider structures after the defendant (who puts the money into the QSF) is no longer involved.

6. Payment alternatives: Make sure lawyer-clients carefully consider how they want to receive the payments over time. Should payments be disbursed over 10 years, over a lifetime, or perhaps for the joint lives of the lawyer and his or her spouse? Should payments start immediately or be delayed for 10 years? Should lump sums be periodically disbursed when the lawyer has particularly large expenses—for example, years in which he or she has children in college?

There is an almost infinite variety of options. However, once the payment structure is set, it cannot be changed. This may make a QSF attractive because it allows the lawyer more time to consider the alternatives before having to make a permanent decision.

7. Contingent fees only: Structuring legal fees generally applies only in cases that are taken on a contingent basis and then settled out of court. However, it may be possible to interpose a fee structure in some cases going to judgment or in cases in which a court awards attorneys' fees.

8. Work with a broker: A qualified settlement broker has access to the life insurance markets and the various annuity tables the CPA will need to review. CPAs should regard brokers as allies in this instance, not competitors. A broker earns a commission on the sale of the annuity product but usually earns nothing unless the transaction closes. Brokers therefore have an incentive to provide lawyers and their accountants with all the necessary data.

Interestingly, bypassing a broker will not save on the broker's commission because none of the major life insurance companies that issue annuities for structured legal fees will reduce a commission even if one deals with them directly. A standard brokerage commission is 4%. Thus, if an annuity is purchased for a premium of $1 million, the broker (or several brokers working together) generally earns $40,000. If the defendant and the plaintiff each have a broker, they may share commissions.

9. Do not get creative: Although there is almost infinite flexibility in payment streams for structured legal fees, this is not a time to get creative with the legal structure. An income stream, blips in the stream, and unusual disbursements are all possible, but do not try to invent a new form of legal fee structure. Stick with annuities to ensure that the arrangement is respected for tax purposes.

10. Consider firm arrangements: If the lawyer-client is a solo practitioner, structuring legal fees is usually simple. In a law firm, additional legal protocols should be observed. Many plaintiffs' lawyers, their law firms, and their accountants 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. Questions that need to be answered include:

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

Conclusion

With the right preparation, a structured legal fee agreement can be an excellent tax planning tool for plaintiffs' lawyers. Even in the case of large law firms it is usually possible to set up a structure so that it works, although it may require extra time and care. Accountants play a key role in the process. There is no right answer for everyone, but it is important to consider the legal structure, the lawyer-client relationship, and matters such as control, firm management, and moneys that might pass to an estate.

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