Deferring Legal Fees Using Structured Settlement Annuities[1]

by

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[1] Information presented is not tax or legal advice and readers should contact their appropriate advisor as required. Opinions or positions are those of the author and not necessarily those of the National Structured Settlement Trade Association or any other organization. This paper was submitted to and accepted by the National Structured Settlements Trade Association, in cooperation with The University of Notre Dame, for its "Master Structured Settlement Consultant" designation, 2015.

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Summary and Introduction

Workers in the United States, including attorneys, are able to defer income. Specifically, attorneys paid directly by clients are able to defer their legal fees and attorneys representing plaintiffs are normally paid directly by clients. This type of practice allows attorneys to defer legal fees on a case-by-case basis even if the client is paid in cash. This article will focus on how attorneys representing plaintiffs may defer legal fees using an annuity used to pay future payments in a structured settlement transaction. There are many issues to consider including proper documentation, the needs of the attorney-taxpayer, settlement, financial and estate planning, the financial product and providers, and of course, taxes. This transaction is called deferred legal fees using a structured settlement or structuring fees for short.

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Structured Settlements

A structured settlement is when a plaintiff receives funds from a dispute over time. It is more specifically defined in two sections of the Internal Revenue Code "the Code".[3] An assigned structured settlement transaction is when a defendant is obligated to make future payments via a settlement agreement. The defendant then assigns that obligation to an assignment company via an assignment agreement. The consideration to transfer this obligation is enough money to purchase an annuity to match the future payments. The assignment company purchases an annuity contract and it is routinely guaranteed by a large financial institution – usually a large life insurance company inside the annuity company's financial family. Once this obligation to make the future periodic payments is assigned, the original defendant is released from that obligation, and the plaintiff looks to the assignment company and its guarantor for the future payments.

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[3] 26 U.S. Code § 104 - Compensation for injuries or sickness. (a) In general. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

26 U.S. Code § 5891 - Structured settlement factoring transactions. (1) Structured settlement

The term "structured settlement" means an arrangement—

(A) which is established by—

(i) suit or agreement for the periodic payment of damages excludable from the gross income of the recipient under section 104 (a)(2), or

(ii) agreement for the periodic payment of compensation under any workers' compensation law excludable from the gross income of the recipient under section 104 (a)(1), and

(B) under which the periodic payments are—

(i) of the character described in subparagraphs (A) and (B) of section 130 (c)(2), and

(ii) payable by a person who is a party to the suit or agreement or to the workers' compensation claim or by a person who has assumed the liability for such periodic payments under a qualified assignment in accordance with section 130.

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Structured Settlement Marketplace

The current marketplace for structured fees include American General Life Insurance Company, Berkshire Hathaway Life Insurance Company of Nebraska, Liberty Life Assurance Company of Boston, Metropolitan Life Insurance Company, New York Life Insurance Company, The Prudential Insurance Company of America, Pacific Life Insurance Company, and United of Omaha Life Insurance Company.

Each company has their own rules on structured legal fee transactions and it is best to check with a structured settlement consultant. In general most annuity companies will allow attorneys to defer their fee when there is a physical personal injury claim being settled, under 104(a)(2) of the Code. This section allows settlement payments to physically injured person to be received income tax-free. Most annuity companies issuing annuities to fund periodic payments in a structured settlement transaction will allow an attorney to defer their fee if even if the injured plaintiff takes cash as the method of receiving compensation. Also attorneys may defer their legal fee even if the payments to their client are taxable.[4]

Process and required documents

The process of obtaining a structured settlement annuity to defer legal fees should consider that the IRS uses what is called the best evidence rule. This means documents are considered and therefore a clear paper trail is highly recommended.[5]

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[4] At least one life insurance company will currently accept this type of transaction. See also as a reference point, Revenue Ruling 2003-115, 2003-46 I.R.B. 1052. Payees and assignment companies from the September 11th Victim Compensation Fund of 2001 are able to exclude periodic payments under IRC Code 104(a)(2) and the amount transferred to the assignment company under IRC 103(a) respectively, even though the claimant made an irrevocable election to receive periodic payments while the receipt of payments is subject to substantial limitations or restrictions.

[5] Internal Revenue Manual – 4.10.7.3.11 (01-01-2006) Best Evidence 1. The best evidence rule requires that, when possible, original evidence be used. Therefore, examiners should always ask to the see original documents when there is reason to believe such documents are available.

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Here is a list and an explanation of documents and transaction items used for a structured fee. These items refer to a transaction when the plaintiff will be receiving periodic payments as well as the attorney. The process is more streamlined when only the attorney is being paid via deferred future periodic payments.

Contingency fee agreement. The contingency fee agreement between the client and the law firm is a critical document when structuring fees. The agreement should do several things to allow the attorney to defer the fee. First, it should anticipate that a structured settlement may be used in the transaction. Second, it should allow the attorney to defer the legal fee. Third, it should allow the attorney to defer their legal fee even if the client takes cash. Fourth, the value of the future payments should be defined as the cost.[6] Sometimes the settlement agreement may serve as an amendment to the original contingency fee agreement. [7] Equity and fairness should

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[6] See Andres, Eugen C. and Moore, Jim. Requirements For Client Retainer Agreements. , 55-Dec Orange County Law 40, December, 2013. Knight v. Aqui, 966 F.Supp.2d 989, (2013), Austern, David "The Ethics of Structured Settlements," Trial Vol. 22, No. 11, p17, November 1986. See case law where the legal fee was based on the cost. Merendino v. FMC Corp., 181 N.J. Super. 503, 438 A.2d 365 (Law Div. 1981), Johnson v. Sears, Roebuck and Co., 291 Pa. Super. 625, 436 A.2d 675 (1981), Tobias v. Autore, 182 N.J. Super. 328, 440 A.2d 1171 (Law Div. 1982), A v D (1984) 196 NJ Super 340, 482 A2d 531, Bartoli by Bartoli v. Baiunco, 197 N.J. Super. 109, 484 A.2d 70 (Law Div. 1984). Matter of Muccini's Estate, 118 Misc. 2d 38, 460 N.Y.S.2d 680 (Sur. Ct. 1983). Landgraf by Landgraf v. Glasser, 186 N.J. Super. 381, 452 A.2d 713 (Law Div. 1982). Donaghy v. Napoleon, 543 F. Supp. 112 (D.N.J. 1982). Iskander v. Columbia Cement Co., Inc., 192 N.J. Super. 114, 469 A.2d 103 (Law Div. 1983), judgment aff'd, 197 N.J. Super. 169, 484 A.2d 353 (App. Div. 1984). Wyatt v. U.S., 783 F.2d 45, 86 A.L.R. Fed. 855 (6th Cir. 1986). Pettiford v. Eskwitt, 189 N.J. Super. 485, 460 A.2d 716 (Law Div. 1983). Schneider v. Kaiser Foundation Hospitals, 215 Cal. App. 3d 1311, 264 Cal. Rptr. 227 (4th Dist. 1989), reh'g denied and opinion modified, (Dec. 15, 1989) and (disapproved of on other grounds by, Moncharsh v. Heily & Blase, 3 Cal. 4th 1, 10 Cal. Rptr. 2d 183, 832 P.2d 899 (1992)), Keller v. Dougherty, 197 N.J. Super. 406, 484 A.2d 1327 (Law Div. 1984), Matter of Chow, 3 Haw. App. 577, 656 P.2d 105 (1982)

[7] A judge allowed a second contingent fee agreement which specified future payments to be paid to the attorney for the fee. Reed v Verwoerdt (1986, La App 5th Cir) 490 So 2d 421.

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be built into legal fee agreements. They should also comply with relevant ethics and model codes.[8] It is important to construct an unambiguous and proper contingency agreement.

Here is some sample language for a contingency fee agreement that covers the above points.

> *The Client and law firm agree that payments to the Client and/or for the law firm's legal fee may be paid upfront or in future periodic payments. The law firm may be paid in future periodic payments even if the Client does not receive future periodic payments. The present value of the periodic payments paid to the Client and/or the law firm shall be the cost of the funding vehicle providing the respective periodic payments. The total legal fee will equal the cost of the funding vehicle providing periodic payments to the law firm plus the amount of the legal fee paid at settlement. (This is sample language and should be used accordingly. It is not legal or tax advice. Practitioners should obtain appropriate advice on this matter and check local ethics and other appropriate rules).*

In some cases, non-economic, or difficult-to-value consideration is used as part of the settlement process. Care should be taken when settling a case in these circumstances. For example, if the settlement includes a promise of future medical care it may be difficult to value in present value.[9]

Mediation stipulation. In a mediation stipulation it is helpful to state that a structured settlement may be used and that the legal fee may be paid by the plaintiff to the attorney in future

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[8] The State Bar of California. Standing Committee on Professional Responsibility and Conduct. Formal Opinion No. 1987-94. What ethical issues arise in the use of structured settlements to resolve civil disputes? Members may participate in using structured settlements to resolve civil disputes. It is not a conflict of interest to recommend the acceptance of a settlement. The manner in which the structured settlement is valued must be considered so that the total compensation provided to the member does not violate rule 2-107. Opinion No. 1994-135, discusses issues when contingent fee agreements are silent on structured settlements.

[9] See Godwin v Schramm (1984, CA3 Pa) 731 F2d 153, cert den 469 US 882, 83 L Ed 2d 187, 105 S Ct 250. The attorney was not able to take the fee upfront and there was a question of the ability of the attorney taking a fee on a future promise of medical payments.

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payments. Here is some sample language, *"Subject to court approval, if required, this matter has settled with periodic payments if selected by Plaintiff and or a cash payment due upfront. An appropriate periodic payment agreement and release will describe the payments and conditions of settlement and the Plaintiff may make periodic payments to his attorney.*

The cost of the entire settlement to the Defendant is $___________________. The amounts due at settlement and to fund the periodic payments shall be paid within (14) days of this agreement or as agreed to in the periodic payment settlement agreement and release.

This settlement is final even if Plaintiff dies. Plaintiff will pay any and all liens, and agrees to indemnify and hold harmless Defendant from any and all claims of lienholders. This will settle all claims including any wrongful death action. All parties will cooperate to sign appropriate documents to effect this settlement. The Plaintiff will execute release documents and attorneys for Plaintiff are authorized to sign a dismissal with prejudice on behalf of all plaintiffs. The mediator at this session shall have continuing jurisdiction.

Settlement Agreement and Release. In this document the defendant agrees to make future periodic payments. Some of these future payments, at the direction of, as specifically requested by, and for the convenience of the plaintiff are redirected to another payee i.e. the plaintiff's attorney. This is to pay for legal fees as required in the contingency fee agreement. Each annuity company will have their own language to accommodate this transaction. This language is usually required in the settlement agreement, the assignment agreement and perhaps the application.[10]

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[10] Sample language may say, *Claimant authorizes and instructs payments to be made to his attorney as provided herein. Such amount shall be paid from periodic payments that otherwise would be payable to Claimant pursuant to this agreement. Claimant acknowledges and agrees that these payment instructions are solely for Claimant's convenience and do not provide Claimant's attorney with any ownership interest in any portion of the annuities or settlement other than the right to receive the fee payments from Claimant in the future as more specifically set forth herein.*

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Assignment Agreement. The defendant assigns this obligation to make the periodic payments to an assignment company. The assignment company accepts money from the defendant and simultaneously it accepts the obligation to make the periodic payments. The assignment company is now obligated to make the payments. The annuity company, at the direction of the assignee makes the payments directly to the attorney. Attorneys will now look to the assignment company, and its guarantor for the future payments and not the defendant. For the assignee to exclude the premium under IRC Code Section 130[11] the claimant must still be the "recipient". The language that is inserted into the settlement and assignment agreements intends to address this issue.[12]

Guarantee. The assignment company is typically guaranteed by a large financial institution, which is usually the annuity company writing the annuity, or another firm which is inside the life insurance company group.

Commutation language. Some annuity issuers may allow a commutation of future benefits. This means that if the attorney dies, the present value of any future remaining guaranteed payments may be paid in a lump sum.[13]

Annuity application. The attorney is normally the annuitant, applicant, or sometimes called the measuring life on the annuity application. The attorney or the law firm may be the payee on the annuity contract.

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[11] A plaintiff is normally still considered the "recipient" (under IRC § 130(c)(2)(E)) of the periodic payments if he redirects payments that would normally be paid to him to a person i.e. a lawyer who cannot exclude the payments under IRC § 104(a)(2). Section 104(a)(2) allows physical personal injury payees to exclude such payments. Therefore, most assignees use language, such as in footnote 10 *supra*, to accept a qualified assignment of such periodic payments. This allows the assignment company to exclude from its income under IRC § 130(c)(2)(E), the amount to fund the future payments. Annuity companies which accept assignments under IRC § 130 have differing policies on accepting obligations which include attorneys' fees

[12] See footnote 10 *supra.*

[13] As this may be an important issue to the attorney, for example, for estate planning purposes, it is best to make sure that illustrations from appropriate annuity issuers are considered. There may be some annuity providers which do not provide for a commutation rider to the annuity contract.

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Annuity Contract. The annuity is purchased by the assignment company to fund its obligation to make the future periodic payments. These are usually issued by large, well-capitalized, highly regulated, and highly-rated life insurance companies. It is a written contract that provides proof that the annuity issuer will make future payments to the payee.

Tax acknowledgment form. This is a form acknowledging that, among other items, the annuity issuer does not provide tax advice. This is a routine document when structuring fees.

Beneficiary form. If the payee is the attorney personally, or a sole proprietorship, some annuity companies allow a beneficiary, other than the attorney's estate, to be designated as the beneficiary of future payments after the attorney dies. The ability to request a beneficiary change is not always available. If the law firm is the payee, some annuity companies require the law firm to remain the payee and beneficiary, even if the attorney who is the measuring life has died. In this case the annuity company may require any change in the payee, to be paid according to the entity's appropriate dissolution papers or the applicable laws covering this item.

Direct deposit. The attorney may have the payments directly deposited.

Reasons for Deferring Fee

Attorneys want to defer their legal fees for many different reasons. These include tax planning, stabilizing revenues, estate planning, retirement, and enjoying the financial benefit of years of service.

Taxes. Structuring fees is a useful vehicle for tax planning. Many cases may take years to settle or come to a verdict. However the legal fee is recognized in one fiscal year. [14] Since income

[14] Commissioner of Internal Revenue v. Banks v. Banaitis, 125 S.Ct. 826, where legal fees were deemed taxable income to the plaintiff.

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averaging has been eliminated by the IRS structuring legal fees allows one to income average forward.

In this way deferring income into future years allows attorney-taxpayers to receive income in years where they will be in lower marginal tax rates. At the peak of many attorneys' careers substantial fees are received and are therefore taxed at the highest marginal tax rates. By deferring income into future years when the practice may slow down, or even when the attorney is retired and not working at all, the income is received when there is little or no other income received.

Avoids income peaks and valleys. Similar to tax planning, attorneys will defer their legal fees to avoid the income and expense mismatches that occur due to the nature of their practice.

Family living expenses. Some attorneys defer their legal fees to guarantee that everyday basic living expenses are covered. This provides a stable financial foundation, and if properly planned, these living expenses may never be outlived.

Planning for large expenses. Some attorneys structure their fees to pay for large anticipated expenses. These could be for educational and college costs for children and grandchildren. Providing for wedding costs, down payments for houses for children and other loved ones, and other future large expenses may be planned for and covered.

Retirement. One of the most popular uses for structuring fees is for retirement. Since an annuity is the only financial vehicle that can pay someone over a lifetime it is a very suitable retirement investment. This financial vehicle allows attorneys to be paid so they will never outlive their money. In this way it may be considered a de-facto private independent retirement fund without the associated costs. Since many plaintiffs' attorneys have a solo practice and may not have deferred compensation or retirement plans in place, structuring fees allows them to effectively defer their income like other retirement plans such as a defined benefit retirement plans, IRA's, 401(k)'s, etc., without the associated funding, deferral, and income limits.

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Some clients defer a portion of each possible case, and create cash flows to begin at the same expected retirement age, say, age 70. This allows attorneys to build a safe and secure retirement cash flow foundation one case at a time. This also allows the attorney to essentially dollar cost average the rate of return of the underlying assets over the years as interest rates change over time.

Retirement funding flexibility. A structured fee arrangement allows for very flexible funding of one's retirement or for other future plans. As each case settles an attorney may decide on a case-by-case basis whether it is the right time to defer income.

Time creation. Structuring fees and creating a stable cash flow for a law practice also frees up an attorney's time to devote to other law-related activities which may be more strategic, important, and profitable. These may include speaking arrangements, exploring new marketing avenues, becoming more active in social media, writing and creating presentations for professional and other conferences, and researching new areas of the law.

Time usage. A fixed annuity provides income with no management or oversight required by the payee. In this way a significant amount of time may be freed-up that would otherwise be spent monitoring and managing that portion of one's portfolio.

Enjoying life. One of the most pleasant things to think about when structuring fees is to fund what one really enjoys doing in life. This is sometimes called funding your passion. For example, many people love to travel. In this way deferring legal fees may be thought of as a lifetime of vacations.

Estate Planning and Age Issues. Attorneys may receive payments from a structured fee arrangement at almost any age. For example, an attorney does not have to wait until age 59 1/2 to receive payments. Also an attorney may prefer to receive payments when they are much older, say age 80 or beyond. At that time the payments may be used for estate planning purposes. For example a successful attorney does not want to be paid any income during her expected worklife time. Instead the payments are deferred and then are paid for an appropriate

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time frame. Upon her death, the payments are to be paid into a trust which has the ability of dispersing the funds according to terms that the attorney had planned for years in advance. For example, an attorney plans appropriate cash flows to be paid to her grandchildren who will be of college age when she is no longer expected to be alive. In fact, the educational institution may be paid directly by the trust, so the grandchildren are never in control of the funds. Other terms may be added to the trust to encourage certain behavior. For example, more money may be paid if a grandchild attends a four-year university and graduates, and perhaps less is paid if no post-high school education or training is obtained.

Estate taxes. A commutation rider may be used to have the present value of unpaid funds paid upon the attorney's death. This may prove useful if estate and related taxes are expected.

Law firm issues.

Some of these issues are similar to individual attorneys as described above, and are discussed in the context of the law firm as the payee and not the attorney personally.

Law firms. A law firm should consider deferring recognition of income using a structured fee arrangement. [15] The fee is then taxable to the corporation in the years the future payments are received. The measuring life on the application may be an individual attorney and the payee may be the professional corporation. An appropriate deferred compensation agreement may allow the attorney who worked on the case to be paid by the law firm in the future. This allows the law firm to deduct the payments to be paid to the individual attorney which offsets the payments that are being paid to the law firm from the annuity via the structured fee arrangement.

Risk. It may seem counterintuitive, but a law firm may be able to take more risk by using a safe and conservative investment strategy when structuring fees. In this way a solid financial foundation of guaranteed cash flow allows riskier cases to be taken on.

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[15] For related information, see Wood, Robert. Legal Fee Structures, Law Firms, and Lawyers: Children of *Childs*? Tax Notes, April 10, 2006.

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Law practice expansion. Structuring fees allows a law firm to expand their law practice as the cash flow for years to come may now be stable and guaranteed. This guarantee healthy cash flow will allow the law firm to take on riskier and/or larger cases that it may not have been able to before.

More staff. Stable future cash flows emanating from structuring fees from prior cases allows law firms to hire additional staff to expand the law firm's capabilities when considering taking on additional cases.

Avoid high interest rate loans. Structuring fees may allow firms to avoid paying high interest rates to fund future cases. Prudent money management of the legal fee from a large case may help front future case expenses without having to take out a case funding loan.

Timing. There is flexibility when payments may be received from a structured fee. The payments may be paid annually, quarterly, monthly, or as lump sums.. The payments may increase at a compounded percentage rate, and attorneys may plan for large anticipated expenses by being paid large single lump sum payments or a stream of payments to be paid well into the future. It is assumed that attorney-taxpayers are on a cash and a calendar-year basis.

Many firms prefer to be paid a single payment at the beginning of the year. There are several advantages to this. One is that there is now money in the bank at the beginning of the year. Also it allows that income to be expensed against for the next 12 months of revenue. Some firms may prefer to be paid on a monthly basis, which allows for a stable cash flow for recurring monthly expenses such as salaries, rent, office overhead, and marketing etc.

If a firm prefers to be paid on annual basis at the beginning of the year, it may be better to receive the money on January15th since a direct deposit that is due on the first of the year may be electronically deposited in the prior year.

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For example, if an attorney wants to receive one hundred thousand dollars per year for 10 years paid on January 1st, and an electronic direct deposit transfer is in place, the electronic transfer may come before January 1st and the bank records may show that the funds were deposited into the attorney's account before January 1st. The IRS may treat this as taxable income in the prior year. To avoid this many attorneys defer the first payment to January 15th.

Flexible payments. The possible payment schedules for a structured settlement annuity are very flexible. This allows an attorney to pay for anticipated future costs and investments that are uneven. In fact, some annuity companies allow the first payment to be delayed up to 18 years or longer. This is important when planning anticipated expenses. For example, a law firm's expansion plan requires a new office building to be purchased in 10 years. That large capital expense can be anticipated and funded using a structured fee arrangement.

Firm Succession / Buyout. Some attorneys may structure fees to help fund and plan for their firm's succession. For example, if an attorney plans to sell his share in a law firm, he may still enjoy the deferred compensation flowing through the law firm even though he may not be actively participating in the law firm. This cash flow may be part of the buyout terms from a new owner.

Avoid the Annual Tax Trap. Structuring fees may help an attorney to get out of the routine of paying last year's taxes from this year's cash flow. This is sometimes known as the annual tax trap. In this way the cash flow from the structured fee may be proactively anticipated to pay for future income taxes. For example, every time a law firm defers its fee, annual payments are scheduled to be paid every April to pay for the prior year's income taxes. A law firm may plan to set aside a portion of each settled case to be paid each April, to build upon prior cash flows so that there will always be funds available to pay for the prior year's income tax obligation.

Therefore, through careful planning, structuring fees may provide the revenue source to pay for income taxes. This is opposed to having to scrape up revenue from various sources such as current cash flow from recently resolved cases, or worse from loans or lines of credit.

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Class Actions. Some attorneys structure their fees from class action lawsuits. In some cases such fees are not taxable to members of the class action. A group of class action plaintiffs were able to exclude from their gross income legal fees that were awarded by the court, and therefore also avoided reporting such payments. [16]

Prior to the class action being filed, each class representative entered into retainer and/or contingent fee agreements with class counsel. These agreement provided that if the subject action was certified by a court, as a "class action," then the class counsel would instead be paid for fees and costs under the "common fund doctrine." If the action was not certified, then the separate fee contracts would apply.

The court certified the class for settlement purposes, as an "opt out" class action lawsuit. This meant that upon this certification, the terms of the prior fee arrangements would not apply. Instead, the legal fees were to be awarded by the court under the "common fund doctrine," from the class-wide settlement fund. The IRS ruled that in general, attorneys' fees awarded in opt-out class action lawsuits, such as the instant case, are not includible in a class member's gross income if the class claimant does not have a separate contingency fee or retainer agreement with counsel.

Therefore it may be advisable for class counsel to explore certifying appropriate class action lawsuits for settlement purposes for the tax benefit of the class members.

Financial product

Annuity. The financial product that is typically used for a structured fee is sometimes known as a litigation annuity or a fixed single premium immediate annuity contract. The word fixed means there is a pre-determined rate of return or payment schedule. The word immediate means the premium is paid upfront and not deferred. The start date of the future payments however

[16] IRS Private Letter Ruling 200518017.

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may be deferred using this annuity. Attorneys will be paid the same interest rates as plaintiffs using a structured settlement annuity.

Avoids market risk and gyrations. A fixed income annuity allows one to avoid the caprice and fluctuations of the stock market. The payments are guaranteed to be paid and are not subject to the ups and downs in the capital markets.

Suitability and asset allocation. Structured fees are routinely funded using a fixed income annuity issued by a large life insurance company. This allows attorneys to help achieve an appropriate asset allocation as they anticipate retirement. Approaching retirement having an appropriate portion of one's assets in a safe, fixed-income investment – i.e. not subject to market risk - may be the foundation for a suitable retirement asset allocation. A fixed indexed annuity and market oriented financial instruments may also be used to defer legal fees.[17]

Portfolio Diversification and Timing. Some financial models have three financial time frames. The first is the asset accumulation phase, the second is the capital increase, protection and stabilization phase, and the third is the income withdrawal phase. Retirement planning is an integral part of one's investment strategy, during all three time periods. Therefore deferring legal fees fits well with this financial model as the income withdrawal phase is integrated and appropriately planned for.

No management fees. Unlike traditional retirement plans such as 401(k)'s, IRA's, defined benefit retirement plans, etc. a structured settlement annuity has no management fees. There is a small initial one-time assignment fee - usually $300 to $750. This is in contrast to some portfolio managers who may charge up to 4% annually. In fact, some hedge fund managers may

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[17] Pacific Life Insurance Company offers a fixed indexed annuity that tracks a stock market index, and the payments may not decrease. There are also other financial vehicles that are or may be subject to capital risks and market fluctuations.

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charge 20% of profits and 2% annually of assets under management, although this may vary widely.[18]

Investment Fund. Some attorneys use structured fees to fund future investments. This allows the future payments to fund specific investment ventures that have been adequately researched and vetted. For example, an attorney settles a very large case that will pay $10 million in legal fees. The attorney wants to invest that $10 million in present value over the next 15 years in various business ventures. The strategy is that the attorney will have 12 months to research and plan an appropriate investment for those future annual 15 years of payments. Having 12 months of time allows the attorney to make a better informed decision on the actual investment. Similarly, spreading the payments out over a long time frame allows the investment portfolio to take advantage of dollar cost averaging the investment payments into stock or capital markets if desired.

Compounded interest. Compounded interest on future payments is an attractive investment feature of an annuity. This is especially an advantage for long-tail periodic payment streams.

Few limitations. Structuring fees avoids many of the restrictions required under most traditional retirement plans. For example there is no 10% penalty if one takes the funds before age 59½. Structured fees are also not covered by the typical restrictions regarding the amount that can be deferred using other deferred compensation arrangements.[19]

Taxes.

The Internal Revenue Service taxes all income under the Code,[20] and it has recognized that taxpayers may defer income. There are several requirements to achieve this. Avoiding

[18] Vardi, Nathan. The 25 Highest-Earning Hedge Fund Managers And Traders. Forbes. Feb. 26, 2014.

[19] Internal Revenue Bulletin 2005-2. January 10, 2005. Treasury Notice 2005-1

[20] 26 U.S. Code § 61 - Gross income defined. (a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived…

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constructive receipt[21] and economic benefit[22] of the financial instrument and the future payments are two key points.

As a vehicle to explore the various tax elements of structuring fees this section will discuss the important Tax Court ruling, the Childs case. [23]

Three attorneys, who were employees and the sole shareholders of a professional corporation, successfully deferred attorney's fees on an individual basis in two separate structured fee transactions. The three cash-based attorneys were Mr. Ben Philips, Mr. Richard A. Childs and Mr. John C. Swearingen. In both cases they received income on a deferred basis and the IRS challenged the deferral. The attorneys prevailed in Tax Court and the 11th Circuit Court affirmed the Tax Court's decision.

In the first settlement, called Garrett, the defendants' two liability insurance companies (Georgia Casualty & Surety and Stonewall Insurance Company), promised to make future periodic payments to the three attorneys directly, not the law firm. This obligation was then assigned to an assignment company, with the condition that this original obligation to make future periodic payments will not be changed, even if the two liability insurers assigned this obligation. Therefore, if the assignment company failed to make a payment or a portion of a payment Georgia Casualty and Stonewall still owed payments to the payees. The settlement agreement stated, "If the obligation of Stonewall Insurance Company or Georgia Casualty and Surety to

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[21] Constructive Recept. 26 U.S. Code § 451 - General rule for taxable year of inclusion (a) General rule. The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

[22] Economic Benefit. 26 CFR 1.83-3 (e) - Property. For purposes of section 83 and the regulations thereunder, the term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account

[23] Childs v. C.I.R., 103 T.C. 634, 1994 WL 720047 (1994), *aff'd without opinion*, 89 F.3d 856, 96-2 U.S. Tax Cas. (CCH) ¶50504, 78 A.F.T.R.2d 96-5176 (11th Cir. 1996).

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make periodic payments herein is assigned, then the rights and obligations of this agreement as to the assignee shall remain unchanged." This is sometimes known as cut-through liability language.

The annuity policies issued by the life insurance company had the three attorneys named individually as the annuitants. The annuity contracts owned by the assignment company had the estates of each attorney named as the beneficiaries. Also, the owner of the annuity could exercise any right of privilege of ownership of the annuity, including changing the beneficiary under the policy by written request while the beneficiary was living.

The second case, Jones v. Columbus Propane, involved a wrongful death cause of action and there was another structured fee. The settlement agreement provided for future payments to be paid to the individual attorneys and this obligation by Stonewall was assigned to Manulife Service Corporation (MSC), the assignment company. However, Stonewall remained obligated to make future periodic payments. In addition the assignment company was guaranteed by the annuity issuer, Manufacturers Life Insurance Company.

The main issues in both cases were if the future obligation to make payments by the insurance companies to the attorneys were funded or secured. This brings up the important issues of funding, security, constructive receipt and economic benefit.

The Tax Court said that if the agreements to pay annuities received by petitioners [attorneys] in these cases are to be held to be taxable under section 83, [24] it is necessary that in addition to the promise to pay by the insurer(s), the evidence shows such promise to be funded or secured.

Funding Issues – In the Garrett settlement the assignment company was found to be the policy owner; the attorneys were the payees and the annuitants of these insurance policies; the two insurance companies Georgia Casualty and Stonewall were both obligors to make these payments, even if there was an assignment, due to the cut-through liability language; the

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[24] See footnote 22 *supra.*

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attorneys could only have general creditorship rights against the owner; the payments could not be accelerated deferred increased or decreased by the recipient; and the owner could change the annuity payees or beneficiaries.

Due to the above findings the "…promises to pay petitioners [attorneys] under the Garrett litigation structured agreement were not funded promises by the obligors, Georgia Casualty and Stonewall.", per the Tax Court.

In the Jones litigation the petitioners [attorneys] were found to not be the owners of the annuity contracts nor were they irrevocable beneficiaries under the policies so the annuities were unfunded. The Tax Court also found that the owner maintained the right to change the beneficiary of the annuity contracts; the petitioners could not accelerate deferred decrease or increase the periodic payments; and the attorneys only had general creditor rights. Therefore there was no economic benefit in either the Garrett or Jones settlements. [25]

Security Issue - The IRS argued that the guarantees by the insurance companies Georgia Casualty and Stonewall and the assignment company, causes the promises to be secured. In addition, the IRS argued that because the insurance companies are required to maintain adequate reserves, this causes the promises to be secured. These arguments were rejected by the Tax Court, "It is well settled that a simple guarantee does not make a promise secured, since by definition a guarantee is merely itself a promise to pay …. Therefore, the mere fact that several insurance companies guaranteed the payments to petitioners [attorneys] is irrelevant to our determination of whether petitioners' right to receive the future payments was secured."

The Tax Court also concluded that since insurance companies are required to maintain adequate reserves for all policy holders, this did not equate to specific property securing the annuities being set aside.

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[25] See also, Minor v. United States, 772 F.2d 1472 (9th Cir. 1985). Physicians successfully deferred income using a trust.

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Constructive Receipt - In both the Garrett and Jones transactions, constructive receipt [26] did not occur.

In reaching its conclusion that no constructive receipt occurred in the Garrett transaction the Tax Court looked to the contingency fee agreement. The attorneys were to receive 1/3 of the gross amount recovered before trial and 40% after any trial. The court interpreted that the word "recovered" implied that plaintiffs receive actual payments versus the right of the plaintiffs to receive future payments. The court said, "'Recovered' implies amounts that petitioners' [the lawyers] clients actually received, rather than amounts that petitioners' clients had a right to receive. Petitioners' clients recovered no money from the litigation until after April 25, 1986 the date of the judgment in the Garrett litigation." The court continued, "Petitioners were not entitled to their fees until recovery by their clients, so their right to receive payment arose only after settlement or disposition of the case. Thus for the Garrett litigation petitioners did not become entitled to their attorneys' fees until the judgment was entered, by which time the structured settlements had been agreed upon."

Similarly in the Jones litigation the court said, "…petitioners [the attorneys] did not have a right to receive payments until the settlement was effected … by which time the parties had agreed upon payment of attorney's fees installments. The right of the petitioners to receive payment of fees existed only after the Jones release agreement became effective, since any rights arising from the fee agreement were dependent on amounts recovered for petitioners' [the attorneys] clients. Petitioners had no right to receive any moneys prior to such time as their clients 'recovered' amounts from the claims. Petitioners never had the right to receive immediate payment, and no fund or property was set aside for petitioners which they could draw upon at a

[26] 26 CFR 1.451-2 - Constructive receipt of income. § 1.451-2 Constructive receipt of income. (a) General rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions of the amounts of money used to fund the life insurance annuity contracts. See also footnote 21 *supra.*

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time of their choosing. Because each of the deferred payment agreements was binding between the parties and was made prior to the time when petitioners acquired an absolute and unconditional right to receive payment, petitioners, who were on a cash basis, were not required to report the proceeds as income until actually received."[27]

The IRS filed an appeal with the 11th Circuit Court on the Childs case on June 7, 1995 and the U.S. Court of Appeals for the Eleventh Circuit affirmed the Tax Court Ruling, which allows attorneys to defer their fees using a structured fee transaction. The one-sentence ruling says, "The appeal is affirmed for the reasons expressed in the Tax Court's opinion." [28]

Post-Childs references. The Childs case has been cited by the IRS and other several administrative sources.[29] It appears that this may mean acquiescence by the IRS to this important tax court case.

Post-Childs Issues. The American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418, added § 409A to the Internal Revenue Code with new rules that affect non-qualified deferred compensation arrangements. However, these rules will not apply to a person, such as an attorney, who is actively engaged in providing services to two or more people who are unrelated to the attorney and to one another.

The IRS and Treasury have issued formal regulatory guidance in Notice 2005-1, 2005-2 Internal Revenue Bulletin, January 10, 2005, that excludes most service providers, including attorneys

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[27] See footnote 23 *supra.*

[28] See footnote 23 *supra.*

[29] IRS Field Service Advice: IRS FSA 200151003 2001 WL 1638420 (IRS FSA Dec 21, 2001); IRS Non-Docketed Service Advice Review: Non Docketed Service Advice Review, 2001 IRS NSAR 0319; 2001 IRS NSAR 10319; IRS Private Letter Rulings: PLR 200836019 (IRS PLR Sep 05, 2008); IRS Technical Memoranda: TRANSFER OR SALE OF COMPENSATORY OPTIONS OR RESTRICTED STOCK TO RELATED PERSONS UIL: 9300.28-00 2004 WL 2397203; State Administrative Materials: NY General Counsel Opinion No. 2-27-2008; NY General Counsel Opinion No. 9-20-2007; Other Administrative Materials: ISSUE: TRANSFER OR SALE OF COMPENSATORY OPTIONS OR RESTRICTED STOCK TO RELATED PERSONS NOTICE 2003-47 2005 WL 5759552, 16 -17, 39 and 43.

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from Section 409A. This is a favorable ruling for deferred legal fee arrangements. The regulations are presented in a question and answer format and Question 8 provides this guidance:

> Q-8 To Which Service Providers Does § 409A Apply?
>
> A-8 …Section 409A also does not apply to arrangements between a service provider and a service recipient if (a) the service provider is actively engaged in the trade or business of providing substantial services, other than (I) as an employee or (II) as a director of a corporation; and (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another.

Conclusion.

The Childs case and other applicable and appropriate tax guidance should be followed as closely as possible when structuring fees. Attorneys may want to anticipate and have appropriate structured settlement language in their contingency fee agreements and mediation stipulations. Clear and precise language must be in the settlement and assignment documents. The attorney should not be able to accelerate, defer increase or decrease the future payments and should not have any rights in the future payments other than those of the general creditor. The attorney may not want to have any of the funds flow through their attorney-client account, and the attorney should not own the annuity.

Structured settlements are an important part of meeting the financial needs of injury victims when settling personal injury matters. In addition, attorneys have a right to structure their fee to defer their income, like other taxpayers, to meet their financial, wealth management, tax, and estate planning needs. A well-documented structured fee arrangement will allow attorneys to defer their legal fees. Preparation and proper advice are critical when entering into such an arrangement.

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