Attorney Fee Structures Are Not Under IRS Attack

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About Tacker LeCarpentier

A recent article circulating among North Carolina contingency fee attorneys and others has regrettably caused confusion about the viability of attorney fee structured settlements. The premise of the article, entitled "IRS Attacks Tax-Deferred Attorney Fee Structures," is that the IRS — via a Generic Legal Advice Memorandum, or "GLAM," which was issued in December 2022 — has "majorly" changed its view on the tax treatment of traditional attorney fee structures and intends to "blast the tax deferral foundation" out from under them. With due professional courtesy to the authors, these statements are brazen exaggerations and are fundamentally inaccurate. In sum, the article significantly overstates the impact of the GLAM on traditional, annuity-based attorney fee structures, which are, and remain, a viable tool for deferring income in contingency fee arrangements, as they have been for over 30 years.

GLAM Addresses Untested Tax Deferral Product Not the Traditional Attorney Fee Structured Settlement

First, the article states that the IRS is mounting an "attack" on attorney fee structures and that the GLAM is the first salvo in this campaign. This misstates what the IRS actually did in the GLAM and confuses the hypothetical product the GLAM addresses with traditional attorney fee structured settlements, the tax treatment of which is settled law.

But what is a "GLAM?" According to the IRS' own procedures manual, the purpose of a "Generic Legal Advice Memorandum" is to assist IRS personnel in reviewing the tax consequences of a particular set of facts.[1] It has no precedential value, and the IRS is free to later completely ignore it. Because the scope of advice given in such a memorandum is carefully crafted before it is internally delivered to the IRS personnel who requested it (and subsequently released to the public), the GLAM here should be taken for what it is: internal guidance that applies only to the specific factual scenario presented by its author and released without rigorous internal review. If the IRS intended the GLAM as an attack on fee structures, it would have done so head-on in more formal published guidance or by re-litigating the matter in court.

As discussed in a more detailed analysis in January 2023, the GLAM does not address an attorney fee structured settlement. In fact, the terms "fee structure" and "structured settlement" do not appear ***anywhere*** in its 25 pages. To the contrary, the GLAM addresses a hypothetical tax deferral arrangement where a plaintiff and defendant agree to a ***cash settlement*** as opposed to the more standard arrangement in which the defendant's insurer agrees to make ***future periodic payments*** to the plaintiff's attorney. In the GLAM's facts, the plaintiff's attorney is entitled to a contingent fee payment of $450,000 upon settlement,

the attorney instructs the defendant's insurer to remit the $450,000 in cash to a "rabbi trust" sponsored by a third-party promoter, and shortly thereafter, the attorney borrows $200,000 (or 44% of the fee) from the promoter. Because the attorney unilaterally directs his cash portion of the settlement to a third party and the attorney is then allowed to borrow against those funds, the GLAM's hypothetical arrangement is, from a tax law perspective, materially different from a traditional attorney fee structure.

In an attorney fee structured settlement, a plaintiff who has retained an attorney on a contingency fee basis settles a lawsuit with a defendant. Before the settlement is finalized, the defendant (or more commonly, their insurer) agrees to make future periodic payments to the plaintiff's attorney (and often to the claimant, as well). The defendant or their insurer thereafter assigns, to an assignment company, the obligation to make the future payments to the attorney, pays the assignment company a lump sum amount in exchange for doing so, and is released from any further obligations to plaintiff's counsel. The assignment company usually then acquires an annuity contract from a highly rated life insurance company to fund the future payments to the attorney.[2]

Although a traditional fee structure and the GLAM's hypothetical product both defer income to the attorney, the material difference is this: in a traditional fee structure, the defendant's insurer assigns a legal obligation to the assignment company; in the GLAM's hypothetical arrangement, the attorney unilaterally initiates the arrangement and tells the defendant's insurer where to send the funds. The former has been permissible under existing law for three decades; it is the latter which is untested in the courts and now may be in the sights of the IRS.

Tax Treatment of Attorney Fee Structures Settled 30 Years Ago By the U.S. Tax Court and the Eleventh Circuit

The Tax Court's decision in ***Childs v. C.I.R., 103 T.C. 634*** (1994), aff'd without opinion, 89 F.3d 856 (11th Cir. 1996 blessed the traditional attorney fee structure and bound the IRS to the same). Because ***Childs*** is a precedential decision of the Tax Court that was affirmed by the U.S. Court of Appeals for the Eleventh Circuit, the IRS cannot just ignore it. In other words, the Tax Court's decision is a decision from a court of law, and the Eleventh Circuit —which along with the other courts of appeals grades the Tax Court's homework — said that the Tax Court got it right.[3]

Although the IRS will occasionally "not acquiesce" to a Tax Court decision it does not agree with, it has never done so with ***Childs***, and a sudden nonacquiescence after nearly 30 years would violate the IRS's policy of announcing a nonacquiescence shortly after a case has been decided.[4] The IRS itself has favorably cited ***Childs*** in letter rulings and other guidance. While the IRS could re-litigate the issues addressed in ***Childs*** if it chose to do so, nothing in the GLAM indicates that it intends to do that and no part of its analysis in the GLAM undermines the integrity of the prior court decisions.

Traditional Fee Structures Have Already Survived the GLAM's Arguments

Finally, the suggestion that the GLAM is a roadmap for how the IRS could try to attack an attorney fee structure leaves out key parts of the story. As we summarized in our January 2023 FAQ, the GLAM argues that the deferral product it reviewed (which, again, was not a fee structure) did not pass muster under the "assignment of income" doctrine, the "economic benefit" doctrine, or Sections 83 and 409A of the Internal

Revenue Code. With respect to fee structures, the Tax Court in ***Childs*** knocked out Section 83 and (by extension) the economic benefit doctrine; Congress knocked out Section 409A via the specific exemption from Section 409A for service providers with multiple clients (like attorneys); and the IRS itself knocked out the assignment of income doctrine by not raising it as an issue when it litigated ***Childs***. Even the GLAM itself recognizes that ***Childs*** is still good law, stating on page 5 that ***Childs*** "does not apply to the transaction" described in the GLAM.

The validity of ***Childs*** notwithstanding, attorneys considering a fee structure should be sure that they're practicing good housekeeping. For example, it is a best practice for the contingent fee agreement to expressly contemplate a fee structure. While the provision can be relatively simple, it should use certain buzz phrases, such as the fee may be paid "in the future" as "a lump sum or a series of periodic payments" pursuant to an arrangement with "a third-party assignment company" and that no assets will be set aside to "secure the future payment stream." In addition, the fee structure should be in place at the time the settlement agreement is executed.

Conclusion

It's unnerving when a regulator does something unexpected, especially when that regulator is the IRS, and taxpayers should always be careful when planning for taxes. We agree with the authors of the article that any arrangement which purports to defer an attorney's income should be reviewed by a knowledgeable tax attorney or CPA. However, the IRS must follow its own rules and is bound by the decisions of higher courts. Although the GLAM caught many by surprise, it is not the calamity for traditional attorney fee structures that the article's authors portend.

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[1] Internal Revenue Manual section 33.1.2.2.3.5 (04-12-2013).

[2] Where the plaintiff's claims involve a personal physical injury pursuant to Internal Revenue Code Section 104(a), the parties will execute a "qualified assignment" pursuant to Internal Revenue Code Section 130(c).

[3] The Tax Court was established by Congress in 1969 as an "Article I" court (technically under the executive branch of government) to resolve disputes between taxpayers and the IRS. This difference has led many to speculate that the Tax Court's decisions are entitled to less weight because it was not established under Article III of the Constitution, which established the judicial branch of government. However, the Supreme Court rejected this view more than three decades ago, stating that the Tax Court exercises the "judicial power of the United States" as a "court of law," even though it is not an Article III court. See Freytag v. C.I.R., 501 U.S. 868 (1991).

[4] See Internal Revenue Bulletin: 2023-11 (Mar. 13, 2023) ("It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement…. 'Nonacquiescence' signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a 'nonacquiescence' indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue

of the deciding circuit.”).

ATTORNEYS MENTIONED

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