Deferred Fee Arrangements … A New Day Dawning?

As long as there have been financial settlements, there have been attorneys wishing to structure their contingent fee arrangements to defer that income. The idea is certainly a good one: Why take a sizeable tax hit if you can defer and soften the blow over time?

Unfortunately, the IRS's stance has long been clear: Attorneys who structure fees must recognize income in the year their client's case is settled.

The Sun Rises

Enter the Jobs Creation Act of 2004, which contained significant changes in the law dealing with nonqualified deferred compensation plans. *Commissioner v. Banks, Commissioner v. Banaitis* and the U.S. Supreme Court's January 2005 consolidated decision notwithstanding, it appears legislation has been reached that is bringing the dawn of a new day for deferred fee arrangements.

The Day Dawns

Of course, this is largely uncharted territory. But the legislation does give rise to all sorts of deferral scenarios. Conceivably, attorneys could work with their tax and financial advisors to structure fee arrangements so that they could take a piece of every fee and build true "defined benefit" programs. Plans could be tailored to provide everything from a child's college tuition to payments to cover the firm's operating expenses.

Keeping It Legal

Again, piloting in uncharted waters, attorneys run the very real risk of running afoul of tax law. Being able to recognize fees as income in the years the deferred payments are received, rather than being taxed in the year the case is settled, is indeed a counterintuitive concept. But not when you consider that the agreement to receive deferred payments is executed *before* you have an absolute, unconditional right to receive those funds. It's all based on two key concepts:

1. Constructive receipt — This holds that you cannot opportunistically "control" the year in which you receive income (see *Palmer v. Commissioner*). Treasury Reg. 1.451-1(a) and 2(a) explain it this way:

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. . .

The key to avoiding this trap is found in *Martin v. Commissioner*, which holds that if an attorney enters into a deferred fee arrangement *before* a settlement agreement is signed, he or she does not have an unrestricted right to receive funds immediately and, for tax purposes, has effectively done so before the fees are considered "earned."

2. Economic benefit — This holds that constructive receipt, for tax purposes, occurs when assets are unconditionally and irrevocably paid into a fund or trust to be used for the taxpayer's sole benefit. (i.e, because the promise to pay deferred compensation is completely funded and secured, you are considered to have received the economic benefit). If so, you must pay federal income tax on the present value of those future payments in the year you sign the settlement agreement.

In Revenue Ruling 79-220, the IRS agreed that economic benefit does not occur when:

- The attorney never realizes the absolute, present right to an immediate cash fee;
- The attorney has no control over the funds of the insurance company (within the annuity vehicle) that are earmarked to pay the deferred fee promise;
- The annuity was subject to the general creditors of the insurance company; or
- The annuity was not purchased in the name of the attorney; rather, the insurance company was the owner of the annuity.

What It All Means

It appears that legislation enabling income deferral has indeed reached critical mass, providing some unique opportunities for attorneys. But to avoid the constructive receipt and economic benefit hazards, attorneys will need to adhere to some precise mechanics when establishing structured fee arrangements. *Deferring the receipt of contingent fees presents a powerful opportunity for attorneys. Contact our office today for the latest thinking and sound on proper structuring of fee agreements.*

On The Client Side

These legislative changes may also benefit your clients. By spreading out the receipt of attorney fees in cases with taxable damages, clients may not be impacted so harshly by the nondeductibility/Alternative Minimum Tax problems of attorney's fees.

Previously, the client's full award (i.e., before deducting attorney's fees) was taxable. Attorney's fees were deductible as a miscellaneous itemized expense. However, more often than not, this deduction provided no tax benefit due to the imposition of AMT, which disallows miscellaneous itemized deductions.

The 6th Circuit Court of Appeals (*Banks*) and the 9th Circuit Court of Appeals (*Banaitas*) allowed taxpayers to net the award, thereby allowing a deduction for attorney's fees. The IRS did not agree. Ultimately, the U.S. Supreme ruled in favor of the IRS, disallowing the practice of netting the award.

Here's what happened: The Supreme Court ruled in January 2005 that contingent fees paid to an attorney out of a taxable damage award or settlement are not excludable from a client's gross income. They are deductible only as a miscellaneous itemized deduction.

However, last October's American Jobs Creation Act of 2004 contained a section addressing contingent fees in certain types of litigation. According to the law, taxpayers may rely on new Section 62(a)(19) for relief. This allows taxpayers with certain discrimination claims to deduct attorney's fees and court costs from their adjusted gross income as an *above-the-line deduction* in very limited circumstances (certain civil rights actions, claims against the government and Medicare fraud claims incurred after October 22, 2004). Because this is an above-the-line deduction, the taxpayer does not have to itemize to claim the deduction.