# A STEP TOO FAR:

## Commentary on the IRS's Recent Memorandum Questioning the Viability of Non-Traditional Attorney Fee Deferrals

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*All resources are linked and can be found on the last page*

On December 9, 2022, the IRS Office of Chief Counsel issued a  detailing the IRS's opinion on the subject of a select, aggressive, type of attorney fee deferral. As declared therein that GLAM 2022-007 "may not be used or cited as precedent."

However, the GLAM gives us some insight into the IRS's "playbook" on attorney fee deferrals.

Importantly, it only applies to the facts submitted where there was much access and control over, not only the timing and mechanism of the deferral, but also over the investment and arguably, access to the amount deferred.  More importantly, the memorandum distinguished the facts before it from the traditional structured settlement attorney fee deferral methodology approved by the tax court and affirmed by the 11th Circuit in *Childs v. Commissioner,* 103 T.C. 634 (1994).

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Even though my concentration while in law school was in tax law, and as much time as I have spent researching the tax code and tax-related decisions since graduating, I am not a tax attorney. However, there is one phrase from my tax professor that echoed through my head as I read through GLAM 2022-07: **"Bulls win, Bears win, Pigs lose."**

He often recited this phrase when referencing cases where the IRS had successfully struck down a novel or aggressive tax deferral or avoidance strategy.

Were these same words pinned to a bulletin board in the office of the Associate Chief Counsel, when they opined on the fact pattern here after referred to as the "Offending Scenario," of GLAM 2022-07, which derailed the hopes of a provider who had attempted to create and obtain approval for an aggressive attorney fee deferral program?

Regardless, the following commentary should not be interpreted as an attempt to give tax advice.  I encourage plaintiff attorneys to discuss the available options with their accountants or tax counsel.

Our Company, Paramount Settlement Planning, LLC routinely participates in these conversations, as a necessary process in our traditional structured attorney fee program and would be happy to do so for any attorney considering their deferral options.

Ultimately, for the reasons detailed herein, I believe that properly established traditional attorney fee structures are not impacted by this memorandum and may now be the only viable and Tax Court sanctioned tax-deferral strategy available.

Nevertheless, it is important that these issues be discussed and dissected, so that plaintiff attorneys are armed with as much accurate information as possible when determining whether or not to defer their fees.

# Understanding the Memo

"In a traditional attorney fee structure, the defendant must agree to make the payments, otherwise owed to the plaintiff, for the portion deferred, in periodic format."

Generic Legal Advice Memorandum (GLAM 2022-007) addresses an "Offending Scenario" in which a contingent fee attorney utilizes a fee deferral strategy and, an unusually aggressive fee deferral arrangement used by a plaintiff's lawyer (referred herein as the "Offending Scenario"). The generic legal advice memorandum, or GLAM 2022-007, concludes that the arrangement failed to defer the lawyer's fee for income tax purposes. Thus, the lawyer was taxable on the full amount of the fee in the year the plaintiff received a lump-sum cash settlement and the deferral was attempted.

> "The law firm must include the fee in gross income in the year that the funds representing the fee are transferred to the third party. The transaction creates a funded compensation arrangement that results in gross income to the law firm under the anticipatory assignment of income doctrine, the economic benefit doctrine, and section 83. Alternatively, to the extent that the arrangement constitutes unfunded deferred compensation, the arrangement is a nonqualified deferred compensation plan subject to section 409A, and the law firm has gross income in the first year of the arrangement because the plan fails to comply with section 409A. (GLAM 2022-007 at page 5)

In my opinion, in this memorandum, the IRS incorrectly applies the "anticipatory assignment" doctrine to a transaction entered into before the settlement was realized.


Furthermore, they broadly include a contract between a law firm and its client as a non-qualified deferred compensation plan under IRC § 409A, even though this section of the code was enacted to prevent abusive deferred compensation plans benefiting executives of companies and service providers. Unfortunately, this is likely due to the fact that the submitter requested either confirmation of an exception to 409A, or, confirmation of compliance therewith.

That part of the application is not clear from the GLAM. However, irrespective of the fact that I disagree with some aspects of the IRS's analysis in the GLAM 2022-007, in my opinion, given what is represented to be the totality of the facts of the transaction in question, the opinion of the IRS, based on those facts, was certainly predictable.

## Distinguishing the Traditional Structured Attorney Fee Transaction Approved in *Childs V. Commissioner**

While the advocate for the Offending Scenario in GLAM 2022-007 apparently, anchored their application on the same precedent relied on by traditional attorney fees structured settlement programs, *Childs v. Commissioner*, 103 T.C. 634 (1994), aff'd, 89 F.3d 856 (11th Cir. 1996), the strategy at the core of the Offending Scenario in the memorandum is far more aggressive than a traditional fee structure. The Offending Scenario does not use the approved structured annuity method, but rather, uses a "Rabbi Trust" methodology. Additionally, the facts which were the subject of the GLAM do not even remotely resemble the fact pattern in *Childs*. In fact, in GLAM 2022-007, Associate Chief Counsel for the Employee Benefits division stated, in no uncertain terms:

> **"This GLAM will explain why *Childs* does not apply to the transaction and Taxpayer cannot avoid income inclusion in the year that the funds representing its fee are transferred to the Third Party."**

*Childs v. Commissioner*, 103 T.C. 634 (1994), aff'd, 89 F.3d 856 (11th Cir. 1996)



As you may be aware, in a traditional attorney fee structured (AFS) procedure approved by the tax court in *Childs*, each plaintiff themselves must acknowledge, prior to the execution of the settlement agreement, the promise to periodically pay any attorney fee obligation from the case that has resolved.

There is no upfront cash payment of the attorney fees which are later redirected as occurs in the Offending Scenario.

Additionally, in a traditional attorney fee structure, the defendant must agree to make the payments, otherwise owed to the plaintiff, for the portion deferred, in periodic format.

Further, in a traditional AFS there is no account established for the benefit of the attorney, nor does the attorney(s) possess any right to assign, accelerate, lien, or loan against that periodic payment obligation. The IRS has issued a separate ruling on similar facts in 2008. In PLR-150850-07, an income tax deferral structure for a non-personal injury, taxable settlement, with similar restrictions and attributes as are required in attorney fee structures, was sanctioned by the IRS, citing *Childs*.

To the contrary, from what we know about the Offending Scenario, not only was the proposed deferral a drastic departure from that in *Childs* but, one could argue that the loan provisions got remarkably close to creating immediate "economic benefit." "Under the economic benefit doctrine, if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is currently includible in the individual's gross income." (IRS Deferred Compensation Audit Technique Guide Revision Date: 6/1/2021)

Below are a few of the relevant excerpts from GLAM 2022-007 which highlight the departures from traditional AFSs, wherein the "Taxpayer" is plaintiff's counsel:

1. "Pursuant to the Settlement Agreement, the Client will release all legal claims against the Defendant in exchange for a **cash settlemen**t of $1,500,000."

2. "Prior to the execution of the Settlement Agreement, Taxpayer enters into a deferral agreement (the Deferral Agreement) with a **third party that was not involved in the litigation** (the Third Party)."

3. "Pursuant to the Deferral Agreement, Taxpayer agrees that 100% of any legal fees it earns arising out of the settlement of the Client's claim will be transferred directly from the Insurer to the Third Party. This "deferral" amount is transferred in **upfront cash."**

4. "Third Party agrees to pay a lump sum amount to Taxpayer on August 1, 2031, equal to the amount of the fee paid to the Third Party, adjusted for gains and losses based on the performance of a hypothetical investment portfolio **selected by Taxpayer**, less an annual administration fee (the Deferred Payment)."

5. "Taxpayer provides written instructions to the Insurer regarding where to transfer the settlement funds. Taxpayer i**nstructs the Insurer to split the lump sum** into two separate wire transfers. One transfer for $1,050,000 is to be sent to Taxpayer's trust account. This amount represents the Client's net portion of the recovery ($1,500,000, less Taxpayer's 30% contingency fee of $450,000). The second transfer for $450,000 is to be sent to the Third Party. **The second amount represents Taxpayer's fee**."

6. **"Just one month after the above transfer to third party is complete, "Taxpayer obtains a $200,000 loan from the Third Party."** and,

7. "In the event of Taxpayer's default on the loan due to non-payment, the Third Party is permitted, under the terms of the Note, to exercise a setoff right, such that **the Third Party can reduce the Deferred Payment by the amount of the loan and accrued interest**, to the extent of the default."
**(emphasis added)**

If these are, in fact, the steps taken and the facts of the Offending Scenario, then, they represent a significant departure from the traditional, *Childs* sanctioned, and IRS adopted deferral arrangement. Importantly, none of the steps outlined above occur in a traditional AFS, nor will any life company currently authorized to issue those structured settlement deferrals permit such language in their documents. AFS, nor will any life company currently authorized to issue those structured settlement deferrals permit such language in their documents.

**Distinguishing the Traditional Structured Attorney Fee Transaction Approved in *Childs V. Commissioner* (continued)**

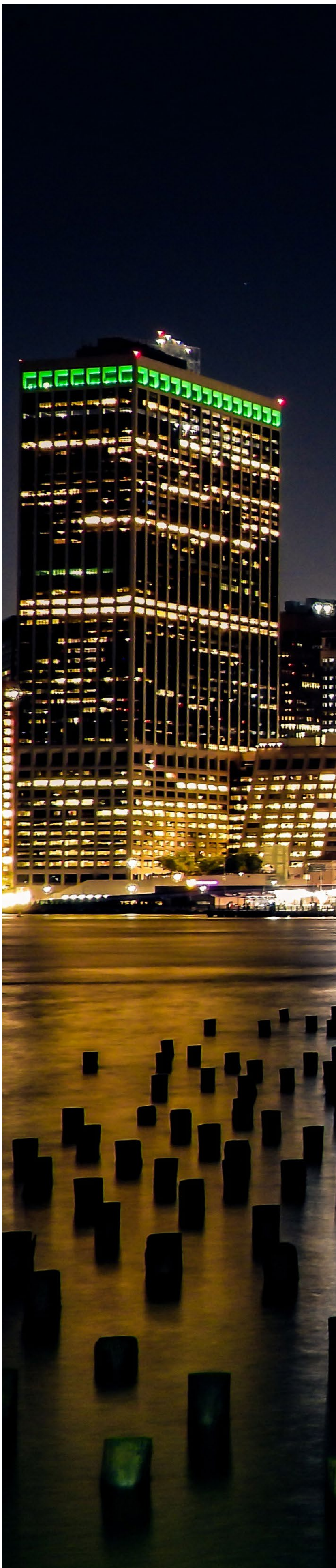
Furthermore, traditional fee structures, as well as other non-qualified structures are considered to be "unfunded" (see PLR-150850-07 citing *Childs*). In fact, GLAM 2022-007, treating the Offending Scenario as "funded" emphasizes the distinctions between the proposed transactions and the traditional AFS methodology.

In *Childs*, the Tax Court determined that the promise to pay the fees in future periodic payments was not "funded" for purposes of Section 83 because the attorneys merely had a promise to future payments from the insurers, and that promise to pay was subject to the rights of general creditors of the insurers.

Further, the purchase of the annuities by the insurance companies did not result in "funding" under Section 83 because the insurers remained the owners of the annuities and reserved the right to change the beneficiaries and, the Taxpayers did not have rights to payment greater than the rights of a general creditor of the insurers.

On the other hand, in the Offending Scenario, the IRS, determined that:

> "Pursuant to the Settlement Agreement, the Insurer agreed to pay the entire settlement of $1,500,000, inclusive of Taxpayer's fee. Treating the Insurer as the "obligor" of the fee, just as the Tax Court did with the insurers in *Childs*, the Deferred Payment became a "funded" promise to pay money for purposes of Section 83 when the Third Party agreed to pay the fee on a deferred basis and the Insurer was released of the obligation to pay the fee under the Settlement Agreement. At that time, the Tax Court's conditions for "funding" under *Childs* were satisfied."



## Access or Acceleration = "Economic Benefit" = Immediate Taxation

Furthermore, the opinion puts a great deal of emphasis on the "economic benefit" doctrine and the anti-acceleration rules of 409A, particularly when applied to the attorney's ability to alter the timing of the future benefit by securing a loan from the plan. Keep in mind that the plan there was apparently submitted as an exception to the restrictions against deferred compensation under IRC §409A. following excerpts from the GLAM 2022-007 the IRS's position on accelerations and loans in non-qualified deferred compensation settings.

> "Under section 409A(a)(3), a nonqualified deferred compensation plan subject to Section 409A cannot permit the acceleration of the time or schedule of any payment under the plan. Likewise, Treas. Reg. § 1.409A-3(j)(1) provides as follows:
>
>> 'Except as provided in paragraph (j)(4) of this section, a non-qualified deferred compensation **plan may not permit the acceleration of the time or schedule of any payment** or amount scheduled to be paid the terms of the plan, and no such accelerated payment may be made whether or not provided for under the terms of such plan. For purposes of determining whether a payment of deferred compensation has been made, the rules of paragraph (f) of this section (substituted payments) apply.'
>
> When amounts were initially deferred pursuant to the Deferral Agreement, Taxpayer elected to be paid in a lump sum in 2031. The anti-acceleration rule of section 409A(a)(3) was violated in 2021 when Taxpayer obtained a loan against amounts deferred with the Third Party. The loan was an accelerated payment of deferred compensation because of the substitution rule in Treas. Reg. § 1.409A-3(f), which provides that 'the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation.' Whether one payment is a substitute for the payment of deferred compensation is based on the facts and circumstances.
>
> If a 'service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, **the payment or loan is a substitute for the deferred compensation.**'" (GLAM 2022-007 at page 23).



Therefore, as a result of this memorandum and, its determination that any acceleration or change in promised benefits violates 409A, I would be genuinely concerned about any purported non-qualified “arrangement” that professes to defer taxation yet, allows for the possible acceleration either by financial hardship, loan or otherwise. IRS regulation 1.409A-(3)(f) should remove any doubt as how they will treat such a flexible fact pattern:

> “In addition, where a service provider’s right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the service provider or the service provider’s beneficiary, **the deferred compensation is treated as having been paid.”** (26 CFR § 1.409A-3) (emphasis added).

Furthermore, it is critical to understand that an important factor in the holding in *Childs*, sanctioning the deferral of taxation on the attorney’s fees, was the fact that the future periodic payment of the plaintiff’s attorney fee obligation was not subject to either acceleration, lien or change in any way:

> “Also, petitioners agreed that they did not have the right to accelerate, defer, increase, or decrease the periodic payments.” (*Childs v Commissioner,* 103 TC 634, 651 [1994]).

Logically, then, any deferral program which claims to allow reconfiguration, acceleration, anticipation, or other early access to the deferred amount simply cannot rely on *Childs* for protection from immediate inclusion in income. Further, GLAM 2022-007 opines that a program with those types of acceleration provisions also violates 409A.

# DISTINGUISHING THE FACTS OF GLAM 2022-007 FROM I.R.S. POLICY AND COURT PRECEDENT

It is clear that GLAM 2022-007 advocates that any earned income "deferred" by way of a strategy resembling the Offending Scenario should, instead, be included on the tax return in the year in which the fee was earned, rendering, the "deferral" aspect ineffective. In light of previous policy and precedent in order for the IRS to arrive at this position it must have, necessarily, treated the "deferral" arrangement as a sham.

First of all, the IRS has long recognized that successful parties to litigation do not have any interest in property or income until the litigation ends and the losing party must pay. The IRS has stated that there can be no anticipatory assignment income or property until this time as there is nothing to assign:

> "With respect to the assignment of claims in litigation, a review of the case law shows that anticipatory assignment of income principles require the transferee to include the proceeds of the claim in gross income where recovery of the transferred claim is certain at the time of transfer, but not where recovery of such claim is doubtful or contingent at the time of transfer." PLR 2012-32-024 *5 (I.R.S. May 15, 2012)

This property or income interest in litigation can ripen in two ways. Either the successful party is entitled a judgment all appeals have been exhausted:

> "*Doyle, Cold Metal Process Co. v. Commissioner,* 247 F.2d 864, 79 Ohio Law Abs.514 (6th Cir. 1957), rev'g 25 T.C. 1333 (1956), follows the view that a taxpayer's right to income on a judgment is not earned or does not ripen until all appeals with respect to the judgment have been exhausted. *Cold Metal* demonstrates the doubtful and contingent nature of a lower court judgment during the time an opposing party is prosecuting appeals." PLR 2012-32-024 (May 15, 2012).

or, an enforceable agreement has been reached and the final documents have been executed:

> "The right of 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' clients. Petitioners had no right to receive any moneys prior to such time as their clients "recovered" amounts from their claims." (*Childs v Commissioner,* 103 TC 634, 655 [1994]).

Secondly, the IRS has successfully argued to the United States Supreme Court that the entire recovery is income to the client and not to the attorney even though there exists a contractual or other legal obligation to pay a portion of said recovery to the attorney.

In agreeing with the IRS’s position, the Supreme court held:

> “The attorney is an agent who is duty bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal.” (*Commissioner v Banks*, 543 US 426, 436 [2005])

I believe that GLAM 2022-007 misinterprets, or even twists, the holding in *Commissioner v. Banks,* 543 US 426, 434 (2005), which clearly determined that the entirety of the contingency recovery was the property of the client and not the attorney.

Following its successful argument in Banks, logic would have dictated that the IRS should take the position that contingent attorney fees are not the property of the attorneys until actually paid to them. Quite simply, that piece of the settlement pie cannot belong to two different parties at the same time. Therefore, since the deferral agreement at issue was executed prior to settlement agreement and prior to the corresponding vesting of an interest and, since the Supreme court has determined that the entirety of the settlement is the property of the plaintiff at settlement, the IRS must have treated the deferral agreement as an example of “form over substance,” due to the control exercised and the opportunity for acceleration of benefits under said deferral arrangement.

The authors of the GLAM must have also assumed that, even though the deferral agreement was entered into prior the signing of the release, the act of cutting the check to the Third Party separated that portion of the proceeds from the plaintiff and converted its ownership to counsel at that moment in time. Perhaps, in the IRS’s view, the conversion occurred at that point, due to the law firm’s instruction to the insurer split the settlement and direction as to where to send the amount of the settlement representing the fee, as opposed to where to send the client’s share. With these assumptions, the memo’s reliance on in the “economic benefit” doctrine and the non-acceleration provisions of 26 CFR §1.409(a)(3) are on better footing, particularly since the firm received the loan of $200,000 within 30 days of the “deferral.”

Furthermore, although the IRS does not rely exclusively on the “constructive receipt” doctrine (codified in 26 CFR § 1.451-2) for its position, perhaps, it was simply the totality of control and the ability to draw upon the funds, albeit in the form of a loan, which caused the IRS to opine as it did in GLAM 2022-007.

> “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.” (26 CFR § 1.451-2) (emphasis added).

## Conclusion

After distinguishing the extreme facts on which it is based, the memorandum provides renewed support for periodic payment attorney fee structure products so long as the *Childs* methodology followed. In fact, upon Shepardizing™ *Childs*, the tracking points directly to GLAM 2022-007. Although, no one should rely on this reference in a court of law, the Shepards™ analysis declares that the memo cites *Childs* as “controlling or persuasive.”

Fortunately, properly established, traditional structured settlement-based attorney fee deferrals, adhering to the tax Court’s decision in *Childs* and the deferral principles of PLR-150850-07, do not attempt to provide such aggressive access to the promised, but unsecured and unfunded, periodic payments.

In my opinion, GLAM 2022-007 reaffirms the reasoning in *Childs*, acknowledges it as controlling and, therefore, ratifies the methodology utilized therein.

History and experience suggest that when the IRS examines the strategies of technically compliant “bulls” and “bears” they may not love the strategies utilized but, are likely to pass with approval if the established rules are followed.

However, it is often the overly aggressive programs, resembling the Offending Scenario, offering access to funds in the event of hardship or offering near-immediate loans that can be offset against the “deferred” payment that are likely to be viewed as “piggish” by the IRS and which are not likely to avoid the agency’s scrutiny. Remember that, in the IRS’s eyes, access and control generally equates to either ownership or income, or, both.

Again, plaintiff counsel should always independently research any proposed deferral arrangement or speak with their accountant or tax counsel before entering any deferral agreement. As mentioned, we, at Paramount Settlement Planning LLC, are happy to discuss GLAM 2022-007 in the context of traditional attorney fee structures and the important steps that are necessary to stay compliant with precedent and IRS published guidelines in fee deferrals.

# Resources

**Click the links below to review the referenced material:**

- Generic Legal Advice Memorandum (GLAM 2022-007);
- *Childs v. Commissioner, 103 T.C. 634 (1994);*
- *Childs v. Commissioner*, 103 T.C. 634 (1994), aff'd, 89 F.3d 856 (11th Cir. 1996);
- *Commissioner v. Banks,* 543 US 426, 434 (2005);
- *Cold Metal Process Co. v. Commissioner,* 247 F.2d 864
- IRC § 409A;
- IRS PLR-2012320-24;
- IRS PLR-150850-07;
- 26 CFR §1.409(a)(3);
- 26 CFR § 1.451-2

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Our team `of planning professionals, are equipped with the experience and solutions that empower injury victims to regain control of their lives following the settlement of their case; guiding them from litigation to living and for life.

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