Income Tax Reduction and Deferral Strategies for Trial Attorney Contingency Fee Income

Part 1—Structured Settlement Annuities Using Private Placement Variable Deferred Annuities

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Overview

Structured settlement annuities (SSA) have been recognized by federal law since 1983. The original use of these arrangements was for physical injury cases. The typical arrangement for cases involving physical injury and sickness as defined under section 104 provides for the defendant to make a "qualified assignment" of the periodic payment obligation as prescribed under the settlement agreement between the plaintiff and defendant to a qualified assignment company.

The qualified assignment company is the applicant, owner, and beneficiary of the annuity contract, which it uses to make payments to the plaintiff. The plaintiff receives tax-free annuity payments and the defendant or its casualty insurance company receives a tax deduction in the year the payment is made. The defendant is released from further liability or obligation in the year it is made.

The marketplace for these annuities has evolved to handle a wider range of cases—workers' compensation claims, employment claims, non-bodily injury property and casualty claims, and other negotiated settlements. SSA arrangements have been used in commercial business transactions as well.

The previous drawback of using SSA arrangements for non-qualified cases (cases not qualifying under section 104 as settlements related to physical injury or sickness) was the inability to avoid adverse tax treatment for the assignments. Life insurers have overcome this problem by creating assignment companies in Barbados. Article 18 of the U.S.–Barbados Income Tax Treaty provides for favorable taxation of annuity benefits, overcoming the limitation of section 72(u) dealing with annuities owned by a non-natural person. This adverse tax treatment is not applicable to SSA arrangements that qualify under section 104 and section 130.

The premium volume for SSA arrangements was reported to be $6 billion in 2007, representing 10%–15% of the total claims. The amount of settlement claims was reported to be in excess of $100 billion in 2007. According to Tillinghast, plaintiff's attorneys earned $30 billion in 2007. Nevertheless, most of these SSA transactions have been for plaintiffs rather than for attorneys deferring contingency fees.

Attorneys have not widely used SSA arrangements for a variety of reasons. First, the annuity contracts offer very conservative returns and in the current low interest rate environment, these returns have been miniscule. Second, a plaintiff's firm has tremendous upfront expenses to litigate a case. It requires a large "war chest" to meet these upfront expenses. Third, most SSA brokers do not have the proper licensing with FINRA to offer a variable annuity solution to provide investment upside for the deferred contingency fee.

The typical contingency fee arrangement for attorneys in these cases is 30%–40% of the settlement amount. Until recently the tax treatment of attorney deferral arrangements has been uncertain. Tax legislation and court decisions have provided the necessary tax and legal technical support for these arrangements.

The annuity contracts in the SSA marketplace include both deferred and immediate annuities. These contracts are issued by some of the largest life insurers in the country, including AIG, New York Life, Met Life, and MassMutual. However, the annuity contracts used have been fixed annuity contracts where the policy's crediting rate has been tied to the investment performance of the insurer's general account assets.

The use of a private placement variable deferred annuity (PPVA) as an SSA is something completely new to the SSA marketplace. What is arguably the best solution in terms of costs and investment flexibility is not being offered by SSA brokers.

PPVA contracts are institutionally priced variable annuities that offer investment flexibility to customize the investment options within the PPVA. These contracts may provide the ability for a lawyer to use his current investment advisor while providing access to investment classes such as hedge funds that are currently unavailable within SSA contracts.

This article describes an enhanced SSA solution for attorneys who elect to defer contingency fee income.

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Tax Support for the Deferral of Attorney's Fees

In *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd*, 89 F.3d 856 (Table) (11th Cir. 1996), the Tax Court ruled in favor of an attorney fee deferral arrangement. This decision was the first and only case supporting the right of an attorney to defer contingency fee income. The court ruled that the attorney did not have constructive receipt of his fees because the attorney did not have any right to a fee until the settlement agreement was signed. Before signing the settlement agreement, the attorney agreed to receive his fee over time. The attorney also did not have any economic benefit—*i.e.*, no funds were accessible by the attorney before the agreement. The life insurer's guarantee did not meet the definition of property under section 83. The Service acknowledged the holding in *Childs* in a discussion of constructive receipt in FSA 200151003.

Section 409A, which was added to the Code in 2004, deals with the requirements for deferred compensation arrangements. The Service issued a notice entitled "Guidance Under § 409A of the Internal Revenue Code" on December 20, 2004. Notice 2005-1, 2005-1 C.B. 274. The notice's question and answer section provides that the limitations of section 409A do not extend to this type of fee deferral arrangement.

In January 2005, the Supreme Court issued a decision in the consolidated cases of *Commissioner v. Banks* and *Commissioner v. Banaitis*, 543 U.S. 426 (2005). The Court ruled that attorneys do not have a property interest in the settlement recovery. This ruling is a critical element enabling an attorney's ability to defer fees.

Tax Requirements for Deferring Contingency Fee Income

An attorney must avoid the application of the constructive receipt and economic benefit doctrines. An attorney should adhere to the following guidelines in structuring a deferred fee arrangement.

1. **Settlement Agreement.** The settlement agreement must certify that a contingency fee arrangement between the plaintiff and attorney is in place and that deferred payments are directed to the attorney for the benefit and convenience of the plaintiff to meet the plaintiff's attorney's fee obligation. The amount and timing of the payments should be specified in the agreement. This agreement must be made in writing before the fees are earned (before the settlement documents are signed). The election must be irrevocable. The lawyer's fee agreement with the client should allow the lawyer to receive all or a portion of contingency fees in the form of periodic payments.

   The agreement should contain the attorney's acknowledgement that the SSA payments "cannot be accelerated, deferred, increased or decreased by the attorney; nor shall the attorney have the ability to sell, mortgage, encumber or anticipate the periodic payments or any part thereof, by assignment or otherwise."

2. **Assignment.** The settlement agreement must require the defendant to assign the settlement obligation to an assignment company. The assignment terminates the defendant's obligation to make periodic payments. The life insurer issuing the annuity typically owns the assignment company. The settlement agreement should contain a provision that the assignment company maintains all ownership rights and control of the annuity.

3. **Annuity Purchase.** Under the terms of the assignment agreement, the assignment company purchases an annuity contract from an affiliated life insurance company to fund its obligation. Funds can be temporarily held in a Qualified Settlement Fund (QSF) under section 468B until the annuity is purchased. The funds are deemed not to be constructively received while parked in the QSF.

PPVA Contracts

PPVA contracts are institutionally priced variable deferred annuity contracts for accredited investors and qualified purchasers as defined under federal securities law. Unlike retail variable annuity contracts, these contracts are unbundled and transparent. The contracts have no surrender penalties and are essentially "no load/low load" contracts. The policy assets are not subject to the claims of the life insurer's assets (and thus are bankruptcy remote).

These contracts provide for the ability to customize the investment options of the contract to include alternative investments such as hedge funds, private equity, and commodities.

The investment performance of the PPVA contract is a direct pass-through to the policyholder, the assignment company. The increased account value within the annuity may increase the attorney's future periodic payments.

The attorney may recommend an investment advisor to the insurance company that—subsequent to the insurer's due diligence review of the advisor—may enter into an investment management agreement with the insurer to manage the assets of the annuity contract. The lawyer cannot control the investment decision-making authority of the investment advisor.

In November 1998, the Service issued a favorable letter ruling regarding the qualification of a variable annuity as a valid SSA. PLR 199943002 (released Oct. 29, 1999). In the ruling, the Service ruled that variable payments still meet the definition of fixed and determinable payments under section 130(c)(2)(A). The ruling did not address whether the variable annuity qualifies as a qualified funding asset under section 130(d).

Case Study

The Facts

Joe Smith, age 60, is a plaintiff's attorney with multiple cases throughout the Southeast. Joe is married with two children and has a personal net worth of $20 million.

The Smith Law Firm has five partners. In a typical year it is involved in legal cases that result in settlements and decisions with damage awards of $5 million or more. Its estimated revenue is $50 million.

Joe currently has a new tort case. The potential damages are conservatively valued at $10 million. He would like to like to defer the entire amount of his contingency fee (estimated to be $4 million).

The Strategy

Joe's fee agreement provides for a contingency payment of 40%. The agreement provides that the claimant may elect to pay these fees as periodic payments over a period of time for the convenience of the claimant. Joe elects to defer all of his legal fees that might be paid as a result of his representation of his client.

The case settles after much negotiation for $10 million. The contingency fee of $4 million will be deferred. The defendant's casualty insurance carrier enters into an assignment arrangement with Acme Assignment, Ltd, a wholly owned subsidiary of Acme Life. Acme is located in Barbados. Under the terms of the assignment agreement, Acme Assignment agrees to pay Joe $3 million. Payments will begin in ten years and will be paid over the joint lives of Joe and his wife; their joint life expectancy is 16 years. Under the terms of the agreement, any investment return associated with the deferred fees is to be paid to Joe as part of the assignment.

Acme Assignment is the applicant and owner of a PPVA contract issued by its parent Acme Life. The policy assets are not subject to the claims of Acme's creditors. Under Barbados law, the assets of the annuity are not subject to the creditors of the assignment company. Article 18 of the U.S.-Barbados Income Tax Treaty provides that the annuity benefits are not subject to U.S. income and withholding tax and will only be taxed to the recipient, Joe Smith, when payments are received in the U.S.

The policy provides for several investment fund options featuring structured products and principal protected notes. These funds offer exposure a wide array of asset classes, including alternative investments such as private equity and hedge funds.

The investment performance over the next ten years achieves a 10% return (net of fees). At the beginning of year ten, the annuity's account value is $10.375 million. The annuity will be annuitized using variable payments. The expected annuity payments will be a minimum of $775,000 at the beginning of each year. Payments may increase based upon good investment performance within the annuity.

Summary

The combination of private placement deferred annuity contracts and structured products provide an exciting solution for plaintiff's attorneys who wish to defer their legal fees. The deferral in virtually every case crosses the breakeven threshold immediately. The deferral of contingency fees is a powerful alternative to any of the qualified plan benefits available to the lawyer through the law firm firm's sponsored benefits.

These arrangements utilize customized annuity contracts that are institutionally priced. The investment strategy guarantees the protection of the investment principal (the amount of the deferred fees) while providing an upside in investment returns through exposure to a wide array of sophisticated investments.

Law firms may use these arrangements to provide for retention of key employees and attorneys. A law firm may manage the occasional financial insecurity of the law firm's cash flow by anticipating overhead expenses and structuring payments to meet these obligations.

The use of PPVA contracts with structured investment products provides an opportunity to revolutionize the use of deferred fee arrangements for plaintiff's attorneys. ■