Forum

Legal Fee Structures Can Hedge the Insecurities Many Lawyers Face

By Robert W. Wood

I am a believer in planning for tomorrow. As a tax lawyer for the last 30 years, I have seen many peaks and valleys in the income of clients and colleagues. I have seen dips and hills in my own income. As a frequent adviser to litigants and their counsel about the tax consequences of settlements and judgments, I have seen no end of contingent fee successes. But I have also witnessed contingent fee failures, and everything in between.

Contingent fee plaintiffs' lawyers often lament the unpredictability of their own income. They may also lament the need to resort to borrowing to finance their cases. Moreover, plaintiffs' lawyers may complain that they cannot take the cases they really want to take, given the financial realities of contingent fee practice.

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To all of this, I suggest a little financial discipline that, amazingly enough, is only available to contingent fee lawyers: the legal fee structure.

Reduced to simplicity, the concept of a legal fee structure is a kind of tax-advantaged installment plan that doesn't rely on the credit worthiness of the defendant or the client. Like much else that is tax-advantaged, it has its formalistic rigidity.

Yet it involves a tried-and-true tax structure that works, and it is grounded in economic reality. In essence, the contingent fee lawyer can decide before settlement that instead of taking his one-third (or other percentage) contingent fee upon settlement of the case, he wants that fee paid over time. The amount of that fee will be paid (usually by the defendant) to a third-party (typically a life insurance company) for the purchase of annuities benefiting the attorney.

The lawyer must decide to do this before the case settles, but that can be right before it settles, even the day before. Although arguably the lawyer has "earned" his contingent fee over the course of the case, the income tax authorities say that the lawyer hasn't technically earned his fee for tax purposes until the settlement documents are actually signed. Amazingly, the attorney can have complete discretion whether to structure all of his fee in this way, or any percentage of it that he wishes.

The case that is uniformly cited as establishing the bona fides of attorney fee structures is *Childs v. Commissioner,* 103 T.C. 634 (1994), affirmed without opinion 89 F.3d 56 (11th Cir. 1996). For a number of years, there was concern that the IRS might disagree with contingent fee structures notwithstanding the *Childs* case. Over the last few years, however, the IRS has begun uniformly citing *Childs* favorably, and is apparently quite comfortable with this.

Done properly, an attorney fee structure obviates the normal tax doctrines of constructive receipt and economic benefit. These fearsome tax doctrines can often result in amounts being taxed to someone even before they actually receive the income. A classic example is the employee who asks to have his year-end bonus paid a few days later in January. Because the employee was entitled to it in December, it is taxed in that year, even if he actually receives it in January.

In the case of properly structured attorney fees, the attorney will be taxed only when and as he receives each periodic payment, according to the schedule the lawyer has set to suit his personal finances.

Why is this such a good deal? It should be obvious that stretching out payments over time yields a better tax result. Depending on the dollars involved, tax rates, and other income, it can mean a lower overall tax burden.

Indeed, most of the work that tax lawyers and tax accountants do relates to timing. It is usually not possible to make taxable income tax-free. Delaying it, though, is often another matter.

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But there is a far more salutary effect of fee structures, and that relates to tax-free compounding. The longer the attorney wishes to stretch out the payments, the better the financial result. In essence, the contingent fee attorney is able to construct a kind of unlimited individual retirement account.

The payments might start right away and go for the next five or 10 years. Alternatively, the payments might be deferred entirely for 10 or 15 years, building up tax-free. Thereafter, they might begin paying out annually for the rest of the attorney's life, or even the joint life of the attorney and his or her spouse. There is almost infinite flexibility.

My practice is all hourly, so I do not qualify for a structured legal fee. They are reserved solely for contingent fee practice. What makes them possible is the technical point that the contingent fee attorney does not "earn" his fee until the settlement documents are signed and all legal and factual impediments to the payment are removed.

When plaintiffs' lawyers complain about the difficulty of contingent fee practice, it is worth reminding them that this is an extraordinary benefit that applies only to them.

I am not suggesting that every contingent fee lawyer should structure fees all of the time. I am not even suggesting that every contingent fee lawyer should structure a percentage of each recovery. On that note, however, I have observed some very successful and cautious contingent fee lawyers who routinely structure a particular percentage of every case as a kind of retirement fund. To me, that makes sense.

If a contingent fee lawyer structures say 15 percent of every fee and puts it away tax-deferred for a rainy day, he would have achieved retirement income stabilization, estate planning and tax-deferred advantage that most people — and even most lawyers — can't achieve.

Ultimately, every contingent fee lawyer should investigate legal fee structures. My father once told me that I should never rely on Social Security to fund my retirement. He was right. I also think that if I were a contingent fee lawyer, I would explore, and probably consummate, legal fee structures as a hedge against the many uncertainties such lawyers face.

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