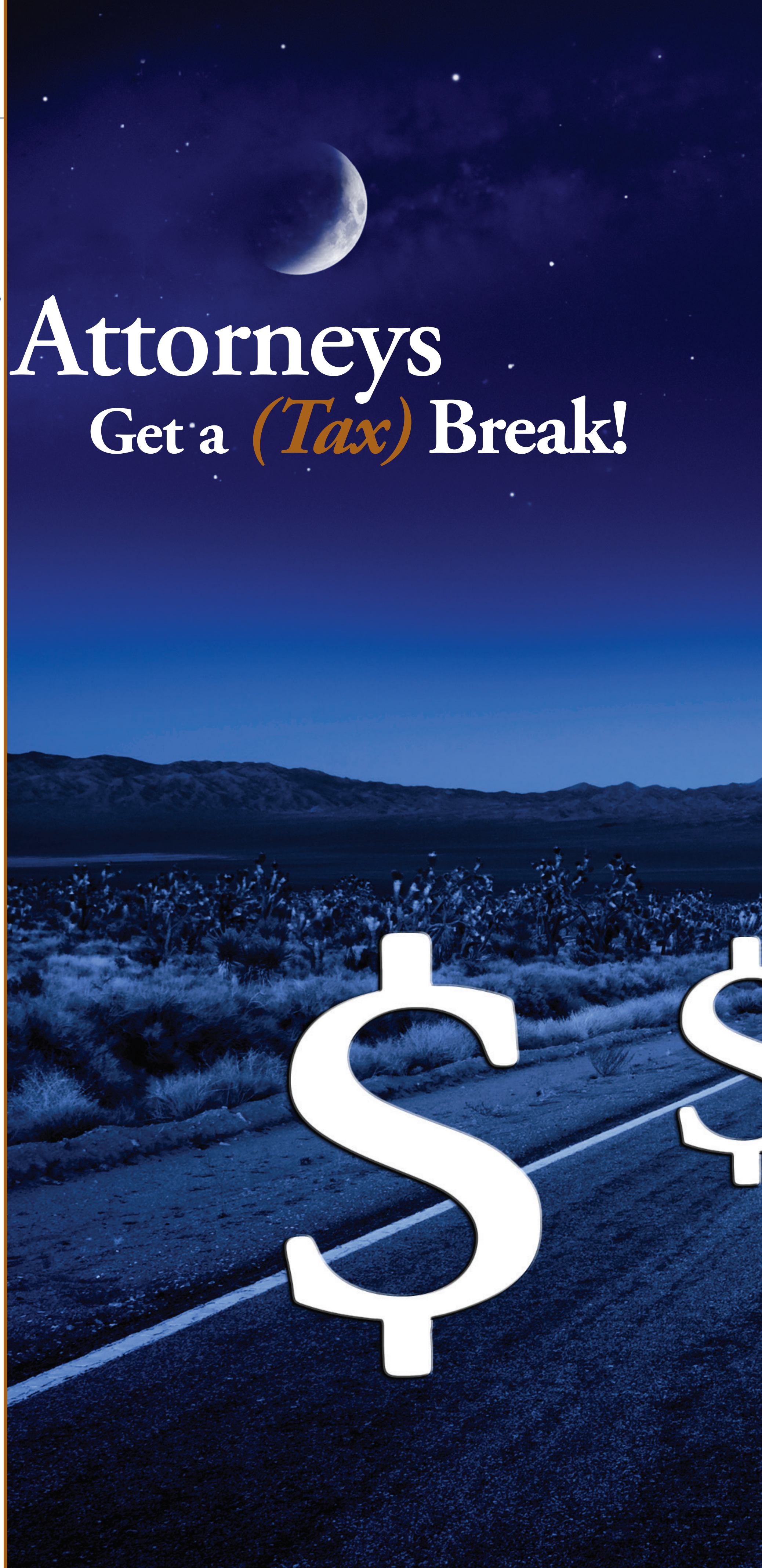
Plaintiff Attorneys Get a *(Tax)* Break!

By Brian Michaels, Esq.



Trial lawyers fight hard for their clients. They can invest years of time and money in a case, with the hopes of getting paid when they recover for their client. The payouts may be few and far between, but when they come, they come all at once—a complete mismatch of taxable revenues and deductions. Such is the world of the contingent fee.

What many trial lawyers don't often consider, or don't know, is that there is a new, unique and powerful option available only to contingent fee lawyers—the deferral of their fees with a customized investment portfolio. That is, the contingent fee trial lawyer can choose how and when to receive the agreed upon fee, including the option of a deferred "customized portfolio," giving him the chance for market-based returns. This "customized portfolio" can consist of a managed portfolio of equities, bonds, structured notes, alternative investments and other non-insurance investments. This new deferral opportunity gives the lawyer the chance to receive a higher rate of return on the deferred fee than was available in the past.

This unique opportunity basically allows the contingent fee to be deferred so that the fee is collected in installments, as determined by the lawyer. The lawyer pays income tax in the year that a cash installment is actually received, and not when the client matter is successfully completed. Why is this so powerful? It allows the lawyer, in essence, to invest his fee on a pre-tax basis (in the same investments as they would after-tax) without the usual restrictions placed upon such arrangements.

Score a tax victory for trial lawyers! Dollars not lost to tax are increased dollars in the lawyer's pocket. Likewise, the earnings on those dollars not lost to tax (or paid in a later year) equal more dollars in the lawyer's pocket.

So, not only is this plan customized, but it is not subject to the income tax rules that regulate other deferred compensation arrangements, nor is it subject to ERISA type constraints such as employee participation requirements, income caps (100% of the fee could be deferred), and ERISA type reporting.

Why would a lawyer consider this type of strategy?

1. INCOME TAX DEFERRAL.

For example, let's assume a fee of $1,000,000 and the lawyer does not defer his fee. Let's also assume a tax rate of 40%. Here the lawyer would net $600,000 to invest, losing $400,000 to tax. Now assume the lawyer defers his fee. He pays no tax in the current year and has the full $1,000,000 to invest. The attorney now has a much larger investment base that can generate much greater returns than if he did not defer his fee. Through proper planning, the lawyer can also design the payout to decrease the overall tax rate paid on the fee over time, saving additional dollars lost to tax—resulting in real, hard dollar tax savings.

This can also be an attractive tool to smooth out income from year-to-year and to minimize problems such as the alternative minimum tax and phase-outs, with the very real possibility of lowering taxes actually paid.

2. RETIREMENT PLANNING.

One hundred percent of income can be deferred. Unlike other retirement plans, there is no income limit and no participation rules. It has been described as an uncapped 401(k) plan. Again, tax deferral, along with the possibility of deferring receipt of income (or smoothing the income) into lower income years can leverage fees into a greater net retirement income.

3. "MATCHING" INCOME AND DEDUCTIONS.

Law firms and solos can use deferred attorney fees to provide for future law firm overhead expenses. By deferring a portion of current fees (or a portion of big spikes in income), firms can lower reliance on lines of credit for future operating costs. In effect, deferring present income allows lawyers to "match" future income and deductions.

Lawyers may feel relieved knowing that firm overhead is completely funded for the next five years and they can focus on cases instead of worrying about paying bills. This state of mind might also enable lawyers to better serve their clients since they don't need to worry about bills.

How does this work?

When the matter generating the fee is being settled, the attorney or law firm determines what amount they want paid in future years and when. That payment stream is then written into the settlement agreement. That obligation to make those future payments is then assigned to an independent assignment company, such as Kenmare Assignment Company Ltd. , or an A.M. Best A or A+ rated life insurance company owned or controlled "assignment company." The future payments are then made directly to the attorney or law firm, according to the agreed upon schedule and amount, by the assignee.

An individual attorney may defer his or her fee or the deferral can be done at the law firm level. The entire fee from a particular case or matter does not need to be deferred, but assignment companies typically require minimum assignments of $100,000. Additionally, the attorney's decision to structure his fees is not dependent upon his client structuring his settlement.

The payment stream is custom-designed by the individual attorney. As discussed earlier, returns can be "market-based," which can be derived from a managed portfolio of equities, bonds, structured notes, alternative investments and other non-insurance investments (generally, any publicly traded asset), or they can be fixed and guaranteed through the use of fixed annuities. Payments can be customized to contain both fixed and market-based components.

In addition, payments can be made monthly, quarterly, semi-annually, annually, or other ways that match the income needs of the attorney. The deferral can be a single lump sum at some future date or a number of lump sums at specified dates. Payments can be made for the life of a recipient (with a guaranteed amount). Any of the options just discussed can be mixed together. The payments can be truly designed to match the specific needs of the financial, operational, and life needs of the attorney or law firm.

Why does this work?

These deferrals have been around for years, approved by the U.S. Tax Court in *Childs v. Commissioner* (2103 T.C. 634, *94 TNT 223-15* (1994), and affirmed by the 11th Circuit U.S. Federal Appeals Court in *Childs v. Commissioner*, (*aff'd without opinion*) 89 F.3d 856, *Doc 96-19540, 96 TNT 133-7* (11th Cir. 1996)).

Why haven't I heard of this before?

While deferring attorney fees has been around for years, the investment options available have been restrictive. Before Kenmare Assignment Company, Ltd. entered the market, the only assignment companies have been controlled by large insurance companies, who restrict funding vehicles to the fixed and variable annuities they provide.

Any caveats?

This is based in federal income tax law. As with any tax matter, work with an experienced deferred attorney fee consultant and your tax adviser.

The assignment companies who offer deferred attorney fees have different requirements. Like many issues that involve tax strategies, procedure and form is very important. It is important that the lawyer works with a consultant with the experience and expertise required in making sure that specific rules are followed.

Deferring one's fees is a powerful tool that has been utilized by contingent fee attorneys for decades and approved by the Courts. It is a flexible and beneficial strategy worth exploring, especially in an investment climate where rates of returns are continually being squeezed. Trial lawyers should take advantage of leveraging the power of deferral to "mitigate the mismatch" and "maximize the value" of their hard fought fees.

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Contributors

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