RESOURCES

IRS Attacks Tax-Deferred Attorney Fee Structures

Carruthers & Roth attorneys Keith Wood, Chris Genheimer and Mike Allen were recently featured in the Litigation Section of the North Carolina Bar Association's (NCBA) NCBarBlog on September 6, 2023. "IRS Attacks tax-Deferred Attorney Fee Structures" gives insight to the recent changes in the IRS's views on the tax treatment of contingent fee deferral arrangements that plaintiffs' attorneys often use.

Full article below or on the NCBarBlog:

Sometimes publicity is a bad thing, and notoriety is even worse. That seems to be the case with respect to an apparent major change in the IRS's views on the tax treatment of contingent fee deferral arrangements that plaintiffs' attorneys often use.

Structured attorney fee deferral arrangements (also known as "fee structures") have been around for decades. Almost 30 years ago, the U.S. Tax Court seemed to validate the deferred tax treatment of fee structures in its 1994 decision in **Childs v. Commissioner**, 103 TC 634 (1994), aff'd without published opinion, 89 F.3d 856 (11th Cir. 1996). From the time of that decision until December 16, 2022, the generally held belief was that a properly constructed fee structure would not be met with IRS disapproval.

However, on December 16, 2022, the IRS issued its **General Legal Advice Memorandum (or "GLAM" AM-2002-007)**.

Coincidentally – or maybe not – in late 2022, Alex Murdaugh, a high-profile South Carolina plaintiffs' attorney, was gaining nationwide notoriety and scrutiny in connection with his suspected murder of his wife and son, and his imminent trial on those charges. A plaintiff's attorney for many years, he also was a prolific, if not notorious and aggressive, user of fee structures, a practice that apparently attracted greater scrutiny as his other issues came to light. It is possible that Murdaugh's notoriety and legal issues were what awakened the "sleeping dog" of favorable IRS treatment of fee structures under **Childs**. Whatever the cause, there is no question that the dog left the kennel howling, in the form of the IRS GLAM.

Regardless of what awakened the dog, plaintiff's lawyers who are considering utilizing a fee structure now, or who already are knee-deep in one, are no doubt concerned about having the IRS looking over their shoulders. If you fall within either category, you are probably aware of the GLAM. According to some, the GLAM generally blasts the tax deferral foundation out from under a fee structure, such that if the GLAM is considered the final word on the topic, the next step is serious time in the IRS "dog house."

Fortunately, the situation is not nearly as bad as it at times has been portrayed. One must remember that a GLAM is in large part an IRS "public service announcement" of its position on the covered topic. This GLAM (or any other GLAM) isn't binding legal precedent. Don't get us wrong – tax practitioners appreciate the IRS issuing these GLAMS, and we read them with interest and, as appropriate, concern. Nonetheless, a GLAM remains a statement of opinion.

All of that said, what do we make of the GLAM, and what do we do about it? First, the GLAM provides a detailed roadmap of how the IRS might attack a fee structure in an IRS audit. Second, the IRS goes on to warn plaintiffs' attorneys that fee structures violate Section 409A of the Tax Code, one of the most onerous and complicated tax sections in the tax code. Indeed, if fee structures violate Section 409A, then participants could face immediate taxation, plus draconian tax penalties.

If you want to decide for yourself whether the IRS or the tax professionals are right or wrong on this issue, you can Google the GLAM yourself and see all the articles that purport to provide step-by-step reasons that the GLAM is misplaced in its application of the tax law to contingent fee structures. These articles will (correctly) point out that the seminal tax case on this topic, **Childs vs. Commissioner**, still has not been overturned. In addition, since the **Childs** opinion was issued, there have been other IRS rulings and pronouncements that would arguably support the position that fee structures work without adverse consequence.

What does all of this mean to the plaintiffs' bar, as a practical matter?

For those of you who are deep into a fee structure already, you probably well know that there really isn't anything you can change about it now. The reason? Because that's the very nature of a fee structure – it's the irrevocable nature of a fee structure that supports its tax deferral argument to begin with. Once you get into one, you can't get out of it. Of course, the irrevocable nature of fee structure is an essential element of them; if you could simply unwind a fee structure just because the IRS scares you, the fee structure would never have passed muster as a tax deferral opportunity in the first place. So, for most of you already into a fee structure, you probably are going to have to plan on holding on for the ride, or adopt a withdrawal plan to start taking into income some of the deferred fees to have as a hedge to any future IRS audit.

For those of you who are **considering** entering into a fee structure, or entered into one last year and still have not yet filed your 2022 tax return, the decision-making analysis is more complicated. If a plaintiffs' lawyer thinking about entering into a fee deferral arrangement came to us today, we would help them analyze the pros and cons, and, depending upon their own personal financial situation and future recovery prospects, we might suggest going for a double instead of a grand slam. That is, maybe we wouldn't defer the **entire** contingent fee, but we would go ahead and pay tax now on just enough of the recovery to use as a rainy-day fund in case the IRS audits the return later on.

Likewise, if a client hasn't signed the fee structure paperwork yet, we would counsel them about the advantages of getting an **up-front tax opinion** (and one that meets the IRS Circular 230 requirements) as a hedge against future exposure to tax penalties. Unfortunately, there is never any penalty defense to a Section 409A penalty mentioned above, which is exactly why the IRS is leaning so hard right now on the Section 409A threat against fee structures under the GLAM.

The next thing we would do is select the CPA who would prepare our client's 2022 income tax return. **How we report** the fee structure is critically important, and we may even decide to go so far as to actually **disclose** on the return itself that we have done a fee structure. By disclosing an aggressive position on a tax return now, we may eliminate penalty exposure down the road. And, although it seems totally counterintuitive, there is little empirical evidence out there suggesting that disclosing an unfavorable tax position on a tax return actually increases the likelihood of a tax return audit.

Then, once we pick our CPA to do the return, we would work side by side with the client to figure out exactly how much information we want to spoon-feed to our CPA. Depending upon where the client is in the process, we would have to be careful about how much we share with the CPA. Communications with a CPA relating to tax return preparation, as opposed to tax planning, aren't fully covered by any attorney-client privilege and instead are fully discoverable by the IRS. So, a little finesse can go a long way.

In summary, the GLAM certainly is something to be taken seriously for those who did a fee structure in 2022 or who are thinking about doing one now. But, fee structures aren't dead. If anything, the GLAM tells us less about whether our clients should or shouldn't do a fee structure, but rather much more about how we should approach after-the-fact reporting on the back end and strategic planning on the front end.

If you have any questions about these topics or other IRS law matters, please feel free to contact Keith Wood, Chris Genheimer, Mike Allen, or another member of Carruthers & Roth's Litigation and Tax team.

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