The Paper Chase

Using the Loan Method of Split Dollar as an Alternative to Attorney Fee Deferrals

One of my favorite movies that inspired me to go to law school was The Paper Chase. The movie follows the trials and tribulations of a first-year law student James Hart at Harvard Law School. During the same period that I was an Army officer stationed at Fort Hood, the Showtime series of the story was mandatory watching. The series followed Hart, the law student in his second and third years of law school. Nevertheless, it never occurred to me to apply to Harvard. I was not a maven when it came to standardized tests. Coincidentally, my friend and West Point classmate who tutored in all the math and science classes, Jim Bowen, did graduate from Harvard Law School. I have always joked that he is the only West Point graduate who has his name on two West Point diplomas, his own and mine.

I took the LSAT at Baylor University on the way to my next duty station, Fort Eustis. I did not apply to law school until three years later while living in South Florida. At that time, the University of Miami (UM) had the only evening law program in South Florida. Since that time, UM dropped its program apparently because prestigious law school programs (like Harvard!) don't have evening programs.

I have written previously about the deferral of attorney contingency fees and have been on a several week rant about the planning power of the Loan Regime Method of Split Dollar. This article focuses on how deferred contingency fees can be strategically repositioned through the Loan Method of Split Dollar to produce more tax efficient benefits during lifetime and at death.

Attorney Fee Deferrals

Attorneys can defer contingency fees in either qualified assignment or non-qualified assignment cases. The seminal case recognizing an attorney ability to defer contingency fees before there is constructive receipt is *Childs v. Commissioner, 103 T.C. 634 (1994), aff'd without opinion, 89 F.3d 856 (11th Cir. 1996).* Fee deferrals in qualified assignments are usually structured in structured settlement annuities or in qualified settlement funds. Non-qualified assignments are usually structured through foreign assignment companies in jurisdictions that have favorable tax treaties with the United States.

In my view, trial attorneys have under-utilized fee deferrals of any sort. Nevertheless, any deferred compensation ultimately has several problems. First, the deferred fee compensation is subject to federal and state income taxation. Second, the deferred fee income is included in the attorney's taxable estate. Third, some attorneys are so wealthy that they enough income for one hundred lifetimes and don't need anymore. The combination of taxes can result in a 70-80 percent erosion in the amount of the deferred fee income. The situation is "Pay now, or pay letter but in all cases, the taxpayer pays.

The Use of Loan Regime Split Dollar as an Alternative to Fee Deferrals

QSFs are trusts that are designed to resolve litigation and satisfy claims of the litigation even if they are not the subject of litigation. The QSF is authorized and governed by the provisions of IRC Sec 468B. A QSF has no statutory time limit within IRC Sec 468B or the treasury regulations regarding how long a QSF may be kept in place.

The QSF has benefits for both plaintiffs and defendants. From a defendant's perspective, the ability to transfer assets to a QSF can resolve the claim and release the defendant from further liability while achieving an immediate tax deduction regardless of when claimants receive distributions. This is a significant tax planning point for the defendant particularly for non-physical injury tort cases.

The plaintiff can achieve numerous benefits. Claimants can use the QSF to time the receipt of their income. Plaintiffs are not taxed until they receive distributions from the QSF. The QSF provides the plaintiff and their attorney with the ability to work out the details of their distribution.

The QSF can hold deferred contingency fees. The trustee of the QSF can purchase an annuity or invest the deferred fees for future payment subject to a payout schedule. Alternatively, the deferred fees can be used to enter into a split dollar arrangement with the trial lawyer or his family trust.

Structured Settlement Life Insurance

The thrust of the structured settlement life insurance strategy is use of the QSF as a source of funds to invest in Private Placement Life Insurance policy (PPLI) or equity indexed universal life insurance. The policy can be personally owned or alternatively owned by the trial lawyer's (taxpayer) family trust using the Loan Regime Method of Split Dollar life insurance arrangement. The objective is to provide the taxpayer with tax-free insurance benefits, tax-free income along with deferred compensation payments. Not a bad combination, right!

The taxpayer's family trust is the applicant, owner and beneficiary of a life insurance contract insuring the taxpayer life. The policy is funded over several years so that the policy is treated as a non-modified endowment contract (Non-MEC). Non-MEC status is a technical acronym to label the policy as one that is eligible for tax-free distributions during lifetime.

The trustee of the family trust enters a Split Dollar Arrangement with the trustee of the QSF using the Loan Regime. Using the Loan Regime Method of Split Dollar, the trustee of the QSF makes a one-time loan to the trustee of the Family Trust. The loan rate is the long-term applicable federal rate which is 1.0 percent in September 2020. The trustee of the QSF receives a collateral assignment interest in the policy cash value and death benefit equal to the amount of the loan plus accrued interest. The agreement provides for repayment at the earlier of the death of the insured, termination of the split dollar agreement or surrender of the policy. The loans proceeds receive tax-free treatment by the borrower.

The excess cash value and death benefit accrues for the benefit of the Trust. The trustee of the Family Trust may access this excess through policy loans and withdrawals on a tax-free basis. The policy is also beyond the reach of the taxpayer's personal and business creditors. The arrangement also provides for the payment of the collateral interest amount payable to the QSF upon the death of the policy's insured. However, these QSF payments would be taxable to the beneficiary. The death benefit payable to the Family Trust would receive income and estate tax treatment.

In the future, the trustee of the QSF and Family Trust mutually agree to terminate the Split Dollar Arrangement. The collateral assignment interest provides for repayment based upon the life expectancy of the insured at the time of the Split Dollar termination. Depending upon several actuarial factors, these factors may create a substantial discount (65-85%) to the amount necessary to redeem the QSF's collateral assignment interest. This method is called the Leveraged Split Dollar Rollout™.

Following the rollout, the policy is owned entirely within the Family Trust without any encumbrances. The trustee may tax-free distributions to make tax-free loans and withdrawals to provide tax-free income to the taxpayer and family members. The policy benefits receive income and estate-tax treatment.

Strategy Example Facts

Larry Lawyer, age 45, is a successful personal injury lawyer in Hartford, CT. He routinely settles enough cases so that his contingency fee income in $2-3 million per year. He currently has a medical malpractice case that will provide a $10 million contingency fee. He would like to defer the entire amount. The award is more than he will need for future income needs.

He would like to defer the fees but reposition and invest the fees in a more tax efficient manner for income and estate tax purposes for his family.

Strategy Example Solution

During settlement discussions, the defendant agrees to place the entire amount of the malpractice award contingency fee into a QSF. The amount of the contingency fee is $10 million. The defendant acquiesced to this arrangement as the QSF is authorized by IRC Sec 468B.

The QSF trustee allocates the $10 million of the deferred contingency fee into a Structured Settlement Life Insurance arrangement. The trustee enters into a Loan Regime Split Dollar agreement with the trustee of Larry's family trust. The trustee will make a onetime loan of $10 million to the trustee of the Lawyer Family Trust. The loan is repayable at Lawyer's death. The loan rate is 1.0 percent.

The trustee is the applicant, owner, and beneficiary of a policy insuring Lawyer's life. The policy has a death benefit of $25 million and premiums of $2.5 million per year for four years. The policy uses the increasing death benefit option (Option B) so that the minimum net amount payable to the trust is a minimum of $70 million. The QSF will receive a collateral assignment interest in the policy equal to the amount of the loan and any accrued interest.

The QSF's collateral assignment interest is restricted until the earlier of the death of the insured, termination of the Split Dollar Arrangement or surrender of the life insurance policy. The Lawyer Family Trust has an interest in the policy cash value and death benefit equal to the amount of cash value and death benefit that is more than the collateral assignment interest. The QSF also has a Death Benefit Only (DBO) arrangement to provide a lump sum payment of the collateral assignment death benefit to the Lawyer Trust in the event of Lawyer's death while the Split Dollar Arrangement is in effect.

The trustee can access tax-free loans and withdrawals from the policy for payment to Lawyer who is an income beneficiary of the Trust. The policy is outside of the reach of any personal and business creditors. The death benefit will receive income and estate-tax free treatment.

In Year 5, the trustee of the Lawyer Family Trust and the QSF decide to terminate the Split Dollar Arrangement using the Leveraged Split Dollar Rollout™, which will end the arrangement. The value of the QSF's interest is valued at an 80 percent discount based upon Lawyer's life expectancy in Year 5 (age 50) and additional actuarial factors and discount rate based upon the corporate bond rate. The trustee of the Lawyer Family Trust uses tax-free withdrawals to make this payment to the QSF. The QSF will use this reimbursement to make a single lump sum payment in Year 6. This payment will be taxable.

In the event Lawyer dies during the Split Dollar Arrangement, the loan plus any accrued interest will be repaid to the QSF. The excess death benefit is payable to the Lawyer Family Trust. The Trust's portion of the cash value may be used to provide tax-free loans and withdrawals during Lawyer's lifetime. The policy owned within the Trust is exempt from the claims of Lawyer's personal and business creditors. The death benefit should receive income and estate-tax treatment.

Summary

The Structured Settlement Life Insurance arrangement is a new planning technique for trial lawyers. It is a more tax efficient strategy than traditional fee deferrals. It provides for greater tax efficiency than existing arrangements either through a traditional QSF arrangement or offshore assignment company. In the battle of tax-deferred and tax-free, tax-free wins every time! This hymn was heretofore missing from the hymnal for trial lawyers and is an exciting addition. One of the best quotes from The Paper Chase is an exchange between Professor Kingsfield and James Hart:

> *Professor Kingsfield: Mister Hart, here is a dime. Take it, call your mother, and tell her there is serious doubt about you ever becoming a lawyer.*
>
> *James Hart: [pause, as he is leaving the room] You... are a SON OF A BITCH, Kingsfield.*
>
> *Professor Kingsfield: Mr. Hart! That is the most intelligent thing you've said all day. You may take your seat.*

Using the words of Professor Kingsfield, I hope that this idea is the most intelligent tax planning idea that trial lawyers and their financial advisors here all day. The opportunity to convert tax-deferred income into tax-free income is an exciting tax planning opportunity for every trial lawyer earning contingency fees.