

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **AM 2022-007**

Release Date: 12/16/2022

CC:EEE:EB:EC:RHNettles
POSTS-101486-22

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 61.00-00, 83.00-00, 409A.00-00, 409A.01-00

date: December 09, 2022

to: Mark Hulse
Division Counsel
Tax Exempt & Government Entities (CC:TEGEDC)

from: Rachel Levy
Associate Chief Counsel
Employee Benefits, Exempt Organizations, and Employment Taxes (CC:EEE)

subject: Payment of legal fees to a third party

This Generic Legal Advice Memorandum (GLAM) responds to your request for assistance. This GLAM may not be used or cited as precedent. All references herein are to the Internal Revenue Code (the Code) and Income Tax Regulations, unless otherwise noted.

ISSUE

A law firm is a cash method taxpayer that represents a client on a contingency fee basis. Before formal settlement of the client's claim, the law firm enters into an arrangement with a third party that purports to defer receipt of the law firm's fee, payable out of the settlement amount negotiated by the law firm on behalf of its client. The opposing party's insurance company sends the portion of the settlement representing the law firm's fee to the third party, pursuant to the terms of the settlement agreement. When does income inclusion for the law firm occur with respect to the fee sent to the third party?

CONCLUSIONS

The law firm must include the fee in gross income in the year that the funds representing the fee are transferred to the third party. The transaction creates a funded compensation arrangement that results in gross income to the law firm under the anticipatory assignment of income doctrine, the economic benefit doctrine, and section

83. Alternatively, to the extent that the arrangement constitutes unfunded deferred compensation, the arrangement is a nonqualified deferred compensation plan subject to section 409A, and the law firm has gross income in the first year of the arrangement because the plan fails to comply with section 409A.

FACTS

In order to respond to your request for advice on this recurring issue, we have developed the following hypothetical facts to illustrate and clarify our position.

Taxpayer is a law firm organized as a partnership under applicable state law and treated as a partnership for Federal tax purposes. Taxpayer is a cash method taxpayer.

Taxpayer represents a client (the Client) in connection with the Client's legal claim against a defendant (the Defendant) as a result of a personal physical injury suffered by the Client. On March 1, 2017, Taxpayer and the Client enter into an engagement letter (the Fee Agreement) pursuant to which Taxpayer will represent the Client in connection with all the Client's claims for damages against the Defendant. In exchange, the Client agrees to pay Taxpayer a 30% contingency fee out of any money paid by the Defendant or the Defendant's insurance company (the Insurer) to the Client, either as a result of a judgment or in settlement of the Client's claims. The Fee Agreement provides that the fee will be payable to Taxpayer upon any recovery through a judgement or a settlement.

During pendency of the case but before trial, Taxpayer negotiates a settlement agreement (the Settlement Agreement) on behalf of the Client. The Settlement Agreement is between the Client, the Defendant, and the Insurer. Pursuant to the Settlement Agreement, the Client will release all legal claims against the Defendant in exchange for a cash settlement of \$1,500,000. For purposes of applicable state law, the Settlement Agreement is binding and effective upon execution by the Client, the Defendant, and the Insurer. The Client accepts the settlement and asks to have it paid in full as soon as possible.

On June 30, 2021, prior to the execution of the Settlement Agreement, Taxpayer enters into a deferral agreement (the Deferral Agreement) with a third party that was not involved in the litigation (the Third Party). The Third Party markets a deferred compensation product to law firms that features a purported income tax deferral and investment vehicles for the amounts deferred. Pursuant to the Deferral Agreement, Taxpayer agrees that 100% of any legal fees it earns arising out of the settlement of the Client's claim will be transferred directly from the Insurer to the Third Party. The Deferral Agreement purports to be irrevocable. In exchange, the Third Party agrees to pay a lump sum amount to Taxpayer on August 1, 2031, equal to the amount of the fee paid to the Third Party, adjusted for gains and losses based on the performance of a hypothetical investment portfolio selected by Taxpayer, less an annual administration fee (the Deferred Payment).

The Client, the Defendant, and the Insurer execute the Settlement Agreement on July 1, 2021. The Settlement Agreement provides that the entire amount of the settlement will be distributed by the Insurer on August 1, 2021, according to payment instructions to be provided by Taxpayer, acting on behalf of the Client.

On July 15, 2021, Taxpayer provides written instructions to the Insurer regarding where to transfer the settlement funds. Taxpayer instructs the Insurer to split the lump sum into two separate wire transfers. One transfer for \$1,050,000 is to be sent to Taxpayer's trust account. This amount represents the Client's net portion of the recovery (\$1,500,000, less Taxpayer's 30% contingency fee of \$450,000). The second transfer for \$450,000 is to be sent to the Third Party. The second amount represents Taxpayer's fee.

On August 1, 2021, pursuant to the terms of the Settlement Agreement and wiring instructions noted above, the Insurer makes the two separate transfers totaling \$1,500,000. Pursuant to the Settlement Agreement, the Defendant and Insurer are discharged of any obligation to pay additional amounts to the Client. Shortly thereafter, the case is dismissed by agreement of the parties. The entire value of the \$1,500,000 settlement is excludible from the Client's gross income pursuant to section 104(a)(2).

Upon receipt of the \$450,000 from the Insurer on August 1, 2021, the Third Party places the funds in a grantor trust that conforms to the model trust language contained in Rev. Proc. 92-64, 1992-2 C.B. 422 (the Rabbi Trust). The Deferral Agreement provides that Taxpayer is a general unsecured creditor of the Third Party with respect to the Deferred Payment, Taxpayer has no right to assign, accelerate, defer, change the terms or time of, or transfer or sell the Deferred Payment, and the Third Party is the sole owner of the assets contained in the Rabbi Trust.

On September 1, 2021, Taxpayer obtains a \$200,000 loan from the Third Party. For this loan, Taxpayer and the Third Party enter into a written promissory note (the Note). According to the Note, interest accrues on the loan at an annual rate of 6%, and the loan principal, plus accrued interest, are payable on September 1, 2025. In the event of Taxpayer's default on the loan due to non-payment, the Third Party is permitted, under the terms of the Note, to exercise a setoff right, such that the Third Party can reduce the Deferred Payment by the amount of the loan and accrued interest, to the extent of the default.

Due to investment gains, net of fees, the value of the Deferred Payment increases from \$450,000 to \$470,000, as of December 31, 2021.

BACKGROUND

Taxpayer takes the position that the \$450,000 fee is not includible in Taxpayer's gross income in 2021, based on *Childs v. Commissioner*, 103 T.C. 634 (1994), *aff'd without published opinion*, 89 F.3d 856 (11th Cir. 1996).¹

In *Childs*, the taxpayers were attorneys who represented a client in a personal injury matter in exchange for a contingency fee. 103 T.C. at 637. The client's legal claims were settled in two separate cases (the Garrett litigation and the Jones litigation). *Id.* at 640, 645. Pursuant to the settlement agreement in the Garrett litigation, two insurance companies of the defendant, Georgia Casualty & Surety Co. (Georgia Casualty) and Stonewall Insurance Co. (Stonewall), agreed to pay the fees to the plaintiff's attorneys over a period of years. *Id.* at 640-42. The settlement agreement in the Garrett litigation provided for an assignment of this obligation to First Executive Corp. (First Executive), without releasing Georgia Casualty or Stonewall from the obligation to pay the fees. *Id.* First Executive purchased an annuity to pay the fees from its subsidiary, Executive Life Insurance Co. (Executive Life). *Id.* at 641. When Executive Life failed to make all the required payments, the shortfall was paid by Georgia Casualty and Stonewall. *Id.* at 644. Pursuant to the settlement agreement in the Jones litigation, the defendant's insurance company, Stonewall, was obligated to pay the fees, and it purchased an annuity from another insurance company, Manulife Service Corp., to pay the fees, though Stonewall again retained the obligation to pay the fees. *Id.* at 645-47. First Executive and Stonewall were the respective owners of the annuities and retained the power to change the beneficiaries, and the taxpayers' rights under the annuities were no greater than those of a general creditor. *Id.* at 643-47. The Tax Court determined that (1) the attorneys' rights to receive payments under the settlement agreements were not "property" for purposes of section 83, and (2) the doctrine of constructive receipt was not applicable to the arrangement. *Id.* at 653-55.

A cash method taxpayer must include amounts in gross income in the year in which they are actually or constructively received. Treas. Reg. § 1.451-1(a). Broadly speaking, a compensation arrangement where a cash method taxpayer is owed compensation for the performance of services and the taxpayer arranges to have the compensation paid in cash in a year later than the year in which the compensation is earned can be categorized as either a funded or unfunded arrangement. See, e.g., Rev. Rul. 69-649,

¹ In terms of the authoritative weight of *Childs*, the Tax Court's precedential opinion is binding on the Tax Court but not on any other court. The IRS has not issued an Action on Decision acquiescing to or disagreeing with the Tax Court's opinion in *Childs*. The Eleventh Circuit's decision affirming *Childs* is both unpublished (that is, not published in the Federal Reporter), and the text of any opinion that may have been issued is not available on any electronic databases, such as Westlaw, LexisNexis, or Bloomberg Law. In the Eleventh Circuit, "[u]npublished opinions are not considered binding precedent, but they may be cited as persuasive authority." 11th Cir. R. 36-2. Because no written opinion is available for reference, it is not clear that the Eleventh Circuit affirmance of *Childs* would have much, if any, persuasive authority in the Eleventh Circuit or any of the other federal Circuit Courts of Appeals. In short, though the Tax Court opinion in *Childs* remains binding precedent in Tax Court, the Eleventh Circuit's affirmance does not bind any court in and of itself.

1969-2 C.B. 106. If an arrangement is unfunded, the compensation is generally included in gross income in the year in which the taxpayer actually or constructively receives a cash payment of the compensation. On the other hand, if a compensation arrangement is funded, the compensation is generally included in the taxpayer's gross income in the year in which funding occurs, regardless of when the taxpayer actually or constructively receives a cash payment.²

Taxpayer's position is that the transaction described in this GLAM constitutes an unfunded deferred compensation arrangement, and, according to *Childs*, Taxpayer is not required to include the compensation in gross income until the year in which Taxpayer actually or constructively receives a cash payment, which is scheduled to occur in 2031. This GLAM will explain why *Childs* does not apply to the transaction and Taxpayer cannot avoid income inclusion in the year that the funds representing its fee are transferred to the Third Party. Historically, when compensation earned by a taxpayer has been paid to a third party, courts have taken various approaches to determine whether the taxpayer must include the compensation in gross income, even though the taxpayer did not actually or constructively receive a cash payment of the compensation. Three of these approaches are discussed in more detail in this GLAM, each of which can be applied to Taxpayer on these facts: the anticipatory assignment of income doctrine, the economic benefit doctrine, and section 83. Only one of these arguments, section 83, was directly addressed in *Childs*. While we believe that the arrangement is funded for the reasons discussed in this GLAM, if the arrangement is not funded, the arrangement must comply with section 409A, which was enacted in 2004, well after *Childs* was decided in 1994. As explained in more detail below, the arrangement fails to comply with section 409A, and the compensation is includible in Taxpayer's gross income in the year of the section 409A violation.

For the reasons discussed below, Taxpayer must include the fee in gross income in 2021.

LAW AND ANALYSIS

Anticipatory Assignment of Income Doctrine

Taxpayer must recognize the fee income under the anticipatory assignment of income doctrine in 2021. When the funds were transferred to the Third Party from the Insurer, the funds represented compensation owed to Taxpayer from the Client under the Fee Agreement. Taxpayer diverted these amounts to the Third Party in anticipation of receiving the income and must include the amounts in taxable income as the party who earned the compensation.

² Stated another way, the three "funding" concepts discussed in this GLAM are exceptions to the general rule that a cash basis taxpayer is not required to include amounts in gross income until the year in which they are actually or constructively received in cash by the taxpayer. See e.g., *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (anticipatory assignment of income doctrine); *Minor v. United States*, 772 F.2d 1472, 1473 (9th Cir. 1985) (economic benefit doctrine); *Childs*, 103 T.C. at 648 (section 83).

Client's Compensation Obligation to Taxpayer

Taxpayer represented the Client pursuant to the Fee Agreement in which the Client agreed to pay Taxpayer a 30% contingency fee out of any money paid by the Defendant or the Insurer in settlement of the Client's claims. Taxpayer thus had a contractual right to compensation from the Client.

In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Supreme Court held that a client in a lawsuit recognizes income for the gross amount of the litigation recovery, even though a portion of the recovery is immediately payable to the attorney in the form of a contingency fee. In *Banks*, the Supreme Court reasoned that the client's cause of action is an asset owned by the client, and the client "retains dominion over this asset throughout the litigation." *Id.* at 435. The attorney and the client are in a principal-agent relationship. *Id.* at 436 (citing Restatement (Second) of Agency § 1, Comment e (1957)). The "attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party." *Id.* When a client relies on the efforts of their attorney to realize an economic gain (that is, the proceeds from settling the client's legal claims), the entire economic gain belongs to the client/principal, even if a portion is payable to the attorney/agent after the gain is realized. *Id.* at 437.

Accordingly, consistent with *Banks*, the entire recovery in the settlement of a lawsuit (including the contingency fee) initially belongs to the Client. The resulting fee constitutes compensation from the Client, payable in exchange for Taxpayer's representation of, and services performed for, the Client. See *Kochansky v. Commissioner*, 92 F.3d 957, 959 (9th Cir. 1996) (contingency fee is "undisputed compensation for [an attorney's] personal services"). The Client owned an asset in the form of the cause of action against the Defendant. When the Client's legal claim was settled pursuant to the Settlement Agreement, the asset was converted into the Client's right to receive the \$1,500,000 settlement, and the entire amount belonged to the Client. Pursuant to the terms of the Fee Agreement, the Client owed compensation to Taxpayer based on the Client's total recovery, payable at the time of the recovery. This is the case even though the funds representing the fee were paid by the Insurer directly to the Third Party. Because an attorney is "dutybound to act only in the interests of," and works for "exclusive benefit" of, their client, the fee represents compensation from the Client. See *Banks*, 543 U.S. at 436.

Compensation Earned by Taxpayer and Paid to the Third Party Represents an Anticipatory Assignment of Income

The broad definition of "gross income" under section 61(a) includes all economic gains not otherwise exempted. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955). Under the anticipatory assignment of income doctrine, "[a] taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party." *Banks*, 543 U.S. at 433 (citing *Lucas v. Earl*, 281 U.S. 111 (1930); *Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948); *Horst*, 311 U.S. at 116-17). The

rationale for the anticipatory assignment of income doctrine is the principle that gains should be taxed “to those who earned them,” *Lucas*, 281 U.S. at 114, a maxim the Supreme Court calls “the first principle of income taxation.” *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949). As explained below, the anticipatory assignment of income doctrine can apply to a funded compensation arrangement where the compensation is earned by a taxpayer and paid to a third party.

When a taxpayer attempts to assign income to another party, “the question becomes whether the assignor retains dominion over the income-generating asset, because the taxpayer ‘who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants.’” *Banks*, 543 U.S. at 434-35 (citing *Horst*). “The crucial question remains whether the assignor retains sufficient power and control over the ... receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes.” *Sunnen*, 333 U.S. at 604. Thus, the anticipatory assignment of income doctrine applies when a taxpayer retains control over the disposition of the income in question and diverts the payment of that income to another person or entity, thereby realizing a benefit by doing so. *Banks*, 543 U.S. at 435. See also *United States v. Basye*, 410 U.S. 441, 449 (1973) (“The entity earning the income ... cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity.”); *Wood Harmon Corp. v. United States*, 311 F.2d 918, 922 (2d Cir. 1963) (“[A] taxpayer who has performed services ... cannot escape the tax on those earnings *merely by transferring the right to income to a third person.*”) (emphasis added). The anticipatory assignment of income doctrine applies here because Taxpayer became entitled to receive income in the form of the fee, retained control over the disposition of the fee, and diverted payment of the fee to the Third Party, realizing a benefit by doing so.

First, Taxpayer controlled the disposition of the fee. In the context of anticipatory assignments of compensation income, the taxpayer providing the services giving rise to the compensation has the power to dispose of the income, which is equivalent to the ownership of that income. *Duran v. Commissioner*, 123 F.2d 324, 326 (10th Cir. 1941) (citing *Horst* and *Helvering v. Eubank*, 311 U.S. 122 (1940)); see also *Kochansky*, 92 F.3d at 959 (for purposes of the anticipatory assignment of income doctrine, an attorney controls the services that produce a contingency fee). Because the fee arose out of services provided by Taxpayer, the fee represented compensation earned by Taxpayer, and Taxpayer controlled the disposition of that compensation income. *Duran*, 123 F.2d at 326; *Kochansky*, 92 F.3d at 959.

Second, Taxpayer diverted the payment of the fee to another entity (the Third Party). *Banks*, 543 U.S. at 434; *Basye*, 410 U.S. at 451 (“[An] agreement ... whereby a portion of the partnership compensation was deflected to” another entity “is certainly within the

ambit of *Lucas v. Earl*.”)³ Taxpayer realized a benefit when the cash representing the fee was received by the Third Party. A taxpayer enjoys the benefits of an item of income when the taxpayer exercises control of the income and causes an amount to be paid to his assignee to satisfy the taxpayer’s wishes. See *Horst*, 311 U.S. at 116-17 (“[I]ncome is ‘realized’ by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants.”); *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941) (“[B]y the exercise of [the taxpayer’s] power to command the income, [the taxpayer] enjoys the benefit of the income on which the tax is laid.”); *Sunnen*, 333 U.S. at 606 (“[T]he receipt of income by the assignee” is “the fruition of the assignor’s economic gain.”); *Raymond v. United States*, 355 F.3d 107, 114 (2d Cir. 2004) (“[E]xercising the right to ‘control[] the disposition’ of a fund is sufficient for the realization of taxable income.”) (citing *Horst*); *Duran*, 123 F.2d at 326 (“[T]he exercise of [the] power in procuring payment to an assignee ... is the equivalent of the enjoyment of the income.”) (citing *Horst* and *Eubank*). Thus, Taxpayer controlled the disposition of the fee by providing the relevant services (to the Client), diverted the payment of the fee to another person or entity (the Third Party), and enjoyed a benefit when the cash was received by the Third Party. *Banks*, 543 U.S. at 435.

Taxpayer may argue that the anticipatory assignment of income doctrine does not apply where income inclusion is merely deferred to a later year and there is no attempt by Taxpayer to avoid taxation entirely; in other words, that the doctrine relates to “who” should be taxed, not “when” that person should be taxed. For example, in *Oates v. Commissioner*, 18 T.C. 570, 585 (1952) (*Oates I*), the Tax Court rejected the government’s argument that the assignment of income doctrine (specifically *Lucas*, *Eubank*, and *Horst*) was applicable where the taxpayers entered into binding agreements to defer compensation before it was payable to them. See also *Gann v. Commissioner*, 31 T.C. 211, 218 (1958) (anticipatory assignment of income doctrine did not apply where the taxpayer “did not sell, assign, or give up their right to receive” payment and “merely agreed to the postponement of the date of payment”). But the anticipatory assignment of income doctrine has not been so limited when income is diverted to a third party. In affirming *Oates I*, the Seventh Circuit Court of Appeals noted that each of *Lucas*, *Eubank*, and *Horst* involved an assignment of income to a third party. *Commissioner v. Oates*, 207 F.2d 711, 713 (7th Cir. 1953). This was not at issue in the case before them, as the taxpayers merely instructed their employer to make the payment at a later date, rather than causing the compensation to be paid immediately to a third party. *Id.* at 714. *Oates I* and *Gann* do not apply because Taxpayer did more than “merely agree[] to the postponement of the date of payment” of the fee from the

³ It is irrelevant that Taxpayer never had a right to receive the fee directly, once the Deferral Agreement and the Settlement Agreement were effective. In *Basye*, the Supreme Court ruled that “[t]he Government need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which his income is received.” 410 U.S. at 452. It was sufficient in that case that the taxpayer earned the income and the parties agreed to divert the income to a third-party trust. *Id.* at 451; see also *Armantrout v. Commissioner*, 67 T.C. 996, 1007 (1977).

Client. *Gann*, 31 T.C. at 218. Taxpayer gave up the right to receive the fee from the Client by diverting the payment to the Third Party.

Here, the anticipatory assignment of income doctrine is being applied to identify “who” should be taxed: Taxpayer, as the entity that performed the relevant services and earned the compensation. As for “when” Taxpayer should be taxed, the Supreme Court has repeatedly ruled that the assignor must recognize income when payments are made to the assignee. See *Lucas*, 281 U.S. 111 (assigned salary and fees taxable to the assignor in the years paid to the assignee); *Eubank*, 311 U.S. at 125 (“[W]e hold that the commissions were taxable as income of the assignor in the year *when paid*.”) (emphasis added); *Horst*, 311 U.S. 112 (bond interest was taxable to the assignor in the years paid to the assignee); *Schaffner*, 312 U.S. 579 (attempted assignments of trust income executed in 1929 and 1930 taxable to the assignor in the years of payment, 1930 and 1931); *Sol C. Siegel Productions, Inc. v. Commissioner*, 46 T.C. 15, 23-24 (1966) (“Ordinarily ... a cash basis assignor is accountable for his assigned income *in the year in which it is paid* rather than in the year in which he makes the assignment.”) (emphasis added); Rev. Rul. 74-32, 1974-1 C.B. 22 (“[A] cash-method taxpayer who contracted to perform services under an arrangement whereby the remuneration for his services would be paid to a third party must include the compensation in his gross income [...] *at the time it is received by the third party*.”) (emphasis added).

It is irrelevant whether Taxpayer’s intent in entering into the Deferral Agreement was to defer, rather than to avoid completely, the inclusion of the fee in income, *Basye*, 410 U.S. at 452 (“[T]he tax laws permit no such easy road to tax avoidance or *deferral*.”) (emphasis added). See also *Banks*, 543 U.S. at 434 (holding that a “discernible tax avoidance purpose” is not required for the doctrine to apply). It does not matter whether Taxpayer assigned its right to the fee before the Client’s case had been settled and the fee had materialized. See *Banks*, 543 U.S. at 435 (“[T]he anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance.”); *Kochansky*, 92 F.3d at 959 (“That Kochansky’s fee was contingent ... does not change the fact that, when the fee materialized, it was undisputed compensation for Kochansky’s personal services.”). The doctrine applies equally to assignments entered into before the performance of services (as in *Lucas*) or after all the services have been performed (as in *Eubank*).⁴ Finally, while the Supreme Court has frequently applied the anticipatory assignment of income doctrine in the context of gratuitous transfers to family members (either directly or through a trust or partnership), for example, in *Lucas*, *Eubank*, *Horst*, and *Culbertson*, the doctrine is not limited to intra-family transfers, as illustrated by *Basye* and *Banks*.⁵

⁴ Under the current facts, the Deferral Agreement was entered into by Taxpayer after the relevant legal services had been performed. The anticipatory assignment of income doctrine would still apply if Taxpayer had entered into the Deferral Agreement before the performance of services (for example, at the same time Taxpayer entered into the Fee Agreement with the Client).

⁵ In *Basye*, the Court specifically noted that the case involved an “assignment arrived at by the consensual agreement of two parties acting at arm’s length.” *Basye*, 410 U.S. at 453 n.13.

In summary, Taxpayer must recognize the fee as income under the anticipatory assignment of income doctrine. Because the fee was compensation payable in exchange for services provided by Taxpayer to the Client, Taxpayer controlled the disposition of that compensation income. *Duran*, 123 F.2d at 326. Taxpayer diverted that income by having the fee paid to the Third Party. *Banks*, 543 U.S. at 434; *Basye*, 410 U.S. at 451. Taxpayer realized a benefit when the Third Party received the cash representing the fee at Taxpayer's direction. *Horst*, 311 U.S. at 116-17; *Schaffner*, 312 U.S. at 582; *Sunnen*, 333 U.S. at 606; *Raymond*, 355 F.3d at 114; *Duran*, 123 F.2d at 326. Taxpayer, as the earner and assignor of the income, "retain[ed] sufficient power and control over the ... receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes," even though it was paid to the Third Party. *Sunnen*, 333 U.S. at 604.

Taxpayer attempted to avoid taxation of the fee in 2021 by having it paid to the Third Party, but as the "entity earning the income," Taxpayer "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to" the Third Party. *Basye*, 410 U.S. at 449. Taxpayer must recognize income in 2021 – the year that the assigned income was actually paid to the assignee. *Lucas*, 281 U.S. 111; *Eubank*, 311 U.S. at 125; *Horst*, 311 U.S. 112; *Schaffner*, 312 U.S. 579; *Sol C. Siegel Productions*, 46 T.C. at 23-24; Rev. Rul. 74-32.

Childs Does Not Apply to Avoid the Assignment of Income Doctrine

Childs does not apply on these facts such that Taxpayer can avoid including the fee in gross income in 2021 under the anticipatory assignment of income doctrine. The Tax Court in *Childs* only addressed whether the taxpayers in that case had income under section 83 or the doctrine of constructive receipt. *Childs* did not address the application of the anticipatory assignment of income doctrine.

Economic Benefit Doctrine

The purported deferral arrangement is also taxable in 2021 under the economic benefit doctrine when cash was transferred to the Third Party and the Third Party promised to pay amounts to Taxpayer that were owed to Taxpayer by the Client. Like the anticipatory assignment of income doctrine, courts have applied the economic benefit doctrine to funded compensation arrangements where the compensation in question has been paid to a third party.

Transfer of Funds to the Third Party for the Benefit of Taxpayer and Beyond the Reach of Creditors of the Client Constitutes a Taxable Economic Benefit

The Client had a contractual obligation to pay a fee of \$450,000 to Taxpayer. Under the economic benefit doctrine, Taxpayer must recognize gross income upon the satisfaction of this obligation by means of the transfer of funds to the Third Party (a third party to the transaction) making them beyond the reach of the Client's creditors. Taxpayer's

agreement with the Third Party is ineffective to stop recognition of income in the year that the funds representing the fee were transferred to the Third Party.

Under the economic benefit doctrine, “the benefit derived from an employer’s irrevocable set-aside of money or property as compensation for services rendered is includible in the service provider’s gross income at the time of the set aside, where the money or property is beyond the reach of the employer’s creditors.” *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1, 53 (2015).

In *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950), *cert. denied*, 340 U.S. 821 (1950), the Second Circuit Court of Appeals, applying the economic benefit doctrine, determined that the value of an annuity purchased by an employer for an employee in connection with the performance of services was includible in the employee’s gross income at the time of the purchase. In *Drescher*, the taxpayer provided services as an officer and director of a corporation, and the corporation purchased nonforfeitable single-premium annuities from an insurance company, with the taxpayer named as the annuitant. *Id.* at 864. Under the annuity contracts, the taxpayer was entitled to fixed monthly payments for life commencing at age 65 and a death benefit payable to the taxpayer’s beneficiary if the taxpayer died before age 65. *Id.*

The court determined that the value of the annuities was includible in the taxpayer’s gross income in the year of purchase rather than when payments were made, because the taxpayer “received as compensation for prior services something of economic benefit” in the form of “the obligation of the insurance company to pay money in the future to him or his designated beneficiaries on the terms stated in the policy.” *Id.* at 865. Even though the employer retained ownership of the annuities, and the annuities could not be assigned by the executive, surrendered for cash, sold, or pledged for a loan, the court found that the “right to receive income payments” in the future “represented a *present economic benefit*” to the employee, and this benefit accrued and was taxable at the time the annuities were purchased. *Id.* (emphasis added). The result in *Drescher* is consistent with the “well-established principle that a cash basis taxpayer must include in gross income amounts paid to third parties exclusively for the benefit of the taxpayer that are not intended to be gifts.” *Hyde v. Commissioner*, 301 F.2d 279, 282-83 (2d Cir. 1962) (citing, inter alia, *Drescher*).

In *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff’d per curiam*, 194 F.2d 541 (6th Cir. 1952), an employer transferred \$10,500 to a trust for the benefit of an employee (the taxpayer) in 1945, with payments to be made in 1946 and 1947. The taxpayer was the “sole beneficiary” of the trust, and “[n]o one else had any interest in or control over the monies.” *Id.* at 247-48. The court determined that the entire amount was taxable income in 1945 (the year the money was placed in trust rather than the years when amounts were distributed from the trust) because the payment to the trust represented an “economic or financial benefit conferred on the employee as compensation.” *Id.* at 247. When the money was placed in the trust, the “employer’s part of the transaction terminated” and “the amount of the compensation was fixed at \$10,500 and irrevocably paid out for [the taxpayer’s] sole benefit.” *Id.* The amount of compensation was not

subject to any contingency, and there was no possibility that it could be returned or forfeited to the employer. *Id.*

Rev. Ruls. 69-50, 1969-1 C.B. 140 and 77-420, 1977-2 C.B. 172, apply the result in *Sproull* and *Drescher* to the creation of an account payable with a third party for the benefit of the party providing services.⁶

In Rev. Rul. 69-50, a doctor provided medical services to a patient who was insured by a nonprofit corporation. The insurance company did not employ the doctor and was thus a third party to the transaction. The doctor entered into an agreement with the insurer to defer a portion of the fees for providing services to the patient. The payments would be deferred until the doctor's death, disability, or retirement. Citing *Drescher*, *Sproull*, and other economic benefit doctrine cases, the ruling concluded that the doctor had gross income once the medical services were performed and amounts were credited to the doctor's "account payable on the books of the" insurer. Once the doctor provided medical services to a patient, the doctor had a right to compensation from the patient, but instead of being paid directly by the patient, the doctor received a right to deferred compensation from the insurer, in the form of an account payable. The ruling concludes that the doctor's patients "funded their obligation" to the doctor, and "in doing so, they ... conferred an economic or financial benefit" on the doctor.

Rev. Rul. 77-420 amplifies Rev. Rul. 69-50 and provides that the tax result remains the same even if the doctor's right to deferred compensation from the insurer is subject to a substantial forfeiture provision in favor of the insurer, because there is no possibility that the deferred compensation could be forfeited to any patient (the recipient of the services).

These cases are applicable to the current facts. In *Drescher* and *Sproull*, a fixed amount of money was placed with a third party (a party other than the party receiving the services) for the benefit of the taxpayer (the party providing the services), the money was irrevocably placed with the third party because there was no possibility the money could be returned to the party receiving the services, and the money was not subject to the claims of creditors of the party receiving the services. That is, there was an "irrevocable set-aside of money ... as compensation for services rendered ... beyond the reach of the employer's creditors." *Our Country Home Enterprises*, 145 T.C. at 53.

⁶ In dicta, one court has read these rulings as only being relevant to the issue of constructive receipt. In *Minor*, 772 F.2d at 1474 n.1, the Ninth Circuit Court of Appeals stated that "[t]he essence of [the rulings] was that the physician had constructively received the income." Because the government conceded the issue of constructive receipt, the court found that the rulings were not relevant to the remaining issue, which was economic benefit. In fact, the rulings involve the application of the economic benefit doctrine, as they both use the phrase "economic or financial benefit" and Rev. Rul. 69-50 cites *Sproull*, *Drescher*, and other economic benefit doctrine cases. The General Counsel Memorandum supporting the two rulings (GCM 33918 (August 26, 1968) and GCM 37244 (June 6, 1977), respectively) make this clear. GCM 33918 notes that the holding in Rev. Rul. 69-50 is based on an example in Rev. Rul. 60-31, 1960-1 C.B. 174, which is based on "the doctrine of 'economic benefit.'" GCM 37244 includes multiple references to "economic benefit." Neither GCM discusses constructive receipt.

In Taxpayer's case, pursuant to the terms of the Settlement Agreement and the Deferral Agreement, a fixed amount of money (\$450,000) was irrevocably placed with the Third Party (a third party that did not receive services from Taxpayer) for the benefit of Taxpayer (the party providing the services) as compensation for services performed by Taxpayer, there was no possibility that the money could be returned to the Client (the party receiving the services), and the money was not subject to claims of creditors of the Client. As in *Sproull*, the exact amount of compensation was known, that amount was not subject to any future contingency,⁷ and there was no possibility that the funds would be returned to the Client. 16 T.C. at 247. Taxpayer was the only beneficiary of the Third Party's promise to pay money in the future, and neither the Third Party nor any other party had any power to change the beneficiary. By the time the money was transferred to the Third Party, all the relevant services giving rise to the fee had been performed, and Taxpayer "had to do nothing further to earn it or establish his rights therein." *Id.* at 248. The only condition on Taxpayer's right to possess the funds was the passage of time, which is not a condition that prevents the application of the economic benefit doctrine. *Stiles v. Commissioner*, 69 T.C. 558, 569 (1978); *Thomas v. United States*, 213 F.3d 927, 932 (6th Cir. 2000).

Taxpayer may argue that the economic benefit doctrine does not apply because Taxpayer's right to the Deferred Payment under the Deferral Agreement merely represents a non-negotiable, non-assignable, and non-transferable promise to pay money in the future that is subject to claims of creditors of the Third Party. The relevant inquiry, however, is whether the funds are subject to claims of creditors of the party receiving the services. *Our Country Home Enterprises*, 145 T.C. at 53 (economic benefit doctrine applies "where the money or property is beyond the reach of *the employer's creditors*") (emphasis added). Here, the Deferred Payment is subject to claims of creditors of the Third Party but not the Client (the party receiving the services). The facts of *Drescher*, *Sproull*, and Rev. Ruls. 69-50 and 77-420, illustrate that the doctrine applies even if funds are subject to claims of creditors of a third party:

- In *Drescher*, the insurance company's promise to pay money to the taxpayer under the annuities would have been subject to claims of creditors of the insurer, as an insurer and an annuitant generally have a debtor-creditor relationship. See *Hughes v. Sun Life Assur. Co. of Canada*, 159 F.2d 110, 113 (7th Cir. 1946). The annuities were not subject to claims of creditors of the employer, though, because the taxpayer was the beneficiary of the annuity, and only the taxpayer had the right to change the beneficiary. *Drescher*, 179 F.2d at 864.
- Because the trust in *Sproull* was irrevocably funded and the employer did not have "any interest in or control over the monies," assets in the trust would only

⁷ The relevant inquiry is whether the amount of compensation is fixed when the taxpayer receives a vested interest in the funds, even though the value may change due to investment gains and losses. In *Sproull*, the court treated the amount of compensation as "fixed" and irrevocable even though the money was placed in a trust and invested by the trustee until payment was due. *Id.* at 247. Likewise, in Rev. Rul. 69-50, the amount payable to the taxpayer in the future was subject to "investment gains and losses."

have been subject to claims of creditors of the trust and not the employer. 16 T.C. at 247-48.

- In Rev. Rul. 69-50, the taxpayer was entitled to an “account payable on the books of the corporation,” meaning it was subject to claims of creditors of the corporation (the third party) but not the patients (the recipients of the services). Rev. Rul. 77-420 notes that the taxpayer could not forfeit any amounts to any patient.

In summary, the economic benefit doctrine applies because money was irrevocably set aside for the benefit of Taxpayer as compensation, beyond the reach of the Client’s creditors. *Our Country Home Enterprises*, 145 T.C. at 53. The economic benefit is the obligation of the Third Party “to pay money in the future” to Taxpayer on the terms stated in the Deferral Agreement. *Drescher*, 179 F.2d at 865. The Client “confer[red] [the] economic or financial benefit” on Taxpayer when cash was transferred to the Third Party and Taxpayer received a right to receive the Deferred Payment from the Third Party, as Taxpayer’s right to the Deferred Payment “emanate[d] from the ... services that [were] rendered to” the Client by Taxpayer. Rev. Rul. 77-420 (citing Rev. Rul. 69-50). Once the fee was transferred to the Third Party, the Client’s part of the transaction terminated and “the amount of the compensation was fixed,” in our case at \$450,000, and “irrevocably paid out for [the] sole benefit” of Taxpayer. *Sproull*, 16 T.C. at 247. As a cash method taxpayer, Taxpayer “must include in gross income amounts paid to third parties exclusively for the benefit of the taxpayer that are not intended to be gifts.” *Hyde*, 301 F.2d at 282. Because the amounts paid to the Third Party arose from the services provided by Taxpayer to the Client, the amounts were not gifts.

For the reasons discussed above, Taxpayer received an economic benefit in 2021 when cash was transferred to the Third Party beyond the reach of the Client’s creditors and the Third Party promised to pay compensation to Taxpayer that was owed to Taxpayer by the Client. This economic benefit was taxable as gross income to Taxpayer in 2021.

Childs Does Not Apply to Avoid the Economic Benefit Doctrine

Childs does not apply on these facts such that Taxpayer can avoid including the fee in gross income in 2021 under the economic benefit doctrine. The Tax Court in *Childs* only addressed whether the taxpayers in that case had income under section 83 or the doctrine of constructive receipt. *Childs* did not directly address the application of the economic benefit doctrine as a basis for income inclusion. While economic benefit doctrine case law is relevant to section 83, as courts (including the Tax Court in *Childs*) have looked to economic benefit doctrine case law to interpret section 83, the economic benefit doctrine remains an independent basis for income inclusion. Courts have continued to apply the economic benefit doctrine in the compensation context following the adoption of section 83 (see, e.g., *Wheeler v. United States*, 768 F.2d 1333 (Fed. Cir. 1985)).

Section 83

Taxpayer also has gross income in 2021 under section 83. When cash was transferred to the Third Party and the Third Party promised to pay amounts to Taxpayer that were owed to Taxpayer by the Client, the transaction constituted a transfer of “property” for purposes of section 83. As discussed below, the section 83 regulations treat a funded compensation arrangement as “property” for purposes of the statute.

Under section 83, “[i]f, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed,” the party providing the services must include in gross income the fair market value of the property less the amount paid for the property.⁸ Section 83(a); Treas. Reg. § 1.83-1(a)(1). “Property” includes (1) “real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future” and (2) “a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.” Treas. Reg. § 1.83-3(e).

If section 83 applies to a transfer of property, the party providing services must recognize income in the first year that the property is either transferable or not subject to a substantial risk of forfeiture. Section 83(a); Treas. Reg. § 1.83-1(a)(1). Property is subject to a substantial risk of forfeiture if the taxpayer’s rights to the property are conditioned upon (1) “the future performance [or refraining from the performance] of substantial services” or (2) “the occurrence of a condition related to a purpose of the transfer.” Treas. Reg. § 1.83-3(c)(1). The risk that the property may decline in value is not a substantial risk of forfeiture. *Id.*

All the requirements of section 83 were met in 2021 when cash was transferred to the Third Party in connection with the performance of services by Taxpayer for the Client. Taxpayer is subject to section 83, as the statute applies to any “person” that receives property in connection with the performance of services, and a partnership is a “person” for purposes of the Code. Section 7701(a)(1). Section 83 applies to employees and independent contractors. See Treas. Reg. § 1.83-1(a)(1); *Cohn v. Commissioner*, 73 T.C. 443, 446 (1979). Taxpayer performed services for the Client by settling the Client’s claims against the Defendant. In connection with the performance of those services, the Client transferred “property” to Taxpayer (as discussed in more detail below) in 2021.

Under section 83, the value of the property is includible in Taxpayer’s income in the year of transfer because the property was not subject to a substantial risk of forfeiture, as Taxpayer’s right to receive the property was neither conditioned on the future

⁸ The property does not need to be transferred to the party providing the services or transferred by the party receiving the services, so long as the “property is transferred to any person other than the person for whom [the] services are performed.” Section 83(a). See also Treas. Reg. § 1.83-1(a)(1) (“This paragraph applies to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed.”).

performance of (or refraining from the performance of) substantial services nor any condition related to the purpose of the transfer. There was no possibility that the property could be forfeited to the Client, and the risk that the Deferred Payment could lose value due to investment losses is not a substantial risk of forfeiture for purposes of section 83.

Taxpayer Received a Transfer of "Property" in the Form of a Funded Promise to Pay, as a Well as a Beneficial Interest in Money Set Aside from the Claims of Creditors of the Client and the Insurer

The term "property" is not defined in section 83. The section 83 regulations provide that the term "includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Treas. Reg. § 1.83-3(e) (first sentence). The term "property" also includes "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." *Id.* (second sentence). Thus, under Treas. Reg. § 1.83-3(e), there are three ways in which money or a promise to pay money can constitute "property": (1) a promise to pay money is funded, (2) a promise to pay money is secured,⁹ or (3) the receipt of a beneficial interest in money, when the money is transferred or set aside from the claims of creditors of the transferor.

As discussed below, Taxpayer received a funded promise to pay money, as well as a beneficial interest in assets (money) which were transferred or set aside from the claims of creditors of the transferor.

Funded Promise to Pay

While the Tax Court in *Childs* did not address the application of the economic benefit doctrine, it did look to certain economic benefit doctrine cases to determine the meaning of "funded" in the context of understanding Treas. Reg. § 1.83-3(e) (first sentence), which provides that "property" does not include an "unfunded and unsecured promise to pay money or property in the future."

Based on a review of *Sproull*, *Minor*, and *Centre v. Commissioner*, 55 T.C. 16 (1970), the Tax Court in *Childs* determined that:

"funding occurs when no further action is required of the obligor for the trust or insurance proceeds to be distributed or distributable to the beneficiary. Only at the time when the beneficiary obtains a nonforfeitable economic or financial benefit in the trust or insurance policy is the provision for future payments

⁹ This GLAM does not address whether the loan obtained by Taxpayer from the Third Party would cause a portion of the Deferred Payment to become "secured" for purposes of section 83. Depending on applicable state law, if Taxpayer obtained a setoff right against the Third Party with respect to the Deferred Payment to the extent of the loan obtained by Taxpayer, Taxpayer could be treated as a secured creditor of the Third Party for purposes of Federal bankruptcy law, causing the Third Party's promise to pay money to become "secured," resulting in a transfer of property for purposes of section 83.

secured or funded. However, if the trust or policy is subject to the rights of general creditors of the obligor, funding has not occurred.”

103 T.C. at 651.

In applying this test, the Tax Court treated the defendant’s insurance companies as the “obligors” of the compensation without discussion. *Id.* at 651. As a result, the Tax Court determined that the promise to pay the fees in *Childs* was not “funded” for purposes of section 83 because the attorneys merely had a promise to pay from the insurers, and that promise to pay was subject to the rights of general creditors of the insurers. *Id.*¹⁰ Further, the purchase of the annuities by the insurance companies did not result in “funding” under section 83 because the insurers remained the owners of the annuities and reserved the right to change the beneficiaries, and the taxpayers did not have rights to payment greater than the rights of a general creditor of the insurers. *Id.*

Under the current facts, pursuant to the Settlement Agreement, the Insurer agreed to pay the entire settlement of \$1,500,000, inclusive of Taxpayer’s fee. Treating the Insurer as the “obligor” of the fee, just as the Tax Court did with the insurers in *Childs*, the Deferred Payment became a “funded” promise to pay money for purposes of section 83 when the Third Party agreed to pay the fee on a deferred basis and the Insurer was released of the obligation to pay the fee under the Settlement Agreement. At that time, the Tax Court’s conditions for “funding” under *Childs* were satisfied:

- “[N]o further action [was] required of the obligor” (the Insurer) for the fee to be “distributed or distributable to the beneficiary” (Taxpayer). *Id.* at 651. Once the funds were transferred to the Third Party, the only condition on Taxpayer’s right to receive the funds was the passage of time. No further action was required of the Insurer for the fee to be distributable to Taxpayer because the Insurer was released of any further obligations once the Insurer distributed the settlement funds. By contrast, in *Childs*, further action was required by the insurers, because the insurers at all times remained liable to make periodic payment to the taxpayers. *Id.* at 641, 645. The insurers’ purchase of annuities in *Childs* to make payments to the taxpayers did not relieve the insurers of the ongoing obligation to pay the fees – when Executive Life failed to make payments under the

¹⁰ This GLAM does not address whether this aspect of *Childs* is now incorrect in light of *Banks*, because the client should be viewed as the “obligor” of the promise to pay the fees, rather than the insurance companies. As discussed above under the heading “Client’s Compensation Obligation to Taxpayer,” in a typical contingency fee arrangement, the client has the sole obligation to pay compensation to the attorney. If the client had been treated as the “obligor” of the fees, funding would have occurred under the facts of *Childs*. Once the insurers agreed to pay the fees pursuant to the settlement agreements, “no further action [was] required” of the client for the amounts to be “distributed or distributable” to the taxpayers, the amount of compensation was fixed and nonforfeitable, and the insurers’ promise to pay was not “subject to the rights of general creditors” of the client. *Id.* at 651. It is sufficient to conclude, as we do in this GLAM, that by treating the Insurer as the “obligor” of the fee, in the same way that the Tax Court treated the insurance companies as the “obligors” in *Childs*, funding occurred when the Third Party agreed to pay the fee and the Insurer was discharged of the obligation to pay.

annuities in the Garrett litigation, the shortfall was paid by Georgia Casualty and Stonewall. *Id.* at 644.

- Taxpayer “obtain[ed] a nonforfeitable economic or financial benefit” in the Deferred Payment. *Id.* at 651. The Third Party’s “obligation... to pay money in the future to” Taxpayer on the terms stated in the Deferral Agreement represents an “economic benefit” to Taxpayer. *Drescher*, 179 F.2d at 865. This economic benefit was also nonforfeitable. At the time the funds were transferred to the Third Party, the funds were not “subject to the possibility of return to” the Client. *Sproull*, 16 T.C. at 247. Taxpayer had provided all the relevant services to the Client giving rise to the Deferred Payment and “had to do nothing further to earn it or establish [its] rights therein.” *Id.* at 248.
- The Third Party’s promise to pay Taxpayer under the Deferral Agreement was not “subject to the rights of general creditors of the obligor” (the Insurer). *Childs*, 103 T.C. at 651. When the settlement funds were transferred by the Insurer to the Third Party, the Insurer was released of any further obligation to pay the fee, and the Deferred Payment was only subject to rights of general creditors of the Third Party, not the Insurer.

Applying *Childs*, because the Deferred Payment became a “funded” promise to pay money in the future, the transaction resulted in a transfer of “property” for purposes of section 83. Treas. Reg. § 1.83-3(e) (first sentence).

Money Set Aside from the Claims of Creditors of the Transferor

Under Treas. Reg. § 1.83-3(e) (second sentence), “a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor” can also constitute “property” for purposes of section 83. While the court in *Childs* discussed the meaning of the phrase “unfunded and unsecured promise to pay money” under Treas. Reg. § 1.83-3(e) (first sentence), it did not analyze whether the attorneys in that case received a beneficial interest in money that was set aside from the claims of creditors of the transferor.

The regulations do not define the term “transferor.” The plain meaning of the term “transferor” in the context of Treas. Reg. § 1.83-3(e) (second sentence) is the person who transfers the “assets (including money).” Here, the “transferor” of the funds representing the fee for purposes of section 83 is either the Insurer or the Client. The Insurer is the “transferor” in the sense that the Insurer directly transferred \$450,000 to the Third Party. Alternatively, the Client is the “transferor” in the sense that the settlement funds (including the fee) belonged to the Client before being transferred to the Third Party, because the settlement funds represented the total recovery that the Client received for disposition of the Client’s legal claims against the Defendant, as discussed above under the heading “Client’s Compensation Obligation to Taxpayer.” In form, the funds representing the fee were transferred by the Insurer to the Third Party, but in substance, the funds were transferred by the Client, because only the Client had the legal authority to direct the funds to another party (that is, the Insurer facilitated the transfer of funds belonging to the Client to the Third Party for the benefit of Taxpayer).

For purposes of this GLAM, however, it is not necessary to resolve this issue, because the tax result is the same whether the Insurer or the Client is treated as the “transferor.” See Treas. Reg. § 1.83-1(a)(1) (section 83 can apply “even though the transferor is not the person for whom [the] services are performed”). In either case, the transfer of \$450,000 to the Third Party constitutes a transfer of property for purposes of section 83, because “money” has been “transferred” to the Third Party for the benefit of Taxpayer, and the money has been “set aside from the claims of creditors of” both the Insurer and the Client. Treas. Reg. § 1.83-3(e) (second sentence). After the Third Party received the money, the money was subject to claims of creditors of the Third Party, but it was no longer subject to claims of creditors of the Insurer or the Client, because neither the Insurer nor the Client had any right to the money after it was transferred to the Third Party.

To summarize, the Third Party’s promise to pay the Deferred Payment to Taxpayer in the future constituted “property” for purposes of section 83 for two reasons. First, the Third Party’s promise to pay was a funded promise to pay money. Second, Taxpayer received a beneficial interest in money that had been set aside from the claims of creditors of the Insurer and the Client. The property was transferred to Taxpayer in connection with the performance of services by Taxpayer to the Client. The property was not subject to a substantial risk of forfeiture, as there was no possibility that the property could be forfeited to the Client. As a result, all the requirements of section 83 were met in 2021 when the money was transferred to Third Party and the Third Party agreed to pay the Deferred Payment, and the full value of the fee (\$450,000) is includible in Taxpayer’s income at that time.

Section 409A

This GLAM has explained why Taxpayer’s compensation arrangement is funded, and therefore taxable, in 2021, under the anticipatory assignment of income doctrine, the economic benefit doctrine, and section 83. Taxpayer’s position, however, is that the arrangement constitutes unfunded deferred compensation, and the fee is not includible in gross income until Taxpayer actually or constructively receives a cash payment of the compensation, which is scheduled to occur in 2031. If the arrangement is viewed as an unfunded deferred compensation arrangement, the Third Party’s promise to pay Taxpayer certain amounts in 2031 under the Deferral Agreement constitutes a “nonqualified deferred compensation plan” that is subject to the requirements of section 409A, and the plan is not exempt from section 409A under the independent contractor exception in Treas. Reg. § 1.409A-1(f)(2). In 2021, the plan failed to comply with the initial deferral election requirements of section 409A(a)(4). Additionally, Taxpayer violated section 409A(a)(3) in 2021 when Taxpayer obtained a loan from the Third Party that, in the event of default, could be repaid through an offset or reduction of the Deferred Payment, because the loan was a substitute for an accelerated payment of deferred compensation. Treas. Reg. § 1.409A-3(f). Because the arrangement violates section 409A, the entire value of the Deferred Payment as of December 31, 2021, is

subject to income inclusion in 2021, plus an additional 20% tax. Section 409A(a)(1)(A)(i); Section 409A(a)(1)(B)(i)(II).

Nonqualified Deferred Compensation Plan

Section 409A applies to any “nonqualified deferred compensation plan.” Section 409A(a)(1)(A)(i). The term “nonqualified deferred compensation plan” means “any plan that provides for the deferral of compensation, other than (A) a qualified employer plan, and (B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.” Section 409A(d)(1). The term “plan” includes any “agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual.” Treas. Reg. § 1.409A-1(c)(1). Taxpayer, a cash method partnership, is subject to section 409A, as section 409A applies to “service providers,” which includes individuals as well as corporations, partnerships, and other entities that “account[] for gross income from the performance of services under the cash receipts and disbursements method of accounting.” Treas. Reg. § 1.409A-1(f)(1).

Unless an exception applies, a plan provides for a deferral of compensation subject to section 409A “if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year.” Treas. Reg. § 1.409A-1(b)(1).

On June 30, 2021, Taxpayer acquired a “legally binding right” to “compensation” payable by the Third Party when the parties entered into a “plan” (the Deferral Agreement), and compensation under that plan was payable to Taxpayer in a later taxable year (2031):

- The Deferral Agreement constitutes a “plan,” because the term “plan” includes an “agreement ... that applies to one person or individual.” Treas. Reg. § 1.409A-1(c)(1). Taxpayer, a partnership, is a “person” for purposes of the Code. Section 7701(a)(1). As a cash method partnership, Taxpayer is a “service provider” subject to section 409A. Treas. Reg. § 1.409A-1(f)(1).
- Taxpayer had a “legally binding right” to a payment because Taxpayer had a contractual right in 2021 to a payment in 2031 under the Deferral Agreement. A “legally binding right includes a contractual right that is enforceable under the applicable law or laws governing the contract.” Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, section III.B, 72 FR 19,234, 19,236.¹¹
- The amounts payable under the Deferral Agreement constitute “compensation.” If the fee had been paid to Taxpayer directly by the Client, the payment would constitute “compensation for services” for purposes of section 61, because

¹¹ On April 17, 2007, the Treasury Department and IRS promulgated final regulations under section 409A (the Final Regulations). 72 FR 19,234.

Taxpayer's right to the payment derived from the performance of legal services. Amounts retain their character as compensation for services even if the payor is a party other than the recipient of the services. in situations in which a right to a payment constituting compensation is substituted or exchanged for a new payment. See *United States v. Woolsey*, 326 F.2d 287, 291 (5th Cir. 1963); *Trantina v. United States*, 512 F.3d 567, 571-72 (9th Cir. 2008); *Turner v. Commissioner*, 38 T.C. 304, 308 (1962); *Flower v. Commissioner*, 61 T.C. 140, 149 (1973); *Henry v. Commissioner*, 62 T.C. 605, 606 (1974); *Seserman v. Commissioner*, 21 T.C.M. (CCH) 1042 (1962); *Ramella v. Commissioner*, 38 T.C.M. (CCH) 747 (1979).

- The amounts payable under the Deferral Agreement were payable in a taxable year (2031) later than the year in which Taxpayer acquired the legally binding right to compensation from the Third Party (2021).

Thus, the Deferral Agreement was a “nonqualified deferred compensation plan” subject to section 409A, because “the service provider,” Taxpayer, had a “legally binding right during a taxable year [2021] to compensation that, pursuant to the terms of the plan [the Deferral Agreement], is or may be payable to (or on behalf of) the service provider in a later taxable year [2031].” Treas. Reg. § 1.409A-1(b)(1).

Independent Contractor Exception

Section 409A does not apply to “an amount deferred under a plan between a service provider and service recipient with respect to a particular trade or business in which the service provider participates,” if certain conditions are met. Treas. Reg. § 1.409A-1(f)(2)(i). This exception only applies to an amount “deferred under a plan *between a service provider and service recipient.*” *Id.* (emphasis added). The fee was “deferred under a plan between” Taxpayer and the Third Party (rather than Taxpayer and the Client). The Client’s obligation to pay the fee to Taxpayer was discharged when the Insurer transferred the funds representing the fee to the Third Party. Taxpayer acquired a legally binding right to compensation from the Third Party pursuant to the Deferral Agreement.

For purposes of section 409A, the term “service recipient” means “the person for whom the services are performed and with respect to whom the legally binding right to compensation arises.” Treas. Reg. § 1.409A-1(g). While Taxpayer had a legally binding right to compensation from the Third Party under the Deferral Agreement, Taxpayer did not provide any services to the Third Party (that is, all the relevant services were provided to the Client). Because the Third Party is not “the person for whom the services” giving rise to the fee were performed, the Third Party cannot qualify as a “service recipient” for purposes of the independent contractor exception to section 409A. Treas. Reg. § 1.409A-1(f)–(g). Section 409A can apply to a plan “even if the payment of the compensation is not made by the person for whom services are performed.” Treas. Reg. § 1.409A-1(g). As such, the amounts payable to Taxpayer by the Third Party under the Deferral Agreement constitute “nonqualified deferred

compensation” subject to section 409A, even though the Third Party is not a “service recipient.”

This reading of the independent contractor exception is consistent with the statute and regulations under section 409A. The statute broadly applies to “any plan that provides for the deferral of compensation.” Section 409A(a)(1)(A)(i). The statute itself does not include any exception for independent contractors; instead, the independent contractor exception is a narrow regulatory exception to the broad reach of section 409A. The independent contractor exception is not intended to provide independent contractors with a categorical exclusion from section 409A.¹² In other words, all deferred compensation arrangements of a service provider are not exempt from section 409A merely because that service provider can meet the requirements of Treas. Reg. § 1.409A-1(f)(2)(i) with respect to one or more service recipients.¹³

Because the amounts payable under the Deferral Agreement represent deferred compensation subject to section 409A and the amounts cannot qualify for the independent contractor exception in the Final Regulations, Taxpayer must comply with the requirements of the statute, including the requirements of section 409A(a)(4) regarding election timing and section 409A(a)(3) regarding the accelerated payment of deferred compensation.

Initial Deferral Election Timing Requirements

A nonqualified deferred compensation plan subject to section 409A must provide, upon adoption of the plan or when otherwise permitted under the section 409A initial deferral election requirements, for a deferred amount to be paid at a time and in a form meeting the section 409A time and form of payment requirements. Treas. Reg. § 1.409A-1(c)(3)(i).

Under section 409A(a)(4), an irrevocable election as to the time and form of the payment of the deferred compensation must generally be made in the year before the taxable year in which the services giving rise to the compensation were performed. Section 409A(a)(4)(B)(i). However, a special timing rule applies in the first year in which

¹² See Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions, section I.C. 70 FR 57,930 (“Among the many objectives underlying the enactment of section 409A is to limit the ability of a service provider to retain the benefits of the deferral of compensation while having excessive control over the timing of the ultimate payment. Where the independent contractor is managing the service recipient, there is a significant potential for the independent contractor to have such influence or control over compensation matters so that *categorical exclusion from coverage under section 409A is not appropriate.*”) (emphasis added).

¹³ The Final Regulations include an anti-abuse rule. Treas. Reg. § 1.409A-1(a)(1) provides that “[i]f a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A and the regulations thereunder.” This GLAM does not address whether the Commissioner could apply the anti-abuse rule to determine that the Deferral Agreement represents a nonqualified deferred compensation plan that must comply with the requirements of section 409A.

a taxpayer becomes eligible to participate in a plan. In that case, the election can be made within 30 days after the date Taxpayer becomes eligible to participate in the plan, but only with respect to services to be performed after the election. Section 409A(a)(4)(B)(ii); Treas. Reg. § 1.409A-2(a)(7)(i).

The Deferral Agreement was entered into in 2021, which was the first year Taxpayer was eligible to participate in the plan. As a result, to comply with section 409A, Taxpayer had to make an irrevocable election regarding the timing of payment of the deferred compensation within 30 days after becoming eligible to participate in the plan, *but only with respect to services to be performed after the election*. By the time Taxpayer entered into the Deferral Agreement on June 30, 2021, and elected to be paid in 2031, all the services giving rise to the fee had already been performed. The legal engagement began on March 1, 2017, and was concluded on July 1, 2021, one day following the execution of the Deferral Agreement. As a result, Taxpayer's election to defer compensation was not timely for purposes of section 409A(a)(4) because it only became irrevocable after all the relevant services had been performed.

Anti-Acceleration Rule and Substituted Payment

In addition to the initial deferral election timing requirements, the plan must also comply with the requirements of section 409A(a)(3) regarding the acceleration of benefits. Under section 409A(a)(3), a nonqualified deferred compensation plan subject to section 409A cannot permit the acceleration of the time or schedule of any payment under the plan. Likewise, Treas. Reg. § 1.409A-3(j)(1) provides as follows:

“Except as provided in paragraph (j)(4) of this section, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to the terms of the plan, and no such accelerated payment may be made whether or not provided for under the terms of such plan. For purposes of determining whether a payment of deferred compensation has been made, the rules of paragraph (f) of this section (substituted payments) apply.”

When amounts were initially deferred pursuant to the Deferral Agreement, Taxpayer elected to be paid in a lump sum in 2031. The anti-acceleration rule of section 409A(a)(3) was violated in 2021, when Taxpayer obtained a loan against amounts deferred with the Third Party. The loan was an accelerated payment of deferred compensation because of the substitution rule in Treas. Reg. § 1.409A-3(f), which provides that “the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation.” Whether one payment is a substitute for the payment of deferred compensation is based on the facts and circumstances. *Id.* If a “service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation.” *Id.*

Taxpayer's loan constitutes a substitution under Treas. Reg. § 1.409A-3(f). Under the terms of the Note, in the event of Taxpayer's default, the Third Party has a right to exercise a setoff right, such that the Third Party can reduce the Deferred Payment by the amount of loan and accrued interest, to the extent of the default. Under Treas. Reg. § 1.409A-3(f), obtaining the loan represents a payment of deferred compensation because the repayment of the loan "*may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan*" (emphasis added).

Section 409A Violations

If at any time during a taxable year a nonqualified deferred compensation plan (1) fails to meet the requirements of section 409A(a), or (2) is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(a)(1)(A)(i). The income tax imposed is increased by an amount equal to (1) 20% of the compensation that is includible in income, plus (2) the amount of interest determined under section 409A(a)(1)(B)(ii). Section 409A(a)(1)(B). These amounts are an additional income tax, subject to the rules governing the assessment, collection, and payment of income tax, and are neither an excise tax nor a penalty.

Because Taxpayer did not make a timely election to defer compensation under the plan, the plan failed to comply with the requirements of section 409A(a)(4) in 2021. The plan also failed to comply with the requirements of section 409A(a)(3) in 2021 when Taxpayer obtained a loan from the Third Party, the repayment of which may be accomplished through an offset of or a reduction in the Deferred Payment.

As a result, the value of the Deferred Payment (\$470,000) is includible in Taxpayer's gross income for 2021, to the extent not subject to a substantial risk of forfeiture and not previously included in income. Section 409A(a)(1)(A)(i). The Deferred Payment was not subject to a substantial risk of forfeiture, because Taxpayer's right to the Deferred Payment was not "conditioned upon the future performance of substantial services by any individual." Section 409A(d)(4). The amounts deferred under the plan have not previously been included in Taxpayer's income. As a result, the entire balance of the plan (\$470,000) is includible in Taxpayer's gross income for 2021. This amount is also subject to an additional income tax of 20% under section 409A(a)(1)(B)(i)(II).

* * *

This written advice was prepared in conjunction with the Office of Associate Chief Counsel (Income Tax & Accounting) and coordinated with key stakeholders in Large Business and International (LB&I). Although this GLAM addresses some of the ways in which the legal fees constitute gross income to Taxpayer at the time they are paid to the Third Party, it does not purport to discuss or provide formal legal advice with respect to all Federal tax issues raised by the facts discussed herein. For example, this GLAM

does not address any self-employment tax issues, constructive receipt issues, or method of accounting issues, such as whether Taxpayer has adopted a method of accounting for the purportedly deferred legal fees. This GLAM also does not address whether the loan Taxpayer obtained from the Third Party is a bona fide loan for Federal tax purposes.

Please call me or Richard Nettles at (202) 317-5600 if you have any further questions.