

Income Tax Deduction and Deferral Strategies for Trial Attorney Contingency Fee Income

Part 2—Closely Held Insurance Companies

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Overview

Part 1 of this series, which appeared in the Summer 2012 issue, examined the use of private placement variable deferred annuities in lieu of fixed annuities for structured settlement payments to trial attorneys. Part 2 focuses on the use of closely held insurance companies to provide tax reduction and deferral for contingency fee income.

Trial attorneys representing plaintiffs are among the mostly highly compensated professionals in our Society. They are also very entrepreneurial from both a legal and financial perspective. The majority of their income is from contingency fees—30%–40% in most cases—but they are compensated only if they win a jury verdict or favorably settle the case for the plaintiff. Some cases take years to settle, and the financial investment of the law firm in expert witness expenses is significant. In the aggregate, trial lawyers nationally earn \$50–\$70 billion per year. Ibbotson Associates Survey on Structured Settlement Annuity Market, 2007. They often have “spiked” income events as a result of a settlement or jury verdict every two–three years.

Many successful trial attorneys also own other businesses outside of the law firm. Many of these businesses are successful in generating additional income as well and become valuable assets on the trial attorney’s balance sheet.

Trial attorneys are limited in their ability to reduce and defer taxable income. For example, a defined contribution plan has a contribution limit

of \$50,000 in 2012 and a salary cap of \$250,000. Notice 2011-90, 2011-2 C.B. 791. Most trial attorneys have not utilized structured settlement annuities, which are conservative fixed deferred annuity products issued by large life insurers. The trial attorney forfeits investment control and flexibility through the structured settlement annuity purchase.

What Is a Closely Held Insurance Company?

A closely held insurance company (captive insurer) is an actual insurance company or reinsurance company with reserves for claims, surplus, policies, policyholders, and claims. Its main purpose is to insure the risks of the operating companies that are owned by the captive’s owner, the trial attorney.

Traditional captive insurers have been primarily viewed as a means to reduce insurance costs or provide coverage not available in the commercial marketplace. The focus of the captive insurer for the trial attorney is to insure the underinsured and uninsured property and casualty risks of the law firm and of other businesses owned by the trial attorney. The captive insurer may also serve as a multi-line insurer, *i.e.*, an insurer that insures property and casualty risks as well as issuing annuities and life insurance.

Taxation of Closely Held Insurance Companies

Small insurers (life or property and casualty) receive preferential tax treatment in the Code. For example, an

insurer can take a tax deduction for contributions to its reserves, its actuarial determination of future claims.

Some captives are able to make an election under section 501(c)(15) to be treated as tax-exempt organizations. These captives must have no more than \$600,000 in gross receipts, and more than 50% must be from insurance premiums. Because of tax abuse of these captives, Congress has created more stringent requirements to meet the requirements for tax-free status.

However, in the context of the trial attorney law firm, this election may be viable due to the ability of each firm partner to own his or her own captive cell, which is treated as an insurance company. Each captive cell in turn underwrites risks for the law firm.

An election under section 831(b) is an option for slightly larger captives, with a limit on premiums of \$1.2 million of premiums annually. The captive is taxed on its investment income but not on premium income. Many partners will be able to qualify for the section 831(b) election. Premium payments in excess of this limit are not problematic. The captive can manage its reserves and timing of income. A section 831(b) election can be made as assets are released and become taxable to the captive.

As noted above, a captive may also be structured as a multi-line insurer. The small life insurance company provisions in section 806 provide a special tax deduction of 60% of life insurance taxable income. Section 816 requires that the company’s reserves related to life and health insurance

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exceed 50% of total reserves of the insurer. The company cannot have more than \$500 million in assets, and the deduction phases out when life insurance taxable income exceeds \$3 million. The special provisions provide the company with an effective federal tax rate of 15%.

In order to be treated as an insurance company for federal tax purposes, the captive insurer must have a certain percentage of unrelated risks. The federal safe harbor is 50%. Rev. Rul. 2002-89, 2002-2 C.B. The amount of unrelated risk in case law is 30%. *Gulf Oil Corp v. Commissioner*, 914 F.2d 396 (3d Cir. 1990).

Basic Strategy

The law firm partners will form a closely held insurance company as a property and casualty company or small life insurer operating as a multi-line insurer. The company will be formed in an offshore jurisdiction in the British Virgin Islands and make an election to be treated as a U.S. taxpayer. The offshore domiciles are among the most highly flexible domiciles from an investment standpoint and allow the trial attorney to invest all or most of the company's assets with existing investment advisors. The shares of the insurance company may be owned outside of the partners' taxable estates for estate tax purposes.

The company will underwrite and issue low risk specialty property and casualty coverage for the law firm. These risks may include the following:

1. Business interruption
2. Reimbursement for time lost and out of pocket expenses incurred to support litigation
3. Loss of professional license
4. Uncollectible advances to clients
5. Unfavorable change in state or federal law
6. Computer technology and privacy problems

The law firm will pay tax-deductible premiums to the insurer. The premium payments will not be subject to gift taxes. Premium payments for excess disability coverage may be made on an after-tax basis so that any claim may be received tax-free. Company assets will be protected from the attorney's personal and business creditors.

The captive may also be licensed to issue life insurance and annuities in the jurisdiction. The insurer may also form an assignment company, allowing the issuance of structured settlement annuities that let partners defer the payment of contingency fees. As discussed in part 1 of this series, a trial attorney may agree in his fee agreement with the plaintiff to defer some or all of his contingency fees.

When settlement occurs, the fee obligation is transferred to an assignment company which is a wholly owned subsidiary of the life insurance company. The assignment company is the applicant, owner, and beneficiary of the annuity contract. It is a Barbados domiciled company in order to take advantage of the favorable annuity provisions of the U.S.–Barbados Income Tax Treaty.

The annuity contract contains traditional settlement options (life only, joint and last survivor) along with customized options for a specific payment date. The investment performance of the annuity contract is dictated by the investment performance of general account assets. The offshore life insurer has greater regulatory flexibility to consider a wider array of investment options.

Strategy Example

The Facts

Joe Smith, age 50, is a partner in a plaintiff's law firm. Joe has a professional corporation. He is married and has three children. He has accumulated \$1 million in the firm's qualified retirement plans. His combined marginal tax bracket for federal, state and city purposes is 40%.

His annual income after bonuses has averaged \$3.5 million per year. Joe's lifestyle requires a net income of \$500,000 per year.

Joe has a family trust that owns a \$2.5 million life insurance policy on his life. He expects to earn an additional \$5 million this year from a contingency fee on a medical malpractice case. Joe believes that he could make premium contributions to a captive insurer of \$1 million per year for property and casualty insurance.

Joe plans to practice law until he is age 70. It is assumed that contingency fees of \$2.5 million per year will be deferred each year with payments being guaranteed by Good Insurance's wholly owned assignment company.

The Strategy

Joe and the Smith Family Irrevocable Trust create a new insurance company, Good Insurance Ltd. (Good Insurance), that is licensed in Barbados. The company is capitalized with \$250,000. The shares are owned by the Smith Family Trust, an irrevocable trust domiciled in Delaware. The company makes a section 953(d) election to be treated as a U.S. taxpayer for federal tax purposes.

Good Insurance will be licensed as a life insurance company and may offer property and casualty insurance as well. It will qualify as a small life insurance company under section 806(a) and will be exempt from taxes in Barbados. Good Insurance will also own an assignment company. Joe's investment advisor will manage captive investments to minimize current taxation.

Joe modifies his fee agreement with his client to provide for the deferral of any contingency fees. When the malpractice case settles, the assignment company enters into an agreement with the defendant to assume liability for payment of Joe's attorney's fees. The assignment company purchases a deferred fixed annuity from Good Insurance. The annuity provides for payments in four years, which is when Joe's daughter plans to enter college.

The annuity after that period will provide for life only payments beginning when Joe attains age 75.

Joe hires Good Captive Management (GCM) to perform a feasibility study for the captive and identify a portfolio of new coverage for the captive. GCM develops the policy forms and performs an actuarial review to determine the appropriate pricing. The projected premiums per year are \$1 million.

Over the next five years, \$5 million of income will be paid to the captive on a tax-deductible basis. The premium income will not be taxed. The captive's investment income will be taxed. The premium payments are not subject to gift taxes. The growth of Good Insurance, which is wholly owned by the Smith Family Irrevocable Trust will escape federal estate taxes.

When Joe is 70, the amount of accumulated deferred contingency income will be approximately \$115

million, assuming an 8% rate of return. At age 79, the amount will have doubled, to \$230 million. Joe has amassed a significant net worth independent of these deferred contingency fees. He elects to annuitize the annuity, selecting the life only option.

At Joe's death at age 82, the balance of the unrecovered annuity is not included in his taxable estate, thus producing estate tax savings in excess of \$115 million. The unrecovered annuity balance is also not taxable for income tax purposes. The profit is captured within Good Insurance, which is owned in the family trust.

Summary

Nothing in the current landscape—economic or tax—suggests that plaintiff's attorneys will make less money due to tort reform or that taxes will be lower. The closely held insurance company

strategy provides a unique approach to manage high taxation from contingency fee income. The captive insurer as a multi-line insurer provides a dual approach to reduce and defer current taxation. The insurer may underwrite underinsured or uninsured risks facing the trial lawyer and his firm. A captive insurer which is also licensed as a life insurer may issue structured settlement annuities.

The attorney's management control of the life insurer should provide a greater degree of incentive and confidence in the arrangement. Ultimately, significant estate tax savings can be achieved using a life only annuity payout. The unrecovered gain from the annuity payout reverts to the insurance company owned by the family trust as profit. The trial attorney defers taxation for decades, and the deferred income is transferred without estate taxation. ■

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