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Beyond the Closing Table: Turning the Sale of a Law Firm into Tax-Savvy Income

Peter Darling

Structured Consulting

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Selling a law firm is literally the culmination of a lifetime of work. It's the Big One. It's the reward for the effort of an entire career -- decades, hundreds and hundreds of depositions, motions, clients, settlements and verdicts lined up, stretching back to law school. Unless one of your ancestors invented something like paper clips or fiber optics, it's probably the biggest transaction of a lawyer's life.

Most attorneys don't handle it well.

Typically, the sale of a firm is set up as a combination of an upfront cash payment and/or a percentage of revenue from current clients – usually 1/3 of future contingent fees -- for a negotiated period of time. The practice, colloquially known as "fee sharing" means some now, in other words, and some later. Typically, selling lawyers -- consciously or un- -- decide to simply close the deal, and figure out what to do with the money later.

As Jeremy E. Poock, Esq., a law firm sale broker with Senior Attorney Match explains, purchasers are familiar with contingency fee sharing because of the pre-existing industry standard of paying referral fees. For sellers, though, monetizing their law firms via fee sharing comes with a price: significant taxes payable when they receive that income. This includes years when significant fee sharing may occur as a result of particularly successful contingency fee matters.

So, yes, selling a law firm means taking in a lot of money. But unknowingly, it probably also means leaving enormous amounts of money on the table when walking away. What's missing?

Structure.

The Structured Sale

While a lot of attorneys are familiar, in general, with structured settlements, far fewer understand that they can also structure their fees. In resolving a case, a structured settlement is one in which a recovery is put into tax-advantaged investments that pay out to the plaintiff over time rather than being received immediately in a single, sometimes highly taxable lump sum. Structured fees work the same way. Just as a plaintiff's recovery can be paid out over time, their attorney's compensation for a contingent-fee case can, in whole or part, be put into the equivalent of a limitless 401(k). It can be invested, and grow, tax-deferred rather than simply paid all at once.

Even fewer attorneys still know that *the same benefits apply to income from the sale of the entire firm*. A plaintiff can structure a recovery. Their attorney can structure their fee. And the revenue generated by selling an entire firm can be structured, too. Rather than subjecting the proceeds of a lifetime's work to the punishment of the IRS's maximum tax rate, some or all of the sale proceeds can be invested on a tax-deferred basis. Thanks to the power of compound interest, especially pre-tax, this can make a massive difference in the value of a firm at exit. And often, set an attorney up for a very comfortable retirement.

The Case Law

The essential case validating the tax treatment of deferred fees was *Childs v. Commissioner*, 103 T.C. 634 (1994), aff'd, 89 F.3d 856 (11th Cir. 1996). Childs concerned the Internal Revenue Service's attempt to challenge structured contingent fees negotiated by plaintiffs' attorneys in a personal injury case. Prior to settlement of a lawsuit, the Childs attorneys arranged to receive their fees as periodic payments rather than in a lump sum. The Tax Court disagreed with the IRS's challenge, and found for the attorneys, thus setting the stage for the broad use of structured fees we know today.

The *Childs* decision rested on two fundamental doctrines. The first is the concept of "constructive receipt" which defines when a taxpayer is treated as having received income, and when not. The concept was first expressed by Justice Holmes in the 1930 case of *Corliss v. Bowers*, 281 U.S. 376 (1930), in which he wrote that "[i]ncome that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as income, whether he sees fit to enjoy it or not." The *Corliss* opinion is echoed in Treasury Regulation 1.451-2(a) which states that:

> *Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.*

In *Childs*, several specific factors supported the attorneys' lack of constructive receipt. ·

- The attorneys set up the deferral agreement before they had a right to their fees.
- The payment obligation was assumed by a third-party assignment company.
- The assignment company's obligation to pay the attorneys was unsecured, and the lawyers had no ownership, control, or acceleration rights.

The second doctrine at work in *Childs* was the definition of "property" as used in Section 83 of the Internal Revenue Code. The court in Childs held that rather than being compensated by property, the *lawyers* received an unsecured, unfunded contractual promise, which did not meet the threshold for the definition of property the Code requires. While situationally specific, this definition laid the groundwork for the use of deferred payments up to the present day.

Upfront Payment

The first, and most powerful, place this benefit appears is with the upfront payment for a firm. Typically, this is determined based on the anticipated revenue the firm will generate based on current clients, brand and reputation, and other factors. While it's a substantial chunk of money, it's also eligible for deferred-tax treatment and investment. Rather than receiving the upfront payment in one lump sum, all of which is immediately taxable, it can instead can be structured, in whole or in part, as a tax-advantaged installment sale[PD1] .

Typically, this is done is through a third party, such as a life insurance company. Let's use the fictitious insurance company LifeCo as an example. The buyer, instead of simply paying the seller, instead assigns the obligation to pay the seller to LifeCo, and funds the assignment with his upfront payment. LifeCo then enters into an annuity contract (usually through a subsidiary) with the seller, pursuant to which the upfront payment is invested in an annuity, which pays the seller over a period of time (5 years, 10 years or whatever) with interest. The seller is only responsible for paying taxes on what he actually receives, when he receives it.

There are a number of advantages to this approach. First, of course, is the impact of deferring taxes. The longer you can delay payment, the better, and the larger the amount at issue, the better also. It's also likely that this will keep the seller of the firm from being automatically moved into the highest possible tax bracket.

In addition, the deferral of taxes until the invested funds are actually paid out means that they can be invested with

In addition, the deferral of taxes until the invested funds are actually paid out means that they can be invested with greater returns and lower risk. Over a multi-decade investment horizon, the compound effect of this is significant. It can more than double the overall value of an upfront payment.

Finally, the applicable rules allow customization of the resulting payout of the upfront payments. In addition to the immediate tax advantage of deferring some, or all of an upfront payment, sellers can set up customized payout schedules designed to dovetail with major life events such as purchasing a home, paying tuition, or anticipated medical expenses. If an attorney anticipates a child in college ten years after selling his firm, an increased payout can be scheduled to cover that. And so on.

10-Year Payout

The same principle applies to the payout portion of the sale price. Typically, in addition to an upfront payment, the selling attorney also receives a percentage of fees paid by clients whose cases have not yet concluded – the fee-sharing discussed earlier. Typically, the payout is 1/3 of the contingent fees due to the firm over 5, 10 or more years. This can also be funneled into a structure. And here is where the flexibility of structured fees really gets significant traction.

For instance, let's suppose that the owner of a practice sells it for a fee which includes a 1/3 (his portion) of 1/3 (the firm's contingent fee) payout over a period of a decade. Let's further suppose that due to his skill in court and the success of his efforts, he's able to cash out, sell the firm and retire at 55. A conventional, unstructured payout will continue until he is 65, at which point, demographics tell us he still can expect to live for 18 to 19 years. Unless he is simultaneously lucky, thrifty and smart, a financial squeeze may result, just when he can least afford it.

Unless he's structured the payout as well. In which case, the strategy tilts in his financial favor. Instead of simply receiving the conventional annual payout, and subjecting it to taxation, he instead redirects some (or all) of it into a tax-deferred investment vehicle with a lifetime payout schedule. The typical approach is to determine the income level he'd like to set up as his baseline, and direct any payout income beyond that – which is typically the case – into a tax-deferred structured fee payout, with a 20-year time horizon.

As Poock notes, deferring taxes during a referral fee payout period effectively increases the sale price of a seller's law firm because, as Robert Kiyosaki teaches, "It's not how much money you make, but how much money you keep."

Depending on how much and how long, and how much of a payout has been received, a selling attorney can often fund a comfortable retirement for the rest of his life, with a tax-advantaged investment strategy, using this approach. And this, of course, is in addition to any retirement funds he may have accumulated during the course of his career. The bottom line is that by structuring the proceeds of the sale of a practice, many attorneys fund a comfortable retirement for the rest of their lives, should they choose to fully retire. And if not? More's the better.

Abraham Lincoln is said to have said that if he had eight hours to chop down a tree, he'd spend the first six sharpening his axe. The same principle applies to selling a firm. Some extra planning can make all the difference.

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