



Robert W. Wood

THE TAX LAWYER

TAXES 01/09/2018

Contingent Fee Lawyers Dodge Bullet In Tax Reform

Many lawyers assume that if they pay for a deposition transcript, a court reporter, or travel expenses for a hearing, they can immediately deduct these costs as business expenses on their taxes. The same for expert witness fees. These seem like business expenses for lawyers. However, the IRS looks at who really bears the impact of these expenses and when, and that often means delayed deductions. On that point, it looked as if contingent fee lawyers in California and the rest of the Ninth Circuit were going to be hurt by the [recently passed massive federal tax bill](#). For years, contingent fee lawyers in the Ninth Circuit had an easier time when it came to tax deductions for client costs. In the huge year-end tax reform bill, Congress was expected to conform the rules in favor of the IRS. But as happens in the sausage-making of tax reform, something happened at the last minute. The provision was *not* included in the final version of the bill. That means lawyers in the Ninth Circuit still have the benefit of a more favorable tax rule.

Business expenses have to be ordinary and necessary to be tax deductible. But the IRS has always had the view that lawyers cannot deduct these costs if the lawyers effectively might get reimbursed for the costs later, at the conclusion of the case. Under most contingent fee agreements, the client pays nothing (not even costs) unless there is a recovery. Under some fee agreements, costs are subtracted from the client's share. In others, costs are taken off the top, before the client and lawyer split the remainder.

In the meantime, *someone* has to pay the costs up front as they are incurred. Usually, that is the lawyer. When lawyers pay these costs, they want to write them off, but the IRS has battled to prevent these deductions. The IRS general rule is that contingent fee lawyers who pay costs for clients are making *loans* to the client. You can't deduct loans. That means paying the costs currently, but not deducting them on your taxes until what could be many years later when the case finally resolves. Only at *that* point could you write them off.



There was—and still is—a way out in California, and throughout the Ninth Circuit, thanks to a tax case called *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995). The Ninth Circuit held that attorneys could currently deduct costs if they had a gross fee contract. A gross fee contract involves the attorney receiving a

percentage of the gross recovery, with costs paid by the attorney taken solely out of the attorney's percentage. Any *other* type of fee agreement is a loan of the costs. Some lawyers in California and other states in the Ninth Circuit go to great pains to make sure they qualify. Some lawyers are less careful, but still hope they get some protection from *Boccardo*. The IRS has long been unhappy over this issue. In fact, the IRS issued a Field Service Advice, 1997 FSA 442 (basically a memo to IRS personnel) stating that it would not follow *Boccardo* except in the Ninth Circuit.

But the IRS has long wanted uniform tax treatment. The IRS wanted Congress to bring the Ninth Circuit contingent fee lawyers into compliance with everyone else. But the fact that the tax bill did not include the IRS fix means lawyers in California can still have gross fee contracts if they want. That gives lawyers in the Ninth Circuit a choice. With the survival of the gross fee agreement in the Ninth Circuit, should lawyers adopt them? That is not solely a tax question. It involves some economics and perhaps even marketing. And it can impact lawyer take-home pay. But the tax reform bill didn't eliminate the choice.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.