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Another Tax Case Limits Lawyer Costs Deduction

A Practice Smart(TM) Feature

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Most lawyers assume that if they pay $1,000 for a deposition transcript or court reporter, they can deduct it as a business expense. What could be more ordinary or necessary to being a lawyer? Contingent fee lawyers know that it may be years before the case settles, and no recovery may mean that the lawyer recoups nothing. But the expense still seems so ordinary. It may or may not be for tax purposes, as we'll see.

When a contingent fee attorney agrees to represent a client in an accident case, taking 40 percent of the recovery as his fee, how does he account for costs? Most lawyers cannot get a client to pay out-of-pocket costs on an ongoing basis, so the lawyer must pay them. In the meantime, the lawyer records the costs as an expense of the case. That way the lawyer and client can tally the costs when they divide the proceeds of a settlement or verdict.

Is the lawyer *advancing* those costs or simply undertaking to pay them? Can the lawyer deduct the costs as they are paid? Many

lawyers still find it difficult to answer those questions. For that matter, many tax professionals do, too. The IRS's position has generally been a denial of deductions, some- thing even Senate Finance Committee Chair Max Baucus, D-Mont., and Sen. Richard J. Durbin, D-Ill., have complained about to the IRS.[1]

The seminal client-cost tax deduction case is *Boccardo v. Commissioner*, but even it has some history[2]. There were three *Boccardo* cases, but in its final iteration the Ninth Circuit held that some attorneys could currently deduct costs as ordinary and necessary business expenses. The key to the deductions was a gross fee contract.

A gross fee contract is simply an arrangement under which the attorney receives a percentage of any gross recovery, with litigation costs paid by the attorney out of his own percentage. Any other fee agreement is really a loan of the costs, with the attorney and client settling up later. In a true gross fee contract, the attorney receives no reimbursement of expenses if there is no recovery. Even if there is a recovery, the split between lawyer and client is not adjusted to account for the costs.

Continuing Controversy

Boccardo did not end the controversy. The IRS issued a field service advice[3] stating that it would not follow *Boccardo* except in the Ninth Circuit. The memorandum asserted that the IRS would continue to argue that gross fee contracts do not change the loan treatment of litigation expenses.

There have been subsequent cases, too. In *Pelton & Gunther v. Commissioner,* [4] the Tax Court held that a law firm's costs were nondeductible loans when the law firm billed the client at a stated hourly rate and not on a contingent fee basis. The Tax Court distinguished the *Pelton & Gunther* facts from the gross fee contract considered in *Boccardo*. Similarly, in *Baddell v. Commissioner,*[5] the Tax Court distinguished *Boccardo's* gross fee contract from arrangements under which clients must reimburse the law firm regardless of outcome.

When there is a reimbursement obligation, it does seem reasonable to view the costs when paid as a loan. Thus, in *Canelo v. Commissioner*[6] and *Silverton v. Commissioner,*[7] the Ninth Circuit affirmed the rule that litigation costs were most appropriately treated as loans. The converse — when costs are simply *paid* and not advanced — *must* be different, and this is where Baucus and Durbin have taken the IRS to task.

They wonder why the Service continues to assert that costs in a gross fee arrangement are loans: In light of the reliance the IRS placed upon

court decisions and, notably, court decisions reviewed by the Ninth Circuit, in formulating its litigating positions prior to 1995, it is not clear why the IRS has declined to follow the Ninth Circuit's *Boccardo* decision.[8]

The senators draw the distinction between gross fee arrangements and other fee arrangements, a distinction that both the Tax Court and Ninth Circuit have recognized. Nevertheless, the IRS (in its field service advice) draws a line around the Ninth Circuit, saying that only within those borders can lawyers using gross fee contracts deduct their litigation expenses without challenge. Outside the Ninth Circuit, the IRS has made its battle position clear.

The most recent case litigating this tired issue is *Humphrey, Farrington & McClain, PC v. Commissioner*.[9] The law firm had four kinds of fee arrangements with litigation clients: fully reimbursable; net fee; gross fee; and class action. For matters for which the firm had a fully reimbursable fee arrangement, clients paid an hourly or flat fee and reimbursed the firm for all advanced expenses incurred, regardless of the outcome of the case.

All other matters (net fee, gross fee, and class action arrangements) operated on a contingent fee basis. In all contingent fee matters, clients paid a legal fee and they reimbursed the advanced expenses to the firm only if there was a favorable outcome. For matters for which Humphrey, Farrington had a net fee arrangement, clients first used the proceeds to reimburse the advanced expenses, then they paid the firm a set percentage of the remaining amount as legal fees.

For matters with a gross fee arrangement, clients first paid the firm a set percentage of the proceeds as legal fees. Thereafter, they reimbursed the firm for advanced expenses out of the remaining amount. In class action matters, clients paid legal fees and reimbursed advanced expenses according to the terms of any eventual settlement or court award.

Given the IRS's position on these matters and the Tax Court's reported cases, the result in this case seemed predictable. Arguments that lawyers are truly bearing an expense without the right or expectation of reimbursement have been tough to win. To their credit, however, the Humphrey, Farrington lawyers argued that the reimbursement rates for their advanced expenses showed they were really bearing the costs.

However, the IRS and Tax Court were hardly persuaded. The court held that those percentages failed to demonstrate that the possibility of reimbursement was insignificant:

- for cases in the net fee internal category, the firm recovered 48.1 percent of expenses in one year and 99.9 percent of expenses in another;
- for cases in the ‘‘gross fee, high risk, and difficult’’ category, the firm recovered 36.5 per- cent of expenses in one year and 42.4 percent in another; and
- for tobacco cases in the gross fee, high risk, and difficult category, the firm recovered 50.8 per- cent of expenses in one year and 55.8 percent in another.
- Predictably, the Tax Court found that there was a significant possibility that these advanced expenses would be reimbursed. The firm screened cases and clients; the firm had a decent probability of winning; and reimbursement rates failed to show that the possibility of reimbursement was insignificant.

But Humphrey, Farrington had one more argument. It maintained that its advanced expenses in class action cases (at least) were deductible because expense awards required court approval and there was ‘‘no identifiable obligor’’ for the advanced expenses. Court approval was a barrier that lowered the probability of reimbursement for its class action expenses, the firm argued.

The Tax Court, however, found it to be a basic legal principle that class counsel is entitled to reimbursement of all reasonable out-of-pocket expenses of prosecuting claims and obtaining settlement. The court noted that this common fund doctrine was well known and that Humphrey, Farrington had fared well under it. In short, as with most other litigated cases on this issue, the lawyers lost.

Fees: Deduct or Loan?

Can lawyers ever deduct costs as incurred? Yes, but rarely. With most contingent fee agreements, the client receives the assurance that he will pay nothing (not even costs) unless there is a recovery. Costs are either subtracted solely from the client’s share, or are taken off the top before the client and lawyer split the remainder according to the percentages on which they have agreed. For plaintiffs’ lawyers who don’t ever want to fight with the IRS, the safest course is to treat the costs they pay for clients as loans.

Clearly, this is painful because the costs are being paid over several years but not deducted until what could be many years later. Suppose you have a standard one-third contingent fee agreement and that you will advance all costs. Assume your fee agreement says that when the case is finally resolved, the costs will come off the top, reimbursing you for all of your outlays. Thereafter, you and the client will split one-third/two-thirds.

Plainly, the costs you are paying during the course of the case are not deductible but are loans to the client. Then, when the case settles in

year 3, 4, or 5, you treat the recovery as income and deduct all the costs in that year.[10] As a result, strictly from a tax perspective, you should want your fee agreement to state that your law firm will be responsible for ‘‘paying’’ (not advancing) all costs and expenses of the case. Then when the case settles, you and the client will simply split one-third/two-thirds, 60/40, or 50/50.

One can presumably factor in likely costs in arriving at that split. The result of fee sharing (making no reference to costs) is that the costs are borne entirely by the lawyer. If the costs come off the top, they are being borne solely by the client or by both the client and lawyer, depending on whether the settlement is large enough to absorb all the costs.

Drafting Agreements

How you draft your fee agreement clearly matters in the Ninth Circuit, and it may end up mattering elsewhere, too. It matters regarding tax treatment and how much money you ultimately recover. Consider the following examples. In my experience, the first three are all common (although Example 2 is less common than examples 1 and 3).

Example 1: You take a case on a 35 percent contingency, with costs to be subtracted from your gross recovery. You recover $1,000 and costs equal $100. You first subtract the $100, which repays you for the $100 you laid out. Then the $900 balance is split 35 percent to you and 65 percent to the client: You get $315. You can’t deduct the $100 in costs until the year of the settlement. Your total cash is $415, but $100 was your own money. Your net cash is $315.

Example 2: You are on a 35 percent contingency, but this time your agreement (truly in gross) is merely to divide the proceeds. In effect, you’ll bear all the costs. If you recover the $1,000 and have $100 in expenses, you receive $350. However, $100 is really a reimbursement of your own money. If you regard the $100 as a loan, only $250 of the $350 is income. In the Ninth Circuit, you can deduct the $100 when you paid it, but you must then take the entire $350 into income when the case settles. Outside the Ninth Circuit, the same rule should apply, but the IRS disagrees. Your net cash is $250.

Example 3: You are still on a 35 percent contingency. This time your fee agreement says you will advance the costs but that when you split 65/35, your reimbursement of the costs will come entirely out of the client’s share. Your costs are still $100. When the case settles for $1,000, you first subtract the $100 that is reimbursed to you. The $1,000 gross is split 65/35, so your share is $350. You receive that $350 plus the $100 reimbursement. The client ends up with $550. Your net is $350.

Example 4: You are still on a 35 percent contingency but now have different rate structures: one if you will bear all the costs (Example 2), one if the client will bear all the costs (Example 3) and one if you share the burden of the costs (Example 1). Rather than any of the examples above, your fee agreement provides that the client can elect one of the following approaches:

1. the costs are deducted first off the top, and then the client pays you 35 percent;
2. the costs are ignored, but the client pays you 40 percent; or
3. the client pays you 30 percent of the gross, and the costs are deducted entirely from the client's 70 percent share.

I have never seen this fourth scenario. Variations of it might call for the lawyer (not the client) having the right to select from the menu, or for the formula with the highest or lowest net to the lawyer to apply automatically. Further, it might be possible to offer some kind of hybrid.

For example, what if the fee contract calls for a gross fee of 40 percent but says that in no event will the share the client receives be less than would be determined under a net fee at 35 percent? That provision could presumably be written into a kind of savings clause. Is there a loan problem (potentially preventing a current deduction by the lawyer) if the savings clause is not triggered?

Is the mere presence of the savings clause enough to preclude a deduction? A list of alternative cost approaches brings the issue into sharp focus. Having alternatives (whether the client or the lawyer has the option of which approach to apply) may make the case for a current deduction harder.

The IRS seems myopic in its focus on the loan model and probably would sniff out a loan in this. That makes Example 2 the clearest and best from a tax viewpoint. If the lawyer is paying the costs in years 1, 2, and 3 only to receive a gross share of a recovery in year 4, it is hard to see how there is a loan, even if the lawyer is trying to factor in the likely amount of the case costs when he sets the percentage sharing in his fee agreement.

Conclusion

I suspect that many contingent fee lawyers continue to deduct their expenses on an ongoing basis regardless of their fee agreement. This is a significant trap and may involve unwinnable tax positions, particularly outside the Ninth Circuit. Even inside the Ninth Circuit, of course, the usual net fee agreement results in the costs being loans and not deductible until the ultimate resolution of the case. For that reason, lawyers and law firms should dust off their contingent fee agreements and consider whether a change is appropriate. Changes

in fee agreements could be made prospectively for new cases. Assuming agreement with the client, changes could even be made retroactively. It should be possible to address pending cases under contingent fee agreements executed in the past.

Inside or outside the Ninth Circuit, lawyers who are willing to shift to a true gross fee arrangement should probably also alter their standard nomenclature. The ‘‘advance’’ moniker may be a word best avoided. Clients may be used to hearing, ‘‘Don’t worry; we advance all of the costs.’’ In a gross fee arrangement, ‘‘advance’’ may be an expensive misnomer, given the IRS’s propensities to ferret out loans.

In a gross fee contract, the lawyer is simply paying the costs. The lawyer may expect to get the money back based on past experience or optimism. Yet even *Humphrey, Farrington* does not suggest that expectations alone are relevant. For law firms considering the gross versus net fee dichotomy, it is appropriate to examine past success rates and the likely nature and scope of costs. Presumably, those calculations should be based on historical cost data in specific types of cases, projected costs, and the nature of particular kinds of defendants.

Costs might be higher in a suit against General Motors than in a suit against Joe’s Used Cars. Costs might be higher against particular law firms or types of law firms, too. Market or customer data would be relevant, including the preferences of clients and the positions of one’s competitors.

Suppose Lawyer A offers a gross fee contract (the lawyer paying all costs) to an auto accident plaintiff on a 40 percent contingency. Suppose Lawyer B offers the same person a 35 percent net fee contract (costs come off the top). Will the plaintiff select Lawyer A or B? Suppose Lawyer A tries to meet the competition by sticking with the 40 percent gross fee contract but offering a guarantee that the plaintiff will receive no less than if using Lawyer B’s fee calculation.

Should Lawyer A deduct the costs as incurred? Will he win in the Ninth Circuit? Elsewhere? These are not simple questions, and they go to a central feature of the way in which most contingent fee litigation is conducted.

[1]Letter to Treasury Assistant Secretary for Tax Policy Michael Mundaca (Apr. 29, 2010), *Doc 2010-9903, 2010 TNT 86-19*.

[2]56 F.3d 1016 (9th Cir. 1995), *Doc 95-5453, 95 TNT 106-7*.

[3]*See* 1997 FSA 442.

[4]T.C. Memo. 1999-339, *Doc 1999-32749, 1999 TNT 196-58*.

[5]T.C. Memo. 2000-303, *Doc 2000-24769, 2000 TNT 188-8*.

[6]53 T.C. 217 1969, *aff’d*, 447 F.2d 484 (9th Cir. 1971).

[7]T.C. Memo. 1977-198, *aff’d*, 647 F.2d 172 (9th Cir. 1981).

[8] *See supra* note 1.

[9] T.C. Memo. 2013-23, *Doc 2013-1247, 2013 TNT 13-8*.

[10] *See Hughes & Luce LLP v. Commissioner*, 70 F.3d 16 (5th Cir. 1995), *Doc 95-10693, 95 TNT 233-2*.

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