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Can Lawyers Write Off Client Costs As Current Business Expenses?

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In this article, Wood and Board consider whether contingent fee lawyers can deduct their case-related expenses as they are paid or must instead capitalize them to be taken into account when the litigation is resolved.

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Contingent fee lawyers face a marketplace that requires them to wait for success. Apart from a one-third, 40 percent, or other percentage contingent fee agreement, clients usually receive assurances that they will pay nothing — not even costs — unless there is a recovery. If there is no recovery, the lawyer bears the costs. If there is a recovery, depending on the fee agreement, the costs may be subtracted solely from the client's share, or they may be taken off the top before the client and lawyer split the remainder 60/40 or two-thirds/one-third.

The tax issues lawyers face can be an uncomfortable topic. Many lawyers assume that if they pay for a deposition transcript or court reporter fee, they can deduct the cost as a business expense. After all, what could be more logical? It may be years before the case settles (assuming it does) and the lawyer is able to recoup the costs. Because the expense is clearly incurred in business, lawyers may assume that it can be deducted from their current income.

However, the IRS and the courts have uniformly ruled that if there is a reasonable possibility that the lawyer will *not* actually bear the expense because he has a legal right to reimbursement, the lawyer cannot deduct the cost when incurred.[1] This result is typically explained by describing the attorney as making a loan to the client, in the amount of the advance, until the case settles.[2] If the case is a success and the client reimburses the lawyer for the costs he fronted, the costs are *never* deducted. Instead, the client's payment is excluded from income as repayment of the lawyer's loan.

As an alternative to the loan characterization, the lawyer could be allowed to deduct his advance as a business expense, albeit on a deferred basis, when the case is resolved and any reimbursement is actually paid. In that case, the costs reimbursed by the client would logically be *included* by the

[1] *See, e.g.*, *Hughes & Luce LLP v. Commissioner*, 70 F.3d 16 (5th Cir. 1995); *Canelo v. Commissioner*, 447 F.2d 484 (9th Cir. 1971); *Hearn v. Commissioner*, 309 F.2d 431 (9th Cir. 1962); *Boccardo v. United States*, 12 Cl. Ct. 184 (1987); *Herrick v. Commissioner*, 63 T.C. 562 (1975); and *Silverton v. Commissioner*, T.C. Memo. 1977-198.

[2] Although the loan conceptualization is rarely questioned, the client's obligation to pay may be conditional on the occurrence of an uncertain future event (*viz.*, recovery in the case). As a result, the loan does not constitute indebtedness for tax purposes. *See, e.g.*, *Frierdich v. Commissioner*, 925 F.2d 180 (7th Cir. 1991); and *United States v. Henderson*, 375 F.2d 36, 39 (5th Cir. 1967) ("no valid debt exists unless there is an unconditional obligation of another to pay . . . a definite sum of money").

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lawyer as compensation in the year received. If the case is a bust and the lawyer is out the costs, he should be able to deduct his advance in *that* year, as if he were writing off a loan to the client.[3]

Deducting Costs Currently

Contingent fee plaintiffs' lawyers are not known for being conservative or avoiding risk. That may extend beyond their practices to their tax positions. Is there an argument that a lawyer can deduct the costs when paid? I have been surprised by how many contingent fee lawyers and law firms deduct costs currently. Given the tax authorities, it would be difficult to write a tax opinion supporting that treatment.

And in an audit setting, if the IRS discovers the issue, it will disallow the deductions. But is it possible to defend a tax position for at least some current deductions? A lawyer's business instinct may be to make sure that the client ultimately bears the costs. But the tax cases make it clear that if the attorney has the right to recover his advances from the client's recovery when the case is resolved, the attorney must treat his payment of the costs as nondeductible loans to the client in the years made.[4]

What if the fee agreement states that the law firm will be initially responsible for paying all costs and expenses but that the lawyer will be reimbursed from the recovery off the top when the case settles? Even in the best-case scenario, in which the lawyer is fully compensated for his advances, he will still be indirectly bearing a portion of the expense because of the reduction of the pool of recovered funds in which he has a percentage interest. How does that sound taxwise?

As a matter of simple math, a lawyer entitled to a 40 percent fee is still bearing 40 percent of the cost of his advance even after full reimbursement. It is therefore arguable that the lawyer should be permitted to deduct 40 percent of his advance when made, since he is bearing that economic cost of 40 percent of the advance even if he is later reimbursed for his entire payment.

Gross Fee Contracts

Is there any argument for allowing the lawyer to deduct 100 percent of the costs when incurred? In *Boccardo*,[5] a much-discussed case regarding deducting client costs, the Ninth Circuit held that attorneys representing clients in contingent fee cases can *currently* deduct the full amount of an advance of litigation costs if the attorney and client have agreed to a fee arrangement known as a gross fee contract. A gross fee contract is one in which the attorney simply receives a percentage of any gross recovery. There is no special payment reimbursing him for the litigation costs that he paid from his own resources.

The law firm in *Boccardo* had originally used a net fee contract in which the law firm agreed to pay all costs of the litigation and to be reimbursed for its costs only out of a future recovery. The first dollars recovered went to repay the lawyer's costs. The lawyer and client then divided the rest (that is, the "net" amount of the client's recovery).

In an earlier case, the Court of Federal Claims had held that the taxpayer, James Boccardo, could not deduct his share of the costs as the law firm paid them, because the firm had a net fee contract with a right to reimbursement.[6] In response, the firm replaced its net fee contracts with gross fee contracts, eliminating any right to reimbursement for costs paid.

Consequently, the law firm and the client would simply split the gross amount of any recovery. Hence, even if a recovery was obtained, the firm would receive nothing from the client for the costs it had paid. Nevertheless, the IRS contended that the law firm could not claim current deductions even under the new gross fee contract.

This time, the case was heard in the Tax Court, which agreed with the IRS that, in substance, the gross fee contract would *still* provide Boccardo with reimbursement for his share of the costs.[7]

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[3] As the Tax Court has noted, including the client's reimbursement payments in income and simultaneously deducting the lawyer's related expenses produces the same result as excluding the reimbursement and denying a deduction under the loan theory. *See Pace v. Commissioner*, T.C. Memo. 2010-272.

[4] *See, e.g., Hughes & Luce*, 70 F.3d 16 (treating an attorney's advances as loans to the client).

[5] *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), *rev'g* T.C. Memo. 1993-224.

[6] *See Boccardo*, 12 Cl. Ct. 183 (1987).

[7] *See Boccardo*, T.C. Memo. 1993-224.

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The Tax Court said that it did not matter if the law firm had no legal right to be reimbursed by the client, as long as the firm had an *expectation* of generating a fee from the matter that would *at least* cover the costs incurred. The Tax Court determined that the law firm's substitution of a gross fee contract for the net fee contract reviewed by the claims court was a change in the form of the arrangement but not its substance.

Therefore, the Tax Court found the costs paid by Boccardo and his firm under the gross fee contracts were de facto reimbursable advances and hence not deductible when made. As a result, the Tax Court, like the claims court, ruled against Boccardo. He then appealed to the Ninth Circuit, arguing that the results of his first two tax cases were unfair.

Reversing the Tax Court, the Ninth Circuit held that Boccardo's firm incurred deductible ordinary and necessary business expenses when it paid the client costs under the gross fee arrangement.[8] The Ninth Circuit considered it normal business practice for plaintiffs' firms to pay client costs. The IRS had argued that this practice violated state professional standards, which meant that the expense was nondeductible as an "illegal" payment described in section 162(c)(2).[9] The Ninth Circuit, however, held that the prohibition on an attorney paying his client's expenses was not actually enforced, so the firm's payments were not illegal for statutory purposes.

Evaluating the tax law, too, the Ninth Circuit found that there was no problem with these tax deductions. It argued that the reason a tax deduction is unavailable with the net fee approach is because the lawyer is essentially making a loan to the client. Under a gross fee arrangement, in contrast, there was no obligation on the client's part to repay the money expended. If the lawyer was simply shouldering the costs, the court reasoned, how could his payment be a loan?

Continuing Controversy

Despite the victory Boccardo achieved in his third time in court with the IRS, taxpayers outside the Ninth Circuit have not fared as well. In *Hughes & Luce*,[10] a large law firm deducted expenses that it paid on a client's behalf, and it lost in both the Tax Court and the Fifth Circuit. By the time of trial, the law firm had decided not to litigate the deductibility issue. Instead, Hughes & Luce argued that the reimbursements it received from clients were not includable in its income since the IRS had already determined that these funds were merely loan repayments.

The IRS countered in the Tax Court that the reimbursements the firm received were attributable to amounts that the law firm had deducted in prior closed tax years. That meant that they had to be included in the firm's income. The IRS said the tax benefit rule and the general duty of consistency dictated that result.

The Tax Court, however, held that the tax benefit rule did not apply, because the firm's prior reporting position (deducting its advances) had been erroneous. On the other hand, the court agreed with the IRS that the duty of consistency required the law firm to *include* the reimbursement payments in income when recovered.

On appeal to the Fifth Circuit, Hughes & Luce continued to argue that it was unfair to force it to include these payments in income. But the Fifth Circuit reversed the Tax Court for failing to apply the tax benefit rule simply because the firm's prior reporting position had been incorrect. Excluding the current reimbursement was inconsistent with the firm's prior position, regardless of whether that prior position was correct.

The IRS responded to *Boccardo* in 1997, when it issued a field service advice memorandum stating that it would not follow the decision except in the Ninth Circuit.[11] The memo said that everywhere else, the IRS would continue to argue that advances should not be currently deductible even under a gross fee contract. To assist taxpayers who wanted to get on its bandwagon, the IRS also issued Rev. Proc. 97-37, 1997-2 C.B.

[8] *See Boccardo*, 56 F.3d 1016.

[9] Under section 162(c)(2), no deduction is allowed for an expenditure if it is an illegal payment under any state law (assuming it is generally enforced) "which subjects the payor to . . . the loss of license or privilege to engage in a trade or business."

[10] *Hughes & Luce*, 70 F.3d 16.

[11] *See* FSA 1997-40.

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455, in which it announced that it would automatically consent to the change of accounting method involved when a lawyer switches from deducting advances to treating them as loans to clients.

In the courts, the battle lines drawn nearly 30 years ago have barely moved. *Boccardo* continues to be the law in the Ninth Circuit, but it does not appear to have won any converts in the other circuits. The number of reported cases with relevant citations to *Boccardo* remains quite limited.

There have been several congressional attempts to move beyond the status quo. In 2009 Sen. Arlen Specter and several cosponsors introduced a bill that would have codified *Boccardo* in gross fee cases. Although the bill was popular with contingent fee lawyers, it failed to make it out of committee.

In 2010 Sens. Max Baucus and Richard J. Durbin wrote to the IRS requesting clarification of the IRS's position. They questioned the 2007 field service advice and urged that *Boccardo* be adopted across the board. At the same time, however, Sen. Chuck Grassley and Rep. Dave Camp wrote to urge the IRS *not* to change its litigating position. Both sets of inquiries received brief letters from the IRS stating that it had no plans to provide additional guidance or depart from the 2007 field service advice.

In 2017 the Tax Cuts and Jobs Act nearly put the kibosh on lawyers deducting costs no matter what kind of contract they used. Both the House and Senate versions of the legislation would have added a new section 162(q) to block the deduction under section 162(a) of any expense (1) paid or incurred in the course of the trade or business of practicing law; and (2) resulting from a case for which the taxpayer is compensated primarily on a contingent basis, until the contingency is resolved. However, proposed section 162(q) disappeared without a trace in the enacted version of the bill. Consequently, lawyers in the Ninth Circuit still have the benefit of the more favorable tax rule for gross fee contracts that was established in 1995.

Drafting Agreements

Costs can be subtracted solely from the client's share; taken off the top before the client and lawyer split the remainder according to the percentages on which they have agreed; or paid only by the lawyer as the case proceeds, with the recovery simply split according to the agreed-on percentages. For plaintiffs' lawyers who do not want to fight with the IRS, the safest course is to treat costs they pay for clients as loans, regardless of whether they use a net fee or a gross fee contract.

This can be painful, especially in cases litigated for years, which may make it worthwhile to calculate different ways to tackle this issue. Suppose you have a standard one-third contingent fee agreement and 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 your outlays. Thereafter, you and the client will split the remainder one-third/two-thirds.

The costs you are paying during the course of the case are *not* deductible but are treated as loans to the client. Then, when the case settles in year 3, 4, or 5, you should be able to include your 40 percent share of the net recovery as income while excluding the reimbursement payment on the theory that it is simply repayment of your loan to the client. In principle, you could achieve the same bottom-line result by treating the full amount you receive (your fee plus any reimbursement) as income and deducting all the costs in that year.[12]

If you are in the Ninth Circuit or willing to take an adventurous position, you could enter into a gross fee contract with the client and deduct costs in the years they were paid. Strictly from a tax perspective, your fee agreement should probably state that your law firm will be responsible for "paying" (not "advancing") all costs and expenses of the case. After all, the term "advancing" suggests that you have a reimbursement right, which is fatal even under *Boccardo*.

When the case settles, the lawyer and client will simply split the recovery one-third/two-thirds, 60/40, or 50/50, in accordance with the gross fee contract. One can presumably factor in likely costs in arriving at this split, thereby

[12] *See Hughes &* Luce, 70 F.3d 16.

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achieving de facto reimbursement. The result of making no reference to costs is that the lawyer can contend that the client has no obligation to reimburse for expenses.

Under the gross fee contract, the costs are legally 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 the lawyer, depending on whether the settlement is large enough to absorb all the costs.

How do you draft a fee agreement in the Ninth Circuit? Consider the following examples.

Example 1. You take a case on a 35 percent contingency, with costs to be subtracted from the client's gross recovery. The case settles for $1,000, and your 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 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 pay it, but you must then take the entire $350 into income when the case settles. Your net cash is $250.

Example 3. You are still on a 35 percent contingency. This time, your fee agreement says you will advance costs but that when you split 65/35, your reimbursement of 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, which 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 costs (Example 1). Your fee agreement provides that the client can elect one of the following approaches:

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

Variations of Example 4 might call for the lawyer (not the client) to have 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 a 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 arrangement at 35 percent? The latter 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?

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 determined in its focus on the loan model and probably would sniff out a loan in this situation. That makes Example 2 the clearest and best approach 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 costs in the case when he sets the sharing percentage in his fee agreement.

Conclusion

Some contingent fee lawyers still seem to deduct their expenses on an ongoing basis, regardless of how their fee agreement may read. Larger and more sophisticated plaintiffs' law firms are less likely to blindly deduct their costs. For tax advisers who work with contingent fee attorneys, it may be appropriate to reconnoiter.

Lawyers (inside or outside the Ninth Circuit) who are willing to shift to a true gross fee

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arrangement should probably also alter their standard nomenclature. Clients may be used to hearing "Don't worry; we advance all of the costs." But in a gross fee arrangement, the term "advance" is a misnomer, perhaps an expensive misnomer given the IRS's propensity to ferret out loans.

In a gross fee contract, the lawyer is simply paying the costs, regardless of the fact that he may *expect* to get the money back (based on past experience or optimism). In any kind of fee contract, using the "advance" moniker may be a hot-button word that is best avoided.

For law firms considering the gross-versus-net fee dichotomy, it is surely appropriate to do some number crunching about how cases come out, how predictable costs are, and so on. Those calculations could be based on historical cost data in cases of a certain type, on projected costs, and perhaps even on 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.

Market or customer data may also be relevant, including the preferences of clients and the positions of 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 Lawyer 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 using Lawyer B's fee calculation. Is Lawyer A back in the running?

These are not simple questions. What's more, they go to a central feature of the way in which most contingent fee litigation is conducted. ■

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