A Taxing Process

By Robert W. Wood

Contingent fee lawyers often customize their arrangements with clients. Even so, the one-third contingency fee agreement, under which the client pays nothing (not even costs) until there is a recovery, is nearly an industry standard. Indeed, over the past couple of decades, it has become customary for plaintiffs' lawyers to advance all costs and disbursements pursuing a client's case. The client receives the assurance that the client will pay nothing unless there is a recovery.

Such costs are either subtracted solely from the client's share, or taken off the top before the client and lawyer split the remainder 60/40 or two-thirds/one-third. Regardless of how the lawyer's fee contract reads, the tax issues lawyers face over costs in a contingent fee case are surprisingly complex.

Most lawyers assume that if they paid $1,000 for a deposition transcript or court reporter in 2008, they can deduct the cost as a business expense.

It may be years before the case settles and the lawyer recoups these costs. In the meantime, the lawyer records the costs of the case, so lawyer and client can tally them when they divide settlement proceeds. Since such expenses are clearly incurred in business, one would assume they could be currently deducted from the lawyer's income tax. Unfortunately, like so much else in the tax world, it's not that simple.

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Costs as Loans to Clients

If you don't ever want to fight with the IRS, the safest course is to treat costs you pay for clients as loans. The IRS clearly prefers this approach. If you advance costs, but don't deduct them, you treat them as loans to your clients until the case is settled.

You will be paying all the costs of the case currently over several years, and yet not deducting the costs until what could be many years later.

A loan has no tax effect, so the lawyer claims no deduction and the client has no income. Then, when the case settles in three, four, or five years, the lawyer treats his share of the recovery and all costs as income, and deducts those costs in that year.

Can You Deduct the Costs Currently?

Most contingent fee plaintiffs' lawyers are not known for being conservative. That often applies beyond their practices to their tax positions too. If you don't like the IRS treatment of this arrangement as a loan, you can deduct the costs as you pay them. However, the IRS may not agree.

You may want to provide in your fee agreement that your law firm will be responsible for paying all costs and expenses of the case, and that when the case settles, lawyer and client will simply split. The result of such fee sharing (making no reference to costs) is that the lawyer is not being reimbursed by the client.

In fact, the costs are borne by both the client and the lawyer in whatever percentage sharing they agree. The IRS could view this as a partial reimbursement by the client, but so far the tax authorities haven't expressly prohibited the lawyer from deducting the costs in this circumstance.

No one has litigated this issue more than James Boccardo, a plaintiffs' lawyer in San Jose who died in 2003. Boccardo's law firm continues in his name. Boccardo deducted costs as it paid them for clients, and the IRS assessed a deficiency.

Boccardo used a net-fee agreement, under which the firm paid all costs, but was reimbursed out of a recovery. Costs came off the top, with Boccardo and the client thereafter splitting the remainder.

After reviewing Boccardo's net-fee contracts, the Court of Federal Claims held Boccardo could not deduct the costs as he paid them. See *Boccardo v. U.S.*, 12 Claims Court 183 (1987).

Boccardo then hired a tax lawyer, and shifted from net-fee contracts to gross-fee contracts. His gross-fee agreement said nothing about costs, other than that Boccardo would pay them. The agreement simply said that lawyer and client would split the gross recovery.

That meant if no recovery were made, the firm would receive nothing for its services or for its advanced costs. Boccardo then kept deducting costs as he incurred them, but the IRS still disagreed with his deductions, even under his gross-fee contract. Not one to give up, once again Boccardo sued the IRS, this time in Tax Court.

In the second Boccardo case, the Tax Court said Boccardo still expected substantial reimbursement. See *Boccardo v. Commissioner,* TC Memo 1993-224 (1993). Because of that, the Tax Court said it didn't matter whether the law firm had any right to be reimbursed for costs from 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. Even Boccardo's gross-fee agreement expected that, so the Tax Court ruled against Boccardo for a second time.

After his second defeat, Boccardo appealed to the 9th U.S. Circuit Court of Appeals, arguing that his first two tax cases were unfair, levying flatly inappropriate tax results on plaintiffs' lawyers.

The 9th Circuit is sometimes jokingly called the "taxpayer's circuit," and this time the court didn't disappoint. It reversed the Tax Court and held that Boccardo incurred deductible business expenses when it paid client costs. See *Boccardo v. Commissioner,* 56 F. 3rd 1016 (9th Cir. 1995).

The 9th Circuit determined that it was normal business practice for plaintiffs' firms to pay client costs, violating neither state professional standards nor tax law. Thus, there was no problem with these tax deductions.

The IRS internally has signaled that it still views net fee contracts and gross fee contracts as equally bad. That is, the IRS thinks attorneys should treat the costs as loans no matter what.

However, recognizing Boccardo's victory, the IRS directed its staff not to argue gross free contracts in the 9th Circuit. See IRS Field Service Advisory, 1997 WL 33313738 (June 2, 1997). That means all of us in California, and elsewhere in the 9th Circuit, have one leg up on the rest of the country on this issue.

Be Willing to Argue

Notwithstanding the substantial victories Boccardo achieved in his third time in court with the IRS, most taxpayers don't fare too well. In *Hughes & Luce*, 70 F. 3rd 16 (5th Cir. 1995), a large law firm deducted expenses paid on a client's behalf, and lost in both the Tax Court and the 5th Circuit. The IRS audited Hughes & Luce, determining that the firm should have treated disbursements as loans to the client. That meant these expenses were neither deductible in the year paid, nor includable in income in the year received when the case later settled.

Interestingly, this tax case did not involve the deductibility issue, since the law firm decided not to litigate this question. Instead, Hughes & Luce argued that the net reimbursements it received from clients were not includible in its income, since the IRS had already determined that these funds were merely loan repayments. The IRS countered in Tax Court that reimbursements the firm received were attributable to deductions claimed in prior closed tax years.

According to the IRS, that meant they had to be included in the firm's income. The IRS said the tax benefit rule and the general duty of consistency dictated this result. The Tax Court found the tax benefit rule did not apply, but agreed with the IRS that the law firm had to include these amounts in income when recovered anyway under the "duty of consistency," an amorphous tax law concept.

On appeal to the 5th Circuit, Hughes & Luce continued to argue that is was unfair to force it to take these amounts into income. The 5th Circuit reversed the Tax Court, finding it had been incorrect in rejecting the tax benefit rule (so Hughes & Luce still lost its tax case).

The cases in this area suggest that the tax battle over client costs is not over. The vast majority of plaintiffs' law firms (either unwittingly or aggressively) probably do deduct client costs as they pay them, rather than waiting until the case settles.

Yet the majority of cases prove that many plaintiffs' firms lose this tax battle if and when they get audited.

For example, in *Pelton & Gunther, P.C. v. Commissioner,* T.C. Memo 1999-339 (1999), the Tax Court held litigation costs a law firm paid on behalf of its clients (which were later reimbursed) were simply nondeductible loan advancements. That's the general rule, like it or not. Using a Boccardo-style gross fee agreement will improve the odds that you can deduct costs as you incur them. It always pays to consider tax issues when drafting agreements.

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