

Lawyers Who Deduct Client Costs: Revisiting *Boccardo*

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In this article, Wood considers how contingent fee lawyers treat costs and when they can deduct them, explaining the relationship between this issue and the fee agreement. He notes that Sens. Baucus and Durbin have recently entered the fray, but that 15 years after the Ninth Circuit decided *Boccardo*, considerable confusion remains.

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Attorneys, plaintiffs' lawyers in particular, often joust quixotically with the tax law. Plaintiffs' lawyers must take risks in their careers and some may take risky tax positions as well. That was certainly the case with James Boccardo, a well-known plaintiffs' lawyer in California who had multiple tax disputes with the IRS over the nettlesome issue of client costs.

Most lawyers assume that if they pay out \$1,000 for a deposition transcript or court reporter, they can deduct it as a business expense, regardless of their fee agreement with their client. It may be years before the case settles and the lawyer is able to recoup these costs, and no recovery means the lawyer recoups nothing. In the meantime, the lawyer records the amount as an expense of the case so he and the client can later refer to the costs when they divide the proceeds of a settlement or verdict.

Contingent Fee Model

If 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 upfront. But is the lawyer advancing these costs to be collected later out of proceeds or is the lawyer simply undertaking the obligation to pay them? Does it matter how the accounting is done and how the fee agreement reads?

Boccardo's tax cases were the first involving these issues but most people still find it difficult to answer these questions. Apparently, knowledgeable U.S. senators don't know the answers either. On April 29, 2010, Senate Finance Committee Chair Max Baucus, D-Mont., and Senate Democratic Whip Richard J. Durbin of Illinois wrote to Assistant Secretary for Tax Policy Michael Mundaca requesting clarification of the Service's position regarding the client cost tax issue.¹ The case on which they seek additional guidance is the seminal client cost tax deduction case, *Boccardo v. Commissioner*.²

In *Boccardo*, the Ninth Circuit held that attorneys representing clients in contingent fee cases can currently deduct litigation costs paid by the attorneys (such as deposition costs, travel expenses, filing fees, and FedEx bills) as ordinary and necessary business expenses. The key to the deductions is that the attorney and the client must agree to a fee arrangement known as a gross fee contract. A gross fee contract is simply one in which the attorney receives a percentage of any gross recovery, with litigation costs paid by the attorney out of his own percentage.

In other words, the attorney receives no reimbursement of expenses paid upon a recovery. Rather, the split between lawyer and client is not adjusted to account for those costs. The IRS had asserted in *Boccardo* that out-of-pocket expenses incurred by attorneys on behalf of clients are not deductible because the law firm expects reimbursement of the expenses on obtaining a settlement or judgment. This issue has some history.

Serial Dispute

Boccardo's firm originally used a net fee agreement, under which the law firm agreed to pay all costs, and to be reimbursed for its costs only out of a recovery. Under this agreement, the first dollars recovered go to repay costs, and thereafter the lawyer and client divide the rest. After reviewing Boccardo's net fee contract, the Court of Federal Claims held that Boccardo could not deduct the costs as he paid them.³

Boccardo then changed to a gross fee agreement, which included nothing about costs. Boccardo would pay all expenses, and lawyer and client would split any gross recovery. If no recovery was made, the firm would receive nothing for its services and nothing for its costs. Yet the IRS disallowed Boccardo's deductions even under his gross fee contract.

¹Doc 2010-9903, 2010 TNT 86-19.

²56 F.3d 1016 (9th Cir. 1995), Doc 95-5453, 95 TNT 106-7.

³See *Boccardo v. United States*, 12 Claims Court 183 (1987).

In Tax Court this time, the court agreed with the IRS that Boccardo still expected substantial reimbursement.⁴ The Tax Court said it didn't 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. Even Boccardo's gross fee agreement was based on that expectation. Therefore, the Tax Court found that the costs paid by Boccardo and his firm under the gross fee contracts with clients were advances and were not deductible when made.

Boccardo next appealed to the Ninth Circuit, arguing that 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.⁵ The Ninth Circuit considered it normal business practice for plaintiffs' firms to pay client costs. Although the IRS argued that this practice violated state professional standards, the Ninth Circuit found no prohibition on an attorney paying his client's expenses.

The Ninth Circuit concluded that the tax deductions were legitimate. After all, the reason a tax deduction wasn't available on the net fee approach was that the lawyer was essentially making a loan. Under the gross fee arrangement, there was no obligation on the client's part to repay the money expended. If the lawyer was simply shouldering the costs, how could it be a loan?

Continuing Controversy

As Baucus and Durbin point out, *Boccardo* did not end the controversy. The IRS issued a field service advice stating that it would not follow *Boccardo* except in the Ninth Circuit.⁶ Moreover, the Service said it would continue to argue that the gross fee distinction should not affect whether advanced expenses are treated as loans. The senators note that the field service advice does not provide any rationale for declining to follow the Ninth Circuit.

Subsequent Tax Court decisions have suggested that the Tax Court may now be in line with the Ninth Circuit, perhaps agreeing that in any circuit, gross fee contracts are different. In *Pelton & Gunther v. Commissioner*,⁷ the Tax Court pointed out that the law firm's fee, which was paid by the client, was billed at a stated hourly rate, not on a contingency basis. Therefore, payment of the firm's fees and reimbursement of costs were on a dollar-for-dollar basis. The Tax Court ruled that the *Pelton & Gunther* facts were clearly distinguishable from the gross fee contract considered in *Boccardo*.

Similarly, in *Baddell v. Commissioner*,⁸ the Tax Court relied on *Boccardo*, distinguishing its gross fee contract from a case in which clients must reimburse the law firm for costs, regardless of the outcome of the clients' case. The court said that when there is a reimbursement

obligation, it is reasonable to view the costs when paid as a loan. That rationale suggests that the rule must have an inverse. When there is no reimbursement arrangement, how could it be viewed as a loan?

This led Baucus and Durbin to conclude that the IRS position in the field service advice is inconsistent with subsequent Tax Court decisions. These decisions do not challenge the holding or rationale of the *Boccardo* case on gross fee contracts, and appear to accept *Boccardo*'s conclusions. According to the senators, the IRS appears to have based its position on Tax Court decisions that were reviewed and affirmed by the Ninth Circuit. Baucus and Durbin cited *Canelo v. Commissioner*⁹ and *Silverton v. Commissioner*.¹⁰

In both cases, the Ninth Circuit affirmed the rule that litigation costs advanced for contingent fee clients cannot be deducted and were most appropriately treated as loans. The converse — when costs are simply paid and not advanced — must be different. As Senators Baucus and Durbin put it:

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.¹¹

The senators point out repeatedly that the Tax Court has accepted the distinction drawn by the Ninth Circuit between gross fee and other fee arrangements. That results in similarly situated taxpayers inside and outside the Ninth Circuit being treated differently for no good reason.

Drafting Agreements

With most contingent fee agreements, the client is assured no payment is due unless there is a recovery. Costs can be paid under a variety of arrangements: 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 attorneys as the case proceeds and the recovery simply split according to the agreed-on percentages. For plaintiffs' lawyers who don't ever want to fight with the IRS, the safest course is to treat costs as loans (that is, a net-fee arrangement).

Clearly, this is painful, for they are paying the costs over several years, yet not deducting them until what could be many years later. Depending on how the fee agreement reads, it may also be overly timid even outside the Ninth Circuit. After all, a business expense is a business expense, and that makes it worthwhile to explore different ways of tackling this issue.

Suppose you have a standard one-third contingent fee agreement and 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 your outlays. Thereafter, you will receive one-third and

⁴See *Boccardo v. Commissioner*, T.C. Memo. 1993-224 (1993), Doc 93-5922, 93 TNT 111-13.

⁵See *Boccardo*, 56 F.3d at 1020.

⁶See 1997 FSA 442.

⁷T.C. Memo. 1999-339, Doc 1999-32749, 1999 TNT 196-58.

⁸T.C. Memo. 2000-303, Doc 2000-24769, 2000 TNT 188-8.

⁹53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971).

¹⁰T.C. Memo. 1977-198, *aff'd*, 647 F.2d 172 (9th Cir. 1981).

¹¹See *supra* note 1.

the client two-thirds. The costs you are paying during the course of the case are not deductible, but are loans to the client. When the case settles a few years later, you treat the recovery as income and deduct all the costs in that year.¹²

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. Then when the case settles, lawyer and client will simply split the proceeds according to the agreement. One can presumably factor in likely costs in arriving at this split.

The result of such a fee-sharing arrangement (making no reference to costs) is that the lawyer is not being reimbursed. In fact, 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 the lawyer, depending on whether the settlement is sufficient in size to absorb all the costs.

How you draft your fee agreement clearly matters in the Ninth Circuit. According to Baucus and Durbin (and they are correct in my view), it should matter everywhere. It matters for tax treatment and it affects how money is divided. Consider the following examples. 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 basis, with costs 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. 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 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. (Baucus and Durbin want to know why.) 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 35 percent to you and 65 percent to the client, 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 that is reimbursed to you. The \$1,000 gross is split 65 percent to the client and 35 percent to you, 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 bear all costs (example 2), one if the client bears all costs (example 3), and one if you share the burden of costs (example 1). Unlike any of the three examples above, 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.

I have never seen this fourth possibility. 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 agreement 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 of 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?

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 somewhere. 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 percentage sharing in his fee agreement.

Conclusion

I am almost afraid to hazard this guess, but I think most contingent fee lawyers deduct their expenses on an ongoing basis, regardless of how their fee agreement may read. When I say my guess is that most do this, I'm not sure if I mean most by numbers of offices, most by dollars, or both. I would assume that the large and sophisticated plaintiffs' law firms (of which there are now many) do not blindly deduct their costs. In fact, unless the large and sophisticated plaintiffs' firms shift to a gross fee arrangement, which they may view as risky from a financial viewpoint (truly the tax tail wagging the dog), they probably account for client costs as loans.

So perhaps my "most" speculation is overstated or just plain wrong. However, even if I am wrong and if the compliance levels are higher than I think they are, I do know there is considerable confusion over this. Baucus

¹²See *Hughes & Luce, LLP v. Commissioner*, 70 F.3d 16 (5th Cir. 1995), *Doc 95-10693*, 95 TNT 233-2.

and Durbin are not wrong. For tax advisers who work with contingent fee attorneys, it would be appropriate to reconnoiter.

Lawyers (inside or outside the Ninth Circuit) who are willing to shift to a true gross fee 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, "advance" is a misnomer, perhaps an expensive misnomer given the Service's propensities to ferret out loans. In a gross fee contract, the lawyer is simply *paying* the costs, even though the lawyer may (based on past experience or optimism) expect to get the money back. Even in any kind of fee contract, the "advance" moniker may be a hot-button word best avoided. Saying you advance costs sounds overly loanlike.

For law firms considering the gross versus net fee dichotomy, it is surely appropriate to do some number crunching on how cases really come out, how predictable costs are, and so on. Presumably those calculations

should be based on historical cost data in some cases, projected costs, and perhaps even the nature of particular kinds of defendants. Perhaps costs might be higher in a suit against General Motors than in a suit against Joe's Used Cars.

But surely market or customer data would also 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. Is Lawyer A back in the soup?

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

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