9th Circuit lawyers get better tax breaks

By Robert W. Wood

Many 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? But is the lawyer *advancing* these costs or actually paying them?

Under most contingent fee agreements, the client pays nothing (not even costs) unless there is a recovery. Costs are subtracted solely from the client's share or are taken off the top before the client and lawyer split the remainder. For plaintiff lawyers who don't want to fight with the Internal Revenue Service, the safest course is to treat costs they pay for clients as loans. This is painful, for they are paying the costs currently but not deducting them until what could be many years later.

The leading case on the issue is *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), but there were actually three separate cases. In the final *Boccardo* case, the 9th U.S. Circuit Court of Appeals held that attorneys could currently deduct costs if they had a gross fee contract under which the attorney receives a percentage of the gross recovery, with costs paid by the attorney taken solely out of the attorney's percentage. Any other fee agreement is a loan of the costs.

Under a gross fee contract, the attorney obviously receives no reimbursement of expenses if there is no recovery. Even with a recovery, the split between lawyer and client is not adjusted for costs. The IRS has made clear that it will follow this rule *only* in the 9th Circuit.

Elsewhere, *even with gross fee contracts*, lawyers cannot deduct costs. The most recent tax case litigating this tired issue is *Humphrey, Farrington & McClain, P.C. v. Commissioner*, T.C. Memo. 2013-23. This firm had three kinds of fee arrangements: net fee, gross fee and class action. All were on a contingent fee basis. This tax court case was in Missouri so was not controlled by 9th Circuit tax law, and that was telling.

Arguments with the IRS or the courts that lawyers are truly bearing an expense are tough to win and almost impossible outside the 9th Circuit. Still, Humphrey Farrington argued that their percentage success rates showed they were *really* bearing the costs. However, the tax court ruled that even a 36 percent chance the firm would get reimbursed was enough to deny the deductions. The firm screened cases and clients and had a decent probability of winning.

As its last argument, Humphrey Farrington argued that in class-action cases costs required court approval, thus further lowering the probability of reimbursement. The tax court noted that class counsel is entitled to reimbursement of all reasonable out-of-pocket expenses under the common fund doctrine and that didn't change the tax result: no deduction.

Lawyers in the 9th Circuit have a unique opportunity to get a better tax result than lawyers in other circuits. But to do so, they must have a gross fee contract. Strictly from a tax perspective, a fee agreement should state that the law firm *pays* (not advances) all costs and expenses. When the case resolves, lawyer and client simply split according to agreed percentages.

The result of a fee sharing agreement with no reference to costs is that the costs are borne entirely by the lawyer. One can presumably factor in likely costs in arriving at the percentage split. How you draft a fee agreement impacts tax treatment and take-home pay. Consider these examples.

Example 1: You take a case on a 35 percent contingency, with costs subtracted from the gross recovery. You recover $1,000 and costs equal $100. You subtract the $100, which repays you for the $100 you advanced. 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, and your agreement (in gross) is merely to divide the proceeds. You bear all costs. If you recover $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 9th Circuit, you can deduct the $100 when you paid it, but must then take the entire $350 into income when the case settles. Your net is $250.

Example 3: 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, and you can't deduct them when you advance them. 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 receives $550. Your net is $350.

Example 4: You are still on a 35 percent contingency but have three rate structures: (a) if you will bear all the costs (as in Example 2); (b) if the client bears all costs (as in Example 3); and (c) if you share costs (as in Example 1). Your fee agreement provides that the client can elect one of the following three choices: deducting costs off the top (then the fee is 35 percent; ignoring costs (but the fee is 40 percent); or costs are deducted entirely from the client's 70 percent share (the fee is 30 percent). One could get even more creative. An agreement might allow the lawyer (not the client) to select from the menu. Alternatively, the formula with the highest or lowest net to the lawyer could apply automatically.

Moreover, a fee agreement might call for a gross fee of 40 percent, but provide in no event will the client's share be less than under a net fee at 35 percent. It is unclear if the IRS would perceive a loan (potentially preventing a current deduction) with this kind of savings clause, whether or not it is triggered.

The usual net fee agreement results in costs being loans and not deductible until the ultimate resolution of the case. Some contingent fee lawyers may continue to deduct their expenses regardless of their fee agreement. They may face unwinnable tax positions even inside the 9th Circuit.

Lawyers and law firms should review their contingent fee agreements and consider if a change is appropriate. Changes in fee agreement could be made retroactively for pending but still active cases under previously executed contingent fee agreements. Of course, new cases could also be under the new agreement.

Marketing and other documents could be altered too. Unlike lawyers in the rest of the country, lawyers in the 9th Circuit can deduct costs when paid if they are willing to shift to a gross fee agreement. Those who do should alter their standard terminology too. Given the IRS propensity to sniff out loans, continuing to refer to "advancing costs" could be an expensive misnomer.

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