Which Client Costs Are Tax Deductible?

By Robert W. Wood

Most contingent fee lawyers cannot get a client to pay out-of-pocket costs on an ongoing basis, so the lawyer must pay them. But is the lawyer *advancing* the costs (to be collected later upon settlement) or simply undertaking the obligation to pay them? Does it matter how the accounting is done and how the fee agreement is worded?

Yes, it matters, and it is surprising that much of the plaintiff's bar doesn't know. Most plaintiff lawyers assume that when they pay $1,000 for a deposition transcript or court reporter, they can deduct it as a business expense. After all, the expense is current and it may be years before the case settles. Of course, there's no guarantee the case will *ever* pay. In the meantime, the lawyer records it as an expense to be tallied before distributing settlement proceeds.

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Understandably, lawyers want to deduct these costs currently. Deposition costs, travel, FedEx, copies, filing fees, process servers: it all adds up. Yet the Internal Revenue Service often attacks these deductions and usually wins. Why?

Most people find it difficult to answer, even knowledgeable U.S. senators involved in passing tax laws. On April 29, 2010, Senators Max Baucus and Dick Durbin wrote the Treasury Department requesting clarification of the IRS's position regarding this issue. The specific case on which they requested guidance is the seminal client-cost-tax-deduction case, *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995).

Here, the 9th Circuit ruled that attorneys in contingent fee cases can deduct costs as ordinary and necessary business expenses if they have a "gross-fee contract." Under a gross-fee contract, the attorney receives a percentage of any gross recovery, with costs paid by the attorney out of his own percentage. This issue has some history.

James Boccardo's firm originally used a net-fee agreement, under which the law firm agreed to pay all costs, to be reimbursed only out of a recovery. Any recovery went first to repay costs, with lawyer and client dividing the rest. The Court of Federal Claims ruled Boccardo could not deduct costs as he paid them, since he was effectively loaning the money to his client.

Boccardo then changed to a gross-fee agreement, which said nothing about costs. Boccardo would pay all costs, and lawyer and client would split any gross recovery. The IRS still denied Boccardo's deductions. In Tax Court this time, the court agreed with the IRS, ruling that the firm had an *expectation* of generating a fee *at least* sufficient to cover the costs. Thus, the Tax Court again found the costs were nondeductible loans. Boccardo then appealed to the 9th Circuit. Fortunately, it reversed, holding that Boccardo incurred deductible business expenses when paying client costs.

Although the 9th Circuit noted it was normal business practice for plaintiffs' firms to pay client costs, its decision did not end the controversy. In fact, the IRS told its auditors, IRS lawyers, and other IRS personnel (in a Field Service Advice) that it would not follow *Boccardo* except in the 9th Circuit (where it must). Ever since then, the IRS has continued to push back when lawyers deduct client costs.

Yet Tax Court decisions suggest that it agrees with the 9th Circuit. This led Baucus and Durbin to conclude that the IRS position is inconsistent with subsequent Tax Court decisions that do not challenge the holding or rationale of *Boccardo*. After more than 10 years, something should give. According to Baucus and Durbin, the IRS appears to have based its position (that expenses are nondeductible and must be treated as loans) on Tax Court decisions that were reviewed and affirmed by the 9th Circuit. Nationwide, the Tax Court has accepted the distinction between gross-fee and net fee agreements, yet the IRS only agrees with this for cases in the 9th Circuit.

With most contingent fee agreements, the client is assured he will pay nothing (not even costs) unless there is a recovery. Costs can be subtracted solely from the client's share, taken off the top before the client and lawyer split the remainder, or simply paid by the attorneys and not accounted for later. For plaintiff lawyers who don't ever want to fight with the IRS, the safest course is for them to treat costs as loans in a net-fee arrangement.

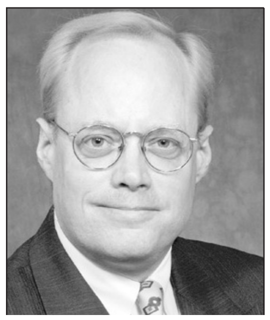
This is painful for lawyers are paying costs over several years, yet not deducting them until what could be many years later. Depending on the lawyer's fee agreement, it may also be overly timid even outside the 9th Circuit.

Suppose you have a standard one-third contingent fee agreement with the lawyer "advancing" all costs. Assume the fee agreement states that when the case is finally resolved, the costs will come off the top, reimbursing the lawyer for all outlays. Thereafter, lawyer and client will split one-third/two-thirds. The costs the lawyer pays during the course of the case are non-deductible loans to the client. Then, when the case settles years later, the lawyer treats the recovery as income and deducts all the costs at that time.

Strictly from a tax perspective, lawyers should have a fee agreement stating that the law firm is responsible for "paying" (not advancing) all costs and expenses of the case. Then when the case settles, the lawyer and client will simply split one-third/two-thirds, 60/40 or 50/50. One can factor in likely costs for arriving at this split.

The result of a fee sharing making no reference to costs is that the client is not reimbursing the lawyer. 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 costs.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.



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