

Why Can't Lawyers Deduct Client Costs?

By Robert W. Wood

For some years now there's been confusion over whether contingent fee lawyers can claim tax deductions for the costs they pay in prosecuting their cases. Exactly what costs are allowed? There is even confusion over why there's confusion and why the lawyer's fee agreement is important.

In some ways, the confusion is counterintuitive.

After all, contingent fee lawyers are in business. Travel, court costs, depositions, expert fees, and many other expenses can total hundreds of thousands of dollars. Some lawyers and firms even have *millions* invested in these costs. Most clients will not or cannot pay costs as they are incurred.

Typically, contingent fee lawyers must pay the costs, and most use the word "advance." The lawyer realistically cannot require the client to front the costs as the case progresses, so the lawyer must do it. Otherwise, the client will go to another lawyer who will. Costs can grow very large and can span a number of years before there's a recovery (if there is ever a recovery).

Can't lawyers deduct these business expenses? Yes and no, but mostly no. There's a split in the circuits, with our own 9th U.S. Circuit Court of Appeals holding that the lawyer can deduct costs only under a "gross" contingent fee agreement that does not account for costs (so the lawyer is never reimbursed for the costs he's covering). The 9th Circuit includes Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington, and the territories of Guam and the Northern Mariana Islands.

Everywhere else, no tax deduction is allowed until the conclusion of the case, no matter how the fee agreement reads and no matter how great the expenses may grow to be. Recently, this issue has become even more controversial. A number of senators tried to persuade the Internal Revenue Service that the 9th Circuit rule allowing some deductions should apply nationwide.

Conversely, a number of other senators have expressed outrage that anyone would think of allowing plaintiffs' lawyers to deduct costs, in the 9th Circuit or anywhere else. This "outrage" camp knows they are stuck with the rule in the 9th Circuit. They want to draw a line in the sand and not allow what they see as the 9th Circuit's knee-jerk-lawyer-favoring plague to spread eastward. Allowing the 9th Circuit rule elsewhere will only foment even more litigation, they contend. A pending bill would allow lawyers nationwide with gross fee contracts to deduct costs, the current 9th Circuit rule.

The gross versus net contract issue is simple, but most lawyers don't understand it. Usually, a contingent fee agreement will provide that the lawyer advances costs on behalf of the client. Then, when and if there's a recovery from the defendant, the costs are first reimbursed to the lawyer. Then lawyer and client split (in specified percentages) the balance.



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This is a "net" fee agreement, though there are certainly variations.

In contrast, a gross fee contract says the lawyer "pays" the costs, is never reimbursed, and the client and lawyer split the recovery according to whatever percentage split suits them. The lawyer may well (and frankly should) factor in the likely costs in determining whether to charge 33 percent, 40 percent or more, but costs are not *separately* accounted for.

The IRS believes that net fee agreements truly call for the lawyer to only loan the costs. Comparing the two arrangements, it is easy to see why the gross fee contract involves no "loan" element, and why the net fee contract arguably does. When the lawyer pays court costs, filing fees, travel expenses and more, the lawyer usually assumes he will be paid back off the top at the conclusion of the case, before he gets his cut of the remaining recovery.

Of course, there is no guaranty the lawyer will recover anything. There

are big risks. In this sense, one can argue lawyers are treated worse than other business people. Most businesses can deduct business expenses as they are paid. Yet the IRS loan view makes some sense, and the courts have agreed. Only a gross fee agreement involves no loan, and then (reliably) only in the 9th Circuit.

The prospects of legislation passing to address this seem to be waning. For plaintiff lawyers here in the 9th Circuit, it seems crazy (to me as a tax lawyer) not to at least consider this issue. This is particularly so since likely costs can be taken into account by setting a percentage for the contingent fees. Lawyers should crunch some numbers, consider the typical duration of their cases, and evaluate converting to a gross fee contract. It may not disadvantage the client and it may be vastly more tax efficient for the lawyer.

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