PERSPECTIVE

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Contingency Fee Lawyers Dodge Bullet In Tax Reform

By Robert W. Wood

It sure looked as if contingent fee lawyers in California and the rest of the 9th Circuit were going to be prejudiced by the recently passed massive federal tax bill. For years, contingent fee lawyers in the 9th Circuit had an easier time with the IRS than lawyers elsewhere when it came to tax deductions for client costs. In the huge year-end tax reform bill, Congress was expected to conform the rules in favor of the IRS.

But as happens in the sausage-making of tax reform, something happened at the last minute. The provision was *not* included in the final version of the bill after all. That means lawyers in the 9th Circuit still have the benefit of a more favorable tax rule. But if you want to take advantage of it, you have to be careful.

Many lawyers assume that if they pay for a deposition transcript, a court reporter, or travel expenses for a hearing, they can immediately deduct these costs as business expenses on their taxes. The same for expert witness fees. These seem like business expenses for lawyers.

However, who really bears the impact of these expenses, lawyer or client, and when? Business expenses have to be ordinary and necessary to be tax deductible. But the IRS has always had the view that lawyers cannot deduct these costs if the lawyers effectively might get reimbursed for the costs later, at the conclusion of the case.

Under most contingent fee agreements, the client pays nothing (not even costs) unless there is a recovery. Under some fee agreements, costs are subtracted from the client's share. In others, costs are taken off the top, before the client and lawyer split the remainder.

In the meantime, *someone* has to pay the costs up front as they are incurred. Usually, that is the lawyer. When lawyers pay these costs, they want to write them off, but the IRS has battled to prevent these deductions.

The IRS general rule is that contingent fee lawyers who pay costs for clients are making *loans* to the client. You can't deduct loans. That means paying the costs currently, but not deducting them on your taxes until what could be many years later when the case finally resolves. Only at *that* point could you write them off.

There was — and still is — a way out in California, and throughout the 9th Circuit, thanks to a tax case called *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995). The 9th U.S. Circuit Court of Appeals held that attorneys could currently deduct costs if they had a gross fee contract. A gross fee contract involves the attorney receiving a percentage of the gross recovery, with costs paid by the attorney taken solely out of the attorney's percentage.

Any *other* type of fee agreement is a loan of the costs. Some lawyers in California and other states in the 9th Circuit go to great pains to make sure they qualify. Some lawyers are less careful, but still hope they get some protection from *Boccardo*. The IRS has long been unhappy over this issue. In fact, the IRS issued a Field Service Advice, 1997 FSA 442 (basically a memo to IRS personnel) stating that it would not follow *Boccardo* except in the 9th Circuit.

But the IRS has long wanted uniform tax treatment. The IRS wanted Congress to bring the 9th Circuit contingent fee lawyers into compliance with everyone else. But the fact that the tax bill did not include the IRS fix means lawyers in California can still have gross fee contracts if they want.

That gives 9th Circuit lawyers a choice. With the survival of the tax-advantaged gross fee contingent fee agreement in the 9th Circuit, should lawyers adopt them? That is not just a tax question. It involves some economics and perhaps even some marketing too. How you draft a fee agreement to take costs into account impacts lawyer 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. 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. 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. 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.

Lawyers should consider anticipated costs, and should consider what kind of fee agreement they want to use. In the 9th Circuit, that decision up to now has been heavily influenced by taxes. But that may change, and soon.

Plaintiffs' lawyers in most of the country won't feel the burn, for they have had this rule for years now. Plaintiffs' lawyers in the 9th Circuit, though, may have a rude awakening. The House version of tax reform says: "No deduction shall be allowed … for any expense paid or incurred in the course of the trade or business of practicing law, and resulting from a case for which the taxpayer is compensated primarily on a contingent basis, until such time as such contingency is resolved."

The Senate proposal includes the same, explaining that it "denies attorneys an otherwise-allowable deduction for litigation costs paid under arrangements that are primarily on a contingent fee basis until the contingency ends." Estimates say that this provision will save an estimated $500 million over 10 years.

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