

## Exploring Contingent Fee Tax Advice

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This discussion is not legal advice.

In this article, Wood and Board discuss contingent fees in the context of Circular 230 and *Ridgely*, and they explore how to approach several contingent fee scenarios.

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Can you charge contingent fees in tax matters? As with so many tax questions, the answer can depend. It should not be surprising that clients ask for this. Why *wouldn't* clients want legal or accounting fees tied directly to the tax result we can obtain for them?

After all, contingent legal fees are the norm in personal injury cases. Increasingly, they are the norm in employment lawsuits, too. Indeed, the types of cases in which contingent fees are

common are expanding widely. These days, even large law firms do this kind of work in intellectual property and other cases.

It is also common with property tax appeals. Who hasn't received a flyer in the mail from a company that says it will lower your property tax bill? Pay nothing upfront, just a percentage of the tax savings. Against this background, it may sound almost un-American to ask what contingent fees are allowed in the tax arena. Allowed by whom?

Yet ask it we should, for the IRS has pushed hard to regulate in this area. The courts are involved, too, which makes this a difficult and controversial subject to review. First, let's examine the authority of the IRS because that turns out to be a key component.

The IRS has the authority to regulate the practice of taxpayer representatives before the IRS.<sup>1</sup> In Circular 230,<sup>2</sup> the IRS says that a practitioner cannot charge a contingent fee for services rendered in connection with *any* matter before the IRS.<sup>3</sup> But Circular 230 recognizes three exceptions:

1. Under section 10.27(b)(2), a contingent fee may be charged in connection with the IRS's examination of or challenge to:
  - a. an original tax return; or
  - b. an amended return or claim for refund or credit when the amended return or claim for refund or credit was

<sup>1</sup> 31 U.S.C. section 330(a)(1). The IRS has argued that there is an alternative grant of authority in 31 U.S.C. section 330(e), which refers to the regulation of written advice "with respect to any entity, transaction plan or arrangement, or other plan or arrangement, which is of a type which the Secretary determines as having a potential for tax avoidance or evasion." The IRS's position was rejected in *Sexton v. Hawkins*, 2:13-cv-00893-RFB-VCF (D. Nev. 2017).

<sup>2</sup> 31 CFR, Subtitle A, Part 10 (Circular 230).

<sup>3</sup> Circular 230, section 10.27(b)(1).

filed within 120 days of the taxpayer's receiving a written notice of the examination of, or a written challenge to, the original tax return.<sup>4</sup>

2. Under section 10.27(b)(3), a contingent fee may be charged in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS.

3. Under section 10.27(b)(4), a contingent fee may be charged for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

If you want to keep the IRS happy, you could abide by these rules. However, in *Ridgely*,<sup>5</sup> a federal district court held that the IRS overstepped its authority in at least some parts of section 10.27(b). After the D.C. Circuit's decision in *Loving*,<sup>6</sup> the court in *Ridgely* said that Circular 230 could regulate only "practice" before the IRS. The court then held that a CPA's preparation of an ordinary refund claim was not practice.

The district court focused on the text of Circular 230's authorizing statute, which uses the term "representative." The court reasoned that the preparation of an ordinary refund claim *before* the practitioner actually became a representative of the taxpayer "before the IRS" would not be practice before the IRS. The court rejected the IRS's argument that it had authority to regulate simply based on *Ridgely*'s status as a CPA.

The *Ridgely* court found that a CPA who prepares and files an ordinary refund claim — before holding any power of attorney — is vested with no legal authority to act on behalf of the taxpayer. Therefore, she is not a representative, which means that preparing the refund claim is not practice before the IRS.

The court's order enjoining the IRS from enforcing section 10.27(b) applies to situations in which the preparation and filing of an ordinary

refund claim precedes the start of any examination or adjudication of the refund claim by the IRS, and the practitioner has not become the client's legal representative before the IRS.

Circular 230 defines "contingent fee" as any fee that is based, in whole or in part, on whether a position taken on a tax return or other filing avoids challenge by the IRS or is sustained either by the IRS or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return or on a percentage of the taxes saved or otherwise depends on the specific tax result attained.<sup>7</sup>

A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee if a position taken on a tax return or other filing is challenged by the IRS or is not sustained. This extends to reimbursement pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.<sup>8</sup>

In the wake of *Ridgely*, what is fair game? To some extent, it depends on whom you ask. The following examples explore some practical, if not real-life, issues.

### Contingent Fee Examples

**Example 1:** *Abe*. Suppose the IRS has notified Abe that he owes \$1 million in tax. Abe wants you to negotiate an offer in compromise for him for less. He offers you a fee equal to 30 percent of any tax savings you can achieve for him. Can you do it?

Yes, it would seem so under section 10.27(b)(2), if your services were rendered in connection with the IRS's examination of, or challenge to, Abe's original return or an amended return. Most likely, the \$1 million tax liability grows out of an IRS examination of or challenge to a filed return. If not, presumably the OIC will not move forward without bringing the relevant tax issues to the IRS's attention. That could trigger some kind of examination or challenge.

But what if the liability is now established, and this is just a collection matter? Here, too, a

<sup>4</sup>Rev. Proc. 2008-43, 2008-30 C.B. 186, clarifies that this includes an amended return or claim for refund or credit filed *before* the taxpayer received a written notice that the IRS was planning to examine or challenge the original tax return.

<sup>5</sup>*Ridgely v. Lew*, 55 F. Supp.3d 89 (D.D.C. 2014).

<sup>6</sup>*Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014).

<sup>7</sup>Circular 230, section 10.27(c)(1).

<sup>8</sup>*Id.*

contingent fee would seem to be OK. After all, your fee would not appear to depend on “whether or not a position taken on a tax return or other filing avoids challenge . . . or is sustained” — so it would not seem to be a contingent fee under section 10.27(c)(1). In that case, section 10.27(b)(1)’s prohibition of contingent fees would not apply in the first place.

**Example 2a: Billy.** Billy tells you he wants to sue the IRS for a refund. He wants you to handle it on a contingent fee basis. He filed his 2015 return reporting ordinary income on a big contract disposition. Later, he filed an amended 2015 return, claiming that it was capital gain. He didn’t get his refund, and now he wants to sue. Can you do it for a contingent fee?

Yes, that seems fine. Billy is suing, so you will be rendering services in connection with a judicial proceeding arising under the IRC. Section 10.27(b)(4) specifically authorizes charging a contingent fee for such services.

Assuming that Billy’s claim on his amended return was actually denied (rather than simply overlooked), it would seem to have been “challenged” by the IRS. So the contingent fee should also be permitted under section 10.27(b)(2)(ii) if it was filed within 120 days after Billy received written notice of the IRS challenge.

**Example 2b: Billy.** Let’s alter the question slightly. What if Billy comes to you *before* he files his amended return for 2015? With this temporal change, can you represent him on the amended return and on any ensuing refund fight for a contingent fee?

At least partially, yes. If the matter goes to court, you can charge a contingent fee for your services under section 10.27(b)(4). If the matter stays *out* of court, you have to deal with section 10.27(b)(2)(ii). This says a lawyer cannot charge a contingent fee for services rendered in connection with the preparation of an amended return — only in connection with an IRS examination of, or challenge to, the amended return.<sup>9</sup>

<sup>9</sup> If the IRS had challenged Billy’s original return, you could argue that you may charge a contingent fee to prepare the amended return under section 10.27(b)(2)(i). However, it appears that the amended return would have to be filed within the 120-day period set forth in section 10.27(b)(2)(ii).

This is where *Ridgely* could come in. Under *Ridgely*, preparing an amended return, by itself, is not practice before the IRS. Hence, section 10.27(b)(1)’s prohibition of contingent fees should not apply. Under *Ridgely*, the practitioner should not need to rely on the exception in section 10.27(b)(2), which applies only if the IRS examines or challenges a return.

**Example 3: Cathy.** Cathy filed her 2014 return and was promptly audited by the IRS. She received a 90-day letter and wants to file in Tax Court. There is \$1 million in dispute, but she wants you to handle it for a contingent fee. She proposes to pay you 30 percent of any money you save her. So if the \$1 million tax bill sticks, you earn no fee. If you eliminate the entire \$1 million in additional tax, you earn \$300,000. Can you do this?

Yes. Here, too, there is no need to invoke *Ridgely*. The contingent fee is permitted under section 10.27(b)(2)(i) because your services *will* be rendered in connection with the IRS’s challenge to Cathy’s original return. The contingent fee is also permitted under section 10.27(b)(4) because your services will be rendered in connection with a judicial proceeding under the code.

Even so, it is worth noting that section 10.27(a) says that a practitioner may not charge an “unconscionable fee” in connection with any matter before the IRS. Could that rule apply? It is hard to see how in this example. Assuming there is a real dispute between Cathy and the IRS, a 30 percent contingent fee does not seem unconscionable. However, depending on the size and nature of the dispute, and the size of the fee, the overall unconscionable fee ceiling might be debated in some cases.

**Example 4: Dennis.** Dennis’s 2013 tax return was audited. His accountant represented him, but eventually, the IRS issued a 30-day letter. It proposes additional taxes of \$1 million. Dennis asks you to represent him in a protest and thereafter at IRS Appeals on a contingent fee basis. He offers you 50 percent of all the money you save him. Can you do it?

Yes. Once again, the contingent fee should be permitted under section 10.27(b)(2)(i) — you are being engaged in connection with the IRS’s challenge to Dennis’s original return. However, is a 50 percent contingent fee unconscionable these

days? If so, section 10.27(a) will be a problem. Whether 50 percent shocks the conscience may depend on the type of case, the degree of difficulty, the size of the case, and what rates are prevailing in the community.

**Example 5a:** *Eli*. Eli has not yet filed his 2016 tax return. He won a large verdict in some family trust litigation and collected \$5 million in 2016. He had to pay his lawyer \$2 million and has \$3 million left. He wants you to represent him on a contingent fee basis against the IRS. He says it was really like an inheritance, so it shouldn't be subject to income tax. Eli says he doesn't plan to treat his verdict as income, but he wants to lock you up as his lawyer before filing his income tax return. He offers you 10 percent of the \$3 million to protect the rest from the IRS in any audit or in court. Can you do this?

This one is a bit tougher to answer. Under the agreement, you do not need to reimburse Eli in *cash* for any of the \$300,000 advance fee, even if the return position is challenged or if it is not sustained. So one might argue that there is no contingent fee under section 10.27(c)(1).

However, the definition in section 10.27(c)(1) says that it reaches:

any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect. [Emphasis added.]

Your advance fee would plainly be covered should you agree to pay Eli's legal expenses (for example, services of another tax lawyer) if the position is challenged. The IRS might argue that Eli's actual arrangement is an indemnity, in which the attorney agrees to reimburse the client *in kind* (services). Arguably, this would be an "arrangement with similar effect" to the cash reimbursement mentioned above.

That would make Eli's payment of the \$300,000 a contingent fee. Notably, the stated facts suggest that you did *not* provide any advice concerning the return position — you just listened to Eli describe it. However, by agreeing to the

deal, you might be signaling that you find the risk acceptably low. Eli might think this is advice regarding his own risk!

Assuming, however, that you give no advice at this point, you are receiving a large fee for which you may not have to provide *any* services. If so, is the \$300,000 payment unconscionable under section 10.27(a)? Maybe. If Eli's position is very strong, so that there is unlikely to be a challenge and it will be easily resolved in any event, your expected cost of performing might be only, say, \$25,000. Charging \$300,000 to assume that liability might be unconscionable under section 10.27(a).

Remember, the default rule under section 10.27(b)(1) is that the lawyer cannot charge a contingent fee in connection with services in any matter before the IRS. The exception in section 10.27(b)(2) is for fees charged for services rendered in connection with an exam or challenge. If there is no exam or challenge, the payment will not be for services rendered.

So the IRS might contend that the default rule of section 10.27(b)(1) still applies. Whether *Ridgely* would apply is unclear. The agreement relates to your *potential* representation of Eli before the IRS. But if the exam or challenge never materializes, there will be no actual matter before the IRS. Can the IRS regulate the terms of an agreement to represent a taxpayer before the IRS if the representation never happens?

It would be safer to have Eli pay a reasonable retainer to keep you available until the IRS sends him a notice of exam or challenge. Once the notice is received, you and Eli should be able to enter into the fee arrangement in connection with your rendering actual services as part of an actual representation.

**Example 5b:** *Eli*. Let's assume the same facts, but this time Eli has filed his return before coming to see you. Can you do it now? This is better. The fact that the tax return has been filed indicates that you did not render any advice regarding the preparation of the return, which is good.

The payment still seems to be for services you *might* have to render if there is an exam or challenge. Again, this fee could be unconscionable under section 10.27(a). And if there is no exam or challenge, the payment will also not be for services rendered as described in section

10.27(b)(2). So the IRS might again contend that the default rule of section 10.27(b)(1) applies — no contingent fee is permitted. Whether *Ridgely* would apply is unclear.

**Example 5c:** *Eli*. Same facts again, but this time Eli has filed his return and has been contacted for an audit before he comes to you. Can you do it now?

Yes, this seems clear. Services in connection with an exam or challenge to an original return are squarely within section 10.27(b)(2)(i).

**Example 5d:** *Eli*. Same facts again, but this time Eli has a 90-day letter, so he needs to head to Tax Court. Can you do it now? Yes, under either section 10.27(b)(2)(i) or section 10.27(b)(4) (judicial proceedings).

**Example 6:** *Frank*. Frank asks you to help him form and qualify a charity with the IRS. He offers you a percentage of the money he collects from his family and from the public. Your fee for helping form and qualify the charity, and to render ongoing tax advice as needed, will be 4 percent of the annual receipts. Can you do this?

It seems doubtful. If you are going to be interacting with the IRS to help get Frank's charity approved, you will be representing Frank and his charity in a matter before the IRS. To deal directly with the IRS, you will need to file a power of attorney using Form 2848. The form will require you to represent, "I am subject to regulations contained in Circular 230 (31 CFR, Subtitle A, Part 10), as amended, governing practice before the Internal Revenue Service." That will make it awkward to invoke *Ridgely*.

You will be paid for your tax-related services only if they are successful enough to get (and keep) the annual receipts flowing. Although other factors will affect the level of receipts, your efforts to qualify the charity seem to be fundamental to the enterprise. Accordingly, payment for your services appears to depend on whether a position taken on a tax return "or other filing" (think Form 1023) avoids challenge or is sustained. That could make your 4 percent a contingent fee under section 10.27(c)(1).

The base line rule of section 10.27(b)(1) is that a practitioner may not charge a contingent fee in connection with "any matter" before the IRS. There has been no notice of an examination or challenge, much less a judicial proceeding, so the

exceptions in section 10.27(b)(2) and (b)(4) cannot apply. Accordingly, it appears that you may not charge a contingent fee.

**Example 7a:** *Gus*. Gus has a company and says he read about the IRS tax credit for research and development. He asks you to look at his books and tax returns, and you agree he might qualify. He wants you to help him amend his returns and claim the credit in exchange for 30 percent of any refunds. Can you do it?

It is hard to see how you can charge a contingent fee under Circular 230 on these facts. The exceptions in section 10.27(b)(2) apply only if there has been an examination of, or challenge to, a return. Neither is present here.

If you are willing to rely on *Ridgely*, however, you could contend that your preparation of these original refund claims does not amount to representing Gus's company in a matter before the IRS. In that case, section 10.27(b)(1)'s prohibition of contingent fees should not apply.

**Example 7b:** *Gus*. Same situation, but Gus says he is willing to pay a flat fee of \$5,000 for you to help him prepare the papers and claim the credit. Then, if he gets the refund, you get 10 percent. Thereafter, if there's any later audit or tax dispute, you will handle the IRS audit and IRS appeal if needed for 20 percent of the amount at stake. Can you do it?

Putting aside *Ridgely*, it is still hard to see how. After all, a portion of the fee arrangement (10 percent of any refund) is contingent on obtaining a specific result relating to a position that the company will take on a return. That seems to make it a contingent fee under section 10.27(c)(1). There has not been any IRS examination or challenge, so the section 10.27(b)(2) exceptions do not apply.

By itself, charging a flat fee for representing Gus in the audit and appeal equal to 20 percent of the amount *at issue* does not involve a contingent fee. After all, the fee is not contingent on obtaining any specific result.

**Example 7c:** *Gus*. Same situation, but this time Gus will pay you 15 percent of the credits that you *identify* for him to claim, rather than any current refunds. Gus may be able to use the credits currently, or in future years if his business has no current tax liability. Meanwhile, your fee is based

purely on the credits you can support based on Gus's records.

Assuming the agreement has no provision for a refund in case the identified credits are ultimately denied, the arrangement arguably does not involve a contingent fee as defined in section 10.27(c)(1). Consequently, the prohibition in section 10.27(b)(1) should not apply.

But what if Gus expects you to pay him back should the IRS deny the credits down the road? You might even be willing to do so in the interest of staying on good terms with Gus. However, what if you issue refunds of this sort frequently, even as a matter of course? If you do it too often, the IRS may suspect that your "no refunds" policy is really a disguise for an undocumented contingent fee structure. At that point, you may just be better off relying on *Ridgely*.

**Example 8: Harry.** Harry is a real estate developer and wants to claim a large conservation easement deduction. He says his CPA is preparing all the paperwork and will file the return. He wants you to defend him in the inevitable audit and controversy. He offers you 15 percent of the dollar amount of the deduction ultimately obtained to represent him up to and including in a Tax Court trial. Can you do it?

If Harry had already received a notice of exam or challenge, your services would be covered by section 10.27(b)(2)(i). A Tax Court trial would also be covered by section 10.27(b)(5). So in either case, it should be fine to charge a contingent fee.

Here, though, Harry has not yet received any notice from the IRS. However, it appears that you will not be providing any services under the arrangement until Harry *does* receive a notice. In that case, section 10.27(b)(2)(i) should apply.

What if, contrary to all expectation, the IRS never examines or challenges the refund claims? Do you still get 15 percent of the refund, even though you didn't have to do any work? If so, there could be an unconscionable fee issue under section 10.27(a).

### Conclusion

What is a business-minded tax professional to do about all of this? One answer is to stick to hourly rates and just say no to prospective clients who want to wheel and deal. Yet the issues can creep up on you, from partial contingent fees and

bonuses to clients paying hourly who eventually run out of money or balk at paying your bills. Even if you are not asked outright to take a 100 percent contingency, you might find yourself scratching your head about these issues.

As you slog away at your work, someone (your colleague, client, or even that little voice in your head) may ask, "Does the IRS really *care*? And how will they *know*?" We can't answer the latter question. But as for whether the IRS cares: It would seem so.

The Office of Professional Responsibility has acknowledged that Circular 230 needs to be revised to address the invalidation of the registered return preparer program in *Loving*.<sup>10</sup> But there is still no indication that OPR believes that the contingent fee rules need to be cut back to take account of *Ridgely*. Perhaps the IRS's decision not to appeal *Ridgely* to the D.C. Circuit prevented it from becoming a precedent that would be hard to ignore.

Like clients, practitioners differ in their appetite for risk. Even so, we suspect that most may be waiting to see whether the deregulation of contingent fees is really going to become the new normal.

In the meantime, clients will continue to inquire about contingent fees for tax advice, probably with increasing frequency as contingent fee arrangements become more common in a wide range of legal matters. Even unadventurous tax practitioners may want to start considering the possibilities. Getting a feel for how section 10.27 may apply in everyday situations is a place to start. ■

<sup>10</sup>*Loving*, 742 F.3d 1013.