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Three Rules For Hiring Contingent Fee Lawyers


(Photo credit: 401(K) 2012)

We are a nation of laws and at times we all need a lawyer. We may need a special ***kind*** of lawyer for criminal defense, divorce, an accident or real estate deal. We need a Will, face a worker's comp claim, insurance company or employment dispute.

You name it and there's a special kind of lawyer for the job. Contingent fee lawyers are common, yet the nuances of contingent fee practice are often misunderstood. Here are three key rules that all turn on tax law.

1. The IRS Tags You With 100% Even if Your Lawyer's Share Comes Off the Top. Whenever your lawyer's share is 33% or more, the IRS treats you as receiving ***all*** the money and simultaneously ***paying*** your lawyer. That can create tax problems. You may only be entitled to a miscellaneous itemized tax deduction for the fees. See The Only Good Legal Fees Are Tax Deductible Legal Fees.

If your case is 100% for physical injuries or for employment there are tax rules to address this problem. Similarly, you'll be fine if you own a business and the suit relates to its operation. But in other situations, watch out. See Seven Key Tax Rules About Legal Fees.

2. Your Lawyer Can Get Paid Over Time. Your lawyer may not ***want*** or ***need*** his share when you get yours. When your case settles, your lawyer may contract with the defendant for a structured fee. Your lawyer can do this whether or not you choose to structure your share. See Tax Deferral Options For Plaintiffs' Attorneys.

This doesn't increase your costs and doesn't cost the defendant more. You agreed to the lawyer's share when you signed a fee agreement. The defendant just sends the lawyer's share to a life insurance company to fund annuities for your lawyer.

That way, he or she is paid over time. Contingent fee lawyers can level out their fluctuating income and do tax planning. The same concept is used for plaintiffs to get structured settlements over time without needing to rely on the defendant to make the payments. See What's A "Structured Settlement"?

3. Your Lawyer Can't Deduct Costs Until Your Case Settles. Most contingent fee lawyers "advance" the costs of your case so you don't go out of pocket. See Doctors And Lawyers Locking Horns Over Taxes. Expert fees, depositions, and travel add up fast. Your lawyer is paying the costs currently but the IRS generally doesn't allow deductions for costs until the case is resolved. See Which Client Costs Are Tax Deductible? Part 1 and Part 2. That's one reason you may find your lawyer is quite conscious of costs. See Lawyers Who Deduct Client Costs: Revisiting *Boccardo*.

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.