Which Client Costs Are Tax Deductible?

By Robert W. Wood

How you draft your fee agreement clearly matters in the 9th Circuit. However, this should matter everywhere. It effects tax treatment and how much money you ultimately recover. Consider the following examples: The first three examples are all common (although Example 2 is less common than Examples 1 and 3).

Example 1: You take a case on a 35 percent contingency, with costs to be subtracted from your gross recovery. You recover $1,000, and costs equal $100. You first subtract the $100, which repays you for the $100 you laid out. Then the $900 balance is split 35 percent to you and 65 percent to the client: you get $315. You can't deduct the $100 in costs until the year of the settlement. Your total cash is $415, but $100 was your own money. Your net cash is $315.

LAST IN A TWO PART SERIES

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Example 2: You are on a 35 percent contingency, but this time your agreement (truly in gross) is merely to divide the proceeds. In effect, you'll bear all costs. If you recover the $1,000 and have $100 in expenses, you receive $350. However, $100 is really a reimbursement of your own money. If you regard the $100 as a loan, only $250 of the $350 is income. In the 9th Circuit, you can deduct the $100 when you paid it, but must then take the entire $350 into income when the case settles. Outside the 9th Circuit, the same rule should apply, but the IRS disagrees. Your net cash is $250.

Example 3: You are still on a 35 percent contingency. This time 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 ends up with $550. Your net is $350.

Example 4: You are still on a 35 percent contingency, but now have different rate structures, one if you will bear all the costs (Example 2), one if the client will bear all the costs (Example 3), and one if you share the burden of costs (Example 1). Rather than either one of the two examples above, your fee agreement provides that the client can elect one of the following approaches:

Costs are deducted first off the top, and then the client pays you 35 percent; costs are ignored, but the client pays you 40 percent; or the client pays you 30 percent of the gross, and costs are deducted entirely from the client's 70 percent share.

Variations of this fourth possibility might call for the lawyer (not the client) having the right to select from the menu, or for the formula with the highest or lowest net to the lawyer to apply automatically.

Furthermore, consider a hybrid fee agreement calling for a gross-fee of 40 percent, but providing that in no event will the share the client receives be less than would be determined under a net-fee at 35 percent. This is a kind of savings clause. It is unclear if the mere presence of the savings clause is enough to preclude a deduction, but it should arguably not be.

Nevertheless, a list of alternative cost approaches brings the issue into sharp focus. Having alternatives (whether the client or the lawyer has the option which cost provision to apply) may weaken the case for a current deduction. The IRS is myopic in its focus on the loan model, and probably would sniff out a loan in any fee arrangement where it can be argued that the lawyer is being reimbursed for costs in whole or in part by the client.

That makes Example 2 the clearest and best from a tax viewpoint. If the lawyer is paying the costs in the first, second or third year , only to receive a gross share of a recovery in the fourth year, it is hard to see how there is a loan. This is so even if the lawyer is trying to factor in the likely amount of costs where he sets the percentage sharing in his fee agreement.

Lawyers (inside or outside the 9th Circuit) who are willing to shift to a gross-fee arrangement should alter their standard nomenclature. Clients may be used to hearing: "Don't worry, we advance all of the costs." But in a gross-fee arrangement, "advance" is a misnomer, perhaps an expensive one given the IRS' propensity to ferret out loans. In a gross-fee contract, the lawyer simply pays the costs, regardless of whether the he or she (based on past experience or optimism) *expects* to get the money back. In any type of fee contract, using the "advance" moniker is a hot button word best avoided. Saying that you "advance" costs sounds like a loan.

For law firms considering the gross versus net-fee dichotomy, it is appropriate to crunch numbers on how cases come out and how predictable costs may be. Such calculations could be based on historical cost data in cases of a certain ilk, projected costs, and even on the nature of particular kinds of defendants. Costs might be higher in a suit against General Motors than in a suit against Joe's Used Cars. Market or customer data is relevant, including the preferences of clients and the positions of competitors.

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For example: Lawyer A offers a gross-fee contract (the lawyer paying all costs) to an auto accident plaintiff on a 40 percent contingency. Lawyer B offers the same person a 35 percent net-fee contract (costs come off the top). Will the plaintiff select Lawyer A or B? Suppose Lawyer A tries to meet the competition by sticking with the 40 percent gross-fee contract, but offering a guarantee that the plaintiff will receive no less than using Lawyer B's fee calculation. Does this guarantee mean Lawyer A can't deduct costs?

These are not simple questions. What's more, they go to a central feature of contingent fee litigation. Many plaintiff lawyers continue to deduct their costs as they incur them. The IRS may not challenge them, but it's position on this matter is clear. If you have a net-fee contract — where your client reimburses you for costs you've advanced and you and your client split the recovery thereafter — you cannot deduct your costs until you settle up the case at the end. This clear rule does not depend on the Circuit in which you reside.

If you want to vary this unfortunate tax result, you should consider a different fee agreement. This article provides a few possibilities, but it is worthwhile to run examples based on your own practice. Even if you do have a gross-fee contract as was approved by the 9th Circuit in *Boccardo*, you should consider the Circuit in which you reside and practice.

While a gross-fee contract allows your fee deduction for costs in the 9th Circuit, it isn't clear what will happen in the other Circuits. You can claim the deduction for costs under a gross-fee contract nationwide and the IRS may not audit. If it does, you might convince an auditor or an IRS appeals officer (the administrative step where a tax dispute goes after the audit is complete) that the result in *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995) should control. Yet, if the IRS does what it promises, it will continue to litigate such cases outside the 9th Circuit. The case law is not crystal clear, but the Tax Court seems disposed to follow the 9th Circuit everywhere.

If you have never been tripped up by the IRS on the costs question, it's time to roll up your sleeves, review your fee agreement, and map out which version makes the most sense for your practice. If you don't, you could end up with a crippling bill for back taxes, penalties and interest.

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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