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Ten Things Attorneys Should Know About Deducting Client Costs

BY ROBERT W. WOOD

Contingent fee lawyers often customize their arrangements with clients; even so, the one-third contingency fee agreement, under which the client pays nothing (not even costs) until there is a recovery, is nearly an industry standard.

Indeed, over the past couple of decades, it has become customary for plaintiffs' lawyers to advance all costs and disbursements pursuing a client's case. The client receives the assurance that the client will pay nothing (not even costs) unless there is a recovery.

Regardless of how the lawyer's fee contract reads, the tax issues lawyers face on the expenses of contingent fee cases are surprisingly complex.

Such costs are either subtracted solely from the client's share, or taken off the top before the client and lawyer split the remainder 60/40 or two-thirds/one-third.

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Understandably, most lawyers assume that if they pay out $1,000 for a deposition transcript or court reporter fee in 2008, they can deduct the cost as a business expense. After all, what could be more logical?

It may be 2010 or 2011 before the case settles and the lawyer is able to recoup these costs. But in the meantime, the lawyer records it as an expense of the particular case in question, so the lawyer and client can later refer to the tally of costs when they divide the proceeds of the settlement or verdict. Since the expense is clearly incurred in business, one would assume it could be deducted from the lawyer's income tax.

Unfortunately, like so much else in the tax world, it is not that simple. Here, then, are 10 things every attorney should know about deducting client costs.

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

1. Consider Professional Rules First

This may be obvious, but first and foremost, consider state bar rules and codes of professional conduct that bear on your legal practice. Those rules may bear on how fees and expenses can be charged. Some state bar rules may still prohibit lawyers from paying the costs of a client.

These rules date to prohibitions on champerty and barratry, antiquated concepts that actually could make it a crime to foment litigation by financing litigation.

Today, although vestiges of these rules remain, they are usually not a problem. Even if they are, your fee agreement can work around such rules, as by advancing the expenses on behalf of the client, which the lawyer then collects on settlement of the case.

2. When You Consider Tax Rules, Do Not Get Tripped Up by Ethical Rules

Although your first concern should be to make sure you are not running afoul of ethical rules (see Rule No. 1), tax rules are often at odds with state bar rules.

For example, your state bar may tell you the client must ultimately be responsible for all costs. This suggests that if you are fronting all costs, you want a fee agreement that provides you will later be reimbursed by the client upon settlement.

But beware. This kind of fee agreement may prevent you from claiming tax deductions when you incur the costs. In general, the courts have ruled that if the law-

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yer is not actually liable for expenses, the expenses are treated as loaned to the client until the case settles. That means the lawyer cannot deduct those costs when the lawyer pays them!

3. IRS Prefers You to Treat Costs as Loans to Clients

If you never want to fight with the Internal Revenue Service, the safest course is to treat costs you pay for clients as loans. IRS clearly prefers this approach.

If you advance costs, but do not deduct them, you treat them as loans to your clients until the case is settled. This is painful. You will be paying all the costs of the case currently over several years, and yet not deducting the costs until what could be many years later.

Suppose you have a standard one-third contingent fee agreement, and that you will advance all costs. Assume your fee agreement says that when the case is finally resolved, the costs will come off the top. Thereafter, you and the client will split one-third/two-thirds.

The safest tax position to take is that all of the costs you are paying during the course of the case are not deductible, but are loans to the client. Then, when the case settles in Year 3, 4, or 5 you treat the recovery as income and deduct all the costs in that year.

4. If You Want to Be Aggressive, Deduct the Costs Currently

Most contingent fee plaintiffs' lawyers are not known for being conservative. That often applies beyond their practices to their tax positions too.

If you do not like the IRS treatment of this arrangement as a loan (see Rule No. 3), you can deduct the costs as you pay them. However, IRS may not agree.

That means you should be ready to defend your tax position. In particular, consider reviewing and perhaps modifying your fee agreement with this issue in mind. There are steps you can take in your legal fee agreement to help your chances in an IRS dispute.

5. If You Deduct Costs, Make Sure They Are Your Expenses, Not the Client's

This is a tough one. In many ways, the lawyers' instincts will be to make sure that the client is charged and ultimately bears the costs. There are several tax cases standing for the proposition that if the lawyer in effect backs out the costs from the client's recovery when the case is resolved, the costs, when incurred by the law firm, should be treated as nondeductible loans to the client.[1]

You may want to provide in your fee agreement that your law firm will be responsible for paying all costs and expenses of the case, and that when the case settles, lawyer and client will simply split one-third/two-thirds, or 60/40. The result of such a fee sharing (making no reference to costs) is that the lawyer is not being reimbursed by the client. In fact, the costs are borne by both the client and the lawyer in whatever percentage sharing they agree.

You could view this as a partial reimbursement by the client, but so far the tax authorities have not expressly prohibited the lawyer from deducting the costs in this circumstance.

6. Remember the 'Boccardo' Cases

It is hard to touch on this area of the tax law without considering the *Boccardo* cases. James Boccardo was a well-known plaintiffs' lawyer in San Jose, Calif. Boccardo deducted costs as he paid them for clients, and IRS disagreed with his deductions and assessed a deficiency.

Boccardo's firm used a net fee agreement, under which the law firm agreed to pay all costs, and to be reimbursed for its costs only out of a recovery. After reviewing Boccardo's net fee contracts, the Court of Federal Claims held that Boccardo could not deduct the costs as he paid them.[2]

After this early defeat—and after Boccardo hired a tax lawyer!—Boccardo shifted from net fee contracts to gross fee contracts.

7. Be Willing to Change Your Fee Agreement

Boccardo changed his net fee agreement to a gross fee agreement. The gross fee agreement said nothing about costs, other than that Boccardo would pay them. Then, the agreement simply said that lawyer and client would split the gross recovery. That meant if no recovery was made, the firm would receive nothing for its services or for its advanced costs.

The Tax Court said it did not matter whether the law firm had any right to be reimbursed for costs from the client, as long as the firm had an expectation of generating a fee from the matter that would at least cover the costs incurred.

Boccardo then kept deducting costs as he incurred them. Unfortunately, IRS disagreed with Boccardo's deductions even under his gross fee contract. Not one to give up, once again Boccardo sued IRS, this time in Tax Court.

In the second *Boccardo* case, the Tax Court said Boccardo still expected substantial reimbursement.[3] Because of that, the Tax Court said it did not matter whether the law firm had any right to be reimbursed for costs from the client, as long as the firm had an expectation of generating a fee from the matter that would at least cover the costs incurred.

Clearly, even Boccardo's gross fee agreement expected that. As a result, the Tax Court ruled against Boccardo for a second time.

[1] See *Hughes & Luce LLP v. Commissioner*, 70 F.3rd 16 (5th Cir. 1995).

[2] See *Boccardo v. United States*, 12 Claims Court 183 (1987).

[3] See *Boccardo v. Commissioner*, T.C. Memo 1993-224 (1993).

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8. Do Not Give Up

This rule is something all plaintiffs' lawyers know very well. Boccardo certainly knew it. After his second defeat, Boccardo went to the Ninth Circuit Court of Appeals, arguing that his first two tax cases were unfair, and that they levied flatly inappropriate tax results on plaintiffs' lawyers.

The Ninth Circuit Court of Appeals is sometimes jokingly referred to as the ''taxpayer's circuit'' and this time the court did not disappoint. The Ninth Circuit came to the rescue, reversing the Tax Court and holding that Boccardo's firm incurred deductible ordinary and necessary business expenses when it paid client costs.[4]

The Ninth Circuit found that it was normal business practice for plaintiffs' firms to pay client costs. Although IRS argued that this practice violated state professional standards (there is the reference to state bar rules again), the Ninth Circuit ruled there was simply no prohibition on an attorney paying his client's expenses. Evaluating the tax law too, the Ninth Circuit found there was no problem with these tax deductions.

9. If You Deduct Costs, Be Willing to Argue About It

Notwithstanding the substantial victories Boccardo achieved in his third time in court with IRS, most taxpayers do not fare too well. In *Hughes & Luce v. Commissioner*,[5] a large law firm deducted expenses paid on a client's behalf and lost in both the Tax Court and the Fifth Circuit.

IRS audited Hughes & Luce, determining that the law firm should have treated disbursements as loans to the client. That meant these expenses were neither deductible in the year paid by the firm nor includable in income in the year received when the case later settled.

Interestingly, this tax case did not involve the deductibility issue, since the law firm decided not to litigate this question. Instead, Hughes & Luce argued that the net reimbursements it received from clients were not includible in its income, since IRS had already determined that these funds were merely loan repayments.

IRS countered in Tax Court that reimbursements the firm received were attributable to deductions claimed in prior closed tax years. According to IRS, that meant they had to be included in the firm's income. IRS said the tax benefit rule and the general duty of consistency dictated this result.

The Tax Court found the tax benefit rule did not apply. Unfortunately, the Tax Court agreed with IRS that the duty of consistency did require the law firm to include these amounts in income when recovered.

On appeal to the Fifth Circuit, Hughes & Luce continued to argue that it was unfair to force it to take these amounts into income. The Fifth Circuit reversed the Tax Court, finding that it had been incorrect in rejecting the tax benefit rule.

10. Consider the Long Term

Any review of the cases in this area should leave one with the concern that this tax battle waged by contingent fee lawyers is hardly over.

The vast majority of plaintiffs' law firms (either unwittingly or aggressively) probably do deduct client costs as they pay them, rather than waiting until the case settles. Yet the majority of cases prove that many plaintiffs' firms lose this tax battle if and when they get audited.

For example, in *Pelton & Gunther P.C. v. Commissioner*,[6] the Tax Court held litigation costs a law firm paid on behalf of its clients (which were later reimbursed) were simply nondeductible loan advancements. That is the general rule, like it or not.

Conclusion

Armed with the 10 points outlined here, contingent fee attorneys and those who advise them can make informed decisions on how to treat client costs, how to write fee agreements, and when and where to fight about the tax issues.

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[4] See *Boccardo v. Commissioner*, 56 F.3rd 1016 (9th Cir. 1995).

[5] 70 F.3rd 16 (5th Cir. 1995).

[6] T.C. Memo 1999-339.