# Internal Revenue Service & Treatment of Attorney Expenses

The Internal Revenue Service (IRS) presently treats out-of pocket expenses incurred by attorneys in contingency fee cases as loans to their clients and disallows any deduction of these expenses under IRC section 162(a) as “ordinary and necessary” expenses in carrying on a business. According to current IRS policy, an attorney may not take the deduction until the litigation is resolved, which is typically not in the year that the expenses are incurred.

Contingency fee agreements between attorney and client occur in personal injury, medical malpractice, workers compensation, product liability, Social Security disability, employment, and civil liberties cases. Under these agreements, an attorney pays all costs associated with a case before any settlement or verdict. Such expenses include costs for expert witnesses, depositions, medical and other records, and court fees. **Therefore, AAJ requests that the Administration revise its current Audit Guideline Manual to reflect case law which provides that attorneys can deduct attorney-paid client costs in contingency fee agreements in the year that they are incurred. Further, the agency should issue a memorandum to address attorney expenses to clear up any further confusion regarding tax treatment.**

The issue has been the subject of federal case law as well as IRS policy. In 1987, an attorney argued in U.S. Claims Court that he should be allowed to deduct out-of-pocket expenses paid on behalf of a client. The Court held that at least in a “net fee” contract, such costs were advances to the client and not deductible because of the expectation of reimbursement, even if the reimbursement was entirely contingent upon the success of the case. Only when out-of-pocket costs become unrecoverable do they become deductible expenses of the law firm. *Boccardo v. U.S.*, Cl. Ct. 184 (1987).

Following the loss in the Claims Court, the Boccardo law firm switched from a net fee contract to a “gross fee” contract. In a gross fee contract, the client is only obligated to pay his attorney a percentage of the amount recovered and is not responsible for specific repayment of costs. In a net fee contract, the client is specifically obligated to pay the attorney for out-pocket costs in addition to a percentage of the amount recovered. However in both types of contingency arrangements, the attorney only recovers his or out-of-pocket expenses if the client recovers above a certain amount. The Tax Court observed that “the fact that the gross fee agreement provides for reimbursement solely from recovery on the client’s claim operates only to affect the degree of contingency.” The contingent nature of the potential reimbursement was specifically rejected by the court as a reason to find that the costs paid by the law firm were not advanced and therefore did not operate as a type of loan to the client. *Boccardo v. Commissioner,* T.C. Memo. 1993-224 (1993).

That same year, the Internal Revenue Service released audit guidelines under its Market Segment Specialization Program ("MSSP") which include an Audit Guideline Manual for Attorneys (the “IRS Manual”). The Manual currently instructs IRS agents on the manner and operation of a law firm, the types of records maintained by a law firm, and the likely areas of non-compliance. The IRS Manual specifically addresses “Advanced Client Costs” for attorneys, and it states, “It has been determined by the courts that advances to and costs paid on behalf of a client are to be treated as loans for tax purposes. They are not deductible by the attorney as a current cost of conducting business. The costs are those of the client and not the attorney since there is an expectation of recovery. A bad debt deduction may be taken in the year that any costs are determined to be uncollectible." The IRS Manual concludes that "court cases strongly support treating advanced client costs as loans…", and it does not mention the *Boccardo* cases.

In support of the IRS Manual, the National Office issued TAM 9432002 (1994 WL 420348), dealing with a law firm that entered into a "net fee" contract in which payments of costs were to be offset from any recovery in the case. TAM 9432002 likened the payment of out-of-pocket expenses on behalf of a client to loans or advances made to the client, rather than a business expense and concluded that such out-of-pocket expenses are not deductible under Section 162(a).

Two years after the decision in the second *Boccardo* case, the Ninth Circuit Court of Appeals reversed the Tax Court's decision by ruling that at least in a gross fee agreement, out-of-pocket expenses were deductible, and were not nondeductible advances. Boccardo argued that under the gross fee contract, there is no obligor; and the firm is no more reimbursed its expenses than a self-employed commissioned salesman is reimbursed the travel costs incurred in making a sale when the commission check for the sale finally arrives. The Ninth Circuit directly refuted the Tax Court's reasoning when it stated

> It is difficult to see how the label of "advances" with its implication of "loans" can be applied as a matter of law to payments when there is no obligation on the part of the client to repay the money expended….The plain fact is that, under the gross fee contract, the firm, like other businesses, can only make a profit if it succeeds in deriving gross fee revenues that exceed its own expenses-that is, if it succeeds in keeping its own costs, including the type singled out by the IRS, lower than the fees it obtains over the course of at given year from the clients whose cases are successful.

*Boccardo v. Commissioner,* 56 F.3d 1016 (1995).

No further IRS Guidance or case law has been forthcoming on this question since the Ninth Circuit decision in *Boccardo* in 1995. The IRS has not relented on its position nor updated its Manual to reflect *Boccardo*, so IRS agents auditing law firms are not accurately advised of the law. This means that over the past 12 years, taxpayers have had to proceed at their own peril -- Ninth Circuit taxpayers risk a conflict with the IRS on this matter despite the case law, and taxpayers outside of the Ninth Circuit have no guidance at all since they cannot directly rely on *Boccardo*,

The confusion gets even deeper as one considers the case law itself. Based on current court decisions, one might reasonably argue that attorneys can deduct out-of-pocket costs under gross fee contracts, but not under net fee contracts. If true, one must question the wisdom of a tax law that differs on a subtlety in an agreement between an attorney and client. Such a rule is a trap for the unwary, and it favors the economics of one arrangement over another – for no sound policy reason. The IRS can and should clarify this question for all taxpayers. Therefore, AAJ recommends that the agency update the IRS Manual to clarify the current deductibility of attorney-paid client costs in contingency fee agreements under IRC section 162(a), without regard to whether the contract arrangement is a net fee or gross fee contract.