DEDUCTIBILITY OF CLIENT COSTS BY A LAW FIRM

As a significant part of the market-oriented approach of the Internal Revenue Service to tax compliance issues, attorneys have become a "targeted group". The Internal Revenue Service developed audit guidelines under its Market Segment Specialization Program ("MSSP") which include an Audit Guideline Manual for Attorneys. The Manual instructs Revenue 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. With respect to personal injury lawyers, the Manual notes that many attorneys improperly deduct client costs which the Internal Revenue Service perceives to be in the nature of a loan.

In support of the foregoing, the National Office of the Internal Revenue Service issued T.A.M. 9432002. The law firm in T.A.M. 9432002 was a cash-basis professional corporation engaged in a personal injury practice. The law firm entered into "net fee contracts" with its clients whereby it made payments to third parties on behalf of its clients for items such as court filing fees, expert witness fees, and charges for outside photocopying and printing. These payments were to be offset from any recovery in the clients matter. In T.A.M. 9432002, the National Office advised that out-of-pocket expenses incurred by the law firm on behalf of its client pursuant to a "net fee contract" were not deductible as ordinary and necessary business expenses under §162(a) since the law firm expected or anticipated reimbursement for such expenses on the theory that the reimbursable expenses should be treated as advances in the nature of a loan. Similarly, T.A.M. 9432002 advised that the law firm did not have reportable income in the year the advances are reimbursed by the client. Relying on Boccardo v. U.S., 12 Cl. Ct. 184 (1987) and Canelo v. Commissioner, 53 T.C. 217 (1969), aff'd 447 F.2d 484 (9th Cir. 1971), T.A.M. 9432002 provides that the law firm may deduct the cost of providing its services when the law firm is paid for the services by the client (i.e., its out-of-pocket expenses associated with the representation of the client) under §162(a) or other applicable provisions of the Internal Revenue Code in the year in which the law firm receives payment by the client.

The Boccardo Court of Claims case involved a "net fee contract" whereby the law firm explicitly agreed "to pay all costs" and the client agreed that all such costs should be repaid only out of a recovery. Further, the National Office advised that if a law firm decided, for valid business reasons, not to bill a client for an out-of-pocket expense, the law firm would be entitled to a §162(a) deduction for the expenses in the year in which it makes the final determination not to bill the client. The foregoing was based on an exception to the general rule that payment by a taxpayer of the obligation of another taxpayer is not considered an "ordinary and necessary" expense for purposes of §162(a).The exception applies where a taxpayer expends such funds in order to protect or promote its own established business. T.A.M. 9432002 concluded that the law firm was in receipt of income in the year in which charges for its fees were paid by the client and where the law firm's cost of providing the services would be deductible under §162(a) or other applicable provisions of the Internal Revenue Code.

Following its loss in the Claims Court, the Boccardo law firm followed the advice of its tax counsel and switched to a "gross fee contract" from a "net fee contract" for its future tax years. In reviewing the "gross fee contract", the Boccardo Tax Court observed that the fact that the gross fee agreement provided for reimbursement solely from a recovery on the client's claim only

operated to affect the degree of the contingency. The Tax Court further noted that the contingent nature of reimbursement had been specifically rejected as a reason for concluding that the costs paid by the law firm were not advanced with the expectation of reimbursement so as to operate in the nature of a loan in Canelo v. Commissioner, 53 T.C. 217, 224 (1969), aff'd 447 F.2d 484 (9th Cir. 1971). In Boccardo v. Commissioner (9th Cir., May 26, 1995) (Docket No. 93-70850), the Ninth Circuit determined that costs incurred by the Boccardo law firm engaged under a "gross fee contract" are deductible ordinary and necessary business expenses when paid. Under the "gross fee contract", the law firm was obligated to pay all preparation and trial costs and was merely entitled to a percentage of the gross sum recovered in the event of a recovery. Absent a recovery on behalf of the client's claim, the law firm would not receive anything for its services or costs incurred.

The Ninth Circuit in Boccardo distinguished a "net fee contract" from a "gross fee contract", and held that costs incurred under a gross fee contract were clearly not "advances" (with the implication of a "loan" having occurred) when there is no obligation on the part of the client to repay the money expended. Further, the Ninth Circuit acknowledged that it was not only necessary for a personal injury law firm to pay some of the costs of many of its clients, it is also customary in the personal injury field. Accordingly, the Boccardo Tax Court Decision was reversed by the Ninth Circuit.

If you are currently representing a lawyer or law firm engaged in an audit, it is imperative that you're aware of the Ninth Circuit Decision in Boccardo! If you generally represent a lawyer or law firm , their fee agreements should be reviewed in light of the Ninth Circuits Decision in Boccardo.