

Deductibility of Litigation Expenses Paid by Alabama Attorneys

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Attorneys in the State of Alabama have an important advantage over their brethren in other states. The advantage lies in the long-standing conflict between the Internal Revenue Service and litigation attorneys throughout the United States over deductibility of litigation expenses paid or incurred by such attorneys “on behalf of their clients.”¹

In 1995, the Alabama State Bar proposed,² and the Alabama Supreme Court adopted, a progressive change in Alabama’s *Model Rules of Professional Conduct*. The purpose of the change was to conform such rules to the demands of 21st century litigation on lawyers seeking to ethically and effectively represent their clients’ interests.³ As a result of the change in the *Alabama Model Rules of Professional Conduct*,⁴ payment of litigation costs by attorneys is no longer required to be merely advances “on behalf of their client” which the client has an unconditional obligation to repay. Alabama attorneys may now incur and pay such expenses in their own name and on their own behalf.

Permitting an Alabama attorney to incur and pay such costs in the attorney’s own name should allow attorneys to currently deduct such costs rather than being required to treat them merely as non-deductible “loans” made to their clients. Unfortunately, many Alabama attorneys and their tax advisors are still unaware of this important change. It is hoped that this article will highlight the change in the *Alabama Model Rules of Professional Conduct*, the resulting potential tax benefits and the actions attorneys should consider in their contractual, tax and accounting treatment of litigation expenses.

The Tax Issue

The costs associated with prosecuting a civil action in today’s legal environment are enormous. These costs are substantially beyond the ability of clients to pay during the course of the litigation or to even reimburse to their attorney at the conclusion of unsuccessful litigation. Obviously, such costs are paid, and have been for decades, normally and properly, by the attorney and not the client.

Historically, the attorney's payment of such costs has been treated as an "advance" to the client, a treatment previously mandated by the *Model Rules of Professional Conduct*.⁵ Generally, such advanced costs have also been contractually required to be repaid by the client to the attorney at the conclusion of the litigation. The client's obligation to repay was fixed and often *not* conditioned upon the outcome of such litigation. The attorney's tax, financial and accounting records would normally also be maintained in a consistent manner, i.e. litigation expenses would be reflected as an account receivable from the client, not as an expense of the attorney.

Based on the client's unconditional obligation to reimburse the attorney for out-of-pocket costs, the Internal Revenue Service has long held that payment of such costs is not a deductible expense for the attorney. Rather, such advances by the attorney have been treated by both the IRS and the courts as a "loan" to the client.⁶ Such a loan was deductible, if at all, only when a client was subsequently unable to repay the debt, i.e., when the "loan" became an uncollectible business bad debt.⁷

The *Boccardo* cases⁸ became the most often cited precedent in the area. These cases not only relied on the "advance" theory of denying a deduction, but invoked the *Model Rules of Professional Conduct* as ethically requiring attorneys to only make such payments as advances "on behalf of the client." After *Boccardo I* and *II*, the *Model Rules of Professional Conduct* became a legal obstacle⁹

to attorneys wishing to treat such litigation costs as their own "ordinary and necessary" business expenses.¹⁰

Ultimately, *Boccardo* did enjoy success using a "gross fee" contract that did *not* require the client to reimburse out of pocket expenses.¹¹ The Ninth Circuit reversed the Tax Court and allowed deduction of litigation expenses as incurred and paid directly by *Boccardo*.¹² As to the requirement of the *Model Rules of Professional Conduct*, the Ninth Circuit noted that such California rules were not laws of the State of California.¹³

Thus, *Boccardo I* and *II* remain as precedent for denial of an attorney's deduction of litigation expenses in all but "gross" fee arrangements. However, "gross" fee arrangements would have to be financially acceptable to attorneys who would be required to estimate costs at the outset of litigation in order to ensure a remunerative fee arrangement. Also, attorneys in all states would have to assure themselves that a "gross" fee arrangement satisfied their applicable ethical responsibilities.

Another element was added by the IRS in Technical Advice Memorandum 9432002. After citing the established *Boccardo* precedent, i.e. one taxpayer could not deduct payments made on behalf of another,¹⁴ the TAM cited an exception to such precedent. A taxpayer can deduct a payment made on behalf of another if the taxpayer is "expending such funds in order to protect or promote his own established business."¹⁵

Recognizing the need to address these issues ethically and responsibly, Alabama lawyers proposed consideration by the Alabama State Bar of modifications to the *Alabama Model Rules of Professional Responsibility*.¹⁶ These proposed modifications carefully and deliberately took into account the need to ensure advancement of legitimate client needs while carefully working within the parameters of the foregoing tax precedent.

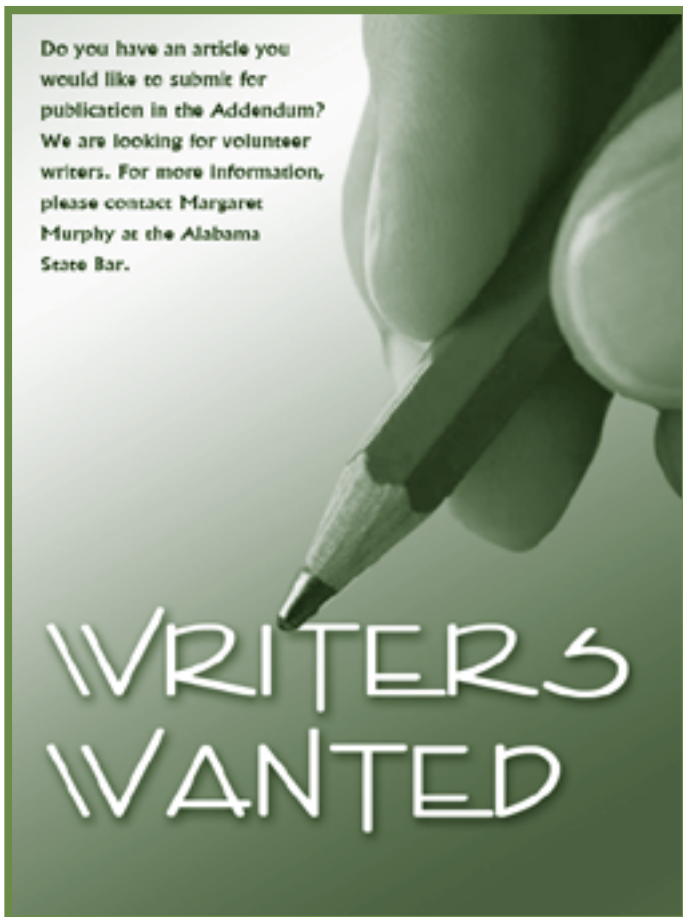
Modification of the Alabama Model Rules of Professional Conduct

In 1990, the Alabama State Bar adopted the American Bar Association's *Model Rules of Professional Conduct* of 1983. Former Disciplinary Rule 5-103(B) was replaced with Rule 1.8(e) which originally provided as follows:

A lawyer shall **not** provide financial assistance to a client in connection with pending or contemplated litigation, **except** that:

- A lawyer may **advance** court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter;
- A lawyer representing an indigent client may pay court costs and expenses of litigation **on behalf of** the client; and
- A lawyer may **advance** or guarantee emergency financial assistance to the client, the repayment of which may not be contingent on the outcome of the matter, provided that no promise or assurance of financial assistance was made to the client by the lawyer, or on the lawyer's behalf, prior to the employment of the lawyer. (Emphasis added)

Alabama's Rule 1.8(e) was slightly different from Alabama's Disciplinary Rule 5-103(B). Rule 1.8(e) did allow the "advance" of litigation expenses in the event repayment was contingent on



the case's outcome. Nevertheless, when incurred, such litigation expenses still constituted "advances" made "on behalf of the client", and, following *Boccardo*, could not be deducted.

In 1995, the Alabama Supreme Court adopted revised Professional Conduct Rule 1.8(e), by adding subparagraph (e) (4) which reads as follows:

A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

* * * *

(4) in an action in which an attorney's fee is expressed and payable, in whole or in part, as a percentage of the recovery in the action, a lawyer may pay, for his own account, court costs and expenses of litigation. The fee paid to the attorney from the proceeds of the action may include an amount equal to such costs and expenses incurred. (Emphasis added)

The exception in Rule 1.8(e) (4) does not provide for an "advance" of litigation costs. Clearly, the lawyer's payment of litigation expenses is "for his own account" and not for the benefit of or on account of the client. Such litigation expenses should therefore constitute "ordinary and necessary" expenses incurred in carrying on the attorney's trade or business. There is no provision for repayment or reimbursement of any such litigation

costs. However, like the "gross fee" arrangement approved in *Boccardo III*, the final fee may, but need not, be grossed-up in order to cover such costs.¹⁷ The exception in Rule 1.8(e) (4) is carefully restricted to percentage-fee arrangements contingent upon the outcome of the case. The long-established and well-reasoned rule restricting financial assistance to a client or potential client is maintained in every other respect.

Recommendations

Potential planning benefits can only be realized if Rule 1.8(e) (4) is properly implemented through attorneys' contracts with their clients.¹⁸ Even if Alabama's *Model Rules of Professional Conduct* permit advantageous treatment and characterization of litigation expenses, potential planning is wholly ineffective unless attorneys' client contracts are appropriately modified.

In any context, consistency of treatment of expenses for financial and tax purposes is clearly advisable, whether or not required. Furthermore, the manner in which a business's financial records treats an item often dictates how the item must be reported for income tax purposes. Thus, attorneys' business records, i.e. financial accounting records, should be modified to be consistent with properly anticipated tax accounting treatment.

Also, professionals, like all persons engaged in activities for profit, must determine what treatment is most appropriate for their practice. For attorneys, however, this decision is first and

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