Must Contingent Fee Lawyers Capitalize Litigation Costs?

Gregg D. Polsky and R. Kader Crawford contend that the INDOPCO regulations promulgated in 2004 now control whether litigation costs must be capitalized.

Lawyers who represent personal injury claimants are typically compensated on a contingent fee basis. And it is becoming increasingly common for plaintiffs' lawyers involved in other types of litigation, such as patent enforcement, to also use contingent fee arrangements. During the pendency of the litigation, contingent fee lawyers often pay the litigation costs necessary to prosecute the claim. For instance, contingent fee lawyers usually pay court fees, expert witness and consultant fees, deposition and court reporters' fees, travel costs, and copying costs.1

Surprisingly, the tax treatment of those payments remains stubbornly controversial.2 The issue is whether contingent fee lawyers can immediately deduct litigation costs in the year in which they are incurred or instead must capitalize them. If the costs are capitalized, cost recovery would be accomplished upon conclusion of the case, either through a basis offset against the lawyer's amount realized or as a bad debt or loss deduction.

The IRS has consistently maintained that all litigation costs paid by contingent fee lawyers are capitalized, regardless of the technical particularities of the contingent fee agreement.3 The IRS has thus far prevailed in all of the reported cases on the issue with one notable exception. In that case, the Ninth Circuit concluded that a relatively unusual type of contingent fee agreement — a gross fee contract — allowed the lawyer to immediately deduct costs.4 After that decision, the IRS stated that it will continue to assert that litigation costs must be capitalized in gross fee contract situations except in the Ninth Circuit.5

Despite the IRS's well-known position on litigation costs and its near universal success in the courts, a prominent commentator on litigation-related tax issues recently wrote that he believed that "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."6 In addition to the controversy over what current law requires, there is controversy over what the law ought to be. Recent legislative proposals would allow all contingent fee litigators to immediately deduct their costs.7 As might be expected, lobbyists for trial lawyers strongly support those proposals,8 while lobbyists aligned with common personal injury defendants have announced their opposition.9

In this article, we contend that the INDOPCO regulations promulgated in 2004 now control whether litigation costs must be capitalized. The INDOPCO regulations establish that while lawyers who use conventional contingent fee arrangements must capitalize their costs, lawyers who use gross fee contracts can immediately deduct their costs.

We also argue that while litigation costs incurred under gross fee contracts are immediately deductible under current doctrine, as a policy matter these costs should be capitalized. Thus, we conclude that (1) Treasury or the IRS should issue prospective-only guidance, as contemplated by the INDOPCO regulations, to require litigation costs incurred under gross fee contracts to be capitalized; and (2) legislative proposals that would allow immediate deductions for litigation costs should be rejected.

A. Litigation Costs Generally

Most commonly, litigation costs paid by contingent fee lawyers are structured as advances or zero-interest loans from the lawyer to the client.10 The client is technically responsible for the costs, but the lawyer agrees to front the costs until the case is resolved. When the case is resolved, the client repays the loan out of the proceeds of the litigation, with the remaining proceeds divided between the lawyer and the client as provided by the contingent fee contract. If the proceeds of the litigation are insufficient to repay the advances, or if there are no proceeds at all, the client may be personally responsible for the shortfall. Alternatively, the lawyer might agree to not seek repayment of any shortfall, in which case the arrangement is effectively a nonrecourse loan with the cause of action serving as collateral.

As explained below, tax motivations have led some plaintiffs' lawyers to depart from this typical arrangement and begin to use a gross fee contract. Under a gross fee contract, the lawyer still pays the litigation costs during the prosecution of the claim.11 However, when the case is resolved, there is no priority allocation of the proceeds to reimburse the lawyer for costs. Instead, the proceeds are simply divided according to the contingent fee percentage. Thus, in a gross fee contract, the proceeds are allocated in the same manner whether the litigation costs were $100 or $100,000. Because the lawyer is no longer entitled to a priority allocation for his costs, the contingent fee percentage is presumably adjusted upward to compensate him for taking on the additional risk.12

In summary, there are three types of advance structures: recourse advances, nonrecourse advances, and gross fee arrangements. To illustrate how each works, consider the following scenarios under a 40 percent contingent fee contract for recourse/nonrecourse advances and a 50 percent contingent fee contract for a gross fee arrangement: (a) $2 million settlement, $200,000 of costs; (b) $500,000 settlement, $200,000 of costs; and (c) $100,000 settlement, $200,000 of costs. Table 1 illustrates the consequences to the parties under each of the arrangements.

Table 1

Type of Arrangement	Lawyer's Reimbursement Of Costs to Lawyer	Lawyer's Share of Recovery	Right to Reimbursement From Client
Scenario A: $2 Million Settlement, $200,000 Costs			
40%/recourse	$200,000	40% of $1.8 million = $720,000	N/A

40%/nonrecourse	Same as above	Same as above	Same as above
50%/gross fee	N/A	50% of $2 million = $1 million	N/A

Scenario B: $500,000 Settlement, $200,000 Costs

40%/recourse	$200,000	40% of $300,000 = $120,000	N/A
40%/nonrecourse	Same as above	Same as above	Same as above
50%/gross fee	N/A	50% of $500,000 = $250,000	N/A

Scenario C: $100,000 Settlement, $200,000 Costs

40%/recourse	$100,000	$0	$100,000
40%/nonrecourse	$100,000	$0	$0
50%/gross fee	N/A	50% of $100,000 = $50,000	N/A

[table continued]

Type of Arrangement	Lawyer’s Total Recovery	Client’s Recovery
Scenario A: $2 Million Settlement, $200,000 Costs		
40%/recourse	$920,000	$1.08 million
40%/nonrecourse	Same as above	Same as above

50%/gross fee	$1 million	$1 million
Scenario B: $500,000 Settlement, $200,000 Costs		
40%/recourse	$320,000	$180,000
40%/nonrecourse	Same as above	Same as above
50%/gross fee	$250,000	$250,000
Scenario C: $100,000 Settlement, $200,000 Costs		
40%/recourse	$200,000	-$100,000
40%/nonrecourse	$100,000	$0
50%/gross fee	$50,000	$50,000

B. Historical Cases

Tax cases involving recourse and nonrecourse advances (as opposed to gross fee situations) have universally found that the lawyers must capitalize the advances.13 Those cases conclude that advances are loans for tax purposes.14 It is axiomatic that when money is loaned, the lender capitalizes the loan amount and then eventually recovers the amount as a basis offset against principal repayments or as bad debt deductions. Lenders cannot deduct the cost of their loans any more than car manufacturers can deduct the cost of their cars. And when attorneys loan money to their clients, they are acting as lenders.

While that conclusion seems obvious for recourse advances, when the lawyer has the legal right to repayment regardless of the success of the underlying case, the analysis is somewhat more complicated for nonrecourse advances. Courts have sometimes struggled in those cases because of the traditional tax definition of a loan as an "unconditional obligation to repay."15 In the nonrecourse advance situation, the repayment obligation is conditional on the cause of action yielding a recovery at least as large as the total amount advanced, because the plaintiff is not liable for any shortfall. But traditional nonrecourse loans have similarly contingent repayment obligations,16 yet it is clear that nonrecourse loans are still treated as loans for tax purposes.17 If a sale of collateral would not result in sufficient proceeds to cover the outstanding debt, a nonrecourse borrower has the option to relinquish the collateral to the lender and be absolved of any liability for the shortfall.18 That the collateral's value must exceed the outstanding debt in order for repayment of a nonrecourse loan to be ensured does not change the fact that nonrecourse debt is clearly debt for tax purposes.19 Thus, in determining whether an obligation meets the federal tax definition of debt as an unconditional obligation to repay, the contingencies resulting from the nonrecourse features of a debt must be ignored.

Nonrecourse advances are simply nonrecourse loans. The collateral is the cause of action, and the attorney's recourse is limited to the proceeds eventually generated by the cause of action. If the proceeds are insufficient (or if there are no proceeds at all), the attorney bears the shortfall, just as a nonrecourse lender bears the shortfall when the collateral's value drops below the amount of the debt. And because it is clear that nonrecourse loans remain debt for tax purposes, the attorney must capitalize advances regardless of whether the client is personally liable for any shortfall.

While courts have consistently reached this conclusion, their analysis is often muddled because they believe that they have to circumvent the "unconditional" issue. Some courts have noted state bar rules that precluded attorneys from advancing costs without requiring clients to be personally liable.20 Others contended that regardless of the legal technicalities, the attorney had a sufficiently high expectation of repayment, emphasizing that the attorney would invest time, effort, and money into a contingent fee case only if he had a high degree of confidence that the case would yield a payout in excess of litigation costs.21 Under the nonrecourse loan theory espoused above, those facts are immaterial; if the advance arrangement is characterized as a nonrecourse loan, the proceeds loaned are always capitalized regardless of state bar rules or the likelihood of repayment.22

Thus, while the courts' reasoning was muddled, their conclusions — that nonrecourse advances had to be capitalized — were consistent. In response to this state of affairs, one law firm, the Boccardo Law Firm, began to use gross fee contracts in some of its cases.23 Under those contracts, the firm would receive 33.3 percent of any pretrial settlement or 40 percent of any post-trial recovery regardless of the amount of litigation costs that it incurred. The IRS took the position that despite the absence of an obligation to repay the costs incurred by the law firm, the costs still had to be capitalized. In a 1993 case, the Tax Court agreed with the IRS, concluding that the gross fee contracts were substantively very similar to nonrecourse advances because of the strong likelihood that the law firm would recoup its costs out of the eventual recovery.24

However, two years later, the Ninth Circuit reversed the Tax Court's decision, determining that the absence of a repayment right in favor of the law firm precluded characterization of the gross fee contract as a loan.25 As a result, the Ninth Circuit held that the law firm's immediate deduction of costs was proper. In 1997 the IRS issued a field service advisory, which announced that the IRS disagreed with the Ninth Circuit's reasoning and would continue to assert that litigation costs incurred under a gross fee contract had to be capitalized, except in the Ninth Circuit where it was bound by the Boccardo decision.26

C. Recent Developments

After the 1997 field service advisory, the state of the tax law appeared to be clear: Advances had to be capitalized under the case law, whether they were made on a recourse or nonrecourse basis. The tax consequences of gross fee contracts, however, remained uncertain. The Ninth Circuit, in the only appellate decision on point, allowed litigation costs to be immediately deductible under these contracts, but the IRS and the Tax Court disagreed. Adding to the confusion, a prominent commentator recently said that he believed that plaintiffs' lawyers are routinely deducting their costs, regardless of whether they are using gross fee contracts or more traditional advance arrangements.27

Given this state of affairs and the large amount of tax dollars at stake, it is not surprising that lobbyists and legislators have been active on these issues. The American Association for Justice (AAJ) (formerly the American Trial Lawyers Association) has pushed for legislation that would allow contingent fee lawyers to immediately deduct their costs regardless of the type of fee arrangement.28 In 2009 Sen. Arlen Specter, along with several cosponsors, introduced a bill that would accomplish this result, but the bill never made it out of committee.29

On the other hand, the American Medical Association (AMA) has pushed in the other direction, arguing that litigation costs incurred by contingent fee lawyers should be capitalized in all instances.30 Two dozen senators asserted that position in a 2009 letter to Treasury Secretary Timothy Geithner that called for the IRS to reaffirm its position in the 1997 field service advisory.31

Despite this recent activity, the IRS has remained steadfastly silent on the issue, responding to inquiries by explaining that it is continuing to study the matter.32 Meanwhile, as the back-and-forth lobbying proceeded, the Tax Court recently decided another case involving litigation costs. In Humphrey, decided in January, the court applied the traditional analysis and confirmed that advance arrangements, even if nonrecourse, required capitalization of litigation costs.33 The court rejected the taxpayer's claims that the likelihood of repayment was sufficiently low to allow for immediate deduction of the litigation costs. The court initially determined that the likelihood of repayment was irrelevant to whether a loan existed for tax purposes. It went on to conclude that even if the likelihood of repayment was relevant to the analysis, the likelihood was high enough in the cases at issue to require capitalization.

D. The Correct Approach Under Current Law

In 2004 Treasury promulgated the INDOPCO regulations,34 which now govern the tax treatment of litigation costs. The recent Tax Court decision ignored the INDOPCO regulations, analyzing instead the traditional case law on litigation costs.35 Commentators on litigation costs likewise have thus far ignored the effect of the INDOPCO regulations.36

Nevertheless, it is clear that the INDOPCO regulations now govern the tax treatment of litigation costs because the costs create intangible, rather than tangible, value. The INDOPCO regulations apply to all costs that create intangible value, except for some intangible interests in real property.37 Advances give the contingent fee lawyer a right to repayment, which is an intangible asset. Costs paid by a lawyer under a gross fee arrangement enhance the lawyer's right to a future contingent fee by bolstering the plaintiff's legal claim. The right to a future contingent fee is also an intangible asset. The INDOPCO regulations therefore apply to the lawyer's payment of litigation costs under either advance or gross fee arrangements.

The INDOPCO regulations generally require capitalization for four types of payments: (1) payments to acquire specified intangibles; (2) payments to create specified intangibles; (3) payments "to create or enhance a separate and distinct intangible asset"; and (4) to the extent identified by Treasury in future guidance, payments to create or enhance a future benefit.38 If a payment that creates intangible value does not fit within one of the four categories, it is immediately deductible.39

Applying the INDOPCO regulations to advances of legal costs is a fairly straightforward exercise. Advances are described in the second category of payments that are required to be capitalized — payments to create specified intangibles. One of the specified created intangibles is a debt instrument "or any other intangible treated as debt for Federal income tax purposes."40 Debt exists for tax purposes when there is an "existing, unconditional, and legally enforceable obligation for the payment of a principal sum,"41 and advances qualify as debt under this definition. As discussed above, the nonrecourse nature of a loan does not cause a loan to be "not debt" for tax purposes even though repayment of principal could be considered conditional for nonrecourse debts. Accordingly, the INDOPCO regulations require the capitalization of advances regardless of whether they are made on a recourse or nonrecourse basis.42

While the tax treatment of advances under the INDOPCO regulations is clear, the treatment of costs paid under a gross fee contract is more complicated. Litigation costs incurred under a gross fee contract do not qualify as payments made to acquire one of the specified acquired intangibles for which capitalization is required.[43] Nor do they qualify as payments made to create a specified created intangible for which capitalization is required.[44] The client has no obligation to pay a principal sum; the client's only obligation is to pay a percentage of the total recovery to the lawyer, and the amount of litigation costs expended by the lawyer has no effect on the amount due from the client.[45] Accordingly, there is no creation of "debt" for tax purposes. Further, the fourth category — payments made for a future benefit identified in Treasury guidance — does not apply because the government has issued no such guidance on litigation costs, and the INDOPCO regulations make clear that that guidance, if issued in the future, would have only prospective application.[46]

Because the first, second, and fourth categories of payments that require capitalization do not apply, litigation costs under a gross fee contract may be required to be capitalized only under the third category. This category covers payments to create or enhance a separate and distinct intangible asset (SADIA).[47] A SADIA is defined, subject to a few specific exceptions, as "a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being transferred or pledged (ignoring any restriction on assignability) separate and apart from a trade or business."[48] The intangible right at issue is the right of a lawyer to receive a fee under the contingent fee agreement. This intangible right appears to satisfy all the conditions of a SADIA under this general definition. It is a property interest that can be valued, that is legally recognized, and that could (ignoring any restrictions imposed by state ethics rules or the contingent fee contract itself) be transferred separate and apart from the lawyer's trade or business. Ignoring, as the definition of SADIA requires, contractual or ethical restrictions preventing an attorney from assigning his rights and obligations under a particular contingent fee agreement, an attorney could find a buyer to acquire those rights and obligations for money.[49] Further, the attorney could hypothetically consummate that sale without also selling her entire law practice.[50] Accordingly, the right to receive a fee appears to qualify as a SADIA under the regulations.

Once it is established that a lawyer's right to a fee under a gross fee contract constitutes a SADIA, the next question is whether litigation costs paid by the lawyer create or enhance that right. It could be argued that the litigation costs do not create the right, which is initially created by the signing of the contingent fee agreement. Then again, if the lawyer does not pay the necessary costs of litigation, which the lawyer is required to do under a gross fee contract, the client can discharge the lawyer for cause, which would cause the lawyer to relinquish her right to a fee.[51] Thus, in a sense, the lawyer's performance of her obligations under the gross fee contract — by providing legal services and paying the necessary costs — create the lawyer's right to a contingent fee. If litigation costs are determined not to create the right to a fee, they would certainly be considered to enhance the right to a fee. There is no definition of enhance in the INDOPCO regulations (or the preamble), although it seems clear that the lawyer's payments of filing fees, expert witness fees, and other litigation costs are intended to enhance her right to a future fee. Otherwise, there would be no reason for a plaintiffs' lawyer under a gross fee contract to pay those fees.

Payment of litigation costs under a gross fee contract therefore creates or enhances a SADIA. Accordingly, unless an exception applies, those costs would be required to be capitalized. The only relevant exception provides that "amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset . . . regardless of whether the amounts result in the creation of an income stream under the agreement."[52] This language is not artfully drafted, but it appears that litigation costs paid under a gross fee contract would constitute amounts paid in performing services under an agreement. This exception was not part of the proposed regulations but was added when the regulations were finalized.[53] Despite the late addition of the exception, the extensive preamble to the final regulations did not even mention the new exception.[54]

Some insight into the meaning of the “in performing services” exception can be gleaned from Example 11 of the INDOPCO regulations,[55] which likewise was added only when the regulations were finalized and also without comment in the preamble.[56] In that example, a mutual fund distributor solicited sales of a mutual fund’s shares in exchange for the right to future fees to be paid by the fund. The distributor solicited sales directly to investors as well as through brokers. Under the agreement between the distributor and the mutual fund, when a sale was made through a broker, the distributor paid the broker’s commission. Before the promulgation of the INDOPCO regulations, the IRS’s position was that a mutual fund distributor’s payments of broker commissions were capital expenditures.[57] However, Example 11 concluded that because the “in performing services” exception applied to the broker’s commissions, the payments did not create a SADIA and therefore the payments were immediately deductible.

A 2010 letter ruling likewise determined that marketing fees paid by an investment adviser were immediately deductible because of the “in performing services” exception.[58] Under the investment advisory agreement between the adviser and an investment fund, the adviser was entitled to a fee, which was calculated as a percentage of the fund’s assets. The fee grew if the fund’s assets grew; accordingly, it was in the adviser’s interest to maximize the fund’s assets. To that end, the adviser entered into marketing agreements with agents to increase demand for investment in the fund. Under the marketing agreements, the adviser paid the agents’ fees for the marketing services, and under the investment advisory agreement, those fees were not reimbursed by the fund. The IRS ruled that payment of the marketing fees by the adviser did not create or enhance a SADIA, citing the “in performing services” exception:

The amounts paid to the marketing agents by [the adviser] are paid in performing services under the investment advisory agreement and, therefore, are treated as amounts that do not create a separate and distinct intangible asset. Although the amounts paid under the marketing agreements are intended to maximize the revenue of [the adviser’s] investment management business, they are not required to be capitalized.

The facts in Example 11 and the 2010 letter ruling are both analogous to litigation costs paid by lawyers under gross fee contracts. In each situation, the taxpayer provides services under an agreement that calls for the taxpayer to pay the incidental costs in providing those services, with no right of reimbursement for those costs. In Example 11, the taxpayer provided distribution services to the mutual fund and agreed to pay any broker fees incurred in connection with sales of the fund’s shares. In the 2010 letter ruling, the taxpayer provided investment advisory services to a fund and agreed to pay the costs of marketing the fund. In the gross fee contract situation, the taxpayer provides legal services to the client and agrees to pay the incidental litigation costs. Example 11 and the 2010 letter ruling therefore support the conclusion that the “in performing services” exception applies to litigation costs paid under a gross fee contract.

There is one lingering textual issue. A careful reader might notice that while payments that create or enhance a SADIA are generally capitalized, the “in performing services” exception appears to exempt only payments that would otherwise create a SADIA. The exception provides: “Amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset.”[59] We concluded above that there was some uncertainty whether litigation costs create a SADIA, although it was clear that those costs either create a SADIA or enhance a SADIA. While payments that create or enhance a SADIA are capitalized under the general rule, the exception, if read literally, carves out only payments that create a SADIA but does not mention payments that enhance a SADIA. In other words, if a payment merely enhances a SADIA (as opposed to creating the SADIA), the exception, which says that some payments are treated as not creating a SADIA, would be irrelevant.

We believe, however, that a literal interpretation is inappropriate. First, and most significantly, there would be no reason for the INDOPCO regulations to give different treatment to amounts paid in performing services that create a SADIA (which would be deductible under a literal interpretation because the exception applies) over amounts paid in performing services that merely enhance a SADIA (which would be required to be capitalized under a literal interpretation).60 Second, if such a counterintuitive and subtle distinction was drawn by the drafters of the INDOPCO regulations, one would think they would have made it clearer in the regulations themselves or at least in the preamble. Third, a literal interpretation would put undue emphasis on the very slippery creation-versus-enhancement distinction. As discussed above, one could argue that litigation costs under a gross fee contract create a SADIA (namely, the right to receive a future fee) because if litigation costs were not paid by the lawyer, the lawyer could be discharged for cause, which would result in the lawyer forfeiting his right to the contingent fee.

We therefore believe the exception was simply poorly drafted and should be interpreted to read: "Amounts paid in performing services under an agreement are treated as amounts that do not create or enhance a separate and distinct intangible asset." This interpretation is supported by the language used by the IRS in the 2010 letter ruling involving marketing agents' fees paid by an investment adviser:

The payments under the marketing agreement are not required to be capitalized as amounts that create or enhance (or facilitate the creation or enhancement of) a separate and distinct intangible asset. Section 1.263(a)-4(b)(3)(iii) provides that amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset, regardless of whether the amounts result in the creation of an income stream under the agreement. The amounts paid to the marketing agents by [the adviser] are paid in performing services under the investment advisory agreement and, therefore, are treated as amounts that do not create a separate and distinct intangible asset. Although the amounts paid under the marketing agreements are intended to maximize the revenue of [the adviser's] investment management business, they are not required to be capitalized under [the INDOPCO regulations].61

The first sentence of the above excerpt concludes that the payment of marketing agents' fees does not create or enhance a SADIA. In support of that conclusion, the next sentence cites and paraphrases the "in performing services" exception, which literally covers only amounts that create a SADIA. The next sentence then applies the facts to the exception and concludes that the fees do not create a SADIA. The final sentence concludes that, as a result, the fees are not required to be capitalized. If the IRS had interpreted the "in performing services" exception literally, it would have been necessary for it to separately evaluate the possibility that marketing agents' fees might have merely enhanced (as opposed to created) a SADIA. Instead, the ruling never addresses the creation-versus-enhancement issue and simply concludes that because the "in performing services" exception applies to the SADIA in question, the payments are not required to be capitalized. That approach is consistent with our suggested interpretation of the "in performing services" exception.

Accordingly, we conclude that under current law, litigation costs that are advanced must be capitalized under the INDOPCO regulations, regardless of whether the advances are made on a recourse or nonrecourse basis. However, litigation costs paid under a gross fee contract are immediately deductible.

E. Policy Issues

1. Treasury should issue guidance requiring litigation costs incurred under gross fee contracts to be

capitalized. The previous section addressed the tax treatment of litigation costs under current law. This section asks whether, as a policy matter, litigation costs should be capitalized. This issue is relevant to Treasury and the IRS, which under the INDOPCO regulations, could issue guidance requiring that litigation costs under gross fee contracts be capitalized in the future.62 The question is also relevant to lawmakers, who have been lobbied on both sides of the issue. The AAJ has pushed for legislation that would allow litigators to deduct all litigation costs incurred by contingent fee lawyers, regardless of the type of fee agreement.63 The AMA has opposed that legislation and contends that the IRS's current position — that all litigation costs must be capitalized — is correct and should be reaffirmed.64

A fundamental principle of income taxation is that costs that are incurred to produce future income should be capitalized and recovered as the income is realized.65 In fact, the key distinction between an income tax and a consumption tax is their disparate treatment of costs incurred to produce future income: An income tax requires those costs to be capitalized, while a consumption tax allows them to be immediately deducted.66 Although the capitalization principle — that in an income tax, costs incurred to produce future income should be capitalized — is easy to state, its application in practice has proven quite difficult. Professor Lawrence Lokken explains:

This conception of the capitalization requirement . . . cannot practicably be directly implemented as a rule of tax law. Many, perhaps most, costs incurred in everyday operation of a business yield some benefit continuing beyond the year in which they are incurred. Most marketing costs, for example, produce some future benefit in the form of repeat patronage, even if they are incurred principally to make current sales. Rigorous application of the [capitalization principle] would require most businesses to divide numerous costs between immediate and future benefits in ways that far exceed reasonable demands for cost accounting. The challenge in developing the capitalization requirement is to implement the essence of the [capitalization principle] without imposing unreasonable accounting burdens.67

Thus, income tax administrators who design capitalization rules must weigh the benefits of adhering closely to the capitalization principle against the practical administrative burdens imposed on taxpayers.

In the litigation cost context, plaintiffs' lawyers incur upfront costs in order to produce future income: their contingent fee. Accordingly, the capitalization principle would require that those costs be capitalized and later offset against any recovery by the lawyer. If there is no recovery by the lawyer, or if the costs exceed any recovery, the lawyer would receive a deduction when the case is resolved.

Turning to the issue of administrative burdens, it would not be difficult for contingent fee lawyers to comply with a rule requiring the capitalization of litigation costs. When contingent fee lawyers pay those costs as advances, which is typical, they must bill them to the client and account for them when the case is resolved to determine how the case's proceeds will be allocated. In gross fee contracts, however, there is no need to keep track of litigation costs to make this allocation, because the division of proceeds is unaffected by the costs incurred. Nevertheless, in light of the widespread traditional practice of keeping careful track of litigation costs, it would be hard for gross fee contract lawyers to argue that this sort of accounting is especially onerous.

The INDOPCO regulations allow the government to issue prospective-only guidance that requires capitalization of intangibles that should be capitalized but managed to slip through the cracks of those regulations.68 Because litigation costs are incurred to produce future income, and because requiring capitalization of those costs will not be costly, the government should issue guidance. That guidance should provide that litigation costs paid by plaintiffs' lawyers in connection with a gross fee contract are payments that create or enhance a future benefit and, accordingly, must be capitalized. Litigation costs should be defined in the guidance as costs incurred by contingent fee litigators that have traditionally been billed to clients as advances, including court fees; jury fees; service of process charges; court and deposition reporters' fees; photocopying and reproduction costs; notary fees; long distance telephone charges; messenger and other delivery fees; postage; deposition costs; travel costs, including parking, mileage, transportation, meals, and hotel costs; investigation expenses; consultant, expert witness, professional mediator, arbitrator, and special master fees; and other similar items. The guidance should also clarify that costs incurred by lawyers as advances, whether recourse or nonrecourse, are required to be capitalized under the INDOPCO regulations as a payment to create a debt instrument.69

This guidance is appropriate for two reasons. First, as previously explained, the capitalization of costs incurred to produce future income is a key principle of an income tax. Departures from this principle should not be taken lightly.70 Allowing some businesses to deduct costs incurred to produce future income gives them an advantage over businesses that are forced to capitalize similar costs. Because there is little administrative hardship imposed on litigators to keep track of their litigation costs, the benefit of hewing closely to the capitalization principle far outweighs any cost of departure. Second, the guidance would neutralize the tax treatment between contingent fee arrangements that use advances and those that are gross fee contracts. As the tax law stands now, there is a tax incentive for contingent fee lawyers to use gross fee contracts. This guidance would put advances and gross fee contracts on the same footing tax-wise.

2. Potential counterarguments are not persuasive. Proponents of immediate deduction of litigation costs can be expected to base their arguments on the risks taken on by contingent fee lawyers in paying litigation costs. In gross fee contracts, as well as in nonrecourse advance arrangements, if there is a defense verdict, the lawyer suffers a loss equal to the amount of the costs. Even if the plaintiff nominally prevails, the settlement or judgment may not cover the amount of costs, and the lawyer could bear the shortfall. Riskiness, however, simply has no relevance to the capitalization issue. For example, taxpayers who buy options must capitalize their purchase prices regardless of how risky the options might be. If and when a risky option becomes worthless, the purchase price will be recovered at that time as a loss deduction. There is no authority for the proposition that the riskiness of an investment makes its cost less of a candidate for capitalization, nor is there a good policy argument to support that proposition.

Table 2

	Year 1	Year 2	Year 3	Year 4
Gross income	$0 (no settlements yet)	$200x (settlement from case 1)	$200x (settlement from case 2)	$200x (settlement from case 3)
Deductions	$0 (case 1 litigation	-$100x (litigation	-$100x (litigation	-$100x (litigation

	costs capitalized)	costs of case 1 recovered)	costs of case 2 recovered)	costs from case 3 recovered)
Taxable income	$0	$100x	$100x	$100x

Table 3

	Year 1	Year 2	Year 3	Year 4
Gross income	$0 (no settlements yet)	$200x (settlement from case 1)	$200x (settlement from case 2)	$200x (settlement from case 3)
Deductions	-$100x (case 1 litigation costs deducted)	-$100x (case 2 litigation costs deducted)	-$100x (case 3 litigation costs deducted)	$0 (no litigation costs incurred in year 4)
Taxable income	-$100x	$100x	$100x	$200x

Proponents of immediate deduction might also argue that because litigation costs are recurring expenditures, there is little cause for concern. To illustrate this argument, assume that a new law firm generates one new case per year for three years, incurs $100x of litigation costs attributable to each case, and all $100x of litigation costs are incurred in the year in which the case originated. Assume also that each of the three cases settle after one year for $200x. If the litigation costs were capitalized and recovered in the year of settlement (that is, the year after the case was originated and the costs incurred), the results in Table 2 (above) would occur.

If litigation costs were immediately deductible, the results in Table 3 (above) would occur.

Proponents of deductibility might point to years 2 and 3, which result in the same amount of taxable income ($100x) under both approaches. While this is true, the argument overlooks that the taxpayer is undertaxed by $100x in year 1 under the immediate deduction approach.71 Eventually, the error is “corrected” by overtaxing the taxpayer in year 4 by the same $100x, but, of course, that does not make the government whole because of the time value of money. More generally, when there are recurring expenditures, the amount of taxable income will be significantly distorted in build-up years, when investments are increasing, and in wind-down years, when investments are decreasing. This is true even though the interim “steady state” years will have similar taxable incomes. Because of the distortions in the build-up and wind-down years, recurring expenditures that relate to future income should be capitalized unless capitalization would be significantly burdensome.72 As argued above, requiring litigators on gross fee contracts to keep track of litigation costs on a client-by-client basis is not onerous, since this sort of accounting is routinely done by contingent fee litigators who advance litigation costs.

F. Conclusion

We have argued that the INDOPCO regulations now control the tax treatment of litigation costs incurred by contingent fee lawyers. When those lawyers advance costs that are reimbursed out of the eventual recovery, the INDOPCO regulations require the advances to be capitalized. This is true regardless of whether the client is liable for the shortfall if the amount advanced exceeds the recovery. However, if a contingent fee lawyer pays litigation costs under a gross fee contract, the INDOPCO regulations allow those costs to be immediately deducted, a result consistent with the Ninth Circuit's holding in Boccardo.

We have also argued that as a policy matter, immediate deductions for litigation costs incurred by a contingent fee lawyer should not be allowed. These costs clearly relate to future income — namely, the future contingent fee. The administrative burdens of attributing litigation costs to particular client matters and keeping track of those costs is insignificant, as evidenced by the fact that contingent fee lawyers routinely perform these tasks for nontax reasons. The government therefore should issue prospective-only guidance requiring litigation costs to be capitalized in gross fee arrangements. For the same policy reasons, legislative proposals that would make all litigation costs immediately deductible should be rejected.

FOOTNOTES

1 The model contingency fee agreement provided by the California bar includes the following list of advanced expenses: "court fees, jury fees, service of process charges, court and deposition reporters' fees, photocopying and reproduction costs, notary fees, long distance telephone charges, messenger and other delivery fees, postage, deposition costs, travel costs including parking, mileage, transportation, meals and hotel costs, investigation expenses, consultant, expert witness, professional mediator, arbitrator and/or special master fees and other similar items."

2 See Robert W. Wood, "Another Tax Case Limits Lawyer Costs Deduction," Tax Notes, Feb. 25, 2013, p. 997 .

3 See, e.g., TAM 9432002 (Aug. 12, 1994); 1997 FSA 442.

4 Boccardo v. Commissioner, 56 F.3d 1016 (9th Cir. 1995) .

5 1997 FSA 442.

6 Wood, "A Taxing Process," L.A. Daily Journal, Jan. 13, 2009, at 5.

7 See, e.g., H.R. 2519, S. 437, 111th Cong. (introduced Feb. 13, 2009). The same proposal giving trial lawyers a tax deduction for litigation costs was attached to H.R. 6049, the Energy and Job Creation Act, also known as the "tax extenders" legislation in 2008.

8 The American Association for Justice (AAJ), the leading organization for plaintiffs' lawyers, listed H.R. 2519, which would provide an immediate deduction for litigation costs, on its 2009 lobbying report, available at http://disclosures.house.gov/ld/pdfform.aspx?id=300181914. The AAJ also hired outside lobbying firms Patton Boggs (2009 lobbying report available at

http://disclosures.house.gov/ld/pdfform.aspx?id=300181677) and the Palmetto Group (2009 lobbying report available at http://disclosures.house.gov/ld/pdfform.aspx?id=300142802) to work on the bill.

9 Most prominent among the groups opposing the legislative change is the American Medical Association. See infra text accompanying notes 29-30.

10 An interesting ancillary issue that Ethan Yale raised with us is whether those advances might result in imputed income under section 7872. Section 7872 applies only to specific below-market interest loans (BMLs). One type of BML to which section 7872 applies is a compensation-related loan, which includes loans “between an independent contractor [the lawyer] and a person for whom such independent contractor performs services [the client].” Section 7872(c)(1)(B)(ii). Thus, on its face, section 7872 would appear to apply to advances. However, it seems clear that the drafters of section 7872 were focused on loans that ran from service recipients to service providers, not in the opposite direction. In the blue book discussion of section 7872, the Joint Committee on Taxation, in its discussion of compensation-related loans, focused only on “loans to persons providing services,” and all of its examples of compensation-related loans flowed only in that direction. JCT, “General Explanation of the Revenue Provisions of the Deficit Reduction Act Of 1984,” JCS-41-84, at 528-530 (Dec. 31, 1984). Also, the JCT explained that “Congress intended that an arrangement be treated as a compensation-related loan if, in substance, there is a compensatory element arising from the transaction.” Id. at 530. Interest-free advances from service providers to service recipients do not involve a compensatory element. Further, the proposed regulations under section 7872 explain that in a compensation-related loan, “the imputed transfer (amount of money treated as transferred) by the lender to the borrower is compensation.” Prop. reg. section 1.7872-4(c)(1). This would mean that application of section 7872 under the proposed regulations would result in compensation being deemed paid by the service provider (the lawyer-lender) to the service recipient (the client-borrower), which is nonsensical. Instead, the deemed transfer from lawyer-lender to client-borrower would be characterized as a rebate or purchase price adjustment for the cost of the lawyer-lender’s services. In short, while the literal language of section 7872 seems to cover advances of litigation costs, those advances were not intended to be subject to section 7872 because they run in the opposite direction as the compensation-related loans that were targeted by that provision.

11 See Wood, supra note 2, at 997-998.

12 See “Lawyer’s Advances on Behalf of Clients — Application of the Trade or Business Expense Rules,” Federal Tax Coordinator, L-4103 (2d ed.) (“To maintain relative economic parity, an attorney would have to receive a higher percentage of the client’s recovery under a gross fee arrangement than under a net fee arrangement”).

13 See Hearn v. Commissioner, 36 T.C. 672 (1961), aff’d, 309 F.2d 431 (9th Cir. 1962); Burnett v. Commissioner, 42 T.C. 9 (1964), aff’d in part, remanded in part on other grounds, 356 F.2d 755 (5th Cir. 1966); Canelo v. Commissioner, 53 T.C. 217 (1969), aff’d per curiam, 447 F.2d 484 (9th Cir. 1971); Herrick v. Commissioner, 63 T.C. 562 (1975); Silverton v. Commissioner, T.C. Memo. 1977-198; Boccardo v. United States, 12 Cl. Ct. 184 (1987).

14 See Canelo, 53 T.C. at 225 (“If expenditures are made with the expectation of reimbursement, it follows that they are in the nature of loans, notwithstanding the absence of formal indebtedness”).

15 See, e.g., Burnett, 356 F.2d at 759-760 (holding that cases requiring “an unconditional obligation to repay are not controlling” and “the question of whether an expenditure constitutes an expense . . . must be determined by the circumstances and conditions under which it was made”).

16 See Commissioner v. Tufts, 461 U.S. 300, n.5 (explaining that nonrecourse debt could “be

considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee").

17 Id. (concluding that, even though nonrecourse debt could be considered a contingent liability, it remains "true debt" for tax purposes). In some cases, nonrecourse debt with a sufficiently high likelihood of default might be considered an option to buy the collateral or some other instrument other than debt. See, e.g., Estate of Franklin v. Commissioner, 64 T.C. 752, 766-767 (1975) (concluding that nonrecourse purchase money debt that was in excess of the property's fair market value constituted an option for federal income tax purposes). For nonrecourse advances, it is unlikely that courts would consider the likelihood of default to be high enough to trigger this recharacterization. Even in the unlikely case that recharacterization along those lines would be appropriate, the purchase price of the resulting asset would still be capitalized.

18 See generally Frederick H. Robinson, "Nonrecourse Indebtedness," 11 Va. Tax Rev. 1, 42 (1991) (describing how nonrecourse debt is equivalent to recourse debt plus a put option in favor of the borrower).

19 See Tufts, 461 U.S. at 300, n.5.

20 See, e.g., Miller v. United States, 679 F. Supp. 692, 694-695 (E.D. Mich. 1988).

21 See Burnett, 356 F.2d at 759; Canelo, 53 T.C. at 225.

22 Cf. Humphrey Farrington & McCain PC v. Commissioner, T.C. Memo. 2013-23, at 4 (concluding that the likelihood of repayment is irrelevant to the issue of deductibility).

23 Boccardo v. Commissioner, T.C. Memo. 1993-224, at 1 (describing the Boccardo Law Firm's gross fee contract).

24 Id. at 4.

25 Boccardo, 56 F.3d 1016, 1018-1019 (9th Cir. 1995) ("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").

26 1997 FSA 442. The 1997 field service advisory reiterated the IRS's position in a 1994 technical advice memorandum (TAM 9432002), which required capitalization of advanced litigation expenses.

27 See Wood, supra note 2, at 1,000.

28 See supra note 8.

29 See supra note 7.

30 Carolyne Krupa, "Organized Medicine to Geithner: Don't Give Lawyers Tax Breaks for Litigation Expenses," amednews.com (Sept. 13, 2010).

31 Letter from 24 senators to Geithner (July 29, 2010) .

32 On May 6, 2010, Treasury responded to a letter from Senate Finance Committee Chair Max Baucus, D-Mont., and Majority Whip Richard J. Durbin, D-Ill., requesting clarification on Treasury's position in light of Boccardo. The response simply stated that the Office of Tax Policy "is aware of the concerns . . . and is considering issuing guidance to clarify this issue."

33 Humphrey Farrington & McCain PC v. Commissioner, T.C. Memo. 2013-23, at *6-*7. While some of the litigation matters were covered by arrangements characterized by the taxpayer and the court as “gross fee” arrangements, those arrangements were inconsistent with the gross fee contracts used by the Boccardo Law Firm. The contracts used by Boccardo split the proceeds of the litigation in accordance with the contingent fee percentage, with no reimbursement obligation running from the client to the lawyer; therefore, the amount of money that went to the lawyer was unaffected by the amount of costs paid by the lawyer. On the other hand, in the “gross fee” contracts analyzed in Humphrey, the proceeds were initially split between the plaintiff and the lawyer according to the contingent fee percentage, but the plaintiff then had to reimburse the lawyer for its costs out of the plaintiff’s initial share. Therefore, the gross fee contract in Humphrey simply involved advances of costs, because the plaintiff was required to reimburse them.

34 T.D. 9107 , 69 F.R. 436-465 (Jan. 5, 2004).

35 The taxpayer’s brief indicates that during the trial, the Tax Court inquired about the potential application of the INDOPCO regulations, but the decision does not mention them. Petitioner’s brief, Humphrey, T.C. Memo. 2013-23, at *17, n.12 (Aug. 9, 2010) (No. 21153-09).

36 It is clear that the INDOPCO regulations can overrule the earlier case law. In National Cable & Telecommunications Ass’n v. Brand X Internet Services, 545 U.S. 967 (2005), the Supreme Court determined that regulations that garner Chevron deference, such as Treasury regulations, can overrule interpretations by earlier inferior courts as long as the regulations’ interpretation is permitted by the underlying statute. In this case, the relevant statutes are sections 263 (which requires the capitalization of capital expenditures) and 162 (which allows the immediate deduction of ordinary and necessary business expenses), both of which provide no detail about how they should apply to litigation costs. Accordingly, the INDOPCO regulations supersede the earlier litigation cost cases.

37 See Yale, “The Final INDOPCO Regulations,” Tax Notes, Special Supplement, Oct. 25, 2004, p. 435 .

38 Reg. section 1.263(a)-4(b)(1)(i-iv). The regulations also require the capitalization of two types of indirect costs: costs incurred to facilitate the acquisition or creation of an intangible for which the direct costs must be capitalized; and costs to facilitate specific business acquisitions and restructurings. See reg. section 1.263(a)-4(b)(1)(v), and -4(e) (definitions and exceptions). Litigation costs incurred by litigators are direct costs, so these rules are not relevant.

39 See Yale, supra note 37, at 436 (noting that the preamble to the final regulations states that “an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits”). As mentioned in supra note 38, some facilitation expenses must also be capitalized, but the litigation costs in question are not facilitation costs.

40 Reg. section 1.263(a)-4(d)(2)(i)(B).

41 Noguchi v. Commissioner, 992 F.2d 226, 227 (9th Cir. 1993) .

42 The so-called 12-month rule is a potential exception to the requirement that payments that create specified intangibles be capitalized. However, the 12-month rule does not apply to the payments that create financial interests such as debt instruments. See reg. section 1.263(a)-4(f)(3).

43 See reg. section 1.263(a)-4(c)(1) (listing acquired intangibles for which capitalization is required).

44 See reg. section 1.263(a)-4(d) (listing created intangibles for which capitalization is required).

45 In contrast, in fee agreements that provide for advances, the client must repay a principal sum, i.e., the amount of litigation costs incurred by the lawyer out of the recovery. Therefore, in these cases, the amount of litigation costs affects the amount due to the lawyer under the contingent fee agreement.

46 See reg. section 1.263(a)-4(b)(2).

47 Reg. section 1.263(a)-4(b)(1)(iii).

48 Reg. section 1.263(a)-4(b)(3)(i).

49 The treatment of contingent fee agreements in divorce and bankruptcy illustrates that interests therein can be valued, are legally recognized, and could hypothetically be sold. For example, some state courts have found pending contingency fee cases to be marital property subject to equitable distribution upon divorce. See National Legal Research Group Inc., “Contingent Fee Contracts as Assets of a Law Practice,” 14 No. 3 Equitable Distribution J. 25 (Mar. 1997). Moreover, some courts have also held that contingency fee cases are included in a debtor-attorney’s bankruptcy estate. See, e.g., In re Carlson, 263 F.3d 748, 750 (7th Cir. 2001).

50 In other words, the attorney could sell her rights under one contingent fee agreement while retaining her rights under all of her remaining contingent fee agreements.

51 See, e.g., Hardison v. Weinshel, 450 F. Supp. 721, 723 (E.D. Wis. 1978); Gary v. Cohen, 231 N.Y.S. 2d 394, 398 (N.Y. Sup. Ct. 1962); Royden v. Ardoin, 331 S.W.2d 206, 209 (Tex. 1960).

52 Reg. section 1.263(a)-4(b)(3)(iii).

53 Compare prop. reg. section 1.263(a)-4(b)(3) with reg. section 1.263(a)-4(b)(3)(iii).

54 Preamble to final reg. section 1.263(a)-4, 69 F.R. 436 (Jan. 5, 2004), reprinted at 2004-1 C.B. 447.

55 Reg. section 1.263(a)-4(l), Example 11.

56 See supra notes 53-54.

57 See Rev. Proc. 2000-38, 2000-2 C.B. 310 (providing three safe harbor methods for recovering capitalized broker fees paid by mutual fund distributors).

58 LTR 201032023.

59 Reg. section 1.263(a)-4(b)(3)(iii).

60 Further, if there were to be different treatment, one would expect “creation” payments to be capitalized and mere “enhancement” payments to be deductible, not vice versa.

61 LTR 201032023 (emphasis added).

62 See reg. section 1.263(a)-4(b)(1)(iv), -4(b)(2).

63 See supra note 8.

64 See supra note 30.

65 See section 263 (capitalization is the norm, while expensing is the exception); section 263A (requiring capitalization for the costs of producing property); INDOPCO Inc. v. Commissioner, 503 U.S. 79 (1992) (requiring capitalization for costs producing a nonincidental future benefit); Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971) (requiring capitalization for costs creating a separate and identifiable asset). This general principle is consistent with the Haig-Simons definition of income. Under that definition, "a cost should be considered a capital expenditure to the extent the value acquired . . . remains part of the taxpayer's 'store of property rights.'" Lokken, "Capitalization: Complexity in Simplicity," Tax Notes, Special Supplement, May 28, 2001, p. 1357 . In other words, the making of a capital expenditure does not reduce Haig-Simons income because it merely changes the form of the property right from cash to noncash property. Id.

66 See Edward J. McCaffery, "Tax Policy Under a Hybrid Income-Consumption Tax," 70 Tex. L. Rev. 1145, 1150-1151 (1992).

67 Lokken, supra note 65, at 1357.

68 See supra note 62. Yale explains that "among Treasury's motivations for promulgating the INDOPCO regulations was dissatisfaction with the level of ambiguity under prior law and a desire to quell controversy by reticulating an exhaustive set of rules. Treasury is rightly concerned that it might have touched every base." Yale, supra note 37, at 451.

69 A related issue is whether costs incurred by contingent fee lawyers that are not typically advanced to clients ought to be required to be capitalized. Contingent fee lawyers do not usually advance payroll costs (such as wages paid to associate lawyers and paralegals) or office overhead (e.g., rent, insurance, and utilities) to clients. In theory, those costs should be capitalized as well since they relate to future contingent fees; however, the "in performing services" exception exempts them from capitalization. See supra text accompanying notes 52 and 59. Should the guidance that we suggest cover these costs as well? On one hand, at least for associate and paralegal costs, personal injury firms are likely already attributing those employees' time to client matters to better inform business decisions such as compensation, staffing, and case selection. Further, in matters in which the plaintiff could recover attorney fees, this information would be necessary to prove the amount of those fees, which are calculated based on the number of hours worked. On the other hand, the INDOPCO regulations generally allow compensation paid to employees as well as overhead attributable to intangible assets to be immediately deductible on administrative convenience grounds. See reg. section 1.263(a)-4(e)(4)(i)-(ii); see also supra note 60. This rule applies even if the taxpayer capitalizes the compensation and overhead for financial accounting purposes.

70 We recognize that the INDOPCO regulations themselves depart from this principle in a variety of circumstances that are unjustified. See generally Calvin H. Johnson, "Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations," Tax Notes, June 2, 2003, p. 1381 .

71 For a longer-period example of this phenomenon, see Johnson, "Soft Money Investing Under the Income Tax," 1989 Ill. L. Rev. 1019, 1072-1077 (1989).

72 Id.; Thomas L. Evans and Gregory W. Gallagher, "INDOPCO — The Treasury Finally Acts," 80 Taxes 47 (Mar. 2002).

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