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Firm Denied Current Deduction for Out-of-Pocket Disbursements

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The tax treatment by law firms of disbursements advanced by them on behalf of litigation clients has been an ongoing source of controversy with the Internal Revenue Service. Some of the rules are fairly clear. For example, if a disbursement is made on behalf of a client and the client is unconditionally obligated to pay the disbursed amount to the firm regardless of the outcome of the matter, the disbursement is viewed as a loan. Accordingly, the firm cannot claim a deduction for that amount unless and until it becomes apparent that payment will not be made by the client; if and when that occurs, a bad debt deduction may be available.

In many contingency fee litigation matters, however, the client has no obligation to pay the disbursements unless and until there is a recovery in the underlying matter (in which case the disbursements are paid from the amount recovered through payment of a judgment, settlement, or otherwise). In those cases, it has been argued that the conditional nature of the obligation to repay converts the disbursements from loans to the client into expenses of the firm, generally deductible at the time they are paid or incurred.

If a disbursement were properly expensed, it might have to be later included in income, but only if later recouped from (for example) the proceeds of a recovery. In this way, the current deduction of advanced expenses would not result in a permanent difference in the cumulative taxable income of a firm. However, if disbursements were generally deductible when incurred, the advantage in terms of timing of income and tax liabilities (as compared to loan treatment) could be significant, especially in litigation contexts where the disbursements for costs of litigation may be relatively large and cases may be pending for years before a final determination.

Unfortunately for lawyers who must account for such advanced disbursements, the IRS has been consistent in its view that they cannot be deducted at the time advanced, even if recovery is contingent on success in the underlying matter and even if there is substantial uncertainty as to whether there will be any recovery. The courts, including a recent Tax Court decision on point, *Humphrey, Farrington & McClain v. Commissioner*,[1] have supported this position.

Facts in 'Humphrey'

The Missouri law firm of Humphrey, Farrington & McClain, P.C. ("HFM") primarily represented plaintiffs in personal injury matters. The firm had several types of fee arrangements with litigation clients. In matters for which the firm had a fully reimbursable arrangement, clients paid fees at an hourly or other rate and reimbursed the firm for advanced expenses, regardless of the outcome of the litigation.

In all of the firm's contingency fee arrangements, however, clients paid fees and reimbursed expenses to the firm only if there was a favorable outcome. The contingency fee matters included personal injury litigation in which the firm's rights to reimbursement were defined by its retainer agreements with its clients and class actions in which fees were paid and advanced expenses reimbursed only upon court approval and according to the terms of a settlement or judgment.

HFM utilized the cash receipts and disbursements method of accounting for Federal income tax purposes. It capitalized (and did not deduct) expenses it advanced in matters covered by a fully reimbursable arrangement. With respect to contingency fee matters that were not class actions, the firm's treatment of expenses depended on whether the likelihood of reimbursement of expenses was considered to be "high" or "low" and whether the underlying litigation was considered to be high risk or low risk. Expenses in matters with respect to which the likelihood of reimbursement was considered to be "high" would generally be capitalized, but expenses in other, higher risk matters were deducted currently—that is, in the year the disbursement was made. All advanced expenses in class actions were deducted currently.

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During 2005, the firm disbursed $675,713 of advanced expenses. Of that total, $73,220 of expenses, either incurred under fully reimbursable arrangements or otherwise considered to have a high likelihood of reimbursement, were capitalized. All other advanced expenses, totaling $602,493, were deducted.

Following an audit, the IRS determined various adjustments to the treatment of advanced expenses on the firm's 2005 tax return, and HFM filed a petition for review by the Tax Court. In Tax Court proceedings the government sought, first, an adjustment of $403,808[2] with respect to advanced expenses incurred in 2005, based on the IRS view that all of the advanced expenses should have been treated as loans rather than deducted as business expenses.

A further adjustment of $2,740,161 was asserted under the IRS's authority to require the taxpayer to change its method of accounting for tax purposes and to include in income for 2005 the cumulative net amount of theretofore unresolved advanced expenses that had been incurred and deducted in years before 2005.

Analysis of Issues

Before the Tax Court, HFM and the IRS disagreed to the legal standard that governs whether advanced expenses can be deducted as business expenses. The IRS contended that, as long as the firm had a right to reimbursement contingent on a recovery in litigation, the advanced expenses must be treated as loans (and were not currently deductible), without regard to the expectation of reimbursement. The firm's position was that the likelihood of reimbursement was relevant and that expense amounts advanced by the firm should be treated as loans to its clients (and not deducted currently) only in situations where there was a high probability of eventual reimbursement of the firm.

Using HFM's own internal categorization of matters, the court found that the percentages of expenses recovered by HFM with respect to various categories of matters resolved in years 2004 through 2009 ranged from 36.5% to 99.9%. On this basis, the court concluded that as to no category of expenses did the evidence support HFM's assertion that the likelihood of reimbursement was low or insignificant. To the contrary, there was at least a significant possibility that the expenses in each category that had been advanced by HFM would in fact be reimbursed.

HFM further asserted that advanced expenses with respect to class action cases in particular should be currently deductible for two additional reasons: (i) because reimbursement required court approval, thereby reducing the probability of reimbursement with respect to class-action expenses; and (ii) because there was no identifiable individual obligor to repay such expenses. Rather, the members of the class to whom the action related would be identified only after the class action was commenced, and the class would collectively bear the costs approved by the court if (and only if) the class action was successful in obtaining a recovery.

The Tax Court was not persuaded by either argument. The court acknowledged that recovery of legal fees and expenses in a class action required court approval. However, because class counsel is entitled to reimbursement of all reasonable out-of-pocket expenses of prosecuting claims and obtaining settlement under the "common fund" doctrine, any court certifying such an action as a class action would generally award such expenses to class counsel.

The Tax Court also noted that HFM had been successful in being named as class counsel in each of its class action cases that were certified. While there was some risk that, in any specific case, HFM would fail to obtain certification as a class action, that risk—at least on the record before the Tax Court—did not cause the probability of reimbursement to be reduced to so low a level that could be characterized as insignificant.

The court concluded that all the advanced expenses that HFM were required to be treated as loans and that HFM was not entitled to deduct those amounts as expenses in the year of payment, but rather only as a bad debt to the extent such amounts were not recovered in the year a case was closed. The court did not directly address whether the advanced expenses would have been deductible currently if the likelihood of recovery was insignificant from inception—but a law firm that routinely accepted such cases might find it difficult to continue profitable operation for very long.

Method of Accounting

Somewhat different issues were raised by the IRS' insistence that HFM "recapture" during 2005 the full cumulative amount of not-yet-resolved litigation expenses that it had deducted in prior years. HFM argued that, even if its treatment of advanced expenses as deductible was incorrect, treatment of those expenses as loans in 2005 and later years was not a "change in method of accounting" that would justify requiring an adjustment with respect to advanced expenses deducted in years before 2005.

Under relevant Code provisions and regulations thereunder cited in the court's opinion, a "change in method of accounting" requires a cumulative adjustment, in the year in which the new method of accounting is adopted by the taxpayer or imposed by the IRS, to prevent the duplication or omission of income or deductions. Such a "change" may consist of either (i) a change in the taxpayer's overall method of accounting or (ii) a change in the treatment of any "material item," that is, "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction."[3]

Cases cited in the opinion confirm that, if the treatment of an item does not permanently affect the taxpayer's cumulative taxable income for all tax periods of its existence, but rather merely accelerates a deduction or postpones income, a change in the treatment of such an item is generally considered a change in method of accounting.

The government was not asserting a change in the firm's overall method of accounting (for example, from the cash receipts and disbursements method to an accrual method). Nevertheless, the change in the treatment with respect to advanced expenses that was required to be made in 2005 was a change in the treatment of a "material item" and therefore required a cumulative adjustment in the year of the change, as its effect was not to increase or decrease income permanently, but, rather, to shift the deduction of advanced expenses from the year in which incurred to the year in which the related case was closed. Accordingly, the government's assertion that the firm was required to make a cumulative adjustment in 2005 with respect to amounts deducted in prior years was upheld.

HFM did have one small victory before the Tax Court. The IRS had determined not only a deficiency, but also an addition to HFM's tax by reason of its having made a "substantial understatement" of tax. However, under Code section 6664, the penalty as asserted by the government would not apply if HFM established that it had reasonable cause for its position and had acted in good faith.

The court noted that, although earlier cases had concluded that advances of litigation costs were not deductible,[4] language in at least some decisions had suggested that the likelihood of reimbursement was or might be relevant as to deductibility. Taking that into account, the firm's practices of segregating cases in which it thought reimbursement was likely from other cases with respect to which reimbursement was highly uncertain and determining the treatment of advances on that basis showed a good faith effort to determine deductibility. Accordingly, the court concluded that the asserted penalty would not be imposed to the extent the firm's understatement of tax for 2005 was attributable to the advanced expenses.

Observations

The conclusion in *Humphrey* as to the deductibility of advanced expenses did not appear to be surprising in light of prior cases dealing with similar fact patterns; and the circumstance that the decision was a memorandum decision, rather than a regular decision, of the Tax Court tends to confirm that the court did not consider the issue to be one of first impression. Nonetheless, the case merits close reading by any law firm that treats expenses advanced for clients in pending matters as currently deductible expenses rather than as loans, and even the court's generosity in failing to uphold the asserted penalty cannot be expected to continue as the adverse authority continues to pile up.

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1 TC Memo 2013-23 (2013).

2 The total amount of advanced expenses set forth as deducted in 2005 was substantially less than the adjustment initially asserted in the notice of deficiency ($902,851) but substantially more than the adjustment of $403,808 that HFM and the government ultimately agreed in Tax Court proceedings would be appropriate with respect to expenses incurred in 2005 if the government prevailed on this issue. The reasons for these differing amounts are not made clear in the opinion.

3 Reg. § 1.446-1(e)(2)(ii)(a).

4 See, e.g., *Burnett v. Commissioner*, 17 AFTR 2d 358 (5th Cir. 1966), affirming 42 T.C. 9 (1964); and *Merritt v. Commissioner*, TC Memo 2003-187 (2003).