



Out-Of-Pocket Expenses: What's Deductible (And When)

It happens every day in law firms across the country: Attorneys dig into their own (or their firm's) pockets to cover litigation costs — filing fees, delivery costs, copying expenses. Oftentimes, there is no retainer to draw from — the money may be spent under a contingency fee arrangement or simply for an established client who has a sudden emergency.

Certainly, as a cash basis taxpayer, the lawyer would prefer to deduct these out-of-pocket litigation expenses in the tax year they are expended. Unfortunately, the rules are not as clear-cut as that.

The IRS Has Spoken

The IRS has addressed the out-of-pocket issue in TAM (Technical Advice Memorandum) 9432002. Here's how it played out:

The law firm addressed in TAM 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 explicitly agreed "to pay all costs" 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. The client agreed that all such costs should be repaid only out of a recovery.

In its memo, the IRS 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, 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.

A Look At Four Different Scenarios

Sometimes an attorney or firm expects to be reimbursed (whether in a matter of days or years later upon resolution of the claim). Other times, the lawyer expects to be reimbursed only if the action is successful. And in some cases, there is no expectation of ever being repaid. As you'll see, a variety of tax scenarios occur, based on how the reimbursement is made:

1) Out-of-pocket expenses for outside services for which the firm expects to be reimbursed by the client. As outlined in the IRS decision, these are *not* deductible expenses. Instead, they must be treated as advances. Therefore, when these out-of-pocket expenses are reimbursed, they are not treated as income by the taxpayer attorney/firm.

2) Out-of-pocket expenses that are billed but never recovered. In this case, the firm may claim a bad debt deduction. But the deduction can only be made in the year that the claim becomes totally worthless, which could be long after the expense is incurred.

3) Out-of-pocket expenses that will never be billed to the client. In cases where the amounts are small or, for some other business reason the taxpayer decides not to bill the client, the firm may claim a business expense deduction for those expenses, but only in the year it makes a final determination not to bill the client.

4) In-house expenses. Assuming that they meet the general rules of ordinary and necessary expenses, they're deductible when paid by an attorney using the cash method of accounting.

Action Items

All law firms should carefully review their client expenses, categorizing them as those that must be treated as advances and those that can be expensed, as indicated above.

Please contact our office today to set up a review of your firm's practices for handling out-of-pocket expenses and structuring fee arrangements.