Congress of the United States

Washington, DC 20510

July 22, 2010

The Honorable Timothy F. Geithner
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Dear Secretary Geithner:

As you know, in April of this year, two Members of the Senate wrote to Michael F. Mundaca, Assistant Secretary for Tax Policy, seeking to "clarify the position of the Treasury Department and the Internal Revenue Service with regard to the application of *Boccardo* v. *Commissioner,* 56 F.3d 1016 (9th Cir. 1995) in gross contingency fee cases." Mr. Mundaca replied that the Treasury Office of Tax Policy "is considering issuing guidance to clarify this issue."

Attorney and author Robert Wood described the specific facts of this case in an article published in *Tax Notes* last month:

> Boccardo's firm originally used a net fee agreement, under which the law firm agreed to pay all costs, and to be reimbursed for its costs only out of a recovery. Under this agreement, the first dollars recovered go to repay costs, and thereafter the lawyer and client divide the rest. After reviewing Boccardo's net fee contract, the Court of Federal Claims held that Boccardo could not deduct the costs as he paid them.
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> Boccardo then changed to a gross fee agreement, which included nothing about costs. Boccardo would pay all expenses, and lawyer and client would split any gross recovery. If no recovery was made, the firm would receive nothing for its services and nothing for its costs. Yet the IRS disallowed Boccardo's deductions even under his gross fee contract. (Lawyers Who Deduct Client Costs: Revisiting *Boccardo, Tax Notes,* June 14, 2010, p. 1287*)*

In *Boccardo*, the Ninth Circuit Court of Appeals held that attorneys who represent clients in "gross fee" contingency fee cases are not extending loans to clients and therefore may treat litigation costs, such as court fees and witness expenses, as deductible business expenses under Section 162(a) of the Internal Revenue Code.

Following this ruling, the IRS in 1997 issued a "Field Service Advice" (FSA) instructing its staff that it should follow the *Boccardo* decision only in the Ninth Circuit but that in all other circuits they should continue to take the position that amounts advanced by attorneys in "gross fee" cases are loans and therefore not deductible business expenses.

The position the IRS instructed its employees to take in the 1997 FSA has remained the Service's position for over a decade. To our knowledge, the IRS has not been reversed in any other Circuit, suggesting that this long-held stance remains a valid view of the law outside of the Ninth Circuit.

The 1997 FSA is consistent with the government's general practice, in which it does not allow an adverse decision in one Circuit to determine its litigation position in all others. That different Circuits could have different rules and standards is not only not unusual, but it is also a central feature of our federal system of government.

Moreover, although we are not aware of any rule dictating when the Service should revise its position in the face of adverse court decisions, we note that in a more recent case, with respect to the collection of the telephone excise tax, the IRS did not alter its position until it had lost litigation in five Circuits (see IRS Notice 2006-50). Similarly, the IRS did not relent in its efforts to require the payment of FICA taxes on medical residents' stipends until the Service had lost litigation on that point in multiple circuits.

Neither other Circuits nor Congress have validated the Ninth Circuit decision. There were two bills introduced in the 110th Congress, H.R. 3314 and S. 814, that would allow the litigation costs in contingency fee cases to be immediately deducted as ordinary business expenses, both in gross and net fee arrangements. The provision was included in H.R. 6049 that passed the House of Representatives in 2008. The provision, however, was not enacted during the 110th Congress and has yet to be brought up for consideration in the 111th Congress. Additionally, the Joint Committee on Taxation (JCT) estimated the provision would cost $1.572 billion. A score of this magnitude would seem to indicate that the Joint Committee does believe the IRS will continue to prevail in disallowing these deductions.

Apparently dissatisfied by the failure of other Circuits to address this issue (and to side with the Ninth Circuit) and the failure of the Congress to legislatively reach that result, the Senators have asked Mr. Mundaca to "clarify" the government's position, though the text of their letter leaves no doubt that what they really want is for the IRS to issue new guidance instructing its staff to follow the *Boccardo* decision in all jurisdictions.

However, in light of the continuing validity of the IRS's 1997 FSA in all other Circuits, it would be a substantial – and in our mind unwarranted -- change in policy for Treasury and the IRS to revise the 1997 FSA.

We urge you not to make such changes in the government's enforcement of the tax laws absent a clear direction from Congress or to comply with court decisions. As those circumstances are not met with respect to the deductibility of litigation costs in contingency fee cases, we believe the appropriate way to clarify this issue is to affirm that the 1997 FSA remains valid.

As a result, we ask that you explain Mr. Mundaca's response. If regulations or guidance regarding this topic are in fact being drafted, we request that you provide the following

information immediately. Please note that all references to Treasury include both the Internal Revenue Service (IRS) and the IRS Office of Chief Counsel (OCC).

1) Copies of all legal memoranda or other documentation, including e-mails and records of conversations, documenting Treasury's authority to issue such regulations or guidance.
2) Copies of all drafts of such regulations or guidance and indicate when these are expected to be effective and whether these were expected to be released for public comment before becoming effective.
3) Explanation of when and why such regulations or guidance was deemed to be urgent and necessary since the issue does not appear to be included in the March 16, 2010, Treasury update of the 2009-2010 Priority Guidance Plan.
4) Copies of all communications, including e-mails, letters and records of conversations, between Treasury and outside parties regarding the issuance of such regulations or guidance.

Please do not hesitate to contact our staff with any questions.

Sincerely,

Chuck Grassley
Ranking Member
Senate Committee on Finance

Dave Camp
Ranking Member
House Committee on Ways & Means