

Issues & Overview

Say NO to Government Subsidies For Frivolous Litigation

Taxes are a major topic of debate in Washington right now. Faced with a massive federal deficit, some politicians have proposed raising taxes on individuals and businesses, despite the obvious negative effects of tax increases on economic growth and job creation. Yet at the same time, some in Washington are actually considering the creation of a new special interest tax break that will hurt economic growth, increase the deficit and fuel increased civil litigation.

The plaintiffs' bar and its allies in Congress and the administration are pushing for the adoption of a nearly \$1.6 billion tax deduction for trial lawyers who take contingency fee cases. This proposed deduction would essentially provide a U.S. government subsidy to plaintiffs' lawyers to increase the number of frivolous lawsuits.

For several years, the plaintiffs' bar has been attempting to push this proposed tax break through Congress. With Congress, so far, unwilling to act, plaintiffs' lawyers have decided on a new approach and are now aggressively lobbying the Treasury Department to bypass Congress and create the deduction through administrative action.

The tax deduction would impose direct costs on the federal government and American taxpayers. According to the Congressional Budget Office, this trial lawyer subsidy would cost nearly \$1.6 billion over ten years, all during a time of record federal deficits.

But these direct costs represent just a fraction of the proposal's potential damage. The contingency fee tax break would, in effect, subsidize ever more costly, frivolous litigation against American businesses. By some estimates, the tax deduction could subsidize as much as 40 percent of the initial plaintiffs' expenses for certain cases. With the federal government paying for such a large percentage of the up-front costs of lawsuits, plaintiffs' lawyers will be emboldened to take on the most speculative and frivolous litigation.

And in these troubled economic times, the last thing America needs is more frivolous lawsuits. As a percentage of gross domestic product, the United States spends more than twice as much on litigation as any other industrialized nation, a cost that reached \$254.7 billion in 2008 according to a report by Towers Perrin.

Much of this cost is borne by businesses that are forced to devote increasingly scarce financial resources to fighting lawsuits instead of making new investment and creating new jobs. According to a recent survey of small business owners commissioned by the U.S. Chamber Institute for Legal Reform, 68 percent of small business owners surveyed expect the number of lawsuits to increase in the next five years, while over two-thirds say that they would have to reduce the hiring of new employees, cut employee benefits or pass increased costs on to customers if targeted by a lawsuit. By encouraging more lawsuits, enactment of the proposed tax deduction would only increase the vast economic costs of the current litigation system.

Supporters of the tax deduction claim that it would simply equalize the playing field between plaintiffs and defendants, because defense firms and their clients can deduct legal expenses from their federal taxes. But this argument ignores the distinction between business expenses and loans, which the IRS does not recognize as a deductible business expense.

When a plaintiff's firm pays for the initial costs of litigation on a contingency fee basis, it is essentially providing a loan to the plaintiff that will be repaid upon the successful disposition of the case. Should a lawsuit not succeed in court, the plaintiff's lawyer can then deduct the bad loan as an expense. Of course, the dirty little secret is that the vast majority of lawsuits result in some sort of settlement – even if the defendant has done nothing wrong.

Many state legal ethics rules specifically prohibit lawyers from providing financial assistance to clients because a conflict of interest could arise if lawyers become the driving force behind a lawsuit and put their own financial interests ahead of their clients' interests. As a result, the accepted practice is for contingency fee lawyers to pay for the costs of litigation through what is effectively a loan to the client paid back at the end of a successful case.

The plaintiffs' bar and its congressional allies also cite a 1995 Ninth Circuit Court of Appeals ruling, *Boccardo vs. Commissioner*, that held that lawyers representing clients in gross fee contingency cases were not extending loans to clients and could treat litigation costs as a deductible business expense. But this interpretation of the law has been rejected by other courts of appeals as well as by the IRS, which in 1997 issued a memorandum explicitly instructing its employees to reject the *Boccardo* interpretation except in the nine states covered by the Ninth Circuit.

For these and other reasons, the proposed trial lawyer tax deduction advances bad public policy and should be rejected by all who support sound government finances, strong economic growth and the success of American businesses. But the plaintiffs' bar is not giving up without a fight. It is crucial that the business community stand together and oppose this costly proposal that will increase frivolous litigation and decrease economic growth and job creation.

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