



Attorneys Audit Technique Guide

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The taxpayer names and addresses shown in this publication are hypothetical.

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I. Purpose

- (1) This Audit Techniques Guide (ATG) will provide information to enable examiners to effectively audit issues pertaining to attorneys.

II. Overview of Attorney Returns

A. Introduction

- (1) The right to practice law as an attorney is contingent on being admitted by a state and/or federal bar. These requirements differ from state to state. Typically, a law degree from an accredited law school is required to sit for the State Bar examination. On passing any required examinations and satisfying any other requirements, such as a background check or committee review on character and fitness, the applicant is licensed to practice law.
- (2) Some courts have additional requirements an attorney must satisfy in order to appear before them. For example, practice before the U.S. Supreme Court requires an attorney to have been admitted to practice in the highest court of a State, Commonwealth, Territory or Possession, or the District of Columbia for a period of at least three years immediately before the date of application; must not have been the subject of any adverse disciplinary action pronounced or in effect during that 3-year period; and must appear to the Court to be of good moral and professional character. The attorney also must have the personal recommendation of two attorneys already admitted to practice before the Supreme Court. Each federal or circuit court establishes requirements to practice, as do special courts, such as the U.S. Tax Court and the U.S. Court of Claims.
- (3) In the United States, attorneys practice their craft in a variety of ways. Some work as employees for government agencies or serve as in-house counsel for larger corporations. Also, a large number of attorneys are self-employed, operating their own sole proprietorships, alone or in a shared expense relationship with other sole proprietors, or as partners or shareholders of larger law firms. This guide will assist you in examining an attorney's tax returns.
- (4) Examining an attorney's return is not unlike the examination of any other business. However, examiners may need to address different issues depending on an attorney's area(s) of expertise. For example, personal injury attorneys typically work on a fee contingency basis. This means that the attorney is paid a percentage of the amount recovered by their client. This percentage may vary depending on the outcome of the case. Typically, an attorney would earn a lower percentage for a case that is settled out of court rather than taken to trial. Examiners should also be aware that, depending on the attorney's specialty, clients might pay a large portion of their fees well in advance. This should be taken into consideration during the examiner's pre-planning activities. Another consideration is that some attorneys may have a greater percentage of cash receipts than others. For example, criminal and immigration attorneys are in a

position to receive cash for services, as their clients may not utilize U.S. banks. Currency Transaction Reports (CTR's), posted to the IRP report may be helpful in determining if an attorney has received large cash payments. Details on each individual CTR are available on the Web CBRS system.

- (5) Attorneys provide their services through sole proprietorships, partnerships, corporations, and limited liability companies. Each entity is subject to unique tax issues. These issues are common to many professional services in addition to attorneys. If the attorney provides services through a corporation, you may face issues including, but not limited to; the corporation being classified as a personal service corporation under IRC § 441; constructive dividends; loans to shareholders; or use of corporate assets. S-corporations also raise additional issues, such as inadequate compensation and built in gains. You need to consider whether the business structure used by the attorney raises any unique examination issues. Some of these issues are discussed in Chapter 3.
- (6) The formula for auditing these returns is simply good use of regular audit techniques: a thorough pre-contact analysis, a fully prepared initial interview, an in-depth inspection of the taxpayer's income records, and judicious use of third-party contacts to verify or refute the taxpayer's assertions.

B. Recordkeeping

- (1) A good accounting system for attorneys will include strong internal controls to monitor both fees billed, and costs and expenses advanced for clients. There are four major types of fee arrangements that attorneys use. These are discussed below in the income section. All four types of fee arrangements are based upon the amount of time an attorney spends on a particular matter. For that reason, attorneys typically maintain detailed records to track the exact time spent on any given case.
- (2) Before time and billing software was used, this information was recorded on client ledger cards. These cards included the time spent on the client's matter, along with all chargeable expenses. Now, this procedure is often accomplished through the use of automated software. These software programs often utilize "pop-up" timers on office workstations, where the firm's attorney or administrative employee will enter the client's code and click on a "start" button to commence billing the client for the time involved on a particular task. Advanced costs are recorded into the system in a similar fashion to other accounts receivables. Usually at the end of each month, the partner assigned to a particular case will review hours and other costs charged to the client and make adjustments to the client's bill, if warranted, prior to issuance. This adjustment log should be reviewed as part of the examination, along with reconciliation of the output of the time and billing system to the appropriate accounts in the general ledger. Attorneys may also maintain time charged and expense information in the client's file.
- (3) Generally, the cash receipts journal will show a breakdown between fees received and expense reimbursements. The cash disbursements journal should

show an allocation between regular overhead expenses paid and client costs paid. The records for smaller firms and sole practitioners may consist of the bank statements and checks. Regardless of the business size, there should still be client ledgers and files.

(4) Attorneys usually maintain the following records:

- Appointment book;
- Client card index;
- Receipts Journal or Daily log;
- Disbursements journal, book or other record reflecting the breakdown of regular expenses paid from bank accounts as well as disbursements made from client trust funds. These disbursement records should provide a mechanism from which disbursements chargeable to a specific client can be noted on their records for billing purposes. The attorney may also maintain a petty cash journal;
- Accounts Receivable journal showing billed receivables;
- Individual client accounts including a description of services rendered, charges and credits, a summary of unbilled charges and work in progress, and final invoices;
- Case time records per client;
- Register of cases in progress, oftentimes organized by client's name; and
- Time summary reports, sorted by attorney and by client, listing the time, dates of work, billings and/or charges.

(5) Examiners can test the validity of reported income by comparing and reconciling the data provided on the above listed reports.

C. Bank Accounts

- (1) Most legal practices use a general operating account and one or more trust accounts. In addition, there may be separate accounts used for payroll, savings, or investment activity. Only the trust accounts have features which are unique to attorneys and will be discussed in detail. An explanation will be given of how these accounts should be handled.
- (2) Trust accounts should be used for all funds and assets received or held by an attorney for the benefit of their clients. The attorney is the trustee of the account and has the power to disburse funds on the client's behalf.
- (3) Trust funds are oftentimes required to be placed in interest bearing accounts, and typically checking accounts are used. These accounts are under the control of the attorney and are labeled "Trust Account," "Attorney/Client Trust Account," "Client's Funds Account," or some similar title. There are two types of trust

account, the General Trust Account and Segregated Trust Accounts. The General Trust accounts, also known as “Interest on Lawyer Trust Account” (IOLTA) are administered under the direction of the program for IOLTA accounts. These programs are created by State Legislation or the state’s court system. The earnings on these accounts are usually used to provide legal services for the poor. Therefore, these bank accounts may show either the identification number of the Bar Association, the IOLTA Program recipient, or the client. The examiner should contact the appropriate State Bar Association to determine the proper handling of these accounts and their earnings.

- (4) Whether the funds are placed in a general trust account (IOLTA account) or into a separate trust account for the benefit of one client is determined generally by the attorney under rules established by the appropriate state. Usually, this determination is based on factors such as whether more than a nominal net return on investment would be received on these funds during the period of time in the account. These two types of trust accounts are explained below.

C.1. General Trust Account

- (1) This account includes funds received in trust on behalf of many clients and may be the only trust account maintained by an attorney. Interest earned on this type of account is generally remitted by the bank or other financial institution directly to the state organization designated to receive IOLTA interest. Some states, such as California, Connecticut, Maryland, New York, and Ohio have enacted statutes detailing the disposition of interest paid on IOLTA accounts. In Indiana and Pennsylvania, the IOLTA programs were originally established by statute, and these programs were later administered by the courts. These two states, and 42 others, now have their IOLTA rules overseen by their state’s highest court, with the actual writings appearing in the state’s rules of professional conduct. The remaining state, Virginia, had their legislature override the Virginia Supreme Court resulting in a voluntary program in that state.
- (2) With an IOLTA account, automatic debits appear on the bank statements for the interest paid to the designated recipient. This type of trust account is commonly used by personal injury attorneys. The attorney could be working on many cases that take several years to resolve. When the case is settled, the award is deposited into the IOLTA account. Checks are then written to various parties to cover expenses, to the attorney to cover his fees and case-related costs, and the remainder goes to the client. Funds are distributed promptly, resulting in very little interest being earned.

C.2. Segregated Trust Account

- (1) This is used if the attorney determines that a separate account should be set up for a specific client. This is strictly a practical consideration and is done at the attorney's discretion under guidance promulgated by the applicable state bar association.

- (2) This type of account may be used for the proceeds of property sold in a divorce or an estate. The amount deposited could be significant. These funds may not be distributed immediately. The interest should then go to the client rather than to the IOLTA program. However, exact treatment and functionality of these accounts may vary by state.
- (3) Therefore, the appropriate bar association must be contacted to determine proper rules, regulations, and handling.
- (4) Finding the specific trust accounts can be difficult. The attorney should be asked in the initial interview about the location of all trust accounts and whether he or she is the trustee of any accounts. IRP printouts may reveal trust accounts under the attorney's name. An EINAD may disclose other names and identification numbers under which the attorney has bank accounts.
- (5) Interest earned on the pooled trust account funds and paid over to the IOLTA program or its designated organization is not taxable to the clients, the attorney, or the organization itself. However, interest earned on the segregated trust funds is taxable to the clients for whose benefit they were established. Rev. Rul. 87-2, 1987-1 C.B. 18.
- (6) The attorney should be able to provide an accounting of any amounts in the trust accounts. Detailed schedules should be maintained naming the client for whom assets are held, the type of asset held in trust, and its value. There should also appear on the attorney's balance sheet a liability account (e.g., "Liability for Client Trust Accounts") equal in value to the total amount of the schedule(s) and the balance(s) of the trust account(s).
- (7) Each state's bar association imposes different criteria for conducting an examination of trust accounts. For example, the California State Bar does not presently conduct random audits of its members' trust accounts. The accounts are only examined if a complaint is received. Examiners should contact the relevant state bar association to determine local policies, as any available examination report can assist with the examiner's work on these accounts.
- (8) Since many attorneys compute gross income based on withdrawals from the client trust account, analysis of that account is obviously the first step in the audit process. However, an attorney may deposit fees into any other personal or business account, or the income may bypass bank accounts altogether. Therefore, the auditor should carefully examine deposits into all bank accounts, and also account for personal living expenses and other cash expenditures. Furthermore, care should be taken to identify loans and other nontaxable sources of income during the initial interview.

D. Other Revenue Sources

- (1) Examiners should be aware that attorneys and law firms may have sources of revenue other than general practice, litigation, tax, and probate fees. They may also receive revenue from performing services as board directors for clients and non-clients, speaker's honoraria, and other outside professional activities.

Inquiries about these types of revenue should be made during the initial interview.

E. Client-Related Expenses

- (1) Attorneys, particularly those working on a contingency fee basis, may advance costs and other expenses for their clients. Such expenses can include, but are not limited to, reproduction costs, court reporting and stenographic costs, filing fees, travel expenses, and communication costs (i.e., long distance telephone calls, etc.). These will normally appear in an asset account such as Unbilled Advanced Client Costs (until they are actually billed, of course). The examiner should determine if the reimbursements received from the client have been reflected in taxable income through either inclusion in gross receipts or as an offset to the actual expense. For further discussion, see Chapter 3.

F. Attorney-Client Privilege

- (1) Attorneys may refuse to provide documents which are commonly used in examinations claiming attorney-client privilege. This can include a client list, general ledger, client ledger cards, invoices, cancelled checks, and client trust accounts. The attorney client privilege is specific as to what material qualifies for protection. The following is a discussion of some of the issues that an examiner may encounter regarding the claim of privilege and a discussion of relevant case law.
- (2) All court cases in this section are categorized and cited in Exhibit 1-2.

F.1. General Rules

- (1) The historical basis of the privilege and how the attorney-client privilege applies is well laid out in *In re Colton*, 201 F. Supp. 13, 15 (S.D. N.Y. 1961), *aff'd*. 306 F.2d 633 (2nd Cir. 1962) as follows:
- (2) The attorney-client privilege as developed at common law was originally a privilege of the attorney, permitting him to keep the secrets confided in him by his client and thus preserve his honor. In the eighteenth century, when the desire for truth overcame the wish to protect the honor of witnesses and several testimonial privileges disappeared, the attorney-client privilege was retained, on the new theory that it was necessary to encourage clients to make the fullest disclosures to their attorneys, to enable latter properly to advise the clients. This is the basis of the privilege today.
- (3) The four general elements of the attorney-client privilege are summarized in *U.S. v. United Shoe Machinery Corp.*, 89 F. Supp. 357, 358-59 (D. Mass. 1950). These are as follows:
 - "Generally it may be said that the attorney-client privilege applies only if:
 - the asserted holder of the privilege is or sought to become a client;

- the person to whom the communication was made:
 - is a member of the bar of a court, or his subordinate and
 - in connection with this communication is acting as a lawyer;
 - the communication relates to a fact of which the attorney was informed:
 - by his client
 - without the presence of strangers
 - for the purpose of securing primarily either:
 - an opinion of law,
 - legal services, or
 - assistance in some legal proceeding, and not
 - the purpose of committing a crime or tort; and
 - the privilege has been:
 - claimed, and
 - not waived by the client."
- (4) With the enactment of IRC § 7525 by RRA 1998, the application of the attorney-client privilege was extended to communications between a taxpayer and any "federally authorized tax practitioner" including accountants, to the extent that such communications would be considered privileged communications if they were between a taxpayer and an attorney. More information about practitioner-taxpayer privilege can be found in IRM section 5.17.6.16.

F.2. Fee Arrangements and Client Identity

- (1) Colton also covers issues relating to fee arrangements and client identity. The case states that neither of these issues falls under what could be considered privileged communication between an attorney and his or her client, as neither is a confidential communication between the attorney and the client.
- (2) In *Baird v. Koerner*, 279 F.2d 623 (9th Cir. 1960), the Ninth Circuit found an exception to the general rule that fee arrangements are not within the attorney-client privilege. In *Osterhoudt*, the Ninth Circuit stated that:
- (3) The purpose of the attorney-client privilege is to protect every person's right to confide in counsel free from the apprehension of disclosure of confidential communications. Fee arrangements usually fall outside the scope of the privilege simply because such information ordinarily reveals no confidential professional communication between attorney and client, and not because such information may not be incriminating.
- (4) In *re Osterhoudt*, 722 F.2d 591 (9th Cir. 1983) (citations omitted).

- (5) In discussing case law related to the disclosure of a client's name, the Ninth Circuit explained:
- (6) *Hodge & Zweig* and other subsequent cases have mistakenly formulated the exception not in terms of the principle itself, but rather in terms of this example of circumstances in which the principle is likely to apply. The principle of *Baird* was not that the privilege applied because the identity of the client was incriminating, but because in the circumstances of the case disclosure of the identity of the client was in substance a disclosure of the confidential communication in the professional relationship between the client and the attorney.
- (7) *In re Osterhoudt*, 722 F.2d at 593.
- (8) Thus, the general rule is that a client's identity is not privileged information. Only in those very rare cases where the disclosure of the very name of the client would constitute disclosure of the nature of the communication between the client and the attorney may the issue arise. See also, *In re Grand Jury Matter No. 91-01386*, 969 F.2d 995, 998 (11th Cir. 1992); *In re Grand Jury Subpoenas (Anderson)*, 906 F.2d 1485, 1491 (10th Cir. 1990); *Tornay v. United States*, 840 F.2d 1424, 1428 (9th Cir 1988); *In re Grand Jury Subpoena (De Guerin)*, 926 F.2d 1423, 1431 (5th Cir 1991); *United States v. Liebman*, 742 F.2d 807 (3d Cir 1984); *Vingelli v. U.S. Drug Enforcement Agency*, 992 F.2d 449, 452-453 (2d Cir. 1993).

F.3. Summonses

- (1) When the taxpayer/attorney still refuses to submit documents based on attorney-client privilege, it may be necessary to issue a summons pursuant to IRC § 7602.
- (2) In *Reisman v. Caplin*, 375 U.S. 440 (1964), the Supreme Court noted in dicta that an Internal Revenue summons may be challenged on any appropriate grounds, such as the attorney-client privilege.
- (3) In *U.S. et al v. Hartigan*, 402 F. Supp. 776 (D. Minn. 1975), the IRS issued a summons requesting an attorney's fee ledger for a particular client. When the IRS sought enforcement of the summons, the attorney argued, among other things, that the ledger was protected by the attorney-client privilege. The Court concluded that summons directing the taxpayer's lawyer to appear before the IRS and to produce his client fee ledger showing charges, fees and expenses along with payments received relating to the taxpayer was properly issued. The client fee ledger did not fit within the attorney-client privilege because it did not constitute confidential communications of the client to the lawyer for obtaining professional advice.
- (4) Courts have consistently held that a lawyer's fee records for a particular client generally are not confidential communications. For example, in *Colton*, 306

F.2d 633, 638 (2nd Cir. 1962), in discussing the attorney's argument that his fees charged to a client are confidential, court stated that:

- (5) ...we see no reason why an attorney should be any less subject to questioning about fees received from a taxpayer than should any other person who has dealt with the taxpayer. There is no further encroachment here upon any confidential relationship than there is in questioning about the existence or date of the relationship. All matters are quite separate and apart from the substance of anything that the client may have revealed to the attorney.
- (6) There is a narrow exception to the general rule that the identity of the client and the amount of the fee paid is not privileged information. As a general proposition, the client's ultimate motive for litigation or for retention of an attorney is privileged. See *In re Grand Jury Proceedings (Jones)*, 517 F.2d 666, 674-75 (5th Cir. 1975). Accordingly, correspondence between the attorney and the client which reveals the client's motivation for creation of the attorney-client relationship or possible litigation strategy is protected. Similarly, other documents, which reveal the nature of the services provided, should also fall within the privilege.
- (7) However, it should be noted that only such portions of the documents which reveal the client's motivation for creation of the relationship or possible litigation strategy would fall within the privilege. Portions indicating the number of hours billed, the fee arrangement, and the total fees paid would not constitute privileged information. See *Gonzalez v. Wella Corporation*, 774 F. Supp. 688, 690 (D.P.R. 1991). Thus, a simple invoice requesting payment which reveals nothing more than the amount of the fee would not normally be privileged.
- (8) The attorney-client privilege does not cover bank records merely because they derive or involve a law firm's client-trust fund bank account. *Gannet v. First National State Bank of New Jersey*, 546 F.2d 1072 (3rd Cir. 1976).
- (9) Remember, the Service may neither issue nor seek enforcement of a summons if the attorney's case has been referred to the Department of Justice for prosecution. IRC § 7602(d).
- (10) In addition, summonses are enforced only after the Service has established the threshold requirements of *United States v. Powell*, 379 U.S. 48 (1964). *Powell* requires that the Service show (1) the investigation is being conducted for a legitimate purpose; (2) the information is relevant to the investigation; (3) the information is not already in the Service's possession; and (4) administrative steps required by the Internal Revenue Code have been followed. *Id.* at 57-58.
- (11) The Service's summons power is not absolute. It is limited by traditional privileges, such as the attorney-client privilege. The burden of proving the privilege applies falls upon the person claiming it. The attorney may not assert the privilege for his own benefit.

- (12) Regardless of the attorney-client privilege, a summons may not be enforced if the request for information is overly broad or vague. See *U. S. v. Tratner*, 511 F.2d 248 (7th Cir. 1975).
- (13) In *Tratner*, the examiner questioned one particular \$10,000 deposit and subsequent withdrawal from the taxpayer's client escrow account. In requesting information related to the \$10,000 transactions, the examiner issued a summons requesting any and all information related to the escrow account, or any other bank accounts. The Seventh Circuit held this request was overly broad.

G. Information Reports

- (1) Generally, attorneys cannot refuse to provide information required by information reporting statutes based upon the attorney-client privilege. For example, in *United States v. Goldberger & Dublin, P.C.*, 935 F.2d 501 (2nd Cir. 1991), the court held that, absent special circumstances, attorneys were required to disclose client information on Forms 8300 pursuant to IRC § 6050I. See also *United States v. Leventhal*, 961 F.2d 936 (11th Cir. 1992). Moreover, withholding the names of clients or fee arrangements because of state ethical rules is not a "special circumstance" that would protect this information from disclosure. In summons enforcement actions, which involve Federal law, it is the Federal common law of privilege that applies. *Goldberger*, 935 F.2d at 505.
- (2) While *Leventhal* recognized "a narrow exception to this general rule where disclosure of a nonprivileged attorney-client communication also would reveal privileged information," the court found this "last link" doctrine was not applicable where the clients involved in the cash transactions were already under indictment. *Id.* at 940-941. The court rejected out of hand the argument that a confidential communication about criminal activity may be inferred from consultation with a criminal law specialist. *Id.* at 941.
- (3) If non filing or improper filing of Forms 8300 are discovered during an examination, contact the Fraud/BSA division to get a specialist to work that issue.

H. Summary

- (1) When an attorney refuses to provide information based upon attorney-client privilege, we can give them a list of the court cases and discuss the following general principles, when applicable:
- Generally, the attorney-client privilege must be claimed by the client and the privilege must not have been previously waived. Any disclosure of privileged communication to a third party or consent of disclosure would result in waiver of the privilege. If the client has no knowledge of the request or asks that the privilege be invoked on his or her behalf, the attorney may claim the privilege on the client's behalf. The attorney may not claim the privilege for his or her own benefit.

- The privilege protects the disclosure of confidential communications between client and attorney.
- As a general rule, the identity of an attorney's client and the nature of his or her fee arrangement is not a confidential communication protected by the attorney- client privilege.
- A summons prepared by the IRS in good faith will be enforced.
- The burden is on the claimant to prove attorney-client privilege.

I. Exhibit 1-2 Attorney-Client Privilege

- (1) As a "general rule," where a party demonstrates that there is a legitimate need for a court to require disclosure of such matters, the identity of an attorney's clients and the nature of his or her fee arrangements with his or her clients are not confidential communications protected by the attorney-client privilege.
- (2) History and Basic Elements
- (3) *In re Colton*, 201 F.Supp.13, aff'd 306 F.2d 633 (2nd Cir. 1962)
- (4) Fee Arrangements and Client Identity
- (5) *Osterhoudt v. United States*, 722 F.2d 591 (9th Cir. 1983)
- (6) *U.S. et al v. Hartigan*, 402 F. Supp. 776 (D. Minn. 1975)
- (7) *United States v. Hodgson*, 492 F.2d 1175 (10th Cir. 1974)
- (8) *In re Colton*, 201 F.Supp.13 (S.D. NY1961), aff'd 306 F.2d 633 (2nd Cir. 1962)
- (9) *Tillotson v. Boughner*, 350 F.2d 663 (7th Cir. 1965). But see *In re Grand Jury Subpoena*, 204 F.3d 516 (4th Cir. 2000)
- (10) *Baird v. Koerner*, 279 F.2d 623 (9th Cir. 1960)
- (11) Note: the identity of a client may be privileged when that information would in effect reveal the substance of a confidential communication. For example, an attorney cannot be compelled to reveal the name of a client on whose behalf attorney anonymously paid taxes. This was what was at issue in the *Tillotson* and *Baird* cases.
- (12) Burden on the Claimant
- (13) *Reisman v. Caplin*, 375 U.S. 440, 84 S. Ct. 508 (1964) *United States v. Kovel*, 296 F.2d 918 (2nd Cir. 1961) *United States v. Gurtner*, 474 F.2d 297 (9th Cir. 1973) Financial Statements
- (14) Information given to attorney to prepare income tax returns that are disclosed to the government is not confidential.
- (15) *Colton v. United States*, *Supra*
- (16) *United States v. Willis*, 565 F. Supp. 1186 (S.D. Iowa 1983)

- (17)U.S. v. Cote, 456 F.2d 142 (8th Cir. 1972)
- (18)Attorney-Client Trust Fund
- (19)Gannet v. First National State Bank of New Jersey, 546 F.2d 1072 (3rd Cir. 1976)
- (20)Information Returns - IRC 6050I Form 8300
- (21)United States v. Goldberger & Dubin, P.C., 935 F.2d 501 (2nd Cir. 1991)
- (22)Federal Law
- (23)Federal, not State law, applies in determining whether the privilege exists
- (24)Colton v. United States, Supra. Fed. R. Evid. 501
- (25)Enforcement of Summons: Attorney-Client Privilege
- (26)Summonses must be issued in good faith. United States v. Powell, 379 U.S. 48 (1964) Colton v. United States, Supra.
- (27)United States v. Hartigan, Supra.
- (28)Dallas L. Holifield v. United States, 909 F.2d 201 (7th Cir. 1990)
- (29)Summons Overbroad:
- (30)United States v. Tratner, 511 F.2d 248 (7th Cir. 1975)

III. Audit Steps

A. Pre-Contact Analysis

- (1) A comprehensive pre-contact analysis is essential in performing an effective audit. Refer to IRM 4.10.2, "Examination of Returns- Pre-Contact Responsibilities," for more information. Given the nature of the cases being audited and the myriad of possible issues, a thorough search of available data is necessary. Some information resources examiners should consider include licensing records maintained by the appropriate state bar association or licensing agency and Internet searches using the attorney's or firm's name. Both asset searches and income searches are discussed in this section.

A.1. Accurint Searches

- (1) Examiners have access to Accurint which provides information on a person, their business, their professional standing, their assets, pending or resolved litigation, and other matters. The following is a discussion of pre-audit information available on Accurint and a summary of what databases should be reviewed during the pre-audit stage. For more detailed information, examiners should refer to the Accurint User's Guide, which is available to IRS personnel on the IRS Intranet site.
- (2) People

- A people search in Accurint will provide address information, telephone numbers and employment information (listed as people at work). This information can be used to verify the size and location of an attorney's offices.

(3) Assets

- An Accurint asset search can provide information on motor vehicles, property assessments, property deeds, watercraft and aircraft. Asset searches may also disclose property ownership, purchases, and sales information that would not appear on a taxpayer's return that may be discussed during the initial interview. While useful, care should be taken reviewing the search results to eliminate duplicate entries. Care should be taken to review parcel numbers, registration numbers, and other identifying information to eliminate duplicate information. An Accurint search of the specific assets should be performed for identified assets. The Federal Aviation Agency (FAA) Internet site also provides searchable information on aircraft assets.

(4) Businesses

- Accurint searches can provide information about business entities, such as the business or taxpayer name, corporate filings, UCC filings, fictitious names (doing business as or "dba" names), and Experian business information.

(5) Licenses

- Accurint searches can provide information on what licenses the taxpayer may possess, such as a driver's license, FAA license, law licenses and other professional licenses.

(6) Courts

- Court files are another useful source of information. These files can provide information regarding marriage and divorce actions, bankruptcies, foreclosures, liens, judgments, and lawsuits. The court records on these legal actions, if available, may provide details of assets and other useful information warranting a trip to the Court where the records are held.

A.2. Internet Searches

- (1) A thorough search of the Internet should be completed prior to the initial interview. Searches should be completed using the taxpayer's name, firm name, and area of expertise. Relevant websites found identifying the taxpayer should be printed and included in the case file for later reference, if necessary.
- (2) A search using the state bar association should be completed. This search may disclose relevant information, such as licensing information, area of expertise, advertising, education, press releases, pro-bono work, professional associations and affiliations, and referral services. As discussed later,

identifying an attorney's area(s) of expertise is important because this may have an impact on various income and expense issues.

- (3) Another source of information available online is the Martindale Hubbel Directory. This is a national directory of attorneys, which provides information on an attorney's educational background, the year they were admitted to practice, any listed areas of expertise, and also a "peer review" rating.
- (4) Other Income Related Searches
 - Income information is available from a variety of sources, some of which are discussed here.

A.3. Web Currency and Banking Retrieval System (WEB CBRS)

- (1) The Federal Government has imposed certain cash reporting requirements in recent years. These reporting requirements were established to help monitor and track large cash flows. Several forms of interest to revenue agents are available from Web CBRS. These forms may be summarized on an IRP report.
- (2) The first form, FinCEN Form 104, Currency Transaction Report (CTR), is used to report cash transactions (deposits and withdrawals) greater than \$10,000 involving various financial institutions. These financial institutions, including banks, savings and loans, credit unions and other non-bank financial institutions such as check cashers, and wire transfer companies file the Form 104. The Form 104 identifies the individual making the transaction, the person or organization for whom the transaction was conducted, the financial institution involved in the transaction, and the amount of money involved.
- (3) The second form, FinCEN Form 105, Report of International Transportation of Currency and Monetary Instruments (CMIR), is used to report the international transportation of currency or monetary instruments that in aggregate exceed \$10,000. Individuals must file a FinCEN Form 105 whenever they carry more than \$10,000 in cash and/or monetary instruments into or out of the United States. Also, individuals who physically send or receive (typically through the mail) more than \$10,000 in cash and/or monetary instruments must file a FinCEN Form 105.
- (4) The third form, IRS-FinCEN Treasury Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, is a report of cash payments over \$10,000 (U.S. dollars or foreign currency equivalent) received in a trade or business. This form is filed by the business receiving funds and is filed by retailers or businesses selling large ticket items, bulk inventory, and luxury goods. It identifies the customer, provides a description of the transaction and goods, and also lists the method of payment.
- (5) The fourth form, FinCEN Form 103, Currency Transaction Report by Casinos (CTR-C), is used by casinos to report cash transactions (either cash received or cash disbursed) that exceed in the aggregate \$10,000 in one gaming day. This

form lists the individual or organization involved, details of the transaction, and the reporting entity.

- (6) The fifth form, Treasury Form TDF 90-22.1, the Report of Foreign Bank and Financial Accounts (FBAR), is required of all entities, including individuals, having a financial interest in or signature authority over foreign bank and financial accounts with an aggregate value of more than \$10,000.
- (7) Printouts of any transactions reported and processed at the Enterprise Computing Center in Detroit are generally included in the case building material or may be obtained from the Web CBRS query system. The CBRS system servers are located in Martinsburg Computing Center. Every POD should have someone trained to access the CBRS query system and retrieve data from Web CBRS in printed or electronic formats.
- (8) Any attorney may receive cash in the course of their business activities. However, some attorneys are less likely to receive cash payments than others. For example, attorneys that are compensated through third party payments (i.e., insurance settlements) are less likely to receive currency.
- (9) Certain attorneys that are more likely to be paid directly by the client include:
 - Criminal defense attorneys;
 - Estate and trust attorneys;
 - Real estate attorneys; and,
 - Tax attorneys
- (10) Attorneys are subject to the reporting requirements for Form 8300. Some attorneys may raise an attorney-client privilege defense for not filing Forms 8300 to report payments in cash. This is another factor to consider in support of referring the case for a Form 8300 examination.

A.4. Return Preparer Listings

- (1) The Return Preparer Coordinators maintain lists detailing all of the tax returns that were completed by a particular preparer. These are useful when an attorney performs tax services for clients. This information may be useful in identifying sources of income, return preparation trends, and the taxpayer's clients.
- (2) The list of Return Preparer Coordinators can be accessed from the SB/SE Examination website.

A.5. IRP Transcript

- (1) IRP transcripts provide information about payments a taxpayer receives that are reported to the IRS. For example, these transcripts provide information about reported Forms 1099, CBRS report summaries, Social Security payments, rental income, property sales, and interest and dividend payments. IRP

transcripts may provide information about previously unknown payments or bank accounts. Both Social Security and Employer Identification Numbers need to be requested for a complete report.

A.6. Comparative Analysis

- (1) It is important to perform a comparative analysis of at least 3 years during the pre-audit planning phase. This step is necessary to determine if there are any unusual changes in income, expenses and taxes paid before initiating an examination.

A.7. Information Document Requests

- (1) A sample IDR that may be utilized is included as Exhibit 2-1. This sample should be modified as necessary to address the unique issues for a particular audit.
- (2) A list of suggested items to request in a bank summons is included as Exhibit 2-2.

IV. Initial Interview

- (1) The initial interview is, perhaps, the most important step of the audit process. If possible, it is important to discuss examination issues with the taxpayer. A representative may not know enough about the attorney's practice to provide detailed answers. Also, it is important to determine the attorney's responsibility for financial transactions.
- (2) Careful planning and preparation for the taxpayer interview will help ensure that the taxpayer provides relevant information. The tax return, pre-contact information in the case file, Accurint reports, bar association information, other Internet searches, and industry related issues should be carefully considered.
- (3) A sample initial interview outline is included as Exhibit 2-3. This sample outline should be modified and expanded upon to address issues identified during the pre-contact analysis. During the interview, be sure to ask follow-up questions based on the taxpayer's responses.
- (4) Questions about how the practice started and areas of specialization will give insights into probable accounting systems, the size and scope of the taxpayer's practice, and what types of income and operating costs to expect. Information on specialized accounting software, if used in the attorney's practice, may be available through Internet research.
- (5) An effective income probe is crucial since unreported income may become an issue as the examination progresses. All possible income sources need to be identified. Some questions to ask are:
 - How much cash was on hand at beginning and end of year?
 - Were any loan proceeds received?

- Were referral fees received from other attorneys?
 - Was compensation received in forms other than cash? Define bartering and use examples such as property interests, services, other assets received from a client in lieu of normal compensation.
 - Are there any foreign accounts or offshore interests?
 - Are there any interests in other entities?
 - What Internet sites are maintained by the taxpayer?
 - On-line income sources including consulting, on-line bartering?.
 - Other on-line services provided?
- (6) A thorough understanding of the taxpayer's bookkeeping system and internal controls is necessary. Have the attorney or the bookkeeper walk through the recordation process from the point where the attorney is retained by a client to the settlement of the account. Clearly determine and document the taxpayer's level of involvement in bookkeeping, check writing, and trust account activity. Generally, an attorney handles the trust accounts personally, but other duties may be delegated. Trust account issues are discussed in a later section of this document. If the taxpayer is not involved in the bookkeeping, find out who is and arrange to speak with that person. Be sure to obtain all required authorizations to do so from a responsible party of the taxpayer.
- (7) Accounting systems vary widely depending on the types of transactions conducted and the types of law practiced. For example, personal injury attorneys seldom receive any fee until a case is resolved, and the fee collected is usually a percentage of the awarded amount. They often advance client costs related to the litigation, such as court costs.
- (8) Question the treatment of these expenses on the books and the tax return. This issue is discussed in a later section. Criminal defense attorneys usually arrange for clients to pay their own court costs. They are sometimes paid in cash and sometimes receive noncash compensation such as an entity interest, bartering or other assets.
- (9) Ask for the bank records for all accounts including any investment accounts.
- (10) Records for trust account(s) should also be requested with the initial IDR. Question the taxpayer about the use of each account. Depending on the size of the practice and the sophistication of the recordkeeping system, a number of different accounts may be used to pay expenses and deposit receipts. It is easier to ask the taxpayer to explain their accounting and recordkeeping system at the beginning and verify the information given than to try to understand these systems by reviewing bank records provided later.
- (11) At the conclusion of the initial interview, you should have an understanding of the taxpayer's accounting system, his or her level of involvement in that system, and also who to talk to about questions that arise during the audit. In addition,

the taxpayer's level of credibility can be established through comparison of the pre-audit analysis and information supplied during the interview. This information will help determine the scope of the examination.

A. Exhibit 2-1, Sample Information Document Request (IDR)

- (1) Please have the following records available at our appointment. These items are needed, but are not intended to be all inclusive; additional items may be required at a later time.
 - All books and records: Cash receipts and disbursements journals, appointment book(s), client's card index, daily log or receipts book, journals of receipts and disbursements from trust funds, payroll journals, subsidiary ledgers, and chart of accounts
 - Bank statements, cancelled checks, and deposit slips for all personal, business and trust accounts for the periods 1/(insert beginning period) through 1/(insert ending period). Bank reconciliation statements for the last month of the calendar year for all business and trust accounts.
 - Investment records, account statements and other investment information
 - Work papers used to prepare/reconcile books with the tax return
 - Client listing for the year(s) under examination.
 - Copies of Forms 1040 for (insert tax year) and (insert tax year).
 - Copies of Forms 8300 filed for the examination year.
 - Employers quarterly tax returns--Federal and State (Forms 940, 941, and State Forms) for the year under examination to the present.
 - Employee(s) Forms W-2 and W-4 for the year under examination and all Forms 1099 received and issued.
 - Invoices covering all acquisitions and dispositions of capital assets during the examination year and verification of basis for the assets shown on the depreciation schedule.
 - Records substantiating the claimed travel & entertainment expenses as required by IRC § 274--diary, itinerary, invoices, cancelled checks, names, dates, business purpose, etc.

B. Exhibit 2-2 Bank Document Request List

- (1) The following information regarding all open or closed checking (interest and non-interest bearing) and savings accounts:
 - Signature cards
 - Bank statements

- Cancelled checks - front & back
 - Deposit tickets & items
 - Credit and debit memos
 - Wire transfer records
 - Forms 1099 or back-up withholding statements.
- (2) Retained copies of all open or closed bank loan or mortgage documents:
- Loan application
 - Loan ledger sheet
 - Copy of loan disbursement document
 - Copy of loan repayment document
 - Loan correspondence file
 - Collateral agreements
 - Copies of notes or other instruments reflecting the obligation to pay
 - Copies of real estate mortgages, chattel mortgages, or other security for bank loans
 - Copies of annual interest paid statements
 - Copies of loan amortization statements
 - Copies of any and all documents in loan package records.
- (3) Certificates of deposit (purchased or redeemed):
- Copies of the certificates
 - Records pertaining to interest earned, withdrawn or reinvested
 - Forms 1099 or back-up withholding statements.
- (4) Open or closed investment or security custodian accounts:
- Documents reflecting purchase of security
 - Documents reflecting negotiation of security
 - Safekeeping records and logs
 - Receipts for the delivery of securities
 - Copies of annual interest paid statements.
- (5) All open or closed IRA, Keogh, and other retirement plans:
- Account statements
 - Investment, transfer, and redemption confirmation slips

- Documents reflecting purchase of investment
 - Documents reflecting redemption of investment
 - Copies of annual interest earned statements.
- (6) Customer correspondence file.
- (7) Retained copies of all Cashier's, Manager's, Bank, or Traveler's checks and money orders.
- (8) Wire transfer files:
- Fed wire, Swift, or other documents reflecting transfer of funds to, from, or on behalf of (the subject's name)
 - Documents reflecting source of funds for wire out
 - Documents reflecting disposition of wire transfer in.
- (9) Retained copies of all open or closed safe deposit box rental and entry records.
- (10) Open or closed credit card files
- Applications for credit cards
 - Monthly statements
 - Copies of charges
 - Copies of documents used to make payments on account.
- (11) Retained copies of Currency Transaction Reports
- (12) Retained copies of bank's CTR Exempt List (if subject is exempt) and documents reflecting justification for exemption.

C. Exhibit 2-3 Interview

(1) TAXPAYER'S NAME:

(2) AGENT:

(3) FORM:

(4) YEAR:

(5) DATE:

(6) INITIAL INTERVIEW AND BUSINESS HISTORY

- Person(s) interviewed:
- Current address:
- Business personal
- Current business phone number:
- Current personal phone number:
- Prior audit and audit issues:

(7) BUSINESS HISTORY:

- How did business start:
- When:
- Area(s) of legal specialty:
- States licensed to practice in:
- Specialty courts admitted to practice before (for example, U.S. Tax Court):
- Geographic area of practice:
- Other office locations:
- Manager in charge of locations:
- Have you ever filed or plan to file for bankruptcy:

(8) PAYROLL:

- Have all payroll returns been filed to date: who handles payroll records:
- Who prepares payroll returns, forms W-2s and 1099s:
- Are 1099s issued to individuals for payments of \$600 or more: when does your company secure SSNs:
- Have you received a notification letter from service center regarding no/invalid SSN/EIN numbers? If yes, what action have you taken:
- How do you pay yourself:

(9) METHOD OF OPERATION:

- Average time between billing & payment:
- Average amount of retainer received:
- Do you advance client costs:
- Agreement with clients re advancement of costs, (net fee or Gross fee arrangement). If case is lost, does client reimburse for expenses:
- Do you receive referral fees from other attorneys:
- Ever receive compensation other than money: (i.e. 2nd trust deed, cancellation of a debt, stock, bonds, real estate interest, business interest, etc.)
- Do you furnish services in exchange for goods or services: do you do pro bono work or work on a sliding fee scale: how do you track time to determine your billing amount: types of payment plans:
- Ever receive cash payments:
- How much and how recorded:
- Over 10,000 received:
- Deposited to which account:
- Accounting system: cash accrual
- Other accounting software program utilized

(10) FORMS 8300 FILED: (get copies);

- Do you notify clients at year end:
- Understanding of responsibility to file:
- Who is responsible for filing:

(11) BOOKS AND RECORDS:

- WHAT RECORDS ARE KEPT:
 - Chart of accounts
 - General ledger
 - Cash receipts journal
 - Cash disbursement journal
 - Accounts receivable/payable
 - Client ledger cards

- Spreadsheet of expenses
- Check register
- Source documents (invoices, statements, etc)
- Monthly bank reconciliation (bank statements, cancelled checks, deposit slips)
- Profit & loss statements
- W/p for tax preparer
- Other

(12)INTERNAL CONTROLS:

- Who keeps records:
- When and where are charges recorded:
- When and where are receipts recorded:
- Who receives client payments:
- Who records client payments:
- Explain how costs and reimbursements are accounted for:
- How do you account for any noncash payments: when and where are expenses recorded:
- Any personal or business expenses paid by cash: when are financial statements prepared: (monthly quarterly yearly)
- Who prepares the statements:
- If prepared by accountant, what information is given and how regularly:

(13)BANK ACCOUNTS:

- Location of bank accounts:
 - Personal
 - Business
 - Investment
 - Trust
- Any foreign bank accounts:
- Any foreign transactions:
- Who prepares bank deposits:
- Who makes deposits:
- Into which account(s):

- Any receipts deposited directly to personal, trust or investment accounts:
- Are all receipts deposited: (including cash) any deposits less cash:
- Have you received any payments by wire transfer or direct deposit:

(14)INCOME PROBE:

- Did you receive any: (personal or business)
 - Nontaxable dividends or interest
 - Gifts or inheritances
 - Bonuses, awards or prizes
 - Gambling winnings
 - Pensions, annuities or insurance proceeds
- Did you sell any assets (business or personal):
- Did you purchase any assets (business or personal): cash on hand beginning of year:
 - Business
 - Personal
- Cash on hand end of year:
- Do you have a safe deposit box:
 - Where:
 - Contents:
- Do you have a safe:
 - Where:
 - Contents:
- Was any money borrowed during the year:
- What was used for collateral:
- Was any money lent during the year:
- Collateral received:
- Related entities:
- Family or relatives working as employees or subcontractors: other entities owned by taxpayer:
- Investment in other entities:
- Trustee of any trusts: (business or personal) beneficiary of any trusts:

- Purchase assets for anyone else:
 - Own any interest in real property:
- (15) ANY DEDUCTION, INCOME ITEM OR CREDIT DISCOVERED WHILE PREPARING FOR EXAMINATION:
- (16) QUESTIONS REGARDING SPECIFIC EXPENSES:
- (17) CLOSING:
- Audit trail: walk through receipts and disbursement transactions
 - Name of person to contact with questions during audit: review initial idr with taxpayer

V. Audit Issues

A. Gross Income

- (1) Audit techniques are described in IRM 4.10.4, "Examination of Returns, Examination of Income." These techniques are also summarized on the Examiner's Mandatory Lead Sheet Work Paper #400 "Minimum Income Probe Lead Sheet." The following provides information specific to this industry to assist in performing the various income analyses.
- (2) As with any audit, it is essential to understand the accounting method used by the taxpayer. Law firms typically use the cash receipts and disbursements method to determine income for tax purposes. Generally, the calendar year is used as their reporting period.
- (3) The first step in auditing income is to determine the type of legal work that is handled and the typical payment arrangements made with clients. Attorneys who do not specialize in one particular field may handle many different types of cases. Other attorneys may engage in one or more specialties such as corporate law, bankruptcy, criminal law, personal injury, real estate, or estate planning. The type of legal work performed may affect how and when income is recognized.
- (4) Some attorneys base their fees on a percentage of the settlement (contingent fee) plus costs. Most attorneys, however, base their fees on hours worked plus any case-related costs. These attorneys should be able to provide detailed records of their time and direct case costs because this is how they calculate their clients' bills.
- (5) State licensing agencies and/or the state bar associations generally establish accounting rules for attorneys. These rules usually describe the type of books and records an attorney must maintain and the record retention period. Examiners should review any relevant regulatory websites to gain an understanding of these accounting and recordkeeping requirements.

A.1. Gross Income Types

- (1) In addition to billing clients based upon time expended, attorneys also use a number of other fee arrangements. The following is a summary of the most common types.

A.2. Specific Retainer

- (1) This is an agreed fee to perform services for a particular case or matter. The attorney typically sends an engagement letter to the client explaining the terms of the fee arrangement. The fee arrangement may be based on an hourly fee plus costs or for a set amount irrespective of how many hours the matter takes. The attorney may also request
- (2) that the client prepay a portion of their fees before the matter is accepted. This advance payment may be deposited into a trust account with transfers made for part or all of the money to the general account as it is earned. Generally, if the attorney is on a cash basis of accounting, the retainer is taxable when received.
- (3) The client is normally given a periodic accounting of the time and costs spent on the case. If the prepaid funds are exhausted, the client is billed for any balance due. Typical cases involving this type of arrangement are divorces, traffic violation cases, business incorporations and immigration cases.

A.3. Annual Retainer

- (1) This is also an agreed and fixed fee, but it covers services over a specified period of time. This agreement may include terms for supplementary fees for special or unusual services. The parties usually sign a written contract for annual retainer agreements. This arrangement is often used for corporate clients. Supplemental fees are earned if the attorney has to perform unexpected services. Again, a cash basis taxpayer should report this as income when received.

A.4. Contingent Fee

- (1) In this type of fee arrangement, the attorney earns an agreed upon percentage of the amount of their client's recovery (either in settlement or awarded in litigation), plus costs. Case time is not a factor in determining the amount of the fee. The focus is on the ultimate amount recovered for the client and what percentage the client agrees to pay the attorney. This type of arrangement is common in personal injury cases. Attorneys typically receive one-third of the recovery, but the contingency amount may vary according to whether the case is settled or resolved through litigation. The total settlement is deposited into the attorney's trust account. The attorney then has the responsibility of disbursing the funds. The disbursements may include litigation costs, the attorney's fee, and reimbursement to the attorney of any advanced costs. The remaining proceeds are distributed to the client. Amounts paid to the attorney from the trust account that do not represent advanced costs are includible in the

attorney's gross income. Net fee and gross fee contingency arrangements are discussed in more detail under advanced client costs, below. A review of the books and records is necessary to determine if a reimbursement payment needs to be included in gross income or if it is an offset to actual expenses incurred.

- (2) The appropriate state licensing agency may have specific limits or guidelines regarding the amount of contingency fees an attorney may charge. Check the appropriate licensing agency's website to see if there are any applicable guidelines or limitations. Variations from these limitations should be questioned and investigated.

A.5. Referral Fee

- (1) This is a fee paid to an attorney who refers a case to another attorney. This generally occurs when an attorney receives a case that could be better handled by another attorney due to his area of specialty or because of his geographic location. A portion of the ultimate award is generally remitted back to the attorney that originated the case or referred the client. Examiners should ask an attorney whether or not they have referred any cases to another attorney. These fees represent recognizable income when received.

A.6. Client Trust Accounts

- (1) Most attorneys will have one or more trust accounts under their control (see Chapter 1 on "Bank Accounts" for a discussion of trust accounts). Careful reconciliation of the trust account(s) to the attorney's other bank accounts are necessary to determine if there is additional unreported income.

A.7. Unreported Income

- (1) Generally, an attorney will deposit settlement and award proceeds to their trust account. Settlement and award checks are usually made out to both the attorney and the client.
- (2) After depositing the funds to their trust account, the attorney must distribute the proceeds. Frequently, the attorney will draw a portion of these funds to cover their fees and case costs. This occurs when a case is taken on a contingency basis.
- (3) It is important to determine if fees were included in income at the proper time. Some attorneys may cash fee payment checks or deposit them directly into personal or investment accounts. If they determined taxable income by totaling deposits made into the general operating accounts, these fees are omitted from income.
- (4) Inspecting the endorsements on checks written to or on behalf of the attorney from trust accounts is one important auditing procedure. These checks are income or expense reimbursements. Special attention should be given to all

checks that either are deposited into accounts other than the general operating account or are cashed.

A.8. Deferral of Income

- (1) After a case has been settled, the attorney may attempt to defer earned income by allowing fees to remain in the trust account until the next year. Once the settlement is received, the attorney's fee is both determinable and available and therefore should be included in income. An effective audit step is to analyze the source of funds remaining in the trust account at year-end, particularly if there is a large ending balance.

A.9. Noncash Sources

- (1) Some attorneys may receive noncash payments instead of fees for services rendered. Examination of the client ledger cards will many times lead to the discovery of noncash payments. Also, verifying the basis of newer assets, such as partnership interests or stock, may reveal that they were non cash payments for services.
- (2) For example, an attorney may accept a partial or entire interest in a property (usually by a quitclaim deed) as payment for legal fees.
- (3) Another example, an attorney borrowed a large sum of money from a corporate client and then paid it off by performing legal services. The loan was shown on the attorney's books, but not the income resulting from the relief of the debt. When no loan repayments were noted, the lender was contacted. They confirmed the loan and the credits against the outstanding balance posted when the attorney rendered legal services.
- (4) As another example, an attorney who sets up partnerships or corporations may accept an interest in the formed entity as payment for legal services rendered.
- (5) Bartering is another source of noncash income. Attorneys may exchange their legal services for other services. An effective audit tool would be to compare the attorney's work schedule with their claimed fees. If the attorney's workload has not decreased, but their claimed fees from one or more clients has, that may indicate they are performing services in exchange for noncash payments. These variations should be noted and questioned, as deemed appropriate.

A.10. Cash Payments

- (1) Cash payments for legal services may be diverted to other accounts or to other entities under the control or for the benefit of the attorney. Some attorneys may offer substantial legal service discounts for currency payments. The IRP report summarizes Cash Transaction Reports (CTRs). Details of each report should be examined. They can be obtained from the Web CBRS. Refer to Chapter 2 of this audit technique guide for more information on Cash Transaction Reports. Additionally, if an examiner believes that the attorney enters into a number of

cash transactions, then a review of Suspicious Activity Reports available on Web CBRS may be warranted.

- (2) The examiner should also be aware of cases where an indirect method may be needed to determine income. Indirect methods are discussed in IRM 4.10.4.6.

A.11. Constructive Receipt

- (1) Income may be earned under the doctrine of constructive receipt. This is an exception to the general rule that taxpayers on the cash basis of accounting must have actual receipt of income before it is taxable. Income is constructively received if it is subject to the demand of a taxpayer and there are no substantial limitations or conditions on the right to receive it. (Treas. Reg. section 1.451-2.)
- (2) For example, a criminal defense attorney was acting as a public defender and was paid an hourly rate plus any costs incurred. The attorney was required to submit a billing statement to the county government on a monthly basis to receive payment. At the end of the year a Form 1099 was issued to the attorney for the income that was actually paid. To defer income, the attorney did not bill the county for services rendered for the second half of the year. Since billings were submitted only for the first half of the year, the attorney's gross income was considerably understated.

B. Expenses

B.1. Entertainment incurred prior to 12/31/2017

- (1) Entertainment expenses should be examined to ensure they meet the requirements under IRC §§ 162 and 274. The taxpayer should substantiate such expenses in accordance with the rules under IRC § 274(d). In general, to be deductible, entertainment expenses must also meet the "directly related" or "associated with" tests as outlined in Treas. Reg. §§ 1.274-2(a),(c), and (d). Even if they meet these tests, expenses for meals and entertainment are also subject to a 50 percent disallowance under IRC § 274(n).
- (2) Treas. Reg. § 1.274-2(b)(1)(i) defines "entertainment" as any activity which is generally considered to constitute entertainment, amusement, or recreation. Included is entertaining at nightclubs, cocktail lounges, theatres, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation, and similar trips. This definition also includes payment of an individual's personal, living, or family needs, unless those expenses are clearly not entertainment (such as paying an employee's meal while they are working overtime).
- (3) Generally, to be deductible, entertainment must meet either the "directly related" or "associated with" tests. The "directly related" test generally cannot be met where there was little or no possibility of engaging in the active conduct of trade or business. This clearly applies where the taxpayer is not present. However, even if the taxpayer is present, the Regulations state that there is little or no possibility of engaging in business where distractions are substantial,

such as when the meetings or discussions occur at nightclubs, theatres, sporting events, cocktail parties, or social gatherings.

- (4) In *Israelson v. United States*, 367 F. Supp. 1104 (D. Md. 1973), an attorney gave a party at a country club. Although the party was attended by some clients, persons who refer clients, and other business associates, no business was discussed. Therefore, no deduction was allowed.
- (5) The following cases denied deductions for entertainment where the taxpayer failed to meet the "directly related" and "associated with" tests:
 - *Walliser v. Commissioner*, 72 T.C. 433 (1979)
 - *Flaig v. Commissioner*, T.C. Memo. 1984-150; 47 T.C.M. (CCH) 1361 (1984)
 - *St. Petersburg Bank & Trust v. United States*, 362 F. Supp. 674 (M.D. Fla. 1973), *aff'd*. 503 F.2d 1402 (5th Cir. Oct 30, 1974) (Table, NO. 73-3762)
 - *Gardner v. United States*, T.C. Memo. 1983-171; 45 T.C.M. (CCH) 1116 (1983)
- (6) The following cases also denied deductions for promotion expenses based on lack of proof:
 - *Roumiguire v. Commissioner*, T.C. Memo. 1980-356; 40 T.C.M. (CCH) 1137 (1980)

B.2. Entertainment and Meals incurred after 12/31/2017

- (1) Section 274 imposes limitations on certain deductions allowed by other code sections, most notably IRC § 162 ordinary and necessary business expenses. The Tax Cuts and Jobs Act (TCJA) of 2017, P.L. 115-97, section 13304, significantly amended IRC § 274. Under the TCJA, IRC § 274(a)(1) disallows a deduction for any activity that is generally considered to be entertainment, recreation, amusement, or qualified transportation fringes paid or incurred after December 31, 2017, even if related to the taxpayer's business, unless it meets one of the exceptions described in IRC § 274(e). This disallowance also applies to expenses incurred with respect to a facility used in connection with an activity which is of a type generally considered to constitute entertainment, amusement, or recreation.

B.3. Exceptions to the General Disallowance Rule

- (1) Section 274(a)(1) disallows a deduction for any activity that is generally considered to be entertainment, recreation or amusement paid or incurred after December 31, 2017. Under IRC § 274(e), there are nine specific exceptions to the general rule of disallowance in IRC § 274(a). Taxpayers may be able to deduct "entertainment" expenses in these categories:
 - Food and beverages provided on the business premises for employees

- Expenses treated as compensation **
 - Reimbursed expenses **
 - Recreational expenses for employees **
 - Employee or stockholder business meetings
 - Meetings of business leagues
 - Items made available to the public **
 - Entertainment sold to customers **
 - Expenses includible in income of non-employees **
- (2) ** These expenses are also an exception to the 50% limitation applied to food and beverages discussed in the next section.

B.4. 50% Limitation on Meals

- (1) Section 274(n)(1) limits an otherwise allowable deduction for food and beverages to 50%. IRC § 274(n)(2)(A) provides exceptions to the 50% limitation. Food and beverage expenses that qualify for an exception are 100% deductible. The exceptions include items listed in IRC § 274(e)(2), (3), (4), (7), (8) or (9) (**see items marked in list above).
- (2) The Taxpayer Certainty and Disaster Tax Relief Act of 2020, section 210, enacted as Division EE of, The Consolidated Appropriations Act of 2021 provides a temporary allowance of a full deduction in section 274(n)(2)(D) for business meals for food or beverages provided by a restaurant and paid or incurred after December 31, 2020 and before January 1, 2023.

C. Travel

- (1) Travel expenses are another area where audit issues may arise. Taxpayers must meet the substantiation requirements of IRC §274(d). Some attorneys are licensed to practice in other states or travel to other parts of the state and must travel for work. However, they are still required to provide proper substantiation.
- (2) For example, one attorney substantiated airfare and lodging for several ski trips. When asked the business purpose he refused to answer, claiming the attorney-client privilege (refer to "Attorney-Client Privilege" in Chapter 1). The examiner questioned the documents provided because they included the names of his children and wife.

D. Disguised Hobbies

- (1) The attorney should be asked about hobbies during the initial interview. Attorneys may attempt to claim an expense deduction for their hobbies. For example, one attorney said his hobby was fine wines. He and two other

associates had a wine cellar they had built and stocked with wines from all over the world. The attorney deducted wine purchases as office supply expenses.

E. Corporate Expenses

- (1) Constructive dividend issues are often present when auditing personal service corporations. For example, one attorney reported earning \$11,000 in income from his corporation. Upon further examination of the corporation, the examiner discovered the corporation paid all of his personal living expenses. The examination resulted in a constructive dividend to the attorney shareholder of over \$200,000 per year.
- (2) Attorneys who are corporate shareholders may use a company credit card for travel, entertainment, or other personal expenses. Constructive dividends or additional wages for personal expenses paid by the corporations should be considered when auditing attorneys who are corporate shareholders.

F. Depreciable Books and Periodicals

- (1) If the attorney maintains a hardcopy library of research material, depreciation of the permanent volumes may be an issue. The general rule for depreciating property is found in IRC §167. It allows for recovery of the costs of any asset used in a trade or business if it has a useful life of more than one year and its value decreases with time. The cost of technical books and services which have a useful life of one year or less (including periodicals and loose-leaf services which are purchased on an annual basis), is deductible currently as a business expense. Permanent volumes are in asset class 57.0 and can be depreciated on MACRS over 5 years (Rev. Proc. 87-56).

G. Advanced Client Costs

- (1) Attorneys commonly pay litigation expenses on behalf of their clients. The costs are then recovered by the attorney out of the settlement or award. This practice is most often used by attorneys who take cases on a contingency fee basis. These attorneys generally use a cash basis of accounting and may deduct those expenses when paid, and the recovered costs are included in income when received. This causes a distortion of income since it can take years to resolve these cases.
- (2) Courts have determined that costs paid on behalf of a client are to be treated as in the nature of loans for tax purposes. They are not deductible by the attorney as a current cost of conducting business. The costs are those of the client and not the attorney since there is an expectation of reimbursement. A bad debt deduction may be taken in the year that any costs are determined to be uncollectible. Cases supporting this position appear in Exhibit 3-1.
- (3) The typical expenses included in this category are listed in *Canelo v. Commissioner*, 53 T.C. 217, 219 (1969), *aff'd* 447 F.2d 484 (9th Cir. 1971):

- The types of costs advanced by petitioners' law firm include travel expenses, costs of medical records, reports, interpreters' fees, witness fees, deposition costs, filing fees, investigation costs, photographs, laboratory tests, and sheriff's fees for service Petitioners ordered the services of process servers, shorthand reporters, investigators, doctors, and expert witnesses to whom litigation costs were paid.
- (4) The Tax Court explains in *Herrick v. Commissioner*, 63 T.C. 562, 569 (1975) (discussing *Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966)) that:
- In our view the clear inference of the Fifth Circuit's opinion in the *Burnett* case is that if the amounts deducted were advances by the attorney to his clients whether for living expenses or other expenses normally paid by the clients and there was an agreement or understanding that the attorney would be repaid, the advances are in the nature of loans and were not deductible business expenses.
- (5) Therefore, attorneys on the cash method of accounting may not take a current deduction for client expense advancements for which an attorney expects to be reimbursed.
- (6) However, attorneys on the cash method of accounting are generally allowed a current deduction for client reimbursed costs which are allocated to normal operating expenses, (for example, secretarial costs or copying costs). These are general office type expenses which would reasonably be incurred even if not charged to a particular client. Of course, if a current deduction is taken, any subsequent reimbursement from the client would be treated as income in the year of reimbursement under the tax benefit rule of IRC §111.
- (7) There is typically a prearranged agreement with the client regarding the payment of case- related costs. Attorneys who advance client costs keep careful records of these expenses to ensure that they are recovered out of the settlement. Generally, a ledger card or other accounting record is maintained for each client detailing the expenses paid. When the recovery is included on the cash receipts journal, it is usually shown separately from the fee income associated with the case.
- (8) Attorneys taking cases on a contingency fee basis generally use two main contractual arrangements. These two contractual arrangements are the gross fee contract and the net fee contract.
- (9) The net fee contract specifically provides that advanced litigation costs are repaid to the attorney before calculating the contingency fee percentage paid from the settlement or judgment proceeds.
- (10) In contrast, the gross fee contract provides that the contingency fee percentage paid from the settlement or judgment proceeds is calculated without regard to advanced litigation costs. The attorney is only entitled to a percentage of the settlement or judgment and is not separately reimbursed for litigation costs advanced. These costs reduce the attorney's net profit. If the case is lost,

attorneys usually do not recover their costs from the client under either contingency fee arrangement.

- (11) Examiners should ask questions regarding the types of contingency fee contracts the taxpayer-attorney uses, if applicable to the audit. Examiners should ask whether the attorney includes a provision in their contingency fee contracts that they are repaid their advanced litigation costs even if they lose a case.
- (12) It should be noted that a common argument used by attorneys taking cases on a contingent fee basis to claim advanced litigation costs are currently deductible is that there is no guarantee they will recover these costs. In the cases where that argument was presented, courts specifically look at the attorney's case selection and fee advancement processes. For example, if an attorney has a high rate of recovery for advanced expenses, this would indicate that the attorney is likely to be reimbursed. Examiners should look at the attorney's success rate for recovering advanced litigation costs as a factor showing that the attorney has an expectation of reimbursement for these costs.
- (13) Advanced client costs may appear on the tax return in various places. Generally, the deduction will be taken under "other expenses" and will be labeled as "client costs" or some similar name. The deduction may also be claimed as a cost of sales. Some attorneys net these costs against gross receipts and show only the netted amount on the return. Therefore, the advanced costs may not be apparent when the return is inspected.
- (14) It is important to determine whether client costs are being advanced. This issue is frequently encountered with personal injury attorneys. It can take years to reach a settlement in this type of case. The attorney typically pays all costs incurred on the case and does not expect to recover any of his or her costs until the case is resolved in the client's favor. This can result in sizable adjustments if costs are recovered over an extended period of time. Conversely, if an attorney is turning over his or her cases quickly or is asking their clients to pay costs up front, this may not be a material issue that requires adjustment.
- (15) Although the court cases strongly support treating advanced client costs as in the nature of loans, there are some opposing arguments presented by the taxpayers and their representatives.
- (16) The argument most frequently raised is that if the advanced costs are to be treated as being in the nature of loans, then the recovery of these "loans" does not create taxable income. This issue was raised in the Canelo case, 53 T.C. 217, (1970). In Canelo, the Government relied upon the tax benefit rule, IRC § 111, arguing that the attorney's recovery of costs deducted in prior years, in which the statute of limitations had expired, was includible in income. The Tax Court held that an "erroneous deduction exception" applied to the tax benefit rule and determined that the tax benefit rule could only be used in cases in which a proper deduction was originally taken. There are several Actions on

Decision which address this issue. A revised Action on Decision, CC-1981-175, explains the Commissioner's position:

- The erroneous deduction exception is inequitable. A person who benefits from a proper deduction is taxed on the recovery in a subsequent year of the amount deducted while a person who benefits from an improper deduction is not taxed on the recovery of the amount deducted. Thus, the exception rewards those who claim deductions to which they are not entitled.

- (17) Many circuit courts have rejected the Tax Court's "erroneous deduction exception." *Unvert v. Commissioner*, 656 F.2d 483 (9th Cir. 1981) (and cases cited therein); *Hughes & Luce, LLP v. Commissioner*, 70 F.3d 16 (5th Cir. 1995). Check your Circuit to see how it is handling the "erroneous deduction exception" and if there is no precedent, check with your local Counsel to see how to proceed.
- (18) The advanced client costs issue should be raised if the amount of deducted client costs is material. The change in treatment of advanced legal costs is a change in method of accounting under IRC § 446 that generally requires an IRC § 481 adjustment. A Service initiated method change is made using the procedures in Rev. Proc. 2002-18, 2002-1 C.B. 678. In appropriate circumstances, a change in method of accounting may be done on a cut-off basis. See § 5.04(2) of Rev. Proc. 2002-18.
- (19) An examiner making a Service initiated method change under Rev. Proc. 2002-18 will ordinarily make the change in the earliest taxable year under examination, or if later, the earliest taxable year that the method is considered to be impermissible. Under certain circumstances, the examiner may designate a later year as the year of change. See § 5.04(1) of Rev. Proc. 2002-18. For example, an exception may exist if the manner in which the attorney's records are kept makes it extremely difficult to arrive at all the required beginning and end of year balances. The examiner must exercise judgment in making this determination, and the reasons for any deviation from the general rule must be well documented.
- (20) An examining agent changing the taxpayer's treatment of advance legal fees will ordinarily result in an IRC § 481(a) adjustment, subject to the computation of tax under § 481(b) (if applicable). The IRC § 481(a) adjustment is necessary to prevent amounts from being duplicated or omitted that result solely from the change in method of accounting. However, the examining agent must apply the limitation on tax provision in IRC § 481(b) if the involuntary method change results in an increase in the taxpayer's taxable income for the year of change by more than \$3,000.
- (21) The IRC § 481(a) adjustment, whether positive or negative, will be taken into account in the year of change. See § 5.04(3) of Rev. Proc. 2002-18.

- (22) The IRC § 481(a) adjustment includes total unrecovered client costs deducted in years prior to the year of change even if those years are barred by statute. The figure needed is the total amount outstanding for client costs receivable at the beginning of the year of change.
- (23) In addition to the IRC § 481(a) adjustment, a current year adjustment under IRC § 446 must be calculated for the year of change and, if applicable, any subsequent taxable year under examination. A current year adjustment is the amount which is attributable solely to the year under audit, and as such, a separate adjustment is made in each of the audit years. Accordingly, a current year adjustment for this accounting method change is the change in the amount of accrued but unrecovered client costs that occurred during the year. The current year adjustment will generally be the difference between the receivables balances at the beginning and end of the year as calculated under the old method of accounting and reported on the tax return for the year.
- (24) A portion of the disallowed costs could result in a bad debt deduction in subsequent years. This would occur if the costs were determined to be uncollectible in that year. The specific rules for bad debt deductions should be followed for this issue.

G.1. Computing the Adjustment

- (1) Making the adjustment is a simple mechanical procedure if balances for outstanding client costs are available. Ideally, the taxpayer will maintain the books in such a manner that the accounts receivable balances at the beginning of the year and the end of the year can be easily obtained. However, very seldom will the books contain more than cash disbursements and cash receipts. In this more typical situation, the computation of the outstanding balances may be quite cumbersome. To obtain the receivable figures, the taxpayer will have to go through the client ledger cards or client files and list the amounts owed by clients at the beginning and end of the year of change. If the audit involves multiple years, outstanding balances for each of those years must also be obtained.
- (2) Figure 3-1, below, presents an example of how to use these figures to arrive at the adjustments, assuming the year of change is 2010.
- (3) Assuming the outstanding receivables balances (client costs and advances accrued but not yet recovered) are:
 - at 1-1-2010 = \$65,000, and
 - at 12-31-2010 = \$85,000
- (4) The IRC § 481(a) adjustment is \$65,000 and accounts for all client costs deducted in prior years but not recovered. The IRC § 446 adjustment is \$20,000 (\$85,000 end of year balance - \$65,000 beginning of year balance = \$20,000). This amount is attributable entirely to the 2010 year.

- (5) Exhibit 3-2 is used to compute the current year adjustment. This work paper should be used only if the audit involves the first year that the attorney was in practice. This schedule makes no calculation for picking up the prior year adjustment. It also makes no allowance for any portion of the IRC § 481(a) adjustment which is included in income in the current year.

Figure 3-1 UNRECOVERED ADVANCED CLIENT COSTS WORKSHEET				
Client	Balances at 1-1-2010	Costs Incurred in 2010	Costs Recovered in 2010	Balance at 12-31-2010
Client A	8,000	2,000	10,000	0
Client B	15,000	10,000	0	25,000
Client C	10,000	5,000	0	15,000
Client D	0	5,000	0	5,000
Client E	20,000	5,000	0	25,000
Client F	12,000	3,000	0	15,000
Total	65,000	30,000	10,000	85,000

- (6) The Current Year Adjustment (IRC § 446) is computed as follows: For the year 2010, the tax return shows a deduction for \$30,000.
- (7) From which you subtract the total costs recovered and included in income during 2010 in the amount of \$10,000.
- (8) To arrive at the Current Year IRC § 446 adjustment of \$20,000.
- (9) Another way to compute the Current Year IRC § 446 adjustment is simply to calculate the difference between the ending balance and the beginning balance (85,000 less 65,000)
- (10) The Prior Year Adjustment (IRC § 481(a)) is 65,000 (the balance as of the beginning of the year)
- (11) At January 1, 2011, the taxpayer's books will show an asset account in the amount of \$85,000 for client costs receivable. Any future expenses incurred are debited to this account, and recoveries are credited. There will be no future entries to income or expense accounts for client costs. One exception exists for unrecoverable costs which are written off following the rules for bad debt expenses.

H. Employee Versus Independent Contractor Issue

- (1) **Note to Examiner:** If you have a potential employment tax issue or a worker reclassification issue, refer the issue to the Employment Tax Specialty Group to work. The discussion below is included to help you identify this issue in your case.
- (2) The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification-independent contractor or employee -- can be valid.
- (3) The first step in any case involving worker classification is to consider Section 530 of the Revenue Act of 1978. An examiner must provide the taxpayer with a written notice of the provisions of Section 530 (Publication 1976) when examining employment status issues. If the requirements of Section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business's, but not the worker's, employment tax liability, including any interest or penalties attributable to the liability for employment taxes.
- (4) In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency -- whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent -- and depends on the principal's right to direct and control the agent.
- (5) Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations: Sections 31.3121(d) -1, 31.3306(i) - 1, and 34.3401(c) -1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding. The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the worker, but also to the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done, but also how it shall be done. It is not necessary that the employer actually direct or control the manner in which the services are performed if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.
- (6) The Service looks at facts in the following categories when determining worker classification: behavioral control, financial control, and relationship of the parties. The 20 common-law factors described in Revenue Ruling 87-41, 1987-1 C.B. 296, summarized in Exhibit 3-3, fall within these three categories.

- (7) **Behavioral Control:** Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. However, virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status. The weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.
- (8) The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.
- (9) **Financial Control:** Economic aspects of a relationship between the parties illustrate who has financial control of those activities. The items that usually need to be explored include:
- whether the worker has a significant investment,
 - whether the worker has unreimbursed expenses,
 - whether the worker's services are available to the relevant market,
 - whether the worker is paid by the hour as opposed to a flat fee for the services performed, and
 - whether the worker has the opportunity for profit or loss.
- (10) The first four items are not only important in their own right but also affect whether there is an opportunity for the realization of profit or loss. All of these can be thought of as bearing on the issue of whether the recipient has the right to direct and control the means and details of the business aspects of how the worker performs the services.
- (11) The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of the services rendered. If the worker is making decisions which affect his or her bottom line, the worker likely has the ability to realize a profit or loss.
- (12) **Relationship of the Parties:** The relationship of the parties is important because it reflects the parties' intent concerning control. Courts often look to the intent of the parties, which is most often embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor. However, a contractual designation, in and of itself, is not sufficient evidence to determine worker status. The facts and circumstances under which a worker

performs services are determinative of a worker's status. The designation or description of the parties is immaterial. The substance of the relationship governs the worker's status, not the label.

- (13) For an in-depth discussion, refer to Internal Revenue Manual 4.23.5, Technical Guidelines for Employment Tax Issues, which includes the Section 530 determination, and related exhibits, and Rev. Proc. 85-18, 1985-1 C.B. 518. Publication 15A, Employer's Supplemental Tax Guide, is an additional resource.
- (14) An employment tax issue may exist where attorneys treat their receptionists, secretaries, paralegals, or law clerks as independent contractors. Paralegals and law clerks are frequently hired to perform research for attorneys and may be used to help prepare any necessary legal paperwork. This can be done on either a temporary or permanent basis as well as on a full or part-time basis (for example, law students hired as summer law clerks or for part-time work). Paralegals and clerks under an attorney's close supervision and control should generally be classified as employees.
- (15) For example, in *Casety v. Commissioner*, T.C. Memo. 1993-410, a paralegal was treated as an independent contractor by the lawyer for whom the services were provided. The Tax Court found, based on the facts presented, that the lawyer retained the right to control the manner in which the paralegal's services were performed. This led to the conclusion that the paralegal was an employee and not an independent contractor.
- (16) The determination is more difficult when other attorneys provide the services since the right to control is not as clear. In *Weber v Commissioner*, 60 F.3d 1104, 1110 (4th Cir. 1995) in deciding whether a United Methodist minister was an employee or independent contractor, the court stated:
- The “right-to-control” test is the crucial test to determine the nature of the working relationship. The degree of control is one of great importance, though not exclusive. Accordingly, we must examine not only the control exercised by an alleged employer, but also the degree to which an the alleged (sic) employer may intervene to imposed control. In order for an employer to retain the requisite control over the details of an employee’s work, the employer need not stand over the employee and direct every move made by that employee. Also, the degree of control necessary to find employee status varies according to the nature of the services provided.
 - The threshold level of control necessary to find employee status is generally lower when applied to professional services than when applied to nonprofessional services. In *James v. Commissioner*, [25 T.C. 1296, 1301 (1956)] this Court stated that “despite this absence of direct control over the manner in which professional men (and women) shall conduct their professional activities, it cannot be doubted that many professional men (and women) are employees.” Also, in *Azad v. United States*, [388 F.2d 74, 77 (8th Cir, 1968)] the Court of Appeals for the Eight Circuit said

that “From the very nature of the services rendered by *** professionals, it would be wholly unrealistic to suggest that an employer should undertake the task of controlling the manner in which the professional conducts his activities.” Generally, a lower level of control applies to professionals. (internal citations omitted)

- (17) The absence of the need to control the manner in which an attorney or other professional conducts his or her duties should not be confused with the absence of the right to control. The right to control contemplated by the common law as an incident of employment requires only such supervision as the nature of the work requires. *McGuire v. United States*, 349 F.2d 644, 646 (9th Circuit 1965).
- (18) Close scrutiny should be given in cases where both Forms W-2 and 1099 are issued to the same party.

I. Corporate Officer is an Employee

- (1) There is an employment tax issue if an officer of a corporation is being paid as an independent contractor. Under IRC §§ 3121(d) and 3401(c), an officer of a corporation is an employee. Consequently, the corporation is liable for employment taxes.

J. 1099 Issues

- (1) Another potential audit issue exists where Forms 1099 are not issued to independent contractors for payments made to the contractors out of an attorney's trust account. The argument that the funds belonged to the contractor will not relieve the attorney from this reporting responsibility. IRC § 6041(a) states that all persons engaged in a trade or business who make payments to another person of \$600 or more in the course of such trade or business are required to file information reports.
- (2) It is possible for a taxpayer to present copies of Forms 1099 to an agent without ever filing them with the Internal Revenue Service or providing copies to the payees. To determine if the IRS has received the forms, a PMFOL can be requested. It will show the number and dollar amount of Forms 1099 filed by a taxpayer.
- (3) 1099s are also required to be filed for payments to recipients of lawsuit settlements or awards unless specifically exempt from taxation under IRC § 104. More information on types of settlements and awards can be found in the *Lawsuit Audit Technique Guide*

K. Form 8300 Issue

- (1) IRC § 6050I (26 United States Code (U.S.C.) 6050I) and 31 U.S.C. § 5331 require that certain information be reported to the IRS and the Financial Crimes

Enforcement Network (FinCEN). This information must be reported on IRS/FinCEN Form 8300.

- (2) Each person engaged in a trade or business who, in the course of that trade or business, receives more than \$10,000 in cash in one transaction or in two or more related transactions, must file Form 8300. Any transactions conducted between a payer (or its agent) and the recipient in a 24-hour period are related transactions. Transactions are considered related even if they occur over a period of more than 24 hours if the recipient knows, or has reason to know, that each transaction is one of a series of connected transactions.
- (3) If you have an issue regarding Form 8300, contact your local SBSE Bank Secrecy Act (BSA) Manager for advice and direction.

L. Related Entities/Taxpayers

L.1. Corporate Taxpayers

- (1) Many times the agent will find that the income of a personal service corporation comes from a partnership. This arrangement is usually set up to lessen personal liability and to establish a pension plan. The Form 1120 will show expenses such as dues, travel, auto, and pension plan deductions. A review of the partnership agreement and return will show if the taxpayer is deducting items that have already been deducted by the partnership or items that are properly expenses of the partnership.
- (2) Sometimes, shareholders deduct personal travel and entertainment expenses as corporate expenses. Oftentimes, these expenses are paid for by the corporation through corporate credit cards.
- (3) Some corporations that pay their employees an auto allowance fail to properly include it on the Form W-2. This can occur either when an employer has a reimbursement or other expense allowance arrangement that does not meet the requirements of IRC § 62(c) or Treas. Reg. section 1.62-2(c), or where the arrangement does meet these requirements but the employee does not substantiate the expenses. In these cases, the advance would be properly treated as wages on Form W-2.
- (4) The agent should be alert to "disappearing corporations." Occasionally, a corporation will cease operations and not take into account liquidating distributions to the shareholder(s). These corporations may simply stop filing tax returns.
- (5) There may be IRC § 482 issues in these audits. If there are other businesses under the control of the attorney, consideration should be given to the reasonableness of allocations for income and expenses between these related parties. If income or expenses are not properly allocated, it may be necessary to determine a more equitable allocation of these items.

L.2. Corporate and Individuals

- (1) Inspection of disbursements to other attorneys from the client trust accounts can lead to the examination of the payees. The backs of checks show into which accounts these payments are deposited. Occasionally, checks are not deposited into the general business account of the payee attorney but rather are cashed or deposited into accounts that appear personal in nature.
- (2) Close scrutiny should be given to all funds entering and leaving the trust accounts. Questionable transactions by clients have been uncovered during audits which resulted in adjustments to the clients' tax returns. Such questionable transactions may include prepayments deducted by clients which are not included in the attorney's income and are returned to the client in a subsequent taxable year, or deductible prepayments which are used for the client's personal benefit rather than for legal services. The agent should be alert for any unusual transactions between the attorney and others as these can lead to related examinations. Third party contacts are valuable tools that should be used to develop these issues.
- (3) For example, a client paid \$100,000 to an attorney and claimed a deduction for legal fees. The attorney deposited the "fees" into his trust account. The "fees" were then returned by the attorney to the client after the end of the client's fiscal year. This transaction resulted in a \$100,000 deduction for the client and no declared taxable income to the attorney.
- (4) In another case, a taxpayer paid "fees" to an attorney and took a deduction for them on his tax return. The funds were deposited into the attorney's trust account. From the trust account, these funds were then funneled into an S-Corporation. The S-Corporation then used these funds to construct the taxpayer's vacation home.

M. Personal Service Corporation Accounting Periods and Tax Computations

- (1) The tax year of a personal service corporation (PSC) must be a calendar year unless the corporation makes an election under IRC § 444(a) or can satisfy the Commissioner that there is a business purpose for having a different tax year. IRC § 441(i)(1).
- (2) In defining a personal service corporation, Treas. Reg. section 1.441-3(f)(1) states that personal services are substantially performed during the testing period (2009 is the testing year for the 2010 tax year) by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost (for personal service activities) for such period is attributable to personal services performed by employee-owners.
- (3) An entity may elect a fiscal tax year by filing a Form 8716 with the IRS Service Center by the earlier of:

- the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or
 - the due date (without regard to extensions) of the income tax return resulting from the IRC § 444 election. Treas. Reg. section 1.444-3T(b)(1).
- (4) Attorneys generally file tax returns using the cash basis, although some of the accounts for income earned, work in progress, and costs advanced will be kept on the accrual basis. Any income the attorney receives over which he or she has control, such as retainers, will be considered income in the year of receipt (see "Gross Income").
- (5) A qualified personal service corporation (QPSC) is taxed at a flat 35 percent rate on its taxable income. For this purpose, a qualified personal service corporation is defined in IRC § 448(d)(2) which states:
- Qualified personal service corporation. -- The term "qualified personal service corporation" means any corporation--
 - substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and
 - substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by--
 - employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),
 - retired employees who had performed such services for such corporation,
 - the estate of any individual described in clause (i) or (ii), or
 - any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).
 - To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).
- (6) The following tax issues arise regarding personal service corporations and/or qualified personal service corporations:
- 35 percent corporate rate. Unlike other C corporations, which are subject to graduated income tax rates beginning at 15 percent, a QPSC, within the meaning of IRC § 448(d)(2), is taxed at a flat tax rate of 35 percent. See IRC §§ 11(b)(1) and (2).
 - Calendar year is required unless permission is granted. Unlike other C corporations, which can adopt a fiscal tax year, a PSC is required to adopt

a calendar year unless it can show a valid business purpose. See IRC §§ 441(i)(1) and (2).

- Passive Activity Losses are limited. Unlike many C corporations, which can deduct passive losses against their active income, a PSC cannot offset passive losses against its active income. See IRC § 469(e).
 - Accumulated Earnings Tax. A PSC may be subject to accumulated earnings tax if the accumulated earnings and profits exceed \$150,000. See IRC §§ 532 and 535(c)(2)(B). The accumulated earnings tax is equal to 15% of the accumulated taxable income, effective for tax years beginning after December 31, 2002.
 - Reallocation of income. The IRS can reallocate income and tax attributes to the employee-owners if it determines that the principal purpose for forming the personal service corporation was the avoidance or evasion of taxes. See IRC § 269A(a). This provision applies to a PSC only when substantially all of the services of the corporation are performed for (or on behalf of) one other corporation, partnership, or other entity. See IRC § 269A(a)(1).
- (7) **Note:** IRC § 269A applies when a physician who is an employee of a single hospital, for example, forms a PSC through which to provide services only to that hospital. The statute does not apply to the most common kind of PSC, which is formed in order to provide services to a large number of patients or clients.

M.1. Exhibit 3-1 Client Costs and Advances

- (1) Mertens Law of Federal Income Taxation (§25:24) states, "Lawyers who advance court costs on behalf of their clients cannot deduct the costs as business expenses where the client is ultimately responsible for payment; such advances are treated as loans, not expenses."
- (2) The following court cases support this position:
- Henry F. Cochrane v. Commissioner, 23 B.T.A. 202 (1931)
 - Thomas Hart Fisher, 5 T.C.M. (CCH) 374 (1946)
 - Reginald G. Hearn v. Commissioner, 36 T.C. 672 (1961) aff'd, 309 F.2d 431 (9th Cir. 1962)
 - Warren Burnett v. Commissioner, 42 T.C. 9 (1964), aff'd on this issue, 356 F.2d 755 (5th Cir. 1966)
 - John J. Watts v. Commissioner, T.C. Memo. 1968-183, 27 T.C.M. (CCH) 886 (1968)
 - Adolph B. Canelo, III v. Commissioner, 53 T.C. 217 (1969) aff'd, 447 F.2d 484 (9th Cir. 1971)

- John W. Herrick v. Commissioner, 63 T.C. 562 (1975)
- Ronald R. Silverton v. Commissioner, T.C. Memo. 1977-198, 36 T.C.M. (CCH) 817(1977), aff'd, 647 F.2d 172 (9th Cir. 1981) (Table)
- James F. Boccardo v. United States, 12 Cl. Ct. 184 (1987), 87-1 U.S.T.C. 9288 (1987)

Note: In this case, the Boccardo Law Firm used the net fee contingency agreement method and the Claims Court concluded the client costs are non-deductible loans. The law firm subsequently changed to the gross fee method and continued to deduct their advanced client costs. In subsequent litigation, the Tax Court determined that the contingent nature of reimbursements meant these costs were nondeductible, similar to a net fee arrangement. Boccardo, T.C. Memo. 1993-224. On appeal, the Ninth Circuit reversed the Tax Court, holding that the gross fee contract did not involve advances with the implication of a loan, where, as a matter of law, there was no obligation on the client's part to repay the money expended. Boccardo, 56 F.3d 1016 (9th Cir. 1995). The Service took the position that it will continue to challenge these expenses, except in the Ninth Circuit. See Field Service Advisory, 1997 WL 33313738 (IRS FSA) 6-2-97.

- Milan, Miller, Berger, Brody and Miller, P.C. v. United States, 679 F. Supp. 692 (E.D. Mich. 1988), 88-1 U.S.T.C. 9209 (1988)

M.2. Exhibit 3-2

(1) Exhibit 3-2 is used to compute the current year adjustment. This work paper should be used only if the audit involves the first year that the attorney was in practice. This schedule makes no calculation for picking up the prior year adjustment. It also makes no allowance for any portion of the IRC § 481(a) adjustment which is included in income in the current year.

- TAXPAYER'S NAME:
- AGENT:
- FORM, YEAR:
- DATE:

CLIENT COSTS/ADVANCES 2010					
Date 2010	Client	2010 Costs	Year Case Closed	Costs Recovered	Cost Outstanding
1-15	Alpine, L.	1,000	2010	1,000	0
1-30	Boulder, S.	500	2010	500	0
2-13	Crockett, A.	3,000	2010	3,000	0
4-19	Douglas, P.	1,500	2011	0	1,500
5-11	Evans, J.	400	2010	400	0
5-24	Fisher, S.	4,500	2011	0	4,500
6-20	Grant, C.	2,000	2010	0	0
8-5	Hill, T.	1,200	1991	0	1,200
9-12	Jenkins, K	600	1991	0	600
10-15	Kane, C.	800	1991	0	800
11-22	Lawrence, O.	1,100	Open	0	1,100
12-14	Mitchell, D.	300	Open	0	300
TOTAL		16,900		4,900	10,000

(2) C. Grant Case was lost and \$2,000 costs absorbed by attorney.

(3) Calculate the adjustment based on the formula:

Current year costs	16,900
Less Current year costs recovered	(4,900)
Less Current year costs unrecoverable	(2,000)
Equals Adjustment	10,000

(4) Verify that the costs recovered of \$4,900 have been included in income.

(5) **Note:** The \$10,000 of disallowed costs should be set up as an asset account on the books. As the costs are recovered (or written off) the receipts will be credited to this account.

M.3. Exhibit 3-3 20 Common-Law Factors/Rev Rul 87-41

- (1) INSTRUCTIONS re when, where, and how a worker is to complete their tasks
- (2) TRAINING provided to the worker
- (3) INTEGRATION of worker's services into business operations
- (4) SERVICES RENDERED PERSONALLY by the worker
- (5) HIRING, SUPERVISING & PAYING ASSISTANTS if the persons for whom services are performed hire and pay assistants, that is indicative of an employer/employee relationship. If the worker hires, pays and supervises assistance, that is indicative of an independent contractor relationship.
- (6) CONTINUING RELATIONSHIP between worker and the persons for whom services are rendered. There may be a continuing relationship where work is performed at frequently occurring but irregular intervals.
- (7) SET HOURS OF WORK the persons for whom services are rendered establishes set hours for the worker
- (8) FULL TIME REQUIRED the worker must substantially devote their full time to the persons for whom services are rendered (impliedly limiting the worker's ability to work for others)
- (9) WORKING ON EMPLOYER'S PREMISES-especially if the work could be done elsewhere
- (10) ORDER OR SEQUENCE SET BY EMPLOYER the employer sets or dictates the sequence of work tasks performed. This can be shown if the employer retains the right to set the order or sequence of work tasks performed.
- (11) ORAL OR WRITTEN REPORTS required by employer
- (12) PAYMENT BY THE HOUR, WEEK OR MONTH
- (13) PAYMENT OF BUSINESS AND/OR TRAVEL EXPENSE by employer
- (14) FURNISHING OF TOOLS AND MATERIALS (employer furnishes significant tools & materials)
- (15) SIGNIFICANT INVESTMENT in facilities by worker that are not normally maintained by employees is indicative of an independent contractor. The lack of investment by the worker is indicative of an employer-employee relationship.
- (16) REALIZATION OF PROFIT OR LOSS a worker who can realize a gain or loss as a result of their services is generally an independent contractor, but a worker who cannot is generally an employee
- (17) WORKING FOR MORE THAN ONE FIRM AT A TIME
- (18) MAKING SERVICES AVAILABLE TO GENERAL PUBLIC (on a regular and consistent basis)
- (19) RIGHT TO DISCHARGE by employer

(20)RIGHT TO TERMINATE by worker without liability